

# Here's What We're Thinking

## Global Portfolio Advisory Group

*The Investment Committee of the Portfolio Advisory Group meets regularly to formally discuss markets, sector allocation and investment recommendations. Below is a brief synopsis of our current views. For specific investment strategy relating to your investment portfolio, please contact your Scotia Wealth Management advisor.*

### **Investment Strategy: Extended economic recovery leaves cycle in later stages; recession odds remain modest**

• **Strategy:** Recent economic data for the first quarter of 2018 suggest the global economy cooled off from its red-hot pace of the second half of last year. However, economic activity remains well above its trend (or potential) growth rate, resulting in diminished excess capacity across most economies. This is reflected in declining unemployment rates and rising capacity utilization rates. As a result, inflation readings have ticked higher as tighter labour and goods markets result in stronger wage gains and quicker price increases. In response, central bankers, including those in Canada and the United States, have become more confident in tightening monetary policy. Strong growth, diminished excess capacity, and rising inflation and interest rates are all consistent with an economy in the later stages of its business cycle. Officially, this is the second-longest U.S. recovery in the post-war period at 8 years and 10 months so far. However, most reliable recession risk indicators (such as yield curve slope, real interest rates, output gap, unemployment rate, credit spreads, etc.) continue to suggest the odds of a recession materializing in the next twelve months remain modest. Thus, notwithstanding a typical increase in market volatility at this point in the cycle, we remain constructive on equities relative to fixed income with a bias toward economically-sensitive segments across asset classes.

• **Equities:** Slightly more than half of S&P 500 companies have reported 2018-Q1 results so far. Of those, 79% have delivered a positive earnings-per-share surprise according to FactSet data. If that number can be maintained, it would mark the highest level reported in the current bull market, which is over nine years old. Year-over-year blended earnings growth is 23%. As far as the corporate top line goes, 74% of companies have reported a positive sales surprise, which is well above the 5-year average of 57%, and blended revenue growth is 8.4% year-over-year. We believe the earnings and revenue backdrop provides strong fundamental support for equity prices in the face of elevated volatility. An easing of trade and geopolitical uncertainties would also support risk asset prices, in our view. We continue to recommend overweight exposure to equities relative to fixed income and to Canadian and international securities relative to their U.S. counterparts.

• **Preferreds:** Preferred shares have exhibited lacklustre performance recently, with all major segments trading modestly lower over the last several weeks. Since April 17, the Canadian yield curve has steepened, with long-end yields rising more than their short-end counterparts. The underperformance of the long-end of the curve has put downward pressure on straight perpetual preferred shares due to these securities' long duration. The 5-year Government of Canada bond yield finished the period little changed relative to where it stood two weeks ago (~2.12%), though bond yields were volatile in the interim. The negative performance in rate reset preferred shares was fueled by energy sector securities. We remain partial to the Canadian preferred share market over the medium-term, yet would not be surprised to see the market trade in a sideways range in the near-term as



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underlying interest rates gradually trend higher alongside stable credit fundamentals.

• **Fixed income: Corporate bonds return to prominence.** Despite anecdotal reports of thin activity, corporate bonds led the Canadian fixed income market over the past two weeks. This is understandable in view of light corporate issuance and a market likely digesting recent new provincial supply. Among corporates, short BBB-rated bonds outperformed, while long A-rated securities were the laggards. We continue to recommend "high-grading" portfolios at this point in the credit cycle, so the BBB outperformance could represent a good opportunity to switch out of BBB's and into A-rated holdings. With the economic backdrop little changed since we last published, we reiterate our corporate overweight recommendation and advocate using provincial debt to fulfill government allocations within Canadian fixed income mandates.

**Currencies and Commodities: Another pipeline setback; USD and CAD head in opposite directions, but will the divergence persist?**

• In the last edition of *Here's What We're Thinking*, we highlighted the elevated level of uncertainty around the Trans Mountain Expansion Project (TMEP) as political pressures continued to mount. Last week, the Canadian pipeline industry received another setback, this time related to the Minnesota segment of the Line 3 Replacement (L3R) project. While the Minnesota Administrative Law Judge (ALJ) recommended approval of the L3R project, the ALJ also recommended the pipeline follow a route different from the one initially proposed and the removal of the existing Line 3. While not binding (a final decision from Minnesota's Public Utilities Commission is expected in June), we believe these recommendations increase the uncertainty around the project's completion. In our view, the market has priced in a relatively low probability of the project being completed. Additional delay - or the cancellation - of TMEP and/or L3R could further dampen Canadian heavy oil prices and the profitability of Canadian energy producers with exposure to them.

• Elsewhere in the energy complex, yesterday's comments from the Israeli Prime Minister suggesting Iran was less than honest about its nuclear weapons program sent the price of crude oil noticeably higher, illustrating the potential effect of adverse geopolitical developments on an already tight market for the commodity. Currently, the global supply/demand outlook for crude oil is constructive, in our view, and supportive of existing prices. This, combined with a narrowing spread between the North American WTI crude oil benchmark and the price of Canadian heavy crude oil, has helped a number of Canadian oil producer stocks outperform the broader S&P/TSX in recent weeks. However, among alternatives within the energy sector, we believe infrastructure stocks offer better risk-adjusted return potential over the long haul.

• The U.S. dollar (USD) has been one of the best performing currencies in recent weeks. The run-up has been supported by the incessant rise in the 2-year U.S. Treasury yield, which crossed the psychologically significant 2.50% level for the first time in almost 10 years, and other major central banks' tempered monetary policy tightening expectations. While technical levels appear to be supportive, a portion of the USD's recent strength may be attributable to weakness in other major currencies given fundamental risks facing the USD (including large deficit spending and rising debt levels). The Canadian dollar (CAD) has mostly trended lower against the USD of late. However, Bank of Canada (BoC) Governor Stephen Poloz and Senior Deputy Governor Carolyn Wilkins testified before the Canadian House of Commons and Senate last week and reiterated the bank's expectation for slightly higher than potential growth over the next three years and above-2% inflation this year. The BoC is encouraged by the progress of inflation and continues to see the need for higher interest rates over time, while maintaining some monetary policy stimulus to keep inflation on target. Scotiabank FX remains constructive over the short to medium-term, and expects to see CAD appreciate toward its fair value estimate of ~US\$0.80.

**Economics: The Fed is expected to stay put; U.S. labour market report for April in focus**

- The U.S. Federal Open Market Committee (FOMC) kicked off its two-day monetary policy meeting this morning and an interest rate decision along with a policy statement will be released tomorrow afternoon at 2:00pm ET. This will likely be uneventful as markets have low expectations of any change in interest rate at this meeting, especially with no press conference scheduled this month. Meanwhile, expectations for the medium/long-term rate trajectory remain the same. Scotia Economics projects two more rate hikes this year, which would bring the upper bound of the federal funds rate to 2.25%, in-line with the Fed's dot plot forecast. Recent economic data have been supportive in the U.S., including last week's GDP and inflation data. The U.S. economy grew 2.3% in Q1 on a YoY basis versus an estimate of 2.0%, despite a pullback from Q4 2017's 2.9% pace. Core personal consumption expenditures (PCE) inflation matched economists' expectation at 1.9% in March versus February's 1.6%, approaching the Fed's 2% target. Meanwhile, the employment cost index also beat expectations (act: 0.8% vs est: 0.7%). Although no rate change is expected tomorrow, any tweaks to the Fed's language in the policy statement could shed light on the path of future monetary policy tightening and therefore shift investors' risk appetite in the near term. Markets are pricing in a 97% chance of a rate hike at the June meeting.

- Looking beyond the central bank event, a flow of economic data releases will be in focus. Following last week's strong GDP and inflation data, the U.S. labour market report for April will be released this Friday. U.S. employers are expected to have added 191k jobs last month, and the unemployment rate is expected to drop further, to 4.0% from March's 4.1%. Meanwhile, the YoY growth of average hourly earnings is expected to hold steady at 2.7%.

**Geopolitical: Iran nuclear deal in jeopardy? At long last, peace on the Korean peninsula?**

- The Joint Comprehensive Plan of Action (JCPOA) looks to be in jeopardy. The JCPOA, better known as the Iran

nuclear deal, has been on the list of U.S. President Trump's concerns since his campaign, but it has finally come into his crosshairs. President Trump first expressed his willingness to withdraw from the deal when it came up for extension in January. He has said stricter sanctions are needed to combat Iran's destabilizing activities in the region (such as its support for Hezbollah, its ballistic missile program, and its human rights abuses). However, failing to renew the JCPOA would affect other signatories and investments they have made since sanctions were suspended. Key sanctions that could be reinstated if the deal is not renewed pertain to European banking and U.S. underwriting (among others). Not suspending sanctions could seriously harm Iran while it deals with an economic crisis. Currently, the European signatories would like to see the deal renewed. They used their summits with President Trump last week to suggest options to avoid dissolution. Those included new sanctions outside the oversight of the JCPOA to control the aforementioned destabilizing activities. While the U.S. stance on these potential options is not yet clear, Israel tried to tip the scales in its favour by revealing evidence alleging the Iranian government hid information from the International Atomic Energy Agency about Iran's nuclear efforts during JCPOA negotiations. The situation is fluid and with almost two weeks until a decision needs to be made, headlines are likely to affect markets given Iran's role as a significant crude oil producer.

- The Korean peninsula took a step toward reunification with a North/South summit last week. For the first time in 11 years and the third time in the post-Korean war period, leaders from North and South Korea held a joint summit. The meeting produced the Panmunjom Declaration which contains a number of pledges between the two nations to work toward peace. Those included a non-aggression pact, plans to resume family reunions, establishment of an inter-Korean liaison office, halting propaganda in the Demilitarized Zone and connecting cross-border roads and railways. While these are seen simply as gestures of good faith and are non-binding, they signal North Korea's willingness to negotiate in a productive manner ahead of its summit with the United States. South Korea has a vested interest in a de-

escalation of the North Korea/U.S. conflict and seeks to facilitate further positive discussions in pursuit of that goal. On the other side, North Korea's summit with the U.S. should bring it legitimacy on the world stage. However, some world powers could be reluctant to believe the North Korean government is capable (in the long run) of adhering to preconditions for peace.

## Recommended Asset Allocation

Asset Class	Strategic	Tactical
<b>Equities</b>	<b>60%</b>	<b>63%</b>
Canadian Equities	20%	21%
U.S. Equities	25%	31%
International Equities	15%	11%
<b>Fixed Income</b>	<b>40%</b>	<b>30%</b>
Global Sovereign Bonds	20%	12%
Global Inv. Grade Bonds	10%	13%
Global High Yield Bonds	10%	0%
Preferred Shares	0%	5%
<b>Alternative Assets</b>	<b>0%</b>	<b>7%</b>
<b>Cash</b>	<b>0%</b>	<b>0%</b>

Sector	Underweight	Neutral	Overweight
Financials			✓
Industrials			✓
Materials			✓
Energy			✓
Healthcare		✓	
Consumer Discretionary		✓	
Technology		✓	
Consumer Staples	✓		
Utilities	✓		
Telecommunications	✓		
Real Estate	✓		

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