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: Economic upswing remains healthy; stay overweight equities with cyclical bent

• **Strategy:** Global markets continue to benefit from solid fundamentals, bolstering our bullish positioning strategy. The economic expansion is running near highs for this cycle with global GDP running at 3%+ aided by both solid consumer spending and a recovery in business investment outlays. The broadening out of economic momentum from the U.S. to other major economies including Canada, Europe and Asia has improved the resiliency of the global economic expansion, now in its ninth year. Healthy activity has helped to drive corporate profitability growth with earnings growing at double-digit rates across major markets. Combined with signs central banks are set to tighten monetary policy at a modest pace as recent inflation readings stabilize and begin to rebound toward 2%, risks of overly aggressive rate hikes seem negligible. In fact, most of the reliable indicators we track to help us gauge the likelihood of recession suggest the next recession is not likely to materialize until 2019. Thus, we maintain our asset allocation recommendation: overweight to equities and underweight in fixed income. Our geographic (Canada, Europe, Emerging Markets) and sector (industrials, financials, resources, technology, consumer discretionary, health care) preferences within asset classes retain a cyclical bias. For investors based in Canadian dollars, the recent weakness in the US dollar has had an important (negative) impact on U.S. market returns, re-emphasizing the importance of currency moves on portfolios.

• **Equities:** Strong earnings, potential U.S. tax cuts, low but rising yields, and a possible rotation into value stocks creates a supportive fundamental backdrop for global equities, in our view. Despite the possibility of a small near-term pullback, we believe equities are still under-owned and offer relatively better value than fixed income. On the back of rising inflation expectations and narrowing global yield differentials, we continue to prefer banks, insurers, broker/dealers, energy, chemicals, industrial metals, paper, semiconductors, communications equipment, internet security, select retail, autos, industrials, and biotech. Geographically, we are overweight Europe (steepening yield curve) and Canada (improving commodity pricing) and underweight the U.S.

• **Fixed income:** Issuance has returned but increases in government yields have kept spreads tight. Issuance returned as summer unofficially came to an end following Labour Day. Over the past two weeks, $6.67B of new product has come to market compared with only $3.02B in the two weeks before the holiday. Normally, that would have led to spread widening as the market absorbed new supply, but strong demand and upward movement on Government of Canada yields have kept spreads at/near recent lows. There have, of course, been exceptions as 4-6yr senior bank debt underperformed, as did pipelines and to a lesser extent junior and senior insurance debt. Notable outperformers have been long-term senior bank debt and integrated oil producers. We suggest keeping an eye on insurance and senior bank debt as areas for cash deployment as we continue to recommend overweight positions in both sub-sectors.

• **Preferreds**: The preferred share market has been slow to react to the significant movement in yields over the last several months. The last time yields were near current levels, the preferred share market was ~12% higher. We have seen this delayed reaction to yield movements in the past, and therefore it is not a complete surprise. However, the rather lacklustre performance of the market in recent weeks (up ~3%) stands in contrast with the 84 bps move higher in Government of Canada 5-year yields over the same timeframe. We think this opens up the possibility of a strong autumn in the preferred share market as long as interest rates remain near current levels. The new issue market is also likely to be a key driver going forward. With underlying interest rates moving higher, the reset spread levels on recent new issues look far less appealing than they once did compared to secondary issues. This spread tightening should continue to spark demand in the secondary market, in our view.

***Currencies and Commodities:* Oil demand firming; CAD posts impressive gain**

• Over the last two months WTI has fluctuated between US$46-US$50/bbl with a recent bias toward the higher end of that range. While U.S. Department of Energy (DOE) weekly inventory data continue to be relatively supportive of WTI, we believe the recent upward revisions to global oil demand growth forecasts provide further support to the oil rebalancing story. OPEC and the International Energy Agency (IEA) both raised their 2017 demand growth forecasts last week, after raising them one month earlier. While we likely have not seen the end of crude oil price volatility, especially as uncertainty regarding further supply cuts likely continues into early next year, the tighter market conditions should be supportive of crude oil pricing, which in turn should be supportive of our preference for cyclical equities. A recent Global Portfolio Advisory Group "Strategy Chart of the Day" illustrates the gap between energy equity performance (relative to the broad market in both Canada and the U.S.) and oil prices has reached historically wide levels, implying energy equities look relatively inexpensive at current levels.

• The recovery in the Canadian dollar (CAD) since May of this year has been noteworthy. Since May 5th 2017, the CAD has appreciated an impressive 11.8% versus the U.S. dollar to US$0.8130. The drivers behind this move include a rebound in commodity prices, a more hawkish Bank of Canada that undertook rate hikes in July and September and a generalized weakening trend in the U.S. dollar versus other major currencies. This recent bout of strength has returned the loonie close to its 46-year average of US$0.83. While a bout of profit-taking in the near-term would not be surprising following such a large move, Scotia Economics sees the CAD's appreciation trend continuing toward US$0.87 by year-end 2018.

***Economics:* Could BoC rate hikes help cool Canadian housing? New Fed plan could be revealed tomorrow.**

• The Bank of Canada has been the centre of attention in recent weeks after it surprised markets with an increase to its overnight rate earlier this month, and many economists are projecting one more policy rate hike later this year. Scotia Economics is penciling in one more 25bp hike in Q4 2017, bringing the overnight rate to 1.25% by the end of 2017 from 0.50% in the first half of this year, and two more rate hikes in 2018. With the BoC having hiked twice in two months, banks have been increasing their prime lending rates at the same time. All major banks raised their prime lending rates by 25bp after the central bank's first rate hike in July and another 25bp after the bank's surprise move earlier this month (from 2.70% to 3.20% in the span of two months). The recent upward adjustment to interest rates combined with additional rate hikes over the coming year will eventually lead to higher debt-servicing costs and could help to cool the Canadian real estate market. The Toronto Real Estate Board reported earlier this month that August sales in the region were down almost 35% from a year ago while prices were up 3% from last August. While sales volumes typically dip during summer months, recent changes in tax and housing finance policies also helped to moderate upward pressure in the housing market. Meanwhile, the Canadian dollar has risen as much as 12% against the US dollar from its May low, dampening the buying power of many foreign buyers.

• Tomorrow's Fed monetary policy decision followed by Janet Yellen's press conference will be in the spotlight as investors anticipate the Fed will announce details about the launch of its balance sheet run-off plan. Yellen could also lay the groundwork for expectations of a possible interest rate hike in December and inform the outlook for next year. Following the August uptick in Consumer Price Index inflation, hawks on the Federal Open Market Committee are now gaining more confidence. However, one single reading of better-than-expected inflation does not make a trend of improving price pressure, especially after five months of disappointing inflation readings. Meanwhile, uncertainty about the path of interest rate policy is heightened by top-level turnover at the Fed, including a possible replacement of Chairperson Janet Yellen when her term expires early next year and the appointment of a new vice-chairperson following the retirement of Stanley Fischer. Scotia Economics is projecting one more Fed rate hike of 25bp this year, bringing the upper bound of the Fed Funds target rate to 1.50%, and two more hikes in 2018.

Geopolitical:* *Merkel set to win German election

• On Sunday September 24th, Germany will go to the polls for a general election. Like the Netherlands, which held elections earlier this year, Germany has a proportional representation election system which makes it easier to elect fringe ideological groups. The rise of populist movements was a concern for the Netherlands but it failed to materialize, and Germany looks to be headed toward a similar result. Germany's populist and Euroskeptic party, Alternative for Germany, is only polling between 9-11%. At this level it holds little sway in the Bundestag (lower house) and few if any parties are likely to cooperate with it. While populism may not be a concern, the level of fragmentation in Germany's political landscape could be. With a proportional representation system and more parties in the running, the shape of governing coalitions becomes more fluid. The centre-right party and traditional coalition partner, Free Democratic Party, may not be the obvious coalition choice as it is currently polling alongside The Left and The Green parties (7-10.5%). Whatever the outcome, Germany's election likely will have repercussions for the rest of Europe. If Angela Merkel's Christian Democratic Union remains in power (36-38%), it is less likely to consider recent EU reform proposals from France, Spain and Italy. On the other hand the Social Democratic Party, Germany's second largest party (20-23.5%), would be more amenable to those proposals but less so on NATO spending.

Recommended Asset Allocation

Asset Class	Strategic	Tactical
Equities	**60%**	**68%**
Canada	30%	33%
United States	25%	28%
International	5%	7%
Fixed Income	**40%**	**30%**
Government	20%	10%
Provincial	5%	5%
Corporate/Credit	10%	10%
Preferreds	5%	5%
Cash	**0%**	**2%**

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

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