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: Fundamental backdrop remains solid; stay overweight equities and cyclicals

• **Strategy:** Global markets have remained in a buoyant mood in recent weeks thanks to a steady stream of positive economic data and supportive monetary/fiscal policy developments. We have always maintained an optimistic outlook with respect to the ability of this current business cycle to continue generating healthy, albeit historically modest, growth. Recent data, however, has been beating expectations consistently with global growth climbing to 6-year highs and (even more impressively) broadening out to all major regions and economies. Falling unemployment rates, expanding business spending on capital expenditures and new highs in manufacturing activity are helping to provide an added boost to this current expansion phase which is in its 9th year. Central banks are also doing their part as they gradually turn toward unwinding a portion of the ultra-accommodative monetary policy settings still in place since the financial crisis. While raising interest rates occasionally causes a short-term spike in market volatility, the improved balance in economic and market drivers helps to improve the durability of the cycle. We remain of the view investors should overweight equities relative to bonds given recession probabilities over the coming 12 months remain quite low, and we continue to prefer cyclical sectors over interest-rate sensitive defensives in this late stage of the cycle as rates/yields trend higher and economic growth remains healthy.

• **Equities:** Within equities, we advised going overweight Canada by underweighting the U.S. at the start of Q3'17 (on the basis of a strengthening C$ and oil recovery) and so far it has been the correct call. Going further back, at the end of Q1'17 we initiated an overweight position in Europe and Emerging Markets (also by underweighting the U.S. – on the basis of a steeper yield curve, positive economic upgrades, and receding political risks). We remain committed to this call as well given strong outperformance.

• Our overall asset class call to overweight equities as opposed to fixed income or cash originated in late Q1'16 which again has gone in our favour. Despite the possibility of a small near-term pullback, we believe equities still offer better relative valuations and remain under-owned. Any potential pullback or spike in volatility would be a buying opportunity in our view. In other words, we believe investors could replace their proverbial fear of an imminent "meltdown" with images of a slow and steady "melt-up" within equities as the risks surrounding the timing of the end of the cycle remain skewed to beyond 2019 rather than sooner. Traditional end-of-cycle indicators remain encouraging in our view.

• **Fixed income:** Bank of Canada commentary has created opportunities in the short end. Comments from Bank of Canada Governor Stephen Poloz reversed the selling in the short end of the Canada curve. The Governor urged data dependence and patience when referring to future increases in the overnight rate that adjusted yield expectations lower (combined with weak GDP data). This created opportunities in the credit market, which we continue to overweight. First,

Enriched Thinking™

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subordinated debt of Canadian banks has lagged the spread compression of deposit notes. Second, energy pipelines have lagged the rest of the energy sector. Third, recent merger and acquisition activity in retail has created opportunities that could benefit the long-term holder. Financials and energy have long been an overweight recommendation and that should continue. Retail opportunities would be more appropriate for investors with a longer time frame, in our view.

• **Preferreds**: In the last week, the preferred share market has broken out of its previously tight sideways trading range. Rate resets have been the main driver of performance, finally catching a bid around the recent movements in underlying bond yields. We suspect that the movement higher is a result of delayed investor response to the previous moves higher in underlying interest rates along with the lack of new issuance. The lagged reaction to yield movements in the reset market should act as a tailwind over the next couple of months, in our view, as should the expectation for further tightening by the Bank of Canada and the Federal Reserve in December.

Currencies and Commodities:* *Crude Oil Ends the Third Quarter on a High Note

• While there was no shortage of volatility in crude oil prices over Q3/17, WTI managed to finish the third quarter up 12% from Q2/17, and up 17% from its quarterly low. Crude oil fundamentals improved over the third quarter with OPEC+ supply constraints, increased global demand growth forecasts from the International Energy Agency (IEA) and OPEC, geopolitical developments (Kurdistan referendum), and tempered U.S. supply expectations all supportive of our view the global crude oil market is gradually rebalancing. However, with WTI currently hovering around US$50/bbl, we are keeping a close eye on incremental U.S. shale production, as potential increases on the back of higher prices could limit further upside in the commodity's price. While energy equities have rebounded on the back of recent bullish data points, we continue to see reasonably attractive valuations in many energy equities and remain overweight the sector at this time.

Economics:* *The Fed leads the way on monetary tightening; European Central Bank (ECB) likely to follow

• At the U.S. Federal Reserve meeting in September, all members of the Federal Open Market Committee (FOMC) agreed to a plan to start trimming the Fed's US$4.5 trillion balance sheet this month. The central bank plans to reduce bond holdings by US$10bn/month through year-end. The central bank will then increase the pace of its balance sheet roll-off every quarter until it hits US$50bn/month. At this pace, the Fed's balance sheet could fall to US$3.5 trillion early in Q4 2019. Meanwhile, the new dot plot published last month, which shows FOMC members' expectations for interest rates, signaled one more hike this year and three more in 2018. In the longer term, the median forecast has rates settling at 2.75%, down from 3%. Although the interest rate decision and the balance sheet reduction plan were widely expected, Fed Chairwoman Janet Yellen's speech at the press conference was taken as more hawkish than anticipated. The Chairwoman pointed out the risk of a possible overheating labour market if there is no modest increase in interest rates over time, potentially creating an inflationary problem down the road. Given monetary policy's lagged effect on economic activity and inflation, keeping monetary policy on hold until inflation gets back to 2% could pose risks to the heath of the economy and the stability of financial markets. Economists are now expecting Yellen to stick to her interest rate outlook as her term as the Chair is due to end early next year and she is not expected to secure a second term. We expect Yellen is eager to shrink the Fed's balance sheet in order to make room for a new round of Quantitative Easing when the next recession starts.

• While the Fed is leading the way on monetary policy tightening, the ECB could be on track to follow as early as next year. The current ECB Quantitative Easing program is scheduled to run until the end of the year, and the central bank is expected to start tapering its pace of bond purchases in 2018. The ECB is currently buying €60bn (approximately US$70bn) worth of securities per month on average, while many economists expect the Asset Purchase Program (APP) to gradually slow and eventually end in Q4 next year. Although the official

statement from the ECB remains dovish, quoting low inflation as a major laggard while policy makers continue to face pressure from a strong Euro, the central bank will likely decide at an upcoming meeting (mostly likely at its October meeting) on the status of its bond-buying program beyond the end of the year.

***Geopolitical:* German political landscape shifts once again**

• Results from Germany's election showed both expected and unexpected results. As expected Angela Merkel's Christian Democratic Union (CDU) garnered the most votes, making her one of the longest tenured leaders in postwar German history. Also expected was the Social Democratic Party (SPD) taking the second most votes. What was unexpected was how small a proportion of the popular vote both parties received. The CDU and SPD had some of their worst results ever, losing 8.5% and 5.2% of the popular vote, respectively. Another unexpected result was the far-right (and sometimes populist) Alternative for Germany (AfD), which polled between 9-11%, ending up with 13% in its first appearance in the Bundestag. The AfD's result is a clear indication of the shift toward populism in Europe. However, at 13%, its presence in government will have more influence on the opposition narrative than that of the ruling coalition. The AfD will certainly be watched in the future as seats in the Bundestag come with increased funding and visibility.

• For now, attention turns to Angela Merkel and the CDU for coalition building. The most likely coalition would be between the CDU, the Free Democratic Party and the Green Party. This group would take 393 of the 709 seats in the current Bundestag and be more right-leaning than the previous "Grand Coalition" between the CDU and SPD. The coalition will likely be opposed to European Union reforms but in favour of more 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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