# 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:* *Strong fundamentals leave bull market intact***

• **Strategy:** Global markets grinded higher over the past month notwithstanding a bout of profit-taking in recent days. Economic reports around the world continue to point to solid growth momentum with 2017 on pace to post among the best global GDP growth rates since 2011. Economic momentum has broadened out to the four corners of the world over the past year with every major economy posting positive growth, reflecting a sturdier global recovery phase. This has translated into solid double-digit corporate earnings growth in the third quarter once the insurance sector has been excluded following its large, hurricane-related losses. Having avoided a correction in excess of 5% since February 2016, the S&P500 equity index has experienced an unusually long stretch without a meaningful pullback, leaving on the table some potential for transient profit-taking at some point. Headline risks abound. These include geopolitical noise out of the Middle East, with rising tensions between Saudi Arabia and Iran possibly putting oil supplies at risk. Meanwhile, the U.S. Congress continues its work on a tax reform bill that can pass both chambers, and the Federal Reserve approaches its meeting in mid-December, when the Federal Open Market Committee is expected to hike interest rates once again. However, with underlying fundamentals remaining supportive, we continue to view pullbacks as an opportunity to put cash to work.

• **Equities:** Our expectation, stated in the last edition of this publication, for a small mid-November price consolidation is underway. The pullback is more easily visible in the S&P Small Cap index which is down 3.4% from its recent peak. This mild pullback is just a healthy pause, in our view. Although it is too early to call a bottom, we believe the overall market is poised to close the year higher. Conversely, we do not see any evidence to support calls for a larger and eagerly-anticipated 10%+ pullback at this time, which could leave cash-heavy investors disappointed. Wall Street analysts share a similar bullish view, with the twelve month bottom-up target price of 2813.44 for the S&P500 implying approximately 9% price return potential based on the recent closing level.

• Global growth is expected to increase throughout 2018 according to the OECD as the current individual country upturn becomes more synchronized. Indeed, when looking at Q3'17 U.S. corporate earnings, U.S. companies with higher global exposure experienced 5.8 times the revenue growth and 2.4 times the earnings growth of domestically-oriented companies. The strength is explained by more than simple USD weakness, and as such we continue to recommended overweights in Canada, Europe, Japan and emerging markets at the expense of the U.S. in the context of our overall equity overweight stance.

• **Fixed income:** The Canadian bond market has been relatively quiet over the past couple of weeks. Last week and so far this week, there have been few market drivers, and yields have crept marginally higher in their absence. Corporate spreads, on the other hand, remain at cycle lows, but opportunities have emerged recently. At the sector level, mid-term BBB's have sold off versus A's and now present value, in our view. Digging deeper, bank

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subordinated debt has lagged, creating a spread between deposit notes that we believe will close as cyclicals outperform. Finally, quarterly earnings have presented medium-term opportunities in the telecom space, in our view.

• **Preferreds**: The preferred share market has been rather balanced over the past month with some recent strength experienced last week. The S&P/TSX Preferred Share Index is moderately positive since the beginning of the month, up +0.36% on a total return basis. The recent uptick in preferred share demand over the last week was supported by the movement higher in underlying interest rates, which are up approx. 6 bps this month. In addition, the lack of new issuance has supported demand for secondary preferreds. Although Scotia Economics recently tempered its expectations for future interest rate hikes from the Bank of Canada, the bias is still hawkish. This continues to support the positive medium-term outlook we have for rate reset preferred shares.

***Commodities:* Seasonal demand weakness could temporarily depress the price of crude oil**

• While supply-demand rebalancing in global crude oil markets has supported the price of the commodity this year, the Scotiabank GBM energy strategist cautions seasonally weak demand early next year could lead to a temporary return of oversupplied conditions in Q1F18. In the strategist's view, that could lead to WTI crude oil prices pulling back toward the US$50/bbl mark before supply/demand deficit conditions re-emerge in the second half of 2018, possibly accompanied by a stronger commodity price.

• The strategist's forecasts are premised on OPEC+ supply caps extending through 2018. We expect further detail on that front to emerge concurrent with OPEC's next meeting, scheduled for 30 Nov/2017. Recent media reports suggest OPEC and its partners likely will extend production limits, which currently are planned to expire in March/2018, although the duration of the extension is open for debate.

• One potential wrinkle in the SGBM strategist's outlook for the crude oil market is geopolitical supply risk, notably a possible escalation of Saudi Arabian-Iranian tensions. Should this materialize, it could lead to a tighter physical market and upward pressure on the price of the commodity.

***Economics:* Inflation remains a laggard among major economic indicators.**

• Global economic growth is picking up, labour markets in major economies continue to tighten, and central banks are en route to tightening monetary policies/scaling back monetary stimulus. While most of the major elements are in place for a late-cycle reflationary phase, one element remains elusive – higher inflation. A number of factors are key to explaining why headline and core inflation remain stubbornly below 2% in most major economies. Possible factors include a historically low labour market participation rate, leaving a large pool of labour supply on the sidelines that could depress the ability of workers to negotiate larger wage gains. As well, demographic forces stemming from the ageing baby-boomer cohort entering retirement could be working to elevate the savings rate and depress average wage gains. In addition, important technological advances that have helped to lower retail prices and reduce energy production costs are also key headwinds in the longer-term inflation outlook. While we adjust to the 'new normal' ranges of lower growth and inflation, monitoring the above factors will be key in tracking the evolution of inflation trends in the years to come.

***Geopolitical:* U.S. tax reform comes to the floor**

• Debate over U.S. tax reform is coming to a head and has captured investors' attention. The U.S. House of Representatives could vote as early as Thursday on its newest tax proposal. However, issues could intensify even if the proposal is passed by the House. It has become apparent the House and the U.S. Senate are divided on a number of key issues. Those include: number of tax brackets, state and local tax deductions, treatment of mortgage interest, and estate tax. Additionally, the House and Senate plans currently envision increases to the federal deficit beyond the first decade of implementation. This would trigger the Byrd Rule, which requires a super-majority, rather than simple majority, to pass the bill in the Senate. The Senate is now working on

changes that would avoid this rule that include delaying the start of corporate tax cuts until 2019. If the Senate manages to avoid the Byrd Rule, or passes the bill with it, the House and Senate versions of tax legislation will have to be reconciled in a conference committee. Obviously much needs to be done before the Trump administration achieves its first major milestone, and markets have been under pressure as participants handicap the odds of success.

## 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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