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: 2018 gets off to a strong start as fundamentals remain solid

• **Strategy:** Global markets have started 2018 in solid fashion with healthy performances across equities (S&P500 +3.1%; S&P/TSX +0.9%), commodities (WTI crude oil +4.1%, gold +0.9%) and currencies (CAD +1.0%) in the first week of trading. Bond yields are also on the march higher year-to-date with U.S. and Canada 10-year federal government bond yields up by 15bp to 2.54% and 2.19%, respectively. These early gains can be attributed to, among other things, ongoing solid economic growth data and the recently approved U.S. tax cut package in late December, which boosts the corporate profit outlook, in our view. Market trends early in the year line up well with our 2018 investment strategy settings including overweighting equities relative to fixed income, preferring cyclical sector exposure (natural resources, industrials, financials) at the expense of interest-rate defensives (utilities, telecoms, consumer staples, real estate), and expecting the U.S. equity market to underperform its international and Canadian peers. We expect global market fundamentals to remain healthy throughout 2018. Notably, we believe global GDP growth is set to remain at 7-year highs as the recovery broadens out to all major economies, interest rates should rise moderately, and commodity prices should remain stable at supportive levels. In the near term, a number of event risks could inject markets with a usual dose of volatility. Those risks include a possible new raft of U.S. trade sanctions on China, a possible U.S. withdrawal from the Iran nuclear agreement, looming NAFTA negotiations that may not result in substantive progress, possible North Korean nuclear missile launches, etc.

• **Equities:** We are approaching the two-year anniversary (in February) of our bullish call on global equities. Although this call has worked out well, we are not yet ready to throw in the proverbial towel and call an end to this bull run. We have hypothesized that it could end up being the longest in history, and so far it is the second-longest (behind only that of the 1990's). In the short term, we are encouraged by strong earnings and macro momentum, firming commodity prices, reasonable equity valuations (in our view), and an analyst community that has been reluctant to increase equity target prices (greater than 30% of S&P 500 constituents are trading above their respective 12-month consensus price targets). In our opinion, these factors bode well for a continuation of equity outperformance relative to fixed income in 2018.

• **Fixed income:** Appetite for corporate debt remains healthy as yields move higher. Since the last edition of this publication, yields moved higher into the end of 2017, largely on the back of upward surprises from economic data. This continued in 2018. That led all major Canadian bond indices to decline over the period, but corporates continued to outperform. Appetite for corporate debt remained healthy amid expected outperformance and limited supply. Demand has been highest for deposit notes and non-viability contingent capital (NVCC) product, which GPAG has been recommending for some time. We expect cyclical sectors to continue attracting solid bids and prefer provincial over federal debt.

Scotia Wealth Management™ Enriched Thinking™

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• **Preferreds**: Canadian preferred shares topped the performance charts in 2017 against both equity and fixed income markets. The S&P/TSX Preferred Share Index registered its second largest annual gain since inception, with a total return of 13.62%. Rate resets were the stars of the show, returning 15.58% based on the Solactive Laddered Total Return Preferred Index. The floating rate segment of the market also delivered strong returns in 2017 (upward of 20%), but remains rather illiquid and a small part of the overall market (~7%). Rate resets and floaters performed well in 2017 as a result of higher underlying interest rates, a strong tone in credit markets, and reduced new issue supply. The Bank of Canada (BoC) bolstered an upward swing in underlying interest rates, hiking rates twice in 2017. The BoC's constructive tone, along with strong economic data prints, sent bond yields higher throughout the second half of the year. The 5-year Government of Canada bond yield moved off a 2017 low of 0.92% in May to a year-end closing value of 1.87%. Bond yields have pushed higher in the first week of 2018 to current levels near 1.98%, supporting our ongoing recommendation to own rate reset preferred shares.

Currencies and Commodities: 2017 year-end CAD rally continues in 2018; WTI crude oil above US$60/bbl

• The Canadian dollar (CAD) relative to the U.S. dollar (USD) had a solid rally to end 2017, and that momentum has carried into 2018. Since the last edition of *Here's What We're Thinking* (published Dec. 13, 2017), the CAD has appreciated ~3% relative to the USD. WTI crude oil's push toward US$60/bbl into year-end 2017 likely supported some of the move, as did (in our view) last week's much stronger-than-expected Canadian job numbers, which resulted in the implied probability (per Bloomberg) of a Jan. 17th Bank of Canada (BoC) rate hike increasing from ~40% to ~80%. Going forward, in our view, monetary policy tightening by the U.S. Federal Reserve should support the USD in the first half of 2018, while the outperformance trend may struggle to extend beyond the second quarter as the monetary policy bias of other major central banks could turn more hawkish/less dovish.

• Similar to the Canadian dollar, WTI crude oil has had a solid start to 2018. The commodity continues to trade above US$60/bbl, which, arguably, could be on the back of geopolitical supply risk given the current situation in Iran. While our medium/long-term constructive view on crude oil and the energy sector remains intact, we remind investors that temporary softness in the commodity and related equities could emerge this quarter owing to seasonally weak oil demand. However, in our view, we expect any potential weakness to be relatively short-lived, and believe energy producer equities continue to have some room to catch up with the price of the commodity.

Economics: Global economic expansion continues, while the Bank of Canada looks set to hike next week

• 2018 kicked off on an optimistic note as the global economic growth outlook further brightened following strong economic data releases from the world's largest economies. Manufacturing purchasing manager index (PMI) readings for December/2017 all beat/matched expectations in the U.S., Europe, and China, while the Economic Surprise Index for the U.S. is hovering at the highest level since 2012. Meanwhile, private-sector economists boosted their U.S. GDP growth forecasts again for 2018, bumping the median forecast to 2.6% versus 2.5%, where the forecast stood last month. However, last Friday's disappointing U.S. labour market report put a dent in some investors' outlooks for the U.S. economy. Gains in nonfarm payrolls decelerated to 148k in December/2017 from a revised 252k in the prior month. Probabilities of a U.S. Fed rate hike in March slid from 88% to 81% following the jobs report, as implied by the Fed Funds futures market and calculated by Bloomberg. As changes in payrolls typically fluctuate from month to month, the 12-month moving average is generally a better measure of employment and remains within a heathy range, in our view. Meanwhile, the Canadian economy continues to run hot and hiring activity remains very strong, increasing the likelihood the Bank of Canada will increase its policy rate at its meeting on January 17th. Scotia Economics is currently calling for a rate hike next week.

Geopolitical: *U.S. budget negotiations intensify*

• As we wrote in our final edition of this publication for 2017, the U.S. federal budget continues to be in focus. After a last-minute extension, the U.S. government moved the deadline for a new federal budget to January 19th. As the new date fast approaches, negotiations are ramping up, with Republicans and Democrats jockeying to include their own priorities in the new budget agreement. Republicans are interested in increasing defense spending that they say has suffered from recent spending cuts, but this would break the long-standing parity between defense and non-defense spending. On the other hand, Democrats want to preserve that parity in order to fund myriad social causes including the Children's Health Insurance Program, the Social Security Administration's veterans' programs, student debt, child care, and rural infrastructure. Further complicating negotiations is the matter of Deferred Action for Childhood Arrivals (DACA) versus spending for a wall along the Mexican border. U.S. President Trump has said he will not approve any spending for DACA without inclusion of border wall funds. At the moment, the two sides remain divided on many of the key issues. As time until a potential government shutdown dwindles, the likelihood markets see bouts of risk-off trade could increase if headlines reveal further distance between Republicans and Democrats on these key issues.

Recommended Asset Allocation

Asset Class	Neutral	Tactical
Equities	**60%**	**65%**
Canada	30%	33%
United States	25%	25%
International	5%	7%
Fixed Income	**40%**	**30%**
Government	25%	15%
Provincial	10%	10%
Corporate/Credit	0%	0%
Preferreds	5%	5%
Cash	**0%**	**5%**

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

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