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: Fundamentals remain supportive notwithstanding noisier headlines

• **Strategy:** Recent weeks have featured elevated market volatility across equities, fixed income, commodities and currencies. This phenomenon erupted abruptly in very late-January following an extended period over late-2017/early-2018 of accelerated gains devoid of any material pullbacks, which left market positioning unbalanced. Having entered into the late stages of the business cycle (the length of the U.S. recovery, assuming it continues, will reach the ten year mark in July 2019, tied for the longest on record in the post-WWII period), it is quite normal that the maturation of the market cycle should be characterized by an elevated range of volatility amid rising interest rates and a flattening yield curve. Markets will also have to continue to contend with increased global trade anxiety as the prospect of new U.S. tariffs on steel and aluminum imports of 25% and 10%, respectively, has strained ongoing NAFTA renegotiation talks and presents a new source of market risk. However, while these factors could be transient headwinds, we expect global market fundamentals to remain supportive over the remainder of 2018. These fundamentals include global economic growth levelling off at an above-trend pace, central bank policy tightening on a gradual path, commodity prices remaining in current ranges, and sustained double-digit earnings growth. As a result, we maintain our asset allocation strategy of overweighting equities over bonds with an eye to deploying excess cash on meaningful equity market pullbacks (such as the recent 10% correction in early February).

• **Equities: *Our two-year bias toward overweighting global equities relative to fixed income remains intact.*** With the Q4 earnings season for the S&P 500 nearly complete, 74% of the companies that have released results have reported a positive earnings surprise, and 77% have reported a positive sales surprise. Both are excellent results, in our opinion, and the sales surprise figure is the highest that has been reported so far during the current nine-year-old bull market. Blended year-over-year earnings growth for Q4'17 is 14.8% so far. Of the companies that issued Q1 earnings guidance, only 47% issued negative guidance – well below the five-year average of 74%.

• Although earnings growth may be peaking, we believe positive growth will continue in the medium term. Corporate sales growth and strong commodity prices should give a lift to inflation-sensitive companies with pricing power. In addition, the end of the recent correction has improved overall market valuation (the current S&P 500 blended forward 12-month price-to-earnings ratio is 16.98), which provides investors an opportunity to put new money to work, in our view. For investors focussed on attractive valuations, we continue to recommend an international overweight (including Canada) relative to the U.S.

• **Preferreds:** Ongoing geopolitical noise has caused bonds to rally in Canada, sending yields lower across the curve. The 5-year Government of Canada bond yield has fallen approximately 14 bps since its year-to-date high on February 15, 2018. Weakness in the preferred share market has likely been driven by this near-term movement lower in underlying interest rates. The

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preferred shares most impacted by the recent movement lower in underlying interest rates have been the lower reset spread issues along with those of weaker credit quality issuers. We expect bouts of volatility to recur this year as we move through the later stages of the current economic cycle. We remain focused on higher credit quality issuers within the rate reset segment of the market as we continue to expect interest rates to trend higher throughout the year.

• **Fixed income: *Canadian corporate issuance has resumed***. We mentioned in the last edition of this publication that our confidence in the market would return when new issuance in the corporate debt market resumed in earnest. It has indeed resumed, with over $8B in new issuance since February 21st. We believe this signals a good entry point for those investors who remained on the sidelines during the recent correction. As for sectors to focus on, we continue to recommend cyclical ones that we believe will outperform heading into the end of the current credit cycle.

Currencies and Commodities: Weak Canadian heavy oil prices could be set for a turnaround; trade rhetoric elevates currency risks

• For Canadian energy investors, the spread between Western Canadian Select (WCS) and West Texas Intermediate (WTI) benchmark prices is a closely followed metric as it aids in the estimation of heavy oil producer profits. Over the last several months, this spread has widened dramatically as transportation constraints have resulted in rising Canadian heavy oil inventories. For some context, WCS traded at a ~US$10/bbl discount to WTI in October 2017. That discount widened to ~US$31/bbl in early February 2018, but has since tightened slightly to around US$24/bbl. However, the Scotiabank Global Banking & Markets (SGBM) commodity strategist is of the view that the spread should narrow further, potentially into the low twenties or high teens, over the next few quarters. The strategist's view is premised on (i) the signing of additional crude-by-rail agreements between heavy oil producers and major railway companies, (ii) a new refinery in Alberta reaching full operating status in 2018, and (iii) improving utilization of the Keystone pipeline following its shutdown last November due to an oil spill in South Dakota. If the strategist's view proves correct, it could provide a much needed reprieve for Canadian heavy oil producers and their share prices.

• The Japanese yen (JPY) is often viewed as a safe-haven currency, an asset investors turn to amid bouts of financial market uncertainty. In recent weeks, the JPY has been well bid as protectionist trade rhetoric and European politics act as headwinds to most other G10 currencies. Adding to the recent strength in the yen was Bank of Japan Governor Haruhiko Kuroda's comment the central bank could consider exiting its stimulus program in 2019, should inflation targets be met. Meanwhile, the U.S. dollar index (DXY) has consolidated near the 90.00 level. Taken together, the Trump administration's recently proposed steel and aluminum tariffs and U.S. Federal Reserve Chairman Powell's testimony to Congress increase the risk of a more aggressive path of monetary policy tightening in the U.S., in our view. Meanwhile, the potential changes to U.S. trade policy mentioned above and weaker-than-expected fourth quarter Canadian growth data have weighed on the loonie. In our view, the Canadian dollar could experience further volatility in the near-term as additional details on both the recent round of NAFTA negotiations and potential U.S. tariffs are made available.

Geopolitical: Italian elections yield no clear path forward

• The completion of the Italian election does not mark the end of a shifting political landscape, in our view. Sunday's election painted a picture of the Italian electorate's leadership desires, but specifics of a new government remain uncertain. It is clear that anti-establishment, Eurosceptic parties gained the most in the election. Exit polls showed the Five Star Movement won 32% and Lega Nord won 17% for a combined 49% of the popular vote. This left the relatively more centrist Democratic Party and Forza Italia with 19% and 14%, respectively. The focus now shifts to coalition building, which will be facilitated by President Sergio Mattarella following the Italian Parliament's first session on March

23rd. Despite their ability to coalesce and form a majority government, the Five Star Movement and Lega Nord are not likely partners (much to the relief of financial markets, in our view). The Five Star Movement has indicated it does not want to share power, and Lega Nord has ruled out a coalition with the Five Star Movement. Another option is for a centre-right coalition between the Lega Nord and Forza Italia. This was considered the most likely coalition heading into the election, and one that likely would be led by Forza Italia. It was also thought to be the closest to a market-palatable outcome. However, following a stronger-than-expected showing from Lega Nord, this option (should it emerge) could retain more populist policies. A third option, new elections, is always possible if President Mattarella cannot coax a coalition out of the minority parties. Regardless the outcome, markets have been warned that Italians are unhappy with the status-quo in the Eurozone. However, it could be some time before Italians get their desired change.

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/Prov's	25%	15%
Inv. Grade Corporates	10%	10%
High Yield	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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