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: Market correction not reflective of strong fundamentals

• **Strategy:** Following a strong start to the year, global equity markets have experienced a sharp bout of volatility in recent days that wiped out much of January's gains. While investor concern is normal during episodes of extreme market movements, we believe this latest bout of selling was overdue given the last market decline of just 5% or more occurred more than 18 months ago and the recent run-up in markets left market positioning unbalanced and thus vulnerable to a short-term correction. However, the medium-term outlook for markets remains constructive, in our view, underpinned by solid economic fundamentals and still-supportive policy settings. In particular, global economic growth remains at multi-year highs with recent data releases pointing to further forecast upgrades for 2018 in coming months. As well, the global recovery has broadened out impressively to every major economy in the world, leaving the economic recovery cycle more resilient to possible shocks and increasing the possible longevity of the recovery. This most recent correction has also helped to sharply improve market valuations, in our view. The S&P 500 price-to-earnings ratio (based on next twelve months earnings forecasts) has fallen from 18.4x to 17.2x, levels last seen in January of 2017, leaving valuations at attractive levels in our estimation. With risks of a recession over the coming year remaining very low, we view this latest market correction as an attractive opportunity to put any cash allocations to work.

• **Equities:** The combination of a market pullback and analysts upwardly revising their earnings estimates to reflect U.S. tax reform has caused the S&P500 blended 12-month forward price-to-earnings ratio to drop 7% from its recent peak. We believe this is a meaningful pullback, as the recent selling, in our opinion, has been disconnected from economic fundamentals (strong earnings growth, healthy labour dynamics). Thus, we retain our two-year-old equity overweight bias, with a geographical preference for Canada, Europe, Japan and emerging markets at the expense of the U.S. We believe commodity sectors (materials, energy), industrials and financials will comprise the top four performing sectors in 2018.

• **Preferreds:** The increase in equity market volatility over the last several trading sessions has also resulted in heightened volatility in sovereign bond yields and credit markets. The preferred share market has been fairly resilient through the latest equity market sell-off, with the S&P/TSX Preferred Share market off 1.35% since Feb 1st compared to the S&P/TSX Index, which is down 3.13%. Although we have seen a significant swing in underlying interest rates recently, the longer-term trend – one supportive of the Canadian preferred share landscape - has been toward higher government bond yields. An impediment to the preferred share market has been the widening of credit spreads, which reflects an increased risk premium demanded by investors. The worst performing preferred shares since Feb 1st have been those securities with a non-investment grade credit rating (i.e. Pfd-3 or lower). We have been encouraging investors since late last year to "high-grade" preferred share positions into securities of stronger credit quality issuers as we move through the late innings of the current business cycle. This recommendation remains

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intact and we intend to emphasize it throughout the year, especially with the expectation of higher volatility in 2018.

• **Fixed income: Spreads widen amid recent volatility.** Credit spreads have widened noticeably in corporate and, to a lesser extent, provincial credit markets amid equity market volatility. Spread movement has been more pronounced in the more liquid AA and A credit markets rather than the BBB sector, about which we wrote cautiously in the last edition of this publication. This makes sense, as these less liquid issues would likely have exhibited more spread volatility were trade volumes higher. At the time of writing, the Canadian corporate credit market is beginning to find its footing. Once it does, we would recommend adding exposure to cyclical sector A and AA-rated corporate credits that have seen their spreads widen in the past week.

Currencies and Commodities:* *Central banks prime markets for continued monetary policy tightening in 2018; rig counts creeping higher as WTI remains above US$60/bbl

• The Canadian dollar has largely held above the psychologically significant level of US$0.80 for most of 2018, buoyed in part by continued strength in domestic data and a murky backdrop for the greenback. Canada's economy grew 0.4% m/m in November/2017, its fastest monthly rate since last May, and inflation readings have extended their recent upward trajectory (consumer price index [CPI] +1.9% y/y in December). Following its January 17th decision to raise its policy interest rate 25bps, the Bank of Canada (BoC) will hold its next meeting on March 7th. The BoC is largely expected to keep the overnight rate unchanged, with a modestly hawkish bent. Market implied probabilities, as calculated by Bloomberg, are signaling a 25 bps rate hike at the April BoC meeting. Scotiabank Economics predicts a total of 3 hikes in 2018.

• The U.S. dollar slid against most major currencies following comments from U.S. Treasury Secretary Steven Mnuchin at the recent World Economic Forum annual meeting in Davos, Switzerland, suggesting the Trump administration could be backing off its traditional "strong dollar" rhetoric. The secretary broke script as he acknowledged a weaker U.S. dollar would be beneficial for trade, though he stated he believes in the strength of the U.S. dollar over the long term. The U.S. Federal Reserve held the federal funds rate unchanged at its January meeting, the last for former Chair Janet Yellen. Current Chairman Jerome Powell will lead a Federal Open Market Committee meeting for the first time in late March. The market has largely priced in a 25bps hike at this meeting.

• In the last edition of *Here's What We're Thinking*, we debated whether U.S. oil producers would show restraint with respect to increasing production as WTI crude oil continues to hover in the low-to-mid-US$60/bbl range. Last Friday, the U.S. oil rig count (a measure of activity in the energy patch) increased by six rigs week-over-week, bringing the total number of U.S. oil rigs currently in production to 765, which is a 31% year-over-year increase. While this may sound like a significant increase, the oil rig count is still well below the high of 1,601 back in the fall of 2014, and remains in line with last year's peak level in August. We will continue to monitor the U.S. oil rig count over the coming months, as a meaningful increase in this metric could adversely impact the global crude oil supply/demand rebalancing currently underway – and, ultimately, the price of the commodity.

Economics:* *U.S. economic data remains supportive; Canada's labour market may have softened in January

• The January/2018 U.S. labour market report came in stronger than expected, adding to the recent batch of supportive economic data. U.S. companies added 200k jobs in January, beating economists' expectation of 180k, while December's number was revised higher from 148k to 160k. Meanwhile, average hourly earnings also surprised on the upside, registering a 2.9% YoY rise in January versus economists' estimate of 2.6%. Although the unemployment rate remained at 4.1%, initial jobless claims from recent weeks suggest it could fall to 3.5% in the coming months. Given the recent flow of strong economic data releases, the case for tighter monetary policy has strengthened. The probability of a March interest rate hike has been climbing and is currently at

93%. Scotia Economics forecasts three rate hikes this year by the U.S. Federal Reserve, with the first one occurring by the end of Q1.

• In Canada, January's labour market report is scheduled to be published on Friday, February 9. After two consecutive months of strong Canadian jobs reports, economists are expecting some pullback in the net change in employment (est: 10.0k vs prev: 78.6k) along with an uptick in the unemployment rate (est: 5.8% vs prev: 5.7%). Bank of Canada (BoC) Senior Deputy Governor Carolyn Wilkins is scheduled to speak tomorrow, ahead of another speech by Deputy Governor Schembri next week. These will be the only two communication events by Governing Council members before the BoC's March 7th interest rate announcement.

Geopolitical: Provincial governments feud over pipeline; U.S. faces a second shutdown

• Tensions are running high amid a battle over pipelines among provinces and the federal government. Last week, the British Columbia provincial government announced plans to limit increases to diluted bitumen (a form of crude oil) transportation in B.C. until further studies can be done on spill management. The move has been seen, in some circles, as a way to further delay Kinder Morgan Canada's Trans Mountain Expansion Project (TMEP) and repair the fractured alliance between the province's NDP and Green Party. In retaliation for a policy that clearly affects both provinces, Alberta's premier announced her province would suspend negotiations to purchase electricity from British Columbia, and subsequently halted the import of B.C. wine. Alberta also plans to take legal action against B.C. Complicating matters further is that interprovincial pipelines such as TMEP are federally regulated, and TMEP has already been approved. In fact, Prime Minister Justin Trudeau, speaking at a recent town hall in British Columbia, defended the government's decision to approve TMEP as "the nature of compromise [we] had to make in the best interests of Canada." As the situation unfolds, it likely will call into question the constitutional rights and responsibilities of provinces within the Canadian federation as well as raise questions about future energy infrastructure investment in Canada vis-a-vis environmental regulations, all within 21 months of the next federal election.

• A U.S. government shutdown is once again in focus. Just a few short weeks after the last government shutdown, the current short-term spending bill is scheduled to expire. Republicans and Democrats must again try to navigate negotiations on immigration and military spending before the deadline on Thursday, February 8, at midnight. Last night, the U.S. House of Representatives passed a Republican-led short term spending bill that would avoid a shutdown until March 23rd. The bill now moves to the Senate and needs to be passed by a supermajority before the shutdown deadline. However, passage in its current form does not look likely as the bill does not address Deferred Action for Childhood Arrivals (DACA) or immigration and provides for a year of funding for the Pentagon without commensurate approval for non-military spending. Complicating the negotiations is the debt ceiling. The Congressional Budget Office now believes the U.S. Treasury would have to start prioritizing payments by around mid-March, before the House spending bill would expire. This sense of urgency is already being felt in the U.S. Treasury market, which is demanding noticeably higher yields for maturities in early March relative to yields for maturities a few weeks earlier and a few weeks later.

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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