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: Volatility to remain elevated offering opportunities to put cash to work. Stick with Equities overweight in cyclicals

• **Strategy:** With the end of the summer, a seasonal volatility pickup in September/October arrived right on time over the past few weeks. Central banks remain at the epicenter of market trends with accommodative policy set to remain despite a recent spike in bond yields. Continued patience from the Fed and clear signaling that the interest rate hiking cycle will be very shallow should keep the USD range-bound and maintain global market tailwinds. Other major central banks staying with ultra-loose monetary policy and signs of firming Chinese economic activity are also supporting the global economic recovery. Remaining economic slack, a very low level of interest rates and the shape of the yield curve suggest economic cycle risks remain modest over the coming year. However, geopolitical risks (driving near-term market volatility) looks to remain elevated into year-end as U.S. November elections take centre stage with the first presidential candidate debate set for Monday September 26th a key near-term focus. We continue to advocate a buy-on-dips approach with the most recent pullback offering attractive opportunities to put large cash overweights to work. Stick with a preference for corporate credit in fixed income while in equities we remain bullish on cyclicals as well as international markets.

• **Equities:** We continue to advocate a cautious but optimistic overweight to equities. We expect returns to be subdued but positive with the occasional interruption from mid-single digit pull-backs. These pull-backs will give investors the opportunity to equitize any excess portfolio cash. As for our bullish bias, we believe the old adage "bull markets climb a wall of worry" represents today's environment as there is no shortage of concerning issues (high US equity valuations, overly optimistic earnings estimates, upcoming US elections, China slowdown/devaluation concerns, solvency of Italian banks, unorthodox monetary policy, high sovereign debt levels, terrorism, crude oil volatility etc.) and yet the new 52 week high for the S&P 500 in mid-July was confirmation for us that the '09 bull market is still alive. Historical studies have shown that the "first 52 week high in 12 months" has a near perfect track record for delivering at least positive twelve month returns when this event occurs.

• In addition, without the usual bear market indicators flashing imminent danger (rising recession probabilities, excessive inflation including wages, tight money supply, high/rapidly rising interest rates, inverted yield curve, irrational exuberance leading to bubbles) we continue to advocate a pro-cyclical investment stance. As recession risks recede and gradual but mild improvement in economic conditions remains likely; our favourite sectors are technology and financials. In addition, we like value, small cap, Canada, international, emerging markets, resources and high beta as these exposures tend to outperform at this point in the cycle. On the flip side, we will remain underweight bond proxies (such as consumer staples, utilities etc.) and will look to get further underweight (due to historically high valuations and crowded longs) if a short term

Enriched Thinking™

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defensive rally materializes as many bond-like equities are short-term oversold.

• **Fixed Income:** The last two weeks have featured curve steepening in Canada and the U.S. The movement was spurred by speculation about the Bank of Japan's plan to steepen its yield curve via its monetary policy. This eventually came to fruition but not until the Canadian 10yr/2yr spread widened to the most since June. While this has likely put pressure on longer rates positions, spreads on A and BBB rated mid-corporate bonds have remained steady. On the short end of the curve, corporate bond spreads continue to tighten, and we expect this to continue as accommodative monetary policy and credit conditions remain in place. This is especially true following the Fed's decision to keep the Fed Funds rate at 0.25%-0.50% and lowering outlooks for rate increases to one in 2016 and two in 2017.

• **Preferreds:** Although volatile, the S&P/TSX Preferred Share Index is relatively unchanged from two weeks ago. The market has gradually clawed back gains over the last week after the previous weeks' decline following the ECB's decision to not implement further stimulus at its latest meeting, which sent a risk-off tone throughout global markets. On the back of the announcement, bond yields globally increased, with 5-year Government of Canada bond yields moving 10bps higher to currently yield approx. 0.72%. The movement higher in yields was partially offset by a widening in credit spreads. The market has also had to digest the $1.5 billion of new issue supply that came online in the last two weeks, which likely fed into some of the previous weakness as investors sold funds in order for cash to settle ahead of trading. Going forward, we expect the market to be relatively range bound with limited catalysts to drive the market marginally higher over the next month, barring any unforeseen events.

***Capital Markets:* No September Fed rate hike, but volatility likely to remain over the near-term. Oil headwinds continue**

• With both the Bank of Japan and the U.S Federal Reserve's policy announcements now in the rear-view mirror, markets will shift their worry towards the outcome of the upcoming U.S. Presidential election. If there is one thing that the capital markets do not view favourably, it is uncertainty. Therefore, we expect the volatility we experienced over the last couple of weeks to continue into the November elections. Given valuations for Canadian and U.S. indices remain near 10-year highs on forward earnings (TSX - 16.9x, S&P500 16.8x), potential turbulence in the weeks ahead should be viewed as an opportunity to deploy excess capital into high-quality cyclical investments.

• WTI crude oil continues its choppy trade ahead of talks between OPEC countries and other major crude producers on September 28 in Algiers. According to the Algerian Energy Minister, the informal meeting next week may actually turn into a formal meeting as OPEC looks to cut production in order to stabilize prices and re-balance the market. Oil has declined about 13% since its recent highs in June, with plenty of volatility in between those highs and current levels. We expect further instability going into and coming out of the meeting as the outcome is relatively uncertain at this point. Adding to the uncertainty around oil was the International Energy Agency's (IEA) revised commentary from last week calling for the crude market to be oversupplied at least through the fourth quarter of 2017. Combine that with the latest Department of Energy crude oil inventories figures which showed a draw of 6.2 million barrels versus expectations of a 3.4 million barrel build and you can see why volatility in the commodity should continue. Last but not least, U.S. drilling activity continues to rise, with rig counts increasing from a seven year low of 316 at the end of May to 416 at the end of last week, but remains well below levels required to stave off production declines. Longer-term, we expect a return to supply-demand equilibrium in global oil markets would support a sustainable oil price recovery, though we believe this likely will not materialize until later in 2017.

***Economics:* Central banks leave policy at accommodative setting; China data improvement brighten international picture**

• The U.S. Federal Reserve decided to leave interest rates unchanged (0.5%) at Wednesday's meeting in a split decision. A downgrading of forecasts from a number of FOMC board members, reinforced by a recent soft patch of incoming economic data, left a majority of voters to opt for no change to policy

settings. Of note, policymakers reinforced in their statement that they continued to see one rate hike as appropriate by year-end, leaving us to continue viewing the December policy meeting as the next most likely opportunity to hike interest rates considering the next committee meeting occurs too close to the U.S. presidential election. This display of ongoing patience by the most important global central bank continues to support our positive medium-term view of global markets.

• Recent Chinese economic data suggest that policymakers efforts to support economic growth are bearing fruit. Domestic demand indicators such as retail sales (+10.6%), fixed asset investment (+8.1%), housing prices (+7.3%), along with industrial production (+6.3%) and imports (+1.5%) have all surprised to the upside. This suggests moves to loosen fiscal (tax & spending) and monetary (interest rates & currency) policies have helped to arrest the decline in China's economic growth in 2016. This is good news for the global economy, as China is the world's second largest economy, and markets providing a potential boost for commodity-related sectors in particular.

Geopolitical:* *Trade Protests and a Cease-Fire Broken, All While the Trump Show Continues

• Last week protesters in major cities in Germany took to the streets to voice concerns over the planned Trans-Atlantic Trade and Investment Partnership. Talks on the deal – proposed between the United States and the European Union – are said to have failed as indicated by comments from Germany's Economy Minister Sigmar Gabriel; "Europeans did not want to subject ourselves to American demands." Those comments likely sparked protests. The European Union is also in the ratification stage of a similar deal with Canada. These protests could signal trouble for the Canadian deal – the Comprehensive Economic and Trade Agreement – which has been deemed just as dangerous by NGOs.

• After a cease-fire was brokered by the U.S. and Russia on September 9th, the situation in Syria has once again deteriorated. On September 19th, an aid convoy heading into rebel territory was bombed from the air in western Aleppo province. The U.S. has implicated Russia, citing intelligence that two Russian Su-24 aircraft were directly overhead at the time of the attack. The cease-fire was already on tenuous ground but this seems to be a tipping point as the United Nations has called off any delivery of humanitarian aid – a key stipulation of Washington in the negotiation. The main goal of the U.S. is to remove the vacuum in which the Islamic State thrives by ending the civil war. This development could impact global oil prices as fighting continues, but more specifically could be used against Hillary Clinton and the Democrats in the U.S. election.

• The 2016 U.S. election campaign continues to make headlines. Most recently Donald Trump has claimed that Hilary Clinton created the birther movement while his campaign suggested he has been adamant about President Obama's birth on U.S. soil for years. This and a host of other topics are likely to be discussed on Monday September 26th during the first of three presidential debates. Polling is suggesting Hillary Clinton has a slim margin over Donald Trump (45.3% vs. 43.9%). However when taking into account votes in the Electoral College pollster FiveThirtyEight is handicapping the odds of Hillary Clinton winning at 57.1% (42.9% Trump win).

Recommended Asset Allocation

Asset Class	Strategic	Tactical
Equities	**60%**	**65%**
Canada	30%	30%
United States	25%	25%
International	5%	10%
Fixed Income	**40%**	**30%**
Government	20%	10%
Provincial	5%	5%
Corporate/Credit	10%	10%
Preferreds - Rate Reset	5%	5%
Preferreds - Fixed Perpetual	0%	0%
Cash	**0%**	**5%**

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None.

The supervisors of the Portfolio Advisory Group own securities of the following companies.
None

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