Here’s What We’re Thinking

ScotiaMcLeod Portfolio Advisory Group

September 9, 2015

Volatility likely to linger, but value starting to emerge from broad market weakness

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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 ScotiaMcLeod advisor.

***Investment Strategy**: Volatility likely to linger, but value starting to emerge from broad market weakness*

- **Equities**: After a sharp selloff that was prompted by concerns about Chinese growth, equity markets have started to stabilize with developed markets modestly outperforming emerging ones. Markets should remain on edge in the near-term, however, as the Street is becoming increasingly divided on whether the Federal Reserve will hike interest rates as early as September 17 (next FOMC meeting) or push out rate hikes into early 2016. So long as global growth remains intact and valuations stay reasonable, we don’t think medium- and long-term investors should fret about potentially higher short-term rates in the U.S. as equity markets have historically performed well during the initial phase of Fed tightening. We think the recent decline in equity markets has created selective opportunities. Having reported another quarter of sound results, we think the 10% YTD decline in the S&P/TSX Bank Index has pushed valuation (10.1x 2016E P/E) and dividend yields (4.5% sector average) to attractive levels. While the potential for higher commodity-related loan losses could keep sentiment in check in the near-term, Canadian bank stocks already appear to be discounting a steep increase in credit losses. We also see select buying opportunities in the U.S. equity market and continue to have a favourable view on large-cap European equities, with exposure to the latter efficiently achieved through an ETF strategy. As we expect a shallow recovery in oil prices over the next 12-18 months, our strategy in the energy sector remains one of high-grading exposure into companies with attractive assets and conservative balance sheets.
- **Fixed income**: Despite the recent uptick in global equities, investor sentiment remains on edge. This skeptical bias has left the long end of both the U.S. and Canadian yield curves behaving in a less disciplined fashion as expectations for Fed hiking in September have waned. We think Fed tightening should eventually be constructive for longer dated maturities but until it materializes tactical trading positions will likely encounter ongoing volatility. As a result, investors may want to trim longer dated positions and revisit when the Fed does eventually begin hiking. We remain cautious on the HY sector (particularly Energy) as expectations for borrowing base redeterminations, which typically take effect in October, could lead to further headwinds for the sector. We continue to favour high quality provincial paper (particularly Ontario/Quebec) and senior bank paper. For highly defensive investors, GICs continue to offer the most favorable risk/reward proposition in the 1-5 year space.
- **Preferreds**: The question this week is “Do 11 days of consecutive positive returns seen in the preferred share market constitute a trend?” While it’s been reassuring to see the preferred share market stabilize, it should be noted that the upward movement has been on limited volume. Although we expect to see opportunities ahead there is still the potential for bouts of volatility, particularly as tax-loss selling season approaches. In the rate reset sector, purchasing the longer dated (+2018) investment grade (> Pfd-2L) securities makes the most sense at this time, as they provide investors with an attractive current yield (>4.75%) while also offering the potential for capital gains should prices appreciate.

***Capital Markets*: Street still divided on Fed rate hikes; Despite rollercoaster equity ride, Main Street China still looking healthy**

- With a temporary calm settling on the Chinese equity market, the market's focus has turned to next week's interest rate decision by the Federal Reserve. Although the Street consensus pegs the probability of a rate increase at only 30%, high profile strategists and institutional investors on both sides of the rate debate have been vocal in recent days. Based on recent comments, even Fed officials are mixed in their views. While the market and the media is clearly preoccupied with the timing of the first Fed rate hike, there is an overwhelming view that the Fed will eventually raise rates by the end of Q1 2016 (77% probability). We believe investors should take advantage of the increased volatility associated with this debate to start investing excess cash balances, as the underlying U.S. economy remains strong (see below).
- Intervention by the Chinese central bank and other authorities, combined with a 40% haircut since June that has reduced the forward P/E on the Shanghai Composite Index to a more reasonable 12.5x from 19.5x has resulted in a stabilization of the Chinese equity market. The selloff was likely exaggerated by the record level of margin debt (US$365 billion, or 6.4% of total market capitalization) that had accumulated by June of this year. As of September 8, total Chinese margin debt had declined to US$152 billion, representing 3.8% of capitalization. By way of comparison, margin debt in the U.S. currently stands at US$487 billion, representing 1.9% of capitalization, and relatively close to the 10-year average of 1.8%. While the maturing Chinese economy's transition from high growth to moderate growth is unlikely to be smooth, the recent volatility doesn't appear to have impacted the increasingly important Chinese consumer (Westpac MNI China Consumer Sentiment Index hit a YTD high in August), as retail sales continue to grow and the residential property market has shown improving pricing trends.
- Weekly oil inventory data continues to garner headlines and drive short-term volatility, even as overall U.S. oil production has moderated. Low oil prices have resulted in a dramatic drop in capital spending by oil producers that is finally starting to impact overall U.S. oil production, which has declined by almost 400,000 barrels/day since early June to 9.22 million barrels/day currently. The U.S. Energy Information Administration recently cut its 2016 production forecast to 8.82 million barrels/day from 8.96 projected last month. Meanwhile, OPEC's latest monthly Bulletin suggests that the cartel's current strategy may be starting to soften as it seeks wider cooperation from non-OPEC producers to potentially rein in production: "There is no quick fix, but if there is a willingness to face the oil industry's challenges together, then the prospects for the future have to be a lot better than what everyone involved in the industry has been experiencing over the past nine months or so. As the Organization has stressed on numerous occasions, it stands ready to talk to all other producers." We think oil prices are in the process of bottoming and should stage a shallow recovery into the mid-US$50/barrel over the next 6-12 months and modestly higher into 2017.

***Economics*: U.S. Q2 GDP growth revised higher; Canada's 1st half recession seen as fleeting; European recovery continues**

- Second quarter U.S. GDP growth was revised higher to a pace of +3.7% QoQ after initially being reported at 2.5% as consumer and business spending advanced at a faster pace. August U.S. employment data (+173K vs. +217K est) was mostly in line with expectations after including +44K positive revisions for June and July. The unexpected drop in unemployment (5.1% vs. 5.2% est and 5.3% last month) places the U.S. within a range considered by economists to be "full employment." Although August wage inflation (+2.2% YoY vs. +2.1% est) doesn't in itself appear worrisome, a record number of unfilled job openings in July (5.7 million vs. 5.3 million est and 5.2 million in June) suggests that employers may soon have to start raising wages to attract workers.

- Canada officially experienced a recession in the first half of the year after Q2 GDP growth declined for a second straight quarter. With June GDP being stronger than expected (+0.5% QoQ vs. +0.2% est) and July and August employment data also showing resilience most economists expect that Canada should deliver modest growth in the second half of the year.
- Europe continues on its slow-but-steady economic recovery path with July unemployment (10.9% vs. 11.1% est) declining below 11% for the first time since early-2012 and preliminary Q2 GDP expanding faster than expected (+1.5% YoY vs. +1.2% est).
- The official gauge of Chinese manufacturing activity confirmed earlier private sector readings that revealed that the sector contracted in August to a level unseen since mid-2012 (Manufacturing PMI: 49.7 vs. 49.7 est and 50.0 last month).

Geopolitical: Iran nuclear deal inches toward fruition; Greek political hopefuls seek to rewrite bailout terms; NDP takes lead in latest polls

- On Tuesday, President Obama received support for the Iran nuclear deal from three more senators, putting the total number of supporting senators at 41. This is a key level as it reduces the chances that any forthcoming Senate Republican bill disapproving an Iran deal will be able to bypass an Obama veto. In Iran, the deal has been endorsed by Ayatollah Ali Khamenei. The increased probability of a lifting of sanctions against Iran, including the ability to ramp up oil exports, is partly responsible for recent weakness in crude oil prices.
- While Greece’s latest bailout was passed on August 19th, the fate of the deal’s future remains uncertain. The country’s major parties are in campaign mode ahead of the September 20th federal election and are promising changes to the agreed-upon deal. The Syriza party has said it would sell only half of the state assets earmarked for privatization as well as abolish the previously approved tax on private education. Also, the New Democracy party has indicated it would not support the tax on Greek farmers.
- In order to implement their deficit spending strategy, the Liberal party has vowed to remove the law requiring federal balanced budgets. The Federal Balanced Budget Act was passed in June 2015 and punishes governments – with funding cuts and/or freezes – that run federal deficits. However, without the act in place the Liberals would be free to run three years of deficits in order to fund new infrastructure spending aimed at boosting economic growth. As of September 6, the NDP (32.4%) and Liberal Party (30.2%) are leading polling with the Conservative party (26.9%) slipping to third place.
- Gold declined to a four-week low as the Indian government approved a plan to tap existing domestic gold supplies as a means to reduce imports. Under the plan, owners of gold jewelry or bullion can deposit their holdings at banks and earn interest while banks recycle these deposits by selling to wholesalers and jewelers. India and China are currently the largest importers of gold.

Portfolio Advisory Group

Recommended Asset Allocation

September 9, 2015

	Underweight		Neutral		Overweight
Equities					
Canada			✓		
U.S.			✓		
Fixed Income					
Government		✓			
Provincial					✓
Corporate				✓	
Preferred					
Rate reset				✓	
Fixed perpetual	✓				
Cash				✓	

✓ = Current recommendation

✔ = Previous recommendation

Source: Portfolio Advisory Group, ScotiaMcLeod

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None.

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

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