Here's What We're Thinking

ScotiaMcLeod Portfolio Advisory Group

January 23, 2015

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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**: 2015 is year to play defense; We're optimistic that crude oil will end the year higher*

- **Equities**: Our 2015 return expectations for equities have moderated. While we continue to favour the U.S. equity market over Canada, the current valuation of the S&P500 is less compelling than in recent years. Furthermore, the outsized gains Canadian investors have earned holding U.S. equities due to currency tailwinds could also be coming to an end now that CAD is approaching USD$0.80. Our 7%-10% return expectation for the S&P500 should come primarily from earnings growth as the current forward P/E ratio of 16.5x has little or no room for further expansion. The Bank of Canada's surprise interest rate cut (see below) confirms our concerns of a slowing Canadian economy and supports our relatively modest 4%-6% return expectation for the S&P/TSX Composite for 2015. Should the timing and pace of recovery in crude oil prices occur sooner than expected our return expectations will prove conservative. The persistence of low short- and long-term bond yields should sustain pressure on bank and lifeco performance this year. For growth, we direct investors toward Industrials, Financials, and Consumer Discretionary sectors in the U.S. For income, we think the Canadian REIT sector remains attractive. We continue to hold a market weight position in defensively positioned Energy equities. The impact of significant budget cuts by North American energy producers has started to appear in the form of reduced drilling rig activity (see below), supporting our optimism for North American oil production to moderate by Q3 and begin declining by year end. We're not prepared to recommend an overweight Energy weighting yet as we're seeking evidence of substantially lower drilling activity in North America. We don't expect OPEC to cut production in the near-term.
- **Fixed income**: In this environment (see rate discussion below), GICs will continue to be the best relative option for investors taking on 1-5 years term rate exposures. We continue to favour the quality trade, believing that investors should be looking to migrate towards higher quality spread product (e.g. deposit notes, provincials) where spreads are more likely to contract or remain relatively stable given lower Canadian government bond yields. The softness in the Canadian dollar will likely continue to favour the economies of the eastern provinces (Ontario, Quebec) relative to the west. For those investors taking on more interest rate risk, we believe these provinces could outperform. As well, provincial exposures would provide greater liquidity relative to corporate names should rates suddenly reverse course. Name selection in the lower grade segments will be particularly important as lower rate levels and lower energy prices could spur event risk. In the BBB space, REITs with strong occupancy rates, longer average lease terms and improving unencumbered asset levels could outperform in the BBB segment.
- **Preferreds**: The first two weeks of the year have been sluggish for the preferred share market with the S&P/TSX Preferred Share Index off a modest -0.84% (total return). With a risk-off tone in the markets, investors are flocking to the safety of Canada and U.S. government bonds, which has pushed yields to historically low levels. Although a movement lower in interest rates typically causes prices of preferred shares to rise, this has not been the case for low rate-reset spread securities with a near-term reset date, as a lower base rate at extension will lower the new fixed dividend and thus the security will payout lower future cash flows. Low reset spread securities are expected to remain volatile throughout 2015 as more of these securities are extended. Therefore, to limit volatility in preferred share portfolios we recommend investors move into longer dated rate-resets (2018-2020) as these securities allow more time for the base rate to move higher as well as the potential to lock in a higher cash flow for the next few years.

***Capital Markets**: Most central bankers are in a race to the bottom; Green shoots in the crude oil market?*

- In recent weeks, many central bankers around the world (Canada, ECB, Switzerland, India, Denmark) have moved to add monetary stimulus in an effort to spur economic growth. In the cases of Canada and ECB in particular, further easing of already accommodative monetary policy has had the intended effect of depreciating the domestic currency. With short- and long-term interest rates in Europe already at ultralow levels, we think the ECB's decision to embark on a EUR1.4 trillion bond buying program won't have the same positive effect as the Fed's now-completed quantitative easing program did. This suggests that Europe's current economic stagnation may become a prolonged slump. We interpret the Bank of Canada's surprise rate cut (to 0.75% from 1.00%) as a desperate attempt to stem the oil-induced economic decline anticipated in oil producing regions by encouraging growth in manufacturing/exporting regions of ON and QC. Although a lower CAD should provide a tailwind to the economies of ON and QC, lags of 1-2 years are often typical before an increase in economic activity is witnessed. So long as crude oil prices remain range bound (our expectation for the next 3-6 months), we think the Bank of Canada could cut rates again. In this context, the US$0.80 CAD support level could be tested sooner rather than later and we wouldn't be surprised if economists started to revise year end CAD targets to US$0.75.
- The sharp decline in crude oil prices (and now natural gas too!) has prompted an inevitable round of budget cuts by oil companies. So far, 2015 capital expenditure budgets are coming in 30% lower than 2014 spending. To monitor the impact of these budget cuts, investors, oil producers, and OPEC members have all diverted their attention to weekly rig count data (Baker Hughes Rotary Rig Count). After rising more than 120% between mid-2009 and December 2014, the latest rig count data shows a 13% drop in rig activity over the past eight weeks. The accelerating nature of the decline suggests to us that a U.S. supply response is underway. Although circumstances are different, during the 2008-2009 experience crude oil prices bottomed when rig count activity dropped 25% from the peak. Interestingly, even after oil prices bottomed, rig count activity continued to decline by another 40%. While we are encouraged to see drilling activity decline, we think more rigs will have to be idled before we become more enthusiastic about a sustained oil price recovery.

***Economics**: U.S. employment, housing and consumer sentiment all at multi-year highs; Canada starts to cool*

- Key U.S. economic indicators point to ongoing momentum in the U.S. economy. December's unemployment rate (5.6% vs. 5.7% est) dropped to a six-year low, while annualized housing starts (1089k vs. 1040k est) also approached a six-year high. Meanwhile, the University of Michigan index of consumer confidence (98.2 vs. 94.1 est and 93.6 last month) accelerated to an eight-year high. Strength in these readings suggests to us that the 3% consensus GDP growth forecast for 2015 may be too conservative.
- Induced by lower energy prices and a strong USD, inflation readings in the U.S. have moderated (December core CPI: 1.6% YoY vs. 1.7% est, wage growth 1.7% vs. 2.2% est). With inflation still running below the Fed's 2% target, and with global risks still elevated, we think it's becoming unlikely that the Fed will raise its key interest rate in mid-2015.
- Canada's flat economic performance has given way to a weakening trend with an unexpected drop in December's jobs data (-4k vs. +15k est) and an unemployment rate stuck in neutral at 6.6%. Alberta and Saskatchewan both experienced a 20bps increase in unemployment to 4.7% and 3.6%, respectively. Annualized Canadian housing starts for December declined to an eight-month low (180k vs. 192k est). Given the magnitude of budget cuts in resource dependent regions, we expect these trends to deteriorate further in coming months.

***Geopolitical*: Cracks developing in some OPEC countries; No signs of retreat by the wounded Russian bear**

- With a high degree of dependence on oil revenues, some OPEC countries are showing signs of succumbing to the dramatic drop in oil prices. Venezuela's president Nicolas Maduro has asked the country's parliament to begin debating the appropriateness of domestic gasoline prices, which at US$0.06/gallon (yes, six cents a gallon!) have not changed in 18 years and are the cheapest in the world. A reduction in fuel subsidies, badly needed to address a mounting fiscal deficit, is bound to create social unrest and reduce popular support for the current Maduro regime.
- Despite rising inflation, risks of a deep recession, and a substantially weaker currency since it occupied Crimea last March, Russia's support of separatists fighting against Ukrainian forces hasn't wavered. According to Ukrainian officials, Russia has more than 9,000 troops in Ukraine and 50,000 along the border. So long as Vladimir Putin's approval rating remains near all-time highs, it's unlikely for this conflict will be resolved. However, there are some early signs that economic hardships are starting to weigh on the Russian public. The question is whether the Russian public will garner the courage to protest against Putin's authoritarian regime.

Portfolio Advisory Group

Recommended Asset Allocation

January 23, 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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