Q2/2019 Quarterly Portfolio Compass

Featured in this report

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- Bank of Canada, USMCA, CAD outlook

United States
- U.S. Federal Reserve, trade negotiations, updated recession model

Europe
- Brexit, manufacturing sector, geopolitical headwinds

Rest of the World
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Asset Classes

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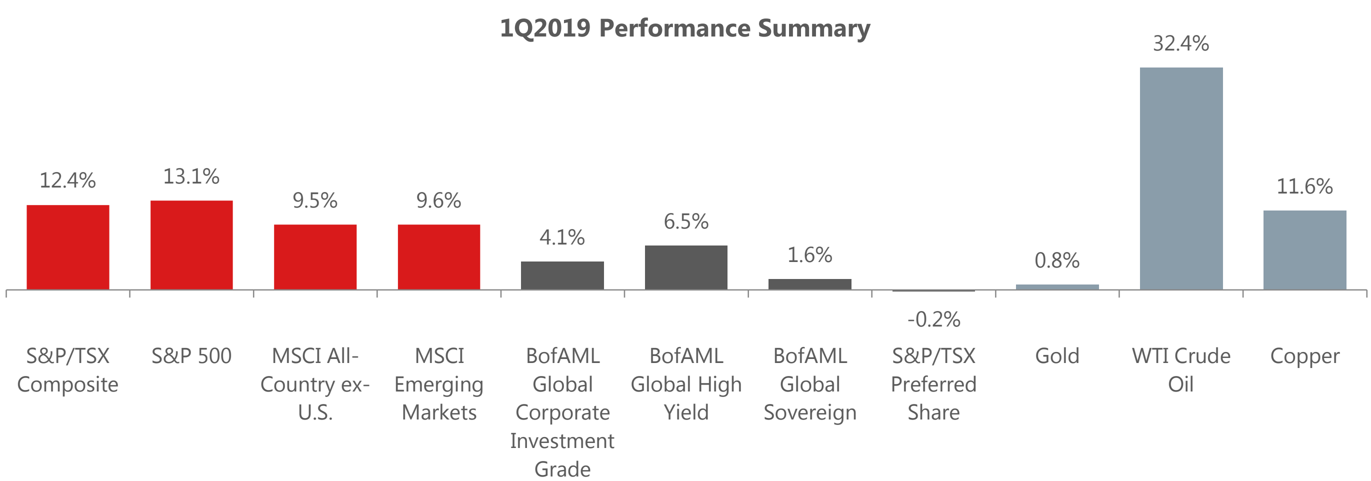
Overview

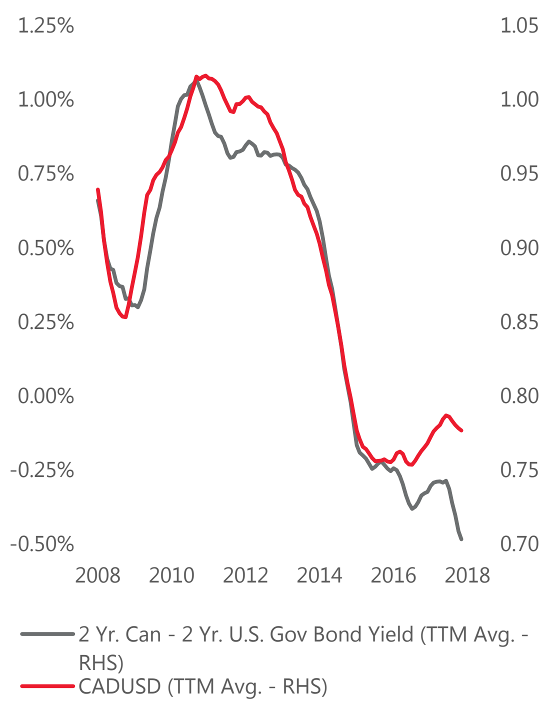
- Global equity markets performed well in the first quarter of 2019, as many central banks central banks remained data dependent amid benign inflation and moderate growth. Investment grade and high yield credit spreads tightened throughout the quarter alongside side renewed investor risk appetite.
- Regional economic performance disparities deepened as European growth was hampered by a stagnant manufacturing industry and Brexit uncertainty. The U.S. economy continued to perform well reaching its 10th year of expansion with unemployment hitting generationally low levels and a robust services sector.
- We expect growth and inflation expectations to reflate as the U.S. Federal Reserve remains cautious about over-tightening, Chinese stimulus measures take hold, and Europe recovers from its soft patch. We expect central banks to remain on the sidelines throughout this coming quarter but would not be surprised if improved economic conditions reignite policy tightening discussions toward the end of the year.



Canada

	Current	2018	2019E	2020E
GDP Growth (%)	1.6	2.1	1.5	1.8
Inflation (%)	1.5	2.3	1.8	2.0
Unemployment (%)	5.8	5.8	5.8	5.8
3 Month Yield	1.68	1.65	1.49	1.60
10 Year Yield	1.76	1.97	1.87	1.96
Yield Curve Slope	0.07	0.32	0.38	0.36
Current Account Balance (%)	(2.7)	(2.7)	(2.6)	(2.5)
Budget Balance (%)	(0.9)	(0.9)	(0.8)	(0.8)
Federal Debt-to-GDP (%)	--	27.7	27.2	26.9

Figure 1: CAD-USD exchange rate closely tracks interest rate differntials



Sources: Scotia Wealth Management, Bloomberg

Canadian economy posts solid start to 2019

- **The Canadian economy ended 2018 on a sour note with month-over-month (MoM) GDP declining 0.1% but roared back in January, expanding 0.3%,** its quickest monthly expansion since the end of 2017. As it was in January, growth will likely continue to be hampered by oil sands production curtailments imposed by the Government of Alberta to narrow heavy oil price differentials, though changes to the legislation have already taken place.
- **Modest growth and somewhat benign inflation signal neither a meaningful deterioration ahead nor a dynamic breakout in economic performance.** Stable commodity prices and normal heavy oil price differentials will be important for the medium-term growth outlook. Further, ratification of the new U.S.-Mexico-Canada Trade Agreement will be of paramount importance for the Canadian economic growth prospects. With elections fast approaching in both Canada and the U.S., the window for parliamentary/congressional approval is narrowing considerably.
- **The Bank of Canada (BoC) has signaled a period of stable rates in the near-term** as the economy traverses a stretch of weak growth. The policy rate remains below the BoC's estimation of the neutral level but there is no pressing urgency to move interest rates higher. We believe that firming domestic inflationary and growth pressures, and improving geopolitical conditions will offer the latitude necessary for the BoC to considering raise rates in 4Q2019 or early 2020.

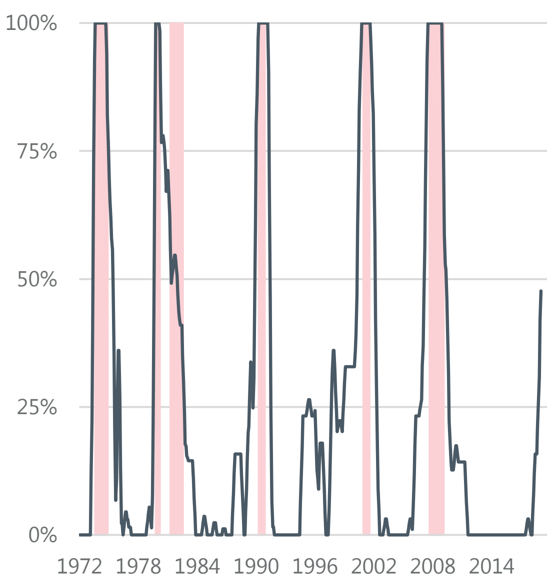
Limited upside in Canadian dollar (CAD)

- **The CAD-USD exchange rate closely tracks short-term interest rate differentials.** All else equal, higher interest rates in a country increase the value of their currency relative to countries with lower interest rates as higher interest rates attract foreign investment. Interest rates alone do not determine the value of a currency. Factors such as net trade, indebtedness, economic and political stability, and commodity prices factor in as well. Particularly in the case of Canada, crude oil prices.
- **The BoC is unlikely to outpace the Fed in raising interest rates** in the coming year, leaving differentials at their current, potentially wider levels. As discussed later, there is considerable uncertainty of the future direction of interest rates in both Canada and the U.S. Given the prospect that both central banks remain on hold for the remainder of the year, other factors may become more important for CAD valuation. WTI crude oil is currently trading in the mid-low US$60/bbl range, the high end of our expected range. We do not see much further upside in oil prices and any prolonged weakening could weigh on the Canadian dollar.

United States

	Current	2018	2019E	2020E
GDP Growth (%)	2.2	2.9	2.4	1.9
Inflation (%)	1.9	2.4	1.9	2.1
Unemployment (%)	3.8	3.9	3.7	3.6
3 Month Yield	2.41	2.35	2.35	2.27
10 Year Yield	2.55	2.68	2.65	2.73
Yield Curve Slope	0.14	0.33	0.29	0.46
Current Account Balance (%)	(2.3)	(2.4)	(2.6)	(2.7)
Budget Balance (%)	(4.2)	(4.2)	(4.6)	(4.6)
Federal Debt-to-GDP (%)	--	77.8	78.4	80.4

Figure 2: Probability of U.S. recession



Sources: Scotia Wealth Management, Bloomberg

Government shutdown likely responsible for sluggish start to the year

- **Early data shows that consumer and business spending slowed marginally in the first quarter this year** as the labour market remained strong. Price pressures were mostly subdued as core inflation continues to lag the U.S. Federal Reserve (Fed)'s 2% target. Fed officials signaled a lengthy pause to its interest rate policy normalization initiative and lowered their expectations for interest-rate expectations for this year and next. The Fed also indicated it would terminate balance sheet reduction efforts at the end of September 2019, sooner than most financial market participants expected, reaching a terminal size of US$3.8T.
- **The U.S. Treasury yield curve inverted briefly at the end of March** as an unexpectedly dovish Fed pressured stocks and long-dated government bonds. Minutes from the Fed's March meeting showed that committee members expect that economic conditions will warrant leaving the federal funds target range unchanged in 2019. They did note that their views could shift in either direction based on incoming data and other developments. The Fed will maintain its "patient" approach to monetary policy adjustments but made clear that that would not prevent them from taking action once conditions warrant it. We subscribe to the opinion that financial markets are overly pessimistic for the U.S. outlook this year and we expect growth and inflation to edge higher, leading the Fed to hike rates at least once more this year. Easing financial conditions resulted in higher equity prices and lower bond yields, which should support growth prospects in the near term.
- **Political headwinds will remain in 2Q2019** as the deadlock in Washington, D.C. appears unlikely to yield any major new initiatives. The U.S. economic outlook is clouded by issues such as the debt ceiling, U.S.-Mexico border, U.S.-Mexico-Canada agreement, on-going trade negotiations with China and Europe, and elections in 2020. These issues appear longer-term in nature and thus should have a minimal effect this quarter, but still pose a risk to the outlook and current market prices.

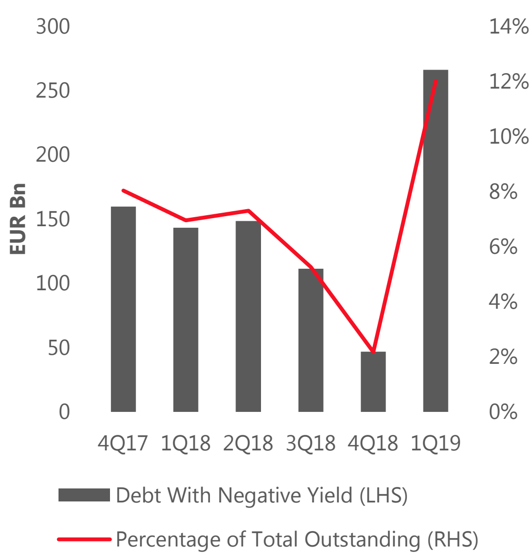
Recession risk building, equity market upside potential remains

- Our U.S. recession probability model consists of eleven weighted factors that measure output, consumer sentiment, labour and financial market conditions. The recession model is forward looking and binary in nature. A reading below 100% signals investors should be more weighted in equity markets. Once the model approaches 100%, we would recommend reducing equity exposure. Following the recommendation of the model, investing the S&P 500 Index since 1973 would have yielded a ~14% annualized return versus ~10% return by remaining fully invested over the entire period.
- **We do not expect a recession in 2019**. Our model suggests that recession risk is increasing alongside amid a decline in investor sentiment, growth and inflation expectations. We continue to believe that growth prospects will improve during 1H19 due to the improved policy clarity and new fiscal and monetary stimulus measures, which should mitigate the global manufacturing slump and boost global demand.

Europe

	Current	2018	2019E	2020E
GDP Growth (%)	1.2	1.9	1.4	1.6
Inflation (%)	0.8	1.7	1.3	1.4
Unemployment (%)	7.8	7.1	6.8	6.7
3 Month Yield	(0.51)	(0.86)	(0.28)	(0.10)
10 Year Yield	0.06	0.24	0.73	0.91
Yield Curve Slope	0.56	1.10	1.01	1.02
Current Account Balance (%)	1.9	1.9	2.1	2.0
Budget Balance (%)	(1.0)	(0.8)	(1.1)	(1.0)
Federal Debt-to-GDP (%)	--	84.9	83.0	80.9

Figure 3: Negative yielding corporate debt ballooned in 1Q2019 in Europe



Sources: Scotia Wealth Management, Bloomberg

The European economy faces a tough slog in 2019 and economic data shows few signs of reprieve

- **The European economy faces many headwinds in 2019** as the outcome of Brexit remains highly uncertain and it must also contend with protests in France, trade negotiations with the U.S. and populist movements in some of its largest individual economies. The European Central Bank (ECB) recently announced further rounds of monetary stimulus and pushed out its forecast for policy rate increases to at least 2020. Compounding the issue further is that its largest economies, which account for ~55% of GDP, are among the most challenged.
- **The European manufacturing sector has continued to drag on growth prospects in 2019** but growth has been supported primarily by resilient services activity. The reprieve from political protests in France and struggles in the German auto sector has been short-lived as the recovery appears to be losing some momentum. The services sector depends heavily on a healthy manufacturing industry. Barring an improvement in the outlook for the manufacturing sector, which appears to be unlikely given slowing economic demand globally, downside risks to services activity has intensified.
- **The European economy surely faces a difficult as the outlook is mired by domestic political issues and mounting trade issues**. The ECB more than halved its growth expectation for 2019 at its March meeting as it conceded that it had underestimated downside risks to the economy. The European economy would likely benefit from the aggressive stimulus undertaken in China and could see a modest rebound in growth by mid-year. Consumer confidence and real income have maintained strength thus far and could support a potential recovery.

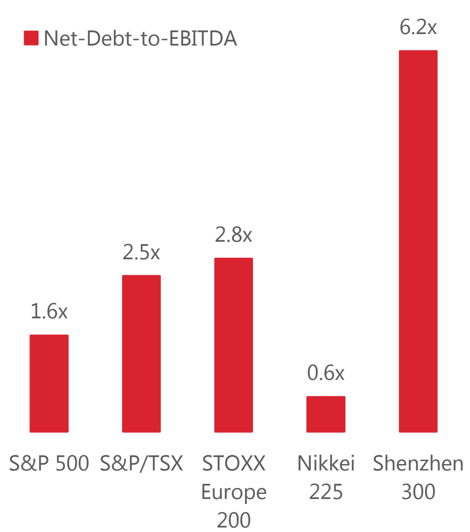
Persistent negative yields cause headaches throughout the financial system

- **Negative yielding debt has ballooned in Europe to begin the year as global growth concerns and stimulus measures have pressure bond yields**. Roughly EUR230bn of corporate debt in Europe, more than 10% of the total outstanding, carries a negative yield (Figure 3). Among those affected are fixed income money managers. Passive managers, that aim to replicate benchmarks, are forced to purchase negative yielding assets that effectively lock in losses, much like buy and hold investors. Active managers have more latitude to sift through offerings and find positive yields, but that is becoming increasingly challenging.
- **Low and negative yields in other parts of the world will also pressure North American yields** as institutional investors search for positive yield. There appears little by way of positive shocks on the horizon to pull the European financial system out from the current low inflation, low-interest rate and low growth environment it currently finds itself in.

Rest of the World

	Current	2018	2019E	2020E	
GDP Growth (%)	5.0	5.0	4.8	4.9	Emerging Markets
Inflation (%)	3.6	3.6	3.6	3.4	
Unemployment (%)	5.7	5.7	5.3	5.2	
3 Month Yield	2.15	2.83	3.13	3.07	China
10 Year Yield	3.37	3.31	3.51	3.58	
Yield Curve Slope	1.22	0.48	0.38	0.51	
Current Account Balance (%)	0.4	0.4	0.1	0.0	
Budget Balance (%)	(2.2)	(2.2)	(4.2)	(4.2)	
Federal Debt-to-GDP (%)	--	51.2	54.4	57.6	

Figure 4: Chinese companies more indebted than their global peers



Emerging market risk percolating in the background for now

- **Volatility in emerging markets (EM) picked up slightly at the end of March** amid election in Turkey and money market restrictions aimed at restricting short selling activity on the Turkish Lira. Recall last year when currency instability precipitated a sharp sell-off in EM assets and fear of contagion wracked financial markets. So far, market reaction has been much more subdued and EM volatility passed without many knock-on effects. Important to consider is U.S. dollar-denominated debt. Safe-haven assets such as the USD become more expensive in times of economic strife, which in turn pushes up financing costs for EM countries and further exacerbates heightened volatility.
- **Prolonged stress in EM regions has the potential to spill over into broad financial markets through defaults and external asset holdings**, but it takes a considerable amount of stress for contagion to have a noticeable effect on developed markets. In periods of economic instability, emerging market assets tend to be among the hit hardest as a result of their comparatively weak economic standing and risk profile. Given the current state of the business cycle, we remain averse to substantial EM exposure and prefer the better risk-adjusted return opportunity presented in developed markets.

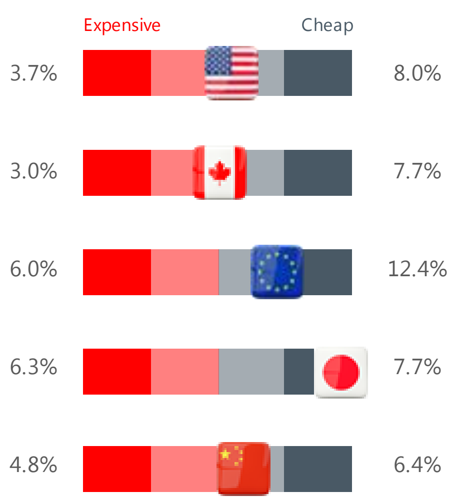
Effects of Chinese stimulus efforts could be felt beyond its borders

- **Capital expenditure in China was notably weak last year as companies undoubtedly forewent large expansion projects in the face of uncertain trade relations with the U.S**. Positively, fixed asset investment trended higher through the latter portion of 2018 but remained well below historical levels. The Chinese government unleashed a sweeping stimulus package that included funding facilities, tax cuts, infrastructure spending, lowered social security premiums and, required reserve ratio cuts.
- **China lowered its growth expectation to "about" 6.0% earlier this year from 6.0%-6.5% previously**. We expect the Chinese government to push forward with its aggressive stimulus efforts but question how effective any incremental aid will be given the indebted and cyclical nature of the Chinese economy (Figure 4). Given new stimulus measures, we expect economic data to weaken marginally as a result of the policy lag effect but expect a modest rebound in the second half of the year. A finalized trade agreement with the U.S. and eventual removal of U.S. trade tariffs would be supportive of such a recovery.
- **The International Monetary Fund (IMF) lowered its global growth forecast in April to 3.3% for 2019** from 3.5% in January citing trade tensions, a decline in business confidence, tighter financial conditions and heightened policy uncertainty. The expected growth of 3.3% is the lowest expected growth since 2009 when the IMF projected negative growth for the global economy. Despite lowering 2019 estimates, the IMF's expectations for 2020 were unchanged as it sees challenges clearing throughout the year.

Equities

	1Q2019 Return	P/E Ratio	Div. Yield
S&P/TSX Composite	12.4%	18.6x	3.1%
S&P 500	13.1%	19.1x	2.0%
MSCI All-Country ex. U.S.	9.5%	15.0x	3.4%
Nikkei 225	6.0%	16.3x	2.0%
Shanghai Composite	23.9%	15.2x	2.6%
STOXX Europe 600	12.3%	17.8x	3.8%

Figure 5: Equity risk premiums moderate in most of the world (current vs. 20-year range)



Sources: Scotia Wealth Management, Bloomberg

Equity markets roared back after 4Q2018 sell-off

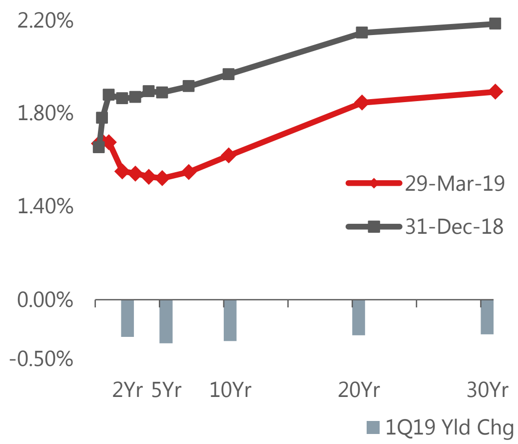
- **Global equity markets enjoyed a solid rally throughout the quarter** as central banks signaled a pause in monetary policy normalization and investor risk appetite resurfaced. U.S. economic performance has supportive of higher equity prices though low yield curve inversion and weakening margin trends represent some early warning signs. Slower growth trends in the U.S. and around the globe will also challenge the next leg higher for equity prices, as corporate profitability wanes given the late stage of the business cycle. We would not be surprised to see some price consolidation in the near-term following the recent run in equities, ~90% of S&P 500 constituents are currently trading above their 50-day moving average.
- **The next leg higher in equity markets will be contingent on earnings results** and companies' ability to maintain profitability late in the business cycle amid modest inflation, tight labour market conditions and geopolitical tensions. U.S. equities are currently trading at ~17.5x trailing 12 months earnings, as valuations have been repriced to reflect lower interest rates. Very early into quarterly earnings season, only a handful of issuers having reported CQ1/2019 earnings but results have been solid as aggregate earnings surprise has registered 4.4% thus far.
- **Year-over-year growth as equities lap difficult growth comparables from 2018 as a result of fiscal stimulus tailwinds.** Trade tensions and lower investor and consumer confidence may dampen earnings results. However, the ISM Purchasing Managers' Index (PMI), a leading indicator of economic health and sentiment, recovered nicely from its dip in December 2018 and has hovered around 55, comfortably within expansion territory. PMI readings such as last months are not typically accompanied by a contraction of corporate profitability.

Moderate equity risk premiums edge higher in 2019

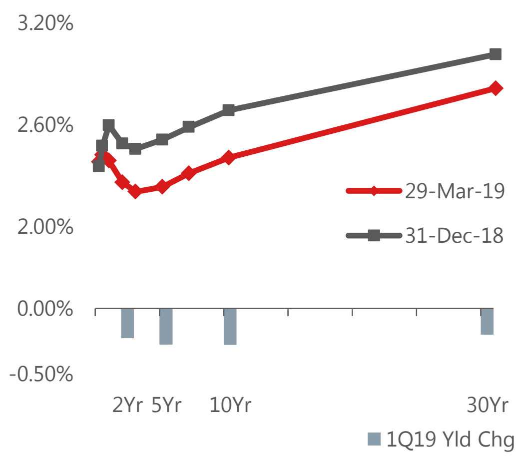
- **Fading equity market optimism has shifted risk premiums modestly higher in 1Q19** as investors digest tighter financial conditions and slower global growth (Figure 5). Investor optimism in 2017 and 2018 was supported by fiscal policy stimulus in the U.S. sending equity markets to record highs. Stocks suffered significant losses at the end of 2018 as investors contemplated the pace of Fed rate hikes, decelerating global growth and U.S.-China trade negotiations. The Fed pause and trade progress has quelled investor fears thus far in 2019 but we do expect to see some incremental equity market volatility in the coming months as quarterly earnings results flow in and geopolitical risks become clearer.

Fixed Income

Canadian Yield Curve



U.S. Yield Curve



Credit fundamentals to remain intact in 2Q2019

- **Investment grade (IG) credits rebounded nicely from there sell-off in 4Q2019 and have traded 27 bps tighter in the quarter**, with most of the tightening occurring in the BBB bracket. Capital inflows into investment grade debt were strong throughout the quarter as fixed income technical indicators supported valuations. Issuance was lower in the quarter when compared to 1Q2018 but those that did come to market priced tighter than expected as investor demand remained strong. We expect credit fundamentals to remain intact throughout the coming quarter despite a deteriorating global outlook and sell-off last quarter. We expect to see limited spread compression in the coming quarter and would recommend being tactically positioned in high quality, liquid issuers and for investors to begin considering extending the duration of their fixed income portfolios.
- **Renewed investor risk appetite drove spreads tighter in 1Q2019** as high yield (HY) debt also experienced solid inflows throughout the quarter. Most of the spread compression came at the top end of the high yield scale with BB rated credits tightened more than their CCC counterparts. Similar to IG credits, we do not expect much further spread tightening in the coming quarter.
- **Preferred share issuance was strong in 1Q2019** with predominately bank NVCC rate reset preferred shares offered. Reset spreads were attractive and new offerings were generally well received. Preferred share performance will likely be dictated by equity market performance and the interest rate outlook. As outlined earlier, we expect some modest upward movement in interest and for equity markets to continue to perform well. We would recommend investors positioning themselves defensively in perpetual or minimum-floor rate reset preferred shares, the top two performing buckets last quarter. Further, we would favour preferred shares that have reset in the last three months or those that reset in at least 12 months.

Figure 6: Fixed income performance by credit rating

	S&P CREDIT RATING	20-YEAR AVERAGE		YIELD TO MATURITY	MATURITY (YEARS)	DURATION	1-YR RETURN	3MO RETURN	CURRENT SPREAD VERSUS 3-YEAR RANGE
		RETURN	DEFAULT RATE						
INVESTMENT GRADE	AAA	5.6%	0%	3.2%	17.0	10.5	5.0%	5.0%	MIN 51 / 61 / MAX 86
	AA	5.0%	0%	3.1%	10.1	6.8	6.0%	5.0%	MIN 53 / 65 / MAX 94
	A	5.0%	0%	3.4%	10.1	7.1	5.1%	3.7%	MIN 72 / 91 / MAX 128
	BBB	5.2%	0%	4.1%	10.8	7.1	5.1%	4.6%	MIN 117 / 154 / MAX 213
NON-INVESTMENT GRADE	BB	6.0%	1%	5.0%	6.1	3.9	4.8%	5.6%	MIN 196 / 223 / MAX 400
	B	6.9%	4%	6.9%	5.4	3.4	6.5%	7.4%	MIN 337 / 410 / MAX 633
	CCC OR LOWER	5.9%	26%	11.7%	5.4	3.2	6.1%	7.3%	MIN 674 / 889 / MAX 1537

Sources: Scotia Wealth Management, Bloomberg

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Standard Deviation is a statistical measurement calculated to indicate the extent of deviation for a group as a whole. The greater the Standard Deviation of an investment, the greater the investment may range in price.