Portfolio Perspectives

OCTOBER 2015

Market Review

The third quarter saw increased volatility and a broad-based selloff in asset prices around the globe. Investor risk appetite waned following macroeconomic events that included a potential Greek sovereign debt default, the surprise Chinese government currency devaluation, an economic slowdown in emerging markets and uncertainty regarding the direction of interest rates by the U.S. Federal Reserve (Fed). In this environment, Canadian equities sank 7.9% for the quarter given ongoing weakness in the energy and materials sectors. U.S. and international equities also declined, falling 6.4% and 10.2%, respectively, for the quarter. The drop was however mitigated in Canadian dollar terms resulting in U.S. equities returning 0.5% and international equities returning -3.6%. Meanwhile, Canadian bonds benefited from their safe haven status and were up 0.2%.

- **Canadian economy shows signs of improvement.** After a cumulative gross domestic product (GDP) decline of 0.9% over the first five months of 2015, the Canadian economy rebounded by nearly 0.8% over the past two months. However, the trade deficit increased primarily on a drop in exports of energy, consumer goods and minerals, and the unemployment rate ticked higher due to a growing workforce. At the same time, Canada finalized talks surrounding the Trans-Pacific Partnership (TPP) trade agreement that will make foreign markets more accessible to Canadian exporters.
- **Fed may raise rates in late 2015**. As the economic recovery continues in the U.S., some economists have grown concerned that it may be facing headwinds as China and emerging markets continue to roil capital markets. Despite these concerns, Fed Chairperson Janet Yellen has said "it will likely be appropriate to raise the target range of the federal funds rate sometime later this year [2015] and to continue boosting short-term rates at a gradual pace thereafter." She cited the probability of increasing inflation which has been the main restraint to a rate increase thus far.
- **Germany approves Greek bailout.** German lawmakers approved a third bailout package for Greece, despite objections from many politicians. Germany now joins the other eurozone nations in approving the deal, paving the way for €86 billion in funds to be released to the Greek government, avoiding a sovereign default. Meanwhile, the President of the European Central Bank (ECB) said that it is ready to release more monetary stimulus into the European economy if inflation and growth continue to disappoint, and if the fallout from the Chinese currency devaluation drags down the European export sector and economy.
- **Slippery slope for Chinese economy.** As the latest slump in trade data shows, the Chinese economy continues to struggle. China has been an engine of global economic activity but after three decades of intermittent double-digit growth, the economy is now struggling to hit a 7% growth rate. As the Peoples Bank of China implements monetary policies such as currency devaluation and interest rate cuts, the International Monetary Fund has signaled that they view China as a continued threat to global economic recovery, having the potential to significantly temper the global growth outlook.

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INDEX (C$)	Change (%) 1 Mth	3 Mth	YTD	1 Yr	Index Level
FTSE TMX Canada 60 Day T-Bill	0.0	0.1	0.5	0.7	158
FTSE TMX Canada Bond Universe	-0.3	0.1	2.5	5.3	985
S&P/TSX Composite	-3.7	-7.9	-7.0	-8.4	13307
S&P 500	-1.1	0.4	9.3	18.8	2572
MSCI EAFE	-4.0	-4.2	6.9	6.5	2203
MSCI Emerging Markets	-1.6	-11.8	-2.2	-3.2	1061

COMMODITIES (US$)	Change (%) 1 Mth	3 Mth	YTD	1 Yr	Price
Gold Spot ($/oz)	-1.7	-4.9	-5.9	-7.7	1115.07
Oil WTI ($/barrel)	-9.7	-25.4	-23.3	-50.5	45.09
Natural Gas ($/MMBtu)	-6.1	-12.0	-16.9	-38.8	2.52

CURRENCIES	Change (%) 1 Mth	3 Mth	YTD	1 Yr	Exchange Rate
C$/US$	-1.3	-6.1	-12.7	-15.9	0.75
C$/Euro	-1.0	-6.5	-5.5	-5.0	0.67
C$/Pound	0.1	-2.5	-10.1	-9.9	0.50
C$/Yen	-2.4	-8.2	-12.6	-8.0	90.05

Source: Bloomberg, as of September 30, 2015.

The Asset Allocation Committee's broad fixed income and equity views are expressed on the following pages. For more information on your specific investment strategy, please contact your Portfolio Manager.

Scotia Private Client Group™

Current View

After months of Greece, China and Fed watching we believe this is an opportune moment to take a step back and try to assess the degree to which the recent sell-off in risk assets is justified by a deterioration in the fundamental backdrop. On the face of it, the current volatility and correction in equity markets is starting to look as if it may be more than a regular late-cycle dip. The catalysts for further weakness might be the upcoming earnings reporting season, a spillover of emerging market challenges into developed markets and further monetary policy uncertainty from the Fed as to the timing of tightening financial conditions.

We acknowledge it may be tough to buy into a market decline that has a number of events at play, and we are increasingly becoming cautious on share prices. However, at this time there are several factors that maintain our interest in equity markets: (1) extreme investor pessimism can quickly reverse on macroeconomic or corporate earnings news that is better than feared; (2) historically, the last quarter of the year has proven to be a seasonally strong period for equities; (3) U.S. domestic demand continues to show resilience despite global macroeconomic tension; (4) the potential remains for further monetary easing from other central banks around the world, particularly the ECB and the Bank of Japan (BoJ); and (5) recently, global currency and commodity prices appear to be stabilizing.

At this point it does seem like long odds to start betting on a perpetual expansion seven years into a recovery. This is not to say that we are forecasting or anticipating the end of the current cycle from a macroeconomic perspective, but it does beg the question as to whether the current issues signal the end of the cycle over the coming couple of years, either through the process of reflexivity or some other mechanism. For now though, this is one of the scenarios among others that we are taking into consideration. We continue to monitor the risks in the marketplace and remain focused on investing in high-quality companies that can weather secular financial market cycles.

The following represents our asset allocation views (as of September 30, 2015):

ASSET ALLOCATION VIEWS		Underweight ◄ Neutral ► Overweight					Change from Last Quarter
Cash	Low yielding environment.	○	●	○	○	○	No change
Bonds	Bias towards high-quality bonds.	○	●	○	○	○	No change
Equities	Focus on companies that can weather secular financial market cycles.	○	○	○	●	○	No change
	Canadian Equity	○	●	○	○	○	No change
	U.S. Equity	○	○	○	●	○	No change
	International Equity	○	○	○	●	○	No change

Note: The term neutral refers to a weighting that is equivalent or close to a portfolio's benchmark.

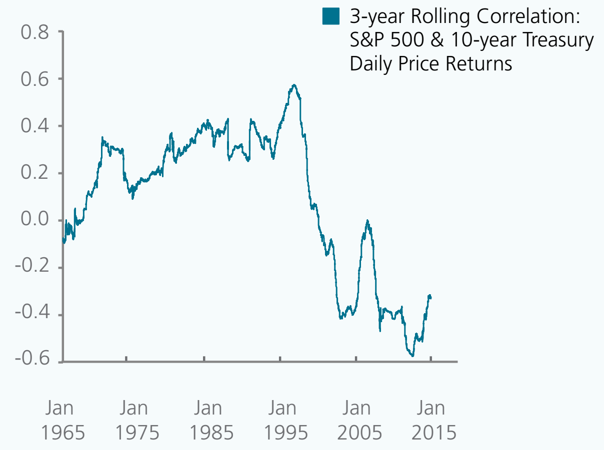
Fixed Income and Currency Views

- **Monetary policy is diverging in North America.** Government bond yields fell over the quarter as worries about slower global economic growth increased. Early in the quarter, the Bank of Canada (BoC) opted to cut its key interest rate to 0.50% to help the Canadian economy rebound from the negative impacts of the commodity downturn. The BoC is likely to keep monetary policy accommodative over the next year, helping the economy transition to one more dependent on business investment and non-energy exports. South of the border, the Fed's policy-making committee held off on raising its near-zero interest rate target at its September meeting amid rocky stock markets and concerns about a global slowdown. Currently, the implied odds of a rate hike in the U.S. before the end of 2015 now sits at approximately 40%, while Treasury bond investors don't expect any policy tightening until at least the spring of 2016.

- **Maintain focus on high-quality investment grade bonds.** While bonds look expensive on almost any fundamental metric we track, they should provide some performance ballast to a balanced portfolio assuming lingering equity volatility and given their negative performance correlation to the equity market over time (figure 1). Some onlookers posit that this negative correlation could break down at any moment although we believe the relationship – which has been in place since the late-1990 Thai baht crisis – will persist as long as global inflation rates remain at historically low levels.

- **Canadian dollar remains levered to commodity prices.** Recently, the Canadian dollar has climbed to a two-month high alongside a rally in crude oil. In the short term, the Canadian dollar could bounce around its current levels. However longer term we believe the Canadian dollar should continue to weaken relative to the U.S. dollar given potentially widening interest rate differentials between Canada and the U.S., softening commodity prices and a rising Canadian federal budget deficit.

Figure 1: Correlation of U.S. stocks to bonds



Source: 1832 Asset Management, Haver Analytics

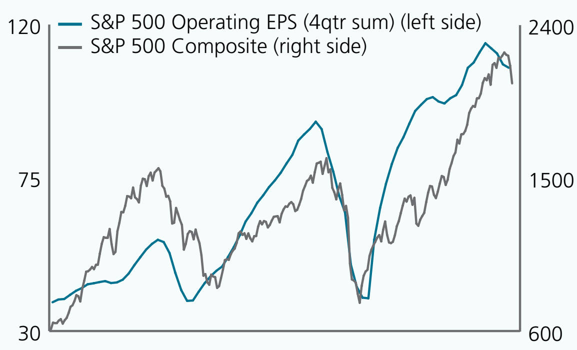
(Correlation is a statistical measure that indicates the extent to which two variables fluctuate together. A positive correlation indicates the extent to which those variables increase or decrease in parallel; a negative correlation indicates the extent to which one variable increases as the other decreases.)

Equity

- **Canadian equity markets underperform.** The Canadian equity market posted negative returns, largely driven by the impact of falling commodity prices on the energy and materials sectors. The health care sector also detracted from performance while consumer staples and telecommunications services, both considered defensive sectors, were the top performers. More recently, the S&P/TSX Composite Index has rallied off its lows on rising energy prices while volatility has subsided, relatively speaking. Overall housing activity in Canada has improved with housing starts surging unexpectedly in September, while new home prices also beat forecasts in August, prolonging a housing boom in the country despite signs of weakness in other parts of the economy. With the federal election finally concluded and Justin Trudeau's Liberals taking a majority, the impact this will have on capital markets in the long run is uncertain. One effect will be how much of a deficit the new government will incur as historically higher deficits are a longer-term weight on the Canadian dollar.

- **U.S. companies reporting season kicks off.** The third quarter reporting season is upon us and investors will once again turn their attention towards the flurry of earnings data set to flood the newswires over the coming weeks. This quarter, however, may be of increased importance given the mounting negativity in the market over the past two months. Heightened volatility and selling pressure in equity markets have left investors nervous and uncertain on the direction of stocks. Earnings are the lifeblood for equities and if the recent sideways earnings action is extended, we think that 'flat' could be the new 'up' for share prices (figure 2). As the earnings season unfolds we will receive more clarity from corporations about their health and any important marginal changes in end market demand.

Figure 2: S&P 500 Index and operating earnings



Source: 1832 Asset Management, Haver Analytics

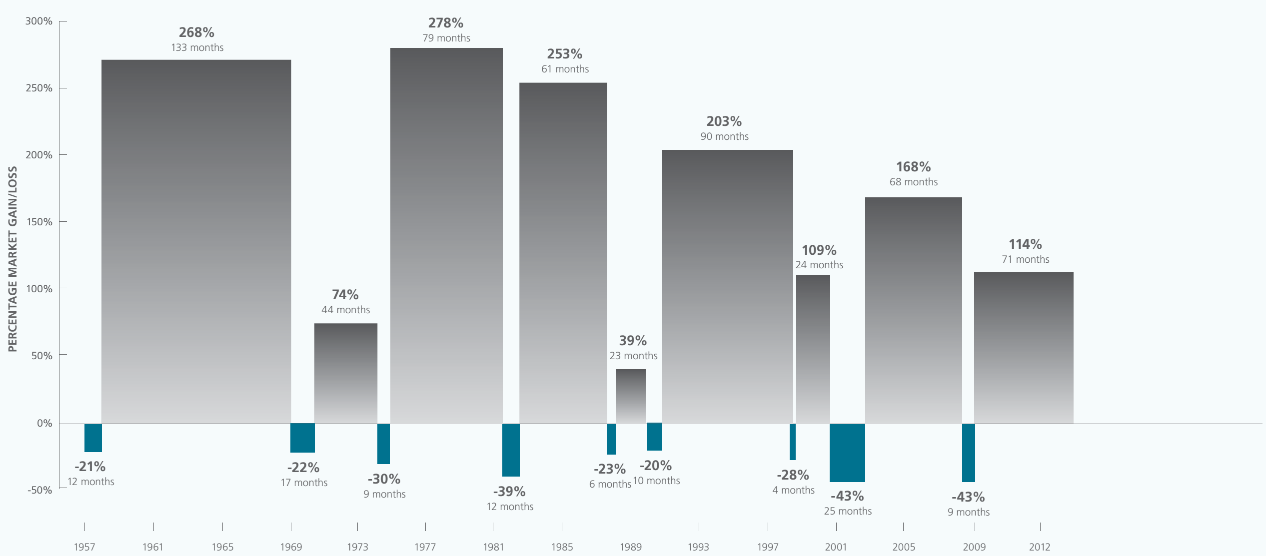
- **Emerging markets remain challenged.** Emerging market activity remains weak and deflationary. As a result, several international central banks are in easing mode which is creating a policy path divergence that might continue to strategically support the U.S. dollar. A stronger U.S. dollar could magnify global financial market tension as it aggravates emerging market liquidity conditions through capital outflows and concerns over the ability of private-sector corporations to service their U.S. dollar-denominated debt. The latest reported economic data from the regions shows some degree of economic stress. One example of economic growth contracting can be seen in Brazil where interest rates are rising and the currency is collapsing. To place this situation in perspective, the Brazilian economy is nine times larger than that of Greece. Russia is another problem, where the fairly deep growth contraction has kept sovereign risks elevated.

- **Bright spots in Europe and Japan.** There has been a string of German data recently, such as factory orders and industrial production, which suggests a potential hiccup for the country. That said, leading indicators such as the IFO Business Climate Index continue to point to improvement for Germany. Meanwhile the latest Japanese unemployment rate ticked higher to 3.4% from 3.3%, but remains near its lowest level since 1997. It appears as though the eurozone and Japanese central banks are inching ever closer to adopting an even more aggressive monetary stimulus stance. The ECB still sees a large output gap, negative headline inflation and risks posed by the turbulence in developing economies. In Japan, the BoJ probably views muted wage growth and a below-target inflation rate as reasons enough to accelerate their program of qualitative and quantitative easing. Both central banks could take action before year's end.

- **Time in the market trumps timing the market.** When markets are as turbulent as they have been in the past few months, it can be a trying time for investors. Our objective as portfolio managers is to invest our client's money in great businesses that are trading at discounts to what we believe they are worth. Over the past few months, a number of companies that we own have sold off significantly for no other reason than they are being painted with the same brush as the rest of the market and many investors have reacted emotionally to the current environment. When the market acts irrationally and tosses out good companies with the bad it provides us with buying opportunities. We believe that is what we are seeing in certain sectors of the market. This doesn't mean that stocks can't go lower in the short term, however, in the long run we have seen that fundamentals win (figure 3). As a result of our investment process, we had held some cash when we thought that equity valuations had become stretched. This also has given us the ability recently to make opportune investments in attractive companies.

Overall, we are clearly working through a more uncertain macro environment. The outlook is clouded by monetary policy uncertainty, disappointing Chinese economic activity and a deepening slump in emerging markets. Our portfolios are positioned in high-quality asset choices - quality growth in equities and high-grade assets in fixed income. This should enhance stability in portfolios during what might prove to be lingering choppiness in the markets over the short term.

Figure 3: S&P/TSX Composite Returns since 1957



Source: Bloomberg. Percentage market gain/loss based on monthly compounded returns from the S&P/ TSX Composite Total Return Index from January 31, 1957 to December 31, 2014. Returns are calculated in Canadian currency. Assumes reinvestment of all income and no transaction costs or taxes. The terms bull market and bear market describe upward and downward market trends, respectively. Bull markets are movements in the stock market in which prices are rising and the consensus is that prices will continue moving upward. Bear markets are the opposite – stock prices are falling, and the view is that they will continue falling. In the above illustration, the generally accepted measure of a price increase or decline of 20% or more, respectively, over any given period, has been adopted.