

Inside **INNOVA**

Innovation by design.

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The Great Divide

From disparate central bank policies to contrasting global economic prospects, 2014 can be summed up in one word – divergence.

U.S. regains its heavyweight status

The bears were in deep hibernation in 2014, as U.S. equity markets led the world through a sustained bull market that pushed major indices to all-time highs before selling off slightly. The S&P 500 returned 24.2% in Canadian dollar terms for the

year, with approximately 23% of stocks hitting 52-week highs and the vast majority of earnings reports meeting or beating Wall Street's expectations. Not to be outshone by the market, the U.S. economy was also a beacon for the rest of the world. Sustained job growth, continued housing gains,

increased business investment and consumer confidence have left little doubt that the stars and stripes can indeed "get it right."

The road less traveled

The U.S. Federal Reserve (the Fed) made good on its well-telegraphed commitment by announcing an end to its

long-running stimulus program that funneled over \$2 trillion into the U.S. economy since 2008. Of the markets impacted by the move, currencies and commodities were front and centre. The U.S. dollar strengthened against a basket of its global peers, recording multiple 7-year highs against the yen, which felt the weight of aggressive stimulus measures in Japan. Alongside the strong greenback, commodity prices fell to multi-year lows. Among the hardest hit was crude oil, which declined 41.6% for the year. While consumers enjoyed a break at the pump, lower prices and over supply posed significant headwinds for energy sector stocks. With the energy sector representing almost a quarter of the S&P/TSX Composite Index, Canada was significantly impacted by the rout in prices. Despite the drag, Canadian equities ended the year up 10.5%.

What you see is not always what you get

With improving economic and market fundamentals, a seemingly more hawkish Fed



Index Performance

Year-end (as at Dec.31, 2014,C\$)

- ▲ 10.5% Canadian equities (S&P/TSX Composite Index)
- ▲ 24.2% U.S. equities (S&P 500 Index)
- ▲ 15.5% Global equities (MSCI World Index)
- ▲ 7.1% Emerging markets (MSCI Emerging Markets Index)
- ▲ 8.8% Canadian bonds (FTSE TMX Canada Universe Bond)

Source: Bloomberg

The Great Divide (continued)

and record low interest rates, the die looked to be cast for a sell-off in bonds. Despite the typical playbook for rising yields and falling prices, both U.S. and Canadian bond yields fell while prices rose, leaving the fixed income asset class ahead for the year.

A light at the end of the tunnel?

Europe spent most of 2014 facing economic headwinds, as manufacturing, job growth and business investment declines were recorded in most leading eurozone nations, notably Germany, France and Italy. This was compounded by heightened deflationary pressures (coined lowflation); with the lower pitch reflecting slumping oil prices and growth prospects. In response to the growing risk – and to reignite its sputtering economy – the European Central Bank (ECB) introduced its own version of Quantitative Easing. The

program includes cutting interest rates while simultaneously purchasing asset-backed securities. Despite the economic doom and gloom, European equity markets remained resilient, posting a respectable 7.63% gain in 2014.

Easy money not so easy after all

Japan's Abenomics – the policy of unprecedented monetary easing, stimulus spending and structural reform named after Prime Minister Shinzo Abe – took centre stage in the world's third largest economy.

After slipping into a recession that saw the economy contract by 1.9% in annual terms in the third

quarter, many have suggested that some of the economic revitalization program's measures were ill-conceived. Prime Minister Abe called an early election on the news (which he ended up winning with a supermajority) in hopes of delaying a sales tax increase that has wreaked havoc on

growth. Markets have breathed a collective sigh of relief, with the Nikkei 225 closing the year up 8.91% in 2014.

Meanwhile, the economic mood was equally sour in the emerging markets. Russia's conflict

with Ukraine limited growth, as economic sanctions took their toll on the domestic economy. China saw its growth decline to levels not seen for over two decades. The country missed its GDP growth target for the first time since 1999, prompting the People's Bank of China (PBOC) to cut its benchmark interest rate for the first time since July 2012. Despite the economic fear factors, emerging markets still posted positive returns for the year. ■



Mario Draghi
President of the European Central Bank

**Portfolio Performance** (as at December 31, 2014)

	3 Mths	6 Mths	1 Yr	3 Yrs	5 Yrs	Since Inception
Scotia INNOVA® Portfolios Series A						
Scotia INNOVA Income	1.75%	2.44%	6.97%	5.57%	5.28%	6.41%*
Scotia INNOVA Balanced Income	1.87%	2.64%	7.60%	7.21%	5.95%	7.63%*
Scotia INNOVA Balanced Growth	2.35%	3.20%	8.81%	9.53%	6.86%	8.84%*
Scotia INNOVA Growth	2.60%	3.38%	9.40%	11.33%	7.47%	10.03%*
Scotia INNOVA Maximum Growth	2.83%	3.55%	9.61%	14.14%	8.39%	11.17%*

* January 19, 2009

Commissions, trailing commissions, management fees and expenses may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed or insured by the Canada Deposit Insurance Corporation or any other government deposit insurer, their values change frequently and past performance may not be repeated. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and does not take into account sales, redemption, distribution or optional charges or income taxes payable by any securityholder that would have reduced returns.

Top Themes for 2015

As we settle into the New Year, thoughts turn to what to expect on the investment horizon. Here are some themes that could dominate headlines in 2015.

1 U.S. leads developed markets, emerging markets slow

U.S. GDP growth is expected to accelerate in 2015, largely on the back of a more upbeat labour market and consumer spending profile.

Growth for the BRIC nations (Brazil, Russia, India and China) could continue to beat those delivered by developed markets, but momentum could moderate further due to ongoing challenges in these regions and an extended slowdown

in Chinese GDP growth.

2 More upside for the U.S. dollar

The U.S. dollar may have more upside potential this year, particularly against the euro and yen where central banks have maintained aggressive monetary easing. Not only are rate differentials likely to move in favour of the U.S. dollar as the U.S. Federal Reserve Board closes in on a rate hike, but booming domestic oil production and lower oil prices should also prove beneficial to the U.S. dollar.

3 North American stocks outperform bonds

Equities are likely to outperform bonds in the year ahead given attractive relative value and signs of ongoing economic improvement. Over the past 35 years, U.S. equities have outperformed bonds during periods of economic improvement, while lagging through periods of economic deterioration.

4 Higher volatility ahead

Historical equity price volatility is near the bottom end of its historic range. But

Continued on page 4...



Lowflation – Meet deflation's scary pal – lowflation. New on the scene and potentially twice as mean, this bully rears its ugly head when prices are increasing, but not fast enough to offer the economic benefits of normal inflation. The term was coined in the wake of the eurozone's sputtering economy. This characterization seems fitting given what's happened in Europe over the past year –

sustained ultra-low, albeit rising inflation that has limited output, hurt employment and revived the memories of Europe's 2011 melt-down.

Easy money – In what seems to be a cruel joke on the working population, this oxymoron gained prominence after the 2008 recession. In its most literal sense, the term "easy money" means "money that is easily acquired." More

specifically however, it refers to the condition of the economy's money supply. After markets were rattled in 2008, the U.S. Federal Reserve allowed cash flow to build up within the banking system. This lowered interest rates and made it easier for the struggling U.S. banks to lend money – thus allowing borrowers to acquire money more cheaply. For better or for worse, easy money has been the reality of the global economy for the past 6 years, and 2014 may prove to be the turning point toward "not-so" easy money; in the U.S. at least.

Dovish vs. Hawkish –

Seemingly a mismatch on paper, you may be surprised which bird has dominated

the economic ring for the past 6 years. The terms refer to the mood implied by the Fed when making moves on interest rates. "Dovish" signals that interest rates may be going down. Conversely, "hawkish" signals that interest rates may be on the rise. Since the financial crisis in 2008, the Fed has undoubtedly been "dovish" – setting record low interest rates that have persisted for a record amount of time. However, with renewed vigour and tenacity in the U.S. markets of late, the "hawks" have begun to sharpen their claws. ■

The Top 6 Themes for 2015 (continued)

economies and monetary policy settings are diverging. While this is likely to create opportunity, it will at times generate more uncertainty and contribute to higher asset price volatility.

5 Energy sector rebounds

Readings in the energy sector indicate it has been oversold, which could bode well for a relief rally. However, the long-term energy outlook isn't nearly as rosy as it once was, given ample supply, sluggish demand and the usual performance headwinds associated with ongoing U.S. dollar strength.

6 Share buybacks and acquisitions continue

Since 2011, U.S. companies have bought back approximately \$1.5 trillion of their shares. Companies will likely continue to use cheap funding in order to repurchase their own shares or the shares of other companies via acquisitions. This form of corporate funding may also contribute to the ongoing slide in the number of publicly listed equities. ■

WORDS FROM THE WISE



Insights* from some of our top investment minds

“ We believe the best way to manage risk is to be diversified, don't make large sector allocations, and have some cash to take advantage of the opportunities that arise when the inevitable volatility comes.”

Jason Gibbs, Vice President and Portfolio Manager,
Scotia Canadian Dividend Fund

“ Playing defense is always appropriate and reflected in our philosophy of “Preservation first. Growth second.” In investing, just as in sports, we believe winning by not losing is a recipe for success.”

Adam Donsky, Vice President and Portfolio Manager,
Scotia Private Canadian Equity Pool

“ We are not market timers, but we do believe the strong returns of the past five years are likely running out of steam. While not bearish, with quantitative easing ending, we do not expect this same level of absolute returns to continue over the next five years.”

Robert Lanphier and David Ricci,
Co-Managers, William Blair & Company (Sub-advisor to Scotia Private U.S. Mid Cap Growth Pool)

“ In 2015, we expect modest returns from bonds as interest rates normalize.”

Romas Budd, Vice President and Portfolio Manager,
Scotia Canadian Income Fund ■

* As of January 2015

Notable Moments in

2014

Not ready to “let it go”...

For anyone who spends time with little girls of a “certain age”, or, opened their doors to a long line of Elsas on Halloween this year, it will come as no surprise that the movie Frozen has captivated people's imaginations. In fact, according to the UK website, BabyCentre, the name Elsa, has shot up the list there cracking the top 100 from more than

200 spots below the year before!

Why carry when you can wear?

2014 is the year when the latest evolution of wearable technology truly took hold. With everything from e-mail enabled watches to fitness trackers to biometric clothing there's never been an easier time to be wired. It's also never been harder to lie (to yourself) about how

active you really are!

If nice guys finish last, perhaps grumpy felines finish first. The cat that launched a thousand memes may also be grumping all the way to the bank with over 7 million likes on Facebook and over 250,000 followers on Twitter. Seems like it doesn't always pay to “turn that frown upside down!” ■

Know thy social network

It's hard to believe that Facebook is already ten years old, and social media is in its teens. What was once accomplished with pen, paper and postage stamps has been rendered virtually obsolete by advances in computing and networking technology.

It seems that every year, more and more social networks are born, making it a challenge to keep up with all the newcomers. While many have heard of Facebook, LinkedIn and Twitter, we've created a short list to help you navigate some of the other popular networks.

reddit – Certainly not a newcomer to the scene (it has been around since 2005); reddit labels itself as the

“front page of the internet” and has over 170 million users. Members can post content to categories, known as “subreddits,” which are ranked by other users according to usefulness. reddit is popular for hosting “Ask Me Anything” question

and answer sessions with experts in any field, including actors, scientists, and political officials.

Snapchat – This popular app allows users to take photos and videos, allowing them to be sent to anyone on their list. The twist is that users set a time limit on how long the recipient can view the message before it disappears.

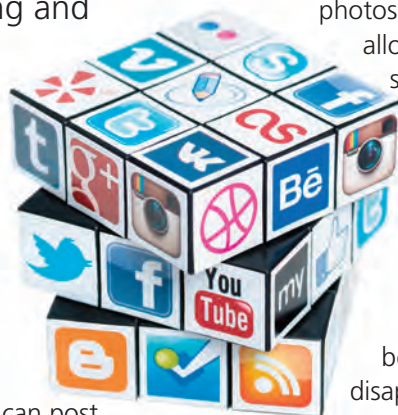
Pinterest, Tumblr and Instagram – Popular with those who prefer images to text, members interact and create content using images, videos or other graphical media.

Pinterest allows users to create and curate pages based on any theme they choose, with content being ‘pinned’ onto the page.

Tumblr is a microblogging network which allows the posting of media-rich content on a short-form blog, and is currently host to 213 million blogs.

Instagram is similar to Facebook but heavier on photos and videos. Users can simultaneously deliver the same content to other networks including Twitter and Facebook. Instagram has over 300 million users and was acquired by Facebook in 2012.

There are many more social media networks in the digital world to consider. Given the transformative times we live in, it's clear that there's no end of innovation to be explored at our fingertips! ■



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