Here’s What We’re Thinking

ScotiaMcLeod Portfolio Advisory Group

June 30, 2015

Volatility likely to continue, but buying opportunities starting to emerge

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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 continue, but buying opportunities starting to emerge**

- **Equities**: We have been anticipating elevated market volatility, whether it's coming from Greece's debt crisis (see below), the Fed's interest rate intentions, or uneven economic data. Troubling as the headlines may appear, we think the risk of contagion is lower than previous debt crises and we see market weakness as an opportunity rather than a reason to panic. Earlier this year we moved to a neutral stance on both Canadian and U.S. equities and have been recommending higher than normal cash balances as a strategy to ride out the current bout of volatility. Although recent geopolitical concerns have wiped out YTD gains in both Canadian and U.S. equity markets we continue to expect mid-single digit returns in these markets on a full year basis. As such, we are seeking opportunities to deploy excess cash during the current volatility into relatively conservative, large-cap, dividend-paying companies.
- **Fixed income**: Given current information and expected probabilities, we continue to view the potential impact of global macro risks as being transitory. With Europe having increasingly ring-fenced itself from contagion risk we think the market and economic impact of a potential Greek default would largely be contained to Greece. A "yes" vote would likely be met with the exit of the Tsipras government, serving as a positive for global markets (negative for bonds). With probabilities, in our view, modestly favoring either an 11th hour deal or a "yes" vote, we believe the rally in bonds is likely to fade in the near term. Counterbalancing these near-term rate risks are our expectations for Canadian economic data to potentially remain on the softer side in Q2 and potentially H2. Canadian April GDP data remained in contraction territory printing at -0.1% MoM. As the impact of lower oil continues to feed through the oil patch over the balance of the year, the Bank of Canada could once again find itself embracing an easing bias. Persistent macro headwinds including Greece, a Puerto Rican debt restructuring and a slowing China could give the Fed pause and delay liftoff. In the near term, the market will likely look past these downside risks leaving rates vulnerable, particularly if the developments in Greece improve quickly. Given the balance of risks, our duration bias would be neutral to shorter with a continued focus on higher quality paper as credit spreads have come under some pressure as a result of the recent flight to quality: corporate exposures in 1-5 year GICs; longer duration exposures should be in higher quality/liquid bank and provincial paper; we remain cautious on high yield.
- **Preferreds**: As quarterly and monthly statements are released shortly, investors will see another month of negative returns from the preferred share segment of their portfolios. Additionally, the recent risk-off market tone relating to Greece has not helped with pricing. However, while we still anticipate the summer months to be illiquid and potentially volatile there are many longer dated rate reset securities which offer investors an attractive dividend yield with the potential for capital gains. For investors holding (2018+) rate resets, we recommend continuing to hold with the expectation that the 5-year bond yield will be higher in the future, which should also move prices higher. For investors with a longer term investment horizon we recommend picking away at longer dated investment grade rate resets which offer a compelling yield.

Geopolitical**: *Greek tragedy enters climax stage… the global economy is better insulated this time around***

- Greece's current bailout program, under which Greece has been able to draw ongoing funding, expires today (June 30). Over the last several months Greece has been negotiating, without much success, an extension of its massive debt with its primary creditors: the European Union, the European Central Bank and the International Monetary Fund, collectively called the "troika." The creditors are demanding reforms to taxes and pensions while the new Greek government led by the left-leaning Syriza Party has only offered limited structural reforms. This has created a stalemate and with Greece due to make a 1.6 billion euro payment to the IMF today it appears highly likely that they will miss this payment and therefore trigger an unofficial default. Greece has a further 12 billion euros in bond maturities and term loans due by the end of August. To preserve liquidity, Greece instituted capital controls over the weekend by announcing the closure of its stock market and its banks for one week with a maximum daily withdrawal 60 euros per day via ATMs. The Greek situation remains highly fluid and in the absence of other material market news Greece will continue to dominate headlines and market sentiment.
- On July 5th Greece will hold a referendum on the proposals of the creditors and ask the Greek people to accept or reject these tough reforms. Despite massive rallies being held by the "no" side, it appears that popular opinion is evenly split. Many reporters/columnists see the referendum as a direct vote on Greece's membership in the European Union but this appears to be far from the truth as the majority of Greek people want to stay in the European Union and want to keep the euro currency as they see a return to the drachma as having a significant detrimental effect on their personal wealth due to what will no doubt be a massive devaluation of their currency should they leave. The outcome of the snap referendum, where the populace doesn't fully understand the details of the reforms in question, is unlikely to materially reduce the uncertainty for Greece as either outcome leads to more negotiations. A "yes" vote will likely mean fresh elections and a mandate for the new government to finalize a deal with the troika. A "no" vote could initiate negotiations for an eventual Greek exit ("Grexit") from the EU and euro, something that was never contemplated when the EU was formed. Although a "yes" vote is the market's preferred outcome, in both cases the market will have to cope with ongoing volatility. As we publish this report, headlines are indicating that Greece's Prime Minister, Alexis Tsipras, has asked the troika for a two year extension to its current bailout program along with a debt restructuring plan. The proposal, seen as a last-ditch effort, was silent on whether Greece would accept the reforms being sought by its creditors.
- The recent weakness in equity markets is due to the risk of contagion where other countries such as Spain, Italy and Portugal are potentially forced out or opt out of the EU, damaging the framework that has been built over the last few decades. The negative impact of a potentially larger exodus from the EU would almost certainly hurt the European economy and could ripple across the global economy. However, unlike similar situations in 2011 and 2012, we think the risk of contagion is lower at present. Indeed, the troika's recent hardline negotiation tactics with Greece reveal its confidence that the European economy can withstand a Grexit. Through these tactics the troika also hopes to avoid a moral hazard that could encourage other countries to renege on commitments. Since the initial crises, the European Central Bank has been given the necessary financial tools to intervene and calm markets, balance sheets of global financial institutions are no longer plagued with tainted Greek debt, and the European economy is in recovery mode. In short, the global economy is much better positioned to withstand a negative Greek outcome.
- Meanwhile, as if the Greek debt crisis wasn't enough, Puerto Rico's governor announced on Monday that the territory is unable to repay its massive US$72B of debt. Unlike Greek debt that is no longer on the books of most financial institutions, it is widely believed that Puerto Rican debt is held by a myriad of municipal bond funds and other institutional investors. This development is also fluid and could keep investor sentiment in check.

- Negotiations surrounding Iran’s nuclear program and the potential lifting of sanctions are going down to the wire and the June 30 deadline could be extended a few days as both sides have cited recent progress. An agreement could result in Iranian oil exports increasing 0.5M-1.0M barrels/day over the coming months, potentially impacting global oil priced in the near-term.

Portfolio Advisory Group

Recommended Asset Allocation

June 30, 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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