Market Snapshot – February 2016

February 8, 2016

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Insights for the Year Ahead

By Joe Zawawi

Every January, HollisWealth advisors from across Canada convene to attend the Private Client Research group's Year Ahead Investment Conference. This event, which has been running for ten years, showcases expert insights from some of the brightest minds in the investment business. While the event always occurs in mid-January, the timing of this year's conference could not have been better given the tough times the markets have experienced since the start of the year.

While the presentations throughout the day explored a variety of matters and the perspectives brought forward inspired deeper thinking, a common theme seemed to emerge: we have entered a year where sluggish global growth will likely weigh on the markets, and the road ahead is going to be a relatively bumpy and volatile ride. But also highlighted were some reasons for optimism.

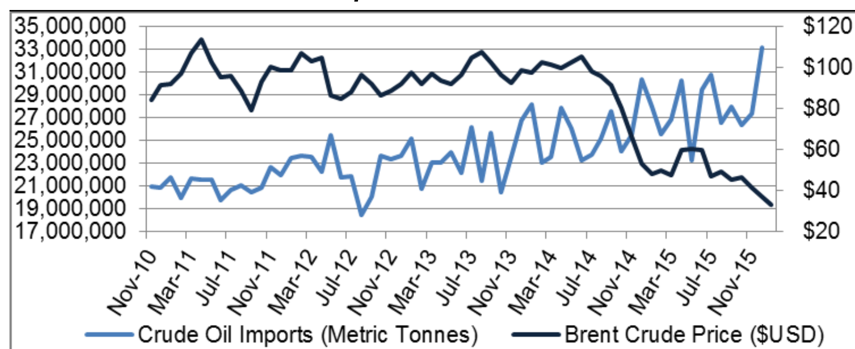
For this Monthly, we are going to highlight the key points discussed by the speakers.

Oil – Supply or Demand?

Scotiabank's Commodity Market Specialist, Patricia Mohr, presented her opinion on precious metals, base metals, and oil. The ramifications of sustained lower energy prices on corporate earnings and economic growth are broad. In a net energy exporting nation such as Canada, where oil pays the rent, low prices have taken a toll on the energy sector itself. This has led to significant cuts in capital expenditures and lower values for exports out of the oil patch, both of which have been a drag on aggregate GDP. The other side of the story is that suppressed prices act as stimulus for net energy importing nations, such as the U.S. Lower energy prices are also viewed as a de facto tax cut for consumers as savings are shifted from producers to consumers.

Mohr's view is that the substantial slide in oil prices has been the result of supply-side factors. This has not been a demand issue. Demand for oil on the world market in aggregate has never been higher; it currently sits around 94 million barrels per day. However, supply has also never been higher – around 96 million barrels are being produced per day. Given that China is now the world's largest net importer of oil, it is commonly cited as a threat to demand. This is because of concerns that slowing economic growth there may translate into lower demand for oil. These fears are in part of what contributed to the drastic price decline during January that pushed crude under $30. Demand for most commodities out of China including oil, however, is still growing. In fact, China's crude oil imports are at all-time highs and rose 8.8% in 2015.

Chart I: China's Crude Oil Imports vs. Price of Brent Crude



Source: Bloomberg, HollisWealth

Any rebound in oil prices would therefore most likely be a result of moderating supplies. Saudi Arabia remains determined to protect its market share and is not interested in cutting production. Because of this, output from the U.S. has begun to edge down slightly, but production cuts have been limited so far. This data runs with a lag, however, and there is the potential for further production shutdowns to appear in the data moving forward. Increasing global demand coupled with gradually tightening supplies could work as significant tailwinds. Mohr believes 2016 may be a transition year. She feels WTI prices could average between $35-$40 USD in 2016 and does not believe a drop to below $25 will occur in the short term, as this is near the cash cost of production for most U.S. producers. A stabilization of oil prices at a higher level would boost earnings and act as a significant positive for the TSX. Oil and gas make up about 40% of all Canada's commodity exports so higher

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prices would also bode well for economic growth overall.

China

Reports of China's volatile currency, contracting manufacturing activity, labour unrest, opaque data, and a softening growth profile overall are headline news these days.

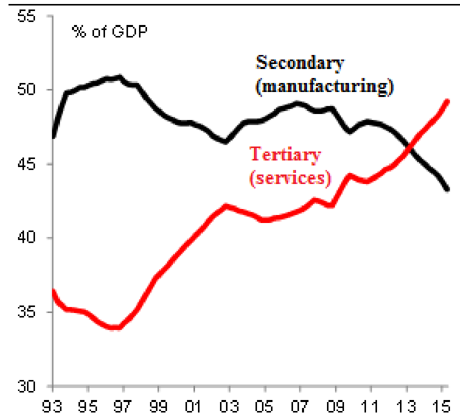
Why does China matter? Because its economy is the second largest in the world, behind the United States. A sharp slowdown in the Chinese economy would significantly hinder global growth through knock-on effects for global corporations and emerging markets. Derek Holt, Vice President of Economics at Scotiabank shared some very intriguing insights and opinions on some of these issues.

One of the main concerns has been the value of the yuan. The sharp selloff in global financial markets following August's surprise devaluation of the Chinese currency is a good example of how this is weighing on investors' minds. Chinese authorities have lost the faith of market participants and Chinese savers who are now aggressively looking to swap yuan for U.S. dollars. Over the past 10 years, the yuan has significantly appreciated and this has begun to weigh on China's competitiveness as an exporter. A cheaper currency would benefit exporters but would increase the magnitude of capital outflows. China is now trying to control the depreciation of its currency without allowing it to go into a freefall. To carry this out, China is using its war chest of foreign exchange reserves to prop up the yuan. The silver lining in this is that these yuan purchases are effectively re-deploying China's excessive savings into more productive channels around the globe, which assists in the rebalancing of the world economy.

Another reason markets have lost confidence is because of the data put out by Chinese authorities. There are suspicions that GDP data may be inflated. For instance, the Chinese reported that export growth to South Korea in December 2015 grew at a 1% clip on a year-over-year basis. At the same time South Korea reported a 20% decline in Chinese imports. That's a massive discrepancy, and very few would suggest the Chinese data holds much water. GDP figures can only be trusted as much as the trade data can be trusted.

There are reasons for optimism, however. In the past few years, China's services sector has been resilient – a sign that the economy is developing. The services sector now comprises over 50% of GDP. Furthermore, the slowdown in manufacturing should come as no surprise to markets given that this shift was an ambition of the Chinese for quite some time.

Chart II: Manufacturing Contracting and Services Sector Growing; as Percentage of GDP



Source: Scotiabank Economics

In addition, residential real estate prices have also stabilized and are beginning to come back up. This can have positive effects on consumption as homeowners' wealth increases. Fiscal policy also has been proactive in addressing challenges as the government actively spends to spur the economy on projects such as infrastructure. In 2015, China achieved 6.9% GDP growth overall. Scotiabank Economics sees this figure slowing to 6.4% in 2016, and 6.2% in 2017. Although growth is expected to slow, the Chinese economy is approaching a more sustainable rate of expansion.

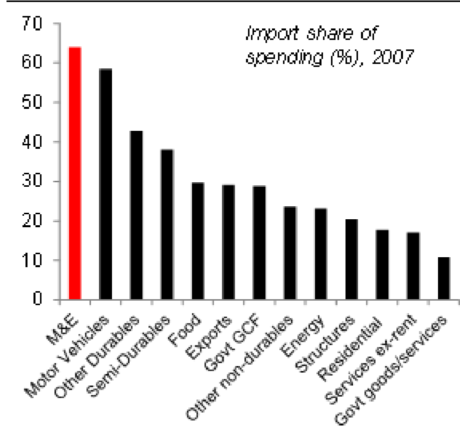
Canada - Between a Rock and a Hard Place

At home, suppressed energy prices are continuing to take their toll on investors' nerves, and all eyes are on the Bank of Canada (BoC). Derek Holt examined whether further rate cuts would have any positive outcomes, particularly for the oil patch where it is needed most. So far there has been about a jaw-dropping 40% drop in energy sector capital expenditures, and this contraction has also been a big weight on aggregate GDP. The two most notable and likely outcomes of lowering short term interest rates are that the currency will depreciate and borrowing rates decrease, which are generally viewed as stimulative. However, it was suggested that continued monetary easing may bring forth more issues than it would be solving,

and here's why:

BoC Governor Poloz has said that further devaluation of the loonie will hopefully benefit other areas of the economy such as manufacturers and exporters and offset some of the slowdown in growth in Western Canada. This has yet to be seen as Canadian GDP growth excluding energy has been slowing. There are two reasons why a cheaper loonie has failed to spur growth so far: sluggish global growth has softened demand for exports, and high import propensities are contributing to rising inflation. As seen in Chart III, capital goods, which would include machinery used by businesses, make up the largest share of total spending on imports, followed by autos, durables and food. A cheaper loonie is effectively importing inflation through these large ticket and widely-used items. With inflation on the rise and core inflation already around the BoC's target of 2%, debasing the currency further could drive prices higher and deteriorate businesses and consumer's purchasing power further.

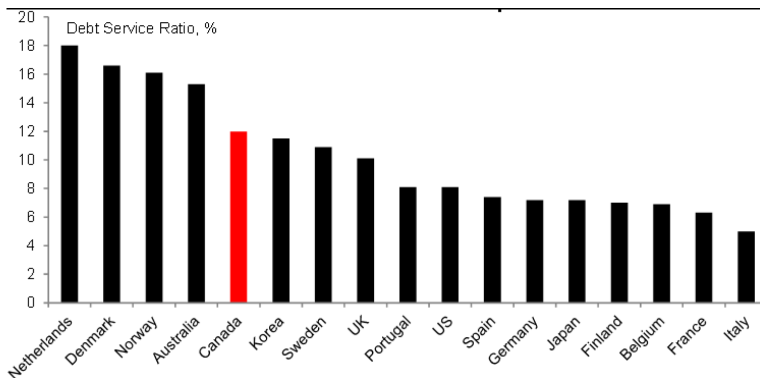
Chart III: Canada's Import Share of Spending



Source: Scotiabank Economics

Myles Zyblock, Chief Investment Strategist at Dynamic Funds, also weighed in on how lower borrowing costs have done little to spur overall growth. His view is that this can partially be attributed to the fact that the price of oil matters more than decreased borrowing expenses do for energy businesses' bottom lines. Stretched Canadian household finances are also limiting potential strength through consumer spending. Household debt sits at cycle highs, with the ratio of debt payments to after-tax income being among the top 5 in the world in terms of stress. Increased purchasing power from borrowing has become highly constrained as a result. Consumer spending makes up approximately 55% of GDP, and given that growth in previous years came from the levering up and spending by households, this is translating into lower demand.

Chart IV: Household Debt Service Comparison



Source: Scotiabank Economics

With the central bank up against the wall, other areas are providing reasons for optimism. Fiscal stimulus through planned infrastructure spending for one could work towards boosting the economy. In addition, the fiscal budget set to be presented in April could add some additional, much-needed stimulus which would begin to take effect closer to the end of the year. Both Holt and Zyblock shared the opinion that the most influential improvement for the Canadian economy would be a stabilization of energy prices to boost energy sector earnings, which is a possibility if 2016 indeed does turn out to be a transition year for oil.

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U.S. Monetary Policy

The U.S. remains a relative bright spot, but this is not without its own speed bumps. Increased market volatility has very much been driven by uncertainty regarding the path of short term interest rates. In December the Fed kicked off a potential rate hike cycle by increasing its key rate by 0.25%. The move was met with much controversy as it deviates significantly from the policies of many of the world's other central banks where the bias is towards more monetary easing. The Fed also laid out their future predicted federal funds rate targets, which outlined the possibility of four more rate hikes to come this year.

Advisors were also witness to a discussion panel comprised of Marc-André Gaudreau of Dynamic Funds, Bob Swanson of Cambridge Global Asset Management and Paul Taylor of BMO Asset Management, where one of the points discussed was the possible path of interest rates. The consensus was that the U.S. economy will not be able to handle four rate increases this year, and that any additional increases could prove to be detrimental for financial markets over the short term. The shared view was that the Fed will move slowly, and we are now in the most muted hiking cycle in history. A slower pace for rate hikes generally bodes well for equity markets as this allows investors more time to digest the changes.

Another important headwind that was discussed was the unwinding effect that could come about as a result of further USD appreciation. Foreign entities have borrowed substantially in U.S. dollar denominated debt, and a stronger greenback creates large issues for the foreign borrowers as they must now repay loans denominated in a stronger currency than their own. In addition, the strong USD coupled with slow global growth could create a drag on earnings for American corporates with significant international operations.

The panel did discuss a number of positives. The U.S. has finally deleveraged, with household wealth as a share of after-tax income near previous highs last seen in 2007, and household debt as a share of after-tax income now sits at decade lows. In addition, employment has remained resilient and the unemployment rate is now considered to be in line with the longer run normal rate, as defined by the Fed. These are all strong stimulative forces backing the most important part of the economy - the U.S. consumer who make up over two-thirds of GDP. Because of this, U.S. corporations with a higher share of domestically generated revenues should benefit from increased demand.

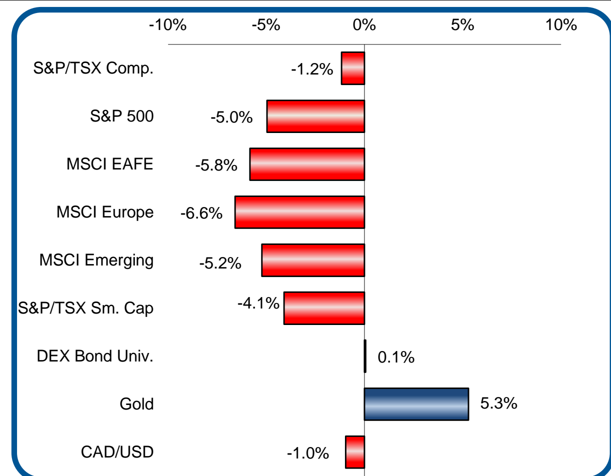
Steady Hands will Prosper

This isn't a perfect market, but markets never are. As the dust settles from the current volatility and when fundamentals eventually begin to improve, fresh market-moving catalysts will develop and new longer term opportunities will emerge. The consensus opinion at the conference was that we are in an environment where growth will be scarce and where market volatility will remain elevated. Valuations may be a bit lofty relative to the slower growth environment, but most of the experts agreed that a prudent investment approach involves having a bias towards quality across all asset classes. For now this includes favouring high-grade corporate bonds and the shares of larger companies with organic growth, successful management teams, low levels of debt and earnings stability.

MONTHLY OVERVIEW

Equity markets were down across the globe during the first month of 2016. Overseas, the Stoxx Europe 600 Index lost 6.4% after ending 2015 up over 10%, while major indices in Asia experienced even deeper losses. The Shanghai Composite Index posted its worst month since the 2008 financial crisis by giving back all of 2015's gains and then some more, losing over 22% for the month. The index returned 11.2% in 2015. In North America, losses were more modest, with the S&P/TSX Composite index losing just over 1% for the month. South of the border, the S&P 500 index shed 5%, wiping out the small gain the benchmark achieved in 2015. (All returns in local currency terms).

1 MONTH RETURNS



Source: Bloomberg, All Returns are TR and in Local Currency

The U.S. economy experienced an annualized increase of 0.7% in GDP growth during the fourth quarter of 2015, a stark difference from the 2% reading in the third quarter, and fell short of the 0.8% expectation. GDP growth for 2015 overall was 2.4%, matching the pace in 2014. The silver lining in the data was that consumer spending, which makes up the lion's share of the economy, was up a stronger than expected 2.2% for the quarter. The strong greenback resulted in a drag on growth as net exports fell to negative 0.5% for the quarter, down from negative 0.3% in Q3. Given the decrease in the momentum of growth in the fourth quarter, the Fed will likely be keeping an eye on this data moving forward to ensure the slowdown is only temporary before pulling the trigger on any further rate hikes. One of the key focuses of the Fed - core personal consumption expenditures (PCE) – rose at an annualized rate of 1.4%, up from a steady 1.3% over the last three quarters, suggesting that prices may be on the rise. Strong employment could continue to fuel an increase in inflation, potentially justifying tighter monetary policy, although prices still have quite a way to go before reaching the Fed's long term target. The job market remained resilient, adding 292,000 jobs in December; far exceeding economists' estimates of 200,000 and finishing the year with over 2.6 million job additions.

Canadian GDP rose by an expected 0.3% in November, following a flat reading in October and a drop of 0.5% in September. Because of the weakness since the summer, the Bank of Canada left its expected growth forecast for the fourth quarter at 0%, and is expecting modest increases of 1% and 2.2% in the first and second quarters of this year, respectively. These projections reflect the confidence the BoC maintains that strength in exports can offset the weakness in the energy sector. 22,800 jobs were added in the last month of the year according to Statistics Canada, far exceeding expectations of 8,000. The unemployment rate was unchanged at 7.1%. The job gains were most robust in Ontario and Quebec, but the bulk of the positions added were in "self-employed" and part-time roles. A bright spot was manufacturing positions which grew to the tune of 30,000 jobs during the fourth quarter; which appears to signal some optimism that increased growth may be underway in that sector of the economy. Although the manufacturing PMI for January remained in contraction territory (below 50), it improved from 47.5 from December to 49.3; the highest reading in five months.

On the seventh of January, the Shanghai Composite experienced its shortest trading day in history as it fell 7% at the open and was shut down in just under 15 minutes of trading. This was the aftermath of another downward adjustment in the yuan by the People's Bank of China. The devaluation fuelled fears that Chinese authorities are of the belief that they may fail to meet growth targets and are acting desperately to drive exports. China achieved full year GDP growth of 6.9% - the weakest annual growth figure in 25 years. For the eleventh consecutive month, the manufacturing purchasing manager's index (PMI) showed a contraction in the manufacturing sector. The non-manufacturing PMI sat comfortably in expansion territory, at 54.4. These readings are consistent with the underlying fundamental shift that the Chinese economy is experiencing as it moves towards a more service-based model.

Also last month in Asia, the Bank of Japan completely shocked financial markets by following some central banks in Europe and adopting a negative interest rate policy. The rate applied to excess reserves at the central bank was cut to -0.1%. BoJ Governor Kuroda announced that this decision was made in order to show the central bank's commitment in meeting its 2% inflation target. Currently inflation sits at just 0.2% for 2015, and this comes after three years of quantitative easing.

MARKET OUTLOOK

Major themes that existed at the end of 2015 that created challenges for the market haven't disappeared simply as a result of a new year starting. Concerns surrounding China, suppressed oil prices and diverging monetary policies across the globe are likely to play out well into 2016. Although the strong dollar is likely to continue to affect net exports in the U.S., this drag could be partially offset by increased consumer spending as the labour market strengthens further. In Canada, if future

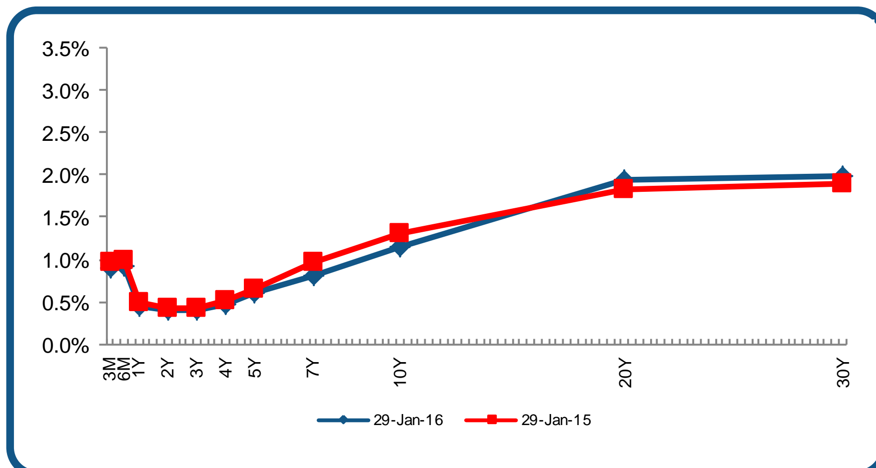
growth data reflects the central bank's outlook for growing strength in the export sector, they may hold back on rate cuts for now. A PMI reading back above 50 signalling expansion in the manufacturing sector would also do a great deal for growth outside of the energy sector.

Monthly Market Statistics: January 2016

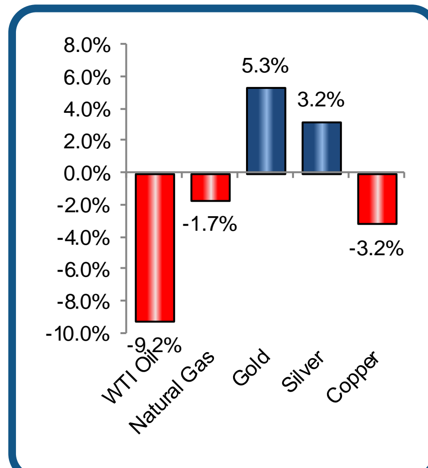
Total Return Index Returns (Annualized After One Year)

	Local Currency Returns							Canadian Dollar Returns						
	1M	3M	6M	YTD	1YR	3YR	5YR	1M	3M	6M	YTD	1YR	3YR	5YR
TSX Composite	-1.2%	-4.4%	-9.9%	-9.4%	-9.9%	3.4%	1.9%	-1.2%	-4.4%	-9.9%	-9.4%	-9.9%	3.4%	1.9%
S&P 500	-5.0%	-6.2%	-6.8%	-3.6%	-0.7%	11.3%	10.9%	-3.6%	0.7%	0.3%	16.4%	9.6%	24.7%	18.6%
MSCI EAFE	-5.8%	-7.2%	-11.9%	-0.4%	-3.3%	8.4%	6.7%	-5.8%	-3.3%	-8.0%	11.7%	1.4%	13.3%	9.2%
MSCI World	-5.4%	-6.8%	-9.3%	-2.9%	-2.4%	9.6%	8.6%	-4.6%	-1.3%	-3.8%	13.3%	5.3%	19.0%	13.8%
MSCI Pacific	-7.5%	-8.0%	-13.8%	-1.7%	-3.1%	11.0%	8.2%	-7.1%	-1.8%	-6.6%	14.2%	2.7%	13.8%	8.7%
MSCI Emerging	-5.2%	-8.7%	-11.5%	-10.3%	-11.6%	-1.0%	0.6%	-5.1%	-5.6%	-10.5%	-3.5%	-12.4%	2.1%	1.4%
TSX Small Cap	-4.1%	-7.2%	-12.1%	-16.9%	-17.3%	-5.2%	-6.4%	-4.1%	-7.2%	-12.1%	-16.9%	-17.3%	-5.2%	-6.4%
Global Small Cap	-7.2%	-7.8%	-11.6%	-4.5%	-4.0%	9.2%	8.2%	-6.4%	-2.3%	-6.0%	11.6%	3.7%	18.6%	13.5%
CDA Bond Uni.	0.0%	1.2%	-0.3%	3.5%	-1.1%	3.9%	4.9%	0.0%	1.2%	-0.3%	3.5%	-1.1%	3.9%	4.9%
CDA 1-5 Yr Bond	0.0%	0.5%	0.1%	2.6%	0.5%	2.5%	2.8%	0.0%	0.5%	0.1%	2.6%	0.5%	2.5%	2.8%

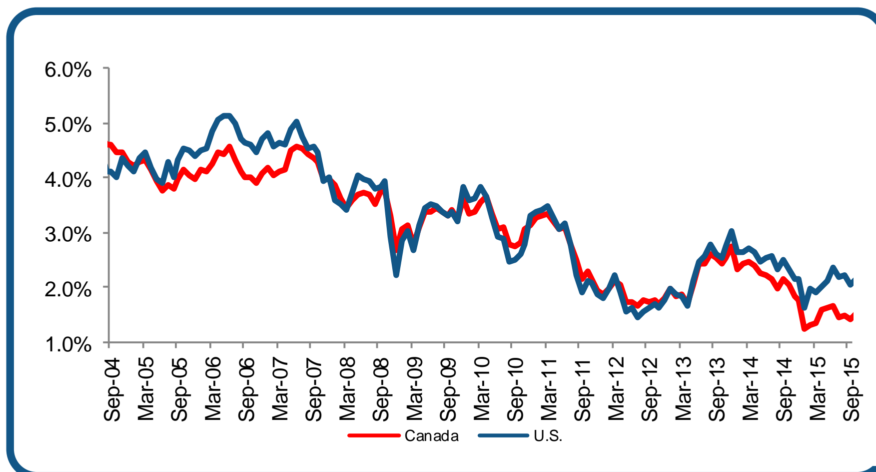
Canadian Yield Curve



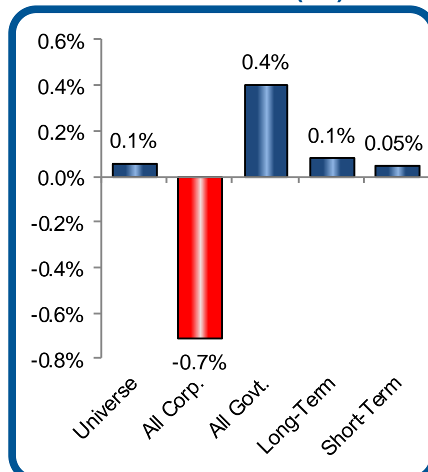
Commodities Performance (1M)



10YR Government Bond Yields



FTSE/TMX Bond ETFs (1M)



Source: Bloomberg, iShares.ca

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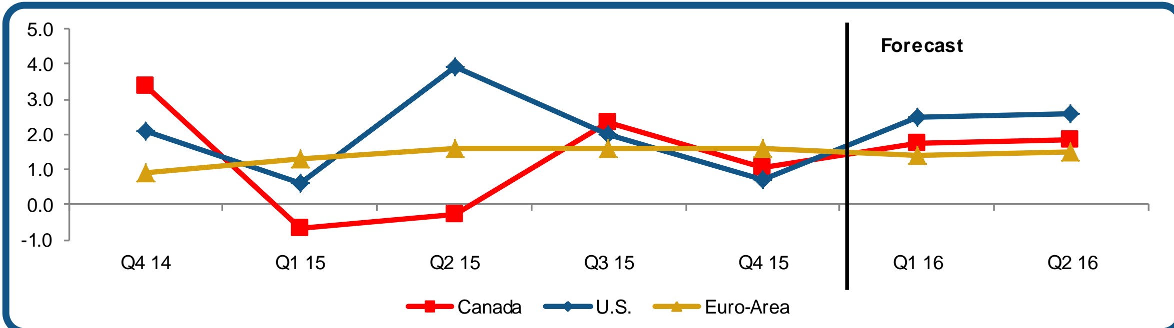
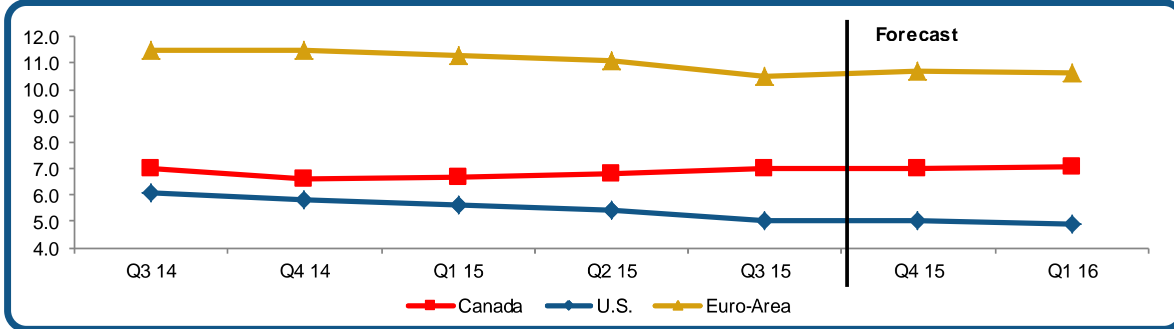
Economic Statistics

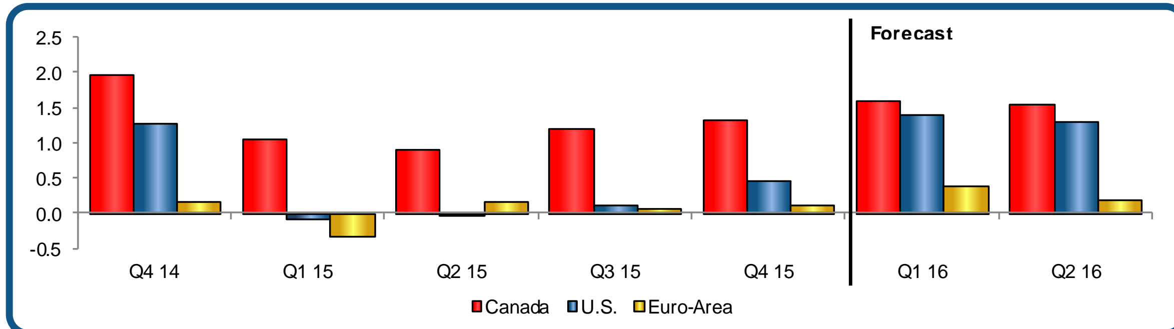
Real GDP (%)



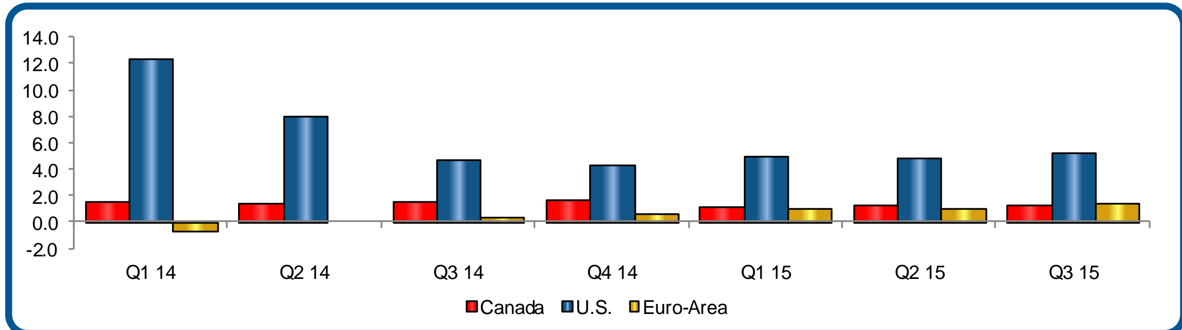
Unemployment Rate (%)



Consumer Prices (YoY %)



Housing Prices (YoY %)



Source: Bloomberg

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