MARQUIS
INSTITUTIONAL SOLUTIONS

Global Asset Allocation Perspectives

Third Quarter 2021 Preview

To help guide the forward-looking positioning of Dynamic's managed asset programs, the Portfolio Solutions team meets regularly with the Portfolio Managers at 1832 Asset Management L.P. The following captures the team's current views and portfolio positioning.

Market Review

Fixed Income

The Canadian bond market rose 1.7% during the second quarter of 2021, following a rocky Q1. Yields along the Canadian yield curve fell, with 10-year Government of Canada issues falling 17 basis points (bps). The curve also flattened from end of March levels due to mixed economic signals. Spread between 2-year and 10-year government yields shrank from 133 bps in March to 94 bps by the end of June. The decline of the interest rates was in response to a variety of mixed data on the ongoing economic recovery and rising inflation. Credit spreads narrowed, as the U.S. high yield spread tightened 35 bps in Q2. High-yield bonds led returns with 2.6% gains.

Equities

Equity markets continued to rebound, on the back of expansionary manufacturing and service activities, with the majority of indices posting positive returns. The S&P/TSX Composite Index returned 8.2%, S&P 500 Index returned 7.1%, MSCI EAFE Index rose 3.8%, and MSCI Emerging Market Index returned 3.6% in Q2. Global markets continued thier rally since late 2020 in anticipation of reopening as vaccination rates accelerated. The majority of global economies maintained an accommodative stance despite inflation spikes, while moving up the tightening timelines as growth forecasts improved. Positive sector returns were broadly observed, and small cap companies marginally outperformed large cap. Growth outperformed value styles. Real estate continued its rebound from Q1, returning 10.1%.

Market Themes

Fixed Income

The main investment theme for Q2 was the reversal in bond yields, especially for long-duration bonds. Longer-duration bonds outperformed those with shorter durations in Q2, which returned 3.7% and 0.1%, respectively. That outperformance was driven by the market's view that the increase in inflation was transitory and the Fed's hawkish tone that it may raise rates somewhat sooner than expected.

Two other noticeable themes in the bond market are: 1) Opportunistic risk-taking in a cyclical uptrend as investors favored higher risk, higher yielding sectors, and 2) Inflation, as the Consumer Price Index continued to surge, up 3.6% year-over-year (Y/Y) through May 2021. This led to strong performance in high yield bonds (+2.6%) and inflation-linked real return bonds (+3.5%).

Equities

Economic activity continued to recover from last quarter as global manufacturing and service PMIs moved up from Q1. Inflation spiked for most major economies this quarter, with higher than expected inflation numbers in May and June. However, this was due primarily to base effects in energy prices, supply chain disruptions and pent-up consumer demand. Most central banks continue to believe inflation is transitory and remain dovish in the near term.

Throughout the majority of the quarter, investors positioned towards the reflation trade, boosting cyclical and small cap companies. The tide turned in June as investors worried that the markets had achieved peak growth and valuations. Along with the resurgence in COVID-19 cases, which may potentially lead to subsequent lockdowns, markets moved into a risk-off sentiment.

Portfolio Positioning

Fixed Income

As economic growth continues and central banks started to signal a gradual reduction of accommodative policies, investors should be prepared for higher market volatility and an upward trajectory on interest rates. We seek to maintain a short duration bias. On credit positioning, we believe that strong economic recovery will keep credit spreads tight, and are maintaining a credit overweight. However, with credit spreads at their all-time tights, we are cautious on taking more credit risk, and use a flexible and well diversified approach to deal with possible diverging scenarios.

Equities

Economic indicators are showing early signs of peaking as growth seems to be softening and inflation is on the rise, which warrants caution. Valuations are rich and are pricing in future economic and corporate earning growth. While still well supported by strong earnings, equity market returns will likely moderate in the second half of 2021. We continue to favor equities over fixed income, in high quality and defensive segments over growth and pro-cyclical. We are also maintaining an underweight to infrastructure and real estate exposure.

Regional Backdrop

Macro-Economics	Fixed Income	Equities
CANADA		
The Canadian economy grew by 1.4% in Q1 2021, slower than 2.2% last quarter. Unemployment rate also edged higher to 7.8% in Q2, which was 0.3% higher than the previous quarter due to continued lockdowns to combat spread of the virus. Number of new cases declined sharply, signaling measured reopening in the near future. Annual inflation rate jumped to 3.6% Y/Y at the end of Q2, primarily attributable to the base effect from last year. Business confidence remains high, but manufacturing activity is softening as Purchasing Managers Index (PMI) dropped to 56.5 this quarter, vs. 58.5 in the previous quarter.	Canadian yield curve flattened in Q2 as 2-year yield rose by 23 bps and 10 and 30-year yields fell by 17 and 14 bps respectively. In June, the Bank of Canada (BoC) reiterated that policy interest rates would remain unchanged until "economic slack" is absorbed around the second half of 2022, and it believed that high inflation was temporary. Although BoC continued its quantitative easing program, it slowly withdrew monetary stimulus by reducing bond purchases. In investment grade credits, infrastructure was the most volatile sector. It led the YTD loss at 5.2%, despite being the top performer in Q2, rising 2.3%.	The TSX returned 8.6% over Q2, driven by cyclical sectors financials, IT and energy. IT was the top performing sector, dominated by 30% rally in Shopify. Energy names continued to be supported by the rally in oil prices. Banks and real estate also did well, while health care struggled. Earnings growth contributed to returns as the TSX forward EPS grew 6.4% over the quarter, as valuations remained unchanged. In terms of style, value, volatility and momentum outperformed since beginning of the year until the reversal in June when growth outperformed value for the first time in six months.
UNITED STATES		
US economic recovery continued as GDP grew by 6.4% (Q/Q annualized) in Q1. While the pace of growth picked up as restrictions were lifted and business activity restarted, inflation concerns started to loom as the annual inflation rose sharply to 5.4% in June. Government also approved $1 trillion infrastructure package to help stimulate the economy, short of the originally announced $2 trillion in spending. The unemployment rate remained flat and ended at 5.9% in June. Both manufacturing and service activity showed strength in Q2 as indicated by PMIs of 62.1 and 64.6, respectively.	US Treasury yields declined over the quarter, with the 10-year falling from 1.74% to 1.47%. The broad backdrop was a continued economic recovery and rising inflation, though the latter was deemed to be transitory. The Federal Reserve shifted to be more hawkish. In its June economic projection, the Fed indicated two hikes for 2023, a notable shift from no hikes for 2023 in its Q1 projection. Moreover, quantitative easing will likely come to an end before the start of any rate hikes. Following the Fed's statement, the 2-yr yield rose and the 10-yr yield fell, with the curve flattening. The Barclays US Aggregate Index gained 1.8% this quarter.	The S&P 500 returned 7.1% (CAD), a strong absolute return with 10 out of 11 sectors posting positive returns. Real estate was the top performing sector, followed by IT. Real estate and infrastructure segments rebounded in anticipation of travel and commercial activity returning to normal. IT sector rebounded sharply in June, offsetting some of the losses made earlier in the year. Utilities struggled to add value over Q2 after stumbling in May when inflation fears receded. Forward EPS grew 9.3%, contributing to returns over the quarter. In terms of style, market leadership rotated back to growth being the top performing style, followed by quality, while value underperformed.
INTERNATIONAL		
The Eurozone economy shrank by 0.3% in Q1 after contracting by 0.6% in the prior quarter due to restrictions on business activity. Unemployment rate is steadily dropping and reached 7.9% in May. Manufacturing and services remained strong as indicated by PMIs at 63.4 and 58.3, respectively. Japanese economy continued to recover and expanded by 2.8% in Q4, whereas the UK's economic growth slowed to 1.3% in Q4 2020 after recovering by almost 16% in Q3. Unemployment rate in UK remains at 5%. Japanese economy contracted by 1% in Q1 after rising by 2.8% in the previous quarter, as COVID-19 cases surged and vaccine rollout was slow.	European government bonds underperformed the US and Canada, amid growing optimism about the region's recovery and accelerating vaccination programme. Yields peaked in mid-May before retreating to levels slightly higher than end of March. The German 10-yr yield rose 8 bps to -0.21%, France was up 17 bps to 0.13%. The Italian 10-yr yield rose 15 bps to 0.82%. The UK was the only major European country seeing its 10-yr yield fell, by 13 bps to 0.72%. The Barclays Global Aggregate Index gained 1.3% in USD this quarter.	The MSCI EAFE Index returned 3.8% (CAD), with a wide range of returns by countries. European countries like Denmark and Switzerland drove performance, led primarily by healthcare names. Japan, 23% of the index, was among the worst performers in Q2 as it struggled with COVID-19 resurgence, hosting the Olympics, and supply chain constraints. CAD appreciation vs most major currencies detracted from CAD denominated returns. Defensive sectors such as healthcare and consumer staples did well. Earnings growth contributed as forward earnings grew 12.7% over the quarter. Growth and quality style outperformed value.
EMERGING MARKETS		
Emerging markets economies showed mixed results, while the pace of recovery slowed. The Chinese economy advanced by 1.3% (Y/Y) in Q2, compared to 3.2% in Q1. Manufacturing PMI moderated to 51.3 due to supply chain disruptions, and service PMI dropped to 50.3 due to anti-virus measures. Brazil's GDP rose by 1.2% in Q1 compared to 3.2% in Q4. A further slowdown is expected due to virus resurgence and rising inflation. Indian economy expanded by 1.6% (Y/Y) in Q1 2021 despite a sharp rise in Covid-19 cases, compared to 0.5% in the prior quarter. Unemployment rate jumped to 11.9% in May, compared to 6.5% in March.	Emerging market debt had a strong quarter, posting 4.1% gains. It almost fully recovered the loss from the first quarter. The rally in emerging markets debt reflected broader global economic recovery and good financial conditions. Weakening of the U.S. dollar is also believed to support emerging market debts. For commodity exporters, rising commodity prices serves as an additional tailwind. Although volatility picked up in June as the Fed adopted a more hawkish tone, the macro backdrop and fundamentals for Emerging market debt remain strong.	The MSCI EM returned 3.6% (CAD) in wide range of returns with Latin America in the lead, followed by Europe and the Middle East. Brazil was the top performing country as vaccine rollout gathered steam and geopolitical conditions improved. Tourism reliant countries such as Thailand, continued to underperform in Q2. Singapore was the worst performing country as it continued to grapple with COVID-19 breakouts. China's markets improved but manufacturing activities continued to soften. Health care, industrials and energy were the top performing sectors, while real estate struggled. In terms of style, volatility and momentum outperformed growth, value and yield.

Asset Allocation Positioning

		Outlook	Comments
ASSET CLASS	Fixed Income	–	Recent drop on bond yields reflect market's view that inflation is likely transitory and growth could be moderating. Yields at such low levels could be vulnerable to surprises and negative returns as inflation is expected to remain high in the near term.
ASSET CLASS	Equities	+	Bull market likely to persist for rest of the year, albeit at moderate rate, given continued re-opening, strong earnings growth, easy liquidity conditions, and improving labour markets. Overweight equity, rotate from cyclical into high quality and defensive sectors.
FIXED INCOME	**Rates**		
FIXED INCOME	Overall	–	Yields likely to stay low as inflation fear fades. Recent price rally reflects concerns on global growth, as China continues to weaken. Spikes in inflation not reflected in longer-term yields, maintain short duration bias to mitigate long-term inflation risk.
FIXED INCOME	Canada	–	Yield curve not reflecting recent spikes in inflation, and only partially reflecting the expected rate hikes in the short end of the curve. Limited room for further declines on yields unless if economic growth prospects significantly deteriorate.
FIXED INCOME	US	–	Robust economic growth, higher inflation, and pent-up demand fueled by stimulus argue for higher yields from current levels, unless virus variants threatens growth and more lockdowns imposed in the near term.
FIXED INCOME	Global	–	Yields across developed and emerging countries to remain low as central banks remain accomodative amidst virus resurgence and slow vaccine rollout.
FIXED INCOME	**Credit**		
FIXED INCOME	Overall	+	Less attractive as credit spreads narrowed further in Q2 to below historical averages. Compensation for taking credit risk is low in high quality issues, highly selective opportunities in cyclical recovery areas in high yield and emerging markets debt.
FIXED INCOME	Investment Grade	–	Spreads narrowing well supported by central banks, vulnerable to deceleration of growth if Delta varient triggers lockdowns. Rising leverage ratios pose higher risks. But high corporate cash level may trigger shareholder friendly activities like share buybacks.
FIXED INCOME	High-Yield	+	Spreads continued to narrow to historical averages, but yields still attractive relative to IG credits. Credit quality remains solid, and default levels peaked. With more Covid-affected sectors, Europe and EM has attractive selective opportunities.
EQUITIES	**Region**		
EQUITIES	Canada	–	Energy and financials sectors may take a back seat as growth slows and inflation retreats, longer-term growth rates remain low for the lack of high growth segments.
EQUITIES	US	+	Resurgence of virus may threaten reimposing of restrictions, hurting the recovery of travel related market segments. Dampening growth forecasts may also trigger market rotation towards high quality and defensive names.
EQUITIES	International	++	Improving economic prospects and earnings. Highly selective opportunities available at significant valuation discount and lower inflation risk.
EQUITIES	Emerging Markets	+	China's move to stimulate the economy, now 50% EM, may provide a boost to turnaround the weakening trend. May rotate from richly valued growth sectors to value sectors which is still at valuation discounts.

Legend

++	Very positive	–	Somewhat negative
+	Somewhat positive	– –	Very negative
0	Neutral		

Index Performance – As at June 30, 2021

FIXED INCOME – Bonds	3-Mth	6-Mth	YTD	1-yr	3-yr CAGR	5-yr CAGR
FTSE Canada Universe Bond C$	1.70%	-3.50%	-3.50%	-2.40%	4.20%	2.60%
Universe Canada All Corporate C$	1.28%	-2.26%	-2.26%	0.82%	4.86%	3.66%
Morningstar CAN High Yield Fixed Inc	2.03%	2.45%	2.45%	10.94%	5.34%	4.97%
BAML US Corporate C$	2.10%	-3.80%	-3.80%	-5.80%	5.60%	3.90%
BAML US High Yield Master II C$	1.30%	0.80%	0.80%	5.10%	5.00%	6.30%
Barclays US Agg Bond U$	1.80%	-1.60%	-1.60%	-0.30%	5.30%	3.00%
Barclays Global Agg U$	1.30%	-3.20%	-3.20%	2.60%	4.20%	2.30%

EQUITIES – Canadian Equities	3-Mth	6-Mth	YTD	1-yr	3-yr CAGR	5-yr CAGR
S&P/TSX Composite C$	8.50%	17.30%	17.30%	33.90%	10.80%	10.80%
US Equities						
S&P 500 US$	7.10%	12.00%	12.00%	28.30%	16.40%	16.60%
Dow Jones Industrial Avg US$	3.53%	10.60%	10.60%	23.96%	12.72%	15.56%
NASDAQ C$	8.24%	9.73%	9.73%	32.35%	23.33%	24.68%
Global Equities						
MSCI World C$	6.50%	10.10%	10.10%	27.30%	13.40%	14.40%
MSCI Asia Pacific ex-Japan C$	2.70%	3.90%	3.90%	27.30%	10.00%	13.20%
MSCI Japan C$	-1.60%	-1.40%	-1.40%	14.10%	5.60%	9.60%
MSCI Europe C€	6.30%	9.10%	9.10%	23.80%	7.20%	10.00%
MSCI Emerging Markets C$	3.70%	4.50%	4.50%	28.80%	9.50%	12.40%

Source: Bloomberg

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As Portfolio Manager for ScotiaFunds and Dynamic Funds managed-asset programs, Judith and team oversee approximately $42 billion in assets under management. The Portfolio Solutions team is responsible for portfolio construction, asset allocation policy, and investment strategy research and selection. The team is also involved in the due diligence and day-to-day management of all portfolio solutions.

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