

Market Snapshot – April 2015

April 6, 2015

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privateclientresearchhw@scotiabank.com**DON'T SWEAT THE FOREIGN CURRENCY EXPOSURE****JAMES GAUTHIER**

The issue of currency exposure within client portfolios is one that we seem to hear a lot about following big swings in the loonie. Currently, investors are lapping up U.S. stock funds, as the performance of these offerings have been propelled by robust returns for these markets, but also by the strength of the greenback. In 2007 and 2011, as the loonie moved above par versus the U.S. dollar, advisors were calling for the heads of those money managers who had not hedged their foreign currency exposure.

Former Fed Chairman Alan Greenspan said the following in July 2002: "There may be more forecasting of exchange rates, with less success, than almost any other economic variable."

Based on that wisdom, we are not going to add our name to the list of failed currency forecasters. Instead, we are going to focus on the idea that for Canadian investors with a long term time horizon, maintaining foreign currency exposure within the equity portion of a portfolio can help reduce portfolio volatility. Additionally, when working with fixed income products, limiting foreign currency exposure is often the wisest course of action.

We believe most clients and advisors understand the value of geographical diversification within the equity portion of a portfolio makes sense. The Canadian market, as represented by the S&P/TSX, has two-thirds of its overall value allocated to just three sectors: financials, materials and energy. If diversification is an objective, gaining exposure to other industries and economies makes sense. The value of currency diversification for the typical retail client is something we see as being less understood.

The Landscape

We'll consider the Canadian mutual fund space a reasonable proxy for the broader retail investment landscape. About 55% of Canadian fund assets are in products that can be classified as being predominantly Canadian. Of course, many Canadian equity and Canadian balanced funds have a fair bit of foreign exposure. With the bulk of the remaining industry assets being in funds that have some sort of foreign bias, most investors are bound to have at least a little bit of their portfolios in non-Canadian investments.

Anecdotally, we can say that most equity managers do not hedge currency exposure and the amount of money in "currency neutral" funds is a drop in the bucket. Therefore, Canadian investors do seem to have a good amount of exposure to foreign currencies, and much of the research we've seen suggests that's a good thing. Let's talk about why that is a good thing.

Foreign Currency Exposure as a Volatility Reducer

According to research produced by Russell Investments, from a Canadian investor's standpoint, exposure to foreign currencies is anti-cyclical and risk reducing. The Canadian dollar was identified as being pro-cyclical (and is sometimes referred to as being a commodity currency), meaning the currency should rise and fall in line with the economy and equity markets. This compares to reserve currencies, such as the U.S. dollar, euro, and Swiss franc, which are anti-cyclical. These currencies tend to benefit from a flight to quality during times of economic and financial stress.

The Russell research looked at things from the perspective of a Canadian investor and attempted to assess how various hedging strategies would impact portfolio volatility and returns. The study considered seven developed market currencies and a portfolio representing six foreign equity markets. The portfolio was assumed to have static weights proportional to market cap weights as of 12/31/2012 and data going back to 1970 was used, where possible.

One of the considerations of the study was the correlation between hedged equities to each of the six currency pairs (plus a reserve currency basket) and the difference between hedged and unhedged returns (or "Currency Surprise").

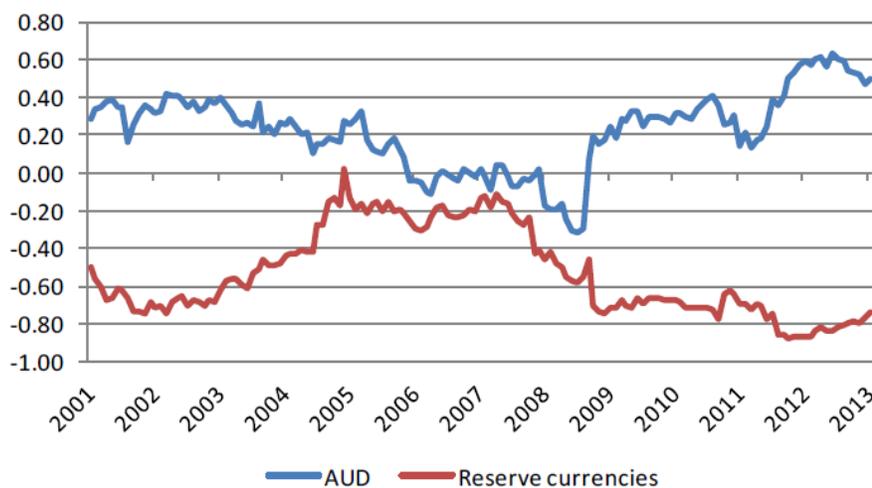
Table I: Correlation of Hedged Equities with Currency Surprise

Currency CAD Investor	Correlation
USD	-0.59
EUR	-0.24
CHF (Swiss franc)	-0.37
GBP	-0.37
JPY	-0.49
Reserve Currencies (USD, EUR, CHF)	-0.58
AUD (Commodity Currency)	0.26
All 6 currencies	-0.57

Source; BNY Mellon

What this data suggest is that, for Canadian investors, exposure to foreign currencies can be very effective in reducing equity market volatility. Chart I illustrates that although correlations do fluctuate over time, exposure to reserve currencies has worked to soften equity market volatility. The Aussie dollar is plotted out as a separate line because it is a commodity currency.

Chart I: 24 Month Rolling Correlation of Hedged Equities with Currency Surprise 1999-2013



Source; BNY Mellon

Table II provides volatility figures for a foreign equity portfolio (again, with static weightings based on market cap as of 12/31/12) from the perspective of a Canadian investor under three hedging scenarios. In all situations, the unhedged portfolio is most effective in limiting volatility.

Table II: Portfolio Volatility for Three Hedging Policies 1999-2012, in Standard Deviation

	Unhedged	50% Hedged	100% Hedged
Full Period (1999-2012)	12.5%	13.3%	15.2%
Pre-Crash (1999-2007)	11.9%	12.0%	13.0%
Post-Crash (2008-2012)	13.5%	15.5%	18.6%

Source; BNY Mellon, OECD

Let's consider a real life example to better illustrate how currency diversification can buffer equity market volatility. The financial crisis that really got rolling in 2008 triggered activity on the part of investors that could be considered somewhat predictable, despite the fact that the end-game of the crisis itself was totally unpredictable. Stocks were dumped, high quality bonds were bid higher, and investors wanted their assets in reserve currencies, U.S. dollars in particular. CAD/USD plummeted from \$0.97 to \$0.79 between September 26 and October 27 of that year. During the same period, the total return for the MSCI World Index was -33%; however, a Canadian investor with fully unhedged exposure to the benchmark would have only suffered a 17% decline in value. That's still a steep downdraft for any one month period, but the foreign currency exposure clearly softened the blow.

What about Fixed Income?

The same Russell research suggests that low risk assets, such as bonds, should have hedged currency exposure. Intuitively, this makes sense. The bond portion of any portfolio is designed to offer stability with a bit of income. Additionally, if one believes that the long term return of a bond is closely tied to its current yield, even the most minor of currency swings could move the return of a bond into the red given how low yields are today. Most Canadian investors with fixed income exposure have the bulk of their assets in instruments that are denominated in Canadian dollars anyway, so this isn't really an issue. It's only when one ventures into the non-investment grade or global bond worlds does the issue of currency exposure become relevant.

High Yield Bonds

The high yield bond market exists predominantly in the U.S. Many Canadian issuers of high yield debt issue their bonds in USD. Take a look at just about any high yield bond fund in Canada. Even those that focus exclusively on Canadian issuers invest primarily in securities that are denominated in USD. You will find that most managers of these funds hedge most or all of the USD exposure. The reasoning is simple – Canadian investors look to high yield bond products to enhance the income received on their fixed income portfolio. Even in the high yield space, yields are not all that robust, so an adverse move on the part of the USD could very easily offset some or all of the yield these instruments generate.

Investors should be willing to live with interest rate risk, credit risk and liquidity risk when it comes to high yield bonds, but we believe it makes sense to neutralize currency risk wherever possible.

In Summary

Using Canadian fund industry numbers as a proxy for the typical client portfolio, domestic investors have a substantial portion of their assets in investments that are denominated in Canadian dollars. From an asset/liability standpoint this makes sense, as Canadian-based investors will have the bulk of their expenses denominated in Canadian dollars.

The numbers also suggest that exposure to non-Canadian dollar denominated assets, particularly on the equity side of the coin, is robust. Only a small minority of products that play in this space utilize tactical or strategic currency hedging overlays, so currency fluctuations do have a real impact on most investors' portfolios. History shows us that that foreign currency exposure from the perspective of a Canadian investor can work to reduce portfolio volatility in the long term.

Additionally, many retired Canadian spend a substantial amount of time in the warmer climates of the U.S. For these individuals, U.S. dollar liabilities should be matched with U.S. dollar denominated assets, thereby furthering the argument for having foreign currency exposure in a portfolio.

While the value of the loonie will ebb and flow over time, patient investors should understand that foreign currency exposure in the equity part of their portfolios is a good thing, while bond investors should work to minimize currency risk by sticking with products that hedge foreign currency risk.

QUARTERLY OVERVIEW

3 MONTH RETURNS

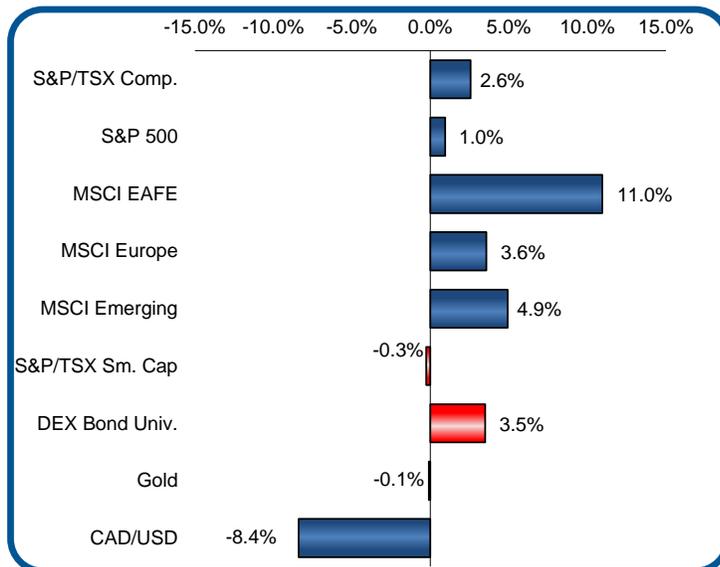
Most equity markets around the world posted a gain in the first quarter of 2015. The S&P/TSX Index (TSX) returned 2.6%, however, the comparison between the domestic index and the S&P 500 Index in Canadian dollar terms was staggering - the TSX lagged its U.S. counterpart by 7.6% over the last three months, while the MSCI World and the MSCI Emerging Market Indices both added close to 11% in the first quarter.

The continued fluctuation in the price of crude oil has been the main contributor to the loss of steam in the Canadian economy this year. Economists forecast that the impact of a sharp slowdown in the oil & gas sector is likely to be seen through softer corporate profits and business investment in the coming months, and may eventually spill-over into lower household spending, lower employment and declining home sales. Nonetheless, an improving economy south of the border should continue to bolster Canadian exports, primarily in the manufacturing and service sectors.

In the U.S., similar to last year, unreasonably cold weather and record snowfall in parts of the country culminated to slower economic activity at the start of this year. However, economists believe growth is likely to pick up pace over the next few quarters. Employment numbers in the U.S. have been largely positive as job growth accelerated at the fastest pace in 15 years and the unemployment rate tapered to 5.5% by the end of the first quarter. Inflation is expected to be held down by the combination of falling energy prices and a rising dollar, which in turn may also shift the focus on U.S. household spending as it increases the purchasing power of the average American household. Overall, the U.S. continues to remain in an enviable position with respect to economic growth relative to much of the rest of the world.

In Europe, the region's purchasing managers' report came in at a ten-month high in March, indicating an improving trend in industrial activity. Business confidence in the euro-zone was bolstered by the ECB's large quantitative easing program in combination with renewed strength in overall German economic activity and falling oil prices. However, domestic spending throughout the region, and most notably in France and Italy remained a challenge due to persistently high unemployment and continued austerity. In addition, Greece's struggle with the ECB on austerity measures while country is on the brink of bankruptcy also shook equity markets from time to time since January.

Economic data from China came in below expectations on a number of occasions over the last quarter; the purchasing manager's index for Asia's largest economy dipped below 50 in February, a number that normally distinguishes between recession (below 50) and expansion (above 50) for a country's industrial sector. Imports, exports, industrial production are all trending lower, reinforcing the softened demand for commodities. The Chinese government added to stimulus measures towards the end of the quarter in an attempt to boost growth; on the last day of February, the People's Bank of China announced a cut in the benchmark lending rates by 25 basis points to 5.35% and lowered the deposit rate by 25bp to 2.50%. If these measures are insufficient to moderate the decelerating growth trend, the People's Bank of China may take additional monetary easing measures in the future.



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

MARKET OUTLOOK

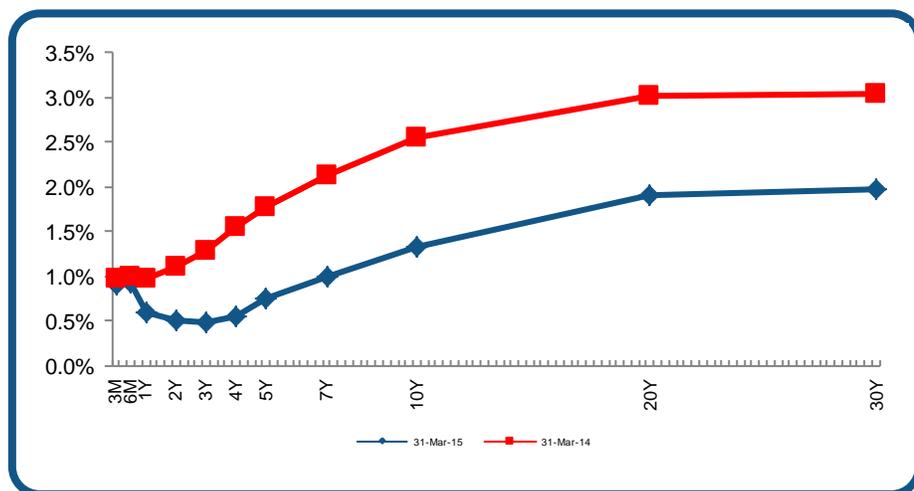
Going forward, investors are likely to be fixated on when the Federal Reserve will raise interest rates. Economists currently are calling for a rate hike in the fall of 2015, but the robust labour market numbers has not eliminated the chance of a rate hike earlier in the year. In Canada, while economists believe the odds of a second rate cut have diminished slightly over the last month since inflation has not been as weak, a rate cut is not completely off the table yet, especially if the oil price route extends into the second half of 2015. From an economic growth standpoint, many countries around the world are continuing to generate mixed economic numbers. The U.S. is still poised to take the lead in 2015, however longstanding structural issues and recurring geopolitical tensions in certain parts of the world is certainly keeping global growth at bay. Overall economists remain broadly constructive on the outlook for U.S. equity markets, although, they have cautioned on the potential for increased market volatility in 2015.

Monthly Market Statistics: March 2015

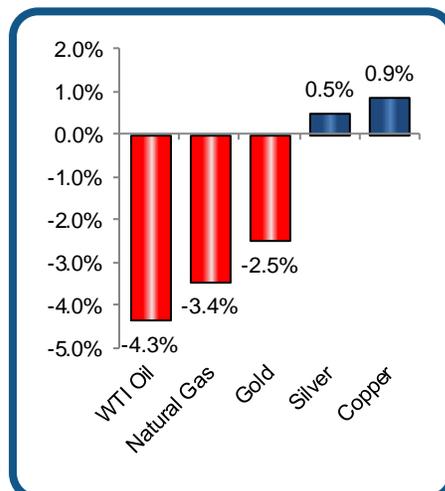
Total Return Index Returns (Annualized After One Year)

	Local Currency Returns							Canadian Dollar Returns						
	1M	3M	6M	YTD	1YR	3YR	5YR	1M	3M	6M	YTD	1YR	3YR	5YR
TSX Composite	-1.9%	2.6%	1.1%	2.6%	6.9%	9.6%	7.4%	-1.9%	2.6%	1.1%	2.6%	6.9%	9.6%	7.4%
S&P 500	-1.6%	1.0%	5.9%	1.0%	12.7%	16.1%	14.5%	-0.3%	10.2%	19.8%	10.2%	29.5%	25.7%	19.7%
MSCI EAFE	1.4%	11.0%	13.0%	11.0%	18.3%	17.1%	9.6%	-0.1%	14.6%	14.6%	14.6%	14.3%	18.6%	11.5%
MSCI World	-0.4%	5.0%	8.5%	5.0%	14.6%	16.2%	11.9%	-0.2%	11.8%	17.2%	11.8%	22.4%	22.2%	15.6%
MSCI Pacific	1.4%	9.5%	15.3%	9.5%	24.2%	20.0%	10.0%	2.0%	17.6%	19.3%	17.6%	23.6%	17.6%	10.9%
MSCI Emerging	0.2%	4.9%	5.0%	4.9%	11.3%	6.8%	5.9%	-0.1%	11.6%	10.6%	11.6%	15.8%	9.0%	6.7%
TSX Small Cap	-3.8%	-0.3%	-9.0%	-0.3%	-9.8%	-1.1%	2.0%	-3.8%	-0.3%	-9.0%	-0.3%	-9.8%	-1.1%	2.0%
Global Small Cap	1.3%	6.9%	12.3%	6.9%	11.1%	17.3%	13.9%	1.6%	14.1%	21.6%	14.1%	19.4%	23.4%	17.6%
CDA Bond Uni.	-0.3%	4.2%	7.0%	4.2%	10.3%	5.1%	6.0%	-0.3%	4.2%	7.0%	4.2%	10.3%	5.1%	6.0%
CDA 15 Yr Bond	0.0%	1.9%	2.8%	1.9%	3.9%	2.9%	3.3%	0.0%	1.9%	2.8%	1.9%	3.9%	2.9%	3.3%

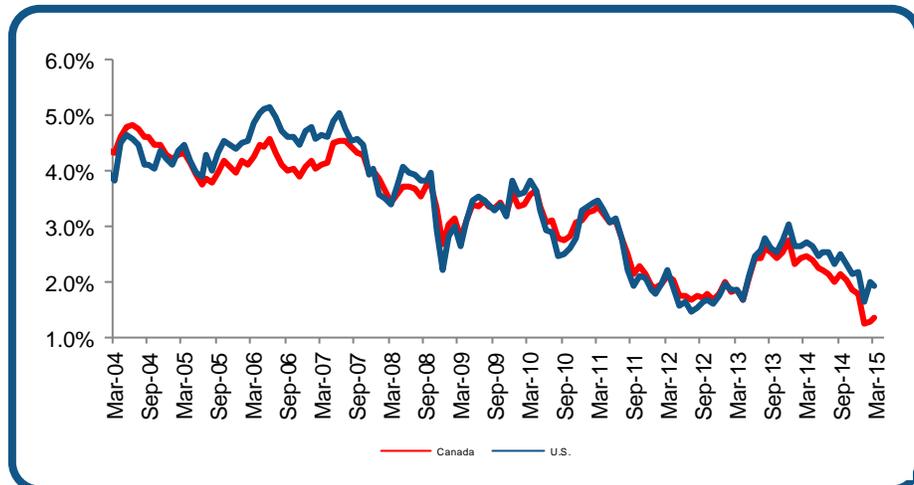
Canadian Yield Curve



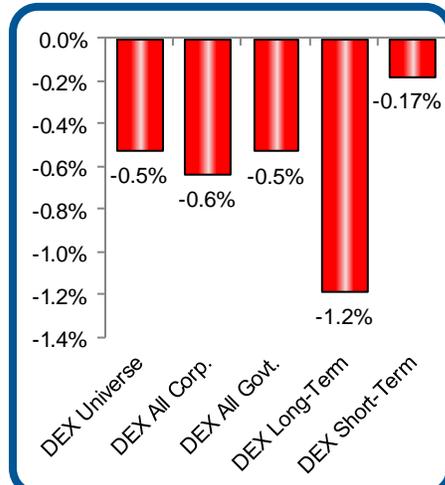
Commodities Performance (1M)



10YR Government Bond Yields



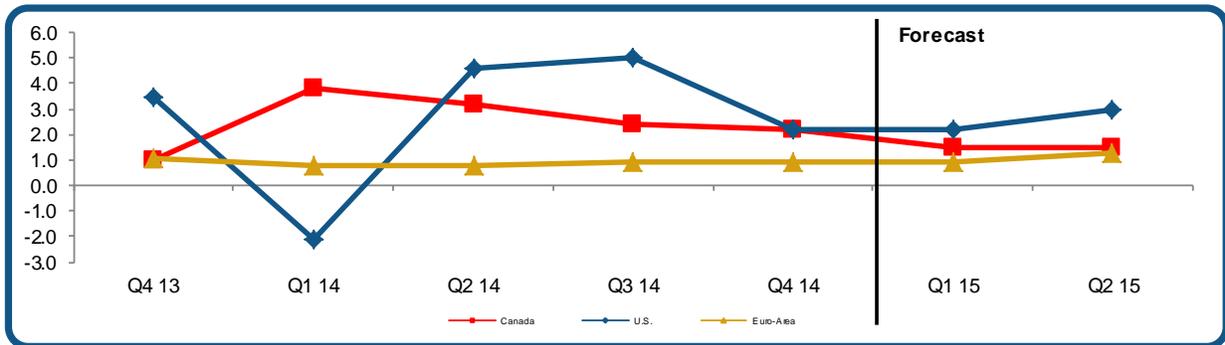
Bond ETFs (1M)



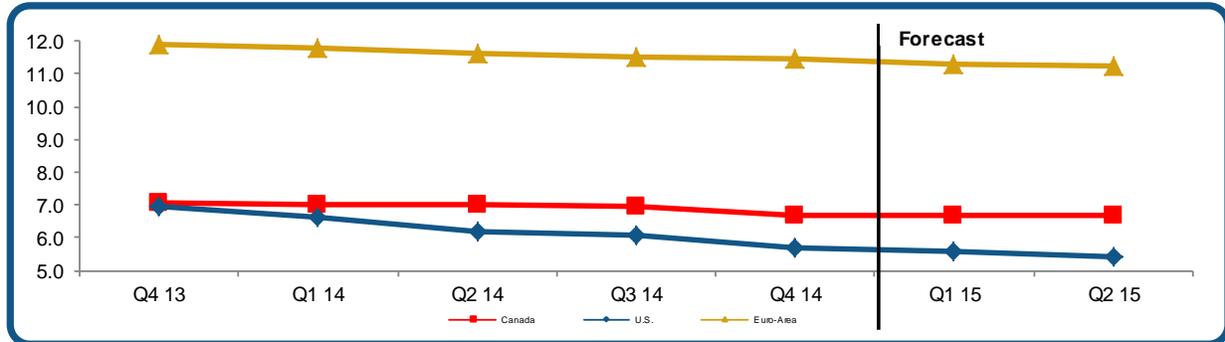
Source: Bloomberg, iShares.ca

Economic Statistics

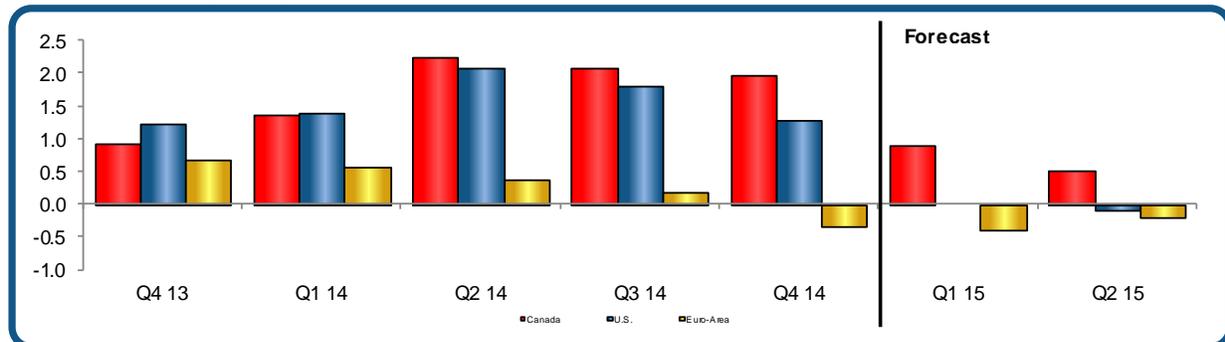
Real GDP (%)



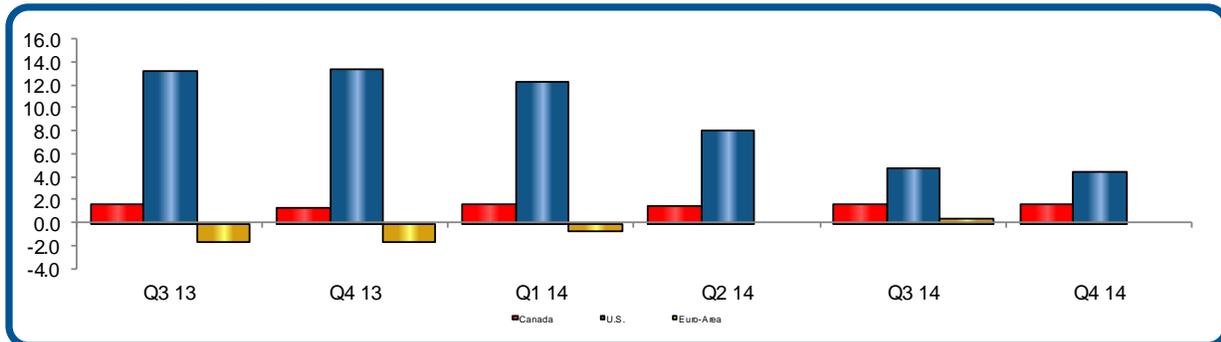
Unemployment Rate (%)



Consumer Prices (YoY %)



Housing Prices (YoY %)



Source: Bloomberg

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