

Market Roundup

Global outlook



Eric Bushell
*Senior Vice-President,
Portfolio Management
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Global capital markets struggled to gain ground through the spring and summer months as every major asset class was shaken by the looming risk of a sovereign debt default that began in Greece and ultimately spread to other peripheral countries, including Ireland, Spain and Portugal. The crisis also threatened the European banking sector, which held large positions of debt in those countries. At the same time, weaker U.S. leading indicators dampened global commodity, currency and credit markets and there were indications by Chinese authorities that they were prepared to cool the country's heated property market.

Investors were eventually reassured and markets were stabilized by the International Monetary Fund and European Central Bank's coordinated €750 billion emergency loan facility for sovereign debtors. In July, as the markets bottomed, European banks passed their stress tests. When bond markets realized that the U.S. Federal Reserve would be a large buyer of government bonds to support the economic recovery, yields fell and commodity prices rebounded. By September, optimism had spread and equity markets recorded healthy gains.

The measures taken by the IMF and ECB this summer provided a solution for Europe's immediate liquidity crisis, but did not solve the region's long-term solvency crisis. Ultimately, further coordinated policies will be required to help peripheral countries restructure their debt. In Europe, we expect to see more bank mergers and rights issues, as the ECB makes it more difficult for weaker players to borrow, and asset sales of infrastructure, as governments attempt to shore up their balance sheets.

We are anticipating continued divergence in the growth patterns of developed and emerging markets over the coming quarters, with GDP growth of 1% to 2% in the developed world and 5% to 6% in emerging economies. We are maintaining our positive outlook for equities, emphasizing income in North America and growth by investing in companies with access to emerging markets such as China and Latin America.

Signature Market Roundup

Global outlook



Drummond Brodeur
*Vice-President,
Portfolio Management
and Global Strategist*

Global economic healing and rebalancing continues, supported by open capital markets and stimulative monetary policies. Record levels of corporate bond issuance show that corporations have access to capital – and that enables economic healing to continue and supports equity and fixed-income markets.

A healthier global economy requires more balance. Deficit countries that have been living beyond their means need to learn to save more and spend less. The spending slack needs to be picked up by consumers in surplus countries with excess savings. Rebalancing will require a period of slower growth in developed economies, particularly the U.S., and stronger growth from emerging economies, led by China. The key risk in the U.S. remains political unwillingness to accept the slower growth associated with deleveraging and the likelihood of sustained high unemployment.

The Federal Reserve's change towards a renewed form of quantitative easing is aimed at the U.S. dollar and may carry greater political risks than many perceive. Rising protectionist rhetoric is a particular concern. We continue to monitor developments at the IMF and G20 for signs of global cooperation to avoid a trade war and bring coordination to the adjustment process. For now, excess liquidity will continue to buoy global markets. In the medium term, it may hasten the shift of economic and political influence from developed economies toward emerging ones.

With interest rates staying low and capital markets open, we expect “de-equitization,” whereby corporations issue debt to buy equity. This will fuel an M&A boom as well as other shareholder friendly strategies, such as special dividends and share buybacks aimed at increasing balance sheet leverage and improving shareholder returns.

Interest rates



James Dutkiewicz
*Vice-President,
Portfolio Management
and Portfolio Manager*

Further quantitative easing by the Federal Reserve has for the most part been priced into the U.S. Treasury market. Government of Canada yields have dropped significantly in sympathy with the U.S. market. Yields are being artificially suppressed by the threat of the Federal Reserve's buying power, making them unattractive. But timing a duration reduction strategy is fraught with danger until details of the magnitude and pace of the expected second round of quantitative easing are known. We expect rates to shift higher – possibly sharply – when bonds are once again priced by profit-seeking agents. With resilient economic growth being our base forecast, portfolio construction is biased to an overweight credit strategy.

Preferred shares



John Shaw
*Vice-President,
Portfolio Management
and Portfolio Manager*

Retail investors' demand for preferred shares remains strong. As interest rates fell during the quarter, retail investors bought fixed-rate perpetual preferred shares. Supply will likely remain low in the preferred market as Canadian banks have ample capital and the Basel III rules are going to force banks to hold more their capital as common equity than in the past. The outlook for the preferred market remains fairly positive, although the best returns are likely behind us. Year-to-date the BMO 50 Preferred Share Index is up 7.28% and will likely go higher in the final quarter, due to very good demand, low supply and central banks that are eager to keep interest rates low.

Real estate



Ryan Fitzgerald
*Vice-President,
Portfolio Management
and Portfolio Manager*

Low interest rates and improving fundamentals have unleashed a massive flow of funds into high-yielding asset classes such as real estate and infrastructure. This has caused valuations of the hard assets themselves, as well as the public companies that own them, to increase dramatically in recent quarters. While valuations are high, in most cases the market is being rational. This is highlighted by the continued wide spread in valuations between top-quality and secondary assets and securities. However, conditions are ripe for asset prices to continue their upward march to levels that no longer reflect fundamentals – but simply reflect a desperate attempt for investors to get more yield. This would not be a healthy or sustainable market. We continue to watch for warning signs of overheating in these markets.

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Financials



John Hadwen
*Vice-President,
Portfolio Management
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Bank regulators have announced further progress in establishing more consistent capital and risk management framework requirements that are less punitive than many feared. Recently, announced targets significantly increase capital requirements, which will encourage higher loan pricing and more selective balance sheet growth. However, a long and gradual implementation period will ensure that bank capital conservation does not threaten a fragile economic recovery.

Health care



Rui Cardoso
*Vice-President,
Portfolio Management
and Portfolio Manager*

The fundamental backdrop for health care stocks continued to be mixed in the quarter. On the positive side, we believe the worst of the impact from health care reforms in the U.S. and austerity measures across EU countries are already reflected and discounted in share prices. On the negative side, we witnessed a slowing of hospital utilization trends and doctor visits in the quarter due to:

- the ending of COBRA extended health care benefits in the U.S., which provides some employees with insurance when they are terminated
- stubbornly high unemployment, which increases the number of uninsured Americans
- and higher deductibles in insurance coverage plans.

This led to weakness in medical device stocks in particular.

In October, utilization trends started to improve and drug dispensing unit volume growth remained positive. In addition, merger mania continues unabated as Johnson & Johnson, Pfizer and Sanofi announced major takeover bids within the last month (for Crucell, King Pharmaceuticals and Genzyme, respectively).

We remain positive on the sector because of very attractive valuations and high dividend yields, an increased focus on emerging markets as a major growth opportunity, and the potential for more mergers as mature pharmaceutical companies with healthy balance sheets fill up their development pipelines and find greater scale.

Industrials



Joe D'Angelo
*Vice-President,
Portfolio Management
and Portfolio Manager*

Industrial products companies continue to experience a recovery in most global manufacturing markets. After the sharp cyclical rebound from the bottom, revenue growth is beginning to stabilize at a lower – but more sustainable – level. Profit margins have been the real source of positive surprise thus far, as companies have been able to translate a high percentage of their revenue growth into profits. This is because of disciplined cost containment and rational pricing.

The growth outlook is strongest in emerging markets, which can represent over 25% of revenues for some companies. In contrast, construction markets in developed economies remain very weak and are probably hitting bottom now.

Cash generation remains strong and companies are starting to feel the pressure of carrying too much cash on their balance sheet. Even though this has resulted in increased acquisition activity and share buybacks, there remains a significant potential to do more as confidence in the economy improves.

We have just entered the mid-cycle of the industrial recovery and valuations are looking reasonable. As such, the near term outlook for many stocks in this sector looks positive from a risk/reward perspective.

Technology, media & telecommunications



Malcolm White
*Vice-President,
Portfolio Management
and Portfolio Manager*

Demand for high-yielding dividend stocks continues as investors search for yield in a low interest rate environment. This trend continues to benefit the telecommunications sector. European and U.S. names are starting to appreciate and are now mirroring Canadian names that have been appreciating all year as this theme progresses.

In technology, the focus has been on exciting new forms like the iPad and its potential to change computing. Business spending continues at a steady pace, but consumer spending is somewhat slower than expected as economies recover from the recession.

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Foreign exchange



James Dutkiewicz
*Vice-President,
Portfolio Management
and Portfolio Manager*

It is clear that the U.S. dollar has been greatly weakened by the widely anticipated second round of quantitative easing. The best way to explain quantitative easing is simply that the Federal Reserve will spend U.S. dollars to buy U.S. Treasuries with money that was neither earned nor borrowed – but created with a few keystrokes. This is a sub-optimal attempt to rebalance the global economy. But, in the face of unyielding fixed-rate currency regimes in emerging nations such as China, it is not surprising. It will be increasingly difficult for these nations to maintain a sterilization policy to keep pace with the Fed's increased monetary stimulus. This is reinforcing investors' demand for hard assets. The Canadian dollar greatly benefits from this trend. As such, the Loonie, which is modestly overvalued on a historical basis, should continue to be in demand by global investors. We expect it to trade around parity with to the U.S. dollar in the near future.

High-yield bonds



Geof Marshall
*Vice-President,
Portfolio Management
and Portfolio Manager*

The high-yield bond market did not participate in the U.S. Treasury bond rally in August. However, it did not sell off, but instead posted a small positive return. High-yield bonds have exhibited a slight negative correlation to interest rates since 1985, and we think this could work to investors' advantage in 2011 when we anticipate that the Federal Reserve will begin to tighten monetary policy.

We are cautiously optimistic heading into the fourth quarter. Economic growth may be slower to return given that the standard tools in central bankers' tool kits, such as lower interest rates, have failed to stimulate the economy as quickly as expected. However, in this environment, we feel that high-yield bonds can do well and defaults are likely to stay low. Valuations suggest good value, but all-in yields are less attractive and the potential for capital gains has diminished. This may push investors into other asset classes, but the bid for yield we are witnessing may continue for a long time, further supporting high-yield levels.

Investment-grade bonds



John Shaw
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Investment-grade bonds outperformed government bonds during the third quarter because of tightening spreads and falling government yields. The Canadian investment-grade market backed up in August on concerns that the rally had gone far enough and because of heavy supply. However, reduced supply in September and the gains in equity markets resulted in continued spread tightening. Investors continue to reach for yield, which means that there remains strong demand for lower-rated and/or higher-yielding investment-grade bonds.

The outlook for investment-grade corporate bonds is slightly positive due to strong fundamentals and supply/demand dynamics. Although spreads are nearing the tight end of their range for the past year, interest rates remain very low and shareholder activity is beginning to pick up.

AS AT SEPTEMBER 30, 2010