Market Roundup

Global outlook

Eric Bushell
Senior Vice-President,
Portfolio Management
and Chief Investment Officer

We exited the third quarter believing that fears of a double-dip recession were overstated and that the bond market, where defensive investors had been hiding since the credit crisis began, had become fully valued. Since then, the U.S. Federal Reserve took out added insurance in November against the possibility of deflation by embarking on a US$60 billion Treasury purchase program. The dollar weakness associated with this second round of quantitative easing (or "QE2") propelled commodities higher, led by gold, as printing of the world's reserve currency can have that effect. Moves higher for economically sensitive commodities like copper, oil and coal were underpinned by real demand and supply disruptions. In our diversified funds, we prefer to emphasize commodities with real uses ahead of gold. Inflation expectations have risen and global real interest rates have headed higher since QE2.

In Europe, the temporary fund set up to ensure financial stability fund was made permanent as the European Central Bank pushed Ireland to become the first nation to accept a bailout. Nonetheless, discussions over private sector losses on government bonds and bank refinancing challenges elevated concerns among investors.

The Republican victory in the U.S. mid-term elections was good news for business, which continued with the Obama administration's agreement to extend Bush-era income tax cuts and add further tax incentives for business. We believe these measures will be effective in unlocking pent-up hiring and capital expenditure activity in coming quarters. Food and wage inflation pressures throughout developing economies also emerged in the fourth quarter, marking an end to the era of global disinflation. Overall, 2011 should see a recovery in bank lending, consumption and business investment. In short, it should be a good year for global growth, and equities should outperform as they did in 2010.

Global outlook

Drummond Brodeur
Vice-President,
Portfolio Management
and Global Stategist

The outlook for global equity markets in 2011 is attractive. While many structural challenges remain – such as sovereign debt in developed economies and rising inflation in emerging economies – our belief is that these issues will be trumped by the unfolding cyclical recovery.

All signs are that the U.S. economy has re-accelerated and should continue to see strong private sector-led growth through 2011, as companies invest and hire to meet growing demand. Meanwhile, policymakers have made it clear they will not tighten prematurely. The Federal Reserve remains committed to quantitative easing until June, while the necessary fiscal austerity has been deferred to 2012 at the earliest with the extension of the Bush tax cuts and other measures to support employment.

Many emerging economies have enjoyed robust recoveries and have begun to tighten fiscal and monetary policy in response to rising inflation. Nevertheless, we do not see this as a threat to their still strong growth. While we believe Europe recognizes the need to find solutions to its debt problems, we are less certain that the same realization exists in the U.S., the world's largest debtor nation. The key challenge facing the global economy in the next few years will be addressing the imbalances between the U.S. and its creditors, led by China. We will be monitoring developments as the world strives to develop a new set of rules for international economic engagement.

Interest rates

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

In early 2011, global interest rate markets are likely to see a continuation of recent trends. Yields rose rather dramatically in the fourth quarter in response to improved economic data and renewed fiscal and monetary stimulus in the United States. Consumer spending over the holidays was up 5% over the previous year, job growth is rebounding and commercial and industrial loan growth has turned positive. These are signs of a strengthening cyclical expansion that has led to a significant increase in consensus 2011 GDP forecasts. However, both core and headline inflation data continue to trend lower. Furthermore, the Federal Reserve at its December meeting indicated that economic growth would have to meet a high hurdle rate before it would curtail the $600 billion Treasury buying program.

This presents a dilemma for bond investors. Where should long-term yields be when overnight borrowing rates are fixed at 0.25%, the central bank is buying bonds and there is no inflation, but growth is rebounding and equities look attractive? We expect that 10-year U.S. yields will range between 3.25% and 4.0% over the next few months and that levels below 3.0% are highly unlikely. Canadian bond yields should track the same general pattern as the Canadian economy recovers from its third quarter swoon.

Real estate and income trusts

Ryan Fitzgerald
Vice-President,
Portfolio Management
and Portfolio Manager

With the passing of 2010, we finally say goodbye to the income trust. The income trust model required constant access to capital markets, something that was severely impaired following Federal Finance Minister Jim Flaherty's 2006 announcement that trust distributions would be taxed at corporate tax rates beginning in 2011. What did not change was investors' need for yield, especially following the precipitous decline in interest rates with the 2008 financial crisis. This resulted in massive fund flows into a select group of income trusts that market participants deemed would be able to sustain their distributions after becoming taxable. Typically, these were the best companies to start with, companies with very stable, long-dated cash flows. Favoured sectors such as pipeline operators, renewable power generators, and REITs (which are not affected by the new trust rules) benefited from this fund flow and, in some cases, saw valuations rise to all-time highs.

In 2011, we expect more of the same. The small set of "winners" will continue to be favoured by investors who have limited options for achieving high yields elsewhere. This creates an environment ripe for overvaluation. Currently, our holdings are concentrated in these favoured sectors, but we are selectively taking profits and looking to re-deploy capital outside of Canada, where valuations are more reasonable.

Financials

John Hadwen
Vice-President,
Portfolio Management
and Portfolio Manager

We felt strongly that U.S. banks were well positioned for 2010 with strong capital positions, sufficient credit reserves, and a view that credit costs would trend lower. Regulatory risks represented a concern but undemanding valuations seemingly provided room to absorb punitive taxes and higher capital requirements. Our positioning served us extremely well in the first quarter of the year, as the market began to recognize significant credit improvement and capital strength in the sector.

In April 2010, however, things took a turn for the worse, as the SEC filed a complaint against Goldman Sachs. This development and the subsequent rhetoric contributed to the passage of a Financial Reform Bill with higher capital requirements and tough restrictions related to proprietary trading, hedge funds, private equity funds, debit interchange, and derivatives activities. The bill's design was quite damaging for the financial sector with direct revenue hits and added structural costs. There is also concern that the new Consumer Financial Protection Agency presents an unpredictable new risk.

Outside of the U.S., industry and regulators were focused on the design and implementation of the Basel III international banking standards. It was well recognized that the quantity and quality of bank capital would be trending higher, but to what degree and timeline? The final capital structure for banks will have significant impact on leverage and thus return on equity and valuation. The Basel proposals entertained challenging (perhaps ridiculous) liquidity requirements and asset/liability matching that could make certain traditional banking services uneconomic. This confusion resulted in significant debate about future bank valuation. In addition, regulators and politicians pushed the capital debate to a new level with the view that new measures were needed to protect governments from future bank bailout expenses.

The sovereign debt crisis added to the sector's woes in 2010, given that any losses on Portuguese, Irish, Greek and Spanish government bonds would have a significant impact.

Over the past two years, regulatory changes and potential regulatory changes have had a much greater impact on bank valuations. This ongoing uncertainty has depressed investor confidence in the sector, which is why it remains significantly undervalued on a global basis. We expect global financial equities to perform well in 2011 as sector earnings, dividends and capital levels continue to recover.

Health care

Rui Cardoso
Vice-President,
Portfolio Management
and Portfolio Manager

The health care sector continued to lag the overall market in closing out 2010 and it finished the year as the worst performer among the S&P 500 industry groups, as more economically sensitive sectors outperformed. Despite a late-year rally, medical device companies were the weakest sub-group in the health care universe because of fears of lower health care utilization and pricing pressures from hospital and insurance groups in the U.S. and fears of reimbursement cuts in Europe. Pharmaceutical stocks fared better, but still lagged the market, while drug distributors and life science tool companies were the best-performing groups.

Looking into 2011, we maintain a positive outlook for the sector due to historically low valuation levels, reduced headline risk related to health care reform, and improving prospects stemming from maturing drug pipelines for big pharma. We expect that investors will increasingly focus on the sector's emerging markets exposure and its high dividend yields provide added income potential for patient investors waiting for valuation levels to normalize.

Technology, media & telecommunications

Malcolm White
Vice-President,
Portfolio Management
and Portfolio Manager

The technology sector started the year with a bang at the Consumer Electronics Show. The focus this year is the growth of the tablet market, pioneered by Apple but now becoming more mainstream as players such as RIM, Microsoft and others launch their product offerings. This is exciting because tablets are a key component of a larger structural revolution that is occurring as we shift to a cloud-based computing paradigm.

The focus of the media sector in 2011 will undoubtedly be the impact of social media in the advertising market. Discussion has heated up as Facebook has now surpassed Google in terms of Web traffic and in light of a potential IPO from Facebook this year or next.

On the telecommunications side, the sector continues to offer attractive dividend yields in a low interest rate environment. Growth is coming from an explosion of data as more people adopt smartphones that offer more utility than simple voice. We are especially excited about the acceleration of data usage in emerging markets as new next-generation wireless data networks are deployed.

Natural resources

Scott Vali
Vice-President,
Portfolio Management
and Portfolio Manager

Energy and materials markets rallied into year-end on the back of favourable economic growth indicators and disruptive supply dynamics. Australia was hit with severe flooding in key thermal and coking coal producing regions, disrupting supply and causing major producers to declare *force majeure*. These disruptions have once again reminded the world that supply is very tight with multiple infrastructure bottlenecks. Supply from this region is likely to be constrained at least until the end of January.

Copper prices also increased as continued strong demand and incremental supply disruptions focused attention on the expected supply deficits in 2011. With limited new production and declining head grades at current operations, the copper market should continue to be strong this year. Oil markets also appear to be tightening. With confidence in global growth returning and increasing North American demand, the markets are anticipating a reduction in spare capacity. The increase in oil prices is leading to a renewal of exploration and exploitation, boosting demand for energy services.

Grain markets are also tight, with disappointing harvests in North America and the ongoing drought in Argentina. However, farm income should continue to be strong, leading to robust fertilizer applications and the restocking of depleted wholesale and retail channels.

Overall, we look for commodities to continue at robust price levels in 2011.

Foreign Exchange

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

As expected, the Canadian dollar has traded at and slightly above parity versus the U.S. dollar. Canada has overcome a trade deficit that is running at an annualized rate of $25 billion in the past four months, which is in sharp contrast to the $40 billion to $50 billion in annualized surpluses in 2007-2008. Net foreign demand for Canadian securities, mostly debt products, has jumped to over $11 billion monthly in the past quarter. This demand, which is easily funding the current account deficit, and higher commodity prices have contributed to the loonie being one of the strongest currencies in the G10 in the past few months.

The predominant story in foreign exchange markets recently has been the resurgence of the U.S. dollar versus the euro. We increased our hedge against the euro in early November as a precaution to a "buy the rumour, sell the fact" market reaction to the quantitative easing announcement in the U.S. Indeed, the euro has retraced much of its rally from the summer, as Ireland sought financial assistance from the European Union and IMF. The outlook for the euro is problematic in the near term, due to an imposing debt refinancing schedule for the peripheral nations. That said, we believe the EU will avert a funding crisis. The euro will experience significant volatility, but is unlikely to trade to new lows versus the U.S. dollar.

High-yield bonds

Geof Marshall
Vice-President,
Portfolio Management
and Portfolio Manager

With a 15.2% return in 2010, the high-yield bond market has posted the best two-year return in the short history of the asset class. Considering the record amount of new issue supply in 2009 and 2010, this has been astonishing. The market has had extended periods of above-average returns in the past, including 1991-1993, 1995-1997 and 2003-2006. The question then is, can the current rally continue?

While all-in yields are modest, valuations as measured by credit spreads (the difference in the yield between the corporate bond and a Treasury bond of comparable maturity), which are currently at +541 basis points, approximate the historical average of +534 basis points. This average, however, has been skewed by the massive widening of spreads that occurred in 2008, so the 1984-2007 average of +456 basis points provides a better yardstick.

Strong corporate fundamentals and an improving economy should ensure that default rates remain low. This makes valuations even more compelling, with a high likelihood of further spread tightening. Price appreciation gains from spread tightening could face a slight headwind from rising Treasury yields, possibly late in the year. In this case, total returns would be in the high-single-digit range, but lower than the previous year, although we made the same prediction last year. As such, we consider high-yield bonds the most attractive part of the fixed-income market and they continue to comprise a core component of our income strategies.

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