

# Market Roundup

## Global outlook



Eric Bushell  
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Investors have rarely been more confused than they were in the second quarter. Beginning in mid-April, there were a number of sharp price movements in various markets:

- Spanish government borrowing costs surged
- Chinese property stocks fell 25%
- the euro fell 15%
- copper fell 20%
- interest rates on 10-year U.S. government bonds collapsed from 4% to 2.9%.

In May and June:

- oil dropped 20%
- European and U.S. stock markets both fell 15%
- funding costs for investment-grade and low-grade debt moved higher
- equity indexes saw volatility rise from 15 to 40.

Clearly, foreign exchange and sovereign debt were the signals that led equity and credit markets.

All of those adjustments reflected an abrupt re-appraisal of the winner in the tug-of-war we have used to characterize the financial markets in 2010. This battle is between reflation/recovery and deflation/non-recovery. On one side, there's the recovery – increased capital spending by companies, normalized consumer behaviour, good corporate profitability, and emerging stability in housing and employment. On the other side are the consequences of the crisis – public sector debt, financial regulation, higher taxes, consumer and bank deleveraging, and consequent deflationary forces. The growth side clearly lost during May and June. Every single one of those market movements noted above reflects this shift in the tug-of-war.

So what happened? What was the catalyst for that abrupt reappraisal? It was mainly the European sovereign debt contagion and related European bank funding and capital adequacy problems. This tipping of the battle then gained momentum with China's economic tightening measures and concerns about growth in the U.S.

Our view is that the European fiscal situation and growth outlook is not as bad as markets believe. These developments came upon the market quickly – but things are going to sort themselves out as facts displace rumour. Nonetheless, the recovery in confidence is going to be a long process following the shocks of 2008.

## Global outlook



Drummond Brodeur  
*Vice-President,  
Portfolio Management  
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Equity markets continue to reflect concerns of a global double-dip recession, a slowdown in China and European sovereign credit concerns. While we are cognizant of these risks and respect the fragile nature of the current economic recovery, we believe that the global recovery remains on track, despite moderating momentum, regulatory reform of the U.S. financial sector, currency reform in China and the European Financial Stability Facility (which is aimed at preserving financial stability in the Eurozone). European funding markets were easing ahead of their bank stress tests and China is achieving the desired slowdown.

This year, the primary trends are the handoff from government-led growth back to private sector-led growth and from developed market consumers to emerging market consumers. In the U.S., private sector hiring and capital spending are showing signs of recovery, although still slow. We expect this to continue into the second half of the year and to be supported by growing credit creation to small and medium-sized enterprises. The U.S. and Europe are expected to experience slower growth as fiscal stimulus is withdrawn, but this will be offset by strong growth from Asia – particularly China. Recently, China announced second quarter growth of 10.3%, while Singapore reported growth of 19.3%. Investors must dig beyond the headlines to help understand the significant shifts occurring throughout the global economy and their investment implications.

## Interest rates



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

The global economy is transitioning from very strong growth through the winter of 2009-2010 to a more subdued pace throughout the summer. This deceleration has increased the volume of the double-dip recession proponents. Concurrently, sovereign risk concerns have stubbornly refused to respond positively to the European rescue package and bank stress tests. All of this has precipitated one of the largest drops in government yields in history. Inflation is low and credit conditions have tightened moderately, so the U.S. Federal Reserve is unlikely to raise rates in the next six months. Our previous forecast of a 75-100 basis points (0.75%-1.0%) increase by the Bank of Canada this year still seems plausible after the 50 basis point (0.5%) increase so far this summer. The Bank of Canada will continue to be very measured in balancing domestic and global conditions.

## Preferred shares



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

Both equity and credit markets sold off sharply in May due to the European sovereign debt crisis, but the preferred share market held up very well in the face of concerns over the Greek debt crisis.

Retail investors' demand for preferred shares has remained strong, despite a modest amount of new issues coming to market. Supply will likely remain low because all Canadian banks, which are the major issuers of preferred shares, currently have ample capital.

The outlook for the preferred market is for mid-single-digit returns this year, which has been lowered given the weaker-than-expected return of during the first quarter. Since new issuance is expected to be light, demand should continue to slowly push valuations higher.

## Consumer



Stephane Champagne  
*Vice-President,  
Portfolio Management  
and Portfolio Manager*

For consumer product companies, the second quarter was a retrospective affair. They either benefited at the top line from the restocking cycle within wholesale distribution channels, or had renewed access to credit. Either way, reported figures gave a perspective on the strength of underlying consumer demand, and gross margins were helped by a good year-over-year comparisons or commodity tailwinds. The key question for consumer stocks was to what extent the current level of promotion in the sector would be sustained. For retailers in the U.S., fragile consumer confidence, little improvement in unemployment and bad weather conditions in April and May led to mixed returns.

In general, we expect tailwinds for the consumer sector in the third quarter to be somewhat offset by headwinds. But, we remain positive on the sector due to good valuations in some sub-sectors and solid long-term fundamentals.

## Financials



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

It seems that credit costs within Canadian and U.S. banks are being contained within recent expectations. As a result, earnings will normalize over the next year or two, assuming modest economic growth is maintained. European banks have been making progress in improving their balance sheets and cleansing troubled loan portfolios, but higher-risk sovereign exposures have set industry earnings back by a couple of quarters. The stress tests on the European banking system is a step forward. Greater clarity is preferable to the confusion that has hung over the sector in recent months. Valuations of Canadian banks look attractive in isolation, but compared to the cheap valuations of global peers, we can't get too excited about the near-term upside.

The two-year U.S. government bond yield is hitting historical lows at 0.58%, which suggests that the market is worried about deflation. If the consensus is wrong, and the U.S. manages to generate mild economic growth and inflation, there will be many equities that generate an average return of 0.58% *per week* over the next two years. Is it time for global investment managers to make a radical move away from supposedly risk-free assets?

## Health care



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

Developments within the sector have been mixed over the last few months as the removal of the U.S. health care reform overhang has been followed by pricing concern risks driven by austerity packages in parts of Europe. Against this backdrop, health care has been a middling performer. In our view, three very positive factors continue to occur in the sector and we believe they will lead to a reset of valuations to higher levels over the next year. The first is consolidation. After the three big mega-mergers last year – Roche/Genentech, Pfizer/Wyeth and Merck/Schering Plough – the sector has continued to consolidate with smaller, strategic and meaningful deals for long-term valuations. We expect the mid-cap biotech and medical devices sectors will continue to be bought up given low valuations and much faster growth outlooks than their larger, better-capitalized peers. The second positive factor is drug approvals. So far in 2010, there has been an acceleration in the number of new drug approvals through the FDA, and the drugs approved have better potential than in previous years. The third factor is emerging markets growth. While the pricing environment in Europe will continue to remain a challenge, drug sales in the BRIC countries continue to grow more than 20% a year. These markets are becoming more relevant to overall operating income with each passing quarter.

## Technology, media & telecommunications



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

During the quarter, technology shares were under pressure largely due to concerns of weaker economic growth in Europe. However, some investor fears are overblown, as seen in the record earnings from Intel. (In the second quarter, Intel reported its best quarter ever as sales jumped 34% year over year.)

Media stocks have also been similarly affected by economic uncertainty.

In contrast, Canadian telecom stocks have been appreciating as investors have realized that the new wireless entrants will have less of an impact than initially feared. The global telecom sector continues to offer attractive dividend yields in the context of a low interest rate environment.

## Foreign exchange



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

Last quarter we cautioned against being too overly optimistic with respect to the Canadian dollar, as it flirted with either side of parity to the U.S. dollar. The second quarter has validated that stance. Global economic growth concerns and a risk aversion spike have forced bullish loonie positioning by investors to be unwound and re-established in a range against the U.S. dollar of about five cents below parity. We expect that range to hold over the next few months. Recently, we reduced our hedge against the euro to a more neutral stance. We anticipate the aggressive negative sentiment toward the euro to partially subside as the European bank stress tests are published and fiscal austerity measures are enacted. The euro/Canadian dollar rate has fallen 20% through June and we believe some partial retracement is likely.

## High-yield bonds



Geof Marshall  
*Vice-President,  
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Despite major moves downward in other markets, the high-yield bond market generated positive returns during two of the three months in the quarter – only giving up ground in May, when the European sovereign debt crisis was at its peak. With a flat second quarter and a 4.74% return year-to-date, high-yield bonds have outperformed all other major asset classes with the exception of government bonds. This could be a reflection of the U.S.-centric nature of the typical high-yield bond issuer, attractive valuations, and possibly even the inherent illiquidity of the asset class.

So far, North American economic data have been in line with our expectations. Growth following a recession is historically strongest at the beginning of the recovery before moderating. While we believe the recovery is going to be slow, we also think a V-shaped recovery or W-shaped retrenchment is unlikely. Since we find ourselves in this situation due to excesses in the credit markets, it is worthwhile remembering that we need functioning lending markets and healthy banks to ensure the recovery continues. In the U.S., high-yield new issuance slowed in the second quarter and we are seeing evidence that credit markets are continuing to recover. For example, the U.S. Federal Reserve Senior Loan Office survey shows banks are easing standards for commercial and industrial loans, reporting stronger demand, and lowering pricing on these loans. We take this as a sign that a large component of the U.S. economy, particularly small and medium-sized businesses, is optimistic regarding growth prospects, whether it is from consumer spending, exports or capital expenditures. If this translates into slow growth and falling defaults, then, given current valuations, high-yield bonds look especially attractive.

## Investment-grade bonds



John Shaw  
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Corporate credit hit a major bump in the road during the second quarter with the European sovereign debt crisis. This brought an end to its year-long rally in spreads. As well, the market was very concerned by the health of the European financial sector, the U.S. financial regulation bill, and the environmental disaster of the Gulf of Mexico oil spill. Global economic growth slowed and investors' outlook for growth fell. Concerns of slowing Chinese growth and the effects that the European debt crisis would have on growth resulted in falling global equity markets and widening credit spreads. Investor demand waned as the flow of funds into investment-grade bonds fell. The weaker corporate credit market resulted in very little issuance in the Canadian investment-grade market. Overall, corporate bonds posted positive returns due to the rally in government yields.

Even though there are a number of major issues facing the market, we believe these concerns will be dealt with in time and that the outlook for credit remains positive. The global economy continues to grow, but certainly at a slower pace. From a fundamental perspective, U.S. home prices and unemployment have stabilized while consumer spending and investor sentiment have rebounded. With improving corporate earnings, this is supportive of corporate bond valuations.