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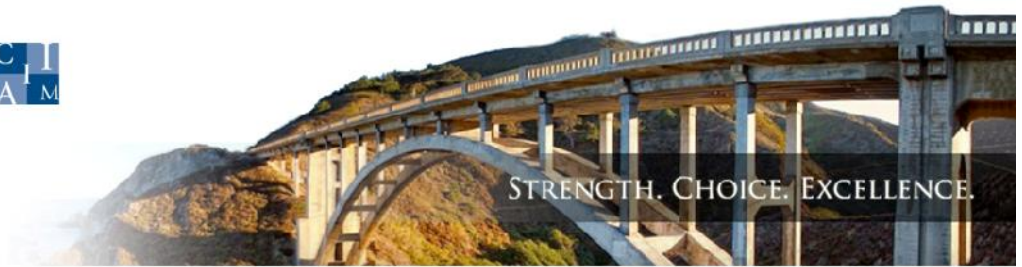
**Shifting tides: From synchronized global recovery to diverging growth paths**

Perhaps the most surprising aspect of the global economy as we enter 2014 is that almost every region is on a clear cyclical upswing. We are in the midst of a synchronized global economic recovery! Economic growth is accelerating and we can comfortably expect that global growth will be stronger this year than in 2013. After five years of recurring crises following the collapse of Lehman Brothers, this improvement and stability are unambiguously positive. Indeed, for the first time in several years, there is no obvious crisis looming. Last year, it was the U.S. fiscal cliff and two years ago, it was the Eurozone debt crisis.

On the heels of a year in which most global equity markets returned more than 20%, it is safe to conclude that, at least for now, the extraordinary monetary medicine administered by central banks has been effective and global economies are healing. With confirmation of a stronger economic trajectory, particularly in the U.S., the next step is to wean the patient off the monetary “drugs” and allow the economies to stand on their own. This process – the so-called tapering in the U.S. – will dominate markets in the first part of 2014. With the U.S. dollar being the global reserve currency, U.S. policy will affect virtually all countries’ interest rates and currencies in some capacity. This year will show which economies have made adjustments and will be able to withstand the start of monetary policy normalization and which have not made the transition.

While the year has started with a synchronized cyclical recovery, we expect the regions to take significantly differentiated structural growth paths. In short, we see the U.S. posting stronger and more sustainable growth. Europe, having bounced out of a long austerity-induced recession, will transition toward a stagnant low-growth environment, as bouts of fiscal austerity and financial sector deleveraging set the backdrop for the ongoing political negotiations on the future of the Eurozone. Meanwhile, Japan’s experiment with monetary magic will face its first real test with a consumption tax increase hitting consumers on April 1.

A similar divergence is expected in the emerging economies. The key country is China, where the new government seems intent on rolling out an aggressive structural reform agenda to help transition the economy to a greater reliance on consumption and services rather than fixed-asset investment. Although China’s leaders clearly understand this will ultimately mean slower growth, they are seeking to maintain growth this year near its current level of 7.5% to support the transition. This project will be a decade-long undertaking and we expect it to be one of stops and starts. To the extent they are successful, it will benefit both China and the global economy over the long term.



Most other emerging nations will benefit from the pick-up in the global economy, but just as in the developed world, some economies are on a sound foundation for sustainable growth while others have avoided the necessary structural reforms and simply benefited from the twin forces of loose global liquidity since 2009 and booming commodity prices prior to 2008.

The correct lens to view the world today is not emerging versus developed economies, but rather those that have undertaken or are implementing structural reforms to improve competitiveness and growth potential versus those that are resisting or avoiding making tough decisions. To mash up some metaphors, while the rising tide of global liquidity has lifted all boats, when that tide goes out, you will see who has been swimming naked. The Fed's commencement of tapering in the first quarter of 2014 signals the change in the tide.

For asset markets, our central scenario sees the U.S. economic recovery continuing and the Fed steadily reducing its pace of quantitative easing over the year. U.S. interest rates, already back to 3% for the 10-year Treasury, can be expected to continue to grind higher, approaching 3.25% by mid-year and 3.5% by year-end. For the second year in a row, investors can expect a negative return from government bonds, albeit a small one. There is also the risk that the shift from bonds to equities will accelerate. With government bond rates rising due to a stronger economy, credit spreads should remain tight, with investment-grade bonds delivering a flat to small positive return and high-yield bonds posting returns in the mid-single digits as the higher coupons offset rising rates.

Equity markets had a stellar 2013, as liquidity trumped fundamentals, driving valuations higher on the back of modest earnings growth. We expect 2014 to see a return to fundamentals as the primary driver of returns. In such a scenario, equities should continue to outperform other asset classes with expected returns of 8% to 12% for the year. As rates rise, we also expect to see higher volatility compared to the past year, with a couple of significant market corrections in the range of 10%, providing opportunities to add value from a tactical perspective.

For currencies, we expect the divergence in economic growth, coupled with diverging monetary policies from key central banks, to support the U.S. dollar against most major currencies, including the Canadian dollar.



## Regional Perspectives

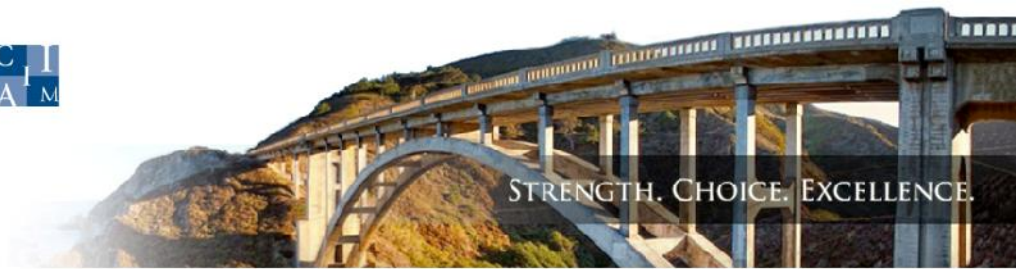
### United States

The U.S. economy appears to be entering 2014 with the best momentum in many years. Following strong headline growth of 4.1% in the third quarter of 2013, subsequent data have largely confirmed the economy's underlying strength. Following the significant fiscal drag from the tax hikes and sequester in the first half of 2013, the re-acceleration of the economy following five years of lacklustre recovery suggests that the deleveraging cycle is waning and that the U.S. is positioned for a more normal business cycle recovery. In May 2012, we wrote a piece ("The U.S. is undergoing an industrial revival") outlining the significant improvement in its global competitiveness following more than a decade of adjustment from the integration of China into the global economy. We argued that in many cases, the U.S. is becoming cost competitive with China, and coupled with the significant energy advantage from shale oil and gas, the U.S. is emerging as the most competitive major economy on the planet for many industries. While some of those advantages were offset by the recent political dysfunction in Washington, the long-term implications of the adjustments made in the U.S. continue to unfold.

In 2014, the U.S. economy could be firing on all cylinders. A key factor will be the lack of fiscal drag from government. While the federal level is unlikely to accelerate spending, it will not be cutting as was the case last year. State and local governments are likely to continue to modestly increase their spending as revenues rise along with stronger economic activity. Housing and consumption are showing signs of resilience and will continue to help drive growth. Both will be supported by improved job creation and while rising mortgage rates will slow housing, they are unlikely to derail the ongoing recovery in housing. Although house prices are rising – the S&P/Case-Shiller 20-City Composite Home Price Index showed a 13.6% annual increase as of the end of October – affordability remains well above longer-term averages.

The final driver for the U.S. economy would for business spending to accelerate, and the conditions are in place to support this development. Corporate cash is at extremely high levels, banks are interested in lending again, the economy is growing and pushing up capacity utilization, and there has been a prolonged period of under-investment. The only remaining ingredient is confidence, which should improve with the economy, while the impact of political dysfunction should lessen as other factors improve.

Overall, the U.S. is the primary engine of the global recovery and we believe there is a strong likelihood of the U.S. entering into a sustainable multi-year economic expansion in the range of 2.5% to 3%.



## Europe

Europe continues to recover from the crushing recession following the sovereign debt/banking crisis in the peripheral Eurozone economies, but we do not see the conditions in place for a strong or sustainable recovery. Following the recent bounce, we expect growth to moderate in 2014 to 0.5% to 1%, below most expectations and certainly well below what is needed to make progress on elevated unemployment and debt levels in several countries. A year ago, we wrote that the Eurozone was three years into a decade-long restructuring process. For now, the actions of the European Central Bank and some easing of fiscal austerity targets has subdued the financial market panic, but has not addressed the long-term structural and political questions surrounding the nature of the Eurozone monetary union.

As the ECB rolls out the banking sector asset quality review and stress tests between now and November, when it takes responsibility for supervising the banking system, the pressure for banks to accelerate their deleveraging to pass the stress tests ensures that credit creation in Europe will remain in contraction and is a key aspect of our thesis that the recovery will remain sub-par. The recent decision that responsibility for backstopping the banking system will remain primarily at the national level shows that debt forgiveness across Eurozone members is not yet in the cards and implies that those countries with excess debt levels must continue down the path of austerity and structural reform. For some, such as Ireland and Spain, significant progress has already been made, but for others, particularly Italy and to some extent France, they have barely started the process. The risks here are twofold. From an economic perspective, such reforms will hurt growth initially. Secondly, from a political perspective, it is not clear that the general populace is willing to support the necessary austerity and reforms, and increasing political turmoil seems likely in the coming year.

While the recent easing of recessionary conditions has led to renewed optimism over the outlook for Europe, as well as a re-rating of asset prices, we believe that the Eurozone will continue to experience a political crisis unfolding over many years and that these concerns will resurface in the coming year. Secondly, the data being released in coming quarters are likely to disappoint investors due to the overly optimistic expectations. As a consequence, we also expect that the ECB will expand its use of unconventional monetary policies in 2014 as it seeks to distance itself from tightening by the U.S. Fed and to offset the growing threat of deflation. On that note, the most recent Eurozone inflation number of 0.8% came in well below the 2% target. With 12% unemployment, a strong currency and slowing growth, the potential of deflation cannot be ignored by the ECB.



## China

China, with its 7.5% growth rate, is the world's other major growth engine, along with the United States. The world's two largest economies together can provide decent non-inflationary growth for the world as a whole. In fact, regardless of whether China's growth slows to 7% or accelerates to 8%, the sheer size of its economy (close to US\$10 trillion in 2014) means that it contributes the most incremental growth to global GDP. So, China does matter.

Late last year, the new leadership in China laid out an aggressive agenda to reform the economy to increase the emphasis on consumption, services and market-driven signals and reduce its reliance on fixed-asset investment and administrative guidance. This represents an explicit recognition of many of the challenges facing the country: misguided investment, excess capacity in heavy industry, excessive local government debt, runaway pollution, and so on. It is clear that many of these issues will take years to fix and that the economy will see significantly slower growth in the coming five years in comparison to the past two decades. The challenges are significant and unpredictable, but the prevailing mood in Beijing appears to be: "The sooner we get started, the better – so let's get started." The approach appears to be pragmatic rather than dogmatic, with the recognition that it's easier for the economy to adjust while the growth rate is still strong. Supporting this process will be the country's high savings rate and low central government debt, which will make it easier to write off bad debts elsewhere in the system. Furthermore, the authoritarian political system can enforce unpopular policies (both for the better and obviously for the worse).

China's progress in this transition must be monitored closely, given the implications for the global economy. For Canada, the changes in China will affect the resource sector, with the growth in demand likely to lag the increase in supply in some sectors. This could hurt commodity sentiment and prices in general.

As for investing in China, like emerging markets in general, we think valuations have corrected significantly and are attractive in a global context. But we are only interested in investing where attractive valuations are also supported by sustainable fundamentals and in that respect, not all emerging markets will be able to adapt to the tighter global liquidity regime that we expect. We remain cautious on countries that have failed to pursue reforms aimed at improving the growth potential of their underlying economies and are reliant on foreign capital. It is our sense that in the next few years, foreign capital flows will be very sensitive to domestic policy developments in debtor nations.



## Japan

Finally, a word on Japan. We continue to stand by our article from last February (“Japan lives to die another day”) in which we argue that Japan’s dire debt situation and demographics ultimately trump any true economic recovery. But in the meantime, the Bank of Japan will print ever larger amounts of money to keep the game going. Foreign investors continue to pile into Japan to chase the momentum in the market (although returns were not nearly so strong if you weren’t hedging the currency), but domestic investors remain net sellers. For now, the performance of Japan is a call on the foreign appetite for Japanese stocks, with very few believing in its long-term potential.

The first major test comes in April when the consumption tax increases from 5 to 8%. This is driving a boom in consumer spending ahead of the increase, but it risks sending Japan back into recession in the second quarter. To help alleviate the risk, we expect the Bank of Japan to expand its already aggressive quantitative easing program just before or just after the tax increase. So, expect more monetary loosening and yen weakness in 2014.

One major concern in Japan is consumer spending. With flat to declining wages, the average Japanese worker will now face a 3% consumption tax increase, rising imported inflation from the falling yen, and higher energy prices following the shutdown of most nuclear facilities in the wake of the earthquake and tsunami in 2011. Japanese consumers are facing the threat of a significant decline in their real incomes, something that has not been an issue for most of the past 20 years of deflation. Japan has embarked on a high stakes game of monetary policy poker in which the risks and outcomes are unknowable. We continue to tread cautiously in Japan.

In summary, our global outlook for 2014 is decidedly sunnier than in recent years. However, we do expect that several squalls will emerge to roil markets and test investors over the course of the year. While the global economy remains somewhat fragile, it has and should continue to strengthen over the coming year.

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