Market Roundup

Global outlook

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

The extraordinary low interest rate environment has created a surge of investments into riskier, higher-yielding, illiquid assets. This behaviour was further encouraged by the Federal Reserve's asset purchase program (QE2), which recently concluded. The effects have been largely consistent across different markets. In our view, this enthusiasm is misplaced when consideration is given to systemic risks we see in Europe and America. Several years of low growth and consumer deleveraging lie ahead and as consumer prices advance against stagnant wages, we expect to see widespread consumer retrenchment. The political and social consequences of the crisis are becoming apparent. Financial regulation is being enacted with some unintended consequences – such as the reduction in market liquidity, which may magnify volatility. At Signature, we are defensively positioned for this environment.

Global outlook

Drummond Brodeur
Vice-President,
Portfolio Management
and Global Stategist

In a financial markets version of the movie Groundhog Day, global markets are embroiled in concerns regarding European sovereign debt defaults and the soft patch in the U.S. economy. We feel that these concerns are overdone. It is unforgivable that the Europeans have failed to use the past year to better dilute the contagion risk from Greece – but here we are. A key difference this year is that the scope of the problem is understood, as are the potential avenues of contagion. There is also a US$110 billion safety net in place that did not exist last spring. So some progress has definitely been made. The major risk last year was a failure to grasp the extent of the problem – today it is a risk of failure on the part of the European politicians to execute a successful containment strategy.

As for the U.S. soft patch, there is no doubt that the second quarter was a lot slower than first anticipated – but much of the slowdown can be attributed to supply chain disruptions in autos and technology resulting from the Japanese earthquake and tsunami. These disruptions were expected, but unquantifiable, immediately after the earthquake. These will likely be reversed in the second half of the year. There is little doubt that elevated oil prices have reached a point where they are a drag on U.S. consumption. As was the case last summer, markets will remain fragile as participants await confirmation of the temporary nature of the slowdown. As in Europe, the risk of incompetence on the part of American politicians looms large. At the time of writing, we expected that a compromise would be reached on the debt ceiling issue; however, it is important to recognize that this is just the early rounds for the upcoming 2012 U.S. election and such political brinkmanship and sparring will be continuous over the coming year and a half.

Having reduced risk in late April, our funds remain conservatively positioned. We will remain data dependent when looking to reinvest some of our cash at more attractive levels – in what we anticipate to remain a volatile market environment.

Interest rates

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

Recent movements in government bonds have been driven in part by direct economic indicators and in part by budgetary uncertainty. Yields had been range bound. This reflected the market's appreciation for the hesitant, but resilient, economic expansion as it dealt with natural disasters and political wrangling. As the second quarter closed, bonds rallied relentlessly through the bottom of the previous yield range in response to signals that growth was below trend in both Canada and the U.S.

Adding to the lower yields was the discord in Washington over the Republican Party's insistence on significant budgetary cuts in exchange for increasing the debt ceiling. Throw in more Greek protests over austerity measures, the seemingly inevitable writedown on Greece's sovereign debt and the safe-haven nature of U.S. government bonds was re-established. This is not a trivial matter. Should the budgetary impasse in Washington lead to doubts about the U.S.'s willingness to pay its obligations, then the subsequent rise in real yields would create economic chaos.

With Chinese inflation rising past 6%, look for more efforts by authorities to reign in growth of the globe's most powerful economic engine. This will help foster the notion of a global economy lacking any meaningful growth drivers. How much of this is priced in to the below 3% yield on U.S. 10-year bonds? A fair bit given that the Federal Reserve's bond-buying program has ended. We liken current yields to the notion of keeping a beach ball under the water. If global policymakers defer the hard decisions in favour of promoting growth, interest rates could pop higher and settle back into their earlier range.

Emerging markets

Matthew Strauss
Vice-President, Portfolio Management,
Portfolio Manager
and Global Strategist

Inflation fears and economic growth concerns weighed on emerging market equities in the second quarter, partially offsetting the gains of 2.1% recorded in the first quarter. The only region that recorded a positive return was Asia, led by strong quarterly gains in Indonesia, Malaysia and the Philippines. Peru was the clear laggard as domestic politics dominated, following the surprise victory of the left-leaning presidential candidate. Renewed uncertainty about the Greek debt situation and the end of quantitative easing (QE2) in the U.S. added to a sombre investment environment.

European event risk aside, we view the current environment as a mid-cycle correction in emerging markets and, after last year's unsustainably high growth numbers, welcome some slowing in economic growth. Furthermore, we believe that many emerging market central banks have done enough or nearly enough to contain inflation without risking a sharp slowdown in their respective economies. Consequently, these central banks are expected to move to the sidelines during the next two quarters. As inflation peaks in the third quarter and fears of a hard landing subside, emerging markets are set to outperform their developed counterparts once again. We will continue to focus on those sectors with direct exposure to the domestic markets, paying specific attention to domestic consumer stocks, financials and health care. From a regional perspective, we continue to favour Asia given its still strong underlying growth dynamics and expectations of a pause in monetary policy tightening.

Preferred Shares

John Shaw
Vice-President,
Portfolio Management,
Portfolio Manager

Retail investors' demand for preferred shares remains very strong as new issuance has been light and redemptions continue to dampen supply. Supply will remain low due to the strong capital position of Canadian banks. Almost all of the $20 billion of bank preferred shares outstanding will be redeemed over the next six years and only a small amount will be re-issued. This will strengthen demand given that almost 35% to 40% of the preferred share market may disappear. The outlook for the preferred market remains positive, especially following the Office of the Superintendent of Financial Institutions (OSFI) ruling that the bank preferred shares will have to be redeemed or exchanged into qualifying securities.

Autos

Massimo Bonansinga
Vice-President,
Portfolio Management
and Portfolio Manager

Along with the rest of the automotive sector, auto parts manufacturers and suppliers suffered from the Japan's earthquake and tsunami. Some auto parts companies had significant assets in the affected area and their share prices were hit accordingly.

Since the March 11 earthquake, the Japanese automotive industry has staged a remarkable comeback. Production levels are scheduled to be back to normal by the end of the summer. But, because of the lack of product, Japanese Original Equipment Manafacturers have lost market share globally and their inventory levels are significantly below normal. Dealerships need inventory to function properly, especially in the U.S., where customers prefer to buy vehicles off the lot, rather than wait and have them built to order.

Over the coming months, Japanese manufacturers will push production rates hard to catch up with lost sales and rebuild inventories. Suppliers benefit from higher production rates because they bill OEMs before the vehicle hits the dealerships, regardless if it is sold to a customer or it is part of the dealer inventory. Japanese suppliers have accelerated their establishment of facilities outside Japan to help manufacturers increase local content and to diversify their locations.

At Signature, we increased our holdings in Japanese suppliers and added new ones in March – less than a week after the earthquake. We believe there will be a fast recovery in production, so we have invested in companies with clear technology leadership and a strong push to sell outside their traditional relationship with the Japanese OEMs. Our investments in Aisin Seiki, JTEKT (both Toyota affiliated) and Keihin (Honda affiliated) have already generated 20% upside. We are confident there is still more to come from multiples expansion and expanding sales and profitability.

Consumer products

Stephane Champagne
Vice-President,
Portfolio Management
and Portfolio Manager

Consumer activity slowed during the second quarter on a sequential basis. The negative stories were sharply higher gasoline prices, higher food costs, slower employment and bad weather. Overall, the S&P 500 Index underperformed the consumer discretionary sector by 340 basis points and consumer staples by 485 bps. Finally, staples outperformed the consumer discretionary sector by 145 bps during the period. The staples index has been helped by an increase in the U.S. unemployment rate to 9.2% at the end of the quarter from 8.8% the previous quarter.

After good U.S. retail sales in April, poor weather conditions and negative employment reports in May, there was decent retail sales growth in June in nearly all segments. Compared the first quarter, softline retailers have been mixed, mostly due to unfavourable weather. Hardline sales were gaining momentum until the decrease in consumer confidence, higher than expected unemployment rate, slower real estate activity and lower durable goods consumption. Restaurant and luxury goods have recovered since the first quarter and have been one of the best performers among the discretionary sector. They also did well compared to softline retailers. Apparel companies started to feel the impact of tough comparable sales in the second quarter. They should experience some pressures from labour costs in Asia and higher cotton costs in the second half of the year. The hotel sector underperformed the discretionary sector due to high valuation and cautious expectations on pricing and volume growth from a major company.

In the staples sector, tobacco and beverage stocks outperformed household and personal care stocks, which outperformed food producers and staples retailers.

Overall, discussion over the next few quarters will be centered on higher interest rates in Europe and China, austerity measures in Europe and how the U.S. economy will respond to the end of the Federal Reserve's QE2 stimulus program which ended in June. Investors should expect continued volatility in equity markets.

We remain confident in our choices due to their cheap valuations compared to historical valuations, high free-cash-flow generation, high-quality balance sheets, and a high return to shareholders (dividends, buybacks, mergers and acquisitions). We are taking a conservative approach to our consumer portfolio, which should help temper portfolio volatility and allow us to take advantage of the opportunities when there is an equity market pullback. For the longer term, we still remain positive toward emerging market consumer stocks.

Health care

Rui Cardoso
Vice-President,
Portfolio Management
and Portfolio Manager

Following solid first quarter results, health care was the best-performing sector in the S&P 500 Index with a return of 7.3% compared to the index return of -0.4% in the quarter. We attribute most of this to a more defensive repositioning of portfolios by the broader market, coupled with a rebound in health care insurers from depressed valuation levels. Beyond a defensive tilt in the market, the sustainability of the rally in health care will depend on a shift in sentiment towards the future outlook for the sector from a top-down basis (that is, the impact of reforms in markets like the U.S. and Germany and the impact of austerity measures across most of Europe), and a bottom-up basis (related to a steep decline in R&D productivity in pharma and medical device segments at a time when a significant percentage of their revenues are at risk of losing patent exclusivity or are facing more severe pricing pressure).

With regards to a shift in sentiment on the top-down issues, our view is that the headline risks remain. Pan-EU measures on cost controls in health care will intensify and the budget ceiling issue in the U.S. will place more of a spotlight on entitlements – especially Medicaid and Medicare programs. That said, the issues with pricing in Europe are well understood and largely factored into estimates (we expect price declines in the region in the 5% range over the next few years). Also, emerging markets such as China and Brazil are vastly under-penetrated in health care utilization and spending levels relative to the developed world. In addition, the wealth effect is leading to rapid increases in hospital procedures and drug and device spending.

From the bottom-up perspective, looking at current valuations and dividend yields for the group, we believe the "patent cliffs" are more than factored in to current expectations. Our favoured sector remains big pharma stocks. Their drug pipelines remain full. The U.S. Federal Drug Administration's focus on risk versus benefit when examining new drugs has swung back to a more rational state, leading to higher approval rates of new drugs since late 2010. Given the high dividend yields offered by the group, we are being paid to wait. Our overall view of the sector remains positive.

Global industrial products

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

Recently, profit trends for industrial products companies have become more predictable. Areas of strength continue to be in mining and energy equipment, industrial automation and electrical equipment. This is a result of growing resource demand due to emerging markets, automation demand driven by labour and/or raw material inflation, and energy efficiency trends. Companies more exposed to weaker geographies and end markets, like construction, are more likely to experience earnings disappointments.

Although industrial companies continue to feel confident about near-term growth prospects, they have been noticing pockets of disappointing growth in Western Europe and the Chinese construction segment. While Chinese construction spending appears to be turning up, the weakness in Western Europe is likely to persist.

Raw material inflation concerns have eased somewhat when compared to the first quarter of this year, which should provide some relief from the growing European macro concerns. Valuations are at normalized levels for the vast majority of industrial companies, but growing sovereign risks around the world could start to challenge investors' appetite for cyclical stocks in the near term.

Technology & telecommunications

Malcolm White
Vice-President,
Portfolio Management
and Portfolio Manager

On the technology side, we are conservatively positioned as we enter the earnings season. We are seeing signs of a subdued consumer, especially in areas such large-ticket television sales. However, we are more positive on business spending and see good opportunities in software, storage and services that cater to this segment.

In telecommunications, we continue to believe that we are in a multi-year cycle of increased spending and want exposure to companies that will benefit from this trend.

While dividend yields look attractive in the telecommunication sectors, we believe that increased spending and problems in Europe will weigh on the sector.

Foreign exchange

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

Similar to the market's portrayal of U.S. Treasuries being a safe harbour, the U.S. dollar benefits during periods of stress. Because the warts of the U.S. dollar are well documented, positioning by investors tends to get lopsided on the bearish side of the ledger. And when the euro, which is currently the only real reserve currency alternative to the U.S. dollar, is the centre of the market stresses, the dollar can rally appreciably. Although not nearly as extreme as 2008, the market pricing of forwards are suggestive of a shortage of U.S. dollars as some investors hoard them.

However, the fact is that countries whose currencies have been dubbed "risk on" due to their positive correlation with global growth have not lost much ground against the U.S. dollar. This is indicative of the market beginning to take the reserve currency stature of the U.S. dollar with a grain of salt. The more uncertainty regarding the U.S. economy, the more protracted the ultra-low policy of the Federal Reserve. In conjunction with looming fiscal constraint this underpins a soft medium-term outlook for the U.S. dollar against Australia, Norway, Canada and Brazil.

Europe needs to formulate a plan to more closely unify the differing fiscal regions. If instituted, then the crisis in the peripheral economies will have spawned a more worthy global currency. The market, by pricing in a loss of confidence in Italy or Spain, is the likely catalyst for joint fiscal and monetary alignment.

Investment-grade bonds

John Shaw
Vice-President,
Portfolio Management
and Portfolio Manager

Investment-grade corporate bonds posted positive returns during the second quarter of 2011 mainly due to falling government yields that outweighed the slight rise in spreads. Corporate bonds outperformed government bonds during the quarter, but as each month passed corporate bond performance slipped. On a fundamental basis, corporate credit remains solid; however it is the political and macro-economic concerns that are causing the market's volatility to rise and returns fall.

There are a number of issues facing the credit markets at the beginning of the third quarter that should be resolved soon – with positive effects on the corporate credit markets. The supply chain disruptions from Japan should be resolved in the second half of the year, thus improving industrial production. The U.S. debt ceiling should be raised once the political grandstanding is over. And even though inflation has ticked up, the fact that U.S. economic growth has been sub-par means the Federal Reserve's monetary policy will remain very accommodative. Together, these factors are supportive of stronger economic growth in the second half of the year and should improve corporate credit strength. However, the biggest concern for us and the market is how the European debt crisis will be resolved. All the positives above could be meaningless unless the Greek crisis is dealt with appropriately to minimize the effects when Greece eventually re-organizes or defaults on its unsustainable level of debt.

The outlook for investment-grade corporate bonds is neutral at this juncture. There are many very good fundamental and demand reasons to remain positive, but the European debt crisis tempers those positives.

High-yield bonds

Geof Marshall
Vice-President,
Portfolio Management
and Portfolio Manager

Historically, the high-yield bond market has been strongly correlated with both industrial production and equity market volatility (i.e. the VIX). Therefore when the ISM manufacturing data came in weaker than expected in May, it is not surprising that high yield sold off alongside stocks. On the whole, it seems the market underestimated the global impact to production from supply chain disruptions in Japan and the impact of rapidly rising commodity prices on end market demand across a number of industries. Further macroeconomic uncertainty relating to European sovereign debt, a Chinese economic growth scare and the end of U.S. quantitative easing made the second quarter of 2011 feel a lot like 2010. During the second quarter, the high-yield bond market pushed higher in April, treaded water in May despite record year-to-date supply and retreated in June in the face of large outflows from U.S. mutual funds.

The high-yield bond market returned 0.99% in the second quarter (Bank of America Merrill Lynch High Yield Master II Index US$). From the middle of May to the end of the quarter, the average price of a high-yield bond slipped approximately 2.25 points to 102.3, while the yield on the five-year U.S. Treasury bond came in seven basis points lower to 1.76%. The net result saw the yield on the average high-yield bond widen 65 basis points to Treasuries to end the quarter at 542 basis points.

The market returned 4.93% in the six months ended June 30. The 542 basis points spread on the average bond was essentially unchanged from the beginning of the year.

Credit experience was mixed in the second quarter as the portfolio benefited when a number of bonds were tendered at prices above par. On the other hand, a couple of issuers in the transportation and food sectors were adversely impacted by lacklustre demand or rising commodity prices and saw their bonds slip in value. Netting this against our defensive positioning resulted in index-like performance for the second quarter. New names added during the quarter include the U.S. dollar denominated bonds of Brazilian oil and gas company OGX Petróleo e Gás Participações, Canadian copper producer Quadra FNX Mining and the term loan of Canadian energy midstream operator Gibson Energy.

The high-yield market bounced when the Greek parliament passed its austerity package. Looking into the second half of the year, the supply chain disruptions from Japan should be resolved, the U.S. debt ceiling should be raised by September, corporate deleveraging should continue, and Fed monetary policy is likely to remain accommodative. Together, these factors are supportive of stronger economic growth in the second half of the year and improving corporate credit strength and lower volatility. As a result, we believe the recent spread widening will prove the exception, outflows will abate, and relative and total return investors will return to the market with conviction.

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