Market Roundup

Global outlook

Drummond Brodeur
Vice-President,
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As we move into the final quarter of 2011, markets have been gripped by fears of a double-dip recession in the U.S, a sovereign debt crisis in Europe and the risk of a hard landing in China. At the core of each of these concerns is the fact that while the risks are economic, the solutions are all about politics. Much of the recent market sell-off has been a repricing of risk, but it has also reflected a growing dismay over the ability of global politicians to rise to the economic challenges they face.

In Europe, there are signs that the debate has shifted from denial to an analysis of how solutions can be implemented from a legal perspective. Ultimately, Europe must recapitalize its banks, provide a backstop to sovereign issuers faced with liquidity problems and manage an orderly default in Greece. This will require the use of the European Financial Stability Facility to help the banks and the backstop of the European Central Bank to protect the sovereigns. Legally and institutionally this is not simple. The EFSF is big enough to help the banks and the ECB has unlimited firepower to support the sovereigns, but it does not have the legal authority to enforce the conditions attached to the loan when it provides support – as it discovered when Italy reneged on its promise of increased fiscal austerity. Ultimately, either the EFSF or the International Monetary Fund – both of which have the ability to enforce conditionality upon sovereign governments – must be enlisted along with the ECB. At Signature, we believe that the tightening of financial conditions and deleveraging of banks will cause a mild European recession in the coming quarters.

In the U.S., we expect a modest bounce in GDP in the final quarter, as the drag from higher oil prices and supply disruptions from the Japanese tsunami reverse. We believe that the pre-conditions for a recession do not exist. Markets will vacillate between focusing on improving economic data and fears of political paralysis as the U.S. approaches moves towards the 2012 election. As for China, we believe that the tightening policies are slowing down the overheated economy. China cannot sustain 10% growth rates and must adjust toward a normal trend of around 8%. This is a slowing, not a hard landing, and in the event that growth slows considerably more than expected, the government has substantial flexibility to ease fiscal and monetary policy. The heart of the issue in China is a massive level of savings and limited leverage – the polar opposite of the challenges facing the U.S.

Interest rates

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

In the past several months, global government bond yields have diverged significantly on the market's perception of credit risk. Across Europe, Germany is seen as the ultimate safe haven and yields are at record lows. Other AAA-rated countries, such as Austria and France, have seen their yields fall – but not to the same degree. With one exception, peripheral European countries are being subjected to default risk premiums and rising yields. Ireland is the exception, where yields have fallen dramatically since the summer – but are still elevated in an historical context. Due in part to the intervention by the European Central Bank, Italian and Spanish bonds have stabilized, but a comprehensive Euro-wide policy initiative is needed to attract large amounts of private capital.

In North America, a weakening economic backdrop and policy paralysis triggered a 20% drop in the S&P 500 Index. The U.S., despite losing its coveted AAA status, saw 10-year U.S. Treasury yields decline to below 2% – modestly outperforming Canadian bonds. Also added to the mix is the U.S. Federal Reserve's latest bond buying program, in which short-dated bonds are sold and mid- and long-dated bonds are purchased. In Canada, we expect rates to remain low because of the combination of strong credit fundamentals and soft growth appeals to both domestic and international investors.

Emerging markets

Matthew Strauss
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The mid-cycle correction in emerging markets, which saw equity markets losing 1.0% in second quarter, turned more violent in the third quarter as European sovereign debt concerns triggered a global rush to safer assets. Concerns about a hard landing in China also stoked fears late in the third quarter. Emerging market equities, as measured by the MSCI Emerging Markets Index, fell by 22.5% in U.S. dollars in the third quarter, with all the countries recording declines. Peru, which was down 4.7%, was the best performer following the presidential election, the announcement of a new cabinet and sensible economic policies. Hungary and Poland recorded the largest quarterly losses.

Compelling emerging market equity valuations, slowing inflation and still strong economic fundamentals should lure investors back into these markets in the fourth quarter. Admittedly, if the European situation deteriorates further, or China is unable to avoid a hard landing, fear selling will quickly return. We consider these as low probability events. Nonetheless, the presence of these risks highlights the important role of policymakers in driving returns in the foreseeable future. Given that policymakers in emerging markets are in a much stronger position than their developed market counterparts, we see emerging equities outperforming developed market equities in the quarters ahead.

Preferred Shares

John Shaw
Vice-President,
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Portfolio Manager

Despite global market volatility, the preferred share market in Canada remained relatively calm during the quarter. Bank-issued perpetual preferred shares continued to outperform the market, as investors expect the banks to redeem them at par on their redemption dates or sooner. To date, banks have called three perpetual share issues. These moves are a result of decisions earlier this year by Canada's bank regulator, the Office of the Superintendent of Financial Institutions, affecting bank capital levels.

On the downside, floating rate preferreds declined sharply, reflecting a slowing global economy and the Bank of Canada's indications that it would keep interest rates low for longer. Another negative was BCE's decision to lower the dividend rate on its next series of reset preferreds, which disappointed the market and was notable given the large size of the issues.

During the quarter, there were seven new preferred issues in the market worth a healthy $2.1 billion, while there were $970 million in redemptions of bank shares.

Health care

Rui Cardoso
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and Portfolio Manager

Through the market volatility of the third quarter, health care performance held up reasonably well as defensive, high-yielding pharmaceutical companies outperformed. We remain positive in our outlook for the group because we expect the overhang of the U.S. health care reform issues to dissipate, while fundamentals for some subsectors in health care start to improve. Most big pharma companies have spent the last five years revamping their drug pipelines. We expect to see increasing flow of data on new drugs in development. The U.S. Food & Drug Administration is becoming more rational in its risk/benefit analysis, leading to an increase in new drug approvals. Year-to-date, it has approved 21 new drugs, compared to 21 in all of 2010 and only 11 in 2006. Pharmaceutical companies trade at low multiples, have relatively clean balance sheets and pay good dividends. We remain cautious on the health care services sector in developed markets (hospitals, insurers and distributors) and medical device companies because they have the greatest leverage to austerity measures. We continue to view health care services as the preferred way to gain exposure to the expansion of health care coverage in the emerging markets middle class.

Consumer products

Stephane Champagne
Vice-President,
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Consumer activity slowed during the third quarter due to higher gasoline prices, food inflation and slower employment rate. Overall, the S&P 500 Index underperformed the consumer discretionary index by 50 basis points and the consumer staples index by 980 bps. Consumer staples have been helped by the European sovereign debt uncertainty, weak employment and fears of a double-dip recession in the U.S.

In U.S. retail sales, lower consumer confidence and slower employment provided negative momentum in July and August, but September, with back-to-school shopping, showed good results. High-end and off-price retailers remained strong during September, while trends at low-price commoditized basics retailers were weaker. After a shaky start to the month, due to Hurricane Irene, shoppers returned to the mall later in the month, ending the back-to-school season on a high note. Overall, mall-based retailers managed slightly higher sales than 2010, but remain on course to decelerate from the stronger pace set in the first quarter.

Retailers usually enter October with good inventories. However, it is largely a clearance month and has little impact on earnings. We continue to believe that global growth specialty retailers are best positioned for further outperformance as top-line visibility and margin expansion opportunities offset domestic uncertainties and offer meaningful long-term earnings growth. We will also favour discounters and drugstore chains due to cheap valuations and earnings visibility. The hotel sector underperformed the discretionary sector due to fear of a global recession.

Defensive sectors performed better than the overall market. Household and personal care stocks outperformed food, tobacco and beverage stocks, which outperformed staples retailers.

We remain confident in our stock choices due their cheap equity valuations compared to historical prices, good free cash flow generation, high-quality balance sheets, and a high return to shareholders (through dividends, share buybacks and M&A activity). We are taking a conservative approach, which should help temper volatility and taking advantage of opportunities when there are market pullbacks. In the shorter term, we remain in consumer staples and emerging market stocks.

Technology & telecommunications

Malcolm White
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and Portfolio Manager

Information technology generally outperformed the broader market during the quarter as investors were more concerned with financials and resources that are more levered to the financial problems in Europe. However, issues in the general economy are expected to lower global growth rates and this will be a perceived negative for technology companies in the months ahead.

High-quality telecommunication stocks were solid, as investors looked for places to hide in stormy market conditions. The concept of relatively high dividend yields and must-have services such as wireless, made this sector look attractive, despite moderating growth as consumers rationalize spending.

Media stocks were subject to selling pressure. Investors view this sector as discretionary and dependent on a healthy economy – all of which are being questioned. Concerns of a softer advertising environment are making investors nervous.

Now, balance sheets matter much more to the market as a whole and investors are gravitating toward cash-rich, investment grade companies and selling companies with higher leverage ratios and cash generation problems.

Foreign exchange

James Dutkiewicz
Vice-President,
Portfolio Management
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Currency has recently followed the well-travelled path of "risk on" and "risk off." Mounting concerns about the health of the global economy resulted in currencies with significant exposure to commodities – such as Canada and Australia – weakening compared to the U.S. dollar. Many emerging market currencies performed quite well throughout the summer, but September was not kind, with many experiencing a 5%-15% drop compared to the U.S. dollar. The euro, with its sovereign debt problems, succumbed in September, falling more than 7% against the U.S. dollar. Even the Swiss franc, traditionally seen as a bastion of safety, fell as the Swiss National Bank publicly announced devaluation against the euro.

The outlook for the foreign exchange market is for more volatility until a unified European solution is found. Washington is no closer to striking a 'Grand Bargain' than it was during the summer. It is likely that some of the lustre of the U.S. dollar will fade as the markets come to appreciate the chasm that divides the Republican and the Democratic parties. The Canadian dollar is approximately 10% overvalued, given current commodity prices, and we expect further weakness. However, it is unlikely to become "cheap" in a fiscally focused world.

Investment-grade bonds

John Shaw
Vice-President,
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In bond markets, Government of Canada bonds and U.S. Treasuries performed well, reflecting investor interest in safe havens during the European sovereign debt crisis. The yield spreads on corporate bonds widened, primarily as a result of the decline in government yields and concerns about an economic slowdown. North American corporate issues outperformed European ones.

The Canadian investment-grade market was split – with higher-rated utility and infrastructure bonds outperforming lower-rated industrial issues – reflecting general fears of a slowing economy. Issuance dropped sharply in July and August, with new issuers having to raise yields to complete a deal. Nevertheless, the cost of issuance remained favourable for corporations. Overall, corporate balance sheets are in very good shape and the credit market remains fairly strong for non-financial corporations, showing that the corporate bond market's underperformance during the quarter was a result of economic factors and not company-specific fundamentals.

High-yield bonds

Geof Marshall
Vice-President,
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No public market has proven immune to the vagaries of the "risk-off" trade precipitated by the European sovereign debt and banking crisis. The high-yield bond market is no exception – despite very good fundamentals. At these levels, we think there is excellent value in the high-yield market. Fundamentally, it is well positioned, given that we have just come through two years of balance sheet repair, cost cutting and refinancings. Credit risk, namely leverage, is at its lowest level in years. While the new issue window was temporarily closed in August and September, it matters less than it did in 2008 because few issuers are facing debt maturities now as companies have spent the last two years extending their debt maturities.

From a technical perspective, there are three important points to make on the high-yield bond market. First, the third quarter sell-off was based on very little volume so it has not been a broad-based capitulation. Second, U.S. mutual fund flows have recently been positive, which is supportive of valuations. And third, compared to 2008, when there were a lot of leveraged investors in the system, we have seen little leverage employed since then. This is key, because leverage in a down market creates forced sellers.

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