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ASSET MANAGEMENT

Signature Sound Bite
April 2013

Global Road Map

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As the Dow Jones index hits new all time highs, it is worth taking the time to review our perspective on the global economy and global financial markets. Over the past four years global equity markets, led by the US have been in a stealth bull market with the US up 120% and the TSX up 65% and the MSCI EAFE index up about 85%. Yet investors continue to be cautious and worry about what will cause markets to sell off next. For four years now, markets have been climbing a wall of worry as investors remain more skeptical than optimistic. In fairness, in the after mass of the global financial crisis the world has been a scary place with a fragile economy prone to setbacks. Where it not for the extraordinary monetary responses of global central banks, it is pretty certain that global markets would have been far more challenging. But understanding the interconnectedness of global economies, global financial markets and importantly, major fiscal and monetary policy initiatives is essential in today's globalised world. It is why at Signature we stress the importance of a team that incorporates specialists focused on all key asset classes and all key geography's as well as the in-depth understanding of the individual companies in which we invest.

At Signature, we entered 2013 with a positive outlook for equities on the basic premise that led by the US, global economies and financial markets would continue to recover, but that the recovery would remain slower than traditional economic recoveries as the dual headwinds from deleveraging and fiscal drag kept growth in check. As a result the extraordinarily loose monetary policy settings that were in place, particularly in the US, but increasingly elsewhere such as UK, Japan and Europe, would not be reversed anytime soon. In the US, the Fed's QE3 program will continue to buy $85 billion a month in securities, primarily treasuries and MBS. This is in effect printing money and forcing the rate structure below the rate of inflation. In other words the Fed is deliberately engineering negative real interest rates with the explicit intention of driving up asset prices (particularly housing and stock markets) and using the wealth effect as one of the primary transmission mechanisms to stimulate stronger economic growth and job creation. Our bullish positioning towards equities across our funds was based on the premise that so long as credit and capital markets remain open and functioning, then the Fed's policies will force investors out of risk free assets that now earn zero (and negative after inflation is considered) and toward global equities.

While nothing has changed with respect to our views on the FED, the dramatic change in policy at the Bank of Japan in early April only reinforces our view. In effect the BOJ will be injecting almost as much liquidity (7 trn yen) per month as the US, yet into an economy about a third the size. Japan's level of monetary easing is unprecedented. While we remain skeptical in their ability to drive strong enough economic growth to ever repay their outstanding debt levels (see our recent article Japan: Die Another Day), they will in the coming two years flood their economy with liquidity. The challenge is that liquidity is fungible. Like pouring molasses onto a plate, liquidity will ooze out across the globe in search of the most attractive asset class. So while the first reaction has been to boost Japan stocks and weaken the Yen, we believe the longer term impact will be to push global risk assets higher. The BOJ will also be walking a fine line to maintain the confidence of investors over the coming years, and the risk of capital flight has clearly risen.

I dubbed 2013 as Investing in the Eye of the Liquidity Storm, for the view that so long as central banks continued to pump excess liquidity into a sluggish but improving global economy, the money would find its way into asset prices, thereby pushing them higher. With most fixed income markets at or near all time highs, and as interest rates cannot go below zero, the capital appreciation potential in fixed income is over and future returns will not match historical returns. The next progression of the global yield grab has begun as investors begin to look toward quality dividend paying companies as a better yield solution than fixed income. We expect this trend to continue unfolding with flattish returns in bonds as policy prevents rates from rising significantly and liquidity is squeezed into equities driving continued outperformance of equities over bonds.

For 2013, our call is for liquidity to trump fundamentals. Equity returns will be driven by a re-rating of equities to higher valuations more so than from stronger earnings growth. So long as we do not see a significant deterioration in the earnings outlook, the potential is there for equity P/E's to move higher. In our view, equities today trade at a slight discount to their longer term averages, they are not cheap, but are certainly fair value. In a world where just about every other asset class is at record valuation levels, those at fair value would seem to us to offer the best risk-return potential.

The Eye of the Storm refers to the fact that at some point policy makers will have to begin to remove the excessively loose monetary policy. It is at that point that we expect to be more concerned with the outlook for asset prices, as switching to a tighter policy regime does not always go smoothly. But there are two caveats. First we do not expect the US stimulus to be removed before there is clear evidence that the US economy is substantially stronger than is currently the case. Second we do not expect the stimulus to be removed before equity prices are substantially higher than they are today. For now our base case is that, notwithstanding a mild pullback or correction in coming months, there is a bigger risk of a significant move higher in equity prices, particularly if investors start to shift from fixed income into equities, a trend that is much talked about but still nascent. That would certainly be the surprise trade for most investors who remain focused on the fundamental economic and political challenges they see splashed over the front pages of the newspapers and are skeptical of what we see as the beginnings of a liquidity driven rally. In functioning financial markets the rule to follow today remains: Don't Fight the Fed, the BOJ, the BOE…!

Having laid out our call for stronger global equity markets, it is also worth expressing our view on the key economic drivers around the world. In a nutshell, we remain most upbeat on the outlook for the US private sector, (for a better understanding of our longer term optimism on the US please refer back to my May 2012 piece on the US Industrial Revival available on our website), followed by China's ability to manage slower yet still strong growth. In Japan, we expect a strong year but remain skeptical about longer term structural reform (see our recent report on Japan). We have seen this movie before, and the challenges facing their economy today are far greater than in the past. Europe will remained mired in a stagnant state of mild recession as they continue their internal rebalancing and debating what Europe should look like when it grows up. Ultimately we expect the policy debate in Europe to shift from austerity and towards growth but not before German elections in September. Europe is a decade long project and we are only three years in. It is however important to bear in mind that buying European companies is not the same as buying into the European economies, and the concerns in Europe have resulted in attractive valuations for many European listed multinationals with strong global franchises.