Market Roundup

Global outlook

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

The investment environment from 2000 to 2010 hinged on a series of interrelated trends – a number of which appear to be in the process of reversing.

After the technology boom in the late 1990s, the world was overweight U.S. equities and U.S. dollars. The market crash of 2000-2002 was met with Federal Reserve Chairman Alan Greenspan's heavy rate cuts, a decade of low real interest rates, and a falling U.S. dollar. Apart from fuelling the leverage boom globally, the low U.S. rate structure drove capital out of the country. Equity and bond investors chased higher growth and yields in developing economies. The MSCI Emerging Market Index delivered a 10-year compound annual growth rate of 24% to the end of 2007. The mirror image can be seen in U.S. equities, which declined a record 3.6% in the 10-year CAGR to the end of 2009.

The 1980s and 1990s saw endemic underinvestment in resources. This resulted in capacity shortages and price spikes throughout the last decade as emerging market demand exploded. Unsurprisingly, commodity-linked currencies and equity markets performed well. Meanwhile, equity valuations de-rated substantially in other developed markets.

As resource capacity additions come on stream and the pace of emerging market growth slows, I expect to see U.S. equities return to favour. With little competition from bonds or Japanese or European equities, the concentration of buying could be quite powerful. After a decade of restructuring, the competitiveness of U.S. industry has been restored, leaving American business in fighting form.

Global outlook

Drummond Brodeur
Vice-President,
Portfolio Management
and Global Strategist

Globally, we remain on track to meet our expectation of a grinding global recovery. The kick-off this year came from the success of Super Mario (Drahgi) taking over the helm at the European Central Bank and launching a dramatic policy initiative in the form of the three-year Long Term Refinancing Operation. The LTRO was successful in re-opening European credit markets and removing the tail risk of a pending financial collapse. This brought good cheer to global financial markets. At Signature, we took our lead from the opening of blocked credit channels by raising our equity exposure and reducing our cash levels by about half. Open credit markets do not resolve Europe's structural challenges, but it does buy time for policymakers to pursue solutions. Europe is in recession and will remain stagnant for some time. So long as Europe does not collapse, the rest of the world will be okay. Upcoming elections in France and Greece will keep Europe on the front pages, but it is sovereign credit spreads and ECB policy that investors need to monitor.

In the U.S., we maintain a belief that the economy is grinding through a 2% to 2.5% economic recovery. First quarter data was stronger than expected, lifting expectations, while more recently there has been slightly softer data. Seasonality, warm weather and other factors make the data less reliable than usual, but so far it has not changed our view that things are improving and will continue to improve in the U.S.

In coming months two competing trends will play out for the U.S. On the positive side, there is growing evidence that a manufacturing revival is beginning to emerge. After a decade of adjustment in many industries, the U.S. is becoming a low-cost manufacturing location. Jobs are coming back from developed countries and China. We believe this is a real and material development that will play out over several years and will have significant investment implications.

Offsetting this will be the negative drag as markets focus on the upcoming U.S. election. We are reminded of the bleak state of politics and the significant fiscal hit to the economy in 2013 if current policies are not changed. But nothing is expected prior to the election in November, which leaves significant uncertainty for the outlook in 2013 – and markets hate uncertainty.

Hard landing concerns and political intrigue have continued to dog China-linked markets and commodities so far this year. We expect China to continue to slow in the first half, but we have remained firmly in the "soft landing" camp. If we are correct, then confirmation of slower, but a still robust 8% to 8.5% growth rate will bring a sense of relief to commodity and emerging markets. However, we caution that our longer-term outlook in commodities is more subdued, despite still strong demand and high prices. Going forward, rising costs of production are expected to see margin pressures and lower trends for return on invested capital.

Emerging markets

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

Emerging markets recorded a strong quarter. Gains came in the first two months and were driven by a broad-based improvement in sentiment following the tentative stabilization of the European financial and sovereign conditions and upside surprises in economic data from the U.S. Hope of a near-term re-acceleration of growth in China added to the global "risk-on" rally. The rally faded in March as investors were confronted with softer-than-expected data out of China, comments by the Chinese Premier setting a lower growth target of 7.5% for 2012 and fewer upside U.S. data surprises. Emerging market equities declined in March, taking the quarter's returns down to 14% in U.S. dollars, and nearly 12% in Canadian dollar terms.

Equities in emerging markets outperformed developed markets, despite the fact that the catalysts for the rally emanated from Europe and the U.S. This reflected the continued high-beta status of many emerging market equities and a preference for markets that had underperformed in late 2011. The three worst-performing countries – Hungary, Poland and India – easily beat the index. Most currencies gained against the U.S. dollar. The Canadian dollar gained 2.3% against the U.S. dollar.

Uncertainties about China's growth, the pace and sustainability of the U.S. recovery and lingering sovereign debt concerns in Europe will likely result in a more volatile period during the second quarter and hinder a repeat of the strong rally at the beginning of the year. We have reduced our cash from 20% to below 10%, and stand ready to deploy additional cash ahead of a more sustained recovery in second half of the year. Despite all the noise, we continue to favour Asia (China, Thailand and Indonesia) and Latin America (Brazil and Chile) over emerging Europe. On a sector basis, our bias remains tilted to the domestic-focused sectors, including financials, consumers and health.

Consumer products

Stephane Champagne
Vice-President, Portfolio Management and Portfolio Manager

U.S. consumer activity was good during the first quarter. Retail sales, led by apparel retailers, department stores and discounters accelerated from January to March. Online shopping was still strong as well. Part of the reason for the strong start was the unusually warm weather, less aggressive promotions and an early Easter. Inventory levels are fine as we enter spring and U.S. consumers are gaining confidence with the positive job data. The declining cost of cotton during the quarter should continue during the rest of the year and help the profitability of apparel retailers. Performance at drugstores has been mixed because of a slow flu season due to warmer weather.

Food inflation started to decline from the second half of 2011. But, higher gasoline prices were the main negative story during the quarter. Overall, the S&P 500 Index underperformed the consumer discretionary index by 400 basis points and outperformed the consumer staples index by 550 bps. The discretionary index outperformed the staples index by 975 bps during the period. The discretionary index has been helped by a better unemployment rate, productivity gains in the manufacturing sector and the stabilization of the eurozone. Softline and hardline retailers gained momentum due to warm weather, an increase in consumer confidence and a slight improvement in real estate. Discussion over the coming quarters will be around the sustainability of U.S. consumer spending and China's potential soft landing.

We remain confident in our choices due to their cheap valuations, high free cash flow and high return to shareholders. For the second quarter, U.S. consumer fundamentals should continue to improve, but we remain concerned about Canadian consumers and their high level of debt. For the longer term, we continue to favour global brands for stable, long-term growth.

Financials

John Hadwen
Vice-President,
Portfolio Management
and Portfolio Manager

We view the recent increase in U.S. bank dividends and announced repurchase initiatives, which followed regulatory approval and stress tests, as a significant confidence booster. As the banks return significantly more of their earnings to shareholders, their relative cost of capital should improve, which would strengthen confidence in the financial system and equity markets. While the year-to-date advance in the U.S. financial sector is dramatic, valuations in the sector are simply recovering lost ground. Limited payouts and strengthening capital positions leave room for notable dividend increases over the next few years. Volatility in the sector is likely to remain in the short term. It appears that the U.S. banks are in the process of transitioning from high-beta trades to stable, dividend-paying stocks, offering modest growth.

Health care

Rui Cardoso
Vice-President,
Portfolio Management
and Portfolio Manager

Within the context of a strong market rebound, the health care sector underperformed in the first quarter of the year. Weakness was seen in pharmaceutical stocks, one of the better-performing sectors of the market in 2011 relative to medical device and life science stocks, which posted strong rebounds from the last quarter of 2011. In our view, the reversal of performance between health care and other sectors and between pharma and other sub-sectors in health care reflects macro-driven factors, rather than any significant changes in underlying fundamentals. Specifically, increased investor appetite for more economically sensitive investments occurred as the risk profile of the situation in Europe improved and more positive perspectives on the growth outlook for emerging markets – China in particular – were taking hold.

We remain very positive on the health care sector and on pharmaceutical stocks in particular, since we expect a renewed focus on fundamentals will drive a re-rating of the sector. Health care equities remain inexpensive relative to fundamentals, and have been that way for many years. With a revamp of pharma pipelines and a more rational Food and Drug Administration, we expect to see an increase in new drug approvals, leading to higher expectations of longer-term growth prospects after the current patent cliff period. Elsewhere in health care, we remain cautious on medical device and health care service companies that are leveraged to mature markets, such as the U.S. and Europe, as we expect continued price pressure will offset a large degree of underlying growth. We remain very positive on opportunities for growth in emerging markets services, but given high relative valuations, we have taken profits recently.

Industrials

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

While earnings estimates have been fairly stable, industrial stocks have seen a significant re-rating this year. Despite this rally, stocks remain reasonably valued within the context of a modest economic growth outlook.

Segments of interest include:

- Automation equipment – labour inflation and raw material/energy efficiencies are drivers.
- Chemicals – shale gas has dramatically reduced the cost economics for the U.S. players, while capacity additions globally continue to be modest.
- Construction spending is seeing a return to growth in the U.S. market – partly aided by a warm winter – while China continues to show declines due to economic cooling measures in place since last year. Northern Europe is showing decent repair and remodel activity and weak new construction, while southern Europe is clearly pointed downwards. Government cuts will be a drag going forward, particularly in Europe.
- Commodity capex – continued strength in order patterns, particularly in oil and gas, has been tempered by concerns that Chinese fixed-asset investment is going through a longer soft patch.
- Coal-exposed industrials, such as railroads and coal equipment providers, have seen activity levels soften due to the mild winter, shale gas activity, and low natural gas prices.

Companies generally feel modestly optimistic about the mid-term outlook with strong U.S. industrial activity being the driver, coupled with an expectation of a recovery in China in the second half. And, they are expecting Europe to remain weak and are stepping up their cost-cutting actions in the region accordingly.

Technology & telecommunications

Malcolm White
Vice-President, Portfolio Management and Portfolio Manager

Technology was an outstanding performer during the quarter, benefiting from improving economic indicators and positive market sentiment.

Apple proved to be a bellwether standout, returning 48% over the quarter on the back of excellent financial results, the launch of the new iPad and the decision to return excess capital in the form of a dividend and a multi-year share buyback. Besides Apple, many other technology stocks also appreciated over the quarter on positive comments around global technology spending and long-term secular growth trends.

Telecommunication stocks, in contrast, lagged the general market. European names tended to sag on issues such as sovereign credit ratings downgrades, dividend cuts and competition concerns. Names outside of Europe were weighed down after excellent performance last year led to profit taking this year, as investors moved away from yield and toward sectors more geared to benefit from a recovery in economic growth, such as the technology sector.

Preferred shares

John Shaw
Vice-President,
Portfolio Management,
Portfolio Manager

The Canadian preferred share market posted positive total returns in the first quarter of the year, but underperformed equities as the mood for higher-risk assets improved. There continues to be strong demand from both retail and institutional investors searching for stable investments in preferred shares.

Interest rates rose modestly and supply was heavy during the quarter, which held back returns. There was a wide variety of new issuers and structures that were quickly bought by the market. Demand is expected to remain strong for new issuance as significant redemptions from banks continue.

We remain positive on the outlook for preferred shares with return expectation so far on target for the 4.5% to 6% range in 2012.

High-yield bonds

Geof Marshall
Vice-President,
Portfolio Management
and Portfolio Manager

The high-yield bond market participated in the broad "risk-on" rally in the first quarter, returning 5.15%, as the yield on the average bond tightened 124 basis points relative to U.S. Treasuries. The price of the average high-yield bond is now above par, which means that the secondary market is increasingly "call-constrained" – limiting further price appreciation. For example, if a bond is callable beginning in 2013 at $104, it is unlikely the bond will trade much above a $104. Generally, a typical high-yield bond is issued with an eight-year maturity, but redeemable at a premium above par at the borrower's option beginning in year four. This lowers the effective maturity and duration of the bond and makes yields much more sensitive to changes in price. There are advantages and disadvantages to this characteristic of high-yield bonds. At times, it makes it more difficult for the market to rally with other higher risk asset classes – and this could be the case for the remainder of 2012. There are also times when the high-yield bond market proved resilient – like the middle of the first quarter when U.S. Treasuries began selling off due to their low duration and strong inflows into the asset class. During this time, the prices of most bonds held steady and valuations tightened. This phenomenon has persisted in the past and we believe it will continue, which leads us to affirm our forecast for high single-digit returns for high-yield bonds this year. The primary market was very active with a record US$98 billion issued in the first quarter. This part of the market is not call-constrained and we generally see more value here than in the secondary market.

CI INSTITUTIONAL
ASSET MANAGEMENT

2 Queen Street East, 19th Floor, Toronto, Ontario M5C 3G7
www.ciinstitutional.com
For more information on CI Institutional Asset Management:
Please call 1.866.760.5274 Or e-mail ciinstitutional@ci.com

1205-0713_E