Signature Market Roundup

Winter 2013

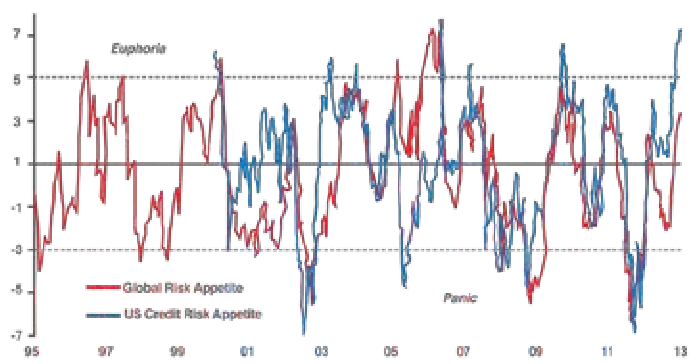
Global outlook

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

Since 2006, conditions in credit and bank funding channels have served as our principal and trusted compass for risk taking in the Signature portfolios. In 2006-2007, we understood that a credit bubble was underpinning leveraged buyouts and the housing market. In 2007-2008, that bubble deflated. Since 2009, we have seen banks and funding markets across geographies progressively stabilize. This process began in the U.S. with the Troubled Asset Relief Program (TARP), various government guarantees and bank capital injections. The U.S. banking system is now fully recapitalized and aggressively competing to deploy spare capital – the credit cycle in America has definitively turned. Europe is far behind but making some progress.

As long as the European Central Bank backstop of sovereign debt holds, I expect financial conditions to stay wide open in 2013. The toggle-on/toggle-off nature of credit markets – as seen in the peripheral European Union countries – will fade. Equity risk appetite is lagging credit risk appetite (see chart), but the gap is likely to close this year. Dell is the first "mega" leveraged buyout being discussed; I expect more. Global risk positioning is low, liquidity is low, real rates are negative and volatility is down. This creates an environment conducive to a risk asset pop, particularly in emerging markets. As we start 2013, our funds remain fully invested.

Exhibit 1: Global and U.S. credit risk appetite



Source: Credit Suisse

The Credit Suisse Global Risk Appetite Index measures changes in market sentiment by tracking the change in the relative performance of safe assets (such as government bonds) versus more volatile assets (such as equities). The U.S. index uses a similar methodology to measure risk appetite for U.S. investment-grade credit.

Global outlook

Drummond Brodeur
Vice-President,
Portfolio Management
and Global Strategist

In the past four years, markets and economies have been buffeted by a maelstrom of fiscal and monetary policy responses aimed at shoring up economies and financial markets in the aftermath of the global credit crisis. As we enter 2013, the uncertainty or tail risks around the key areas of concern – namely the euro crisis, the U.S. fiscal cliff, and a hard landing in China – have abated significantly. The underlying problems are not necessarily solved, but the understanding of the challenges and the activation of policy responses have reduced the immediate downside risks.

In particular, we have seen four years of increasingly aggressive monetary policy responses, led by the U.S. Federal Reserve, followed by the European Central Bank and now the Bank of Japan. The result has been a monsoon of liquidity pouring into markets, offsetting some of the adverse impacts of deleveraging. To the extent that such policy gains traction in improving the underlying real economy, 2013 may turn out to be a benign year of relative stability with slow but improving economic conditions and continued extremely easy monetary policy. This scenario would be very positive for financial markets and we enter the year with a favourable outlook for equities and corporate credit.

But a word of caution is also in order. As in the eye of a storm, the stability is just a lull before the winds begin to blow in the other direction. If economic conditions do continue to improve throughout 2013, particularly in the U.S., then at some point the challenging task of reversing the massive monetary stimulus will need to begin. Furthermore, while the outlook for asset markets in 2013 looks favourable, we remain cognizant that we are in uncharted territory with regards to monetary policy. While the intended outcome of stimulating the underlying economy may work, there are bound to be unintended consequences that may be hard to quantify in the near term but could have corrosive longer-term implications. Financial repression, where interest rates are forced below the rate of inflation, resulting in negative real rates, does have a cost. At the very least, it is a significant tax on savings and imposes a substantial burden on savers, pension funds and insurance companies, amongst others. For investors, one message is clear: You will lose money in government bonds! Unless the U.S. falls into deflation, which is not our expectation, then negative real interest rates will erode the purchasing power of your money, and if interest rates do begin to rise at some point in 2013, you will lose money in absolute terms as well. Do not be fooled by historical returns in the government bond market – they are mathematically impossible to replicate from current starting yields.

At Signature, we have continued to increase our equity exposure and reduce our bond exposure. The diminishing risks related to the three key concerns of the past few years should allow the current rally in risk assets to continue. Hopefully, as the global economy continues to heal, we will return to a more typical economic environment that is dictated by the global business cycle and strong enough to withstand the eventual normalization of both fiscal and monetary policy. However, this is more likely a story for 2014. The massive liquidity does wonders to cover up the fragility of the economy, but it still remains. We expect, much as in a game of "Whack-a-mole," that new challenges and risks will arise, the result of unintended policy consequences, political actions or exogenous events. Strong macro surveillance and active tactical asset allocation remains a must in negotiating global markets.

Our broad view is that global growth will be led by a combination of the U.S. private sector and China, while Europe and Japan remain stagnant. Economies and companies geared to the former two should benefit from improving underlying fundamentals, while those geared to the latter two regions will be hostage to alternating perceptions of hope that things are improving to fear that they are falling apart.

Emerging Markets

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

After a lacklustre start to the fourth quarter of 2012, equity markets enjoyed a strong finish to both the quarter and the year. Signs of economic activity gaining momentum in China, a smooth leadership transition in China, reduced tail risks out of Europe and expectations that the U.S. would avoid the so-called "fiscal cliff" all helped to reignite investors' risk-taking appetite. Emerging market equities rallied aggressively during the quarter, taking the calendar year return for the MSCI Emerging Markets Index to 18.6% in U.S. dollar terms. However, the strength of the Canadian dollar took some of the shine off these stellar returns. Nonetheless, emerging market equity returns outpaced developed markets for the calendar year by about two percentage points.

During the fourth quarter of 2012, Asia and EMEA (Eastern Europe, Middle East and Africa) increased by 5.9%, while Latin America lagged somewhat. The performance highlights the broad-based nature of the fourth quarter rally. However, returns varied on annual basis, reflecting different economic growth and earnings profiles, as well as policy approaches. EMEA gained 22.5% in 2012, led by Turkey (64.9%), while emerging Asia was up 21.2%, thanks to strong rallies in the Philippines, Thailand, India, South Korea and China. Latin America lagged the other two regions and recorded a more subdued 8.9% increase in 2012, restrained by Brazil (+0.3%). Unlike China, the Brazilian government's inability to turn around a slowing economy disappointed markets. Also, unlike India, a number of policy decisions in Brazil, such as aggressive currency intervention, increased protectionist policies and a controversial decision regarding the power industry, left equity investors skeptical and cautious.

Going into 2013, the risk of a hard landing in China has been replaced by increasing signs of an economy that is stabilizing. Economic growth is expected to increase to around 8.0% in 2013. The encouraging news is not limited to China, with most major emerging economies expected to record better growth in 2013 compared to last year. Stronger economic activity, accommodative monetary policy in most emerging markets and exceptionally low interest rates in developed markets should continue to support emerging market equities well into 2013. Wrong policy decisions or a shift in global risk sentiment pose a risk to our more constructive view, although the tight correlation between emerging market equities and global events is expected to decline further in 2013 – opening the way for investors to acknowledge structural improvements in emerging markets.

Financials

John Hadwen
Vice-President,
Portfolio Management
and Portfolio Manager

It seems that the equity markets surprised most investors in 2012 with positive performance, especially in the global financial services sector. Despite ongoing regulatory pressure, consistent, widespread disgust for banks and significant economic headwinds, the global financial sector appreciated approximately 28% during the year. We managed to do much better than that with our non-domestic financial positions. Many of the best-performing financials in 2012 had the most significant earnings headwinds, which caught many investors off guard. In the end, extremely depressed valuations became less depressed, as global risk premiums declined with improving sovereign bond markets.

Moving forward, we believe the very recent trend of declining risk premiums in the financial sector will gain momentum, as it is self-reinforcing. Much of the financial sector balance sheet restructuring is done and the magnitude of remaining adjustments should not overwhelm functioning credit and equity markets. Generally, we remain most constructive on U.S. money centre banks, although the valuation discounts to other financials has narrowed following their strong rally. We continue to expect material dividend growth from depressed levels, which will support expanding valuations in the sector, initially in the U.S. and then in Europe.

Resources

Scott Vali
Vice-President,
Portfolio Management
and Portfolio Manager

The resource and energy sectors lagged the broader markets in 2012, as fears over a hard landing in China, in conjunction with risks of a broader contagion from the peripheral to the core countries in Europe, kept investors on the sidelines.

Last year began with a restrictive Chinese housing policy precipitating a slowdown in consumer demand for white goods, which resulted in manufacturers reducing inventories of both finished goods and raw materials. As domestic concern over a hard landing gained pace, corporate confidence and economic activity declined. In response, the Chinese government announced stimulative measures to boost the economy in late May, including less restrictive housing policies.

In Europe, widening sovereign credit spreads increased risks that the debt crisis was spreading to the central European states. In order to arrest this contagion, the European Central Bank announce a plan to backstop sovereign debt in late July, helping to eliminate the tail risks that had concerned investors.

The combination of these actions, along with the continuation of quantitative easing in the U.S., should produce a positive backdrop for energy and resource equity performance as we enter 2013. Specifically, the reduction in perceived tail risks should lead to increased consumer and corporate confidence in both China and the U.S., resulting in a restocking of raw materials like iron ore and copper in the first half of 2013.

The increase in economic activity will also support global energy markets, and we expect global crude benchmarks to remain strong. However, in North America, infrastructure bottlenecks will result in the continuation of wide differentials in crude prices. The addition of new pipeline capacity will eventually lead North American crude discounts to narrow, as producers will achieve greater access to markets to compete with global imports. We expect to see this first with the narrowing of spreads between West Texas Intermediate and Brent and then with the narrowing of light-heavy differentials in the third quarter. Canadian heavy oil producers will see permanent benefits as new pipeline capacity is fully installed in 2014.

Natural gas markets remained depressed in 2012, but coal-to-gas switching during the early summer months helped increase demand. However, a relatively warm start to winter has kept prices below long-term averages needed to incentivize additional production. Eventually, the large decline in natural gas-directed rig count will result in a balancing of supply and demand in the domestic market. In addition, increased liquid natural gas export capacity will be a new source of demand in the future.

The price of gold remained elevated in 2012; however, equity performance lagged as gold producers battled disappointing production and the increased capital cost in growth projects. Initially, we see gold bullion prices being constrained as the economic recovery gains pace. However, longer-term inflation pressures will provide solid support as governments deal with excessive debt loads.

We are confident as we enter 2013 that equity performance will improve as energy and resource markets find a more supportive backdrop for renewed demand growth. As always, we will focus our investments on corporations with strong balance sheets and are able to sustain production growth and return capital to equity holders.

Consumer

Stephane Champagne
Vice-President,
Portfolio Management
and Portfolio Manager

U.S. consumer activity during the fourth quarter was affected by Hurricane Sandy and a holiday season with mixed results. At the same time, job creation and housing data were positive. During the period, high-end retailers continued to do well, discounters and clubs were steady and drugstore sales accelerated due to colder weather and increased incidence of the flu. Department stores and specialty stores posted mixed results, while online shopping continued with a strong growth rate in the mid to high teens, driven by discounting, free shipping and better offerings.

Holiday sales came at the expense of gross margins for many retailers. Following weak sales early in December, retailers stepped up promotions to drive sales. The other theme that was clearly evident during the holidays is the outperformance of the higher-end versus lower-end retailers.

Overall, the S&P 500 Index underperformed the consumer discretionary index by 800 basis points but outperformed the consumer staples index by 600 bps in 2012. The discretionary index outperformed the staples index by 1400 bps during the year. Consumer discretionary names benefited from the third round of quantitative easing by the Federal Reserve, central bank intervention in Europe, continued job creation and growth in the U.S. housing sector in the second half.

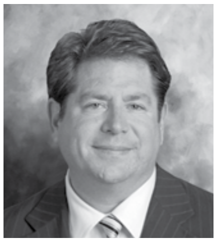
In 2013, we expect U.S. consumer discretionary spending to be affected by the 2% increase in payroll taxes and the higher tax rates on capital gains and dividends and those making over $400,000. On the other hand, the sector will benefit if gasoline prices remain stable and the housing sector and employment continue to improve. In Canada, we remain concerned about consumers' high level of debt.

European consumer confidence remains fragile in 2013, with recessionary conditions and high and possibly increasing unemployment in some countries, especially in southern Europe. Firms focused on Northern European domestic consumers will fare better. Russian consumer spending is benefiting from oil and gas price stabilization and government efforts to stimulate the economy. Consumption in other Eastern European countries remains weak.

In Asia, especially China, the economy bottomed in the third quarter, and consumer confidence and spending improved through the fourth quarter. This trend is expected to continue in 2013. In Latin America, consumer fundamentals were solid in the fourth quarter and should remain good this year. We favour firms with exposure to Mexican and Andean consumers. Brazilian consumer confidence should continue to improve due to government stimulus programs and preparation for the World Cup in 2014.

At Signature, we continue to favour companies supported by sustainable fundamentals, strong global brands for their pricing power, and exposure to the long-term growth of emerging markets. We remain confident in our choices due to their cheap valuations, high free cash flow and high return to shareholders.

Technology, media and telecommunications



Malcolm White
Vice-President,
Portfolio Management
and Portfolio Manager

Technology started as one of the most attractive sectors last year but momentum started to fade as the year closed. This was best illustrated in the performance of Apple, which hit an all-time high of US$700 only to fade to the $500 level in subsequent weeks. While there are still great thematic investment opportunities as the penetration of tablets and smartphones continues globally, many of these opportunities involve companies that had underperformed and can be volatile. The Apple effect, economy and austerity measures will likely be headwinds for technology as we start the year.

Media investments remain attractive given box office results and the continuation of content monetization opportunities. However, one cautionary area is advertising, which should decline year over year as the effects of electoral and sports spending wane. Additional economic uncertainty can also have an added negative impact to ad spending.

Telecommunications is a mixed picture. Last year was marked with a slew of dividend cuts from large European operators, who subsequently underperformed massively. Steadier names with safe dividend payout ratios, in contrast, performed quite well in this low rate environment. The outlook for 2013 implies some form of mean revision as oversold names appreciate, while safe dividend names have largely run their course. Emerging market names are the most attractive telecommunications investments in this context, as they still have growth prospects and at the same time could introduce or increase their dividends to investors.

Health care

Rui Cardoso
Vice-President,
Portfolio Management
and Portfolio Manager

Health care finished the year on a strong note, with the sector outperforming the broader indexes. The sector was led by biotech, as pipeline successes by companies like Gilead and Amgen drove a re-rating of the group. Life science tools and pharmaceutical companies also performed strongly during the year. Health care insurers were the laggards, reflecting uncertainty as to how the competitive landscape will change with the implementation of insurance exchanges under “Obamacare.”

After two years of outperformance relative to the broader market, we expect health care to continue to perform well, though the dichotomy of the returns within the group should widen. We are mindful of the economic constraints that Western governments are placing on the sector. Despite the cheap valuations, we cannot see how developed market health care service companies that run on relatively thin margins can outperform given the intensified pricing pressure we expect, even with the uninsured U.S. population gaining access in 2014. We believe this pricing pressure will filter down from the service companies to the equipment suppliers and medical device companies.

While pricing will be a focus for big pharmaceutical companies, we expect pipeline developments and new drug launches to remain a positive catalyst. With pharma companies having strong balance sheets and high dividend payouts, we expect the more innovative ones to continue to perform well. We have taken profits in some of our holdings that are now reflecting fuller valuations, but we remain constructive on the pharma group and retain relatively high exposure to the sector.

Industrials

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

The elevated macroeconomic uncertainty put pressure on the earnings of many industrial companies in 2012. Cost containment has become a key focus, as companies try to increase earnings on very low revenue growth.

Despite the slow growth outlook, many high-quality industrials continue to generate significant free cash flow and have strong balance sheets. They generally pay solid and growing dividends, as well regularly buy back shares. Acquisitions remain a significant opportunity for these companies given the potential for synergies, and we expect this activity to increase in 2013.

Although management teams remain concerned about end market growth in 2013, there is a sense of improvement in China, while Germany and Scandinavia are showing signs of resiliency despite the challenges in Europe. Furthermore, the outlook for the U.S. industrial economy is expected to improve somewhat this year.

Although valuations can no longer be considered cheap on traditional metrics, ultra-low interest rates create a supportive backdrop for some multiple expansion. In addition, earnings expectations appear much more reasonable, as analysts have factored in lower economic growth in their assumptions. We prefer higher-quality companies in both the basic materials and industrials sectors that are generating strong free cash flow, have a successful culture of controlling costs, and can capitalize on interesting acquisition opportunities.

Preferred shares

John Shaw
Vice-President,
Portfolio Management
Portfolio Manager

Canadian preferred shares posted another solid gain in the fourth quarter, with a total return of 1.6%, led by the performance of fixed-rate perpetual preferred shares. Retail investors' demand for preferred shares remains strong given low interest rates, the lower tax rate on dividend income, and the numerous macroeconomic uncertainties affecting the equity market.

The Bank of Canada kept interest rates on hold at 1.0% for the quarter. The market is not expecting an increase until early 2014, due to the relatively strong Canadian dollar, economic weakness in Canada and the U.S. Federal Reserve's indication that it will not raise rates until 2015. Our outlook for the preferred market remains positive, with the total return for the BMO Preferred Share Index estimated to be in the range of 3% to 4.5% for 2013. This is lower than last year's estimate and the total return of 5.5% for the index in 2012.

Foreign Exchange

Matthew Strauss
Vice-President,
Portfolio Management
and Portfolio Manager

The tight correlation between currencies and other asset classes that was evident during the first nine months of the year loosened somewhat in the fourth quarter of 2012, with the Japanese yen being the most obvious example. The yen, driven by expectations of more aggressive monetary policy in 2013, weakened 9% against the U.S. dollar. The U.S. dollar in turn, struggled against the euro, as tail risks in Europe continued to subside, global risk appetite increased and the "fiscal cliff" negotiations got under way.

Despite moderate swings during the quarter, the Canadian dollar ended the quarter only marginally weaker against the U.S. dollar. However, for the year as a whole, the Canadian dollar still managed to gain 2.9% against the U.S. dollar, largely thanks to an overall improvement in global risk sentiment – which also powered global equities to a strong year. Despite meaningful swings during 2012 between the Australian and Canadian dollar, the former lost only 1.1% against the Canadian dollar over the 12 months. Signs of increasing economic activity in China led to a strong recovery in the Australian dollar in the fourth quarter. Sharply declining volatility across most currency pairs was another major talking point in 2012, with the Japanese yen being the only exception, especially against the US dollar.

Japanese yen weakness, competitive devaluations and U.S. dollar strength are important themes as we head into 2013, although the latter theme will likely only play out once the U.S. fiscal negotiations are out of the way. While the euro is currently back in favour on declining tail risks, the strength of the currency will hamper exports and might necessitate further monetary policy stimulus by the Europe Central Bank. The Canadian dollar is vulnerable to a more dovish central bank and domestic economic developments. Although we do not foresee a strong trend in the Canadian dollar, we are looking for a stable to slightly weaker Canadian dollar against the U.S. dollar in 2013.

High-yield bonds

Geof Marshall
Vice-President,
Portfolio Management
and Portfolio Manager

The high-yield bond market in 2012 was characterized by record new issuance yet low secondary liquidity and highly correlated bond returns. The primary driver of the index return was price gains in the largest bond complexes, a phenomenon we attribute to blind buying by ETFs, as those products experienced substantial inflows. Many of the largest high-yield bond issuers are over-leveraged companies that, in our view, do not provide adequate compensation for the credit risk. These "high beta" bonds are anathema to our approach, so we leave them to the index huggers.

Many of the new positions we established in the Signature funds in the fourth quarter are fairly priced, good risk-adjusted securities of well-run companies not to be found in any ETF. These include the U.S. dollar 6.5% hybrid preferred shares of insurance company XL Group, the Canadian dollar 6.875% bonds of Canadian homebuilder Mattamy Homes, the U.S. dollar 11% bond securitizing a royalty stream for a new gastro-intestinal drug from Ironwood Pharmaceuticals, and floating rate U.S. dollar term loans for Intrawest.

Past commentary has articulated our thoughts on the resilience of high-yield bond valuations in the face of the global "yield grab" and the possibility of a mid-single-digit high-yield bond return in 2013. ETFs are likely to be important market factor again in 2013 and a change in sentiment or a reversal in ETF flows could be material risks to this forecast. In this case, our astute and differentiated security selection and portfolio positioning will be key to capital preservation.

Investment-grade corporate bonds

John Shaw
Vice-President,
Portfolio Management
and Portfolio Manager

Investment-grade corporate bonds continued to post positive returns in the fourth quarter, even though interest rates edged higher. The reason was that spreads over government bond yields tightened, as investors felt more confident in putting money into the market.

Confidence was boosted by improvements in U.S. employment and housing and actions in the third and fourth quarters by the European Central Bank and the U.S. Federal Reserve. The Fed's decision to undertake quantitative easing for an indefinite period is forcing credit investors to search for higher yields.

With regards to the U.S. "fiscal cliff," the taxation question was answered, but the debt ceiling and spending cut issues remain. In Europe, the crisis lingers but European finance ministers agreed to give Greece its long-awaited aid instalment in December. The market now expects that Greece will remain in the euro at least until after the German federal elections in the fall of 2013. Fundamentally, North American corporate credit remains sound. However, as investors search for yield and expect lower returns, companies are likely to use the inexpensive debt to finance shareholder-friendly activities.

The Canadian investment-grade index returned 0.8% in the fourth quarter, outperforming government bonds by 75 basis points due to spreads tightening seven basis points over the quarter. Investor demand was solid as they sought the relative safety of corporate bonds over equity markets. Issuance was strong during the quarter but was easily absorbed by the market. Unusually, December was the busiest new issue month of the year.

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