Market Roundup

Global outlook

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

The European Central Bank intervention in bank funding markets in December produced a three-month window of confidence that broke down in April. European sovereign debt markets and bank credit markets came unstuck as squabbling over the Spanish bank bailout mechanism reminded investors of the complexity in crafting true solutions in Europe. A negative spiral has taken hold in peripheral Europe between weak growth, deteriorating fiscal positions and financial stress. Damage to corporate and consumer confidence spread globally, provoking a spending freeze – as we see in the second quarter earnings results. In our view, a European "TARP moment" lies ahead, which will pressure leaders into finding a solution. The ECB will again lend a hand, but only if and when politicians commit to bona fide Eurozone integration. The era of gradualist approaches to the problem has now passed.

Global outlook

Drummond Brodeur
Vice-President,
Portfolio Management
and Global Strategist

The global outlook remains challenging. The Eurozone remains swamped in a crisis of political leadership in which policymakers have repeatedly failed to grasp the imperative of making difficult political decisions and have squandered the windows of opportunity that have been achieved through measures such as the European Central Bank's aggressive Long-Term Refinancing Operation. Markets are losing patience and a slow-motion bank run and euro unwind is occurring.

Whether the authorities can get ahead of the crumbling edifice of confidence in the euro is uncertain as "too little too late" seems to be the preferred approach. Yes, progress is being made but the lack of any clear vision or consensus of what the Eurozone wants to be when it grows up weighs heavy. Markets are not unaware of this and while we remain very cautious on the European outlook, we also recognize that the chief risk to our view would be any decisive policy action. Not expected, but not impossible.

Meanwhile, the recent data from the U.S. have been weaker than we anticipated and leaves the economy with much slower momentum as we go through the traditional slow summer period and begin to face the headwinds of the elections and impending expiry of tax cuts at year-end – the so-called fiscal cliff. The uncertainty surrounding these issues will dampen the near-term outlook and add to volatility over the summer. But we remain of the opinion that the U.S. private sector continues to improve and is positioned for better growth as the headwinds of political uncertainty recede by year-end. Our issue here is more of market positioning and timing rather than longer-term concern.

As for China, the slowdown there is also proving more persistent than many expected but policy has clearly shifted into a more supportive mode, both from a fiscal and monetary perspective, and we expect to see improving economic growth in the second half of the year.

I would note that pessimism about the above issues is pervasive and clearly constitutes the consensus and yet, at the end of the quarter, most global markets were still positive for the year-to-date! Valuations are attractive and dividends can far exceed bond yields. This is not the time to hide your money under the mattress; it is a time to partner with a strong and proven investment team that can help you navigate through the negativity and volatility, help protect your capital and earn a return on your investments. It is what our 32-person team of global investment specialists at Signature does every day.

Emerging markets

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

In the second quarter, emerging market equities gave back most of the gains recorded during the early part of the year. European worries dominated global investment sentiment, which deteriorated as the Spanish banking crisis worsened and the possibility of a Greek exit from the euro increased. Weaker-than-expected economic reports from the U.S. and China added to global growth concerns. The inability of policymakers in Brazil to turn the economy around, despite aggressive monetary policy loosening, was a further reminder that emerging markets likely will not recover as quickly as they did in 2009. The MSCI Emerging Markets Index was down 7.0% in Canadian dollar terms during the quarter but was still up 4.1% for the first half.

In relative terms, emerging markets underperformed developed markets, reflecting their continued high-beta status, global growth concerns and increased worries about the growth slowdown in emerging markets. Economic reports, especially production data, disappointed markets across the emerging regions. Lower commodity prices further questioned the growth potential of many resource-sensitive countries, including South Africa, Brazil and Russia. The latter two countries were also the worst-performing emerging markets in the second quarter. Only two emerging markets managed positive quarterly returns in U.S. dollar terms: the Philippines (4.1%) and Turkey (1.3%).

Efforts to stabilize the growth slowdown in China are underway, but the expected bottoming and subsequent recovery will be later and more muted than originally anticipated. Chinese growth is, nonetheless, still expected to remain above 7.0% and probably closer to 8.0% in the latter part of the year. The U.S. election and fiscal situation are likely to add to global uncertainty, amidst the ongoing European problems. We therefore enter the second part of the year defensively positioned, with cash levels of around 10%. From a regional perspective, we have increased our exposure to Eastern Europe but still remain underweight Russia. We have also reduced our exposure to Brazil following disappointments in its growth and the pace of reform. In Asia, Thailand and China remain our favourite destinations. On a sector basis, our bias is tilted to the domestic-focused sectors, including financials, consumers and health, and away from energy, materials and industrials.

Consumer products

Stephane Champagne
Vice-President,
Portfolio Management
and Portfolio Manager

U.S. consumer activity slowed during the second quarter. Retail sales, led by drugstores, low-end department stores and apparel retailers, decelerated from April to June. Part of the reason for the weakness was the unusually warm weather in the first quarter, which moved sales forward and led to more aggressive promotions in the second quarter. The European debt crisis and weak U.S. employment also affected consumer confidence.

Online shopping was still strong, with an average growth of 15% to 16%, while performance at discounters, high-end department stores and clubs was steady, as consumers were still looking for bargains. Inflation continues to decline on a sequential basis due to lower gasoline prices – the main positive story during the quarter.

Overall, the S&P 500 Index underperformed the consumer discretionary index by 28 basis points and underperformed the consumer staples index by 540 bps. The staples index has been boosted by the weakening economic situation globally.

For the second half of the year, the sector will depend on the pace of growth in the U.S. and the potential withdrawal of stimulus at year-end. The European situation and whether or not China will experience a soft landing will add to the uncertainty. We also remain concerned about the high level of debt held by Canadian consumers.

We have increased our cash level and stand ready to deploy this cash ahead of a more sustained recovery later in the year. We continue to favour consumer staples over discretionary and prefer global brands for stable, long-term growth. We remain confident in our defensive choices due to their cheap valuations, high free cash flow and high return to shareholders.

Financials

John Hadwen
Vice-President,
Portfolio Management
and Portfolio Manager

Canadian financials – We continue to view the dividend yields on Canadian financials as very supportive of their valuations, especially for the banks. The life insurance companies are also trading with attractive dividends, but the higher capital intensity and challenging low interest rate environment leave little room for dividend growth in the medium term.

European financials – "Worth less or worthless" seems to be the debate in the markets as many large European financials continue to trade at distressed valuations. The sector has made considerable progress in strengthening capital positions and liquidity has been improved through ECB actions, but sovereign debt concerns are overwhelming the healing process. This will remain a frustrating environment, as historically unique valuations will remain clouded by numerous macro uncertainties.

JPMorgan is our favourite global financial holding at this time. It is clearly an industry leader in size and market share with solid management and, as such, will generally produce above-average returns. The franchise has such breadth that there will be some negative development in some part of the business at all times. While there remains significant uncertainty over regulatory changes and the ultimate impact on the business, we view its recent valuation as absurd relative to our expectations of future earnings power and dividend generation. We remain confident in the company's ability to meet capital requirements while returning significant capital to shareholders over the medium term, despite the recent trading losses and expected regulatory burden.

Health care

Rui Cardoso
Vice-President,
Portfolio Management
and Portfolio Manager

The health care sector had a solid rebound in performance in the second quarter and is now outperforming the broader market on a year-to-date basis. The major catalyst in the quarter came in the form of the U.S. Supreme Court decision to uphold "Obamacare" (formally known as the Affordable Care Act). While the historic result was unexpected, the impact on the sector was minimal. Hospitals were bid up as their bad debt provisions will decline because "free" care for the uninsured will turn into "paid" care, and insurers were clipped as increased government involvement in insurance exchanges may crowd out commercial insurers.

In our view, the bad news is that without drastic cuts to major programs like Medicare, the current market for health care is not sustainable in the long term. The good news is that the decision has removed a major near-term overhang to the sector's performance and reduced the likelihood of health care reform continuing as a major political issue.

We remain constructive on the health care sector, and on pharmaceutical stocks in particular, as we expect a renewed focus on the 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. We expect to see an increase in new drug approvals, leading to higher expectations for longer-term growth. Elsewhere in health care, we remain cautious on medical device and health care service companies leveraged to mature markets (the U.S. and Europe in particular), as we expect continued price pressure will offset much of the underlying growth. We remain very positive on opportunities for growth in emerging markets services, but given high relative valuations, we have recently taken profits in this area.

Technology & telecommunications

Malcolm White
Vice-President,
Portfolio Management
and Portfolio Manager

The second quarter saw a complete reversal of the risk-on trade that investors were comfortable with in the prior quarter. May was particularly volatile, starting with concerns over Greek and French elections, compounded with ever-widening Spanish bond yield spreads. June added to the concerns when incoming economic data showed a larger slowdown extending from Europe into China and the U.S.

Technology stocks sold off on the general macro concerns and the flight away from higher-beta names. Cisco's warnings on weaker enterprise spending and Facebook's failed IPO also weighed negatively on the sector.

Telecommunication and media names were better performers. For media names, the summer box office and ad spending around global sports events and elections have been solid. Telecommunication names have benefited from a flight to safety in a similar fashion to what has happened to global bond yields.

Much has transpired in the past three months in the tech, media and telecom sectors. Stocks have largely reacted in anticipation of negative news. In the coming months, we will be closely watching results to see how macro events have impacted our adjusted earnings outlook.

Natural resources

Scott Vali
Vice-President,
Portfolio Management
and Portfolio Manager

The price of crude oil experienced a sharp decline in the second quarter due to a reassessment of global economic growth. It has been a challenging environment for many crude oil producers and this has been reflected in the valuations of equities. We believe that the market is still debating what the growth in oil demand will be for the remainder of the year. Natural gas continues to trade at depressed levels in North America. Many companies have continued to earn a good return based on the liquids associated with natural gas. As these supplemental gains decline, we believe there will be a pullback in drilling and that will help to boost prices somewhat.

Copper prices remain at robust levels. Supply-side tightness should limit the downside and help keep prices stable. Suppressed iron ore prices rose as the Chinese announced economic stimulus measures and demand for steel returned to the market. Gold prices have fallen as a result of the absence of a third round of quantitative easing in the U.S. Barring "QE3," we don't expect to see gold prices move dramatically higher, but we have a positive longer-term outlook for the commodity.

Overall, resource markets are likely to remain uncertain over macroeconomic concerns. We remain positive on the long-term prospects of our energy and materials holdings and continue to look for opportunities in well-capitalized companies.

Preferred shares

John Shaw
Vice-President,
Portfolio Management,
Portfolio Manager

The Canadian preferred market continued its low but steady performance in the second quarter. The BMO 50 Preferred Share Index posted a positive 0.86% total return, led by a 1.21% rise in fixed-rate perpetual shares.

Retail investors' demand for preferred shares remains strong given the numerous uncertainties in the macroeconomic picture and need for yield. There were 12 issues in the quarter totalling $2.2 billion from a wide range of financial and non-financial companies. There were two redemptions for $300 million by Canadian Utilities.

The Bank of Canada kept rates on hold during the quarter at 1%. The market is not expecting another increase in Canada until the second half of 2013, due to the relatively strong Canadian dollar and the U.S. Federal Reserve's indication that it is on hold until 2014. The Fed has extended "Operation Twist" until the end of 2012 in an effort to keep rates low.

The outlook for the preferred market remains positive, as retail investors pursue the relative safety of the preferred market, interest rates remain low and net issuance of preferred shares is balanced.

High-yield bonds

Geof Marshall
Senior Vice-President,
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and Portfolio Manager

The high-yield bond market proved to be resilient in the second quarter, with the benchmark Bank of America Merrill Lynch U.S. Master II Index returning 1.8% in U.S. dollars. Despite the positive return, valuations deteriorated slightly as the yield on the average bond widened 45 basis points relative to Treasuries. At the end of the quarter, the average yield in the market was 7.4%.

Having raised the cash level even higher in April, portfolio activity was muted in the quarter. New names added to the portfolio include: the 8.75% bonds of Canadian copper producer Inmet Mining; a secured term loan of Gibson Energy, an operator of energy infrastructure assets in Alberta; the 8.5% bonds of Sabre Holdings; and the 13% secured bonds of Canadian satellite broadband provider xPlornet Communications.

Our management of the portfolio's currency exposure contributed to performance, as we progressively lowered the hedge on our U.S. dollar exposure in May and June, during which time the U.S. dollar gained 4.6%.

The high-yield bond market is in good shape fundamentally: valuations are mixed, yields are low and prices high, but spreads to Treasuries are wide and expected future defaults are low. Technically, the market is also in good shape, as investment inflows and modest supply support prices. Like other asset classes, high-yield bonds are being affected by macroeconomic events, with the European crisis affecting business and consumer confidence worldwide. However, we expect high yield to weather these events with better risk-adjusted returns than equities and better returns than investment-grade bonds.

Foreign Exchange

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

Global sentiment continued to drive broader currency moves in the second quarter, with "risk off" the dominant theme for most of the period. Against this backdrop, the so-called safe-haven currencies, the U.S. dollar and Japanese yen, outperformed. More surprising was the resilience of the Australian and Canadian dollars, given that commodity prices declined by more than 7%. These currencies depreciated by less than 2% versus the strong U.S. dollar. Solid economic fundamentals and the continued foreign buying of government bonds of these two AAA-rated countries provided a partial offset to declining commodity prices. The Australian and Canadian dollars remain vulnerable to another round of declining commodity prices, but strong fiscal positions should prevent a 2008-style sell-off.

The euro finally broke lower, reflecting both the deterioration in investor sentiment towards the Eurozone, as well as looser monetary policy by the European Central Bank. With inflation not a concern, European policymakers will most likely accept further declines in the euro in coming months. Slow progress to address the region's problems and the concomitant impact on confidence could also continue to weight on the currency.

Despite a strong recovery late in the quarter, commodity-based emerging market currencies felt the full brunt of the "risk-off" bias during the three months. Russia and Brazil filled the bottom spots on the performance scale for these currencies. In a world of uncertainty and concerns over global growth, volatility in emerging market currencies is expected to remain elevated, especially for those countries close to the Eurozone, (Hungary, Poland), with weak economic fundamentals (India) or those closely linked with commodities.

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