Signature Market Roundup

Fall 2012

Signature GLOBAL ADVISORS

Global outlook

Drummond Brodeur
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We remain trapped in a battle between the fragile and sluggish nature of a post-credit bust economic recovery and aggressive policy responses. But through the process, global rebalancing and selective deleveraging are happening.

In Europe, we expect a stagnant economy as officials attempt to build the institutions for a greater fiscal union. We continue to expect ongoing mini-crises will be required to keep politicians focused on the agenda, but the progress over the summer with the European Central Bank commitment to utilize its balance sheet to defend the euro was a significant step forward and has reduced the looming tail risk of an imminent euro collapse. While the ECB cannot fix Europe's problems, it has bought the politicians time. It was these events in Europe that led Signature to increase our equity exposure to markets over the summer months.

While China has continued to slow, a lack of rising unemployment has kept Beijing relatively sanguine. Fiscal and monetary policies continue to be relaxed but there has been no sign of panic or escalation in the degree of policy response. In the coming quarter, I expect confirmation of stabilization in China's growth at a slower but sustainable level. Should this play out, it should support the beaten-up commodity markets; however, I would emphasize that a recovery from depressed levels is a tactical call, as a structurally lower growth trend in China will be less supportive of the commodity complex than the boom years of the past decade.

In the U.S., signs of improving economic data support our view that the economy is in a 2% growth trajectory with minor cyclical swings around the trend. This will be the third year in a row we see evidence of a pickup heading into the fourth quarter and this, along with reduced European tail risk, largely explains the recent rally in equity markets over the third quarter.

In the coming quarter, there are two key catalysts that will impact markets. The first is clearly the U.S. election and looming fiscal cliff. I expect this to lead to further volatility in the markets and would tend to use pullbacks to add to market exposure. While the risk of the fiscal cliff is very real, it also has a clear timetable, so the situation will be clarified very soon.

The second key catalyst that investors must understand is the dramatic shift in the monetary policy stance in the U.S. The Federal Reserve recently launched a third round of quantitative easing (QE3), and this policy is unlike any other previous rounds of policy from the Fed. Briefly, officials are determined to increase the rate of growth of the economy to drive job creation. To do so, they are deliberately driving interest rates below the rate of inflation and committing to keep them there longer than expected. This is financial repression. It is a deliberate tax on the wealth of risk-averse savers. It will drive a wall of liquidity out along the risk curve in search of yield, and ultimately across asset classes into dividend-paying equities. This policy is aimed at achieving stronger economic growth and ultimately monetizing the U.S. fiscal debt. Understanding this dynamic and monitoring the timing and sequencing of developments is the challenge for all asset managers in the coming years.

Emerging markets

Matthew Strauss
Vice-President, Portfolio Management,
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The third quarter of 2012 saw emerging markets rally 7.9%, outperforming developed markets by 1.1 percentage points. At the end of September, the year-to-date returns stood at a healthy 12.3%. The quarter started on a lacklustre note, but indications by ECB President Mario Draghi in late July that the bank may be willing to restart its sovereign bond-buying program triggered a strong positive response from the market. With tail risks reduced in Europe, tentative signs of progress on the European political front and the announcement of QE3 in the U.S., emerging market equities had a strong quarter. In Canadian dollar terms, the gain was a more modest 4.1% because of a strengthening Canadian dollar.

The performance was driven by Asian equities, which were up 8.9%, led by India (15.4%), Taiwan (11.8%) and Thailand (11.3%). In India, a number of policy announcements were well received by investors. The rupee also appreciated sharply following these announcements and added to the equity returns for foreign investors. A number of Eastern European markets also recorded double-digit returns (Poland, Czech Republic), with the rest recording high single-digit returns following the encouraging developments in the Eurozone. Though Chinese economic growth continues to struggle, it is still expected to remain above 7.0%.

The focus of global investors is likely to shift from the Eurozone to the U.S. in the fourth quarter as the presidential election enters its final stages. Following the elections, the focus will turn to the fiscal cliff and approaching debt ceiling. Major missteps or disappointments by European officials remain a risk to global sentiment.

Of the four major emerging markets, only China is currently an overweight position in our portfolio. From a regional perspective, we remain slightly overweight Eastern Europe but underweight Russia. In Asia, Thailand remains our favourite destination. On a sector basis, we continue to prefer the domestic-focused sectors, including financials, consumers and health care, at the cost of energy and materials.

Financial services

John Hadwen
Vice-President,
Portfolio Management
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Canadian – With Canadian household debt levels as high as they are, the market is appropriately anticipating modest asset and earnings growth for the Canadian banks in coming years. We share that outlook but find the dividend yields to be very supportive of valuations. The Canadian banks have built up capital levels towards the new higher requirements and are generally well positioned to grow dividends at least as fast as earnings. With low asset growth, much of their earnings can be considered distributable cash flows, which will support a return of buyback activity. The dividend yields on the life insurance sector are very appealing, yet the low-yield environment continues to depress the group's fundamentals. For the time being, we continue to favour banks over life companies.

European – Risk premiums have been declining from very high levels as challenged European sovereign bond markets recover. To recap, most financials performed dreadfully in the back half of 2011 as banks were largely shut out of funding markets on regulatory uncertainty and sovereign debt concerns. Late in 2011, the ECB provided significant liquidity to the banking sector, removing bank funding pressures and supporting a strong rally into the spring. However, that rally was short-lived in the face of fears over the future of the European Union. Market participants spent the summer looking for evidence of sufficient political will to prevent additional sovereign defaults and a euro break up. In August, ECB statements convinced the market that the euro has a future, however challenged, and this supported sovereign bond prices.

Banks, of course, aren't designed for sovereign defaults and thus improving sovereign bond pricing has made European banks an investable category again. This has encouraged the investor universe to reduce its underweight exposure to the space, boosting stocks. We believe capital is generally adequate across the European financial space. We increased our exposure in August from very low levels and participated in the rally. European financials will remain challenged, although we continue to find select companies that are very undervalued relative to their future distributable earnings power.

U.S. – The Federal Reserve is taking drastic action to ensure mortgage rates remain low, which adds to increasing confidence in the U.S. housing outlook and at the same time will push fixed-income investors out along the risk curve. Of course, an improving housing market is fantastic news for U.S. banks, as it will reduce credit costs and legal expenses as they deal with their troubled mortgage portfolios. Improved housing markets should reinvigorate confidence in investment, leading to growth in employment and loans. The price the banks have to pay for the improving housing market is significant pressure on net interest income margins, which is offsetting many of the above-mentioned benefits. We continue to view the larger U.S. banks as undervalued and remain overweight. The sector is very well capitalized. Even as payout ratios increase, there will need to be a notable improvement in asset growth to prevent the sector from becoming overcapitalized in the next two to three years.

Resources

Scott Vali
Vice-President,
Portfolio Management
and Portfolio Manager

The global growth scare that began in the spring of 2012 dissipated as the European Central Bank announced further stimulus measures in the third quarter. That, along with the promise of another round of quantitative easing by the Federal Reserve, provided the catalyst for a rally in equity markets, with commodities and commodity stocks leading the upsurge.

In addition, a relatively tight production market in North America pushed the price of oil to US$100 a barrel for West Texas Intermediate at the end of the quarter. Internationally, Brent prices remained supported at high levels due to production outages in the North Sea and geopolitical concerns in the Middle East. We believe WTI prices will remain within the range of $US80-100 a barrel, which is positive for our holdings in large diversified energy services companies. A large differential in prices for different types of North American crude was evident in the period, with markets furthest from the Gulf Coast trading at large discounts to international prices. At the end of the quarter, these differentials narrowed as railway capacity was introduced to relieve the bottleneck in North America's network of crude oil pipelines.

The price of gas has rebounded from historical lows of below US$2 per million cubic feet (mcf) to $3.40 per mcf in anticipation of upcoming cold winter temperatures. We expect the price to remain in the $3.00 to $4.00 range for the short term. Strong demand for natural gas during the past summer has reduced our concerns that forced production curtailment would be necessary to alleviate storage congestion. Hot, dry summer weather in the third quarter resulted in poor corn, soybean, and grain crops, and in turn, high grain prices. Increasing corn prices typically lead to increased demand for fertilizer and other crop inputs. In addition, domestic producers of nitrogen fertilizers have benefited from the low price of natural gas in the U.S.

The markets are likely to remain volatile for the remainder of 2012. Broadly speaking, our portfolios carry an overweight position in energy and an underweight in materials, with holdings concentrated on gold bullion within materials. We favour the longer-term outlook for resources and believe that company fundamentals are generally sound and expect to continue to find good investments in this area. Leading indicators are starting to point toward a recovery in Chinese demand, which, along with the recovery in the U.S. housing market, should be positive for resource-based investments.

Technology

Malcolm White
Vice-President,
Portfolio Management
and Portfolio Manager

The sentiment in the technology sector has varied widely throughout the year. At the start of the year, as investors gravitated to risk, technology was one of the "go to" sectors for attractive earnings growth and incremental beta relative to the market. This led to great performance in the first quarter of the year.

But by May, this optimism was fully reflected in the performance of many stocks. The bulb seemed to burn brightest with the announcement of the highly anticipated Facebook IPO. Its subsequent poor performance soured the overall IPO market and the tone for the technology sector in general.

May turned out to be a volatile month. The market declined as perceived risks around Europe surfaced. Additionally, throughout the summer, some of the areas that were expected to be key drivers had less of an impact than originally anticipated. For example, the personal computer market was relatively soft despite excitement surrounding the launch of Microsoft's new operating system, Windows 8. This was also one of the few years where "back to school" was essentially a non-event.

The market is expected to be challenging as year-end approaches. Most geographies are experiencing moderating growth trends, including historic economic powerhouses such as China. We believe that earnings estimates will get adjusted down but the magnitude of this change is unknown.

We still believe, however, that technology is a relative secular winner. It offers decent growth rates, is not sensitive to a single troubled geography, and still offers upside if offshore cash on the balance sheet can be unlocked to the benefit of shareholders.

Health care

Rui Cardoso
Vice-President,
Portfolio Management
and Portfolio Manager

The health care sector performed well in the third quarter and, unlike previous positive moves in the sector since 2008, the outperformance occurred with a relatively strong market backdrop. That is, the health care move was not a defensive option call to buy less economically sensitive and high dividend-paying stocks to protect from a further unravelling of the situation in Europe or potential macroeconomic growth slowdown in some emerging markets. The move was more offence than defence. Outperformance was led by the biotechs and big pharmaceutical stocks, although medical device and life science tools companies surprisingly followed along for the ride.

In our view, the outperformance reflects a shift in sentiment – not only will the big pharma companies (which still makes up more than 65% of the health care investing universe) make it through their patent cliffs (the 2010 to 2012 period where some of the highest revenue generating drugs in the market lose patent exclusivity and witness steep declines in sales as generic entrants use price to steal market share), but there is life on the other side. We believe that the initial move in the sector from historically low market multiples (in the 8 times P/E multiple range) to the current range that is close to the S&P 500 average has reflected the understanding that the stocks were too cheap relative to fundamentals (clean balance sheets, high dividend yields and high return on invested capital businesses).

The latest move in health care, in our view, is driven by innovation. There are still massive unmet medical needs and room for significant innovation in areas like diabetes, oncology, hepatitis C and Alzheimer's. After years of revamping pipelines, drugs are starting to clear Phase 3 hurdles and gain acceptance from the Food and Drug Administration, and we believe this is driving multiple expansion. In addition, after wholesale changes at the C-suite level at a number of major health care companies, we are seeing much greater focus on generating returns for shareholders through increased share buyback activity (like Amgen, which is in the process of buying in 20% of outstanding shares), strategic restructurings and carveouts (like Pfizer's plans to sell and/or spin off its nutritionals and animal health assets), and increased dividends (like Baxter). These moves have been well received by investors.

While we have taken profits in a number of our holdings, which has lowered our overall weight in the sector, we remain very constructive in our views and expect the sector will continue to re-rate in the near-term. Big pharma continues to be the health care segment where we see the greatest opportunities for investment returns. Although expectations are low, we believe that fundamentals in medical device, U.S. health care insurance and in life science tools are weak and potentially deteriorating.

Consumer products

Stephane Champagne
Vice-President,
Portfolio Management
and Portfolio Manager

Overall, the S&P 500 Index underperformed the consumer discretionary index by 115 basis points but outperformed the consumer staples index by 300 bps during the third quarter. The discretionary index outperformed the staples index by 400 bps, due to ECB intervention in Europe, the new quantitative easing program, continued job creation and an improvement in the housing sector in the U.S.

U.S. consumer activities were mixed during the quarter. Retail sales accelerated from July to August, before slowing for the remainder of the period. The back-to-school season had varied results, with 38% of retailers we track beating expectations, 38% missing and 23% reporting results in line with the previous season. Year-over-year comparisons for the quarter show that low-end and off-price retailers outperformed middle and upper-end retailers. Performance at discounters and clubs has been steady, suggesting that consumers are still looking for bargains. Online shopping remained strong, with an average growth rate of low double digits to mid-teens.

For the fourth quarter, inventory levels are fine as we approach the fall and holiday seasons. U.S. consumer fundamentals should be stable or improving slightly if gasoline prices remain steady, and the housing sector and job creation continue to experience improvement. We remain concerned about Canadian consumers and their high level of debt. The European consumer outlook is fragile for the fourth quarter and the first half of next year as some countries enter into recession and unemployment remains high.

In Asia, consumer confidence remains low given the economic slowdown and the transition of the Chinese government. Confidence should pick up in the second quarter of 2013. Finally, in Latin America, consumer fundamentals remain solid. Concerns for the fourth quarter include the U.S. election, the fiscal cliff in January 2013, ongoing sovereign debt concerns in Europe, and China's deceleration.

We continue to favour sectors supported by strong fundamental recovery and global brands for their pricing power and their long-term growth. We remain confident in our choices due their cheap valuations, high free cash flow and high return to shareholders.

Automotive

Massimo Bonansinga
Vice-President,
Portfolio Management
and Portfolio Manager

I was in Europe recently for the Paris auto show, to meet with European auto company executives and visit some factories in the U.K. and Germany. Overall, the sentiment in the European auto industry is increasingly negative.

According to ACEA (European Automobile Manufacturers Association) data, German auto sales were down 11% year over year in September, leaving the U.K. as the only large market with positive sales growth during the first nine months of 2012. On paper, European sales were down 750,000 year over year but, in reality, final sales are even worse. ACEA tracks registrations and many European dealerships are self-registering cars that end up sold in the second-hand market with a large discount, despite being new.

Manufacturers are spending extensively to support dealerships and sales. Some companies told me that they plan to restructure their dealer networks in Southern Europe, especially in Spain. Many factories are already operating below their break-even point and mass market automakers are expected to report mounting losses in the coming months.

Despite the negative news, there is the potential for game-changing action in Europe. The North American market was equally oversupplied and went through painful restructuring and it is now quite healthy. It is Europe's turn to right-size its auto industry. Consensus is building that the current industry structure is unsustainable. Some unprofitable factories are being closed and even countries traditionally opposed to restructuring, like France, are getting closer to accepting significant plant closures. Timing is uncertain but the result is practically inevitable.

Meanwhile, the Korean automakers are doing well, increasing both their market share and the number of vehicles sold in Europe. They continue to be formidable competitors globally and are being successful in Europe – unlike the Japanese manufacturers, who achieved only weak market penetration.

We are not invested in European manufacturers and have most of our underweight position in the automotive sector in names with extensive U.S. market exposure.

Industrials

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

Earnings growth expectations for industrial companies continued to grind down as 2012 progressed. European end markets, although weak, appear to have stabilized recently, while China has continued to disappoint. Despite concerns about the "fiscal cliff," U.S. industrial end markets have been more resilient.

Looking into 2013, subdued global GDP growth means that industrial companies will likely show moderate earnings growth, on average. Although this may seem disappointing at first blush, in the context of ultra-low interest rates and a sluggish macro outlook, industrial stocks should be able to show steady performance as valuations remain in line.

Given sluggish demand growth, industrial companies have been focusing much more on cost reduction. Those that have been proactive on this front have shown better margin stability and stronger share price performance. It appears that we are in the early stages of cost cutting within the sector, and expect this trend to accelerate into 2013 as companies hope to show earnings growth against a flat sales growth backdrop.

In addition, acquisitions can drive earnings growth, especially if there are significant synergies available. Although M&A has been fairly subdued to date, we expect this activity to increase, given the availability of cheap debt and high cash levels at many firms.

In conclusion, given the macro uncertainty, we remain underweight the sector due to the risk of further declines in capital expenditures. We prefer to invest in quality companies that have a greater degree of recurring revenues, a sharp focus on cost containment, as well as those that can execute on accretive acquisitions.

Real estate

Ryan Fitzgerald
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Portfolio Management
and Portfolio Manager

As anticipated, the Federal Reserve announced a third round of quantitative easing in September. The massive scale of the new program, combined with the commitment to keep interest rates near zero through 2015, is having a dramatic impact on the valuations of high-yielding assets. Valuations of traditional high-yield sectors such as commercial property and infrastructure are already near all-time highs and could go even higher. As real interest rates (interest rates minus inflation) go negative, savers will continue to desperately seek cash flow streams that are linked to inflation.

While we acknowledge that high valuations could go even higher, we are still wary of putting new money to work in these areas. We are instead focusing on regions that still have reasonable valuations (such as Australia and Hong Kong), or on general equity sectors that have high dividends but have yet to be caught up in the "yield trade." We believe that once yields have compressed to unreasonable levels in the traditional yield areas, general equity dividend stocks will be the next destination for yield-seeking capital flows. We want to be in front of those flows.

Preferred shares

John Shaw
Vice-President,
Portfolio Management
and Portfolio Manager

The Canadian preferred market posted a solid performance in the third quarter with a total return of 1.64% (BMO 50 Preferred Share Index), led by fixed-rate perpetual and floating rate preferred shares. Global capital markets rebounded from the weakness of the second quarter when the head of the ECB said the central bank would do whatever it takes to support the euro. Additionally, the Federal Reserve announced its third quantitative easing plan to provide indefinite support to boost the U.S. economy.

Retail investors' demand for preferred shares remains strong given the numerous uncertainties in the macroeconomic picture and quest for yield. There were eight issues in the third quarter totalling $1.8 billion from a wide range of financial and non-financial companies. There were four redemptions for $750 million, for a net issuance of just over $1 billion.

During the quarter, the preferred market was led by a 2.48% rise in floating rate preferred shares, which were bouncing back after a weak return last quarter. Bank perpetual preferred shares continued to do very well, returning 2.22%.

The outlook for the preferred market remains positive, as retail investors pursue the relative safety of the preferred market, interest rates remain very low and net issuance of preferred shares is very manageable. Overall, we remain positive on preferred shares, with the index returning 3.85% for the year-to-date, which is on track for our estimated total return of 3.5% to 5% for 2012.

Foreign exchange

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

Global sentiment continued to dominate broader currency moves in the third quarter. Whereas the second quarter had largely been a "risk-off" environment, the third was characterized by a strong "risk-on" orientation. This, together with the Fed's decision to introduce another round of quantitative easing, explained a large part of the weakness in the U.S. dollar during the quarter. The other two traditional safe haven currencies, the Japanese yen and Swiss franc, were the second and third-worst performing currencies in this group.

The Canadian dollar gained 5.0% against the U.S. dollar during the quarter, supported by the global risk-on trend, elevated oil prices, increasing metal prices and a hawkish central bank. Growth concerns out of China continue to pose a risk for commodity-based currencies. Economic weakness, either globally or domestically, could also push the central bank towards a more dovish stance, adding to potential downward pressure on the Canadian dollar.

The euro fell to a two-year low of 1.2043 against the U.S. dollar in July – a 15% decline from the recent high recorded in November 2011 – but recovered sharply following comments by ECB President Mario Draghi in late July that the bank might be willing to restart its sovereign bond buying program. In early September, the ECB formally announced it would buy sovereign bonds under certain conditions. These developments and the quantitative easing announcement in the U.S. pushed the euro to almost 1.32 by mid-September. We view this as a short-term correction in a structurally down trend for the euro.

Investment-grade bonds

John Shaw
Vice-President, Portfolio Management and Portfolio Manager

Investment-grade corporate bonds continued to post positive returns in the third quarter, as spreads tightened and interest rates fell slightly. Concerns about the future of euro abated and investors looked to put their cash to work. However, the crisis continues, with Greece still struggling, lack of progress on a European banking union and Spain playing coy about whether it will seek a full aid program. Canadian and U.S. GDP growth is positive but slow and monetary policy will remain low for a number of years as central banks try to boost growth.

Fundamentally, corporate credit remains very good in the non-financial sectors and the banking sector continues to build capital and liquidity to meet the upcoming Basel III rules. Consumer confidence is holding up, U.S. house prices have stabilized and the slow economic and job growth are providing a decent backdrop for credit investors.

The investment-grade index returned 2.1% in the third quarter, outperforming government bonds by 158 basis points due to spreads tightening 22 bps over the quarter. Investor demand was very strong as concerns in the equity markets and low government yields continue to draw investors to the relative safety of corporate debt. Issuance was decent during the quarter and was easily absorbed by the market.

The outlook for investment-grade credit is mixed for the remainder of the year and into 2013, as political and economic concerns need to be addressed. However, the strong central bank support provides a backstop and the quantitative easing programs are boosting liquidity, which is balancing out those concerns.

High-yield bonds

Geof Marshall
Vice-President,
Portfolio Management
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The European Central Bank's moves to defend the euro supported risky assets in the third quarter, despite soft economic data from the U.S. and China. High-yield bonds fully participated in what can be called a global yield grab, as yields and spreads have declined significantly and new issues are being very well received. During the third quarter, high-yield bonds returned 4.61% (Bank of America Merrill Lynch U.S. Master II Index, in U.S. dollars) as the yield on the average bond tightened 75 basis points to end the quarter at 6.62%, or 569 basis points over Treasuries. These two numbers represent the mixed message the market is presenting to investors. On one hand, the yield is near its all-time low and average prices are above par, indicating that the market is rich. On the other hand, the spread is above the long-term average, which suggests that the market is cheap. However, as long as investors have reasonable expectations for future returns, the risk of large outflows from the asset class pressuring returns is negligible.

We entered the third quarter with an elevated cash position and were active throughout the three months deploying cash, mostly in the new issue market. New bonds added to Signature portfolios include the 9.5% U.S. dollar bonds of Canadian copper producer HudBay Minerals, the 6.75% U.S. dollar bonds of Canadian mid-tier gold producer Iamgold, the $10.5% Canadian dollar bonds of Golftown, and the $8.875% U.S. dollar bonds of automotive and industrial supply chain manager SPL Logistics, when it was spun out of Caterpillar.

Reconciling the valuation measures noted above with the Signature macroeconomic view points to mid-single digit returns over the next 12 months for the overall high-yield market. Given the low yields on income alternatives and equity market volatility, this "coupon-like" return will be seen as attractive. To mitigate risk as the global yield grab progresses, we are continuing to invest in quality risk-adjusted securities of well-run companies that are out of favour with the broad market. We will continue to invest in securities and companies set to benefit from global deleveraging. We will not simply invest in higher-yielding or higher-risk securities that have not yet appreciated in price. We will continue to seek maximum diversification and take full advantage of our flexibility to preserve capital and generate income.❖

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