

Signature Global Advisors
July, 2012

*For the third year in a row, **Eric Bushell**, Chief Investment Officer of Signature Global Advisors, recently travelled to Europe to meet with business leaders and policymakers. What follows is a summary of his impressions of the current state of the Eurozone.*

- There appears to be no end in sight to the problems emanating from Europe. The sovereign debt and banking crisis continues to move from the peripheral countries to affect stronger core nations, with Spain now in need of a bailout. The debt crisis has become a political problem that now involves the entire Eurozone.
- After nearly three years of political dithering, the market pressure has still not become severe enough to prompt decisive action, and coordinated leadership is still lacking. European leaders began discussions about the possibility of a centralized banking regulator and deposit insurance scheme at the most recent summit in late June. Unfortunately, it will take about two years for the ECB to build this capability.
- Europe's transition necessarily will be unpleasant as tax hikes and government spending cuts weaken their economies and banking systems, and they are still in the early stages. Greece will need to do another restructuring, and we are seeing financial fragmentation in which northern European pension, insurance and banks are shedding exposure to the southern European assets due to the possibility of currency devaluation if countries exit the Eurozone.
- Market responses to policy developments coming out of Europe are becoming more muted; we are seeing bailout fatigue setting in, and a deeper realism is now being reflected in most stock markets outside of the U.S.
- The uncertainty is also beginning to weigh on the global economy as businesses and consumers postpone investment decisions until they see some real progress. This is evident in the earnings misses for technology companies such as Cisco and EMC, in the current slowdown of the broader U.S. economy and of emerging markets such as China, Brazil and India.
- Despite uninspiring employment and growth figures, the U.S. remains fundamentally stronger, and is on a healing trend in its housing, banking and credit markets.
- Canadian stocks in the resource sectors have been re-priced in the past few quarters, but we are seeing more opportunities globally. Our Australian holdings, such as Westfield Group and Telstra, have performed very well, offering very attractive yields as interest rates have come down in that country. Signature has spent the past 10 years building the global capability to find these types of investment opportunities in developed and emerging markets all around the world.

- Our approach is one of caution and patience. We are keeping a high currency hedge on the euro, as we expect it to fall in value, and low hedges on our U.S. dollar exposure. Interest rates for short-term Canadian bonds are still about 100 basis points higher than they are in Europe, and the Canadian dollar could lose value if the Bank of Canada eases later this year. In anticipation of such a move, we have a defensive posture in most of our balanced funds, holding cash positions of about 10-12% and maintaining our government bond holdings.

*Signature Vice-President and Portfolio Manager **John Hadwen** recently returned from a European tour that included meetings with officials from Commerzbank, Deutsche Bank and the European Central Bank, as well as discussions with European financial sector investors.*

- Financial markets participants remain almost uniformly pessimistic on the European banks' ability to deal with losses related to sovereign debt, a view that is reflected in valuations. The sector seemed to have bottomed in the second quarter of 2011, but re-tested those lows in May. The European Central Bank's long-term refinancing operation (LTRO) late last year helped to ease some of the liquidity pressures facing these banks, so that they do not have to reduce balance sheet assets when they refinance. However, regulators have raised capital requirements to a level that means the banks would have to double their historic profit margins to be able to make distributions to shareholders – a tall order in a recessionary environment.
- There now appears to be enough capital in the system to avoid European bank failures, but restructuring will take time and the earnings environment is not helping them build up the capital reserves they need.
- Well-capitalized banks will continue to win market share over their competitors. HSBC has been core holding in many of the portfolios; it has maintained its value and its dividend. In addition to good capital levels, the bank has good loan to deposit ratios, diversified geographic exposure and enjoys a funding advantage over its competitors.
- We also own Lloyds and Barclays, which are trading at about 40-50% of tangible book value. These banks are involved in the Libor class action suit, but a resolution is five to 10 years away. Most of the bad news for these and other European banks is embedded in share prices, which makes for good long-term buying opportunities. However, there are still significant risks ahead and our position sizes reflect this.
- Our biggest U.S. holdings remain JPMorgan and Citigroup. JPMorgan has lost about \$6 billion so far to the "London Whale" trading, but has unwound about 70% of that position. The bank could lose up to \$7 billion, about one-third of its annual profit. The franchise is in good shape, however, and will probably begin to buy back stock in September. We expect stock repurchases and dividends should exceed JPMorgan's current market capitalization over the next six to seven years.
- Canadian banks have been trading at flat valuations for about a year, but are expected to deliver about 4% dividend growth over the long term. So we are

expecting to get back about 60-65% of our investment back in dividends over the next 10 years. TD is still our favourite Canadian bank, based on an improving U.S. business and good risk management. There is a possibility that TD could consider another U.S. acquisition at some point. Overall, we don't expect a run-up in Canadian bank shares as asset growth is moderate and there is still some concern about a decline in the Canadian housing market.

- We own ING, which is divesting its insurance business. Manulife is expected to be a bidder for ING's Japanese and growing Asian markets business, but at \$5 billion, it is a stretch for them. We are underweight Manulife, partly because of this deal risk and because, like most insurance companies, it continues to struggle with low rates.
- Elsewhere, our investments in Thai banks Bangkok Bank, Kasikornbank and Siam Commercial continue to add value to the portfolios, and we have trimmed our holdings as the share prices have risen.
- Overall, the Signature funds are underweight financials due to the sector's volatility. We are maintaining a market weight in financials in our Canadian equity accounts to keep up the Canadian content in the funds. Outside North America, we are slightly underweight in the global portfolios and about 30% underweight in the international funds. The long-term values are enticing, but plenty of risks remain.

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