

Signature sound bites November 2012



Low global growth, fiscal issues keep lid on rates

By Paul Simon

- The Bank of Canada has backed away from its more hawkish stance on monetary policy, with Governor Mark Carney recently stating that a rate increase is “less imminent.” Weakness in the broader economy, softer Canadian housing data and significant risks that remain in Europe are the main reasons for the Bank’s more dovish tone. The Bank has also expressed concerns about high levels of household debt in Canada and the effect higher rates would have on borrowers.
- The Bank had been among the world’s most bullish central banks in the first half of 2012, pointing to constructive economic and financial conditions and expressing confidence that the Eurozone was making progress to solve its fiscal crisis. Its outlook for growth in the second half of the year, however, has been largely shelved. The Canadian dollar, which had been popular with foreign investors because of its positive fundamentals, the strength in commodities and the Bank’s outlook, is now likely to lose some of its lustre among “risk-on” currencies. We expect the Canadian dollar to fall in value and trade below parity in the near term.
- The declining fiscal health of a number of provinces, most notably Ontario and Quebec, will also contribute to Canadian dollar weakness. The newly elected government in Quebec appears to be backing away from spending cuts planned by the previous government. However, Quebec’s fiscal situation is not as weak as Ontario’s, where the recent resignation of Dalton McGuinty as premier and the prorogation of the legislature has left Ontario without a clear fiscal direction. The province is behind in its borrowing for the current fiscal year at a time when market sentiment is tepid. As a result, the Signature portfolios are significantly underweight provincial bonds, Ontario in particular. There will be more headline risk for the provinces and ratings downgrades are possible, but Ontario has about 18 to 24 months to put its fiscal house in order before that would occur.
- The housing market, meanwhile, is finally starting to show signs of weakness in Canada with a price decline during the usually strong fall market. We believe prices could correct up to 10% in some regions, based on tighter mortgage lending rules, weakness in the economy and long-term elevated prices.
- The U.S. Federal Reserve seems willing to discount the inflation-fighting part of its mandate in order to target nominal GDP and boost employment. It may publicly acknowledge this shift as part of its efforts to boost inflation expectations. We believe the current “Operation Twist” program, which sells short-term bonds to buy longer-dated Treasuries; will be replaced with a new bond purchase program to run along side its third round of quantitative easing (“QE3”), which targets mortgage loans. The Fed intends to buy about US\$85-90 billion worth of bonds, and could easily end up owning half of the Treasury market by early 2013. They are trying to crowd investors out of safe assets into riskier assets and raise asset valuations in the process.



- Given low congressional approval ratings and the slowing economy, the “fiscal cliff” is highly unlikely to proceed, regardless of the makeup of Congress. The automatic budget sequestration cuts are likely to be pushed further down the road. Both parties recognize that reduced government spending will have a direct impact on already weak GDP.
- Credit ratings agencies are looking for some concessions on the U.S. budget. Markets recognize the U.S. is not really a truly AAA-rated credit any more, but with few strong options the U.S. will remain a safe-haven investment.
- The solutions to the Eurozone’s problems are now more political than economic. Spain’s troubled fiscal situation is the latest near-term risk element in Europe, and we believe the country will enter into a mandated austerity pact with the ECB.
- The Eurozone economy is decelerating faster than anticipated, with Germany and France now posting weaker business activity. The region’s economy could contract in the second half of 2012, putting more pressure on policymakers to find sustainable solutions. Efforts to create a tighter fiscal union that includes a banking union, debt mutualization and infrastructure bonds are being resisted by several countries, including Germany and Greece. It will be difficult for risky assets to perform in this environment.
- We are cautiously optimistic about the extent to which European policymakers grasp the scope of their problems, but less confident about their abilities to solve them. After buying into the rally in riskier assets that benefited European equities in the third quarter, Signature expects more volatility and we are likely to unwind some of our European positions toward year-end.
- The Signature bond portfolios are slightly short duration, and overweight corporate bonds. Within corporate credit, we are rotating out of higher-beta positions and into more mainstream companies, with an emphasis on good cash flows and higher credit quality. Given our outlook for a weaker Canadian dollar, we are maintaining currency hedges on both the U.S. dollar and euro at 40% in the equity funds and 76% in our bond portfolios. We may increase our euro hedge if the currency falls in value.

Markets reward corporate cost-cutting and M&A activity

By Joe D’Angelo

- Companies are now acknowledging the limited potential for revenue growth in 2013, particularly in Europe, and are looking at cutting costs to support earnings growth. Dow Chemical, for example, recently announced the closure of 20 plants, 2,400 layoffs and the suspension of growth-focused capital expenditure programs, mainly in Europe.
- The market is rewarding companies that are cutting costs. FedEx’s stock rose when it recently announced US\$1.7 billion in cost savings, based on the view that the air courier industry is structurally oversupplied as companies cut back on the most expensive shipping options. Similarly, Dow’s stock also went up when it announced its aggressive cost-cutting program.



- The job picture for 2013 remains uncertain. Temporary staffing firms like Randstat and Adecco, which are extremely cyclical, had been busy earlier in the cycle to support corporate growth, but are now reporting lower demand. Many companies, especially those in Europe where layoff costs are high, are reluctant to hire.
- In the past, we have looked for double-digit earnings per share growth to support a price-to-earnings ratio of 14-15 times earnings. But many companies are looking at single-digit earnings per share growth next year. Revenues are more likely to grow at a rate of about 3% to 4%, so adding in cost reductions and the effects of share buybacks, a good company such as CN Rail may grow earnings per share by about 10%. Industrials stocks on this basis do not seem so expensive because the valuation metric has changed, based on a scenario of low growth and low interest rates.
- On the positive side, corporate balance sheets are strong and companies continue to generate good free cash flow. Low growth and low confidence is resulting in less capital expenditures, so companies are returning their excess cash to investors in the form of raising dividends and share buybacks.
- We are starting to see some smaller mergers and acquisitions, and expect this type of activity to pick up over the next few quarters, fuelled by cheap debt and the potential for efficiencies and synergies. The tone also seems to be becoming a bit more positive for Chinese business recently. Air freight out of China is starting to pick up, and ports shipping data is a bit more positive. Companies operating in China are more optimistic about the country's new leadership and potential for government spending in the new year. Signature Emerging Markets Fund, for example, has benefited from companies involved in increased rail construction activity in that country.
- The Signature portfolios are generally underweight industrials and basic materials companies due to their vulnerability to a potentially more severe economic slowdown.

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