Signature Market Roundup

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SIGNATURE GLOBAL ASSET MANAGEMENT™

Global outlook

Drummond Brodeur
Senior Vice-President, Portfolio Management and Global Strategist

The first quarter was incredibly eventful, with many longer-term trends coming to a head. Following these significant moves in many macro and policy variables, we appear to be entering a period in which markets are attempting to find a more stable equilibrium. Greater stability in the economic and policy realms should result in a constructive backdrop for risk assets.

Global economy

It is our view that we are moving into a period of global synchronized growth and we expect to see the U.S., Japan and the Eurozone all growing above their trend growth rates for the first time since the crisis. Europe and Japan are experiencing economic recoveries following their policy-induced slowdowns in 2014, defying consensus expectations. With lower energy prices, lower currencies, looser fiscal policy and aggressive quantitative easing (QE) in both the Eurozone and Japan, it would be difficult for their economies not to bounce! This should support moderate growth for the coming year, though we remain unconvinced of a longer-term recovery in Japan or Europe due to challenging structural headwinds and demographics. The better economic outlook helped to underpin the significant gains in their equity markets in the first quarter.

As for the U.S. economy, first quarter data has once again surprised to the weak side. However, we expect the U.S. to remain on track for close to 3% growth in 2015. Strong employment numbers, lower energy prices and high consumer confidence should support improving consumer and housing data through the year, while energy-related reductions in capital spending will represent a drag. At current levels, the stronger U.S. dollar should have only a minor impact, as the U.S. is less affected by trade swings.

Monetary policy divergence

The divergence in monetary policy has been and will continue to be a major driver of asset market returns. In Europe, the scale of the QE program announced by the European Central Bank exceeded expectations and resulted in a continued collapse in European rate structures. However, without the tough reforms needed in both the Eurozone and Japan, we believe that QE just eases the pain of decline.

Meanwhile, having exited QE in 2014, the U.S. Federal Reserve is preparing to start increasing interest rates. To the extent the economy continues to improve as we expect, we now believe the first rate hike will be in September. This continues to fuel angst in financial markets, but we believe that with no significant inflationary pressures yet building, the Fed will move slowly.

Currency markets

The policy divergence between the Fed and its counterparts in Europe and Japan has had a significant impact on currency markets. We expect that currency markets have already made their big moves for now, until new data or policy shifts cause a reassessment of the trends.

Oil prices

As the market seeks the price that will balance supply with demand, it is our sense that the equilibrium price is higher than the current US$50 level. It may be $60 to $70, but we are unlikely to see $100 again for many years. Clearly, lower oil prices will be positive for individual consumers and a net boost to almost all developed countries which tend to be net importers. The offset will be a hit to energy producers and related industries. As an oil-producing nation, Canada will be one of the few developed countries likely to see a net negative impact.

European politics

European politics remain one of the bigger near-term geopolitical risks. First, the risk of Greece leaving the Eurozone appears higher than at almost any time during the crisis, although the risks of contagion are arguably much lower. Second, it is unlikely that the results of the U.K. election in May will contribute to political and economic stability.

Conclusion

In the coming quarter, we expect increasing stability in many economic variables coupled with emerging data to support our view of a synchronized global economic recovery. This environment should provide a benign backdrop for corporate credit and set the stage for equity prices to continue to move higher.

Within equities, following the catch-up rally in both European and Japanese markets, all developed markets are back at the rich end of their historic valuation ranges. In the context of record low global rate structures, this leaves equities relatively attractive versus most other asset classes. It also means that we expect only modest mid-to-high single-digit returns, despite the favourable backdrop. The one area that does remain both relatively and absolutely cheap is emerging markets. In many cases, emerging markets are cheap for a reason, but with the lack of truly attractive valuations anywhere else, we may well see a similar catch-up rally. In particular, we are paying close attention to the ongoing reforms in Chinese financial markets, which could eventually have a significant impact on global markets. It is a key reason behind Signature's decision to open an office in Hong Kong earlier this year.

Emerging markets

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

Emerging market equities rallied 11.8% in the first quarter of 2015 in Canadian dollar terms (according to MSCI). As was the case last year, most of these gains came from a weaker Canadian dollar. In U.S. dollar terms, emerging markets were up 2.3%, marginally underperforming developed market equities, which increased by 2.5% during the quarter. Emerging market equities started the year without much direction as opposing forces failed to overcome one another. On the negative side, declining oil prices, sharply lower copper prices, broad-based U.S. dollar strength and economic growth uncertainties weighed on emerging market sentiment, but the lower U.S. yield curve supported the view that the eventual tightening of U.S. monetary policy would be more benign than anticipated. Even though investor sentiment improved in February, the subsequent rally in emerging market equities was fairly muted compared to historical rallies.

The divergence in country performance during the first quarter continued to highlight the increasing discerning nature of emerging market investors and a departure from the "incoming tide lifts all boats" mentality that dominated the first few years after the 2008 crisis. On a regional basis, Asia rallied 5% during the quarter, led by the Philippines (10%), China (8%) and India (5%). Malaysia (-2%) was the sole Asian emerging market that recorded a loss during the quarter. With commodity prices still under pressure, the underperformance of the Latin American equity markets did not come as a surprise. Of the five emerging markets in the region, only Chile (0.1%) managed a (very small) positive return. The biggest market in the region, Brazil, was down 15%, with the loss due to the currency falling 17% during the period. While most emerging market currencies suffered declines against the U.S. dollar, the Russian ruble appreciated by 4% following last year's sharp losses. Some move towards a tentative resolution in Ukraine saw investors returning to the Russian markets to buy deeply undervalued stocks and bonds. Russia's equity market (19%) was the best-performing emerging market in the first quarter, but was still down 25% compared to a year earlier.

As the market ponders the timing and pace of rate hikes in the U.S., the importance of U.S. monetary policy on emerging market assets remains as important as ever, if not more important given that emerging economies were major recipients of the easy money flowing out of the U.S. due to quantitative easing and ultra-low interest rates. Even though equities are less directly affected by moves in U.S. rates, the sensitivity of emerging market bonds and currencies to such changes leaves emerging market equities vulnerable to a sharp move higher in U.S. rates. With U.S. economic data on the soft side, we continue to expect only a gradual rise in rates, which should augur well for emerging market assets for the rest of the year. However, the uncertainty surrounding the timing and pace of hiking, as well as the increase in currency volatility, will likely hinder a strong bull run. Regionally, we still prefer the commodity importers (Asia) over the exporters (Latin America).

Global resources

Bob Lyon
Senior Vice-President, Portfolio Management and Portfolio Manager

While the energy recovery may be slow, we believe that the worst for both oil and natural gas prices has now passed. We are closely monitoring the global price of crude oil. After the significant price drop experienced during late 2014, we expect a rebound extending into 2016. This recovery should be gradual, with OPEC increasing its production and maintaining its global market share as demand rebounds.

With warmer summer temperatures, the price of natural gas will also likely rebound from its currently depressed level. Higher demand is expected to come from power generation, as well as from new industrial and chemical plants which use natural gas as a primary feedstock. If the industry responds rationally to the low prices for both oil and gas by drilling a significantly smaller number of wells in 2015, this should help to slow the rate of supply growth, which in turn should help set the stage for a price rebound sometime during 2015-2016.

Material and mining prices are also well off their previous highs, and we expect to see these markets stabilize over the remainder of the year. The new supplies of iron ore that we anticipated coming into the market are now upon us, and have had a negative impact on the commodity price. We believe the price of iron ore will bottom sometime in the latter half of 2015, which could provide an opportune time for investments in related equities.

Copper may have limited upside in the short term, as weak global growth and new mine supply combine to keep the commodity price range-bound. In the medium-to-longer term, we believe that copper supply is more structurally constrained, which will help to support prices at levels required to incentivize new production. Coal markets, however, remain challenged due to an abundance of global supply. If demand is negatively impacted from additional climate initiatives, the result could be a long-term structural downtrend in coal markets.

Telecommunications and information technology

Malcolm White
Vice-President, Portfolio Management and Portfolio Manager

Whereas 2014 was a year in which large capitalization technology stocks outperformed the general market as business conditions improved and as earnings multiples expanded accordingly, 2015 in contrast is likely to be more mixed. Areas that had positive momentum, such as the PC market, which improved due to a corporate refresh product cycle, are now seeing headwinds as demand moderates. This is affecting the performance of many semiconductor and computer equipment companies.

The strength of the U.S. dollar is also dragging down business conditions as the price of computing goods, usually priced in U.S. dollars as a base, are suddenly more expensive in local currency terms. While we saw a currency effect only through accounting translation in the first quarter, we do expect to hear of demand impairment in the second quarter as companies in the computing supply chain determine how to adjust pricing and which entity absorbs the margin impact. This headwind, however, is reversed in Europe, benefiting our investments located there.

Outside of these macroeconomic factors, we still believe that the technology sector remains relatively attractive over the long term.

Apple is launching its highly awaited iWatch, signaling the arrival of a new category of technology – wearables – that has the potential to expand the consumer electronic market beyond smartphones and PCs.

Merger activity has been heightened in an environment of cheap lending, and deals have been received positively for both the target and acquiring companies based on very accretive pro forma projections of the combined business. This dynamic was seen in our position in NXP Semiconductors when the market reacted to its proposed merger with Freescale Semiconductor. More merger activity is expected to come.

Although investors are wary of the high multiples currently in the U.S. market, technology valuations are still below the market average and are therefore attractive. The same, however, cannot be said about private market technology investments, where we are growing increasingly concerned about valuation levels. This problem manifests itself in terms of less attractive IPOs.

We are quite positive on global telecommunication stocks, with the exception of Canada's. Many countries now have negative sovereign interest rates, making the mid-single-digit dividend yields of their telecommunications companies look attractive. This yield spread is at a historically wide range and is very attractive to income investors. Valuations are moving higher, as seen with newly offered telecommunications companies such as Sunrise in Switzerland, and investor demand is healthy. Appetite in Canada, however, is dampened by the regulatory overhang around roaming charges, despite the Bank of Canada's recent rate cut.

Although our outlook is mixed, we remain very excited about secular growth prospects as Internet connectivity deploys globally and as new applications of Internet technology expands into automotive, medical, financial and retail opportunities.

Consumer products

Stephane Champagne
Vice-President, Portfolio Management and Portfolio Manager

The U.S. consumer discretionary index outperformed the broader S&P 500 Index by 394 basis points and the consumer staples index by 403 basis points in the first quarter of 2015. The outperformance of the discretionary index reflected a better economic environment for discretionary spending, with lower gasoline prices, continued job creation and low food inflation. In-store sales trends improved over last year, due to better inventory levels, fewer promotions and a rebound from the depressed levels of last year caused by severe winter weather. We expect the American discretionary consumer sector in the U.S. to continue to progress in the second quarter on the back of easier credit access for real estate buyers, robust job creation, increased consumer confidence and lower energy costs.

In Canada, after a weak fourth quarter, retail sales fell 1.7% from December 2014 to January 2015. We are still very cautious regarding Canadian consumer stocks, which are fairly valued. Canadian discretionary spending is likely to remain under pressure for the rest of the year because of high debt levels, slowing real estate activity and higher unemployment rates in Western Canada.

In Europe, consumer confidence improved slightly due to central bank monetary stimulus, lower gasoline prices and lower unemployment rates, which positively affected retail sales trends. The greatest retail sales strength was in the U.K., Italy, Spain and Germany, while France and Scandinavia remained weak. For the remainder of the year, we continue to favour domestic-focused retailers, mainly in the U.K., Italy, Spain and Germany, and global firms with geographic diversification.

In Eastern Europe, retail sales remained in negative territory during the quarter, led by Poland and Russia. Russia was still facing high inflation due to the depreciation of the ruble and the ban on food imports from Western countries. We continue to avoid the region because of weak consumer confidence, high valuations, high inflation and political instability.

Latin American consumer fundamentals were still weak in the first quarter, especially in Brazil, where unemployment was up, and currency depreciation, higher inflation and high interest rates are likely to continue to limit discretionary spending. We see the potential for improvement in the Andean consumer sectors due to economic stability in Mexico, Chile and Peru. Over the long term, consumers in those regions should continue to benefit from middle class growth and a stable inflationary environment.

In China, new year celebrations failed to give a boost to retail sales, which were also affected by weak consumer confidence and real estate activity, mostly in second and third-tier cities. Although basic consumption is growing at a normal rate due to low food inflation, we expect discretionary spending to remain under pressure in the first half of the year. Over the long term, we continue to be positive because of the country's high savings rate and disposable income levels.

In Southeast Asia, retail sales remained slow in Thailand and Vietnam and slowly rebounded in Indonesia. Political changes in Indonesia and India continue to boost consumer confidence and consumption. We expect this pace to continue and remain constructive over the longer term as the region's middle class continues to grow.

We continue to favour sectors supported by sustainable fundamentals, strong global brands, free cash flow generation and return of capital to shareholders, led by share buybacks or dividend increases.

Financials

John Hadwen
Vice-President, Portfolio Management, and Portfolio Manager

We have believed for a few years that large U.S. banks offered the opportunity for tremendous dividend growth from the extremely depressed levels established in 2010, and that valuations would normalize as dividends increased. The dividend growth has lagged our initial expectations as regulators have discouraged dividend payout ratios above 30% and as regulatory capital hurdles continue to rise. Total payout ratios (stock repurchases and dividends as a percentage of earnings), however, are expected to exceed 60% in 2015. The U.S. Federal Reserve appears to be more comfortable with buybacks than dividends, as dividends are viewed as something less easily halted in a crisis.

We think it is important that investors recognize the more modest dividends as lower risk in assessing attractiveness of the sector. The Dodd-Frank Stress Test and Comprehensive Capital Analysis and Review have become the binding capital constraints for the 30 largest U.S. banks. These exercises combine to ensure that large U.S. banks set their dividends at levels that would be prudently sustainable through a horrific financial crisis. The higher capital buffers and stress test-approved dividend payout ratios argue for lower risk premiums on the modest dividend yields.

The strong dividend growth among U.S. banks remains supportive to valuations and should help financial companies regain their importance within dividend mandates. U.S. bank dividends are expected to total more than US$25 billion in 2015, and about $30 billion in 2016, indicating highly attractive sector dividend growth as large money-centre bank payout ratios normalize.

High-yield bonds

Geof Marshall
Vice-President, Portfolio Management and Portfolio Manager

Thankfully, the first quarter of 2015 proved less stressful than the last months of 2014, although it was not boring, as volatility persisted, especially in U.S. Treasuries and global currencies. For credit managers where a good (but the expected) outcome is getting our money back at a bond's maturity, boring is good. A continued bid for long-dated government bonds and U.S. dollar strength were still key themes in the first quarter, but the high-yield bond market began to show some resiliency. The last 12 months witnessed high-yield valuations widen 100 basis points and average prices drop approximately 4.5 points. This begs the question, is the spread move attributable to fundamental fears or is it technical concerns? That is, is the U.S. economy slipping into recession without the stimulative effects of quantitative easing (QE)? Or is the market overly concerned that the U.S. Federal Reserve's rate increase cycle will re-price the fixed income markets? The "taper tantrum" of mid-2013 provides a good analogy. When Fed Chairman Ben Bernanke first mused about tapering QE, rates and credit markets re-priced higher very quickly. High-yield bond spreads widened 105 basis points in the span of seven weeks, while overall yields increased almost 1.8%. Given that the Fed is expected to raise interest rates sometime in the second half of 2015, and the premise that "the market hates the unexpected," current spread levels seem too high (i.e. cheap). From a fundamental perspective, the economic picture, especially in the U.S., is more optimistic than 12 months ago, especially given the strength in the U.S. consumer sector.

It feels like credit markets are on their way to recovering from the widening spreads experienced last year. The sell-off that occurred in the second half of 2014 can be attributed to three inter-related factors. By our estimation, one-third of the move was related to the global deflation scare signaled by U.S. Treasury strength, commodity weakness, and currency volatility that coincided with the end of QE3 in September. Another one-third was related specifically to the energy sector, where there has been outright over-reaction in trading levels. Issuers in this sector have already undertaken a lot of balance sheet repair, with liquidity runways extended and dividend and spending cuts. Nonetheless, we expect defaults to be marginally higher in 2016 unless we see a rebound in the price of oil above US$60. The remaining one-third of the sell-off was due to technical factors, namely investor fatigue and redemptions. U.S. high-yield mutual funds experienced record redemptions in 2014, but that feels like a headwind that is now behind us. Importantly, each of these factors can be reversed with good economic data and more confidence that modest U.S. economic growth is sustainable.

The European Central Bank's QE program should help to mitigate tail risk events in Europe for some time, including even a Greek debt default and exit from the European Union. While monetary policy in Europe and Japan can hedge against tail risks, it does have spillover effects. Half the sovereign bond market in Europe now has negative yields. European high-yield bond yields average less than 4%, with spreads making up more than 100% of the all-in yield. Better relative value can be found in U.S. high-yield bonds at 6%, with a better outlook for growth and corporate credit quality. Global investors are likely to respond to this yield difference and so we reiterate: high-yield bonds are much better value than last year, bordering on cheap, and we think a modest amount of spread tightening back to historical averages can produce returns in the high single-digit range over the next 12 months.

Interest rates

Kamyar Hazaveh
Vice-President, Portfolio Management, and Portfolio Manager

Late-stage cycle behaviour in fixed income

Global economic growth continues to slow at the aggregate level. The divergence among different regions has meant cyclical upturns in Europe and Japan spurred by substantial monetary and fiscal stimulus vs. downturns in China and the United States. Despite the consensus view of continued expansion in the United States, the fixed-income market is behaving "late stage." Positive economic news has resulted in a sell-off in short-term bonds and a rally in long-term bonds. Credit spreads have failed to make new lows since last year. This is consistent with a fixed-income market in the latter stages of an economic cycle.

In Europe, quantitative easing has pushed long-term rates to historically low levels. Long-dated bonds in Europe were the best performing asset class during the first quarter. The lack of sufficient new issuance and the exclusion of bonds that yield less than the deposit rate in Europe have meant that the European Central Bank (ECB) must buy long bonds to reach its monthly purchase quota.

The drop in commodity prices is expected to lead to substantial softness in economic activity in oil-producing provinces and, by extension, across Canada. In that context, the decision by the Bank of Canada to cut interest rates in January was prudent. The bank later leaned against market expectations of further cuts, noting the need to assess the impact of the January move.

In the first quarter, 10-year rates in Canada fell by 0.65%. The comparable declines in 10-year bond yields in the U.S., the U.K., Germany, Spain and Australia were 0.25%, 0.15%, 0.38%, 0.42% and 0.50%, respectively. The long end of the yield curve continued to outperform, and curves flattened globally.

Investing in an illiquid world priced for perfection

There are two phenomena occurring at the same time in the global markets. Global interest rates are making new lows as a result of bold, unconventional monetary stimulus. That has pushed the valuations of all financial assets beyond fair value, to rich in some cases. At the same time, the impact of banking regulation enacted since the financial crisis is becoming evident. Dealer balance sheets have shrunk to comply with the Dodd-Frank Act.

This has resulted in the elimination of shock absorbers in the monetary system, leading to violent moves in markets. On October 15, 2014, the on-the-run 10-year U.S. Treasury yield fell 0.30% intraday, which represents significant volatility for U.S. Treasuries as the most liquid market on the planet. On March 18, 2015, the euro-U.S. dollar currency pair had a 4% intraday swing upon the release of the Federal Reserve policy decision. What this signifies is that the liquidity situation in fixed income and currencies has deteriorated substantially.

It is in this environment that constructing well-diversified portfolios in duration, curve, credit and currencies is critical. Unlike the last few years where the performance of credit spreads masked the deficiencies in duration and curve portfolio construction, duration and curve positioning is going to dominate relative performance. Our portfolios remain long corporate credit exposure to collect better income, but since the cycle is well advanced and liquidity is poor, we are using duration as a hedge against liquidity events.

Foreign exchange

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

The U.S. dollar continued to demonstrate broad-based strength in the first quarter. It strengthened against all major currencies with the exception of the Swiss franc. After almost three and a half years of defending the Swiss franc from appreciating beyond 1.20 against the euro, the Swiss central bank surprised the market in January by announcing an end to the policy. The franc appreciated by more than 20% on the day of the decision and by the end of March was still up 15% against the euro for the year-to-date.

This radical move by Switzerland's central bank was done in anticipation of the European Central Bank's decision to formally start buying sovereign debt (quantitative easing). This ECB decision was announced on January 22. The decision and the anticipation of the decision unleashed a renewed round of interest rate cuts around the world as central banks tried to thwart any significant appreciation of their own currencies. Not only did a number of countries close to the Eurozone cut interest rates in a surprising fashion (Denmark, Sweden and Switzerland), but a large number of emerging market central banks also joined this flurry of surprise cuts under the auspices of declining inflation/deflation fears. No less than 12 emerging market central banks cut rates during the first quarter, and most of these decisions surprised investors. As a result, currency volatility spiked in an environment that felt like a currency war amongst central bankers. Even the Bank of Canada cut rates by 25 basis points in a surprise decision in January that was described by the bank as "insurance" against downside risks to inflation and financial stability following the decline in oil prices.

The euro, which ended the quarter 11% lower against the U.S. dollar, was the worst-performing developed market currency, followed by the Swedish krone and the Canadian dollar (-8%). As far as emerging market currencies were concerned, the Brazil real was the only currency to underperform even the euro, declining 17% against the U.S. dollar. Most other emerging market currencies depreciated by between 2% and 10% against the U.S. dollar, with the Russian ruble (+4%) the only exception following a disastrous 2014, when it fell 46%.

Heading into the second quarter, the timing and pace of U.S. interest rate hikes will be key to whether currency trends stabilize or whether the U.S. dollar continues its ascent. We expect that the tight correlation between oil prices and the Canadian dollar will soften over time and that interest rate differentials will become even more important in driving the value of the Canadian dollar against its U.S. counterpart. Given the sharp depreciation in the first quarter, we are hopeful that the Canadian dollar might find some stability in the near term, although further weakness over the medium term can't be ruled out.

Preferred shares

John Shaw
Vice-President, Portfolio Management, and Portfolio Manager

The Canadian preferred share market had a very poor quarter as fears that rate reset preferred shares would be extended past their first scheduled call date turned into outright panic selling by retail investors. All preferred shares are perpetual in term, but many investors always believed that their rate reset shares would be called at the first call date. When the issuer chooses to not call the issue and extend their schedule at a lower dividend rate, there is a risk to the shareholder. In the first quarter, the Bank of Canada's 25 basis point rate cut, an "insurance" policy against the effects of falling oil prices on the Canadian economy, elevated that risk. Government of Canada five-year interest rates plunged 65 basis points to 0.75%, but other risky assets did much better, as credit spreads tightened and equity markets rose in the U.S. and Canada.

The BMO 50 Preferred Share Index posted a -4.81% total return for the first quarter, which is the weakest return since the fall of 2008, while the broader S&P/TSX Preferred Index returned -4.87%. Perpetual preferred shares had the strongest returns at 0.87%, while floating rate preferreds were down -10.95%, due to the Bank of Canada rate cut. Fixed reset preferred shares declined 7.40%.

Redemptions were $950 million, with another $580 million already announced for the second quarter. Issuance picked up to $2.78 billion over 10 issues, led by Royal Bank of Canada with two deals totaling $900 million. All new issues were rate reset shares that had much wider reset spreads than existing shares from the same issuer. This only caused more selling, as the older, lower reset spread preferred shares looked comparably expensive.

Our outlook for the preferred market was cautious at the beginning of 2015, with our preferred share weight in the Signature Dividend Fund at the bottom of the range. However, we did not think the market would sell off so aggressively. We believe the market is now fairly priced and offers a good entry point to the preferred share market. While our initial return estimate for the preferred market was between 3% and 4.5% for 2015, we have revised it to flat for the year, based on the large sell-off in the first quarter.

Forward-Looking Statements

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