Signature Market Roundup

First Quarter 2013

Global outlook

Drummond Brodeur
Vice-President,
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and Global Strategist

At Signature, we started 2013 with a positive outlook for equities on the basic premise that, led by the U.S., global economies and financial markets would continue to recover, but that the recovery would remain slower than traditional economic recoveries because of the dual headwinds of deleveraging and fiscal restraint. As a result, the extraordinarily loose monetary policy globally would not be reversed soon. The U.S. Federal Reserve will continue to buy $85 billion a month in securities, effectively printing money and forcing interest rates below inflation. In other words, the Fed is deliberately engineering negative real interest rates with the explicit intention of driving up asset prices (particularly housing and stock markets) and using the wealth effect to stimulate growth and job creation. As long as credit and capital markets remain open and functioning, then the Fed's policies will force investors out of risk-free assets and toward global equities.

The dramatic change in policy at the Bank of Japan in early April reinforces our view. The level of monetary easing planned by the BOJ is unprecedented and will flood the economy with liquidity over the next two years. The challenge is that liquidity is fungible and will search the globe for the most attractive asset class. While the change has boosted Japanese stocks and weakened the yen, we believe the longer-term impact will be to push global risk assets higher.

I dubbed 2013 as "investing in the eye of the liquidity storm" for the view that, as long as central banks continued to pump excess liquidity into a sluggish but improving global economy, the money would find its way into various assets, pushing their prices higher. With most fixed-income markets at or near all-time highs, and as interest rates cannot go below zero, investors are now looking towards quality dividend-paying companies for yield solutions. We expect this trend to continue unfolding.

Our call for the rest of the year is for liquidity to trump fundamentals. Equity returns will be driven primarily by a re-rating of equities to higher valuations rather than stronger earnings growth. In our view, equities today trade at a slight discount to their longer-term averages – they are not cheap, but are certainly fair value. In a world where just about every other asset class is at record valuation levels, those at fair value would seem to us to offer the best risk-return potential.

Our base case is that, notwithstanding a mild pullback or correction in the coming months, there is a bigger risk of a significant move higher in equity prices, particularly if investors start to shift from fixed income into equities, a trend that is much talked about but still nascent. That would certainly be the surprise trade for most investors, who remain focused on the fundamental economic and political challenges they see splashed over the front pages of the newspapers. In functioning financial markets, the rule to follow today remains: Don't fight the Fed, the BOJ, the BOE…!

In brief, we believe the key economic drivers will be the U.S. private sector, followed by China's ability to manage slower yet still strong growth. In Japan, we expect a strong year but remain skeptical about longer-term structural reform. Europe will remain mired in a stagnant state of mild recession as it continues its internal rebalancing. Ultimately, we expect the policy debate in Europe to shift from austerity and towards growth, but not before German elections in September. It is important to bear in mind that buying European companies is not the same as buying into the European economies, and the concerns in Europe have resulted in attractive valuations for many European-listed multinationals with strong global franchises.

Emerging Markets

Matthew Strauss
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Emerging market equities were unable to sustain the upward momentum that started late in 2012. After reaching an 11-month high on January 3, 2013, emerging market equities consolidated before investor interest started declining in February. This was also reflected in capital flows to emerging market equities, which turned negative late in February. Contributing factors were concerns about growth in China in 2013 (exacerbated by measures to control property prices and dampen the rampant growth in shadow banking credit), the failure of Brazilian manufacturing production to reaccelerate, and the stalling momentum for reform in India. Lower commodity prices and European banking issues late in the quarter added to the guarded approach towards riskier emerging market assets.

The MSCI Emerging Markets Index fell 1.8% in U.S. dollars but gained 0.4% in Canadian dollar terms during the quarter. Health care was the best-performing sector. Geographically, performance was quite dispersed across regions and countries, with Latin America the only region to record positive returns despite a small decline in Brazil. Mexico and Chile led the region. Performance out of emerging Asia was hampered by negative returns from China, Korea and India. EMEA (Eastern Europe, Middle East and Africa) was a sea of red, with Turkey the only country reporting positive returns during the quarter. This diverse performance highlighted the importance of taking country-specific developments into account when investing in emerging markets.

Investor sentiment towards emerging markets has moved from being highly optimistic at the end of 2012 to a more cautious view. This is warranted in the case of some of the major emerging markets such as Brazil, India and Russia, especially in the absence of structural reforms. However, we still believe that China will be able to record economic growth of 7.5% to 8.0% in 2013, although the recent reports about a new strain of bird flu in China and disappointing first quarter GDP data raise the near-term risks. Also, a rising U.S. dollar and higher U.S. interest rates could pose a threat to overall emerging market performance later this year or in early 2014. In the current environment, we continue to prefer countries with strong commitments to reforms and/or strong business cycle momentum, such as Mexico, Peru, Thailand and Turkey. On a sector basis, we remain cautious on the commodity complex while preferring domestic and consumer-focused companies.

Financials

John Hadwen
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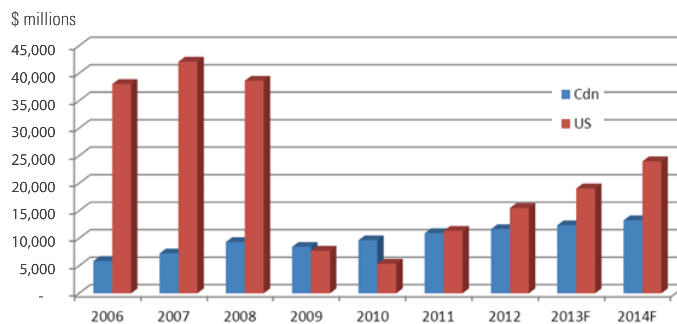
The theme has not changed in financials – the bank sector is getting healthier by the day, capital is strengthening and dividends are growing from depressed levels. The chart shows why we like U.S. financials. In the crisis, dividends were cut dramatically and regulators materially raised the bar in regards to capital adequacy – poor timing by the regulators. Another stress test on the U.S. banks has confirmed our views that the sector is healthy and we believe risk premiums will decline as dividends grow. From such depressed levels, bank dividends will grow faster than the market, so an above-market dividend yield with above-market growth supports the investment case.

Bank dividends



Source: Signature Global Advisors, Bloomberg

The chart shows the combined dividend payments and analysts' forecasts for dividends of the Big Five Canadian banks versus a basket of U.S. banks.

Health care

Rui Cardoso
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Health care has had a strong start for the year, with the sector posting the highest returns in the MSCI World Index (with a 13.4% return in the first quarter versus the broader index of 7.2%) and in the S&P 500 Index (15.2% for health care versus 10% for the index). A significant portion of the outperformance was driven by Japanese pharmaceutical companies, which represented eight of the top 10 performing equities in the MSCI index in the period. Outperformance was driven mainly be the sharp declines in the yen, rather than any significant improvements in corporate fundamentals. Outside of the Japanese names, performance was balanced between the health care sub-sectors, with a number of top performers coming from biotech, big pharmaceuticals and medical device names. Health care service companies were some of the weaker performers in the quarter given lingering uncertainty as to how the rollout of "Obamacare" will affect the sector.

We maintained a significant overweight position in health care equities across our funds as we entered the second quarter. Our holdings are biased toward the big pharma companies, which still represent the majority of the weight in the sector. Our positive view remains premised on our expectations for a continued re-rating of valuations as companies move past their "patent cliffs," better-than-expected margins resulting from the corporate restructurings, and drugs starting to make it through a much more rational Food and Drug Administration process.

A number of our holdings (Lilly and Roche in particular) have signalled that their drug pipelines are full. As we start to see more data on pipeline drugs and a capping of R&D spending leading to increased operating leverage, we still view stocks as too cheap on estimates that are too low. The sector has clean balance sheets, high dividend yields and attractive valuations relative to fundamentals, so we remain positive in our outlook.

Outside of pharma, we still expect to see a tougher pricing environment in medical devices, where innovation versus the drug world is less compelling (and therefore making it more difficult to improve pricing). We expect Obamacare to be positive to hospitals and negative for insurers in the near term. In the longer term, however, as the government gains greater control over how health care is administered, we expect pricing pressure on hospitals to increase, and this will filter down the value chain. Our holdings in medical device companies and health care services remain marginal.

Resources

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The Canadian equity market lagged its global peers in the first quarter, due in part to weakness in the resource sectors. The big story for the energy sector continues to be crude oil price differentials. Since late last year, limited refinery capacity, pipeline constraints and increased production by U.S. oil producers conspired to widen the price differential between the Western Canadian Select and West Texas Intermediate benchmarks, driving down the price of Alberta's heavy oil. We have started to see a moderate narrowing in relative prices so far in 2013, along with the potential for further improvement as pipeline capacity is added. Considering expectations for global growth, we believe energy prices will remain within a range that is positive for our holdings in large diversified energy services companies.

In the materials sector, gold producers, particularly the junior miners, continued to be challenged by management issues and cost overruns on several projects. We believe gold equities will continue to underperform in the near term as the growth prospects for the global economy improves and inflation remains subdued.

After plunging to three-year lows, iron ore prices rallied to over US$130 a tonne during the first quarter. We believe that iron ore will start to become over-supplied as we get closer to 2014 and we expect to trim our positions in that space.

Copper prices, after rallying up to US$3.80 a pound in the last quarter of 2012, began to decline mid-way through the first quarter of 2013. The market has been worried that demand from manufacturers will fall behind the pace of new production, leading to a surplus. However, projects require prices above $3 per pound to meet investment hurdles. Without these development projects, the market will return to deficit in two years.

Consumer

Stephane Champagne
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U.S. consumer activity was slow during the first quarter of 2013, due in part to the impact of the "fiscal cliff" agreement in which the 2% payroll tax was restored. Retail sales were mixed, with discounters and off-price clubs doing well and department and specialty stores showing signs of slowing sales. Drug stores benefited from a more severe flu season. Online shopping remains solid, with average growth in the low teens driven by continued discounting, free shipping and better offerings. Consumers in Europe and Canada remain stretched.

The S&P 500 Index (up 10.0%) underperformed the consumer staples index by 375 basis points (up 13.7%) and the consumer discretionary index (up 11.7%) by 175 basis points in the first quarter. Staples benefited from the negative impacts on consumer confidence and investors' shift from bonds into equities in the search for higher yields. We believe that we are still in the early innings of this shift and hold an overweight position in staples relative to discretionary stocks.

We expect the fiscal cliff measures to continue to affect the U.S. consumer discretionary sector in the second quarter before fading in the second half of the year. If gasoline prices remain stable, the housing sector and job creation should continue to foster an improving outlook. In Canada, consumption will be affected by high debt levels and a slowing housing sector.

European consumer confidence remains fragile given recessionary conditions in some countries and high and potentially rising unemployment rates. We favour firms focused on northern European and German domestic consumers over southern and Eastern European consumers. One exception in the East is Russia, which has benefited from stable oil and gas prices and government reforms to stimulate the economy.

In Latin America, consumer fundamentals remained solid in the first quarter. We still favor Mexican and Andean companies, and we expect the situation in Brazil to improve through 2013 due to government stimulus programs and preparations for the World Cup in 2014. In Asia, consumer activity was affected by the government transition in China and weak consumer confidence. We expect the Asian consumer sector to continue to improve over the rest of the year along with the rest of the economy.

Overall, we continue to favor companies offering sustainable fundamentals, strong free cash flow, returns to shareholder through buybacks or dividends, and strong global brands. We remain confident in our choices due their cheap valuations, cash flow and high return to shareholders.

Foreign Exchange

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Portfolio Management
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Two currency themes dominated the first part of 2013: Japanese yen weakness and U.S. dollar strength. The yen continued to fall against the major currencies in anticipation of more aggressive momentary policy by the Bank of Japan. The central bank, under the new leadership of Governor Kuroda, surprised by delivering an even more aggressive easing decision than expected during a policy meeting in early April, entrenching the yen's weakening trend. The yen has weakened 12% against the U.S. dollar since the start of the year (to April 8). The pound, the second-worst performer amongst the major currencies, has weakened only 6% – highlighting the extreme decline in the yen. Although we view the Australian dollar and the euro vulnerable at current levels, losses against the U.S. dollar have been limited so far.

The U.S. dollar ended the first quarter gaining against most major currencies in anticipation of the eventual removal of quantitative easing. However, softer economic data and weak employment numbers published in early April cast some doubt on this view. We view the current situation as a pause rather than a trend reversal, as we remain constructive on the U.S. economy in the second half of the year.

Although the Canadian dollar managed to hold its own against most other major currencies in the first quarter, it weakened by 2.5% against the U.S. dollar. The risk of further weakness in the Canadian dollar remains high, and these risk factors include U.S. dollar strength, soft commodity prices, declining housing markets, a slowing domestic economy and low interest rates.

Government bonds

Paul Simon
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On the third day of the year, U.S. President Obama signed into law a bill that averted most of the tax increases and spending cuts embedded in the "fiscal cliff," eliminating the most obvious economic risk factor in the minds of investors and allowing them to focus on positive themes. In the U.S., these included income and consumption growth, rising home prices, and the investment in unconventional shale gas and its economic benefits.

Excess oil inventories and tepid demand for other commodities dampened inflation in North America during the quarter, but had adverse effects on the Canadian economy. Commodity-related capital expenditure has slowed and tax revenues have declined, prompting additional fiscal restraint by federal and provincial governments. This comes at a time when housing, a chief driver of economic growth, is weakening. Acknowledging these trends, the Bank of Canada softened its stance on the imminence of interest rate hikes and downgraded its growth and inflation forecasts. The Canadian dollar weakened significantly on this shift before recovering somewhat at the end of the quarter.

European markets benefited from a period of relative calm through the start of the quarter. Healthy investor appetite rallied peripheral government bonds until the Italian election results, with votes largely split between three factions, shook confidence. The financial crisis in Cyprus took centre stage in March and ended with a bailout agreement that, for the first time in the European crisis, imposed losses on bank depositors. Following this, credit spreads for sovereign and bank debt of peripheral countries began to widen.

The most important development in shaping risk appetite occurred in Japan, where the Abe government prepared markets for a dramatic and aggressive shift in monetary policy. It is apparent that currency devaluation will be one of the tools implemented in an attempt to awaken Japan from its decades-long economic slumber.

Globally, policymakers continue to aggressively support growth and are engaging in more and more monetary recklessness to do so. Still, many leading indicators are weakening at the margin, and the latent effects of fiscal tightening in the U.S. will become more meaningful into the summer months. It appears that the seasonal pattern of global growth momentum observed over the past three years is intact.

High-yield bonds

Geof Marshal
Vice-President,
Portfolio Management
and Portfolio Manager

The $28-billion leveraged buyout of H.J. Heinz is a good example of the message from our fall 2012 roadshow message: on a relative value basis, the income opportunity is now increasingly oriented to equities rather than fixed income. And it seems Warren Buffett agrees.

The transaction was funded with $12.1 billion of equity from Berkshire Hathaway, $4.1 billion of equity from Brazilian private equity investor 3G Capital, and $14.6 billion of debt. The debt financing consisted of $11.5 billion of floating rate secured revolving and term loans priced at Libor plus 2.5%. This was broadly syndicated and there was a lot of appetite for this paper. This makes sense, as many financial institutions globally would love to do more business with Warren Buffett and U.S. loan mutual funds and collateralized loan obligations continue to experience large inflows.

The $3.1 billion in high-yield bonds was one of the largest individual tranches ever placed in the market. These B1/BB- rated bonds priced with a yield of 4.25% for an eight-year maturity. That is not the type of yield I normally associate with the high-yield bond market, but we are seeing higher-quality BB issuers increasingly placing eight-year and 10-year bonds in that context. Despite the credit rating, the risk of default might be quite low given this is a very stable consumer staples business, and lenders may take great comfort from having Buffett own $12.1 billion of equity beneath you in the capital structure.

On a relative value basis, however, it is a component of that equity that is the most attractive in the capital structure: $8 billion of 9% preferred shares. Where we are seeing company management teams finally respond to low borrowing levels with share buybacks and M&A, Buffett has smartly taken it a step further by leveraging cheap financing to buy a business with stable cash flow and, in the process, manufacture for himself income from a very attractive equity investment.

Preferred Shares

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Canadian preferred shares had a solid start to the year with the BMO 50 Preferred Share Index posting a total return of 1.8% for the first quarter. Risky assets globally had a very good start to the year, as concerns about the U.S. "fiscal cliff" abated and investors had plenty of cash to put to work.

Interestingly, at the end of March, the first rate reset issue reached its reset date. The Bank of Nova Scotia decided to leave its BNS P 5% preferred shares outstanding. They have a reset rate of +2.05%. Holders of the security then had to choose to take the five-year fixed rate at 3.35% or the floating rate of three-month T-Bills + 2.05% set quarterly and starting at a yield of 3.028%. Investors were somewhat indifferent between the fixed or floating rate, with 54% taking the fixed rate and 46% the floating rate. The market has responded well to the event and the structure has proven both its usefulness and fairness for both issuers and investors.

Our outlook for the preferred market remains positive, with the total return for the BMO Preferred Share Index estimated to be in the range of 3% to 4.5% for calendar year 2013.

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