Signature Market Roundup

July 2014

Global outlook

Drummond Brodeur
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Having reached the halfway point of 2014, the global economy and markets remain in decent shape. We are seeing an overall pickup in growth as the global economy transitions to a more normal rather than a crisis-driven background. We expect growth to be led by the U.S. and select emerging markets, including China. Europe faces structural challenges that will lead to sluggish growth, disappointing expectations, but will not push the Continent back into recession, while Japan's value-added tax hike in April ensured a roller-coaster ride for the economy in the first half, with any clarity on growth and inflation only likely to become visible through the fall.

Overall, our conclusion from January still holds: "In summary, our global outlook for 2014 is decidedly sunnier than in recent years. However, we do expect that several squalls will emerge to roil markets and test investors over the course of the year. While the global economy remains fragile, it has and should continue to strengthen over the coming year."

Clearly, the weather-induced decline of nearly 3% for the U.S. economy in the first quarter was a bit more than just a squall, but the subsequent bounce in the second quarter has provided evidence of the slowdown's temporary nature. The resilience of both global economies and capital markets to the U.S. slowdown, and other events such as Russia's incursions into Ukraine and Argentina's default flirtations, leads us to conclude that the global economy is no longer as fragile as it has been in recent years.

This remains a positive backdrop for risky assets. The desynchronized nature of global growth means that the economy is advancing more slowly than in past recoveries, which in turn is helping to contain inflationary pressures. The most important driver for the global economy and markets continues to be the trajectory of the U.S. economy and the Federal Reserve's monetary policy. June's employment report was significantly stronger than expected, confirming that the U.S. recovery has rebounded from the self-inflicted fiscal cliff contraction of 2013 and the weather impact at the start of 2014. We expect the U.S. economy to grow at close to 3% in the second half before slowing to a more sustainable 2.5% to 3.0% for 2015. With the data confirming an acceleration in economic activity, an improving labour market and firming inflation, the Fed has begun to spell out its exit strategy from its unconventional monetary policies.

At its most recent meeting, the Fed announced that it would end its monthly asset purchases – its quantitative easing program – in October, two months earlier than previously scheduled. This implies that the Fed plans to begin raising rates as early as next spring. While the pace of increases will be dictated by the economic data, we believe rates are unlikely to rise much higher than 3% in the coming years.

This forecast of "lower for longer" interest rates has significant implications for investors. First and foremost, the focus on achieving higher yields – what we call the "yield grab" – will go into overdrive. More assets will be priced based on the current record low interest rate structure as fears of significant increases diminish. To date, most of the fixed-income or bond world is well down that path, with the impact spreading into the realm of income equities. The one asset class that has yet to be significantly re-rated to a lower for longer rate structure is equities.

In absolute terms, equities are currently priced at the upper end of historical fair value. But almost every other asset class has been re-rated well above historical levels in an absolute sense. Today, our central case of a positive outlook on equities does not rely on rising valuations, but rather on equities performing more in line with expected earnings growth of 8% to 10%. However, we do see a fair probability that equities will continue to re-rate to historically expensive levels, reflective of the current low rate structure.

Emerging markets

Matthew Strauss
Vice-President, Portfolio Management,
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The tentative rally in emerging market equities that started late in the first quarter of 2014 gained further momentum during the second quarter, helped by positive developments in a number of emerging economies and the drop in U.S. 10-year yields, as rate hike expectations in the U.S. remained muted. Hopes of policy changes in Brazil and Indonesia, a market-positive election outcome in India and an official response from Chinese authorities to arrest the decline in economic growth added to the positive momentum. Investor interest in emerging market equities returned as reflected by a change in foreign investment flows into emerging market equities from a very large outflow of US$38 billion in the first quarter to an inflow of $13 billion in the second.

Emerging market equities rallied 6.7% in the second quarter in U.S. dollar terms, outperforming developed market equities, which recorded an increase of 5.0%. For the first six months of the year, these indexes were up 6.1% and 6.6%, respectively.

We remain constructive on emerging market equities but remain cautious of emerging market currencies that have rallied too far too quickly since the end of January 2014 – specifically, the currencies of Brazil, Turkey and South Africa. Auguring well for overall sentiment towards emerging markets are early signs that the targeted policy measures in China are having a positive effect on economic growth and the property market, continued momentum for reform in India and Mexico, and tentative but increased social stability in Thailand and Colombia. Adding to the positive momentum is a more constructive global growth outlook for the second half of the year compared to the first half. Disappointing election results in Brazil and ongoing labour strikes in South Africa could dampen the outlook somewhat, but the biggest risk to a constructive emerging market outlook would be rising expectations for a hike in U.S. interest rates.

Although we think U.S. rates will increase over the remainder of the year, we do not expect a repeat of last year, when 10-year Treasury yields increased by more than 130 basis points within four months. Our base case is for a gradual increase in U.S. yields, which should not create any panic selling of emerging market assets. Although higher oil prices could increase inflationary pressures in emerging economies, the more important inflation component, food price inflation, is heading lower in a number of economies, opening the way for a number of central banks to contemplate cutting interest rates in 2015. We expect beneficial developments to more than offset the negative risks, leading to a continuation of positive equity returns in emerging markets over the next six months and beyond.

Technology, media and telecommunications

Malcolm White
Vice-President, Portfolio Management, and Portfolio Manager

Technology
High-growth and hence high-valuation names continue to be out of favour, despite in-line business trends. We had anticipated that these names, last year's market outperformers, could suffer from returns that revert to the mean and this continues to be the case. However, we were still positive on the other parts of the technology ecosystem, as we believed that valuations were compelling in the larger-capitalized names and thought that if trends improve in out-of-favour segments such as PCs that these names could outperform in 2014. This has been the thesis for the year and it is playing out as expected, especially as market generalists find this segment attractive based on valuation and capital return potential. We expect this trend to continue throughout the year.

Media
After strong relative performance last year, media names have been relative underperformers this year on concerns of a slower advertising market. Events like the World Cup were also disruptive, as they can shift advertising dollars away from some companies and shift the timing of ad spending. We had anticipated as much and took profits in these names entering the year. We plan to revisit a few of these names once the impact of a softer first half is priced in.

Telecommunications
Global merger speculation is still running rampant in the sector, although it appears that many hypothetical scenarios will not transpire regardless of investors wishes: AT&T announced a transaction with satellite provider DirecTV instead of bidding for Vodafone, and it appears that the French industry will not consolidate despite Bouygues' desire to purchase a competitor. Nevertheless, Germany approved the merger of Telefonica Deutschland and E-Plus, paving the way for consolidation in that country, and Tele2 sold its Norwegian assets to TeliaSonera, which should help the market dynamic in that country. We continue to wait for the much-rumoured merger announcement between U.S.-based Sprint and T-Mobile to occur in the coming months.

The Canadian wireless market is still struggling to resolve the question of whether a fourth player is viable in this market structure. The Canadian government continues to press ahead with this policy path as seen in its regulatory approach for the next spectrum auction, despite many other countries heading in the opposite direction. Additionally, investors are still concerned with the after-effects of pricing pressure in the market.

We continue to be positive on countries where consolidation can lead to market repair and more pessimistic on regions such as Canada that have not resolved their optimal competitive structure.

Consumer products

Stephane Champagne
Vice-President, Portfolio Management, and Portfolio Manager

Overall, the S&P 500 Index outperformed the consumer staples index by 75 basis points and the consumer discretionary index by 156 basis points in the second quarter. The performance of the discretionary index reflected sluggish returns for retailers during the quarter. Although expectations were high for the second quarter, retail sales excluding auto and gasoline remained weak despite a brief acceleration in March. We expect the discretionary consumer sector in the U.S. to improve in the third quarter to reflect robust job creation. With employment increasing by more than 200,000 positions in each of the last five months, along with low inflation and an improving housing sector, consumer confidence has increased.

We have been surprised by the resilience of Canadian retail sales, which ticked higher in April. We remain cautious regarding Canadian consumer spending for the rest of the year, as disposable income remains under pressure from high debt levels and slowing housing activity.

In Europe, inflation remains very low, affecting retail sales growth. Retail sales are growing in the U.K. and Germany, are weak in France, and have stabilized in Italy and Spain, though both countries face a high unemployment rate. We favour domestic-focused retailers in Germany and the U.K. and global firms with geographic diversification.

In Eastern Europe, retail sales remain sluggish. The sector in Russia was still facing pressure in the second quarter due to the Ukraine conflict affecting the entire region. We intend to avoid the region over the next six months because of its political instability, weak consumer confidence and high valuations.

Latin American consumer fundamentals are likely to remain weak in the second half, especially in Brazil, where inflation at 6% and high interest rates over 11% are likely to limit discretionary spending. We are now more cautious on the Mexican and Andean consumer sectors due to lower-than-expected economic activity; however, we remain positive over the long term as consumers in those regions should benefit from positive structural reform and a more benign economic environment.

In China, consumption was still weak in the second quarter. Retail sales were lower than expected, with poor consumer confidence, a clampdown on luxury spending and weak real estate activity. Though basic consumption is growing at a normal rate, we expect discretionary spending to remain under pressure in the second half. In the long term, we continue to be positive, as the savings rate and disposable income are high. In Southeast Asia, retail consumption was also slow in the second quarter due to lower GDP growth, political changes in Thailand and Indonesia, and inflationary pressure from currency depreciation leading to limited real wage gains. We expect this pace to continue in the second half, but we 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.

Preferred shares

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

The Canadian preferred share market had another strong quarter as interest rates continued to fall and investor demand remained strong in the face of higher issuance. Canadian and U.S. GDP growth expectations continued to fall in the second quarter and with them interest rates. As well, rising global tensions in Eastern Ukraine, Iraq and Syria added to the demand for income securities. Additionally, on June 5, the European Central Bank lowered interest rates to fight falling inflation in Europe and outlined programs that could see the bank begin quantitative easing in the fall. As a result, Government of Canada five-year bond yields declined 18 basis points to 1.52% at the end of the period. The BMO 50 Preferred Share Index posted a 2.42% total return for the second quarter, while the lower quality and broader S&P/TSX Preferred Share Index returned 2.66%.

Redemptions continued at a brisk pace during the quarter at $3.59 billion, while another $1.7 billion have already been announced for the third quarter. In addition, there is likely to be another $1.0 billion to $1.5 billion in redemptions this year. The heavy redemptions are due to rules by the Office of the Superintendent of Financial Institutions that require preferred shares to be convertible into common shares should the regulator deem it necessary to save a bank.

Issuance picked up in the second quarter as banks continued to replace non-qualifying preferred shares with new non-viability contingent capital (NVCC) compliant securities. Issuance totaled $3.775 billion, which was fairly balanced to the level of redemptions.

Following the preferred share market's strong 4.45% total return in the first half, our outlook for the remainder of the year is neutral. We expect interest rates to gradually move higher for new issuance to remain steady. We also recognize that investor demand for the safety of preferred shares remains strong. Our total return estimate for the BMO Preferred Share Index for the second half is in the range of -0.5% to 1%.

Foreign exchange

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

Not to dismiss the strength of the Canadian dollar but it was euro weakness that dominated currency developments during the second quarter of 2014. Since the summer of 2012, when the president of the European Central Bank, Mario Draghi, declared that the bank would do "whatever it takes" to save the Eurozone, the euro had been strengthening as investors piled back into European securities, especially peripheral European debt. However, European policymakers were becoming increasingly concerned about the adverse impact on the economy as the currency surged more than 15% against the U.S. dollar. Draghi's comments in early May 2014 that the currency is a cause for serious concern, backed by promises of further monetary easing, was a turning point for the euro in what we believe could become a multi-year decline against the U.S. dollar.

After struggling for two quarters, the Canadian dollar made a spectacular comeback in the second quarter, strengthening against all developed market currencies and even outperforming the strong British pound. A confluence of factors supported the Canadian dollar during the quarter: investors reducing their negative bets on the Canadian dollar; a general improvement in global risk appetite; higher-than-expected domestic inflation; surprisingly strong recent domestic economic data; and an uptick in commodity prices. Despite these cyclical tailwinds, we are concerned about a number of structural issues, including competitiveness, productivity, underperforming U.S. economic growth and slowing growth in full-time employment. Also, even though oil prices have spiked recently due to the developments in Iraq, we do not view the rise as sustainable and are looking for oil prices to weaken slightly. Thus, we maintain our bearish view on the Canadian dollar.

As the U.S. economic recovery strengthens following the weather-related weak first quarter, investors' expectations are that the first rate hike in this cycle might be brought forward, supporting the U.S. dollar against most currencies. The fact that most other major central banks are either not planning rate hikes or are looking to ease monetary policy even further should provide further support to the U.S. dollar.

On emerging market currencies, the strong rally since late January 2014 seems to be running out of steam, partly because local central banks are again focusing on the negative externalities of a stronger currency. Rising U.S. yields could see a faster reversal in the currencies of Brazil, South Africa and Turkey. However, given the experience of May 2013, we believe both the Federal Reserve and the local central banks will act pre-emptively to avoid a currency correction from turning into a crisis.

Interest rates

Kamyar Hazaveh
Vice-President, Portfolio Management and Portfolio Manager

Escape velocity still elusive

Despite the market's high hopes for 2014 to be the year that the U.S. private economy finally reaches escape velocity, economic growth in the first half was flat to negative, based on the latest estimates. First quarter growth was revised to -2.9%, confirming that the slowdown in the U.S. economy was real and not entirely temporary and weather-related. Developed market bonds gained further in the second quarter with the U.S. and Canadian benchmark 10-year yields down by about 0.22%. The decline in yields was 0.06% in the U.K., 0.54% in Australia, 0.28% in Germany and 0.57% in Spain.

Developed markets constrained by demographics and debt

The unconventional policies of the major central banks following the global financial crisis have achieved their first goals of a recovery in asset prices and confidence. The gains in the real economy of such expansive policies have been slow and differ among regions, as the U.S. and the U.K. enjoy better cyclical prospects relative to Europe. The pace of job creation in the U.S. has been above 200,000 jobs per month on average and the headline unemployment rate has fallen. Headline and core inflation measures in the U.S. and Canada have rebounded from multi-year lows. However, despite the better cyclical economic releases, the focus has shifted to structural issues, as the Federal Reserve and other major central banks have downgraded long-term growth forecasts. This has been particularly bullish for long bonds, resulting in the flattening of the yield curve in the U.S. and the U.K.

Outlook for currencies and bond yields

Policies of major central banks are deviating at the surface but the interconnectedness of the global economies and capital flows restrain how much bond yields can deviate. As the Federal Reserve and Bank of England are exploring exit strategies from unconventional policies, the European Central Bank is using a new set of tools to ease monetary conditions in Europe, which will have spillover effects on other developed markets bonds and should cap the rise in bond yields globally.

In our valuations, U.S. benchmark 10-year bonds are trading at the lower end of their range with fair value of about 3.25%. As a result, we have a relatively small short-duration position to take advantage of the normalization of bond yields to fair value. Given the divergent cyclical prospects in the U.S. and the U.K. relative to Europe and Japan, we are also overweight U.S. dollar and British pound bonds. This view is reinforced by historically wide yield differentials between the U.S. and the U.K. vis-a-vis the rest of the G10 at the long end of the curve, which makes U.S. Treasuries and U.K. Gilts a better source of income.

Investment-grade bonds

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

Investment-grade corporate bonds enjoyed another very good quarter during the second quarter, outperforming Government of Canada bonds as interest rates continued to fall and spreads tightened modestly. Expectations for economic growth continued to fall and with them interest rates. Tensions in Ukraine, Iraq and Syria added to the demand for bonds. Additionally, on June 5, the European Central Bank announced a broad array of actions to support the struggling economy, including lowering interest rates and supporting bank lending to small and medium-sized enterprises.

The lowest estimates of first quarter U.S. GDP growth ended up being wildly optimistic as the final figure was a negative 2.9%, due to falling exports, a reduction of inventories and lower personal consumption expenditures. Economists have blamed the poor GDP report on winter storms that hit the East Coast, but there appears to be continued underlying weakness in the economy. Clearly, the bond market was correct in indicating that the economy wasn't as strong as first thought. The one bright spot has been the monthly job report, as unemployment fell to 6.1% in June.

The U.S. Federal Reserve continued tapering its quantitative easing program by $10 billion per meeting and expects to end the purchases at its October 29 meeting. At the beginning of the year, many bond strategists had thought that the tapering would cause rates to rise; however, the falling U.S. government deficit and strong demand for bonds have more than countered the tapering pressure. As well, the European Central Bank's plan to flood the European banks with cheap term funding will ensure the world remains awash in liquidity.

Corporate credit quality remains very good, but leverage is rising at non-financial companies as shareholder-friendly activities pick up. Concerns are rising that there will be more debt-funded M&A, hurting credit quality. Spreads continue to make new cycle lows as investors reach for yield without going into equities. We believe that investment-grade corporate bonds have enjoyed the best returns in this credit cycle as fundamentals are beginning to slip and spreads are tight. However, banks remain a bright spot, with improving credit quality driven by regulators forcing them to hold more and higher-quality capital, as well as exit riskier business lines.

The Canadian investment-grade corporate bond index returned 1.79% in the second quarter, outperforming Government of Canada bonds by 31 basis points, mainly due to the extra carry on corporates. Spreads also tightened three basis points thanks to strong technical factors with both solid demand and moderate supply working together.

We are still constructive on investment-grade credit, but much less so than at the beginning of the year because there is little room for spreads to tighten from current levels. However, there is still money to be made in credit markets, but more so for individual credits or issues than on the overall market. The North American and European economies are expected to pick up gradually and any increase in interest rates will be moderate, which are very good conditions for credit investors.

High-yield bonds

Geof Marshall
Vice-President, Portfolio Management, and Portfolio Manager

Credit joined equities and government bonds in posting very respectable year-to-date gains. High-yield bonds were up 5.6% as spreads tightened 46 basis points for the first six months, exceeding our expectations. This return is just marginally lower than the 7.1% year-to-date return of the S&P 500 Index (in U.S. dollars). This is an odd outcome given the negative U.S. GDP result in the first quarter, the Federal Reserve's tapering of quantitative easing, geopolitical noise, and the roughly 50 basis point rally in U.S. 10-year bond rates, which is more indicative of a "risk-off" episode.

Aside from rates, two intertwined parts of the market continue to drift lower: volatility and liquidity. Both give us cause for concern. As an aside, the VIX is an index of implied equity market volatility and, historically, a good proxy for high-yield bond spreads. A lack of volatility suggests complacency, or a high degree of confidence that the U.S. economy and risk assets can stay on the smooth glide path envisioned and so far engineered by the Fed. The lack of liquidity in the market is a function of both of the lack of volatility and new banking regulations, specifically the Volcker Rule, which prohibits proprietary trading. This limits the banks' ability to warehouse risk and, in turn, their ability to dampen large market moves.

The Signature base case is for a successful Fed exit, rate increases in mid-2015 and continued low growth and low yields across the belly of the U.S. Treasury yield curve. In this scenario, we believe high-yield bonds are likely to remain the "best house on a bad street" in fixed income over the intermediate term. We are less concerned currently about credit risk (i.e. defaults increasing) than the complacency, lack of volatility, and illiquidity in all markets and have tactically taken some cards off the table in the high-yield bond allocations.

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