Signature Market Roundup

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Global outlook

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Lower for longer: Pondering the global savings glut

We believe the recent volatility and market correction can be characterized as a "growth scare," which caused a shakeout in market positioning and set up an opportunity to increase exposure to risk assets, and that these events did not signal a change in underlying fundamentals. This is not to say there are not some challenges facing the global economy – there certainly are – but rather that the market has shifted from a focus on what is working to what is not.

In our view, we are firmly in a U.S. and China-led global economy, where all other countries and regions are either too small or lack the growth potential to make them relevant to the global economic equation. What matters is that they do not implode, in which case they will take us all down with them. (Hello Eurozone!) Therefore, the key issues now are the state of growth in the U.S. and China and the situation in Europe.

United States

We believe that very little has changed with respect to the underlying fundamentals of the U.S. economy and that it should continue to grow at a rate of about 3% in the fourth quarter and into 2015. In that case, and with the Federal Reserve's decision to end quantitative easing (QE), we can expect the first interest rate increase in June next year. The exact timing of the first rate increase is, as Fed Chair Janet Yellen has emphasized, data dependent with a particular focus on the labour market.

The Fed is also closely watching three broad issues, of which two will act as a drag on growth and one will support growth. The first is the slower global economy, which reduces demand for U.S. exports, and acts to keep global interest rates lower. The stronger dollar also acts as a tightening of monetary conditions in the U.S. and will reduce or delay the need for the Fed to increase interest rates. Offsetting these is the positive impact of lower oil prices, which acts as a de facto tax cut for American consumers.

China

Even as China's growth rate slows, it will still be the largest single driver of incremental global GDP. We believe China will continue to slow as its leaders double down on restructuring the economy away from infrastructure and real estate investment and toward consumption and services. It will take a decade or so, but recent comments from China's leadership show that they understand the need for continued reforms. So long as employment holds up, we expect the Chinese will tolerate a slowing growth rate.

While this is very positive from a longer-term perspective, it does have direct implications for commodity markets, commodity-producing countries and commodity-linked currencies, none of them positive. That includes Canada. While China's demand for commodities will not drop off a cliff, the penny is dropping for many market participants that the growth in demand for many commodities has peaked just as increasing supplies are coming to market.

Europe

Europe remains the biggest challenge and risk for the global outlook today, with its growth and inflation rates having continued to deteriorate. As a result, the European Central Bank has continued to expand its range of unconventional monetary policies. The challenge is that monetary policy alone cannot solve Europe's challenges. It must be complemented by fiscal policy to support stronger domestic demand, as well as aggressive structural reforms. However, Germany's opposition to fiscal stimulus and inaction in France and Italy have left the ECB as the only game in town.

Given this backdrop, we expect that ECB officials will continue to look for new ways to expand monetary stimulus. Where ECB President Draghi appears most active, however, is in trying to help instigate a grand bargain that will see Germany relax its opposition to fiscal expansion in exchange for measurable commitments to structural reform from France and Italy. This will not be easy but we do expect some limited progress.

We do not expect a sustained loss of market confidence in Europe at this point. While the situation remains quite fluid, we believe that the stop-go process of Eurozone adjustment will continue to play out for a couple of years and that the threat of the continued rise of anti-European Union political parties may help move the fiscal bargain forward.

Emerging markets

Matthew Strauss
Vice-President, Portfolio Management,
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Following a strong rally in emerging market equities from February to August, September turned out to be a very challenging month. Not only did emerging market equities decline substantially during the month (-7.4% in U.S. dollar terms), but they also underperformed the all-country global equity index, as most developed markets declined by only low single digits. For the third quarter, emerging market equities were down 3.4% in US dollar terms and up 1.5% in Canadian dollar terms.

Globally, the sharp increase in currency volatility weighed on cyclical assets, including emerging market equities. The broad rise in the U.S. dollar added to the woes. Thirdly, declining commodity prices – partly the result of the stronger U.S. dollar and expectations of more supply coming online in the next few years – weighed on commodity-producing emerging markets like Brazil, South Africa and Indonesia.

Local economic and political developments also weighed on returns: upcoming Brazilian elections; disappointing activity data from China even after the mini-stimulus during the summer months; fear of default in Venezuela; ongoing tension between Russia and Ukraine; and corporate governance issues in South Korea. Positive developments such as the de-escalation of the Ukrainian conflict late in the quarter and the reduction in Euro-area interest rates during the quarter could not fully offset these negative developments.

Although the reversal in returns reinforces the cyclical nature of emerging market equities in general, the sharp divergence between country returns highlights the increasing and growing importance of dedicated investors into emerging markets – investors who understand and appreciate the differences amongst this group of non-homogenous countries. Despite the challenges in September, a number of emerging markets performed in line with the global sell-off (Eastern European countries, Philippines, Thailand and India), while problematic emerging markets like Brazil, Turkey and South Africa declined much more than the emerging market average.

Although ETF flows into emerging markets have increased the cyclical nature of this asset class, the fact that net foreign inflows into emerging markets in September remained positive suggests that investors continue to engage emerging market equities despite the recent turmoil. We continue to see a better growth year for most emerging markets in 2015 compared to 2014 and with valuations cheap compared to developed markets and fair in historical terms, we will be looking to re-deploy the cash raised during this period of instability.

Consumer products

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

Overall, the consumer staples index outperformed the broader S&P 500 Index by 64 basis points and the consumer discretionary index by 105 basis points in the third quarter. The performance of the staples index reflected an unstable geopolitical environment, lower yields on 10-year U.S. bonds and lower commodity prices during the quarter. Back-to-school trends were better than last year, helped by better inventory levels and fewer promotions. Moderate food inflation and lower energy inflation have also been a positive catalyst. We expect the discretionary consumer sector in the U.S. to rebound in the fourth quarter due to easier credit, robust job creation, increased consumer confidence and lower energy costs.

In Canada, after a strong first half, retail sales fell into negative territory in July at -0.6%. We still remain cautious regarding Canadian consumer stocks as they remain fairly valued and Canadian discretionary spending should remain under pressure for the rest of the year due to high debt levels.

In Europe, consumer confidence and inflation remains very low, affecting retail sales growth. Overall in Europe, retail sales rebounded in August mainly in the U.K. and Germany after a decline in May and July. Retail sales in France, Italy and Spain were weak. For the remainder of the year, we still favour domestic-focused retailers mainly in the U.K. and global firms with geographic diversification.

In Eastern Europe, retail sales remain very weak, led by Poland and Russia. The sector in Russia was still facing pressure in the third quarter due to the ban on food imports from Western countries and the ongoing conflict with Ukraine. We still intend to avoid the region over the next three to six months because of its political instability, higher inflation, weak consumer confidence and high valuations.

Latin American consumer fundamentals are likely to remain weak in the fourth quarter, especially in Brazil, where unemployment is increasing for the first time in a decade, and currency depreciation, higher inflation and high interest rates are likely to limit discretionary spending. We are now more cautious on the Andean consumer sectors due to political reform, higher corporate taxation, and lower GDP; however,

we remain positive over the long term as consumers in those regions should continue to benefit from middle class growth and a stable inflationary environment.

In China, consumption was still weak in the third quarter. On a sequential basis, retail sales continued to decline with poor consumer confidence and weak real estate activity. Although basic consumption is growing at a normal rate due to low food inflation, we expect discretionary spending to remain under pressure in the fourth quarter. For 2015, we believe that the Chinese New Year in February should be a good proxy of the consumer trends for the rest of the year. Over the long term, we continue to be positive, as the savings rate and disposable income are high.

In Southeast Asia, retail sales slowly rebounded during the quarter compared to a decline in the first half of the year. Political changes in Thailand, Indonesia and India boosted consumer confidence and consumption activities. We expect this pace to continue in the fourth quarter 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.

Health Care

Jeff Elliott
Vice-President, Portfolio Management and Portfolio Manager

Health care outperformed the broader markets again in the third quarter, both globally (3.6% compared to the MSCI World Index of -2.1%), and in the U.S. (5.5% compared to the S&P 500 Index return of 1.1%). Despite a steady performance from the sector as a whole, however, it was yet again an eventful quarter for specific sub-sectors of the group.

Large-cap pharmaceutical stocks performed relatively well in the quarter, with several companies reporting positive clinical data for potential new blockbuster products. Portfolio companies Novartis and Sanofi had encouraging updates at the European Society of Cardiology meeting in the third quarter, which drove relative outperformance of these stocks. Biotechnology stocks (particularly large-cap companies) were strong as product launches, anticipation of pipeline read-outs and some selective M&A (Intermune was acquired by Roche) continue to drive the sector. Given the multi-year run in biotechnology share prices, we are not entirely comfortable with the current risk/reward profile, as we believe overly optimistic views on the likelihood of positive pipeline updates are being priced into many stocks.

Actions by the U.S. Treasury regarding tax treatment of "inverted" companies, as well as speculation regarding potential M&A activity drove significant volatility in the specialty and generic pharmaceutical subsectors. We remain on the sidelines, with a lack of obvious catalysts to drive the stocks higher, uncertain fundamentals and stretched valuations all leaving us cautious.

Health care providers outperformed in the third quarter, as utilization in the U.S. health care system showed a significant uptick with the second quarter results, driven by some combination of increased coverage resulting from the Affordable Care Act and improved economic fundamentals. It remains to be seen if this uptick is sustainable and should it prove transient (which we think is more likely than not), the gains in these stocks will likely reverse.

After a long run of outperformance (health care was the top performer in the third quarter and for the year-to-date) and valuations that more appropriately reflect the underlying fundamentals, we elected to reduce our exposure to health care equities across our funds and are now relatively neutral weighted. Our holdings remain biased to the large-cap pharmaceutical companies, which show solid fundamentals, good product-driven news flow and reasonable valuations.

We expect continued volatility in the health care services subsectors given the uncertainty regarding impacts of the Affordable Care Act and are not convinced the fundamentals of the companies warrant current valuations. Similarly, we remain concerned about longer-term price pressures for medical device companies, given a relative lack of innovation potential and therefore are currently underweight these sectors.

Preferred Shares

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

The Canadian preferred share market had a mixed quarter as global growth concerns and rising geopolitical tensions increased volatility and hurt markets for risk assets. The TSX and S&P equity indexes gave up gains made in June and July to finish flat on the quarter. Interest rates were also fairly steady in Canada. Investor demand remains strong for high-quality issuers as banks redeem product. The BMO 50 Preferred Share Index posted a -0.11% total return for the third quarter, while the lower-quality and broader S&P/TSX Preferred Index returned a positive 0.38%.

Redemptions continued at a brisk pace during the quarter with $3.05 billion of redemptions and another $975 million already announced for the fourth quarter. Issuance remained strong, as non-financial issuers joined banks in the primary market. Total issuance of $3.105 billion over 10 issues remained fairly balanced to the level of redemptions.

The negative return of the BMO 50 index was entirely due to the heavily weighted fixed reset sector, which fell 0.55% while all other structures posted positive returns. Floating rate preferred shares led the way, rising 2.16% on the back of rising rate expectations for next year. Fixed resets fell as heavy issuance weighed on the market and widening credit spreads hurt the lower-quality preferred shares that make up a greater proportion of the fixed reset area.

Our outlook for the preferred market remains neutral following the strong first half of the year due to the global growth and geopolitical concerns balanced by the strong demand for the relative safety offered by Canadian preferred shares. The BMO 50 index has returned 4.33% in the first nine months of the year. Our total return estimate for the fourth quarter is in the range of -1% to 1%.

Interest rates

Kamyar Hazaveh
Vice-President, Portfolio Management and Portfolio Manager

Draghinomics and the Japanification of Europe

This was the quarter for the triumph of fundamentals in both Europe and Japan. At the beginning of the year, Mario Draghi, head of the European Central Bank (ECB), was adamant that the nature of disinflation in Europe is different from Japan's lost decades. By the end of the third quarter, the ECB had unleashed one of the most aggressive monetary policy stimulus packages worldwide to combat deflation and falling economic growth. Mr. Draghi's full wish list outlined a program of monetary and fiscal stimulus combined with structural reforms that had stark resemblance to Prime Minister Shinzo Abe's 2012 plan for rescuing Japan from its lost decades, called "Abenomics."

Separately in Japan, the April consumption tax hike has had a large impact on the economy despite the consistent forecast by Haruhiko Kuroda, the Head of Bank of Japan's (BoJ), of the temporary nature of the weakness. It is now clear that the impact is eerily similar to 1997 tax hike that sent Japan into a recession. It is ironic that as Mr. Draghi is attempting to launch Draghinomics in Europe, Abenomics, which is based on the same intellectual foundations, is failing in Japan.

These developments in Europe and Japan had substantial impacts on currency and rate markets globally. Developed market bonds gained further in the third quarter, with the U.S. and Canadian benchmark 10-year yields down by about 0.08% since the beginning of the quarter to mark new year-to-date lows. The decline in yields was 0.36% in the U.K., 0.06% in Australia, 0.34% in Germany and 0.64% in Spain. The euro collapsed 7.75% against the U.S. dollar. The decline in the Japanese yen was equally spectacular at 7.60%.

Central bank activism and bridges to Hopetown

The performance of the real economy after almost six years of zero interest rate policy (ZIRP) and multiple rounds of unconventional policies in the U.S., Europe and Japan has been disappointing. It is our opinion that this cycle is different from most economic cycles and that is the key to understanding the behaviour of interest rate curves as well as the behaviour of the currencies. The classical stimulation mechanism from the central bank to the real economy works only if the economic agents are able to use the low interest rates to borrow and spend. With the level of public and private debt (as a percent of GDP) already at elevated levels, economic agents are unable to respond to monetary stimulation to the same extent.

It is in this environment that central banks are trying every available monetary tool to keep the financial markets and the real economy afloat. Their efforts have borne fruit in as so far as avoiding the failure of the banking system and a 1930-style depression, but it is becoming increasingly clear that central banks are unable to solve the problems in the real economy that have to do with over-indebtedness and the lack of competitiveness.

Outlook for currencies, bond yields and credit spreads

In our valuations, the U.S. benchmark 10-year bonds are trading at the lower end of the range, with fair value at about 3.0-3.25%. Given the divergent cyclical prospects in the US and the UK relative to Europe and Japan, we are underweight the euro and yen-denominated bonds.

In the U.S. and the U.K., both central banks have been vocal in their intention to raise short-term rates sometime in 2015 in response to better cyclical employment and growth data in the third quarter. As such, the so-called "forward guidance" has been put aside by central bankers Mark Carney and Janet Yellen in favour of "data dependency." This seems premature to us as economic cycles in both countries have already peaked and a fresh slowdown relative to elevated expectations lies ahead. Besides, with the ECB and Bank of Japan exporting deflation worldwide, it is only a matter of time before the Federal Reserve and the Bank of England would have to admit that they are missing their respective inflation targets. The expected return of the five-year sector in both countries seems attractive to us relative to global developed market counterparts.

Investment-grade bonds

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

Investment-grade corporate bonds posted positive returns in the third quarter but underperformed Government of Canada bonds as interest rates continued to fall and corporate bond spreads widened. Global GDP growth expectations continued to fall during the quarter and with them, interest rates. European economies are stagnating at best, while China lowered its growth expectation to 6% and emerging markets are struggling as commodity prices tumble and the higher U.S. dollar weighs on economies. Additionally, geopolitical tensions remain high with conflict in the Middle East and Ukraine. The ebola crisis in Western Africa continued to grow with cases reported outside the originally affected countries. All these had the effect of increasing volatility and reducing the demand for riskier assets, including Canadian investment-grade corporate bonds.

The Canadian economy produced moderate growth in the third quarter with unemployment falling to 6.8% in September. The U.S. GDP bounced back strongly in the second quarter after the negative result in the first, and now appears to be settling in for 3% GDP growth in the third quarter. The unemployment rate continued to fall; however, wage growth remains low. This is likely explained by the still-high underemployment rate of 11.8%.

The U.S. Federal Reserve continued tapering its quantitative easing (QE) program and ended the purchases in October 29. The Fed has not changed its statement language of low rates for the "considerable time" post-QE, but the market is beginning to believe that it will begin raising rates in the second half of net year. Interest rates have fallen throughout the year as the global growth and inflation outlooks have eased, thus making the U.S. interest rate and dollar relatively attractive.

Corporate credit quality is good, but event risk is picking up as companies continue to take advantage of cheap debt while it lasts. Leverage is rising at non-financial companies as dividends, share buybacks and acquisitions increase. During the quarter, Burger King bought Tim Hortons, BCE bought the shares of Bell Aliant that it didn't already own and Manulife bought Standard Life's Canadian business.

The Canadian Investment Grade Index returned 0.77% in the third quarter, underperforming Government of Canada bonds by 10 basis points as spreads widened six basis points over the period. Spreads moved wider throughout the quarter due to the weaker bid for risky assets but remain near their cycle lows. We believe that investment-grade corporate bonds have enjoyed their best relative returns in this credit cycle as fundamentals are slipping.

The outlook for credit is more challenged than at the beginning of the quarter due the slowing global growth exacerbated by geopolitical tensions. The Federal Reserve exit from QE has increased volatility. We remain overweight investment-grade credit and believe that it will outperform government bonds over the next six months, but are very selective in our holdings.

Foreign exchange

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

The third quarter was dominated by policy divergences in the three major economies, with exchange rates moving fairly aggressively to reflect these changing views. The fast adjustment in major currencies also led to a spike in currency volatility, challenging investment themes based on low-volatility strategies. Many of the "carry" strategies continue to do well, but the increased volatility highlighted the risks to these strategies and has led to the partial unwinding of positions in highly cyclical assets such as equities, commodities and emerging market currencies.

The U.S. dollar benefited from a number of developments during the quarter: increasing focus on the first rate hike in the U.S.; further monetary easing in Europe and expectations of further easing in Japan; and broad-based risk-off sentiment. In the U.S., the end of quantitative easing in October has turned attention to the timing of the first U.S. rate hike, with short-term rates (as measured by two-year Treasuries) increasing from 0.46% to 0.57% during the quarter. In isolation, this might not have been enough to push the U.S. dollar higher, but with the European Central Bank easing monetary policy during the same time and introducing its version of quantitative easing, the largest currency pair in the world fell dramatically during the quarter, with the euro losing 7.7% against the U.S. dollar. The Japanese yen fell by 7.6% and the British pound lost 5.2% against the American currency.

Commodity currencies faced additional pressures: falling commodity prices. This was particularly true during September with the Australian dollar, South African rand, New Zealand dollar, Brazilian real and Russian ruble clustered at the bottom of the performance ladder with losses of 5.5% to 8.6%. The Canadian dollar lost 2.9% against the U.S. dollar in September, falling to 89.6 cents to bring the quarterly decline to 4.7%.

Diverging monetary policies, the debate about the timing and pace of the U.S. rate tightening cycle and broader risk sentiment will continue to drive currency trends into 2015. Concerns about a too rapid appreciation of the U.S. dollar and possible delays in the timing of the first Federal Reserve rate hike could hamper the upward trajectory of the dollar, but when all is said and done, we see a continuation of recent trends (weaker Canadian dollar and euro against a generally stronger U.S. dollar) with position-driven corrections along the way.

High-yield bonds

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

High-yield bond yields began widening in July after a great first half of the year. As this was largely asset-class specific, we attributed this to stretched valuations and U.S. mutual fund outflows in a new regulatory environment where brokers are less able to use their balance sheets to provide trading liquidity and facilitate trading. Federal Reserve Chair Janet Yellen discussing excesses in the leveraged finance markets also probably did not help. An improved tone in early September was met by substantial new issuance, but this acted to pressure the market later in the month and into October as part of the larger "risk-off" trade. We have now witnessed the market trade from a low of 4.84% yield-to-worst (+355 basis point spread-to-worst) in mid-June to 6.29% (+493 bp) in the middle of October. While we thought high-yield valuations were likely range-bound in a low-rate, low-growth environment, we thought a 5% floor and 6% ceiling were reasonable limits and still do over the intermediate term.

As commodities have sold off and the IMF has lowered the global growth forecast, it is worth remembering that high-yield bonds are a U.S.-centric asset class, especially in terms of end market revenues. A strong U.S. dollar, lower commodity prices, and a dovish Fed provide a tailwind to consumer spending and ultimately corporate credit quality, at the expense though of exporters. Despite the volatility, funding channels remain open, with the forward calendar populated by opportunistic refinancings as opposed to upcoming maturities. As a result of these various factors, we do not see a fundamental change of credit quality or, more importantly, future credit quality, and therefore current conditions present an buying opportunity in the high-yield sector.

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