Signature Global Roadmap:

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Signature's 2015 Global Outlook: Sunny with a Chance of Meatballs

A number of cross-currents are buffeting global markets and economies, promising to make 2015 an interesting and challenging year for investors. On the upside, the global economy should continue to accelerate led by the U.S., which having just grown by 5.0% in the third quarter of 2014, is entering 2015 with substantial momentum. The U.S. has dealt with several imbalances and has emerged from the crisis as the most competitive, dynamic and flexible major economy on the planet. But even Europe and Japan, each with a laundry list of unaddressed structural challenges, are expected to see a pickup in growth over their dismal performances in 2014. Unlike last year, when we argued that both regions were poised to disappoint, we now see them at the bottom of a shallow economic cycle and on track for modest improvement. Neither Europe nor Japan is on a path to sustainable growth, and both are flirting with longer-term economic and social implosion should they fail to alter their current intransigence about addressing their structural challenges. The current political and policy backdrops in Japan and the Eurozone are best viewed as palliative care. But in both cases, supportive monetary policy, relaxed fiscal policy, weaker currency and lower oil prices will provide short-term support as we enter 2015.

If I had to choose a movie title for 2015 it would be *Sunny with a Chance of Meatballs*. The broad economic backdrop is quietly constructive, but there are some definite meatballs out there that will serve to challenge any rosy outlook. First and foremost, there is the potential contagion from the recent and very rapid drop in oil prices. While lower oil prices are unambiguously positive for global consumers, you cannot have a 50% collapse in such a key commodity and not expect some disruption in global markets and economies. The second potential meatball, appropriately enough, comes from the Eurozone, where the political realities of the half-baked union will continue to hamper any sustained economic recovery. Here, two areas of concern include relations between the European Central Bank (ECB) and Germany in implementing supportive monetary and fiscal policies, and the rise of anti-EU political parties. Greece, Spain, the U.K., Portugal and potentially Italy could all face market-challenging ballot-box angst. The third meatball surrounds the U.S. Federal Reserve's expected interest rate increases. Other areas of potential stress include: 1) the mess in the Middle East (also related to meatball #1 above); 2) China's rebalancing and reform agendas and the implications should they succeed or fail; 3) the risk of loss of confidence in the fiscal sustainability of Japan; and 4) knock-on effects from a rising U.S. dollar.

To the extent the global economy can weather the risks and volatility associated with these meatballs, 2015 should be a rewarding year for investors. Broadly speaking, as the global economy

and markets continue to normalize in 2015, I expect interest rates, particularly in the U.S., to approach last year's high of 3% on the benchmark 10-year U.S. Treasury bond. While the strength of the U.S. economy would dictate even higher levels, the inability of the U.S. rate structure to fully decouple from global deflationary trends and the aggressive monetary policy emanating from Europe and Japan will keep U.S. rates lower for longer. (We explored the lower for longer thesis in both our third and fourth quarter 2014 Global Roadmaps, which can be found on the Signature website.) While the Fed will probably raise overnight rates two or three times in 2015, the long end of the yield curve is expected to remain very well anchored. With such a backdrop, government bond markets are unlikely to repeat their strong 2014 returns, remaining flat or dipping slightly lower. And with rates rising only moderately against a stronger economic backdrop, we expect corporate bond markets to see a modest 2-5% return, led by the high-yield sector. High-yield spreads widened in December, providing room for a modest narrowing of spreads in the coming year.

We again expect equities to be the best performing asset class, and believe a high single-digit return in the range of 8-10% is reasonable, based on EPS growth of about 8%, a 2% dividend yield and no change in equity valuations. We enter 2015 with the global forward P/E ratio approaching 15x, led by the U.S. at just above 16x. These levels are near the upper end of recent historical ranges, but are at the cheap end relative to the current interest rate structure. In other words, the equity risk premium remains elevated. While we are not forecasting an expansion in valuations with a rate tightening cycle about to begin, the risk of yield-starved investors pushing up valuations in the context of supressed interest rates remains a possibility. A significant P/E contraction remains unlikely so long as the global economic recovery remains on track.

While the above may be our base case for 2015 returns, our degree of confidence that such a cozy outlook will eventuate without considerable shifts and shocks is incredibly low! Indeed, elevated market volatility will likely remain the norm throughout the year, so keep your seatbelts fastened. We have entered 2015 with our portfolios positioned defensively, having increased cash and lowered our equity exposure last September. We also maintain significant underweight allocations to the energy and materials sectors. Overall, higher volatility and lower market liquidity should offer Signature's portfolio managers opportunities to take advantage of periodic market sell-offs. The world remains fragile and in a considerable state of flux. Here is a closer look at some of the meatballs that could disrupt the smooth evolution of our base case forecasts:

Meatball #1: Implications of the oil price collapse

Since September, Brent crude has dropped in price from above US$100 to below $60. There are many theories as to why, but from a purely economic perspective the increase in U.S. oil production to multi-decade highs has been a significant supply-side shock. This, along with sluggish global demand, particularly from China, resulted in overall excess of supply. Oil prices started to slide over the summer and accelerated downward in October and November. But it was OPEC's reaction at its

November 27 meeting that cemented the sell-off and hammered Brent below $60 in mid-December. OPEC has continued to emphasize that it will protect its market share of 30 million barrels per day and have refused to cut production to support prices. This is a fundamental shift in how the cartel has been operating and appears to be an acknowledgement that the supply increase from the U.S. has broken the ability of OPEC to maintain prices in the recent $100 range. Saudi Arabia has bluntly stated that it will not cut production just to see the U.S. shale industry increase its output. In effect, the economics of oil have changed. Under the cartel, the low-cost producer (Saudi Arabia) used to cut production to maintain prices. Now Saudi Arabia wants to force the high-cost producers to cut production to bring the market back into balance. With so many moving parts, no one knows how low or for how long oil prices will fall, but it will have to be lower and for longer than most expect if it is to curtail supply in a sustainable manner. This will be incredibly painful for oil producers in 2015.

One area feeling the pain is Russia. Coupled with the sanctions related to Ukraine, the collapse in oil prices has led to a collapse in the ruble, and Russia is now facing a significant recession and potential economic collapse. While low sovereign debt and significant foreign currency reserves (in the US$400 billion range) provide a substantial cushion, the trajectory of such shocks is inherently unpredictable, with risks significantly skewed to the downside. The economic pain, coupled with Putin's highly nationalistic and warped sense of the world, makes Russia an unpredictable economic and geopolitical outlier in 2015.

Other oil-producing countries will also be challenged. Back-of-the-envelope calculations indicate that OPEC countries could suffer as much as $500 billion in lost revenues! That is a lot to lose, particularly for those wholly dependent on oil to fund their budgets. Venezuela looks to be on the brink of collapse, while Nigeria is also questionable. More mainstream countries such as Brazil and Mexico are also very reliant on oil revenues. Oil company budgets will also be impacted. While many of the large global exploration and production companies retain very robust balance sheets, small and mid-size companies face much higher risks. In recent years, the energy sector has grown to represent 16% of the U.S. high-yield market. These issuers are more speculative and at current oil price levels there will be a rise in defaults. This has so far been reflected in widening yields in the high-yield energy space to 930 basis points, or close to 300 basis points higher than the rest of the high-yield market. Overall, the potential for oil-dependent countries and companies to default on debt and social obligations and the ensuing contagions constitute our number one risk for 2015.

However, the drop in oil prices is also unambiguously positive for consumers and oil-importing nations. It is in effect a $500 billion transfer from the pockets of OPEC to the oil consumers of the world, who get a de facto tax break through lower gas and energy prices. While there will be some offsetting impact from lower capital expenditures and employment in the energy industry, we believe the broad-based boost to consumers will significantly outweigh the adverse impact on the energy industry. Estimates suggest a net boost to the U.S. economy of 0.3-0.5% of GDP in 2015 and 2016.

The impact on inflation is more nuanced. Lower oil prices will show up in a lower headline Consumer Price Index, but core CPI tends to exclude energy due to the volatile and transitory nature of oil prices on inflation. For an economy that imports oil, any oil-induced deflation is what we call "good deflation," as it represents an increase in consumers' real incomes. The concern that lower oil prices will lead to lower U.S. inflation numbers and hinder the Fed's ability to raise rates is likely misplaced. While it will certainly be unprecedented for the Fed to begin raising rates in the face of a falling headline CPI, the central bank has clearly indicated it views such deflation as transitory and the medium-term impact of the oil price drop to be inflationary! To the extent that lower oil prices boost GDP growth at a time when the output gap is closing, they will tend to increase inflationary pressures in the medium term. For the Fed, lower oil prices and a negative CPI will certainly provide it with the ability to defer a rate hike, but they also increase confidence that the U.S. is in a self-sustaining recovery. Hence, there is a greater likelihood of rate increases in 2015, not less.

For both the Bank of Japan and the ECB, the tea leaves read slightly different. The reality of lower energy prices is absolutely positive for their economies, but both are facing the threat of deflation and are concerned about the longer-term corrosive nature of entrenched deflation. As such, both central banks have gone to great lengths to target higher inflation and inflation expectations. That energy might threaten to pull inflation expectations lower will tend to push both central banks toward further easing measures next year. For the ECB, Mr. Draghi will try to use the threat of negative CPI points to help marshal broader support for quantitative easing (QE) in Europe.

Meatball #2: Eurozone politics

The Eurozone is poised for a minor acceleration in growth following 2014's credit squeeze as the banking system de-levered ahead of the ECB bank stress tests. The credit supply constraint on the Eurozone has now been eased and should be less of a drag through 2015. While we expect credit demand in Europe to remain anemic, easier credit should be positive for GDP growth in 2015 versus last year. In the same vein, fiscal austerity also continues to ebb and will not be a drag for 2015. We do not expect any impact from the Juncker plan to raise 300 billion euros for infrastructure spending, but there is always a chance something minor may happen before the end of the year. Monetary stimulus will be beneficial at the margin, but with rates already approaching zero it is not the price of credit that is the problem, it is the lack of demand. The ECB is pushing against a string! What will help Europe is the significantly weaker euro, which will provide a boost through exports and the trade account. This, along with lower energy prices providing a boost to real incomes, should help push the Eurozone economy toward 1-1.25% GDP growth next year, up from a likely 0.8% in 2014. Not spectacular, and not enough to resolve their imbalances such as unsustainable debt and double-digit unemployment, but at least moving in the right direction.

The challenges to this muddle-through scenario are twofold. First, the German policy prescription for tight monetary and fiscal policy is incredibly misguided in an economy with a structural deficit

of demand. Following through fully on the German approach would be the right prescription to turn the recession into a 1930s style depression. The ability of the ECB to enact stimulative monetary policy in the face of resistance from the German central bank and potentially the German Chancellor will likely be tested in early 2015. It is unclear legally and politically if Mr. Draghi can launch QE, or what form QE might have to take to clear such hurdles. While we expect the negative inflation data to provide Mr. Draghi sufficient cover to launch some form of sovereign QE in 2015, markets may be rattled if relations between the ECB and Germany truly break down, as they threatened to do last September.

The second risk in Europe is also political, with the increased likelihood of an anti-euro populist party being elected. Elections in Greece on January 25, following the failure of the ruling party to secure enough votes to elect the President, will be the first test, while Spain must also go to the polls in late 2015. As a wild card, there are continuing rumours of a snap election in Italy, always a good locale for political meatballs.

Overall, the Eurozone remains a mess and progress towards rebalancing internal competitiveness, lowering debt burdens and reducing unemployment remains painfully slow. They are simply not addressing the challenges required to make the euro monetary union sustainable. The risk in 2015 is that politics overruns the slow-moving economic adjustment process.

Meatball #3: The Fed raises rates

Our third meatball comes from the fact that the U.S. economy is truly picking up steam and appears to have transitioned to a self-sustaining trajectory. With some of the strongest quarterly growth rates in over a decade in the second and third quarter of 2014, the latest non-farm payroll numbers above 300,000, unemployment at 5.8% and falling faster than expected, and early signs that wage inflation is finally beginning to stir, the U.S. economy is clearly getting back on its feet. This is great news but also means that the Fed is unlikely to waver from its current plan to begin a classic rate tightening cycle starting in the middle of 2015. While the decision remains data dependent and the Fed will respond to the state of the economy between now and then, so far the data continues to be robust. With the collapse in gas prices providing U.S. consumers with a de facto tax cut, we fully expect that U.S. economic growth will continue to track above 3% as we enter 2015. At this point it would take quite a reversal in the data for the Fed to change course.

Overall, rising rates due to a stronger economy is generally supportive of risk assets, but often comes with greater volatility. That would remain our central case going into 2015. However, U.S. monetary policy also broadly impacts all global assets. In particular, with the U.S. beginning to tighten and both the ECB and BOJ expected to loosen policy, we can expect that the U.S. dollar will continue to strengthen. Other things being equal, a strong U.S. dollar will be a headwind for commodities, U.S. dollar-linked emerging economies and commodity-linked currencies such as the Canadian dollar. These asset classes will experience a completely opposite effect to the significant

tailwinds experienced during the weak dollar period from 2001-2011. As we have argued over the past few years, we believe the stronger U.S. dollar trend has been evident since 2011, and while it took a pause in 2012-13, it has clearly resumed its trajectory since mid-2014. As the world reserve currency, the behaviour of the U.S. dollar impacts every other asset class in the world, so investors have to pay attention.

One risk from such a scenario will come from funding mismatches, where foreign companies or countries with primarily local revenues have issued debt in U.S. dollars and are now faced with higher financing costs. In the case of oil-exporting countries that have also seen a significant revenue or currency devaluation, the likelihood of debt market stress and defaults will continue to rise through 2015. Past episodes such as the Mexican debt crisis, the Asian financial crisis and the Russian default in 1998 are all past examples of currency mismatches gone awry and the memory of such episodes will haunt markets throughout 2015.

For 15 years, Signature has been making the case that Canadian investors need to diversify their assets globally, that it is effectively impossible to property diversify a portfolio in Canada due to the lack of listed companies in several key industry groups, including health care, technology and global consumer products. This has never been more apparent than it is today given the continued underperformance of the Canadian market. Yet many Canadian investors retain a significant home country bias in their portfolios. For many, the weak U.S. dollar and strong China-led commodity boom of the last decade masked the inherent lack of diversification in a domestically biased portfolio. For Canadians with the heavy overexposure to energy and materials that a Canadian portfolio often contains, the past two years have been a painful wakeup call as gold collapsed in 2013, followed by oil in 2014. While both may see a bounce in 2015, the factors leading to their corrections are, in our opinion, structural in nature. The commodity supercycle, led by the explosive growth in demand out of China, has ended and will continue to unwind many of the inherent excesses in the coming years. The 2010s have not been and will not be Canada's decade, particularly from a market exposure perspective (our economy is not as imbalanced as our stock market). It is not too late for investors to increase their foreign exposure and we at Signature can help. As Canada's only truly integrated global multi-asset class investment team, Signature's team of over 40 investment specialists are one of Canada's largest global investors, managing over $25 billion in global assets and over $50 billion in total assets. Our range of global investment products and solutions, such as Signature Global Income & Growth Fund, Signature Global Dividend Fund and Signature Select Global Fund, can help investors to achieve a properly diversified and well-managed portfolio.

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