Signature Global Roadmap: Third Quarter 2015

Drummond Brodeur, Portfolio Manager and Global Strategist
Signature Global Asset Management
July 20, 2015

Signature Global Roadmap: Much Ado About Nothing

Without a doubt, the six weeks from late May to early July were dominated by significant macroeconomic and political events that eclipsed fundamentals as the key drivers of the markets. First and foremost was the ongoing Greek Tragedy, in which there appears to be a deal as I write, and secondly, there was the attention paid to the Chinese stock market decline, which was overrated in our opinion. We will touch further on both these issues, but our view as we enter the second half of 2015 is that these geopolitical issues will fade from the front pages and markets will shift back to focusing on fundamentals, such as underlying economic health, future policy direction and earnings growth – all of which remain constructive to the outlook for risk assets such as credit and equities.

In our last outlook, we discussed how the prices of energy, monetary policy, interest rates and currencies had moved significantly over the previous six months, driven by changes in the underlying fundamentals, and as such, would be unlikely to return to their previous valuation ranges. We also said that the bulk of the adjustment had already taken place and what policymakers and markets wanted was for markets to stabilize and establish new near-term equilibrium trading ranges. While political instability grabbed the spotlight in the past quarter, we have seen much more stability emerge among key economic variables. At the same time, stronger U.S. economic data support our view that the first quarter weakness was transitory and puts our central economic thesis of synchronized global economic growth for 2015 back on track.

It has been encouraging that North American equity markets have continued to trade sideways so far in 2015 despite the weak first quarter economic data, strong U.S. dollar and global political noise. During that time, there was a significant decline in expected earnings from U.S. companies, led by a collapse in energy-related earnings, such that the U.S. market valuation has been essentially flat. This is also consistent with our view that at 17 times earnings, the U.S. market is no longer cheap and further gains are likely to be driven more by earnings growth than by further increases in valuation. During the first quarter, U.S. companies posted low single-digit growth in earnings, beating expectations for a decline. As I write, we are just entering the second quarter earnings season and, as in the last quarter, expectations have been beaten down to a tad below zero, led by energy.

We expect that companies will once again surpass these lowly expectations, and that markets will start to price in a reacceleration of earnings growth as the U.S. economy bounces back from the first

quarter decline and the hit from lower energy prices and a strong dollar starts to fade (estimates for 2016 earnings growth are currently close to 12%). Therefore, we believe that equities and credit markets, particularly high yield, will have a stronger second half compared to the sluggish first half.

In terms of economic outlook, U.S. data continue to paint a picture of a herky-jerky recovery. The strongest results continue to come from the labour market, where the number of new jobs rebounded above the 200,000 level in June after dropping to 126,000 in March, while housing data and loan growth are also indicative of a broadening economic recovery. Against the backdrop of a slow tightening in labour markets and with further evidence that the U.S. has recovered from its first quarter soft patch, it still seems likely that the first rate hike by the Federal Reserve will come in September. At the same time, we would expect the Fed to emphasize that the pace will remain gradual so as not to cause too much consternation in rates markets. While we expect some increased volatility into the lead-up to the first rate increase, we would also expect that once the world doesn't come to an end following a mere 25 basis point increase, the markets will quickly settle down and begin to discount a gradual rise in yield curves.

In this environment, we would expect U.S. 10-year rates to rise from around 2.4% currently to about 2.75% by September and 3% at year-end. While this should leave broad rates markets with a flat return, to the extent that it is accompanied by an improving economic backdrop, it is unlikely to derail the modest earnings-driven returns expected in equity markets.

Europe

In Europe, beyond Greece, economies continue to bounce back from last year's recession as stimulus from lower energy prices, a weaker euro and quantitative easing (QE) by the European Central Bank (ECB) continue to have an impact. So far, there has been no negative impact on the broader European economy from the recent Greek drama, and should the Greek issue drift off the front pages in the coming weeks, we would expect the Eurozone recovery to remain on track. In particular, I would expect the engines of growth to be Germany, which is in great shape, and Spain, where the pain of recent reforms is fading and leaving plenty of room for catch-up growth. On a recent trip through Europe, I was pleasantly surprised to learn of the extent of Italy's economic reform agenda. Having passed electoral and labour market reforms, the country is pressing ahead with judicial and banking reforms, seeking to completely alter the way the country does business. While there is still a long way to go, my sense is that Italy could be the economic surprise of 2016 as the reform process begins to bear fruit.

Overall, while Europe should continue to exceed modest expectations in terms of its economic recovery, it is also clear that the ECB is closer to the start of its QE program than the end. As such, monetary policy will remain very accommodating throughout most of 2016. With the ECB keeping the monetary floodgates open and the Fed beginning to raise rates, we would expect to see further modest weakness in the euro. Most of the adjustment is behind us, however. At a meeting with ECB

officials in May, they mentioned that they were pleased with the early impact of the QE program and the level of the euro, which was trading around US$1.10 at the time. They also indicated that they were not comfortable when the euro had overshot toward the $1.05 level. However, we expect they would be happy to reach $1.05 over an extended timeframe.

Greece

Greek Prime Minister Alexis Tsipras appears to have reached an agreement with European officials on a third bailout aimed at keeping Greece in the Eurozone – for now. While the issue will continue to play out in Greece over months and years, it should cease to be a market-moving event in the short term. For Greece, passing the agreement will not fix its problems and fully reopening the banking system could still take months. The summer tourist season has been impaired, helping to plunge Greece back into a deep recession. The tragedy is that Mr. Tsipras and his Syriza party have ended up with a deal that was available months earlier, before the significant economic and social damage caused by shutting down the banking system. While it is not clear how badly the economy has been hurt this year, it will be substantial. The economy had already contracted 25% under previous programs, yet was on a recovery track prior to the election of Syriza.

While the agreement is positive for the broader European economy and markets in the short term, the mishandling of the whole affair and the glaring lack of leadership in Europe, particularly from Germany, has likely inflicted significant damage on the long-term outlook for the euro. It has highlighted the glaring lack of a fiscal and political union that is needed for a monetary union to function over the long term. This has been understood from the early days of the euro, and never has it been so obvious, yet the popular and political will to move toward more united Europe seems absent. Unless there is a dramatic revival of pro-Europe sentiment over the next five years, then we expect that the Eurozone will start to fray. The fact that officials formally discussed a process for Greece to exit the euro has opened a Pandora's Box. However, this is an issue that is likely to play out over the next three to 10 years. Still, politics is a funny and unpredictable business, so these underlying cracks and wounds could always become important sooner than people expect.

China

Once again the Western press was full of speculation of problems in China following the roughly 30% drop in the Shanghai stock market from mid-June to early July. While the policy reaction from Beijing clearly had a whiff of panic about it and undermined its commitment to developing freer capital markets, it is important to keep the issue in perspective. First, the domestic stock market has next to no relation to the underlying economy and is dominated by retail investors who see it much like gambling, often putting in money based on a hot tip and expecting a significant return within weeks. It is also important to keep in mind that only an estimated 5% of households actually have active accounts, so despite the large absolute numbers of retail investors, the market affects a small segment of the overall population and is less systemic than many fear. In addition, given China's

closed capital account, there is extremely limited participation by foreign investors. Most foreign equity investments are made through the H-share market traded in Hong Kong, which has not seen the same upside nor downside. Finally, while the Shanghai market did fall by 30% from its high, even at that point the market was up 8% for the year-to-date and by roughly 70% versus a year ago. This bubble was overdue for a significant correction.

We do not foresee the stock market decline having any impact on the underlying economy, especially given the short timeframe of the bubble and the correction. What might be of significance is any sign of a change in government policy regarding its commitment to market liberalization. Having acted as a cheerleader for the rise in the market, the government appeared to panic with policies aiming to prevent the sell-off. If this signals an unwillingness to tolerate market volatility, it might lead to a pause in the financial reform process. While a slight delay in China's reform timetable is not much of a concern, given that it was already a rather opaque process, we would be concerned if a more broad-based resistance to financial reform and liberalization were to emerge.

Trans-Pacific Partnership

Beyond Greece and China, another significant recent development was congressional approval in June of the Trade Promotion Authority (TPA), which clears the way for the Obama administration to conclude the Trans-Pacific Partnership (TPP) free-trade negotiations. While TPP talks have been ongoing for several years, without TPA, many countries were unwilling to put forward the politically sensitive concessions needed to reach agreement. There is now some urgency among key players, in particular the U.S. and Japan, to complete the deal this year, before the upcoming 2016 U.S. presidential elections sideline any hope of American approval.

In terms of scale, the TPP is massive, encompassing 12 countries and roughly 40% of global GDP. Most of the text and rules of the agreement have been completed, with the remaining issues being politically sensitive to at least one member. With minister-level meetings scheduled for the end of July, participants are expecting breakthroughs on these issues soon. Failure to finalize a deal by year-end would risk TPP being sidelined by elections in both Japan and the United States. While there are some sensitive issues for Canada, such as access to our supply-managed agricultural markets, we believe TPP will benefit Canada through increased access, better intellectual property protection and more transparent rules and regulations for trade across a broad swath of Pacific countries. We expect there will be increased attention paid to TPP issues in the second half of 2015.

Although not likely to be a market-moving event, a successful agreement will be positive for economies and markets in the coming years and will have economic and company-level implications that investors must recognize. One macro impact will be seen in Japan. For the past two years, we have cautioned investors about getting too enthusiastic about "Abenomics" in Japan as the hype far surpassed the potential. The TPP is a key part of Prime Minister Shinzo Abe's reform agenda. The global trade agreement is seen as a way for Abe to push through key structural reform

over the objections of entrenched interests, such as the agricultural and rice lobbies, while blaming foreigners. For many countries this is a tried-and-true method to implement domestically painful structural reforms that are required for longer-term economic efficiency and growth. Abe has staked significant political capital on getting TTP passed to help open a broad part of Japan's economy to the discipline of foreign competition and potentially higher growth. We would expect a successful TPP to reinvigorate some of the market enthusiasm that has ebbed from Japan as Abenomics has wallowed in Japan's legendary political quagmire.

Conclusion

We expect that global risk markets will have a decent second half in 2015, with global political drama fading, signs of modest economic growth returning in the U.S., and global monetary policymakers still on high alert to support the sluggish but enduring global recovery. Evidence of stability in key variables such as energy, rates and foreign exchange, along with some modest earnings growth, would support this view. In light of this outlook, we have started to change the defensive positioning of our funds, which was characterized by relatively high cash levels and significant underweight positions in energy and commodities. We recently increased our equity exposure by a modest amount, and added to our emerging markets positions.

This commentary is published by CI Investments Inc. It is provided as a general source of information and should not be considered personal investment advice or an offer or solicitation to buy or sell securities. Every effort has been made to ensure that the material contained in this commentary is accurate at the time of publication. However, CI Investments Inc. cannot guarantee its accuracy or completeness and accepts no responsibility for any loss arising from any use of or reliance on the information contained herein. This report may contain forward-looking statements about the funds, future performance, strategies or prospects, and possible future fund action. These statements reflect the portfolio managers' current beliefs and are based on information currently available to them. Forward-looking statements are not guarantees of future performance. We caution you not to place undue reliance on these statements as a number of factors could cause actual events or results to differ materially from those expressed in any forward-looking statement, including economic, political and market changes and other developments. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. ®CI Investments and the CI Investments design are registered trademarks of CI Investments Inc. ™Signature Global Asset Management is a trademark of CI Investments Inc. Published July 2015.