Signature Global Roadmap: Fourth Quarter 2013

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``Attention investors: what you have just witnessed was a false alarm. There is currently no taper in progress. You may now return to your desks. Thank you, the Fed."

The decision by the U.S. Federal Reserve on September 18 to postpone any reductions in its US$85 billion a month asset-buying program surprised markets. Not because it was premised on weaker-than-expected data – that had been apparent all summer – but because since May 22, Fed officials had effectively guided the market consensus away from the previous data-dependent messaging and toward a more calendar-driven timeline to commence tapering, and they had kept the view anchored on a September start right through the weakening data.

For a Fed intent on developing clear forward guidance as a key policy tool, this was a colossal failure, and clearly has and will cost it in terms of credibility as it seeks to guide markets in the future. However, officials also would have known this (they are not stupid) and so the question arises as to what changed over the course of their meeting to defer the decision in the face of the hit they would take to their credibility. That the economic data had been weaker than anticipated, and that the bond market reaction to the prospect of tapering had been more aggressive than anticipated or desired would not have been news to the Fed committee.

In our opinion, the additional swing factor was likely the deteriorating rhetoric and dysfunctional environment in Washington over the passing of the next budget and the debt ceiling. Better to wait and see if Washington deliberately crashes the U.S. economy into a wall before pulling the plug on quantitative easing. And rightly so as it turns out, with the government shutdown underway as I write. Therefore, the Fed has reverted to its original mantra that the process of exiting quantitative easing will be data dependent. From an economic perspective, this is eminently sensible and consistent with our argument earlier this year that tapering made more sense toward the end of the year than in September.

But, we want to emphasize that tapering has been delayed, not derailed. The summer months provided investors with a test run of what can be expected as the U.S. exits quantitative

easing on the back of an improving economy. While there is currently a bit of a relief rally for some of the assets that were hit the hardest over the summer, we do not expect markets to revert to their previous view of endless liquidity being pumped into the system. Regardless of the precise timing of the exit for quantitative easing, we have passed the inflection point for U.S. monetary policy and the actions of the Fed are merely changing the speed of adjustment, not the direction. We have entered a period of decreasing monetary stimulus, not increasing, and financial markets have to adapt. For investors, in a rising rate environment with improving economic fundamentals, equities should outperform bonds but with slower gains and more volatility than in the recent past.

U.S. Outlook

We are five years past the collapse of Lehman. Five years of increasingly aggressive monetary loosening. Five years of the U.S. economy grinding along in a slow, fragile recovery battered by the deleveraging of the worst financial excesses on the balance sheets of banks and households. After five years, the economy is poised for a pick-up in its growth trajectory.

The expectation was that the fourth quarter would provide evidence of a strengthening economy as the drag from the "fiscal cliff" tax hikes and the sequester in the first half of the year diminished. Indeed, most of the soft data, such as ISM surveys, leading indicators and confidence surveys, were all picking up going into September. Markets were anticipating that the hard data, such as employment, production and income, would confirm that the U.S. was heading toward a growth rate of 2.5% to 3% as we enter 2014.

While an improving economy remains our base case, political events are effectively pushing out the timing by about a quarter into early 2014. The prime culprit is the ongoing government shutdown and debt ceiling showdown. While the direct economic effect is expected to be minimal, it is more difficult to quantify the impact on both business and consumer confidence, and resulting delay in hiring and purchasing decisions. The longer the showdown lasts, the greater the impact will be. In the context of a fledgling economic acceleration, it does not take much to slow momentum. The offset to this delay is the decision by the Fed to delay tapering, effectively maintaining the liquidity-driven environment that has supported risk assets.

It is worth noting, however, that our view and the market's view is that the current setback will only delay the recovery story and not reverse it – not yet, anyway. This is critical, as a loss of market confidence at this point would be one of the key risks to our market outlook. Investors must also keep in mind that it is uncertainty that upsets markets most and that the potential for the uncertainty to evaporate with a solution to the impasse is also high. For Signature, having increased our cash weights over the summer, a further politically induced

pullback would be seen as an opportunity to deploy some of our cash back into equities. Sell complacency, buy crisis.

Europe

Europeans took the summer off from even mentioning any of the underlying challenges still facing the Eurozone as they collectively held their breath ahead of the German election in September, hoping that Frau Merkel would be re-elected. She was, and now needs to cobble together a new coalition government, as her previous coalition partner did not get any seats in the new parliament. This process typically takes a month or so. At that time, Europe can collectively exhale and relish the mirage of political stability and an improving economy. Indeed, Europe saw its first quarter of positive economic growth following six quarters of recession, prompting many to declare the crisis over and sparking a significant flow of investment into European bourses.

This is where a reality check is required. Yes, European equities had gotten too cheap and were ripe for a rebound, particularly as Europe is home to many strong global corporations, such as Nestle, LVMH, Bayer, Schneider, etcetera, which we own in our funds. But this is not the same as saying the European crisis is over. It is not! The economy is bouncing back, but we do not expect to see strong, sustainable growth going forward. We expect growth will rebound toward the range of 0 to 1% and fluctuate around that level for a few years as the European financial sector continues its slow, drawn-out deleveraging process. Lessons from Japan in the 1990s show that a failure to accelerate the recapitalization of the banking system derails the credit creation mechanism required to support stronger economic growth. The result is a series of short and shallow business cycle recoveries and very slow overall growth.

The challenge in Europe is that slow growth will be insufficient to absorb the record high unemployment levels or to pay down the record government debt levels in several of the peripheral countries. Both of these issues will return to centre-stage in 2014, when the reality of a subpar recovery becomes apparent. In the meantime, other challenges – such as the German constitutional court ruling on the European Central Bank's Outright Monetary Transactions (OMT) program, the start of the ECB's asset quality review and stress tests for the banking system, and Italian politics – all have the potential to break the current complacent attitude towards Europe. We expect that so long as the overall economy appears to be recovering, markets will remain complacent toward the structural challenges. It is only when the shallowness of the recovery becomes apparent, likely in the first or second quarter of next year, that we expect a renewed focus on the structural challenges facing Europe.

We like some of the companies and valuations on offer in Europe, but are skeptical that Europe is out of the woods. Europe is four years into what will be at least a decade-long restructuring process. We are currently in the complacency stage of the CRIC (crisis, response, improvement, complacency) cycle and we expect that ongoing crisis will be required to keep the restructuring agenda moving forward. Enjoy the calm; it will not last.

Japan

Our view on Japan has not changed. The Japanese have embarked on an unprecedented policy of monetary stimulus and government spending in an attempt to end 20 years of deflationary stagnation, but they remain unwilling or unable to make the difficult structural reforms required to improve the growth potential in the underlying economy. That failure to embrace reforms dooms the attempt to ultimate failure as the depth of the fiscal problems (debt of close to 250% of GDP, which makes Greece look good) trumps all.

Timing here is key. Japan's economy is seeing a strong cyclical bounce, having started from a very depressed level, an aggressive government stimulus package of about 2% of GDP, a much weaker yen flattering export earnings, and the Bank of Japan buying of REITs and equities, helping ignite an asset price bubble. In addition, with the government approving a 3% increase in the value-added tax as of April 1, 2014, spending is already being pulled forward and will be particularly strong in the first quarter of next year. But we expect to see the country head back toward recession as the tax-induced air pocket hits in the second quarter. The Japanese consumer is being hit with a double whammy of the tax increase and rising imported inflation, particularly in energy and electricity, while the government is aiming offsetting tax relief at corporations, with the hope that out of their good hearts, they will use the tax relief to increase wages and offset the squeeze facing consumers. While this may work in Japan, it is certainly not the way economies normally do!

All of this remains consistent with our view expressed in the piece "Japan: Die Another Day" published earlier this year. The only way we can see the charade continuing beyond 2014 will be to inflate a domestic property bubble large enough to attract and retain capital in Japan. The end game will be triggered when the domestic saver loses confidence and begins to shift assets out of the country en masse, triggering a currency collapse, rising rates and hyperinflation. While that is the most likely end game, it is also not yet imminent and may take many years unfold.

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Emerging Markets

Overall, many emerging markets had a rocky reaction to the expected withdrawal of monetary stimulus by the Fed. For most countries, the outcome of having to adapt to tighter liquidity conditions will be higher domestic interest rates, weaker currencies and slower growth than otherwise anticipated. All of which is consistent with how a structurally sound economy would be expected to perform. The trouble arises in structurally weaker economies that have been surfing the wave of global liquidity and avoiding difficult structural market reforms. For them, the change in monetary backdrop could be more severe. Countries at risk include India, Indonesia, Brazil, Turkey and South Africa. Their ability to regain market confidence and attract capital flows to fund current account deficits is not a certainty. It is worth noting that the recent delay of tapering by the Fed has bought time for these countries to adjust to these challenges. In that respect, the events over the summer may have served as a warning shot to governments that had grown complacent in an era of abundant liquidity. For more on our view on emerging markets, please see recent comments from Matthew Strauss, Signature's Emerging Markets Strategist.

Conclusion

Recent events in the U.S., such as the delay in Fed tapering and the federal government budget and debt ceiling impasse, have caused us to push out our economic recovery scenario by about a quarter into early 2014. The reaction of markets over the summer should be seen as a warning for what we can expect in 2014 as signs of a stronger U.S. economy result in the withdrawal of the extraordinary monetary stimulus currently in place. While the pace of the increase in interest rates has slowed, it has not been reversed. Investors should expect to see zero returns at best from government bonds in the coming year. For positive returns, we continue to like credit, where high-yield rates have returned to more attractive levels above 6%. While the best returns from equity markets may lie behind us, we continue to expect equities to outperform bonds in the coming year, albeit with greater volatility. While the global economy is healing and moving on from the financial crisis, many of the problems that were unearthed by the crisis, such as those in Europe and Japan, will not be resolved anytime soon. Any recovery will remain fragile. In such an environment, we want to take advantage of the volatility by adding to risk assets in times of perceived crisis and reducing our exposures in times of complacency.

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