Signature Global Roadmap:

Fourth Quarter 2015

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October 19, 2015

Cognitive Dissonance

We enter the final quarter of 2015 in the wake of significant volatility across almost all asset classes and geographies. As market pundits and news shows blare conflicting narratives, investors are wondering what the future holds. The confusion is understandable. Depending on where you look you can find dramatically differing signals as to the health of economies and markets. It is my sense that we stand at a crossroads, with many significant economic and financial cycles and trends changing direction. Key examples include commodity cycles, monetary policy and currencies. Such periods of transition tend to be both more perilous and opaque than times of economic stability. We also live in a time in which more information is instantaneously available than at any time in history. Within the resulting avalanche of information, the vast majority is noise that tends to obfuscate, rather than clarify, the situation.

Put in other terms, today's financial signal-to-noise ratio is extremely low. I would like to help cut through the noise of the irrelevant and focus on the signals that we at Signature feel are relevant in mapping our investment strategy for times of transition. When concerns mount or confidence falls, our approach is to protect capital first, and as I write, we remain defensively positioned across our portfolios.

There are two big shifts in the global economy that are driving the current angst in asset markets:

1) The changing trajectory of global monetary policy from seven years of progressive easing to an expectation of tightening, led by the U.S. Federal Reserve. Transitions from loosening to tightening tend to induce greater volatility, as they accelerate deleveraging, or the unwinding of broad carry trades that depended on low rates and low volatility.

2) A recognition in the market that the 15-year-long commodity supercycle is over and not coming back. While the drivers behind the collapse in energy and industrial metals are different, the end result is the same. Both sectors now face long-term structural oversupply conditions. This is the exact opposite of the past 15 years, during which excess demand drove prices relentlessly higher.

Either of these shifts on their own would have a major impact. Occurring together, they have injected significant turmoil, confusion and cross-currents into the global economy and asset

markets, contributing to the cognitive dissonance surrounding which parties will win or lose as the trends unfold. At a very minimum, the confluence of these two major shifts elevates the level of uncertainty about the likely paths forward in markets and economies. Companies, sectors or countries that relied on abundant, cheap capital and high commodity prices now face a significantly more challenging future. No party is more exposed to these trends than emerging market commodity producers, who find themselves in the crosshairs of not just one, but both of these trends.

But it is not a one-sided story. A balanced perspective recognizes that there will be beneficiaries of the current shifts. Keep in mind that the Fed is only talking about raising rates because the U.S. economy is actually doing well. And while commodity producers will get hurt from lower prices for their goods, commodity consumers everywhere will benefit. Just think of oil prices. A $50 drop in the price of oil can mean a proportionate drop in the prices paid by consumers at the gas pumps and a $50 drop in the amount of money sent to OPEC oil-producing states. So it's great for consumers everywhere, bad for OPEC.

Let's dig a little deeper into each of these trends and some of the broader implications.

Shift in monetary policy

While the Fed chose not to increase rates at the September meeting, it also clearly indicated a desire to start increasing rates, preferably before the end of 2015 and that its move will be data-dependent. Leaving aside the debate of, "will they or won't they," the Fed has communicated that it *wants to*. This is because the U.S. economy continues to grow above its potential at a pace of 2-2.5%. Unemployment is declining, and Fed models anticipate that the tightness in labour markets will begin to impact inflation levels as employers bid up wages to attract workers. In other words, rates need to be higher because the U.S. economy is quite healthy. The current growth rate may not be as fast as some would like, but we expect that this reflects a new slower but steady growth potential for the economy. Think of the U.S. economy as solidly stuck in second gear. We are not racing along in fourth gear, but we are nowhere near being stuck in neutral, let alone reverse.

This shift towards tightening follows seven years of ever-looser monetary policy since the financial crisis. The Fed itself technically shifted stance in 2013 when it began to reduce or taper quantitative easing. But through 2014 and 2015, while the Fed was tightening, both the European Central Bank (ECB) and the Bank of Japan (BoJ) significantly accelerated their monetary loosening. The BoJ upsized its QE program while the ECB engaged in QE for the first time. This combination was more than enough to offset the mild tightening from the Fed, and throughout 2015 global monetary conditions have continued to ease. But the tide of global monetary policy is now turning. As the Fed begins to raise rates – albeit very gradually – no other major central bank has the capacity to offset the shift in global monetary conditions. Those who were previously swimming with the tide are now swimming against it!

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Without a doubt, the biggest beneficiaries of the easing monetary tide have been financial players engaged in levered carry trade transactions that took advantage of the very low rates and, more importantly, the suppressed volatility associated with QE. They were able to borrow large amounts of cheap short-term capital to invest in higher-yielding securities and capture the spread or carry between the two rates, confident in the knowledge that the Fed would react if either rates or volatility threatened to escalate. For the Fed, the concern was a sluggish real economy that was too fragile to withstand higher rates or volatility, but the central bank created a backdrop that enabled participants to effectively game the system through the carry trade. (In itself this is not a bad thing, as such intermediaries are part of the transmission mechanism through which Fed policy impacts the real economy. But it can also cause problems when mixed with excessive leverage and a lack of regulation and risk controls, as we experienced in 2008.)

With carry trade positions building for seven years, the impact of such flows extended to significant cross-currency flows into high-yielding emerging markets. The shift in the monetary tide, along with the expectation of both higher rates and higher volatility, means that these trades are being unwound by many of the hedge funds and speculators. It is very difficult to know just how big the issue is, or how much further the deleveraging has to play out. It is our sense that this process of unwinding has been ongoing since the 2013 "taper tantrum," such that its impact need not be disorderly.

It is certainly our view that the size and scale of the current leverage buildup is nowhere near what led to the 2008 crash. However, the stress is clearly evident across emerging market debt and foreign exchange markets as capital continues to leave these countries. In several cases, emerging currencies have declined 30-40% against the U.S. dollar, while central banks have been forced to spend foreign currency reserves to slow the declines. The result is a significant tightening in local financial conditions. Several emerging markets such as Brazil are already in recession and we expect to see several emerging market corporate and sovereign credit events in the coming year. The big questions are: will the stresses in the emerging world tip over into the developed economies of the U.S. and Europe through slower growth? And will a tightening of financial conditions be sufficient to halt their sluggish economic recoveries? We shall see. If China can stabilize its economy at the current growth rate of 6-7%, which we believe is likely, then the problems in the rest of the emerging world will not be big enough to topple the current developed market recovery.

Commodity supercycle is over

Arguably, the more significant shift is the growing recognition that the commodity supercycle of the past 15 years is over, and unlikely to return. This is the biggest fault line running across global economies and markets. Companies, industries and countries that have relied on ever-rising prices for their commodities now face structurally oversupplied markets and falling prices. Those who cannot reduce their costs to break-even levels will be severely challenged. This

conclusion applies across most industrial commodity markets, including iron ore, coal, steel, and oil and gas.

For the industrial commodity complex, the driver is the end of China's infrastructure boom, during which the required infrastructure for a continental-sized economy was created in an incredibly short period of time. But it is done. Having largely built the cities, roads, bridges and rails to take China from rice paddies to a modern industrial economy, they do not have to build it again! There will be a continued need for further expansion and upgrading, but the commodities required will be far less than the 40-60% of global production that was needed to build the nation. Supply has now caught up to and surpassed the slowing pace of demand.

In truth, the peak was four years ago in the wake of China's post-2008 infrastructure program, during which the government spent four trillion renminbi (about US$600 billion) to counter the feared impact of a collapsing global economy. With it, China effectively pulled forward all shovel-ready infrastructure plans for several years to come, built many uneconomic projects and funded massive corruption in the process. The new leadership recognizes this stimulus was a huge mistake, continues to reverse some of the damaging side effects and remains strongly committed to shifting the economy away from fixed asset investment-led growth to a more services and consumption-led economy. There are early signs of success in this regard and it is our view that China has the resources and commitment to manage the transition. As such, the current fears of an economic hard landing in China are overdone. But it is a two-tiered economy. Those looking at services, e-commerce and consumption see a robust growing economy, while those looking only at the more traditional industrial metrics will perceive a hard landing. China will continue to see slowing but strong overall economic growth in the 6-7% range, but for those companies and countries exposed to China's industrial commodity demand, it is already a hard landing and unlikely to improve.

Before anyone says, "but can't India or other emerging markets replace China?" The answer is an absolute NO, not in our lifetimes. China's economy is substantially larger and there is no "next China" with the ability to drive the same volume of investment-led growth. Only India can rival China in population, but India's economy is about 20% the size of China's and has a crippling bureaucracy that inhibits the pace of growth. We do expect India to grow at a reasonable pace, but not with the same commodity-intensive style.

Unlike the industrial commodities, oil prices dropped in half only a year ago. The seeds of oil's demise lie in the U.S. and its ability to respond to elevated oil prices by harnessing technological innovation and financing to tap vast new sources in an economical manner. The shale oil revolution has returned the U.S. to peak oil production levels after 40 years of decline, and in so doing ruptured the ability of the OPEC cartel to control pricing. From an economic perspective, the emergence of the U.S. shale industry represents a supply side shock that has returned oil to a market-determined pricing structure.

In such a market, the price of oil should settle around the cost of the marginal barrel of oil. In other words, how much does it cost to produce the next available barrel of oil? That barrel today comes from the U.S., but the true marginal cost for the shale industry remains unclear. The industry and the technology are still new. Producers are trying to increase efficiencies and cut costs but there are still a lot of variables involved, including the level of the U.S. dollar. With prices bouncing around the US$40 range – below what we believe is the sustainable cost – the industry is in the process of determining what the cost dynamics look like. We expect to see significant consolidation in the North American energy patch as higher-cost producers retrench and cash-strapped players are forced to sell to stronger ones. The capital discipline enforced by lower prices will help curtail supply from higher-cost producers and drive the industry back into balance. We suspect that at $60, however, many producers will be encouraged to once again increase production, making $60 a likely price ceiling in the near term.

For many companies that have borrowed excessively or oil-dependent countries running budgets that require oil prices of $90 or higher, this will result in massive pain. Entire Middle East countries will swing from surplus to deficit while companies such as Petrobras will creak under bulging debt levels they can no longer serve. Corporate defaults and sovereign credit stress are a given in the coming year if prices remain below $60, as we expect they will.

Here, the questions that arise are similar to those posed by the capital flight from emerging markets. Will the damage and defaults from the energy and commodity complexes cause significant contagion to the broader markets and economy? And will that damage offset the otherwise reasonable growth prospects in the developed economies of the U.S. and Europe?

The key channels of contagion that we monitor from these trends are twofold. The first and easiest to comprehend is the real economy, where falling demand from emerging markets as well as falling investment and jobs in the oil patch are a direct hit to the economy. But there is an offsetting benefit from lower commodity and energy prices for consumers, which can act as a broad-based boost to real incomes. While not an exact measure, consuming nations will tend to benefit while commodity and energy-producing nations will be adversely impacted. Across the developed world this will be predominantly positive, although not so much for Canada, while OPEC countries and other commodity-skewed economies such as Brazil and South Africa will be significantly affected. In our opinion, from a broad market investment perspective, lower energy prices will be a net positive for the global economy and should act as a gentle tailwind in coming years.

The second and more pernicious channel of contagion is financial markets. Capital flight based on increasing fears of defaults and general uncertainty will serve to tighten financial conditions across all geographies and sectors. The primary avenues of contagion we monitor are global, particularly U.S. credit markets, where both investment-grade and high-yield spreads have been jumpy and widening through the summer and early fall. While a repricing of credit in the more

challenging sectors is to be expected, there is a risk that rising uncertainty and unwinding carry trades will force a much broader and wider backup in credit spreads for all sectors of the economy. It would be through a broad deterioration in the health of credit channels that the contagion from emerging markets and commodity industries could infect otherwise healthy segments of the economy enough to imperil the current economic recoveries.

This is not a done deal! But for Signature it is a key dynamic we continue to monitor. To the extent that capital markets and volatility settle down, and credit markets continue to fund at healthy levels, it will be a signal that markets are managing the transitions in a healthy manner. Markets are performing as they should in their role of allocating capital across the economy and the risk of contagion is ebbing. As it does, we will increase our exposures to risk assets. But to the extent that the contagion and volatility feeds on itself and stresses continue to grow in credit channels, the risk of significant damage to an otherwise healthy fundamental outlook for developed economies and markets will rise. It will be the resolution of the current cognitive dissonance between the underlying developed economies and the state of global sovereign and credit channels that will determine our risk appetite in the coming quarter.

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