

Market Commentary

Second Quarter 2018



Signature Canadian Balanced Fund

The second quarter of 2018 was dominated by rhetoric from the Trump administration on tariffs and trade wars. It began as a trade dispute but deteriorated into a trade war by the end of the quarter. The tariffs continue to be part of a tactic to drive concessions from U.S. trading partners, including China, Europe, Canada and Mexico.

Canada generally fared well amid the growing uncertainty, on account of the energy sector in particular and materials, both late cycle sectors.

Growth in the U.S. remained robust, enabling the U.S. Federal Reserve (Fed) to continue tightening monetary policy by raising interest rates for a second time this year at its June meetings. As U.S. monetary policy continued to diverge from the rest of the world and put pressure on the global cost of capital, U.S. corporate bond spreads and emerging market bond spreads steadily widened. Despite these developments, the Fed signalled intentions to raise interest rates two more times before the end of the year. Clearly, the hurdle for the Fed to cease hiking is significantly higher than in 2013 (with the taper tantrum) or in 2016 (with the deflation scare).

The Bank of Canada hiked interest rates in January to 1.25% and in July to 1.50%. A combination of mixed economic data throughout the second quarter as well as business uncertainty induced by NAFTA re-negotiations persuaded the Bank of Canada to proceed with caution in its hiking cycle.

Canadian investment-grade corporate bonds widened four basis points in the second quarter of 2018 due to a general selloff in risky assets, but much less than U.S. investment-grade bonds which were +14 basis points wider due to shareholder-friendly merger and acquisition activity. Canadian investor demand for corporate bonds remained good given new issuance volumes running at record levels.

Performance – equities

The fund performed well during the quarter. Consumer discretionary and energy were the main contributors.

In consumer discretionary, Canada Goose was an outstanding performer. The company recently offered its shares to the public and posted outstanding results, a testimony of the increasing popularity of its brand both in Canada and internationally. Canada Goose announced a major expansion program to increase production and meet the growing demand for its products. We

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reduced our position on account that cash flow will be negatively affected by the expansion in the short term and that the stock, in our opinion, got ahead of itself.

Our long-term position in Amazon continued to perform well as it moves into new industries, the most recent being pharmaceutical drug distribution. The company is continuing on a path of further disruptions in established industries.

Energy also performed well on the back of higher oil prices but just as importantly, it was catching up since energy equities previously lagged the underlying oil price. This was one of the conundrums going into 2018. Oil prices have been rallying since the most recent lows in mid 2017 but oil-related equities were lagging significantly, indicating markets were sceptical on the sustainability of the move in oil. Some, but not all of the gap was closed in Q2 with energy equities rallying strongly. Strong performance in the energy sector was obtained from a collection of individual companies like Encana, Suncor Energy and Devon Energy.

Uncharacteristically, information technology was a detractor as the holdings in the portfolio underperformed. Blackberry and Samsung Electronics were both detractors in the quarter.

Performance – fixed income

The total return outcome of the portfolio was primarily driven by a modest drop in longer-term Canadian interest rates with some support coming from select Canadian government and corporate credit spread exposure.

Residual currency exposure was the most significant contributor to performance, while duration and yield curve positioning was the main detractor.

Within the spread product arena, corporate credit exposure was alpha accretive, offset by the effects of government credit positioning.

U.S. dollar exposure net of hedges was supportive for alpha, as the U.S. dollar gained ground against the Canadian dollar over the quarter. Portfolio foreign currency positions are actively managed through a hedging overlay.

Duration and yield curve positioning subtracted from portfolio alpha, coming from the underperformance of our U.S. duration exposure relative to Canadian duration, and the flattening of the Canadian yield curve. The 10-year to 30-year segment of the Canadian yield curve flattened eight basis points during the quarter, while the U.S. 10-year yield rose some seven basis points more than its Canadian counterpart in the same timeframe.

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Portfolio duration is moderately short, featuring an underweight in the 10-year to 20-year area of the yield curve. Provincial bonds are used to manage this yield curve position while collecting better income. In the spread product sphere, we are cautiously overweight corporate credit, underweight Canadian government agency debt, and retain long positions in U.S. inflation-linked bonds.

In the second quarter, we lowered Canadian duration mainly in the 10-year area of the yield curve. Late in the quarter, we sold our U.S. agency mortgage holdings, moving some of the duration back to the Canadian market.

Outlook

We continue to monitor developments in global trade wars although we would note that global growth remains constructive. Until there is more clarity on trade negotiations for NAFTA, Brexit, and U.S.-China, we expect volatility to remain elevated and note that the probability of downside risks across global capital markets has risen. Therefore, we stand ready to manage these risks in the portfolio by adding duration (interest rate exposure) and/or reducing exposure to spread risk premia.

Class F Returns (in %) as at June 30, 2018	Year-to-date	1 year	3 year	5 year	10 year
Signature Canadian Balanced Fund	1.5	8.6	5.4	8.1	6.3

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