Market Commentary
First Quarter 2018

Signature Income & Growth Fund

The S&P/TSX Composite Index was one of the worst-performing stock markets globally in the first quarter of 2018. Financials were generally weak, led lower by diversified financials and life insurance amid a pause in interest rate hikes. In addition, the energy sector was particularly weak despite higher oil prices. This was not unique to Canada. In the U.S., both oil services and exploration and production energy companies were also down. In normal circumstances, the two sub-sectors perform in line with energy prices. The likely explanation is the lack of investor confidence in the sustainability of higher oil prices.

Broad market performance across ratings was commensurate with credit risk (e.g. CCCs outperforming Bs; BBs outperforming BBBs, etc.) which would be expected in a spread-tightening environment. However, in the first quarter it was correlated with duration as the U.S. yield structure increased despite equity volatility. Typically, duration falls in sync with credit ratings but the first quarter was anything but typical. Cross-asset correlations and volatility spiked (i.e. portfolio diversification failed) as U.S. government bond yields moved higher. Whether it was increased T-bill supply on larger budget deficits, front-end corporate bond selling as U.S. companies repatriated foreign profits, or increased funding costs causing leveraged carry trade unwinds, there were few places to hide. The spread on the ICE BofA ML U.S. High Yield Index increased 11 basis points (to +382 basis points from +373 basis points) although the all-in yield increased 51 basis points to 6.35%.

Spreads for risky assets, in particular corporate bond and emerging market debt (U.S. dollar debt), widened in the first quarter of 2018, but are still significantly below their long-term averages.

Performance: Equities

Financials detracted from performance with Wells Fargo and Synchrony Financial leading the decline. On the order of regulators, Wells Fargo is not allowed to grow its balance sheet following the sales scandal that erupted in 2016. Meanwhile, credit-card company Synchrony is being affected by higher charge-offs, a sign that credit quality is deteriorating. We remain positive on both stocks. Wells Fargo is a quality name that is finding its way and now trades at a discount to peers. Synchrony is a quality company in which charge-offs may be rising but from a low base that doesn't threaten its current positive outlook. We believe markets are over-reacting to the downside.

On the positive side, information technology was a contributor to performance with a positive showing by Micron Technology and Alibaba. We continue to hold both names. In the consumer sector, Amazon was a strong contributor during the quarter. The stock started to correct at the end

of the quarter after U.S President Donald Trump tweeted negative comments about the giant retailer. We believe this is also overdone on the basis that the president has limited power to directly intervene in Amazon's business.

Performance: Fixed income

The total return outcome of the portfolio was primarily driven by the drop in longer-term Canadian interest rates, offset by a significant widening of Canadian government credit spreads.

Overweight exposure to inflation-linked bonds was beneficial for alpha, given their outperformance relative to their respective nominal government benchmark bonds. Corporate credit selection and underweight government credit positioning was also alpha accretive, with 10-year Ontario spreads widening some nine basis points during the quarter.

A contributor to performance was Getty Images; we own the 7% bonds due 2020, and the L+350 term loan due 2019. Getty Images is a global leader in stock photography and digital images. The debt securities, previously trading well below par, rallied as the prospect of early refinancing gained steam with investors.

Duration and yield curve positioning subtracted the most from portfolio alpha, due to the underperformance of our U.S. duration exposure relative to Canadian duration. U.S. 10-year yields rose some 29 basis points more than their Canadian counterparts during the quarter.

Outlook

We remain unenthusiastic about the Canadian market. While Canadian banks remain solid, they offer limited upside. Meanwhile, the energy sector isn't benefitting from higher oil prices, at least for now.

The outlook for global equity markets is cautiously positive given the favourable economic backdrop and continued easy financial conditions, even if at the margin these will begin to tighten. Our lack of concern in the face of higher interest rates resides in the fact we remain in the early stages of any rate hikes, especially with respect to Europe and Japan. Nevertheless, this remains a delicate balance because a faster pace of rate hikes has the potential to derail markets. Our base case is that rate hikes will remain measured because inflation will remain contained.

Although risky assets have pulled back due to rising interest rates and an increased risk of a trade war on numerous fronts, global growth remains constructive. We continue to advocate a well-diversified portfolio of exposure as the best way to navigate the current environment in fixed income, including duration positioning across different portions of the yield curve, credit spreads, interest rate volatility and inflation compensation.

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High-yield bond credit risk, valuations and sentiment are neither in the polar region nor the tropics, therefore subject to the trade winds of larger asset classes. And that is not a coincidental choice of words, as trade policy and the escalating rhetoric between the U.S. and China is a risk to growth in 2018.

Class F Returns (in %) as at March 31, 2018	Year-to-date	1 year	3 year	5 year	10 year
Signature Income & Growth Fund	-1.4	6.0	4.1	7.5	6.7

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