Market Commentary
Second Quarter 2018

Signature Income & Growth 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.

Inter-rating spread compression was the theme of second quarter trading behavior as investment-grade bonds widened 13 basis points (ICE BofAML U.S. Corporate Index) and emerging market bonds gapped out 62 basis points (JP Morgan Emerging Market Bond Index) but high-yield bond spreads were unchanged (although yields were 18 basis points higher at 6.53% to end the quarter). For example, spreads on high-yield countries like Turkey, Argentina, and South Africa were at their widest levels since Q4 2016, while CCC spreads – the lowest rung of performing high-yield corporate bonds – were at their lowest levels since Q3 2014. Typically, these asset classes move together but the breakdown in correlation can be attributed to dramatic flows, supply and quality differences. There is a note of caution warranted here about drawing conclusions from markets and indexes dominated by both large issuers and idiosyncratic risk.

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Performance – equities

Consumer discretionary and energy were the main contributors during the quarter.

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

Performance 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.

The financial preferred shares we own in lieu of a higher weight in fixed-rate high-yield bonds were a drag on performance, caught up in the same rise in short-term U.S. dollar funding that has caused European and Asian-based investors to sell higher-rated bonds as after-hedged yields are now less attractive.

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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.

Portfolio duration is moderately short, featuring an underweight in the 10-year to 20-year area of the yield curve. 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. The high-yield bond market lacks both positive and negative catalysts and is subject to broader risk sentiment. 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 Income & Growth Fund	1.8	9.1	5.8	8.4	6.7

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