Market commentary
August 2016

Adrenaline shot for capital markets

Eric Bushell, Chief Investment Officer

I've had enough of the military analogies for unconventional monetary policy, bazookas and all that. It's time for something new to freshen up this dull global deflation story. I just watched the clip from the movie *Pulp Fiction* where John Travolta plunges a massive adrenaline shot into an unconscious Uma Thurman's chest and thought, that's more like it!

Truly, it is more like it. Travolta marked his target with a red felt pen, wound up and delivered the hormone dose straight to the heart. It worked – an instantaneous recovery.

On March 10, our favourite deflation fighter, European Central Bank President Mario Draghi, performed the same operation with an eight billion euro injection directly into Europe's financial bloodstream. The ECB pushed the plunger on its new Corporate Sector Purchase Program (CSPP) – full dosage adrenaline shots into euro-denominated corporate bonds that are set to continue indefinitely. The innovation of directing asset purchases into risk assets, rather than solely government bonds, paid handsomely; the rally in corporate credit globally from that point forward has been unprecedented. Critically, the spillovers were immediate into the U.S. credit market, magnifying the stimulus tenfold. North American issuers promptly diverted their issuance to Europe to take advantage of the depressed funding costs and, in so doing, reduced supply in their home markets. (To be fair, the upturn in energy markets played a role in the credit inflection as well.) The CSPP stimulus proved to be potent in combination therapy with the steady morphine drip of government bond purchases in Japan and Europe. An added benefit from Mr. Draghi's perspective was the assistance this provided to European Union banks after his own move to negative interest rates had mangled bank profitability and was straining funding costs. After the July 2012 outright monetary transactions and the EU's quantitative easing in February 2015, Draghi's March 2016 CSPP was his finest work as a deflation fighter – scoring particularly high marks for creativity.

And then there was Brexit.

After the vote and before markets opened on June 24, central banks committed themselves fully to preventing any dislocations in financial funding markets. The U.S. Federal Reserve, by extension, was expected to be on hold nearly permanently, given the legitimately bad political and economic consequences of Brexit. Sovereign bond yields mechanistically and appropriately collapsed, particularly in the U.K., where rate cuts are anticipated. Elsewhere, long-dated bond yields fell sharply as bond investors capitulated to the "deflation forever" view, and reached for yield in the last spot where it existed – the long end. Vast quantities of sovereign bonds broke the zero-bound barrier, inflicting

excruciating pain on financial entities with duration mismatches in their portfolios. The abrupt Brexit rate shock delivered a second adrenaline shot into a financial system that was still quivering from the first.

The financial body was weak coming into 2016. Signature had described the markets of 2013 through 2015 as a carry unwind cycle, with fixed-income capital generally retreating from risk markets to safety and liquidity. This capital flow lifted the U.S. dollar and punished emerging markets and commodities. The dual adrenaline shots of 2016 are reversing that flow: risk-free asset yields below zero and skinny credit spreads are driving investors back into emerging market bonds – ourselves included. Having withstood the carry unwind and Brexit quake with remarkable poise, emerging market bonds, with their fat yield pickups over Treasuries, look appealing. Hints of lower correlation to risk and reduced U.S. dollar currency sensitivity also drew capital back to emerging market bonds. Yield curves from China to Chile have fallen a lot this year, with a further step down post-Brexit. Easier financial conditions in the world's growth geographies are an indisputably positive development.

As the credit and rate declines took effect, equities with predictable, long-duration cash flow were revalued, as seen in the utility and consumer staples sectors. Equity markets have broadly rallied alongside bonds as discount rates declined. Equity volatility fell at a record pace as income seekers sold volatility risk for income. Much was made of the new highs on the S&P 500 Index, but returns in the 18 months since January 2015 have been a meager 3.8%, while the Nikkei and Eurostock 50 indexes remain down 7% over the same period. Overall, policy responses to shocks have retained their effectiveness in driving risk appetite across markets.

What's next?

What lies beyond the double adrenaline shot? A continuation of lacklustre growth and political upheaval, or a merger wave fuelled by cheap funding as we experienced in the 2003 leveraged buyout boom? In fact, the answer is likely both, which makes the point that financial market-directed stimulus strategies have run their course and are not getting through to the real economy. The distance of sovereign yield curves above zero, the distance of credit curves above sovereigns and the distance of emerging market yields above Treasuries are three key measures of how much adrenaline is left in the vial. The vial is nearly empty.

A shift in policy from monetary to fiscal measures, as has been taken in Canada and is being discussed in the U.K., would not be so bullish for bonds. U.S. inflation would rise and bond supply would increase. A change in inflation targets or helicopter money would surely shift expectations about inflation. So we need to be wary about bond exposures and bond proxies in our funds. Our transition from nominal to real assets must continue.

Market commentary

We have advocated retaining bond exposure for years due to our deflationary view. We championed credit on our spring roadshow, with appropriate kudos to Mr. Draghi. In the recent Brexit rally we cut back our allocations to government debt, held our corporate credit and added some U.S. dollar-denominated emerging market sovereign bonds.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. This commentary is published by CI Investments Inc. It is provided as a general source of information and should not be considered personal investment advice or an offer or solicitation to buy or sell securities. Every effort has been made to ensure that the material contained in this commentary is accurate at the time of publication. However, CI Investments Inc. cannot guarantee its accuracy or completeness and accepts no responsibility for any loss arising from any use of or reliance on the information contained herein. This report may contain forward-looking statements about the funds, future performance, strategies or prospects, and possible future fund action. These statements reflect the portfolio managers' current beliefs and are based on information currently available to them. Forward-looking statements are not guarantees of future performance. We caution you not to place undue reliance on these statements as a number of factors could cause actual events or results to differ materially from those expressed in any forward-looking statement, including economic, political and market changes and other developments. This commentary is provided as a general source of information and should not be considered personal investment advice or an offer or solicitation to buy or sell securities. ™Signature Global Asset Management is a trademark of CI Investments Inc. Published August 2016.