Market Commentary

Signature
GLOBAL ADVISORS

Eric Bushell, Chief Investment Officer of Signature Global Advisors, was part of a panel discussion at the Morningstar Investment Conference on June 6, 2012. Here is a summary of his remarks.

View of the U.S. economy

The financial crisis gave U.S. corporations an opportunity to restructure, resulting in a profitability and competitiveness "shock" to the U.S. This extensive restructuring has not occurred anywhere else and has reset U.S. competitiveness, with a reduction in wages, labour power, housing costs, and so on.

This newly competitive U.S. economy is a major threat to Central Canada, which needs to adjust its competitiveness, hopefully through currency adjustment and not just wages and asset values.

Why the U.S. market is more attractive than Canada's

It's not just a matter of valuations. There is growing recognition that the Canadian market is poor in diversity, liquidity and quality of issuers. There are very few large, globally competitive Canadian companies any more, with numerous takeovers over the past decade or so. Investors are rightly questioning the relevance of the TSX as a benchmark.

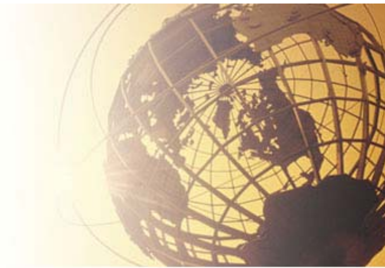
The situation in Europe

European banks lost access to debt markets last fall while facing billions in debt maturities early this year. So the ECB yielded and made a trillion dollars in loans to the banks. So it's already been a dangerous situation and financials are the primary channel of risk transmission throughout the global economy.

Resolving the solvency of the banking system is key and there is extraordinary pressure on the Europeans to do so. So it makes sense to adopt deposit insurance schemes and so forth, but it remains very difficult and complex, as are solutions to the overall crisis. The leaders understand where the endpoint is but they may not be the leaders as this goes on.

What we are finding is that austerity and deflation don't function well with democracy. Look what's happening in Montreal with the smallest little adjustment in tuition fees. There could be a lot of unpredictable changes in who's at the table in Europe and how this plays out.

The preconditions for the core to provide guarantees are balanced budgets, recapitalized banking systems and standardized social safety nets. As we de-fund overly generous social safety nets in the



Western economies over the next several years, we're going to have social and political chaos. And that is the most tragic aspect of this leveraged banking mess.

The path of political least resistance may be to allow inflation to spread that cost across the whole system, support income and asset levels and grow their way out of those nominal debt liabilities.

For investors, that means do you want to own real assets or nominal assets and at what point do you shift from one, epitomized by the fixed-rate government bond, to the other, epitomized by the house or the commodity or equity.

Implications of a Greek exit from the euro

The notion that the euro could come undone is already contributing to a restructuring of the financial system. Even a 5% chance of an exit from the euro will prevent banks in the core from lending to the periphery because of the risk of huge foreign exchange losses on those loans. The banks will want to reorganize so that any loans to the periphery are supported by deposits in those areas.

Current opportunities

We like technology and health care. Selected companies have strong balance sheets, generate good cash flow and have global opportunities but little competition from emerging markets. Their valuations have been declining for the past decade so they are much more focused on creating shareholder value.

We are also seeing that large corporations, particularly in the U.S., have a big cost of capital advantage, contributing to a "winner take all" environment. So even in a stagnant environment, selected companies will do well. Grainger is just one example of a company taking market share and increasing profitability.

Investment managers have become focused on macro developments in recent years, and that's been necessary to run money competently, but there are still company-specific opportunities.

Recommendations for older clients who still need some growth

A portfolio of high-quality, investment-grade dividend-paying global equities offers higher yields than government bonds but with growth potential. That plays in to my "strong get stronger" view. Shareholders are demanding more return of capital from companies through dividends and share buybacks and more and more companies will be increasing their dividends.

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View on Canadian interest rates

In an integrated global economy, central banks are pinned down by low U.S. interest rates because they are afraid to boost their currencies. If global conditions stabilize, the rate structure in Canada should move up.

Greatest concern and encouraging sign for investors

The pace of deleveraging matters. Regulators and policymakers can smooth the path and make it less disruptive. To the extent there are no shocks from the financial system, the rest of the world can move on. It's all about the Pacific – Asia and Latin America. There have been a lot of lessons learned from the Asian crisis and the economies there are so much more robust. I'm of the view that North America can right its ship and hitch it to Asia. An example is how Canada is trying to reorient its energy industry to meet Asian demand.

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