Market Outlook
Fourth Quarter 2017

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Drummond Brodeur, CFA
Senior Vice-President and Global Strategist
Signature Global Asset Management

While you were sleeping

As we enter the final quarter of 2017, Signature's Humpty Dumpty thesis continues to unfold[1]. A key conclusion of the thesis is that the global economy has emerged from a decade of rolling crisis management as policy makers grappled with the reverberations triggered by the 2008 global financial crisis. The world is now in the midst of the first true synchronized economic recovery in over a decade as all major regions are in expansion mode. Unlike in the original nursery rhyme, all the kings' central bankers have put Humpty together again, and he is indeed back on the wall.

With the crisis decade now over, central bank support, particularly in the form of monetary policy, is being slowly removed. As with any recovering patient, it's important not to withdraw the medication too quickly and risk a relapse, but rather slowly wind it back at a pace consistent with the patient's improving health. In our view, following the monetary policy errors of 2014/2015, global central bankers are well aware of this sensitivity and that the withdrawal of monetary stimulus will be synchronized globally and proceed gradually. With weak inflation continuing to confound econometric models, central bankers for now have the luxury of continuing in a slow and cautious manner. In a nutshell, global economic and investment fundamentals remain constructive and supportive of risk assets, with equities being the most attractive asset class.

Following a decade of rolling crisis and policy responses, the global economy is returning to a more normal environment, and investors must respond accordingly by shedding their acute concerns and defensiveness regarding when the next economic crisis will erupt. Economically, the world is more stable, and the recovery is broad-based both geographically and across economic sectors. It's arguably the most balanced recovery we have seen in several decades. Investors must understand the evolving breadth and depth of the global recovery and position portfolios accordingly.

This isn't to imply that investors can simply revert to a pre-crisis approach to investing, nor pile headfirst back into risk markets without understanding what new risks may be lurking. There are four key elements that are fundamentally different to how the world looked a decade ago.

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[1] See Signature's video blog: Regime change to Humpty Dumpty.

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Every investor must understand the emerging risks and implications of these issues as they will be instrumental in determining investment outcomes in the years ahead. While you were looking elsewhere, these key developments emerged:

- Real risk-free return is ZERO!
- Technology and digital disruption is impacting all business models
- China is moving aggressively to dominate the high-tech industries of tomorrow
- Geopolitics and populism is a global phenomenon.

Real risk-free return is ZERO!
This, in my opinion, is the biggest challenge for savers and investors everywhere. Despite the strength and breadth of the global economic outlook, we remain in an environment of incredibly low interest rates compared with the last 50 years. While interest rates have risen above the all-time lows reached in July 2016, at 2.3% today for the U.S. 10-year Treasury bond, they reside materially below the levels during the last expansion in the 2000s of 4-5%. In both Germany and Japan, the yield curve is negative beyond the seven-year mark. So while the global economy may be back to normal, interest rates clearly aren't.

Even with most major central banks on or approaching a tightening path, no-one, including markets, central bankers or ourselves expect rates to reach anywhere close to the levels of past cycles. While the ultimate pace and final level of interest rates will depend on how the economy unfolds in coming years, the current estimates from the U.S. Federal Reserve (Fed) indicate the overnight rate will reach a neutral level around 2.75%, while market estimates are even lower. My own view would peg it around 2.5%. For reference, during the last cycle the Fed funds rate peaked above 5% in 2006/2007. Most of the economic work, including that from the Fed, indicates that the neutral real rate of interest in the U.S. economy today is roughly zero. The real rate is simply the nominal rate of interest you see, less the rate of inflation. In other words, it is your return above that which is required to protect the purchasing power of your investment. For long-term investors, it's the real rate of return that matters.

The intricacies of the neutral rate are academic and beyond the scope of this commentary, but it has huge implications for investors and how they position portfolios. Historically, through 1980 to 2008, the real yield on 10-year government bonds was 2-4%. In other words, investors could receive a 2-4% return above and beyond the level of inflation by parking money in the risk-free government bond market, or a 4-6% return if one assumes a 2% inflation rate. A risk-averse investor or the risk-averse portion of your portfolio was paid to hold risk-free assets. This was awesome! Investors will miss that environment even if they haven't yet grasped its significance. Today, the return on risk-free assets is ZERO after the impact of inflation is taken into consideration, and inflation matters as it's the most insidious and silent killer of long-term savings. Investors looking for or requiring a long-term return greater than the ongoing loss of purchasing

power can no longer avoid investment risk; instead they must consider how to manage alternative forms of risk in a manner most likely to enable them to achieve their desired savings objectives. This is the reality that we face today and, likely, for years to come. Zero or negative interest rates are a tax on savings and investors must recognize this new reality and manage both expectations and portfolios accordingly. We must rethink risk. There is no easy answer.

Technology and digital disruption

Over the past decade, as the world was recovering from the global financial crisis, the power of Moore's law[2] on the costs and compounding power of technology continued to ramp up at an exponential rate. The power of semiconductors has collapsed the cost of computing while the evolution to cloud-based architecture makes computing available on demand to anyone. What computers couldn't even accomplish only a few years ago can now be achieved for less than the cost of your morning coffee. We see it every day in the power of our smartphones and as we find ourselves increasingly ordering online without even thinking about it. But in the background, entire business models and industries are being disrupted – think of the music, media and retail industries as key examples, or of Amazon, Facebook and Netflix as examples of disruptors. Every industry will face both new opportunities to harness digital capabilities or threats from digital disruption from both existing, more-adaptive players and from new entrants. Investors must pay attention and do their homework if they want to invest in a manner that keeps them ahead of digital disruption.

China 2.0

The third area that has changed has been the ongoing evolution of China's economy, which has grown exponentially since 2006. Today, China is close to a US$12 trillion economy, second only to the U.S., and growing at three times the pace. It remains the single biggest driver of global domestic product growth and will continue to be for many years to come. But unlike the 1990s and 2000s, when China fueled the global commodity super-cycle as it sucked in over 50% of global commodities to build its continental-sized economy, the China of today and tomorrow is a very different beast. China is now investing aggressively to be the leader in the industries of tomorrow. The country's e-commerce market is already twice the size of the U.S. and increasingly mobile. It also has the world's largest market for electric vehicles, and is home to two-thirds of global solar production capacity, as well as to 28% of the world's renewable energy capacity. Investment in research and development, and advanced education is rapidly propelling China up the ranks of innovation in leading areas. According to the National Science Foundation, an independent U.S. federal agency, the number of scientific papers published by China has increased from 6.4% of the

[2] The American Heritage® Science Dictionary defines Moore's Law as the observation that steady technological improvements in miniaturization leads to a doubling of the density of transistors on new integrated circuits every 18 months. The 18-month pattern held true into the 21st century, though as technology approaches the point where circuits are only a few atoms wide, new technologies, possibly not involving transistors at all, may be required for further miniaturization.

global total in 2003 to 18.2% today, way ahead of Japan at 4.7% and in line with the U.S. at 18.8%. In the coming decade, China 2.0 isn't just about commodities but about being the leader in innovative industries and business models. Western players must watch for not just the opportunities in the Chinese market, but also for the competitors set to emerge and become global players[3].

Geopolitics

Investors can't completely ignore the rise of populism, and the impact and threats from a clear shift in the geopolitical outlook. I could debate the many nuances of any given issue from Trump to Brexit, Macron's Europe or North Korea – the topics are endless. We spend a lot of time and resources monitoring and seeking to understand the implications and likely outcomes of all of these. However, we always do so by analyzing the probabilities through an economic and investment lens, not a broader social lens. We recognize the broad social implications and, believe me, from a longer-term perspective this is the most troubling juncture the free world has seen in several decades. But if you try to invest using a sociopolitical lens, you will get your face ripped off! (Yes, that is a technical market term!).

Sound investing requires correctly analyzing the economic and investment fundamentals. That is what will drive investment returns over the one to three-year time horizon. The question has to be how a given political issue will impact the economic outcomes in that timeframe. As discussed, the economic fundamentals today are as favourable as they have been in decades, and most of the political events that could adversely impact economic outlooks are either lower probability or more localized events, rather than global in perspective.

Despite all of the brinkmanship and sabre rattling, even the threat from North Korea remains a lower probability of a truly adverse outcome. Both sides know a military option is unacceptable to their own interests and, while certainly not impossible, would be accidental in nature, not by design. In the U.K., Brexit is far more of a local issue than a global one, while Macron's win in France has clearly shifted the political discussion in the Eurozone area away from dissolution toward a discussion of how to improve its stability. While there will be no easy progress, the fact remains the direction of debate has shifted entirely in a more positive direction.

In the U.S., the current administration has achieved nothing and that is unlikely to change materially. But here again, the discussion has moved from the self-destructive health care debate to attempting tax reforms, or at a minimum some tax cuts. While very little is likely to be achieved in this arena, there are also no great expectations in the market; nor does the current economy need further stimulus. If some form of tax bill is pulled through Congress, it's unlikely to have a

[3] See Signature's blog: China's sputnik moment

significant economic impact, but will most certainly be positive for risk assets. As always, it will be the actual details that will matter, but we're still a long way off.

Conclusion

Our Humpty Dumpty call this past summer was a recognition that the world has emerged from a decade-long crisis-fighting era, post the global financial crisis. The period of crisis is over and we have emerged into a new economic cycle. For now, the economic outlook remains constructive of risk assets as the global economy is into its second year of synchronized recovery. The acceleration may be over but growth remains both healthy and broadly distributed geographically and by sector.

With an improved economic backdrop, central banks have begun to tighten monetary policy from the extremely easy conditions implemented in recent years, while the sluggish pickup in inflation means the pace of tightening will be gradual. This remains a favorable backdrop for risk assets. Signature portfolios remain close to the upper ranges in equities exposure (with a cyclical tilt), and underweight government bonds. While equities valuations aren't cheap at 15x globally, they are supported by strong earnings growth (+15% in 2017) and offer an attractive equity-risk premium in the face of still very low interest rates everywhere.

Despite our belief that we're returning to a more normalized economic cycle following the ravages of the recent credit cycle, we also see significant new challenges facing investors that caution against believing all is rosy going forward. Major shifts have occurred in the past decade – in terms of economies, markets and the political landscape – that we expect to result in significant new challenges for investors going forward. The first step in navigating these challenges is recognizing the world has changed and seeking to understand the implications for our investors. Signature's unique team architecture, encompassing over 50 investment specialists across all asset classes, industries and geographies puts us at an advantage in helping our clients navigate the challenges.

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