Signature Market Roundup

Global outlook

Drummond Brodeur
Senior Vice-President,
Portfolio Management,
and Global Strategist

Perhaps the most surprising aspect of the global economy as we enter 2014 is that almost every region is on a clear cyclical upswing. We are in the midst of a synchronized global economic recovery. Economic growth is accelerating and we can comfortably expect that global growth will be stronger this year than in 2013. After five years of recurring crises following the collapse of Lehman Brothers, this improvement and stability are unambiguously positive. Indeed, for the first time in several years, there is no obvious crisis looming. Last year, it was the U.S. fiscal cliff and two years ago, it was the Eurozone debt crisis.

On the heels of a year in which most global equity markets returned more than 20%, it is safe to conclude that, at least for now, the extraordinary monetary medicine administered by central banks has been effective and global economies are healing. With confirmation of a stronger economic trajectory, particularly in the U.S., the next step is to wean the patient off the monetary "drugs" and allow the economies to stand on their own. This process – the so-called tapering in the U.S. – will dominate markets in the first part of 2014. With the U.S. dollar being the global reserve currency, U.S. policy will affect virtually all countries' interest rates and currencies in some capacity. This year will show which economies have made adjustments and will be able to withstand the start of monetary policy normalisation and which have not made the transition.
While the year has started with a synchronized cyclical recovery, we expect the regions to take significantly differentiated structural growth paths. In short, we see the U.S. posting stronger and more sustainable growth. Europe, having bounced out of a long austerity-induced recession, will transition toward a stagnant low-growth environment, as bouts of fiscal austerity and financial sector deleveraging set the backdrop for the ongoing political negotiations on the future of the Eurozone. Meanwhile, Japan's experiment with monetary magic will face its first real test with a consumption tax increase hitting consumers on April 1.

A similar divergence is expected in the emerging economies. The key country is China, where the new government seems intent on rolling out an aggressive structural reform agenda to help transition the economy to a greater reliance on consumption and services rather than fixed-asset investment. Although China's leaders clearly understand this will ultimately mean slower growth, they are seeking to maintain growth this year near its current level of 7.5% to support the transition.

Most other emerging nations will benefit from the pick-up in the global economy, but just as in the developed world, some economies are on a sound foundation for sustainable growth while others have avoided the necessary structural reforms and simply benefited from the twin forces of loose global liquidity since 2009 and booming commodity prices prior to 2008.

Equity markets had a stellar 2013, as liquidity trumped fundamentals, driving valuations higher on the back of modest earnings growth. We expect 2014 to see a return to fundamentals as the primary driver of returns. In such a scenario, equities should continue to outperform other asset classes with expected returns of 8% to 12% for the year. As rates rise, we also expect to see higher volatility compared to the past year, with a couple of significant market corrections in the range of 10%, providing opportunities to add value from a tactical perspective.

For currencies, we expect the divergence in economic growth, coupled with diverging monetary policies from key central banks, to support the U.S. dollar against most major currencies, including the Canadian dollar.

Emerging markets

Matthew Strauss
Vice-President, Portfolio Management,
Portfolio Manager
and Global Strategist

The last quarter of 2013 started off on a strong note for emerging market equities, but upward momentum stalled as the quarter progressed. Nonetheless, the gains in the quarter ensured that these markets ended the year in positive territory as measured in Canadian dollar terms. However, measured in U.S. dollar terms, returns were slightly negative. Apart from the sharp sell-off in May and June 2013 and the subsequent recovery in September and October, emerging equities as a group traded in a narrow range of between -2% and +6%.

However, within this group wide performance discrepancies were recorded. These performance differences were most evident in the strong outperformance of India and Mexico in the fourth quarter and markedly lagging performances by Thailand and Turkey. Economics played a lesser role in explaining these variances, while politics featured strongly. Politics, along with growth expectations, will be key domestic determinants of performance in 2014. From this perspective, we continue to favour emerging countries with stable politics, a political environment that is conducive to structural reforms, healthy fiscal balance sheets, positive current account balances and improving growth prospects. Mexico and the Philippines stand out in these respects.

Although domestic developments are important, the change in U.S. Federal Reserve policy and the changes in U.S. Treasury yields may easily overshadow local developments in emerging economies and may result in a challenging investment environment in emerging markets during the next few quarters, especially for those countries that are dependent on easy and cheap global liquidity, i.e. those running current account deficits with limited monetary and fiscal policy flexibility such as Brazil and Indonesia. However, given the structural differences amongst many emerging economies, we view periods of extreme bearishness as an opportunity to selectively add to holdings in structurally stronger emerging economies. For the latter economies, the focus remains on domestic sectors such as consumer, health, education and financial services. For the weaker and more vulnerable economies, export plays and company specific developments remain key themes.

Resources

Scott Vali
Vice-President,
Portfolio Management
and Portfolio Manager

In 2013, investors continued to focus on macro events that could disrupt equity markets and commodity markets in particular. The belief that the beginning of tapering by the U.S. Federal Reserve would lead to a dramatic reduction in emerging market growth kept participants in commodities markets close to the exits. However, commodity prices remained robust, confounding the skeptics. Specifically, China continued to show strong demand for commodities.

In North America, the year began with crude trading at historically high discounts to global markets, as pipeline constraints and disruptions met renewed domestic crude supply growth. Many commentators felt that this large discount was the new normal and North America was expected to be awash in oil. However, as we entered the summer months, the discount turned to a premium, with robust demand from domestic refiners and additional rail capacity removing the bottlenecks. Against this backdrop, U.S.-listed exploration and production equities rallied as production growth, increasing resource capture and higher oil prices were recognized by the markets. Global crude prices remained high as tensions in the Middle East increased and production disappointed, benefiting many of the large integrated producers. Additional pipelines will enter service in North America this year, allowing more northern crude to access the refining systems of the Gulf Coast. This should be of particular benefit to heavy oil producers.

Natural gas remained rangebound, with heating demand driving the price higher. However, more recent gains in the front-month contracts for natural gas have been offset by further declines in longer-dated contracts due to the anticipation of additional supply as pipeline constraints in the Marcellus shale region are mitigated. At the beginning of 2014, the natural gas curve is flat at just over US$4 per mcf (1,000 cubic feet). Western Canadian producers should benefit from higher natural gas prices through 2014 as last year's realized prices were very low due to a tolling arrangement implemented by TransCanada on its main line, which should not be repeated this year.

Chinese steel production and consumption grew beyond most forecasts in 2013. This led to record-high demand for iron ore, which supported prices above market expectations. We expect iron ore prices to decline but remain above their long-term averages, benefiting low-cost producers. Copper prices were equally strong as Chinese demand surprised to the upside, leading to one of the largest counter-seasonal inventory drawdowns through the summer of 2013. Inventory remains near the lower end of historical levels and we believe prices should remain supported.

Gold and gold equities were the worst-performing asset class. Given our base case assumption of continuing slow non-inflationary global growth, we expect gold prices to lag again in 2014.

Overall, as we enter 2014, we continue to believe that selective opportunities will present themselves in both the materials and energy markets. We are watching closely events in Indonesia, where new regulations on processing raw commodities could reduce the exports from this important supply source. This could have meaningful implications for the alumina, nickel and copper markets. In addition, recently announced and unexpected zinc mine closures could push that market into deficit.

Technology, media and telecommunications

Malcolm White
Vice-President,
Portfolio Management
and Portfolio Manager

Technology was a tale of two sectors in 2013. Higher-beta names and names tied to the Internet did extremely well. Twitter had a very successful IPO, unlike the problems that Facebook suffered the prior year, and a bid to all names, including Facebook, lifted valuations in 2013. Investors liked the high growth rates and high barriers to entry so much that they were willing to stomach the extreme multiples that Internet companies command. Older technology companies, in contrast, underperformed. There were a litany of problems, including secular downturns in segments such as personal computers and a slowdown in government and enterprise spending.

In the year ahead, we expect that this dynamic reverses. We are already seeing that, although PC spending is not as robust as it was historically, growth is bottoming and product segments such as ultra-portable are interesting as consumers and businesses alike consider refreshing dated models. Valuations here are cheap relative to the entire market, which could make last year's underperformers this year's go-to stories.

In the telecom sector, there was a large uplift in sentiment in European wireless. The acquisition of Vodafone's Verizon Wireless stake and the hope of a new EU regulatory framework that would make acquisitions easier lifted multiples in the region on the speculation of further market consolidation. Canada was the opposite: investors endured more uncertainty as it became clear that the Canadian government was trying to encourage more competition. The large telecom companies in the U.S. were notable relative underperformers, with Verizon digesting its huge acquisition and AT&T rumoured to be buying the rest of Vodafone. The outlook for the sector is somewhat binary now depending on whether or not AT&T proceeds with the acquisition of Vodafone.

In media, the interest in global media assets continued as investors gravitated to sectors expected to improve with the global economy. Weak advertising trends appeared to have bottomed in Europe and this put a bid to advertising-linked assets in this region, which had good performance in 2013. U.S.-based names continued to grow as the U.S. economy trended upward. Acquisitions of several cable operations in Europe have raised multiples in this region and this trend continues in the U.S. with the proposed acquisition of Time Warner Cable by Charter Communications. Unfortunately, it seems that too much good news is priced into this sector now and we are taking a more cautious approach as emerging markets are still weak and growth rates for developed markets, while improving, are still somewhat muted.

Consumer

Stephane Champagne
Vice-President, Portfolio Management, and Portfolio Manager

In 2013, the S&P 500 Index was up 30% but underperformed its consumer discretionary index by 1,100 basis points and outperformed its consumer staples index by 700 basis points. The consumer discretionary index reflected higher spending on hard goods such furniture and appliances, a positive consequence of the home improvement cycle. The defensive staples index lagged due to the increase in bond yields during the year, weak volume in U.S. and the impact of currency devaluation in emerging markets.

During the fourth quarter, consumer activity in the U.S. produced decent results, as consumer confidence increased due a positive stock market, higher property values and an improving job market. In December, retail sales were above consensus but were driven by promotional activities at the expense of margins. According to ShopperTrak, holiday sales rose by 2.7% from the same period a year ago and consumers in U.S. spent US$266 billion on holiday items this year, compared with $259 billion a year ago. Year over year, segments such as general merchandise stores, clothing and accessory stores and online retailers showed accelerating growth in December. On the other hand, building materials, home furnishings, sporting goods and electronics showed a decline. For the first quarter, we expect continued improvement overall, with clothing stores being a notable exception. The consumer discretionary should continue to be supported by low food inflation, the positive trends in the homed improvement sector and the lower unemployment rate.

In Canada, we expect consumption to remain slow as disposable incomes remain under pressure due to high consumer debt and slow housing activity. For Europe, consumption trends will also remain subdued. As a result, we favour U.K. domestic consumer stocks as the economy and retail sales have continued to recover. We also favour large-cap European consumer names for their global footprint. In Latin America, consumer fundamentals are being affected by higher inflation, higher interest rates and currency depreciation versus the U.S. dollar. We continue to favour Mexican and Andean consumer stocks.

In Asia, Chinese consumption will remain under pressure for the first half of the year, with the government transition moving slower than expected. We remain positive on the Chinese consumers for the long term, due to secular growth and low stock valuation among the emerging market regions. Finally, Southeast Asian retail consumption should remain slow, due to currency depreciation (Indonesia), political issues (Thailand), and the negative impact of the recent natural disaster in the Philippines.

In 2014, we continue to favour sectors supported by sustainable fundamentals, strong global brands, free cash flow generation and return of capital to shareholders.

Industrials

Joe D'Angelo
Vice-President, Portfolio Management, and Portfolio Manager

The environment in 2013 for most industrial companies was one of slower than expected revenue growth, which was offset by better cost performance and resulted in earnings that were broadly in line with expectations.

While share price performance was very strong in general, this was driven mainly by multiple expansion rather than earnings growth. Companies that focused on gaining market share, improving productivity, and improved free cash flow generation tended to outperform. For yet another year, companies held off on making acquisitions, preferring to announce larger buybacks and higher dividends, which rewarded shareholders.

In 2014, we expect earnings growth in the sector to accelerate as the global economy improves. We notice chief executive officers becoming a little more confident about opportunities for growth; therefore, we expect capital expenditures to increase. With improved confidence, we believe acquisition activity will pick up this year as well, particularly when companies compare this alternative to buying back stock at current levels. We also expect to see more meaningful improvement in the U.S. non-residential construction market, in addition to a continuation of solid growth in the housing market.

Although capital expenditure trends are expected to improve this year, it is in the context of a structurally slower global economic growth environment when compared to historical cycles. As a result, investments will focus on productivity, technology, market expansion and replacing of old equipment, while cost-efficiency initiatives remain an active driver of earnings growth.

In summary, we are feeling incrementally more optimistic about the growth prospects for industrial companies as we head into 2014. However, we will continue to closely monitor the macro environment globally and company-specific news throughout the course of the year. Lastly, while valuations have moved to the upper end of historical levels, given the relatively low interest rate environment and better growth prospects in the near term, we don't believe that they have become too stretched at this point.

Real estate

Ryan Fitzgerald
Vice-President, Portfolio Management, and Portfolio Manager

Rising interest rates have had a profound and varied effect on high-yielding securities. While high-yield bonds held up very well in 2013, Canadian REITs had a rough ride, and at year-end traded at wider-than-historical spreads. A further rise in rates is already at least partially priced in to these securities.

Going into 2014, we are holding relatively high cash weightings, and feel we can afford to be patient in waiting to invest at the right price. For example, we recently increased our investment in Plazacorp, a small, well-run REIT that is the preferred developer for Shoppers Drug Mart in Eastern Canada. Plazacorp went through a period of cash flow stagnation in 2013, so when a large block of the company came up for sale in the fourth quarter of 2013, Signature was one of the few buyers. We were able to dictate a price 6% below the company's trading value at the time. We feel confident that we can find and participate in similar deals in 2014. Notably, we expect to find more opportunities in the emerging markets, where valuations have dropped sharply with the rise in U.S. bond yields.

Preferred shares

John Shaw
Vice-President, Portfolio Management, and Portfolio Manager

In the fourth quarter of 2013, the Canadian preferred share market could not overcome retail investors' tax-loss selling in the first half of December. Preferred shares posted positive returns in October and November following the U.S. Federal Reserve's decision not to taper its $85 billion a month quantitative easing program in September. Most other risky assets rallied throughout the quarter on the Fed decision to wait for signs of further strength in the U.S. economy and employment. Thus, when the Fed did announce in late December that it would begin tapering in 2014, the capital markets took it as a good sign that the economy could continue strengthening on its own.

Canadian preferred share investors remain concerned about the degree to which interest rates are going to rise as the Fed tapers over the coming quarters and thus are requiring higher dividend rates for new deals. The market is continuing to differentiate between ratings and the re-set spreads on rate re-set structures. This can be seen in the lower returns for the broader TSX Preferred Index compared to the higher-quality BMO 50 Preferred Share Index. Institutional investors have been supporting the higher-quality issuers as they have money to put to work. Issuance remained lighter than normal with only six issues totalling $1.065 billion during the quarter, while there were two redemptions for $330 million, for a net issuance of $735 million. However, there have been announcements that another nine issues worth $1.85 billion will be redeemed in in early 2014.

The BMO 50 Preferred Share Index posted a negative total return of 0.18% during the fourth quarter, led by floating rate shares, down 5.56%, and rate re-sets shares, down 0.19%. Retractable and straight preferred shares bucked the trend by posting positive returns of 0.64% and 0.70%, respectively. For 2013, the index posted a negative total return of 1.23%, which was the first negative year since the financial crisis of 2008.

The outlook for the preferred market is mildly positive from these levels with our expectation that Canadian preferred shares will provide a total return in the range of 3% to 4% in 2014. The Bank of Canada and the U.S. Fed have indicated that short-term rates are on hold even as the Fed has begun tapering. Redemptions in 2014 are going to be a major positive catalyst for higher-quality bank preferred shares, as an estimated $5.4 billion or 8.7% of the entire preferred share market is likely to be redeemed. However, this could be tempered by issuance of preferred shares that meet new international rules for non-viable contingent capital (NVCC) later in the year, as well as by fears of rising interest rates.

Interest rates

Paul Simon
Vice-President, Portfolio Management, and Portfolio Manager

On October 1, 2013, the U.S government entered the 18th "shutdown" in its history. The failure of Congress to agree on a budget for the new 2014 fiscal year presented a new set of uncertainties for economy watchers. Data released during the third quarter did not depict the acceleration in demand that many analysts had expected. Due to the budget impasse, disruptions to government procurement spending and public sector pay would further cloud the outlook. The government closure also interrupted the flow of key economic releases monitored by the Federal Reserve to gauge economic well-being, all but ensuring that the body would not begin reducing its asset purchase program of $85 billion per month at its October meeting.

The Washington drama did very little, however, to upset strong investor appetite for risk. When a budget deal was struck in mid-October, U.S. Treasury bond yields were little changed, investment-grade credit spreads were 10 basis points tighter, and U.S. equity prices were 2% higher than they were at the beginning of the month. After several weaker releases, the economic data eventually validated some of that optimism as monthly hiring grew to 200,000 per month and headline GDP growth trended near 2.5%. With that backdrop, the Fed chose to begin reducing its asset purchases at its December meeting from $85 to $75 billion per month, an equal-weighted reduction between Treasury and residential mortgage purchases.

Meanwhile, there is a clear divergence in monetary policy between the Federal Reserve and the Bank of Canada. The Canadian economy continues to expand moderately but at a slower pace than the U.S. due to several factors that neither the monetary authority nor government deems to be sustainable in the long term. Traditionally reliant on export-led growth, Canada has developed a persistent trade deficit of 3% of GDP that does not appear to be improving with stronger growth by its largest trade partner and the pricing of Canada's chief exports has been weak. Instead, recent strength has been driven by the economy's weakest link – a housing-fuelled, heavily indebted consumer. As a result, the Bank has recently dropped language from its policy rate statement implying that it would be raising its key rate at the earliest possible opportunity and the Canadian dollar weakened 3% over the quarter.

The Federal Reserve has communicated an intention to end asset purchases before the conclusion of 2014, provided that the current economic expansion continues apace. This eventual withdrawal of bond market support is likely to result in higher volatility in interest rates, but the bond market itself is better positioned for tapering than it was in the summer, and it may be best for the central bank to wean investors off quantitative easing while there is better data with which to justify doing so.

Foreign exchange

Matthew Strauss
Vice-President, Portfolio Management, Portfolio Manager and Global Strategist

Another quarter and another strong performance for the U.S. dollar as U.S. treasury yields continue to march higher with 10-year yields increasing from 2.5% late in October to 3.0% at the end of the quarter. The dollar appreciated against most emerging market currencies and a number of developed market currencies, including the yen and the Australian and Canadian dollars. The yen, however, continued to lead the declines amongst developed market currencies and ended the year 17% lower against the U.S. dollar. European currencies, on the other hand, held their own against the U.S. dollar during the fourth quarter. For 2014, a generally stronger U.S. dollar, especially relative to European currencies, might well be the dominant currency theme for the year as the U.S. Federal Reserve continues to scale back its asset purchase program. As far a the euro is concerned, further monetary easing by the European Central Bank in the Eurozone could weigh on the euro after the currency defied expectations in 2013 by strengthening against the U.S. dollar.

The Canadian dollar started the fourth quarter at a relatively strong level of 97 U.S. cents, up a few cents from the lows recorded in August. The Canadian dollar slid to 93 cents during the quarter and ended 2013 near the lows of the year with U.S. yields increasing and Canadian economic activity disappointing. We see a continuation of this weakening trend in the Canadian dollar, a trend that could last into 2015.

As seen during the initial "tapering scare" in the summer of 2013 and again after the December tapering announcement, vulnerable emerging market currencies remain very sensitive to shifts in U.S. yields. The currencies of Brazil, Turkey and Indonesia lost 6% against the U.S. dollar during the fourth quarter. These currencies, including the South African rand, remain particularly vulnerable in the current environment given their dependence on foreign capital inflows to finance current account shortages. Thus, despite already sizable depreciations in 2013, these currencies face a challenging 2014.

Investment-grade corporate bonds

John Shaw
Vice-President, Portfolio Management, and Portfolio Manager

Investment-grade corporate bonds posted positive returns during the fourth quarter and outperformed government bonds as tightening spreads overcame the rise in interest rates. The market remained focused on when the U.S. Federal Reserve would begin tapering its bond-buying program. Risky assets rallied throughout the quarter on the Fed's decision in September not to taper, but to wait for signs of further strength in the U.S. economy. When the Fed did announce in late December its plans to begin tapering, the capital markets took it as a good sign that the U.S. economy could continue strengthening on its own. Europe continued to post positive economic news and move slowly on its banking reforms. Investor sentiment improved dramatically as the quarter unfolded, which supported corporate bonds.

Fundamentally, North American corporate credit remains very good, but leverage is rising at non-financial companies and management teams need to find ways to support their stock prices. With revenue growth slow and having already implemented cost-cutting plans, management must either hunt for M&A targets or increase leverage to drive earnings per share higher. The best times for credit investors are behind us for this cycle. There is still money to be made in credit markets, but it will depend more on specific credit events than on movements in the overall market.

The Canadian investment-grade index returned 0.94% for the fourth quarter, outperforming government bonds by 78 basis points. This was mainly due to spreads tightening 11 basis points. Spreads tightened steadily throughout the quarter because of the Fed's decision to delay tapering until January 2014. Investment-grade credit spreads are now on average at the bottom of the range in spreads since the financial crisis. As well, investor sentiment improved as the amount of new issuance slowed as the year-end approached.

The outlook for investment-grade credit remains positive for 2014. We believe that corporate bonds will outperform government bonds, but the degree of outperformance will be lower than the 300 basis points achieved in 2013. The U.S., U.K. and European economies are improving, investors continue to search for yield and are more comfortable that any back-up in interest rates will be a result of higher economic growth, which is good for credit. However, individual name and issue selection will be very important as managements in general undertake increased leverage and M&A activity.

High-yield bonds

Geof Marshall
Vice-President, Portfolio Management, and Portfolio Manager

What does it mean when high-yield bonds returns are "call constrained"? High-yield bond issuers, on the belief they are on a trajectory of improving credit quality, want the option to refinance high-coupon debt prior to maturity. High-yield bond investors grant this right, but at cost of a redemption price above par. The typical high-yield bond has an eight-year maturity with a call beginning in year four – at price of half of the coupon (i.e. a 7% bond due in 2022 would typically be callable starting in 2018 at 103.5, with the redemption pricing falling each year afterwards).

In an environment like this, where the credit cycle is well advanced and valuations are supported by low rates, low economic growth and low defaults, high-yield bond returns can become capped by their call price. Further credit quality improvement may be likely, but further valuation improvement (or spread tightening) becomes less likely. This is because as the yield on a callable bond decreases, price appreciation is capped by the call price as the effective maturity of the bond drops to the call date. All else being equal, spread tightening on a shorter duration bond is going to result in less price gain than spread tightening on a longer duration bond.

This is where we find ourselves in 2014. Fundamentals are supportive; earnings growth should continue and a significant increase in defaults is not on the short-term horizon but generally, most bonds are trading on top of their call price. Technicals are also supportive as new issuance in 2014 is likely to be lower than last year. That said, rising Treasury yields are a headwind for all fixed-income investors, although as I have said in the past, high-yield bond spreads have a historically negative correlation to rates and can do much better than other types of bonds. All told, these factors could add up to a mid-single-digit return in 2014, a middling return that could be the best in fixed income.

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2 Queen Street East, Twentieth Floor, Toronto, Ontario M5C 3G7 I **www.ci.com**

Head Office / Toronto	Calgary	Montreal	Vancouver	Client Services
416-364-1145	403-205-4396	514-875-0090	604-681-3346	English: 1-800-563-5181
1-800-268-9374	1-800-776-9027	1-800-268-1602	1-800-665-6994	French: 1-800-668-3528

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