Market Roundup

Global outlook

Eric Bushell
Senior Vice-President,
Portfolio Management
and Chief Investment Officer

My focus in 2012 will remain on funding and refinancing risks.

The extreme overhaul of the financial system is triggering dislocations and obstructions in the flow of capital through critical global funding channels. Banks and debt markets matter – and they are not functioning properly today.

Cross-border bank lending is shrinking, as are cross-border credit markets. Why is this?

Pressure on European Union banks to shrink their balance sheets has led them to exit multiple international markets in order to preserve the core. This reversal of international loan growth is a global pattern as governments re-appraise the contingent liability risks embedded in their deposit insurance guarantees. Loan losses abroad could force rescues by taxpayers, as it did in Ireland. No finance minister can run such a risk. Hence the decree – "Renationalize the loan book."

Apart from banks, credit markets are exhibiting similar behaviour. Global companies that have historically accessed funding in Australia through Kangaroo bonds, or in Japan through Samurai bonds are finding less local appetite. A trend toward home bias has arisen as bond investors re-assess the risks. The U.S. debt market is the linchpin. If U.S. dollar debt markets begin to ration credit availability by geography, or rating bucket, borrowers with refunding needs may find themselves without a chair when the music stops. All financial markets will take a cue from this development.

Interest rates

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

The story on global government bond markets remained unchanged in the fourth quarter. The market is ruthlessly distinguishing between viable credit-worthy nations and, to varying degrees, all the rest. The transition that's occurring in First World countries as they shift away from a society financed on debt is proving to be stressful. The days of ever increasing leverage across the private and public sector are over. This is having, and will continue to have, an enormous impact on the structure of the global economy.

Bond yields in North America stayed depressed for most of the second half of 2011. Nominal interest rates are still well below current rates of inflation. This is a hefty cost for safety and liquidity as it implies an erosion of purchasing power over time. But it also represents a significant savings to heavily indebted borrowers such as the U.S. and U.K. governments. Various forms of quantitative easing by central banks continue to exert downward pressure on yields.

Rating agencies have put all of Europe on negative watch and downgrades seem likely. This was after the European heads of state failed to deliver enough progress toward a tighter fiscal compact between the Eurozone nations. Spreads of bonds of AAA nations such as Germany, France and Austria have stabilized, but are at historically wide levels. Refinancing rates for Italy and Spain have been extremely volatile and the European Central Bank's open market purchases of these countries' bonds have done little to ease apprehensions in the private sector.

Global outlook

Drummond Brodeur
Vice-President,
Portfolio Management
and Global Strategist

Following a highly volatile 2011 in which markets were driven by macroeconomic events, our expectation for 2012 is for a continuation of the trends we have been navigating since 2009. The crash of 2008 marked the end of a 30-year cycle driven by falling interest rates, increased globalization, deregulation and leverage in a world of U.S.-dominated political and economic stability. Significant global economic imbalances in competitiveness between countries led to unprecedented buildups in current account deficits in the consuming countries – U.S. and peripheral Europe – and massive pools of savings in the current account surplus countries – China, Germany, and some emerging markets. Many of these trends are now unwinding. Market volatility and ongoing political and social crises are symptoms of these imbalances. Global rebalancing, deleveraging, the rise of emerging markets and the demise of the U.S. middle class are interrelated and reflective of the rebalancing that must occur. The economic rebalancing, along with the required difficult political decisions, will take months and years to play out. This volatility offers opportunities for portfolio managers to add value and protect capital through more active tactical asset allocation. Company fundamentals and valuations remain attractive in absolute and relative terms, compared to other asset classes such as government bonds, which trade close to record highs.

The year will likely be characterized by ongoing political realignment in Europe as the European Central Bank looks for clearer commitments from sovereign governments to restructure their fiscal situation before becoming more explicit in loosening policy. If the ECB stepped in and alleviated the current sovereign debt crisis, the political will to restructure would be lost and the problems deferred to another crisis in the future. More of a worry in Europe is the ongoing policy-induced recapitalization of the banking sector that is forcing a credit crunch and virtually guaranteeing a recession. It is also threatening a global contagion through interconnected global credit channels. This is our key worry, but we continue to believe that unlike 2008, policymakers are well aware of the risks and will act to mitigate any escalation.

Within the U.S., 2012 will be a year of ongoing economic improvement which will be favourable for equities, offset by volatile sentiment from the paralyzed and dysfunctional political process. With 2012 an election year, nothing can be expected out of Washington before 2013.

In China, the two-year policy tightening to slow the economy has begun to bear fruit. The economy and inflation are both slowing and policymakers have started to loosen as they shift their focus to supporting growth. We are in the camp expecting a soft landing as China retains significant conventional policy tools. At the end of the day, increasing consumption and reducing savings is easier than reducing spending to pay down debt and deleveraging. We expect China to continue to tighten on the property side, a trend that will continue to haunt commodity markets.

For investors, the rules are changing. They can either recognize the change and adapt, or fail. At Signature, we focus on trying to understand the evolving investment landscape and the implications for our investors.

Emerging markets

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

Emerging market equities struggled to sustain rallies during the first half of 2011 due to tightening monetary policy across many economies. The second part of the year, especially the third quarter, saw equities declining sharply as European debt concerns spilled over into a global flight to quality, and away from riskier and perceived riskier assets.

Emerging market equities underperformed the developed market in U.S. dollar terms, despite stronger economic fundamentals than the U.S. and Europe. March and October 2011 were the noteworthy exceptions and the latter could well be a curtain-raiser for 2012, if some sense of stability returns to global markets. European developments will be pivotal in determining the pace and timing of this expected development, although the importance of policy decisions in emerging markets must not be underestimated. On the downside, if the European problems and deleveraging cycle continue to adversely affect global funding markets, emerging market equities will struggle, particularly in countries that run current account and government deficits. We believe the countries most at risk are India, Turkey and South Africa. Brazil might also fall into this category if the global funding situation deteriorates dramatically.

Acknowledging the global and European risks, we are positive on emerging markets and look for opportunities during the early part of 2012 to deploy cash – if and when the macro and financial pictures improve. We continue to favour China and Brazil over emerging Europe. Also, we prefer local plays, such as consumer and health care, over pure export exposures.

Resources

Scott Vali
Vice-President, Portfolio Management and Portfolio Manager

North American natural gas prices continue to be depressed as increasing supplies are met by lacklustre demand. The continued drilling of wells in North America saw a supply increase of 6% year-over-year to the end of November. The industry continues to shift to liquid-rich natural gas plays away from dry gas reservoirs. Wells with higher liquid contents improve the well returns as the production captures some oil pricing. (Prices of liquids such as condensate, propane, butane and ethane are tied more closely to oil.) The higher the liquid content, the better the pricing realized by the producer. Liquid-rich wells are allowing producers to realize the equivalent gas price of US$5.50 per million cubic feet (mcf) and higher, making these wells highly economic.

In addition, improvements in drilling technology are starting to lower the cost of drilling many of these unconventional reservoirs. Natural gas prices are likely to remain below US$5 dollar per mcf for the foreseeable future. In the longer term, increased demand from power generation, chemical producers and exports in the form of liquefied natural gas will help balance the supply-demand equation. However, these are still in the early planning phases and will not make a material difference to the market in the next five to 10 years.

This cheap source of energy will be advantageous to businesses that are able to capitalize on its use over the next several years. On the whole, it benefits the North American economy.

Consumer products

Stephane Champagne
Vice-President,
Portfolio Management
and Portfolio Manager

Led by strong Black Friday sales in November, U.S. consumer activity was resilient during the fourth quarter. ShopperTrak indicated consumers spent $11.4 billion on Black Friday, up 7% from last year and the biggest year-over-year increase since 2007. The National Retail Federation indicated that Black Friday weekend sales were up 16.4% to $52 billion, and the total number of shoppers who visited stores and websites was up 6.7% to 226.8 million. Online shopping was strong as well. ComScore reported online spending increased 18% on U.S. Thanksgiving weekend to $479 million and Black Friday sales increased 26% to $816 million. We think part of the reason for the strong start to the holiday selling season may be that more retailers are opening earlier and there were more aggressive promotions. We note that sales performance for apparel retailers was mixed during Thanksgiving because the weather was warmer than it was last year.

U.S. food inflation peaked in November and was one of the negative stories. During the fourth quarter, the S&P 500 Index underperformed the consumer discretionary index by 150 basis points, but outperformed the consumer staples index by 180 bps. Finally, the discretionary index outperformed staples index by 325 bps during the period. After bad retail sales numbers in October, U.S. retail sales gained momentum in November. Also, in November, the discretionary index was helped by better Black Friday sales and a decline of the unemployment rate from 9.0% to 8.6%. Softline retailers have been mixed mostly due to warm weather, hardline sales gained momentum due to an increase in consumer confidence, a lower unemployment rate and a slight improvement in real estate activities.

Overall, discussion over the next few quarters will be centered on the effect of the European austerity program on GDP growth and China's potential soft landing. We remain confident in our holdings due their cheap valuations, high free cash flow generation, high-quality balance sheets, and high returns to shareholders via dividends, buybacks and M&A. For the first half of 2012, we are taking a conservative approach to our consumer portfolio, which should help temper the market volatility. We will take advantage of the opportunities when there is an equity market pullback. For the longer term, we continue to view global brands as the preferred way to gain exposure to the expansion of the middle class in the emerging markets.

Health care

Rui Cardoso
Vice-President,
Portfolio Management
and Portfolio Manager

Health care finished the year on a high note, relative to the broader markets, as the defensive rotation that began in the third quarter accelerated toward year-end. Our outlook remains positive with a bias to sub-sectors, like pharmaceuticals, that have less leverage to developed world health care reform and austerity measures that impact price or demand. We believe Big Pharma, which represents approximately 65% of the health care universe, will have a turnaround in fundamentals that will lead to a re-rating of the group to levels that better reflect its high profitability and stable growth potential once most of the companies exit their "patent cliff" periods. For years, pharmas have been preparing for the cliff in different ways: major acquisitions of companies with no cliffs to dilute the overall impact, such as Pfizer's acquisition of Wyeth; major cost rationalizations; and a revamping of drug development pipelines. Pharma stocks are cheap on estimates that, in our view, appear too low. We see room for further multiple expansion as pipelines start to pass through the U.S. Food and Drug Administration approval process. In a sector with high dividend yields and clean balance sheets, we are paid to wait.

We remain cautious on health care services in developed markets – hospitals, insurers and distributors – and medical device companies, as they have the greatest leverage to austerity measures. However, we continue to view health care services as the preferred way to play the expansion of health care coverage to middle classes in emerging markets.

Industrials

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

It was a volatile year for industrial products stocks as future growth expectations were reduced throughout the year. Despite that, it was a good year operationally for most companies as they reported solid revenue growth and margin expansion. Balance sheets are very strong and managements are using their free cash flow to reduce debt, grow dividends and buyback shares.

Areas of capital expenditure (capex) strength continue to be in energy and mining end markets, as well as automation and energy efficiency. Industrial distributors have also benefited as they take market share from smaller, weaker competitors and as customers continue to replace worn-out parts. Construction markets remain globally depressed. Government deficits in mature economies continue to hamper infrastructure spending, while inflationary pressures in emerging markets have dramatically reduced growth rates. Given the economic uncertainty, inventory destocking was gradual and steady throughout the year as companies tried to be more conservative. However, they are cautiously optimistic about growth heading into the new year and are not planning any drastic reductions in operations at this point.

Valuations in the sector appear to be reasonable and seem to be factoring in a slower-growth environment, but an elevated risk of recession still poses a downside risk for these stocks.

Technology & telecommunications

Malcolm White
Vice-President,
Portfolio Management
and Portfolio Manager

Despite a tough macro environment, information technology has been a relative outperformer in the broader market as investors look to sectors with strong balance sheets and secular growth. However, technology is not entirely immune from global conditions as we are starting to see early signs that growth rates are moderating in the short term due to weakness in Europe. Flooding in Thailand had also damaged parts of the technology sector supply chain, leading to supply shortages and higher prices in certain segments.

The telecommunication sector continues to be a good place for investors seeking shelter from stormy markets. High dividend yields provide valuation support and wireless data growth continues on a global basis as customers upgrade to more advanced phones. Those wanting more consolidation within the telecommunications sector have been disappointed with the recent actions of the regulatory authorities in the U.S., who pressured AT&T to scrap its proposed takeover of T-Mobile USA.

Foreign exchange

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

Currency cross rates continue to bounce around the well-travelled path of "risk on/risk off." As forecasts for weaker global growth gather momentum, higher-beta currencies with significant exposure to commodities, such as Canada and Australia, have lost value compared to the U.S. dollar. Across most commodities, prices continue to reprice in the face of decreased demand and a strengthening U.S. dollar. During the fourth quarter, most emerging market currencies steadied, although Eastern European currencies have failed to find a floor compared to the U.S. dollar. These crosses tend to act as high-beta plays on the euro, which hit year-to-date lows compared to the U.S. dollar, in December.

The U.S. dollar rallied significantly toward year-end. It shrugged off the failure of the Congressional budget supercommittee to agree to significant budget cuts. The focus of the foreign exchange market is still squarely on the wrangling in Europe. The more discourse there is in Europe, the more long-term investors reduce their exposure. Somewhat paradoxically, the more aggressive the ECB is at loosening monetary policy, both conventional and unconventional, the more stable the euro will become because the threat of a collapse is reduced.

High-yield bonds

Geof Marshall
Vice-President,
Portfolio Management
and Portfolio Manager

Despite the positive return in 2011, the high-yield market is now cheaper than it was 12 months ago by about 200 basis points. So, what's in store for 2012?

Much has been written on Europe and its probable outcomes, but it is important to qualify that the "risk-on/risk-off" trade will likely be the prime driver of high-yield bond returns again in 2012. It is always tempting to look for precedent. A decade ago, capital markets were marked by low interest rates, persistent and elevated equity market volatility and uncertain geopolitical risks. While the average spread level entering 2002 was similar to now, yields were higher and prices much lower as the market was still recovering from recession and terrorism in 2001 and the debt-financed telecom bubble. These factors, and the high-profile bankruptcies – Enron, Worldcom and Dynegy – that followed in 2002 make this comparison imperfect.

We expect defaults in 2012 to climb slightly, but remain relatively subdued. In the low-growth, low interest rate environment that should continue into 2012, we are inclined to think high-yield bonds can generate "coupon-like" or high single-digit returns. Surprisingly, the high-yield bond market has never had a year with a return in the 7% to 10% range. Nonetheless, if this forecast proves incorrect and the high-yield return is lower, stocks probably will do much worse – like 2002 and 2011. If, however, the forecast proves too conservative, and we hope it does, stocks may struggle to do better than high yield without a growth surprise to the upside, such as a recovery in the U.S. residential housing market and by extension, the banking sector, or a resolution in Europe – like 2010, 2003 and 2004.

Preferred shares

John Shaw
Vice-President,
Portfolio Management,
Portfolio Manager

The outlook for the Canadian preferred share market remains positive due to continued strong demand from both retail and institutional investors searching for stable investments. Additionally, I believe the bank preferred share market will be shrinking over the next three years, while new issuance will be manageable.

In these uncertain times investors are looking for decent but stable returns and are finding these in the Canadian preferred share market. Returns for 2011 were in the 6% to 7% range, with the bank perpetual preferred shares once again being the strongest contributors.

The market has seen a number of new issuers in 2011 and we expect this to remain the case in 2012. The new variety is great for the market, but credit quality or structures have been weaker than the preferred shares being redeemed. Investors must be wary of the new names coming to market.

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