

Signature Market Roundup

Second Quarter 2013



Global outlook



Eric Bushell
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The yield-seeking behaviour that had sent investor capital flowing into riskier, less liquid markets for years came to a screeching halt in May with comments by U.S. Federal Reserve Board Chairman Ben Bernanke indicating that the central bank would gradually exit its long-standing asset purchase program – conditional on sustained job growth. As leveraged investors moved to quickly liquidate assets, most markets were dragged downward. Yields for U.S. Treasuries surged from about 1.6% to 2.6% as investors weighed the consequences of higher rates, and prices for most other corporate and government bond markets also adjusted accordingly.

A good example of an abandoned market was Brazil, where bond yields climbed 1.5% and the currency dropped 15% as investors sought to unwind their positions. This raises questions about how Brazil and other large emerging market countries such as India and Turkey will be able to access much-needed foreign capital, and at what cost.

China's growth rate, meanwhile, continued to slip as the new administration reinforced its determination to tackle some of the country's larger structural problems, including excess industrial capacity, unregulated debt markets and environmental reforms. Unlike other emerging market countries that rely on foreign capital, however, China's closed capital account and high savings rate insulates the country from the consequences of higher U.S. rates.

Mr. Bernanke's comments also showed that there will be growth consequences for all asset markets as the Fed's easy money policy is withdrawn, and commodity markets will be particularly affected. The anticipation of higher short-term rates in the U.S. and lower rates in Europe is supporting the U.S. dollar, and had a hugely negative effect on the price of gold, which dropped by about 25% during the quarter. The Canadian dollar has begun its adjustment to the lower commodity level.

Eurozone members, meanwhile, failed to come to an agreement regarding the supervision and risk management of the region's banks, mainly because of the large amount of non-performing assets in peripheral Europe. One of the biggest issues facing global investors is whether Germany will continue to support further sovereign debt and banking bailouts. In the near term, however, investors have maintained their faith in the European Central Bank's pledge to defend the euro.

For the first time in about a year, two-way risk resurfaced in the capital markets as the interventionist environment began to show cracks and more natural market forces came into play. The Fed's signal that it would scale back its intervention was needed to rein in some of the distortions that were building as investors blindly assumed more risk. Investors are now being compensated for that risk, as assets such as high-yield corporate bonds have been re-priced with more generous yields. This is a positive development, and we believe the worst sell-off in U.S. rates has probably occurred. We will look for opportunities as further market disturbances occur.

Global outlook



Drummond Brodeur
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We are at an inflection point for many asset markets. The end of monetary easing from the U.S. Federal Reserve requires a hand off in the drivers of market performance from liquidity injections back to fundamentals. The fiscal drag resulting from the U.S. fiscal cliff-related tax hikes has been far milder than expected, and with U.S. payroll data continuing to indicate roughly 200,000 new jobs per month, the time for the Fed to begin reducing its level of liquidity support appears to be a few months earlier than expected. This means the underlying economy has grown healthy enough to withstand a withdrawal of the monetary drugs the Fed has been administering. We are through the eye of the storm, and our premise behind investing at this time has worked very well as asset prices have buoyed, particularly in housing and equities.

It is not the end of outperformance by risk assets, but returns are likely to be lower and more volatile going forward. In particular, government bond returns are now negative and are unlikely to turn positive as long as we continue in a grinding economic recovery.

Managing the higher volatility and the changing correlations among asset classes is imperative in such an environment. We believe the shift to a stronger U.S. dollar following a decade-long weak dollar environment from 2001-2011 is the most important one for Canadian investors to understand, as different asset classes will perform differently in different currency regimes. Those that thrived under the weak U.S. dollar, therefore, could suffer in comparison to those that prosper due to a stronger dollar. Canada was a significant beneficiary of the weaker U.S. dollar and does not fare nearly as well under a strong U.S. dollar, nor do commodities or emerging markets in general. High production costs will make it increasingly difficult for Canada to compete with the U.S. The underperformance of the Canadian equity markets is expected to continue.

Overall, however, a stronger U.S.-led global economy is a positive development following five years of crisis management. While we expect the U.S. economy to continue to strengthen, we are not as optimistic that either Europe or Japan is on a path to sustainable growth. Both geographies need to be understood and monitored for the risk of further systemic crisis. Barring such an event, Europe faces several more years of internal rebalancing, while Japan has embarked on an unprecedented monetary experiment that remains in search of a true reform agenda. China is yet another country with challenges on the horizon, as it attempts to cope with the shift from a production to consumer economy.

At Signature, we remain focused on trying to identify and manage the risks while recognizing that such periods of change and adjustment also create opportunities for investors who have both the ability and conviction to take advantage of them.

Emerging markets



Matthew Strauss
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The second quarter will not be remembered for the initial recovery in emerging market (EM) equities as the sell-off later in the quarter far outweighed the gains. Although speculation about the tapering of quantitative easing in the U.S. overshadowed market developments during the quarter, the sell-off in EM equities would have been much more muted were it not for a number of EM-specific factors. These include the record-high foreign ownership of EM fixed-income products, currency weakness, growth concerns, lower commodity prices and political uncertainty.

During the last few years, as developed market interest rates continued to plunge, an increasing number of investors turned to EM fixed-income products to augment their returns. Backed by higher yields and the belief that EM currencies will continue to strengthen against developed market peers, record amounts of money found its way into emerging market debt instruments.

However, as U.S. yields started rising, EM fixed-income products followed, but in a more aggressive fashion as positioning, leverage and low liquidity exacerbated the decline in EM assets. As capital inflows turned into outflows, fixed-income investors scrambled to hedge their currency exposures. The falling emerging market currencies added to the equity losses in U.S. dollar terms. If that was not enough, declining economic growth profiles in China, Brazil and India cast doubt over the earnings outlook for many EM companies. Protests in Turkey and Brazil, and political wrangling in India, South Africa and Thailand rounded out a quarter full of uncertainty in emerging markets.

Not surprisingly, the region most exposed to changes in commodity prices recorded the biggest declines, with Latin American equities falling 15.5%, compared to single-digit losses in Asia and EMEA (Eastern Europe, Middle East & Africa). All five Latin American countries recorded double-digit losses. Hungary, Malaysia and Taiwan recorded positive returns for the quarter.

Even though valuations are much more reasonable than a few months ago and are considered cheap compared to developed market valuations, earnings concerns remain. Also, valuations differ significantly across sectors and regions, with troubled countries or sectors trading at huge discounts. For a more sustained rally in EM equities, we are looking for stability in U.S. Treasury yields, EM fixed-income markets, foreign exchange markets and/or a bottoming in Chinese growth in particular and emerging market exports growth in general. On the domestic front, policy decisions, structural reforms and political stability will become important differentiators between emerging market countries and their respective equity market performances.

Consumer products



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Consumer activity in the U.S. produced mixed results during the first half of 2013, as the consequences of the “fiscal cliff” and budget sequester had a negative impact on consumer confidence. Retail sales picked up in the second quarter, partly due to a delay in tax refunds, with off-price clubs and discounters continuing to do well as consumers looked for bargains. Department stores and specialty stores also showed signs of increased activity in the second quarter compared to the first quarter. Retail activity in Europe, Latin America, Asia and Canada, however, remained weak.

Overall, the S&P 500 Index outperformed the consumer staples index by 180 basis points and underperformed the consumer discretionary index by 500 basis points in the second quarter. The discretionary index has been helped by the improving unemployment rate, which has boosted consumer confidence. On the other hand, the more defensive staples index decelerated after a strong first quarter with the increase in bond yields and potential reduction in quantitative easing. We believe, however, that the staples sector should continue to benefit from weak bond market returns, and that we are in the early innings of a shift that favours higher-yield staples stocks over bonds.

In the second half of the year, U.S. consumer discretionary spending should increase as the negative impacts of the fiscal cliff continue to fade. Providing inflation remains stable and the housing sector and job creation show improvement, this should continue to be a positive catalyst for discretionary spending. We expect Canadian consumption, however, to be slow as disposable incomes remain under pressure due to high consumer debt levels and slow housing activity.

In Europe, consumption remains fragile. We favour Northern European and U.K. domestic consumers due to the high unemployment rate in the southern regions of Europe. Elsewhere, Russian consumers are benefiting from the country’s stable oil sector and President Putin’s economic reforms to stimulate the economy. In Latin America, consumer fundamentals should continue to decelerate due to lower consumer confidence led by declining consumer subsidies, lower real wage rates, a higher unemployment rate and currency depreciation versus the U.S. dollar. We favour Mexican and Chilean consumer stocks, while Brazilian consumer demand should remain weak in the second half of the year.

Chinese consumption could remain under pressure in the second half of the year. The government transition is moving slower than expected and is negatively impacting Chinese consumer confidence. Southeast Asian retail consumption is also decreasing as these countries experience currency depreciation and lower consumer confidence.

We continue to favour sectors supported by sustainable fundamental, strong global brands, free cash flow generation and return of capital to shareholders, led by share buybacks or dividend increases.

Resources



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Volatility increased significantly in the second quarter of 2013 after the U.S. Federal Reserve committee members spoke more candidly about the eventual end of quantitative easing, with Chairman Bernanke suggesting that the program could be brought to an end by 2014.

The anticipation of higher short-term rates in the U.S. and lower rates in Europe was supportive of the U.S. dollar, and had a negative effect on the price of gold, which dropped by about 25% during the quarter. Gold stocks underperformed bullion's price decline, as gold producers felt a further squeeze on profit margins that had already been under pressure due to rising costs and various additional challenges. We remain underweight and selective in our holdings.

Within the materials market, we continued to focus our attention on large diversified bulk miners. Iron ore prices have appreciated from the beginning of the year and currently remain stable. The market is concerned that increased production in the second half of 2013 will put downward pressure on prices into 2014; however, with record steel production in China and low iron ore inventory levels, we believe the price may remain more stable than currently reflected in equity valuations.

In the energy sector, we saw the crude oil price differentials that had penalized North American producers begin to dissipate. Throughout the quarter, the gap between domestic and global benchmarks narrowed as additional rail capacity freed up space on pipelines, removing some of the bottlenecks in the market. This, combined with better drilling efficiencies and resource growth, helped propel U.S.-based exploration and production equities. Furthermore, the recovery in the price of crude oil has benefited the oil service companies that focus on extraction technologies in the U.S.

Natural gas prices, after falling to deeply depressed levels in 2012, have recovered and inventory levels are now in line with the five-year average. Demand for cooling purposes has been slightly lower than last year but has been offset by a slowing pace of natural gas production. However, there are still many wells waiting to be connected to pipelines and for the infrastructure to be put in place to process the gas. In the near term, gas will continue to trade with the weather patterns but we believe the price will be capped at US\$5 per mcf in the near term and US\$4.50 over time as ample wells can be brought into production with very good economics. The lower price level will be reached as the cost of drilling and completing wells continues to decline, and as producers move to more efficient pad drilling.

It is necessary to watch natural gas liquid pricing much more closely going forward, as more natural gas liquids, including ethane, propane and butane, are brought to market. The increased supply will force prices for these components to decline, as domestic demand is insufficient. This is starting to impact the economics of liquid-rich wells, but not enough for reduced drilling at this point.

We continue to focus our investments in energy-related industries and in those companies that have the ability to grow their resource base with attractive rates of return.

Preferred shares



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The Canadian preferred share market had a difficult second quarter as the U.S. Federal Reserve spooked the bond market in May and again in June. Preferred shares sold off as interest rates rose, posting only their second negative quarter since the fall of 2008. Globally, all risky assets had a very volatile time during this period. The U.S. economy is the relative bright spot as other major global economies sputter. China is slowing from admittedly high rates of growth but the deceleration is being felt across Asia and in resource-rich countries like Australia and Canada. Europe continues to be mired in high debt levels and stagnant growth.

In May, Fed officials began discussions looking at reducing the central bank's US\$85 billion monthly quantitative easing program. In mid-June, Chairman Ben Bernanke tried to calm the markets by giving clear guidance that the Fed would only start tapering its bond purchases if the U.S. economy was strong enough to push the unemployment rate below 7.0% while keeping inflation in check. However, the market only heard the potential of higher U.S. interest rates, thus causing global interest rates to rise. Many believe the Fed will start tapering in the fall.

Retail investors' demand for preferred shares came to a halt as interest rates began to rise sharply. Yields in 10-year Government of Canada bonds rose 57 basis points while five-year bonds didn't do much better, rising 51 basis points. Investors first began selling fixed-rate perpetual preferreds and then all types of preferred shares. Institutional investors still have demand for preferred shares, but are very cautious about stepping into the market until retail investors stop selling. There were seven issues in the second quarter totalling \$1.6 billion, while there were six redemptions for \$787 million, for a net issuance of \$813 million. Future issuance is expected to be light until the market calms down. This in itself will be a small positive factor for preferred shares.

The outlook for the preferred market is mixed. With the back-up in prices, the yields on preferred shares are more appealing than earlier in the year, but retail investors are likely to remain reluctant until interest rates stabilize.

High-yield bonds



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Leveraged loans, floating-rate loans, syndicated loans – whatever you call them there is much investor interest in this part of the market. As one of the largest loan managers in the country, the Signature high-yield bond team gets a lot of questions on this topic. Leveraged loans are a sister market to the high-yield bond market. There is plenty of overlap in the issuers and the credit analysis is very similar. Yet, where high-yield bonds are typically senior unsecured obligations in an issuer's capital structure, loans are almost always senior secured. Where high-yield bonds have a fixed coupon (e.g. 7%), leveraged loans are floating rate in nature, with the coupon reset quarterly based off a reference rate (e.g. three-month LIBOR plus a spread of 400 basis points or "L+400" which currently equals 4.27%), suggesting this should be a resilient asset class in the event of rising rates.

High-yield bonds provide some call protection – meaning if credit quality or market sentiment improves and the issuer wishes to refinance at a lower rate prior to maturity, the issuer must pay holders a premium over par. This ensures bondholders participate in some of the upside from the improvement in credit quality. Loans on the other hand generally do not provide any call protection and are typically refinanced as soon as the issuer can do so at a lower rate. It is for this reason that adding to the leveraged loan allocation in the Signature funds has been challenging as loans issued in 2012 were consistently being redeemed and refinanced at lower rates in the first half of 2013. Hence, it is hard to stay invested. Nonetheless, loans proved their worth as floating rate instruments in a diversified portfolio in the second quarter as government bond yields backed up, returning 0.2% (S&P/LSTA Loan Index) – the best quarterly return in fixed income – as high-yield bonds lost 1.35%.

New additions in the second quarter included the loans of Canadian customs broker Livingston (bankers' acceptance+450 bps, 125 bps floor due 2019), packaging company Waddington (L+425, 125 bps floor due 2020) and consumer products contract manufacturer Kik Custom Products (L+425 bps, 125 bps floor due 2019).

Foreign Exchange



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Broad-based U.S. dollar strength, weaker emerging market currencies, a still resilient euro and a sharp fall in the Australian dollar dominated global currency markets in the second quarter.

Higher bond yields in the U.S. in anticipation of the tapering in quantitative easing provided strong support for the broad-based uptrend in the U.S. dollar. Emerging market currencies were particularly vulnerable as U.S. yields increased, given the huge inflow of capital into emerging market fixed-income products during the last five years as investors sought higher yields outside developed markets.

Within the emerging market group, commodity-based and/or current account deficit countries recorded the sharpest depreciations (Brazil, India, Chile, South Africa and Turkey). The Australian dollar also lost its appeal and fell 13% during the quarter. The currencies of Norway and Canada held in longer but towards the end of the quarter also succumbed to a generally stronger U.S. dollar.

The moderate gains of the euro and Danish krone against the U.S. dollar in the second quarter were wiped out during the first few days of July as the European Central Bank showed a willingness to ease monetary policy further, highlighting the opposing paths between the U.S. Fed and the European Central Bank. With the U.S. expected to lead the way in terms of scaling back quantitative easing, and other major central banks still contemplating more monetary stimulus (the U.K., Europe and Japan), we see the currency trends of the second quarter continuing into the second half of 2013.

However, as uncertainty increases about the individual monetary policy paths of the various central banks and how that might impact global capital flows, a continuation of these trends will coincide with increased volatility. This could result in periods of stronger emerging market currencies, a stronger Canadian dollar and a weaker U.S. dollar. However, these reversals will likely be shallow and short lived in an otherwise strong U.S. dollar environment.

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