# Market Roundup

## Global outlook

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

The second phase of the post-Lehman recovery in risky assets may be drawing to a close in April 2011. The first phase ran from March 2009 to April 2010 and was halted by the European sovereign crisis and a U.S. slowdown. The second phase began with the U.S. Federal Reserve launching an unconventional easing policy dubbed QE2 in September 2010. This action saw investors exit the dollar and scramble for real assets ranging from property to commodities, credit and equities. As we near the end of this policy, prospects for dollar stabilization grow; this would be helped through U.S. fiscal retrenchment and relief on the part of bond markets.

## Global outlook

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

Global equity markets were exceptionally strong in the first quarter despite significant macro shocks such as high oil prices, unrest in North Africa and significant supply chain disruptions following the earthquake, tsunami and nuclear fears in Japan. The underlying resilience has been driven by clearer indications that the U.S. economic recovery is gaining traction and as inflation fears continue to ease in China. While markets may be more volatile in the coming quarter as they anticipate the ending of QE2 in the U.S., we expect that the strengthening of the U.S. and global recovery will continue to dominate. With many emerging markets well advanced in their monetary tightening cycle, and the developed world just beginning, we have also seen renewed flows into emerging markets, which have returned to a valuation discount to the developed world. We expect this trend to continue.

We also expect strong capital expenditures in the second half in the U.S. on the back of Obama's accelerated depreciation allowance for 2011 and are encouraged by the rapidly emerging consensus on the need to attack the U.S. deficit situation. While the politics will be messy, the debate seems to have shifted decidedly to how to deal with the deficit and not whether to deal with it. This will lower the medium-term growth outlook but should also ease fears of a U.S. debt spiral. From a political perspective, the U.S., Europe and China are now focused on addressing the key challenges facing their respective economies. While solutions will take years and likely require ongoing mini-crises to move the agenda along, it is far better than the lack of recognition that existed only a year ago. However, to have political leadership in Japan may be asking just a bit too much.

## Interest rates

James Dutkiewicz
*Vice-President,*
*Portfolio Management*
*and Portfolio Manager*

We anticipated that bond prices would be range-bound for a while, a scenario that played out in the first quarter. Yields for 10-year U.S. Treasuries moved between 3.20% and 3.75% for the period, only going below 3.25% in the aftermath of the earthquake in Japan when fears of a nuclear meltdown were at a peak. But the range of 3.40% to 3.60% was more typical for the period.

We continue to believe that interest rates will drift higher as the Bank of Canada tightens monetary policy two or three times this year. With the bond market now having priced in roughly that number of rate increases, we no longer need a cash buffer to protect against rate hikes because our bond positions are providing sufficient yield. If rates rise the same amount, or less than the market expects, these bonds will outperform cash.

## Real estate

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

Global capital markets were positive in the first quarter, driven by improved economic data and exceptionally loose monetary policy. In this environment, real estate investment trusts continued to perform well. The Canadian REIT market, for example, was up more than 14%.

We believe that a key reason for recent strength in REITs and other higher-yielding securities continues to be strong funds flow. Investors have taken on more risk to achieve higher yields, causing asset prices to go up (and conversely, yields to go down). This phenomenon has, in turn, pushed investors even further out the risk curve as the number of asset classes that still provide decent yield continuously diminishes. We think that flows into securities such as REITs and infrastructure will continue to be strong and may even spill over into more general high-dividend-paying equities such as consumer staples and pharmaceuticals.

## Healthcare

Rui Cardoso *Vice-President, Portfolio Management and Portfolio Manager*

The healthcare sector had a rebound in the first quarter of the year, with returns largely in line with the broader market. (Healthcare was the third-best performing sector in the S&P 500 for the quarter with a return of 5.0%, versus the market return of 5.4%). However, the returns within healthcare were not very broad based. Specifically, U.S. insurance companies, companies receiving acquisition offers and industry heavyweight Pfizer drove most of the sector's returns, while the rest remained relatively mixed. Our outlook for the group remains very constructive as we expect that the valuation gap, relative to the market and relative to intrinsic valuations, will close over time, leading to strong returns.

The group we are most positive on within healthcare remains big pharma stocks. With pipelines maturing and new drugs filtering through to U.S. Food and Drug Administration approvals, ongoing cost rationalizations leading to greater operating efficiencies, and expansion into emerging markets, the sector remains the most attractive even when factoring in patent "cliffs," government reforms and austerity issues. The timing of the valuation bounce-back is difficult to predict – valuations don't seem to matter until they hit extremes – but we are happy to get paid 3% to 6% dividend yields while we sit and wait for valuations to normalize.

## Natural resources

Scott Vali
*Vice-President, Portfolio Management and Portfolio Manager*

Oil prices continued their upward climb in the first quarter as political events in the Middle East increased the risk premium. With the disruption to Libyan oil production, global spare capacity has moved closer to three million barrels and only one million barrels above the level seen in the spring of 2008. Global oil prices continue to trade at a premium to West Texas Intermediate, with Brent crude recently trading US$14 higher than WTI. This unique dynamic is the result of insufficient take-away capacity from Cushing, Oklahoma, to the Gulf of Mexico during a period of increased production from Canada and the northern U.S. As a result, U.S. mid-continent refiners continue to realize high crack margins relative to coastal and international refiners. Concerns over demand destruction as gasoline approaches US$4.00 per gallon in the U.S. are causing some to reduce demand forecasts. However, we believe that with the backdrop of improving employment and a recovering economy, demand is likely to be more resilient than expected.

## Consumer products

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

The price of oil shot up to over US$100 per barrel in the first quarter. With consumer spending representing about 70% of U.S. GDP, this could negatively affect the recovery. Overall, the S&P 500 Index outperformed the consumer sectors, with consumer discretionary doing better than consumer staples. Consumer discretionary was helped by positive employment reports, and the unemployment rate fell to 8.8%, its lowest level since early 2009. These reports gave some positive momentum to U.S. retail sales. Softline retailers such as teen and apparel retailers should start to feel pressure from rising labour costs in Asia and cotton prices in the second half of the year.

Defensive sectors such as consumer staples lagged the overall market. In the staples sector, tobacco/beverage stocks outperformed food producers and staples retailers, which outperformed household and personal care stocks. Most of the underperformance of the staples was due to fears over input cost inflation and the earthquake in Japan, which has had a slightly negative impact on companies with exposure to Japan, such tobacco and beverage companies.

We expect that the markets will be focused over the next few quarters on how the economy will respond when quantitative easing ends in June. We remain confident in our security selections due to their cheap equity valuations versus historical valuations and peers, high free cash flow generation, high-quality balance sheets, and returns to shareholders through dividends, buybacks and mergers and acquisitions. We are taking a balanced approach to our consumer portfolio construction with equal exposure to discretionary and staples, which should help temper portfolio volatility when there is an equity market pullback. For the longer term, we still remain skewed toward consumer stocks with exposure to emerging markets.

## Preferred Shares

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

The biggest news in the Canadian preferred market came on February 4, when the much-delayed Advisory on the Treatment of Non-qualifying Capital Instruments was released by the Office of the Superintendent of Financial Institutions (OFSI). Under the advisory, currently outstanding bank preferred shares are deemed to be non-qualifying capital instruments and as such will not count as capital past their par call date. The banks have three possible choices. Firstly, the banks could leave the preferred shares outstanding, but the preferred shares would be expensive after-tax funding without receiving capital treatment. Secondly, the banks could amend the terms of the preferred shares to bring them into compliance with Basel III rules on Non-Viability Contingent Capital, which would generally require a vote of 66% in favour – which we believe would be difficult to reach. Finally, the banks could call or tender for the preferred shares, probably on the par call date, which of the three choices is the most likely to occur.

Bank perpetual preferred shares had been moving higher on the expectation that such a ruling would be made, but continued to outperform following the announcement as the advisory provided greater certainty to the market. Perpetual preferred share yields are still very attractive compared to rate reset preferred shares.

Supply will remain low as all Canadian banks will likely redeem all of the $20 billion of preferred shares outstanding over the next six years and only re-issue a small amount as preferred shares. This will result in a constant demand for preferred shares given that almost 40% of the market may disappear.

We remain positive on the outlook for preferred shares and especially for bank fixed-rate preferred shares.

## Global industrial products & transportation

Joe D’Angelo *Vice-President, Portfolio Management and Portfolio Manager*

Chief executive officers of industrial companies are becoming more bullish on sustainable volume growth, and believe they have pricing power to fully offset input cost inflation (with a small time lag). They’ve also begun to rehire employees.

Companies in general are much more willing to increase capital expenditures, resulting in broad-based spending growth across many sectors of the economy. The resource and energy markets continue to ramp up spending programs, while energy efficiency and automation expenditures have become more of a focus in other industries.

Valuations are broadly in line with mid-cycle levels, which imply that share price appreciation from this point forward will be very closely tied to earnings growth. Although earnings growth is looking good for 2011, it’s difficult to see how strong growth could be in 2012 and beyond, since many companies have already returned to prior peak profit margins. In summary, the industrial products sector continues to look attractive from a risk-reward perspective, given reasonable valuations and near-term earnings growth.

## Investment-grade bonds

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

Investment-grade corporate bonds posted modest positive returns during the first quarter even though government yields rose, due to spread tightening. Investment-grade corporate bonds performed well due to the continued demand for higher yielding assets. Rising equity markets and stable short-term interest rates, along with very good fundamental credit quality, provide the ideal backdrop for investment-grade corporate bonds to do well. Canadian investment-grade corporate bonds did underperform in March due to the Japanese earthquake/tsunami/nuclear accident and the record new issuance during the quarter.

The Office of the Superintendent of Financial Institutions (OFSI) finally released its much-delayed Advisory on the Treatment of Non-qualifying Capital Instruments on February 4, outlining the phase-out method for Canadian bank capital securities. The result was fairly positive for the investment-grade market and provided increased certainty on when securities would be called or matured.

The outlook for investment-grade corporate bonds remains positive due to strong fundamentals and demand dynamics. However, relative returns will be moderate as compared to the past few years as spreads have returned to more "normal" levels.

## Foreign exchange

James Dutkiewicz
*Vice-President, Portfolio Management and Portfolio Manager*

The currency markets in the first quarter 2011 were buffeted by natural disasters, geopolitics and policy changes. Floods in Australia pushed the Australian dollar lower. The New Zealand earthquake forced the central bank to change tack from tightening to an emergency easing, which put downward pressure on the Kiwi dollar. In mid-March, the initial market reaction to the earthquake and tsunami in Japan was to strengthen the yen on fears of massive repatriation by Japanese investors of overseas assets. However, coordinated intervention by the G7 to sell yen was successful and market participants began to see the reconstruction of Japan as being bearish for the yen.

Protests and conflict in the Middle East threatened or curtailed oil production. The U.S. dollar, already under pressure due to quantitative easing, buckled further as the recycling of U.S. dollars by OPEC producers intensified. The European Central Bank (ECB) adopted a much more aggressive anti-inflationary stance than the Federal Reserve and indicated that rate hikes were coming. This led to the euro being the strongest G10 currency in the first quarter, despite Portugal following Ireland and Greece in requiring financial support from core European countries.

Amid this turmoil, the Canadian dollar behaved as expected. It strengthened against currencies hurt by natural disasters and against the U.S. greenback. The euro and Scandinavian currencies outperformed. Our expectations are for further gains versus the U.S. dollar, but valuations are becoming stretched, so we will only look to increase our hedges on temporary bouts of strength. We feel there are downside risks to the market's forecasts of a 100 basis point tightening by the ECB. Thus, we will be seeking opportunities to further increase our hedges versus the euro.

## High-yield bonds

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

As other asset classes experienced a geopolitical-induced pullback in the first quarter, the global appetite for yield persisted. The high-yield bond market obliged with positive returns and a strong quarter of issuance. Fundamentals in the high-yield bond market also co-operated as first quarter earnings were generally inline or above expectations. Although seven companies defaulted on $1.5 billion of debt, the default rate was 0.8% at the end of March – well below last year's 6.3% and the long-term average of 4.3%. There were no defaults in the Signature portfolios.

Since 1987 high yield bonds have experienced a slight negative correlation to both the front end of the yield curve (U.S. 30-month T-bills) and the back end (U.S. 10-year T-bonds). In looking at the five Federal Reserve tightening cycles since 1987, it is clear that, on average, high-yield bonds have generated positive mid to single-digit returns in the periods six months prior to a tightening, during the tightening cycle, and six months after it has ended. This is due to two factors: high-yield bonds trade on a price rather than a spread basis, and secondly, these companies are levered to economic growth so normally the credit risk of investing in these bonds decreases as the economy grows and rates rise.

If high yield does show a positive correlation to rising interest rates, which is possible, we would point to the 4.3-year average duration of the high-yield bond market, a record low for the asset class. (We are running the high-yield bond portfolios within the Signature funds with a duration of 3.4 years). This is much less interest rate sensitivity than a typical Canadian bond fund, which would be about seven years. There are three other key points to make:

- High-yield bonds typically have an even shorter duration than modelled, as most high-yield bonds are callable before maturity at the issuer's option.
- We have held overweight positions in the commodity and energy sectors in the high-yield bond portfolios and we continue to add to the energy weighting. We would expect the most spread tightening in these sectors in the event of either growth-induced higher interest rates or an inflation scare.
- Additionally, we have introduced floating-rate debt – specifically, leveraged loans – into our holdings. These securities have a duration of less than three months since the coupon is reset quarterly. Leveraged loans are essentially the same as high-yield bonds except they are secured like a mortgage, and they are floating rate instead of fixed. We intend to increase the floating rate exposure within the high-yield bond portfolios within the Signature funds throughout 2011.

Our 2010 and first quarter 2011 high-yield performance has been very good despite the fact the positioning puts us a little more defensive than the index. We are willing to maintain this positioning for the foreseeable future.



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