Signature Global Roadmap: Second Quarter 2015

Drummond Brodeur, Portfolio Manager and Global Strategist
Signature Global Asset Management
April 17, 2015

Signature's Global Outlook: Groundhog Day All Over Again

After an incredibly eventful first quarter in which many longer-term trends came to a head, it is starting to feel a lot like the movie *Groundhog Day* all over again. A year ago, I started our 2014 second quarter outlook with the statement that from a broad macro perspective, the roadmap was beginning to look pretty boring in comparison to previous post-crisis years. As we enter the second quarter of 2015, it seems very similar. Following significant moves in many macro and policy variables, we appear to be entering a period in which markets are attempting to digest these significant changes and find a more stable equilibrium, at least in the short term. There has been a significant resetting of many relative prices over the past six months. Markets, economies and investors are all in the process of adapting to the new reality.

The key variables include:

- Energy, where the price of oil has declined by half since last summer
- Monetary policy, where the Bank of Japan expanded its quantitative easing (QE) program last October, and the European Central Bank launched QE in the past quarter
- Interest rates, where European rates have hit all-time lows, with many in negative territory
- Currencies, where the euro fell from a peak of US$1.40 last summer, to $1.20 at start of 2015 and a low of $1.05 in March, while the yen fell from about 100 to the dollar last year to 120 now, and the Canadian dollar has continued its fall from US$0.86 at the start of the year to a low of $0.78 in March.

As all of these moves reflect changes in the underlying fundamentals, they are not likely to reverse anytime soon. But the adjustment is now done. The real surprise has been in the speed of the price adjustments, not the magnitude. For instance, while the increase in the U.S. dollar leaves it well within its historical valuation ranges against most other currencies, the speed at which it adjusted is the fastest on record. On a trade-weighted basis, the dollar appreciated by 21% against other major currencies in only nine months. While a 20% appreciation is not unusual, it typically plays out over three to four years, not nine months.

After such rapid moves, we want the markets to settle down and map out new equilibrium trading levels. This is the type of boring we are hoping for in the coming quarters. Should there be greater stability in economic, financial and policy realms, the backdrop should remain constructive for risk assets. Let's look at each area individually.

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Global economy

The global economy continues to grind forward with some significant shifts evident in the past quarter. It is our view that we are moving into a period of global synchronized growth and we expect to see the U.S., Japan and the Eurozone all growing above their trend growth rates for the first time since the crisis. As we expected in our 2015 outlook, both Europe and Japan are experiencing economic recoveries following their policy-induced slowdowns in 2014. Their recoveries are defying consensus expectations. (Our earlier optimism was not consensus.) With lower energy prices, lower currencies, looser fiscal policy and aggressive QE in both the Eurozone and Japan, it would be difficult for their economies not to bounce! While we remain unconvinced of a longer-term secular recovery in Japan or Europe due to challenging structural headwinds and demographics, we do believe the cyclical bounce now underway should support moderate growth for the coming year. The better economic outlook is becoming recognized and was a major factor underpinning the significant gains in their equity markets in the first quarter. For Europe, we believe the relative outperformance is broadly over as equity valuations are now in line to slightly expensive relative to the U.S., while Japan, having narrowed the gap with the U.S., remains at a slight discount to historical relative valuation levels.

As for the U.S. economy, first quarter data has once again surprised to the weak side. While the softer GDP for the fourth quarter of 2014 and first quarter of 2015 should be sufficient to postpone the start of the Federal Reserve's rate hikes from June to September, we do not believe it reflects a significant downshift in the trajectory of the U.S. economy. Rather, we expect the U.S. to remain on track for close to 3% growth in 2015, but with a few wobbles.

To put the recovery in context, following a weather-induced decline in the first quarter of 2014, there was a rapid bounce in the U.S. economy with growth of 4-5% (at an annual rate) in the middle of the year – way above trend. We believe the recent data reflect the deceleration – and inventory destocking – following last year's bounce. That destocking, along with another tough winter and strong currency, has remained a headwind into the first quarter of 2015. However, we expect to see a repeat of last year with the economy rebounding into the summer, in the range of 3%. Strong employment numbers, lower energy prices and high consumer confidence should support improving consumer and housing data through the year, while energy-related reductions in capital spending will represent a drag. At current levels, the stronger U.S. dollar should have only a minor impact, as the U.S. is a large continental economy that is less affected by trade swings. The stronger dollar will provide a boost to the purchasing power of U.S. consumers and companies, with a slight offset from the reduced competitiveness against non-U.S. companies.

Monetary policy divergence

One of the major themes of 2015, the divergence in monetary policy, has been and will continue to be a major driver of asset market returns. The surprise in the first quarter was the scale of the QE program announced by the ECB. At 60 billion euros a month for at least 18 months, the ECB clearly exceeded expectations. The result has been a continued collapse in European rate structures with the 10-year yields for Germany, France and Spain at 0.19%, 0.48% and 1.21%, respectively, as of early April. Large swaths of shorter-dated sovereign paper currently trade with negative yields – you pay for the privilege of lending your money to the government!

Such is the scale of the QE program in Europe that the ECB is buying more bonds than governments are currently issuing, shrinking the supply. From the central bank's perspective, this is exactly the point. It is taking away the supply of risk-free bonds to force investors to move into risk assets, which in theory will support stronger economic growth. Investors can buy corporate bonds, reducing corporate borrowing costs, or equities, reducing the cost of equity capital, or foreign assets, reducing the value of the euro and improving its competitiveness. Whether the theory will work remains to be seen. In our opinion, it will not succeed in the longer term unless governments deliver on the structural reforms required to improve the efficiency and competitiveness of the region's economies. Without the tough reforms in both the Eurozone and Japan, QE is just a palliative monetary drug that eases the pain of decline but does not fix the problem. But that is not this year's story.

While the ECB and Bank of Japan are fully engaged in QE for the next year at least, the Fed continues its slow march toward normalization. Having already fully exited QE in 2014, the Fed is preparing to start increasing interest rates. To the extent the economy continues to improve as we expect, we now believe the first rate hike will be in September. While a move to 0.25% will have no material impact on the real economy as it remains way below what the neutral rate might be, it will continue to fuel significant angst and volatility in financial markets, due to fear that the economy is too fragile for rate hikes. It is not so much the first hike that markets are worried about, but how far and how fast the Fed will continue to raise rates once it starts. Here, we are less worried than the market. With no significant inflationary pressures yet building, the Fed will likely move slowly. A primary concern is to move rates away from zero so officials have the ability to ease again when needed. As long as the economy continues on a stable growth path, equity markets will begin to look past the fear of rate increases and perform based on improving economic growth and earnings expectations.

Currency markets

The policy divergence between the Fed and its counterparts in Europe and Japan has had a significant impact on currency markets. Indeed, one could make the argument that monetary policy is currency policy, but that would tend to upset your central banking friends who have to politically distance themselves from such arguments. Given other challenges facing the Eurozone and Japanese economies, we expect that their weaker currencies will be the primary channel through which QE will boost economic growth in the near to medium term. But markets are also forward looking and so tend to price trends in advance. We expect that currency markets have already made their big moves for the time being. Until new data or policy shifts cause a reassessment of the trends, the magnitude of any shifts should be smaller than in recent months.

Oil prices

Since last summer, oil prices have dropped by more than half, with West Texas Intermediate falling from north of US$100 a barrel to under $50. Importantly, the downward momentum appears to be easing, with prices now roughly flat for the year-to-date. It is important that we start to see some stability as markets seek the price that will balance supply with demand. The two questions for oil are: What will be the new near-term equilibrium price? And how long will it last? While I do not know the answers, it is worth looking at a very brief summary of the shift in the economics of the energy industry.

The biggest development underlying the fall in oil prices has been the emergence of the U.S. shale oil industry. The level of shale production has far exceeded expectations and constitutes a significant supply side shock to the industry. The extent of the U.S. shale revolution in effect led Saudi Arabia to suspend the OPEC cartel last November as the Saudis realized that any time they cut production to match a decline in demand, U.S. shale producers simply increased their output. The result of continuing would have been a spiralling down of Saudi production. To protect their market share, they launched a price war designed to force out weaker and high-cost producers and to determine at what price shale expansion would be curtailed. We are currently in such a period of price discovery.

In simple terms, the long-term price of oil is determined by the marginal cost of the next barrel of oil. Prior to the shale revolution, the marginal barrel was from either the oilsands or the Brazilian deep water offshore oilfields. Both are very high-cost sources and hence the price of oil had been fluctuating above $100 since 2011. With the explosion in shale production, that marginal barrel now comes from U.S. shale, and so we can expect that the equilibrium price to gravitate toward the marginal cost of producing a barrel of oil from the U.S. shale fields, and it should continue to track that price as long as the U.S. shale industry has the capacity to expand. The challenge is that because the industry is so new, we don't know the marginal cost or the size of the reserves. But the answer to these questions, and many others, will be important factors shaping the future of oil prices in the coming years.

It is our sense that the equilibrium price is higher than the current $50 level. It may be in the $60 or $70 range, but we are unlikely to see $100 again for many years. Following such a massive price correction, a period of more stable prices will allow companies, investors and consumers to make better informed decisions on the implications for the industry and impact on economic variables.

Clearly, lower oil prices will be positive for individual consumers and a net boost to almost all developed countries who tend to be net importers. The offset will be a hit to energy producers, both companies and countries, who will see a fall in revenues, and it will hurt investment and jobs in the energy and related industries. As an oil-producing nation, Canada will be one of the few developed countries likely to see a net negative impact.

European politics

European politics remain one of the bigger near-term geopolitical risks. First, the risk of Greece leaving the Eurozone appears higher than at almost any time during the crisis, although the risks of contagion are arguably much lower. Second, it is unlikely that the results of the U.K. election in May will contribute to political and economic stability.

Assuming both sides still want Greece to remain in the Eurozone, the risk of a political accident leading to its exit is elevated. Greece remains effectively bankrupt with a series of debt and interest payments coming due in the next few months. Absent a new deal, meeting the payments will become increasingly difficult. Yet both sides continue with brinkmanship, with the Germans offering the morally indignant mantra of no more bailouts and the Greeks insisting on no more austerity while refusing to even attempt structural reforms to improve the woeful competitiveness of their economy and institutions. Both sides are wrong, in our opinion.

Options in the coming months include reaching an agreement to release more funds to Greece and maintain the current charade, allowing Greece to default and write down its debt within the Eurozone, or Greece defaulting and exiting the Eurozone. In the near term, we expect an agreement on the first option, but it would appear obvious to just about everyone that a debt restructuring or default has to occur at some point. So the question remains whether it occurs within or out of the Eurozone. While it would be far less disruptive for all parties to keep Greece inside the euro, it will not be easy to achieve.

However, we also believe that the contagion risk from a Greek default will be far less severe than would have been the case a couple of years ago. Outside of Greece, most of its debt is now held by institutions that can absorb the losses (such as the ECB, International Monetary Fund, etc.) and the recent launch of QE by the ECB gives it tremendous firepower to offset any contagion selling in other peripheral debt markets. While such an outcome would shake up markets, we would expect the disruption to be short lived. For now, markets remain pretty sanguine about the issue.

The recently launched U.K. election campaign shows how the country has shifted from a two-party system to one of fragmented coalitions. Strong leadership is unlikely to emerge and with the incumbent Conservative-led coalition committing to a referendum on EU membership, neither leading party appears to offer a path towards economic and political stability.

Conclusion

While global political uncertainty shows no sign of easing, it is always important to keep in mind that political issues tend to be overplayed in the media and are not as significant to investment returns as many people believe. What matters most today are the economic and earnings outlook and monetary policy. As outlined above, we expect to see emerging signs of stability in many economic variables following the recent dramatic moves in commodities, rates and currencies. In the coming quarter, we expect this stability coupled with emerging data to support our view of a synchronized global economic recovery. With interest rates remaining suppressed, even with a hike or two from the Fed, this environment should provide a benign backdrop for corporate credit and set the stage for equity prices to continue to grind higher.

Within equity markets, following the catch-up rally in both European and Japanese markets, all developed markets are back at the rich end of their historic valuation ranges. In the context of record low global rate structures, this does leave equities relatively attractive versus most other asset classes.

It also means that we expect only modest mid-to-high single-digit returns, despite the favourable backdrop. The one area that does remain both relatively and absolutely cheap is emerging markets. In many cases, emerging markets are cheap for a reason, but with the lack of truly attractive valuations anywhere else, we may well see a similar catch-up rally. In particular, we are paying close attention to the ongoing reforms in Chinese financial markets, where the recent easing of restrictions on moving capital out of the country is allowing mainland investors to start investing beyond their borders. While it is very early days and there remain strict limits on where they can invest, the opening of China's capital account could significantly affect global capital markets in the coming years. It is a key reason behind Signature's decision to open an office in Hong Kong earlier this year. Stay tuned.

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