Market Roundup

As the 2009 was coming to a close, we surveyed the portfolio managers at Signature Global Advisors for their views on the markets and the outlook for the New Year.

Interest rates

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

Expect both the Bank of Canada and the U.S. Federal Reserve to keep interest rate increases on hold until the summer of 2010. The Bank of Canada will probably move first – but by the time it raises rates, the market will have already anticipated hikes by the Fed. In both countries, longer-dated, 10-year bonds should trade in the range of 3%-4%. We anticipate economic growth to continue in the 3% range (quarter-over-quarter) throughout the first half of 2010. Higher inflation is unlikely to creep into the pricing of longer-dated bonds until late in the year. In the U.S., bond supply should continue to put mild upward pressure on the U.S. yield curve.

Investment-grade corporate bonds

John Shaw
Vice-President,
Portfolio Management
and Portfolio Manager

The investment-grade corporate bond market has returned to more normal times after the credit crisis and recession of the past 18 months. Following unprecedented government support, the risk premium that was built into corporate bond spreads because of the financial meltdown has now disappeared. During the first half of 2010, we expect that the number of new issues will continue at a robust pace as companies extend the term of their maturities to take advantage of low yields and to build excess cash for future needs. Investor demand for corporate bonds is expected to remain strong because there is still a lot of cash on the sidelines that needs to be deployed. In 2010, earnings growth will improve the credit metrics for companies and support a tightening of corporate bond spreads. Investment-grade corporate bonds are expected to outperform government bonds.

High-yield corporate bonds

Geof Marshall
Vice-President,
Portfolio Management
and Portfolio Manager

Fresh from the fear of frozen lending markets, companies spent 2009 refinancing debt and "de-risking" their balance sheets. We expect to see the beginning of a "re-risking" cycle in 2010, as companies become more shareholder friendly. Late in 2009, there were several unusual bond issues, including one to fund dividends and another of payment-in-kind (PIK) bonds, which pay interest in additional bonds instead of cash payouts. We expect new issues of high-yield bonds to be on the agenda for 2010 as companies finance share repurchases or mergers and acquisitions – particularly leveraged buyouts. But, investors should tread cautiously. While spreads are attractive and defaults are likely to fall substantially, there will be a lot of new supply coming on stream, as the leveraged loan market refinances.

Income-producing investments

Ryan Fitzgerald
Vice-President,
Portfolio Management
and Portfolio Manager

Many investors have a deep mistrust of equity markets, interest rates are low, and baby boomers are nearing retirement. These statements describe today's situation – but they also described the situation in 2001. Back then, these conditions set off a historical run in income-producing investments such as income trusts, commercial property and infrastructure. Today, the demand for yield will play out differently. The Canadian income trust market is due to shut down as of January 2011 and two highly levered sectors, real estate and infrastructure, suffered a tremendous blow during the financial crisis. There will be plenty of innovation in the income market as participants work to marry cash flow-yielding assets with huge investor demand. IPOs, the privatization of government infrastructure, and the emergence of a high-yield bond market in Canada are all possibilities. Some ideas will be good and others bad, but one thing is certain – there will be no shortage of opportunities.

Preferred share market

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

Despite weathering the financial crisis in good health, Canadian banks and insurance companies still felt the need to increase capital through record preferred share issues in early 2009. Retail investors, who have been facing very low interest rates, bought the tax-advantaged preferred shares and supported Canadian financial institutions. Now, with capital levels at record highs and the economy slowly coming back to life, we expect fewer new preferred share issues in 2010. Interest rates are likely to remain low for most of the year, so investors will continue to search for higher-yielding assets. We believe the outlook for preferred shares remains very good.

Financials

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

The bank went over the mountain… Globally, banks have been climbing mountains of loan problems – structured credit, sub-prime mortgages, home equity loans, prime mortgages, credit cards, and commercial and industrial loans. As they ascend the commercial real estate mountain, we wonder which banks will make it to the top and what the view will be from the summit. It is unlikely there will be another mountain to climb, so the investment case for the surviving banks is very encouraging. We have reached a point in the credit cycle where the winners can be identified, yet valuations continue to reflect tremendous uncertainty. This provides enticing investment opportunities.

Technology, media & telecommunications

Malcolm White
Vice-President,
Portfolio Management
and Portfolio Manager

Technology was an outstanding performer in 2009 and its supply chain staged an early recovery when global credit was restored. But is future capital appreciation more challenging, given that good news seems to be priced in the market already?

Media has been a steady performer and is expected to benefit from a recovery in business spending.

Telecommunications is the contrarian sector for 2010. Defensive, late cycle businesses have been out of favour. However, the sector's high dividend yields are attractive given the low interest rate environment.

Industrial products & transportation

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

Industrial companies weathered the credit crisis much better than expected because of cost-cutting actions, low prices for raw materials and strong balance sheets. In addition, they managed to maintain healthy prices for their finished products and services, which helped to protect profit margins. These actions resulted in a strong rally for share prices toward the end of the year, as profit expectations were steadily revised upward from their summer lows. In addition, mergers and acquisitions activity began to pick up and increased orders indicated a return to growth in the next quarter or two, so there is a strong likelihood of further share price appreciation. Despite that, capacity utilization remains at very low levels, raw material prices have been rising significantly and valuations are beginning to factor in a stronger growth outlook next year, which presents a growing risk that profits may fall short of expectations some time in 2010. Beyond that, we see meaningful upside for share prices as companies continue to focus on achieving an adequate return on their investment.

Foreign exchange

James Dutkiewicz
Vice-President,
Portfolio Management
and Portfolio Manager

Lower volatility in foreign exchange markets will likely continue during the first quarter of 2010. We feel that the big moves in the U.S. dollar are finished for now, but by the second quarter, the uncertainty surrounding government "exit strategies" will likely begin to put pressure on foreign exchange markets and add more volatility. According to our economic projections, bond and foreign exchange markets will expect governments to lay the groundwork for their tightening of fiscal and monetary policies by the second quarter of the year. If policymakers fail to do so, the markets will likely punish them with a weaker U.S. dollar and higher yields. In other words, the markets will view the failure as evidence that the printing presses only have an "on" switch.

Global outlook

Drummond Brodeur
Vice-President,
Portfolio Management
and Portfolio Manager

As we enter the second decade of the 21st century, the world is radically changed from when we entered the first. The spectacular growth of key countries has positioned the emerging world as the driver of global economic growth. China now has world's second-biggest economy and is the largest market for everything from raw materials to cell phones, and the Internet to automobiles. At the same time, rescue policies in the wake of the financial crisis have left many governments in the developed world massively indebted. Key emerging nations must continue to evolve into leading global economies in order to provide the growth required for the West to rebalance and pay down excessive debt. As a fragile stability returns, investors need to expand their perspectives, encompass the reality of a larger, more-diversified global economy and shift their investment universe beyond the G7 countries to include the new world of G20 investable markets.