# Perspective on the Markets
# with Signature Global Advisors' Eric Bushell

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*With especially volatile markets early in August, we asked seasoned portfolio manager **Eric Bushell, Chief Investment Officer of Signature Global Advisors**, to join us for a special edition of the Wealth Matters webcast on August 9, 2011 to explain recent economic and market developments. His insights, summarized here, include his thoughts on how Signature is positioning its investment mandates during this period of uncertainty to minimize the downside while taking advantage of opportunities created by this environment. Mr. Bushell's team at Signature manages approximately $35 billion of global equity and fixed-income assets. We are committed to keeping you informed of market developments and of the strategy and discipline we employ in constructing and managing your portfolio.*

**The current situation**

- The downgrade of U.S. long-term debt is not an isolated event, but a continuation of the 2008 financial crisis. It's a consequence of the costs associated with automatic stabilizers, unemployment insurance, and stimulus programs, which cost global governments as much as 20% of GDP.
- Now some governments have reached their limits of sustainable debt loads and markets are beginning to insist on fiscal adjustments.
- This marks the beginning of what will be a turbulent social and political period where some of the elements of social safety nets across Western economies are no longer affordable.
- Templates for fiscal adjustment are emerging in peripheral Europe, core Europe, the U.S. and elsewhere.
- Policy interventions to ease the process of adjustments by governments and consumers are shaping markets more than fundamentals.

**How is Signature positioning its mandates in this environment?**

- Since April we have had a defensive positioning – incrementally taking cash levels from zero to about 15% in balanced and equity strategies. The funds are about 4%-4.5% gold bullion, and underweight equities in the balanced mandates.
- Our emphasis is on large caps that provide liquidity and quality.
- We have had a 90% hedge on the euro, and a 50% hedge on the U.S. dollar.
- By sector, we are underweight energy and materials and overweight defensive stocks.

**What's the rationale for Signature's conservative portfolio positioning?**

- Last August, the U.S. Federal Reserve introduced the $600 billion asset purchase program that came to be known as Quantitative Easing 2 (QE2). It was aimed at boosting asset prices and confidence, in hopes that a feedback loop from markets into the real economy would foster investment and job formation – and it worked for a while.
- Globally, equities were up 35%. Commodities – everything from grains to energy – were up 40%. Credit markets tightened. Investors moved out the risk curve seeking yield, some bought less liquid and lower-quality assets.
- In our view, share prices became inconsistent with the longer-term, low-growth reality that government and consumer deleveraging would mean. That was the principal reason for our move to a more defensive posture.
- A second dimension was that QE2 created inflationary pressures in developing economies, which led to policy responses and a slowing of growth. As a result, the world's growth engine caught a cold from QE2.
- The third reason is that markets were becoming less resilient to shocks because of financial regulations – Basel III and the Dodd-Frank bill in the U.S. This reduced the capacity of the broker/dealer community to absorb and hold risk, and reduced liquidity in the derivative markets that were used to hedge risks.
- Along comes the U.S. debt ceiling debate, with lots of fanfare and the downgrade, plus a more significant and immediate issue – which was the spread of the European sovereign debt contagion to Italy.
- Currently, the European Union bailout/bridge loan mechanism is undersized and requires three to four times the scale. That key decision hinges on German willingness to provide regional credit guarantees – something they will only offer once paths to balanced budgets are in view in overlevered EU member states.

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**Sell-off – but no market meltdown**

- We've had a sharp sell-off but there are two preconditions for a full market meltdown that do not exist today: widespread leveraged participants and the significant use of short-term funding by market participants, such as corporations and investment banks. In 2008, these led to forced selling and true market meltdowns.
- The traditional leveraged financial participants, the broker/dealer community and the hedge fund community, have little or no leverage.
- In the short-term funding market, U.S. commercial paper issuance has been reduced by half and asset-backed commercial paper is completely gone. Corporations have moved to longer-term financing through the bond market.
- GDP estimates are being reduced, and some earnings estimates will probably be lowered, but a recession still doesn't look likely.
- Equity markets may have overreacted, but a reset was needed.
- Templates that have emerged to address the debt issues include the Greek debt rescheduling and principal reductions by holders of Greek bonds being pushed to recognize losses – which are forming a basis for similar actions elsewhere.

**A longer-term view**

- We have to recognize that this 40-to-50-year cycle of consumer and government debt accumulation, funding extra growth in the developed economies with richer social safety nets, has now run its course. Less generous social safety nets and lower growth lie ahead.
- Markets and policymakers are trying to find a stable pathway to deleverage those two important components of the economy – the government and the consumer – without impacting markets, the banking sector or economies in a profound way.
- Capital is migrating to higher-growth, less-indebted emerging economies, where balance sheets for consumers and governments can still expand and support growth.
- This deleveraging in the developed economies is going to take various forms – default, inflation and outright principal paydown – until a sustainable equilibrium is established in terms of the debt load.
- It's going to be a turbulent time, but that doesn't mean it's unmanageable in all geographies.

**What are some of the investment implications?**

- It means lower rates, for longer, in the developed economies. Investors who are seeking yield will still have that problem.
- So long as there's not an outright recession, it's a supportive environment for credit.
- On the equity side, companies trading at 11 or 12 times earnings, with strong balance sheets, and rising dividends look appealing. But one caution is that this is a margin squeeze – as consumers facing stagflation in developed economies trade down.
- Refugees from riskier sovereign bond markets or economies will continue to flood into the fiscally sound geographies – including Canadian dollars – and this is going to manifest itself in low interest rates here.
- In terms of foreign exchange markets, further U.S. dollar weakness is part of the strategy to restore competitiveness, attract foreign direct investment and sponsor employment. All those things will keep money looking for alternatives to the U.S. dollar.
- Signature believes that commodities will have higher floors since they are valued in U.S. dollars. This is clearly evident in the gold market, and will be verified in the oil and property markets, we believe, as investors look at real assets as stores of value.
- In emerging market equities, valuations are now low. We think that there's durability in the emerging economy growth cycle, and even if they try to cool things down, everything that's gone on in the last few months makes them more inclined to sponsor growth. We believe long-term growth is intact in emerging markets.
- Our baseline case is that income strategies will continue to work and so will equities of high-quality companies with dividends.