Signature Year In Review and 2018 Outlook

Global resources and energy

Robert Lyon
Head of Equities, Senior Vice-President, Portfolio Management and Portfolio Manager

2017 was a strong year for commodities – much stronger than most market participants (ourselves included) had predicted. Most major commodities performed well during the year, including copper, lumber, coal and oil. Even gold managed to rise from about US$1162 to $1309 per ounce for a solid 12% gain, despite the threat of U.S. interest rate increases which would normally act as a drag on the price. The chemical group also performed strongly, with the equities additionally driven by consolidation activity in the sector.

While each commodity was influenced by individual factors, there were three key issues that positively impacted the broad commodity complex: (1) a strong global economy, which had a positive impact on demand; (2) five years of slowing investment, which resulted in limited new supply; and (3) Chinese policy adjustments – largely based on environmental factors – which limited the supply of certain commodities out of China. The result was a strong year for the materials component of the equity markets, with the MSCI World Materials Sector Index rising 26.2%. The MSCI Energy Sector Index lagged with just a 2% return. Certain components of energy performed well, specifically integrated oil and refining companies, but overall equity performance was lacklustre. Energy could be a bright spot for equities in 2018 if the recent strength in oil prices continues.

While always hard to predict, the three positive factors that influenced commodities in 2017 look set to continue in 2018. The global economy has reached a level of synchronized growth not seen since 2010-2011, during the early years following the financial crisis. While that period was more of a short-term bounce based on crisis recovery, the current situation looks and feels more like a typical mid-late cycle surge based on strong fundamentals. In essence, the crisis is over, the global financial system has been largely repaired, and global economies are in a sweet spot of strong growth and low inflation. This bodes well for the demand side of the commodity equation.

On the supply front, mining and energy companies look set to continue limiting their capital growth projects in 2018, though likely at a less restrictive level than the past few years. For mining companies, the painful recent years of low commodity prices is likely to limit how quickly they ramp up spending. While this may keep a lid on production/volume growth, it should help to support commodity and equity share prices. A similar story holds true in energy. While onshore North American shale producers will likely react fairly quickly to rising commodity prices, the rest of the energy-producing world should remain relatively restrained in their capital expenditure plans in a US$60-ish oil price environment. This should help to limit global supply growth and help to support prices. The final piece of the supply equation comes from China, where 2017's surprisingly strong environmental restrictions resulted in that country limiting its output of coal and iron ore, in particular, but also in implementing policies that have helped to support global pulp, paper and fertilizer prices. A continuation of these policies would go a long way to ensuring another strong year of commodity prices in 2018.

On the equity front, valuations for commodity-producing companies are relatively benign. While equity prices have generally rallied, they have been equally matched by rising earnings and cash flows. Unique circumstances exist, such as high valuations in certain specific energy shale companies. But by and large, commodity-producing company valuations are well within historical ranges. Combined with an attractive commodity price backdrop, 2018 is shaping up as another strong year for commodity-producing stocks.

Currency

Matthew Strauss
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The unrealized expectation of broad-based U.S. dollar strength in 2017 was probably one of the biggest consensus misses for the year. At the start of the year, the market eyed a strong U.S. dollar rally as Donald Trump entered the White House with promises and threats of trade protectionism, fiscal stimulus and capital repatriation. But over the course of the year, the U.S. dollar lost 7% on a trade-weighted basis as Trump's rhetoric mostly failed to deliver (the most noteworthy exception was the passing in December 2017 of tax reform legislation). Further, moderate U.S. economic growth and muted inflation allowed the U.S. Federal Reserve to pursue the gradual normalization of rates as opposed to more aggressive hikes that could have sent the U.S dollar higher.

Over the next 12 months, the U.S. dollar is unlikely to follow a uniform path of either appreciation or depreciation. It's more likely to see idiosyncratic movements in specific currency pairs based on expectations about interest-rate differentials between the two countries rather than on U.S. rate expectations alone. This was already evident in both the euro and the Canadian dollar in 2017. The euro rallied to 1.20 from 1.04 during the first nine months of 2017 before settling into a range of 1.16-1.20. The initial move higher was triggered by comments and expectations that the European Central Bank would have to start contemplating its own exit strategy from extraordinary monetary policy, the so-called process of policy normalization. The outlook for EUR/USD remains constructive, although it is likely to see a measured upward move rather than a spike higher as the ECB embarks on a gradual path of policy normalization.

Similarly, the sharp move in the Canadian dollar in mid-2017 was driven by the Bank of Canada's unexpected move towards tightening, which saw it hike rates twice in 2017. The interest rate spread with the U.S. narrowed significantly during this period.

The Canadian and Australian dollar will likely be some of the more challenged developed-market currencies later in 2018. Although we don't see a sudden and sharp downward correction in either currency, the balance of risks favours a drift down rather than up. For Canada, these risks include oil prices that are currently trading towards the higher end of our expected price range, economic growth that is expected to slow towards 2% in 2018, the absence of meaningful core inflation, elevated housing prices, a high level of household indebtedness and ongoing renegotiation of the North American Free Trade Agreement. However, current job-growth momentum in Canada remains strong and will limit the extent of any near-term sell-off in the currency. Our view is for the currency to trade in a range of 77 to 82 U.S. cents for most of 2018. We believe the currency will trade towards the higher end of the range early on as the Bank of Canada may further increase interest rates. The lower end of the range could be tested as the year progresses.

Emerging markets

Emerging market equities rallied by 37.5% in 2017 in U.S. dollar terms, easily outperforming developed market equities (+23%) for a second consecutive year. Even though performance was led by the technology sector (up 59% during 2017), an improving global macro backdrop provided the necessary setting to convince investors to deploy more money into cyclical assets, including emerging market bonds and equities. As a result, 2017 saw a record inflow into emerging market bonds and for emerging market equities, 2017 became the second-strongest year of inflows ever recorded (only 2010 attracted more equity flows). Taken together, emerging market assets not only recorded stellar returns, they also saw the strongest annual inflows on record.

The rally in emerging market equities was supported by the Russian and Brazilian economies coming out of recession, China's economy surprising on the upside of growth expectations, and firm commodity prices. Despite increased geopolitical tension on the Korean peninsula, uncertainty about the future of South Africa's ruling party, a surprisingly aggressive reform agenda in Saudi Arabia, an ongoing investigation into Russia's meddling in the U.S. presidential election and Venezuela defaulting, political risks couldn't derail the positive sentiment towards emerging markets. Even the gradual tightening of monetary policy in the U.S. didn't dent the attractiveness of emerging market assets. Positive momentum in economic growth, earnings and investment sentiment far outweighed the downside risks in 2017. The positive backdrop is expected to continue in 2018, although emerging market equities will most likely underperform 2017. For 2018, equity returns of 8%-12% are expected given the overall economic growth and earnings outlook.

The technology and banking sectors should do well, although rising valuations may present a key risk for the former. The banking sector will benefit from normalization in the global rates structure as moderate inflation returns to the U.S. and many emerging markets.

We continue to prefer Asia over other emerging market regions given still-strong overall growth, muted inflation, a growing middle class and significant savings. Despite obvious political

and geopolitical risks in Asia, the probability of these risks materializing is significantly lower compared with the risks in the Middle East, Eastern Europe (Turkey), Africa (South Africa) and Latin America (Mexico, Peru and Brazil). Globally, U.S. interest rate policy under the new Fed chair, a stronger U.S. dollar, declining commodity prices (the latter most likely driven by an unexpected slowdown in the Chinese economy) and trade protection pose some of the bigger global risks to an otherwise constructive outlook for 2018. We enter the year positioned for another encouraging year in emerging market equities.

Financials

John Hadwen
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United States – A year ago we debated whether the post-election bank rally of 23% had priced in too much hope. Our view was that the rally was well supported by anticipated tax cuts, a strong U.S. economy and abating regulatory headwinds. The U.S. bank index (KBW Bank Index) returned 19.2% in 2017, a great return but a tad below the broader S&P 500 Index benchmark. The pending improvement in U.S. corporate tax rates exceeded our expectations and regulatory headwinds now seem to be turning into tailwinds as Republicans attack excessive regulation.

With much of the "blue sky" potential playing out is it now time to sell excessive optimism? As usual it remains a tough call, but our view is that U.S. financials remain absolutely and relatively appealing. We thought we would need to sell into a year-end rally when all this good news was priced into the stocks, however in most cases the price appreciation has not kept up with our updated appraisal targets. Healthy loan growth, ongoing low credit costs, net interest margin expansion, potentially more capital flexibility, moderating regulatory burdens, improving efficiency ratios and the tax cut can support a meaningful improvement in the sector's return on equity in the short and medium term. U.S. banks will improve returns and become better businesses, significantly narrowing the profitability and valuation gap with Canadian banks.

Canada – While earnings growth has moderated for the domestic banks they continue to be excellent compounders of capital, which supports reasonable dividend growth and the occasional acquisition. The Canadian banks generated a respectable 14% total return in 2017 which felt appropriate as fundamentals remained supportive. Our base case expectation is for domestic earnings to be up by mid-single digits, and foreign earnings segments to be slightly stronger, supporting positive but modest earnings growth and price appreciation. We currently view the domestic economy as somewhat fragile given high household debt ratios, and acknowledge that Canada is susceptible to potential trade disappointments with the Trump administration. Signature's mandates started 2018 with a slight underweight to our domestic banks and a material overweight in Manulife Financial.

Europe – European banks have significantly lagged their global competitors in recent years and appear to offer the most compelling regional investment opportunity within global financials. The

outlook for European banks has been a relatively hopeless one in recent years with an extremely low interest rate structure (even negative), weak economies and high political risks (ie. Brexit), and still a few hundred billion in non-performing loans just in Italy. The MSCI European Banks Index has returned only 33.5% over seven long years. However, we now believe the sector is poised for a catch-up trade relative to global competitors given less demanding valuations, an improving economic backdrop, a very recent and material decline in regulatory uncertainty (Basel IV), and an anticipated rise in European interest rate structures in the medium term. We have conviction that the sector offers compelling dividend yields and growth relative to the market. We believe our positions in Nordea, Swedbank, Intesa Sanpaolo, Lloyds and Moneta are trading with 2018 dividend yields of 6.3%, on average.

Emerging markets – We continue to find reasonably attractive valuations in select emerging market financial companies which add growth potential and diversification to the portfolio. Many of our emerging market financial investments performed extremely strongly in 2017, leaving us slightly less constructive than a year ago. We will tactically reallocate capital within the portfolios as valuations and information influence our outlook. Regionally, we have a preference for India within Asia, and are able to find very attractive opportunities within Central and Eastern Europe and throughout Latin America.

Real estate

Joshua Varghese
Portfolio Manager

Global real estate was a highly bifurcated asset class in 2017, which rewarded asset allocation strategies over stock picking. The MSCI World Real Estate Index returned 8.5% in Canadian dollar terms, and this was heavily influenced by a few key themes, namely, e-commerce and growth. As an example, consider the three main property types that are most linked to further digitization – cell towers, data centres and industrial properties. Note that the first two categories are largely non-traditional real estate types, and these got a major boost from the tech theme. The performance of Signature's real estate portfolio was largely flat, as we missed out on the momentum in cell towers and data centres. Our value-oriented strategy of identifying strong real estate companies trading at large discounts to NAV (which worked very well from 2010-2015) worked against us, relative to the growth theme that most markets experienced in 2017.

The shine has come off traditional property stocks in the past couple of years, during which time we have been underweight real estate by about 25% in our portfolios. The overcrowding of investors in real estate a couple of years ago has now been in the process of reversing (ie. investors are abandoning the space). We believe this will open a potential buying opportunity where we will get a chance to step in and take our weights up materially.

We are already seeing evidence of real estate experts disagreeing with stock market experts. Examples are cropping up whereby stock market investors trade real estate stocks down to levels materially below their net asset value, and subsequently a real estate expert comes in to take the company private (ie. Unibail buying Westfield, or Brookfield bidding for GGP). The continued lag in stock prices will likely add to more mergers and acquisitions in the real estate sector going forward as it remains a very strong asset class.

It is always difficult (or impossible) to predict short-term stock price movements, but there may be continued weakness REITs in the first part of 2018, and that should open some investment opportunity. That said, we are seeing some opportunities already. We recently added positions in single family rental companies in the U.S. (American Homes 4 Rent most recently, and Tricon since early 2017), as well as office REIT Gecina in Paris. We have many stocks currently on the radar which we will be ready to act on should pricing permit.

Infrastructure

Kevin McSweeney
Vice President, Portfolio Management and Portfolio Manager

In aggregate, we believe that infrastructure will continue to benefit from predictable cash flows, irreplaceable assets with monopoly characteristics, and low volatility. Valuations will be key as investors balance strong underlying performance with an expectation of higher cash flow discounting from increased government bond rates.

2017 was a strong year, with the MSCI World Core Infrastructure Index returning 20% in U.S. dollars and 12% in Canadian dollars. For Signature, we believe that these levels could potentially be reached again, but the 2018 outlook for the infrastructure space varies significantly by subsector and geography.

Transportation infrastructure such as airports, ports and toll roads should see their operating performance benefit from the generalized global growth on display. Volumes in these areas tend to correlate with economic performance and commercial activity. We expect more consolidation in this space following the ongoing acquisition attempt of Spanish toll road operator (and Signature holding) Abertis. We do, however, feel that the expectations – and likely occurrence – of rising global interest rates will restrain the valuation on these types of assets.

Telecom infrastructure recorded a strong 2017, with tower, fibre and data centre companies all benefitting from higher consumer data consumption and the low interest rate environment. In this sector, we will be cautious as potential telecom consolidation (reducing the need for growth in tower requirements) could reduce growth expectations in securities with high valuations.

In midstream energy infrastructure, we feel comfortable that growing North American volumes of oil and gas production will continue to support accretive investments and growing cash flows for companies such as Williams Companies, Enbridge and Kinder Morgan (all Signature holdings). While Canada and United States each share the underlying growth, the valuation setup for the U.S. is significantly more favourable due to a weak 2017 performance in the U.S. midstream space (due to money exiting the sector to more growth oriented industries, and uncertainty around tax reform's impact on the tax-advantaged MLP sector). We believe the value aspects of this sector will show through in 2018 and are comfortable that risks around commodity prices and technological change are generally reflected in valuation levels as we enter 2018.

Technology

Malcolm White
Vice-President, Portfolio Management and Portfolio Manager

The past year has been an excellent year for technology and we were positioned accordingly all year. The sector continues to benefit from long-term positive drivers. Advancements in artificial intelligence have driven the use cases for data. Enhanced sensors, such as the 3D and imaging sensors in new smartphones and automobiles, enable more intelligence and applications in these devices. E-commerce and cloud-based web sites have been able to leverage these technologies to provide better products and services to consumers globally.

These innovations are driving the need for new technology applications and the digital transformation of every global business. This is our investment tenet for 2017 and beyond. Digital winners benefitted accordingly as demand grew; digital losers suffered as expected.

Looking ahead to 2018, we expect the long-term secular trend will continue. We are still in the early days of the innovation cycle and we expect further advancements in areas such as sensors, artificial intelligence and blockchain (the internet of value).

This will be offset, however, by some backlash against the technology sector based on fears that it has become too powerful. Europe has lead regulatory reform against the sector and will implement new data privacy rules (GDPR) in 2018 to reinforce consumer ownership of their own data. We also wait to see if Apple's new innovative features gain traction with consumers given the much higher price points.

Regardless, corporate spending intentions look positive as more industries seek to digitally transform their businesses, and this represents a new opportunity in the backdrop of improving global fundamentals.

High-yield bonds

Geof Marshall
Head of Credit, Senior Vice-President, Portfolio Management and Portfolio Manager

A persistent firm tone in investor sentiment drove spread compression in 2017. The market remained resilient at times despite missteps, tweets, and sabre-rattling from the U.S. administration, and at other times, the market rallied because of legislative progress. European political risk abated in early 2017 and positive risk positioning was warranted as global economic conditions improved in the absence of sufficient inflation to merit extraordinary central bank action. Specific to high-yield bonds, whereas sector selection drove 2016 returns with the commodity complex recovery, sector returns were more uniform in 2017 and security selection became more important; a trend we believe will continue in 2018.

Our forecast for 2018 sees further spread tightening from both investment-grade and high-yield bonds, supported by synchronized global growth, cautious central banks, and a declining default rate. This is despite pockets of weakness in retail, generic pharmaceuticals and wireline telecom. This spread compression should be sufficient to drive positive returns despite the expected three to four rate hikes from the U.S. Federal Reserve in 2018, just like last year. There are wildcards, like Fed policy under the new leadership of Jerome Powell, the future of the European Central Bank's stimulus program, record low volatility across asset classes, groupthink and complacency, and headwinds – principally valuations. Current spreads (and prices) are on the expensive side of historical averages, but not irrational. U.S. tax reform should be positive for credit, as lower corporate tax rates boost cash flows. This will be partially offset by increased expenses on the elimination of interest deductibility, but the net effect raises the after-tax cost of debt. Higher after-tax cost of debt should lead to some deleveraging, especially since borrowers' cost of equity has decreased with stocks at or near record highs. Foreign profit repatriation is also a slight credit positive, although there seem to be more beneficiaries in large-cap technology and pharma investment-grade names than in high yield, and proceeds will probably be directed to share repurchases and M&A rather than debt reduction. All told, what companies do with this largesse will determine the trajectory of credit markets in later years.

In our view, 2005 may be the best analogy for 2018. By 2005, the Fed was well along a predictable hiking path, the economic expansion was reaching middle age, and credit spreads had already narrowed dramatically. Further, now as in 2005, we are beginning to see new issuers coming to market with aggressive leverage and looser terms, and we are inclined to believe deregulation at the U.S. Securities and Exchange Commission, Federal Reserve, and Consumer Financial Protection Bureau is likely encourage further credit excesses, but again, in later years. What made 2005 unique, however, was the surprise downgrade of General Motors and Ford from investment grade into high yield. This pushed investment-grade bond spreads 20 basis points and high-yield bonds spreads 100 basis points wider in just a few months. In 2018, we think the positive tone will persist, but we are watching for the surprises or issues no one is watching. Higher idiosyncratic risk, and the requisite importance of security selection, we view as a marginal positive; an indication of market discipline that was absent when the high-yield bond market was at similar valuation levels in 2013 and 2014. Taken together, a mid-single digit return driven much more by carry than price appreciation is possible for high-yield bonds in 2018.

Rates

Kamyar Hazaveh
Vice-President, Portfolio Management, and Portfolio Manager

As 2017 comes to an end, it is only appropriate that we reflect on positioning and performance across our fixed-income strategies and set the course for what is shaping up to be a challenging 2018. That is not to say that 2017 was not challenging. In fact, when we compare "consensus" expectations for 2017 with actual results, we see that this past year has been anything but predictable (see Figure 1 below). Not that this should surprise us – as the common saying goes: "Fool me once, shame on you. Fool me twice, shame on me." If the last several decades have taught us anything, it is that investors' predictions (in aggregate) have almost always been wrong. When the U.S. Federal Reserve was in tightening mode, investors persistently predicted fewer hikes than the Fed delivered, and the rest of the time, interest rates were supposed to shoot for the moon, but ended up six feet under. When in doubt, blame gravity.

Figure 1: Consensus expectations versus outcomes for 2017

Consensus Expectations for 2017	Realizations throughout 2017
US 10-year interest rates would be roughly 3% by the end of 2017	US 10-year interest rates are sub 2.4% today (i.e. they are lower than they were at the start of 2017)
US wage growth would pick up and inflation would exceed expectations	US inflation has missed survey expectations 7 out of 11 months (so far) this year and market's inflation expectations are lower today than at the start of 2017
USD would outperporm a trade-weighted basket of developed market currencies	USD has been the worst performing among all G10 currencies (EUR was the best performer)

Source: Signature Global Asset Managemnet

"To guess is cheap, but to guess wrongly is expensive."

Signature's approach to managing its fixed-income strategies leaves nothing to pundit prognostications. We adopt a carefully designed framework that enables us to diversify our strategies' exposures across the fixed-income risk spectrum and improve their risk-reward profiles over the long run.

As we turn our attention to 2018, we maintain our core total return positioning. As for our core portable beta positioning, we continue to maintain a diversified exposure to fixed-income risk premia by coupling duration-sensitive government bonds with global investment-grade credit, U.S.-dollar-denominated emerging market sovereign debt, inflation-linked bonds, U.S. agency mortgage-backed securities and, where appropriate, global high-yield credit and preferred shares. The composition (i.e. the relative allocations between the various assets) will continue to be managed tactically. This is especially important because throughout 2017, some of the asset classes, particularly U.S. investment-grade corporate bonds, outperformed on a risk-adjusted basis and look fully valued.

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