The Signature Position:
Latest Equity Market Sell-off

By Jean-Philippe Bry, October 12, 2018

To quote the market's most *stable genius in chief*, Donald Trump, a stock market correction was overdue. A correction was something we have been anticipating, and highlighted as recently as early October at our conference in Scottsdale, Arizona.

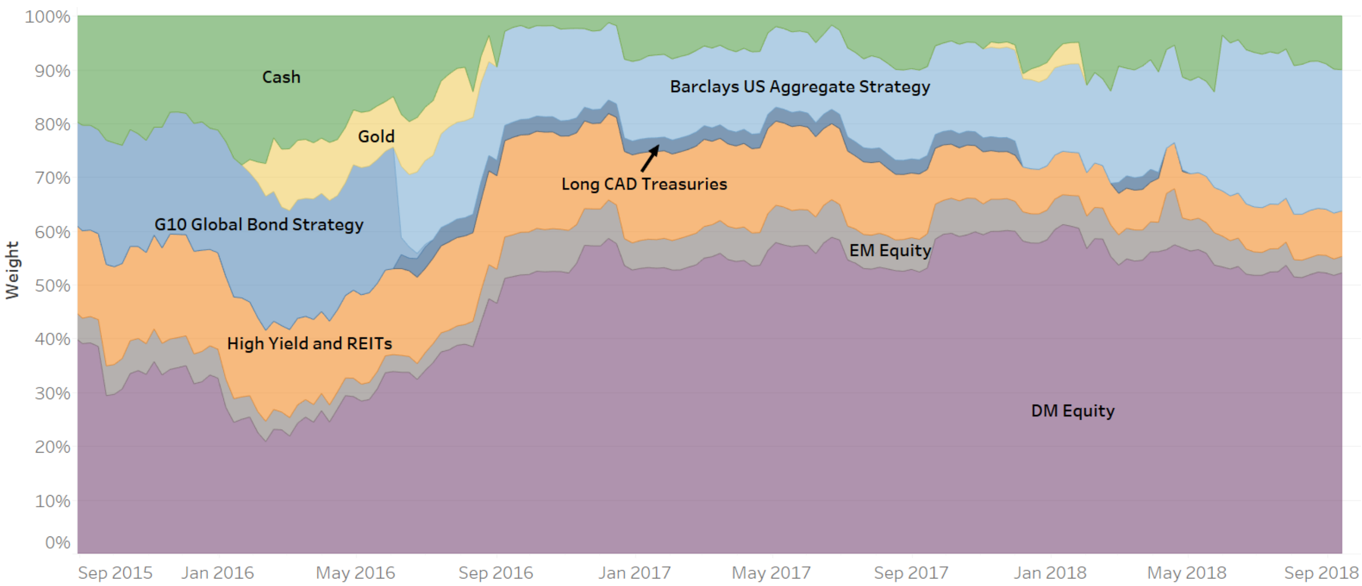
The premise is that as rates normalize at higher levels, volatility – long suppressed – would ultimately normalize as well. The period when both rates and stock markets would rise, encouraging increased risk taking, appears to have reached its limits – at least for now.

Markets outside the U.S., namely Europe, Asia and emerging markets, have been suffering for some time as the period of global synchronized growth experienced in 2017 gave way to de-synchronized growth. This saw the U.S. growing faster and the rest of the world slowing down, albeit from high levels. In fact many markets are bearish, negatively affected by higher U.S. rates and a higher U.S. dollar, as well as higher energy costs in many instances.

The U.S. is only catching up to the rest of the world in terms of bearishness, with technology leading the downside. In fact, within the U.S. market, a rotation to more defensive sectors has been under way since the summer. The break in technology was the straw that broke the market's back to something that was already being signaled by the defensive nature of the market. Note how well sectors like health care, which was actually out-performing technology, has performed in the last several months.

These are the reasons that Signature moved to a neutral position on equities and an underweight in technology in all our balanced funds (Signature Global Income & Growth Fund, Signature Income & Growth Fund and Signature Canadian Balanced Fund) this past summer, and went slightly underweight in September after a long period of being overweight. (*See Chart 1 for historical perspective*).

Chart 1 – Signature Global Income & Growth Fund Asset Mix (September 2015 to September 2018)



The equity weight for Signature Global Income and Growth Fund as of September 30 2018 was 55%; the corresponding benchmark equity weight was 60%. (The benchmark is a combination of the MSCI All Country World Total Return Index - 60%, the J.P. Morgan Global Government Bond Total Return Index - 25% and the Bank of America Merrill Lynch U.S. High Yield Total Return Index - 15%).

Source: Signature Global Asset Management as of September 30, 2018.

So now what?

Importantly, there is no panic in markets and, so far, the decline is orderly. There is no flight to U.S.-dollar safety or U.S. government bonds. Volatility is higher but contained. High-yield bond spreads widened but from very tight levels that were at multi-year lows.

That being said, U.S. markets are not oversold (although they might be by the end of day at the time of writing) and changes in volatility affect positioning and risk taking. We estimate that trades were unwinding to the tune of about $40 billion and while this is likely to grow over the coming weeks, we don't anticipate it being a problem for the market to deal with given the market environment we described above.

The more pertinent question is whether this is something bigger and a sign that we are at the end of the cycle, which would suggest meaningfully more downside for stocks. The answer is NO.

As we outlined recently at our conference, we see this market consolidation as positive in that it alleviates market pressure in terms of either valuation, liquidity, rates or the U.S. dollar.

The issue for markets is more the pace of change rather than an absolute number. Markets have difficulty digesting rapid moves in long U.S. rates or the U.S. dollar. This correction should alleviate the pace of rate rises at the long end and possibly at the short end should the U.S. Federal Reserve decide to pause in 2019 – something that becomes more probable with a meaningful correction. (*More on this below*). The pace of the U.S. dollar rise has also been more subdued in the last several weeks.

There are no signs currently to suggest a U.S. recession is on the horizon. In fact, it still appears a number of years away given the lack of excesses in the system, strong employment growth and reasonable wage growth. Trade is a negative but only marginally for the time being.

Importantly, inflationary pressures remain subdued which is a key factor in anticipating an eventual slower pace of increase for rates.

It is the reason that our next asset mix move is more likely to increase risk and exposure to equities, rather than reduce it.

Nevertheless, one has to be concerned with the deterioration in global markets, which are heightening concerns about growth internationally and the possibility that over time this will feed back negatively into the U.S.

It is important that these markets stabilize which will require greater assurance around some important risks.

The first is the global trade war between the U.S. and China. Clearly this has the potential to disrupt global supply chains and impede global growth. Perhaps more distressing is the danger of conflict between the two superpowers that would unnerve markets as highlighted by the under-reported incident last week involving U.S. and Chinese naval vessels that almost collided.

There are reasons to believe the situation will improve as it is in both countries' interest to resolve the issues. The last-minute deal on NAFTA 2 (now the U.S.-Mexico-Canada Agreement, or USMCA) is a sign that Trump can also make deals and not just destroy them. There are admittedly deeper issues with China, but an agreement is in everyone's interest. Arguably, Trump is sensitive to the stock market, associating his success with that of the market. A market correction increases the probability of Trump seeking a deal with China.

The slowdown in China is also a risk to global growth and emerging markets; but, interestingly, China is actually opening up its markets to Europe as well as Japan – a move that should offset the negative impact form U.S. tariffs over time.

A number of additional risks, from Italy to Brexit, are evident and are negatively impacting Europe. These have relatively short fuses so an outcome that we believe should be interpreted positively by markets will emerge soon.

Ultimately our constructive longer-term outlook is based on the lack of inflationary pressures globally and in the U.S. in particular. This should limit upward rate pressures and offer the U.S. Federal Reserve a window to pause its rate hike program some time in 2019. A pause in U.S. rate hikes would be the signal to re-enter risk assets globally.

The Signature Position: Latest Equity Market Sell-off

IMPORTANT INFORMATION

This commentary is published by CI Investments Inc. It is provided as a general source of information and should not be considered personal investment advice or an offer or solicitation to buy or sell securities. Every effort has been made to ensure that the material contained in this commentary is accurate at the time of publication. However, CI Investments Inc. cannot guarantee its accuracy or completeness and accepts no responsibility for any loss arising from any use of or reliance on the information contained herein. Certain statements in this document are forward-looking. Forward-looking statements ("FLS") are statements that are predictive in nature, depend upon or refer to future events or conditions, or that include words such as "may," "will," "should," "could," "expect," "anticipate," "intend," "plan," "believe," or "estimate," or other similar expressions. Statements that look forward in time or include anything other than historical information are subject to risks and uncertainties, and actual results, actions or events could differ materially from those set forth in the FLS. FLS are not guarantees of future performance and are by their nature based on numerous assumptions. Although the FLS contained herein are based upon what CI Investments Inc. and the portfolio manager believe to be reasonable assumptions, neither CI Investments Inc. nor the portfolio manager can assure that actual results will be consistent with these FLS. The reader is cautioned to consider the FLS carefully and not to place undue reliance on FLS. Unless required by applicable law, it is not undertaken, and specifically disclaimed that there is any intention or obligation to update or revise FLS, whether as a result of new information, future events or otherwise. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

The statements contained herein are based on material believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. CI Investments Inc. and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.