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Q&A-Canadian election result positive across sectors; Steeper yield curve expected as BoC tapers: Kevin Headland, Manulife Investment Mgmt

The Liberal win in the Canadian election was fairly benign for equity markets, and expected fiscal spending should be supportive, **Kevin Headland, senior investment strategist at Manulife Investment Management,** told the Reuters Global Markets Forum on Tuesday, September 21.

He also said as Bank of Canada (BoC) continues to taper and the government continues to spend, the yield curve is expected to steepen, adding "if you had to find opportunities in Canada, you are likely best off in provincials that offer a better yield."

Following are edited excerpts from the conversation:

Q: What are your thoughts on the implications of the election results last night? Any particular sectors in equity or credit that look attractive, or any you'd be more cautious on?

A: Typically, the election results in Canada do not really have much of an effect on the broad Canadian market. Given the market reaction so far today, it would seem as though the results are fairly benign for the S&P/TSX (Toronto Stock Exchange). The results likely indicate a status quo for policy. Now that the election is over, market participants have more a of clear signal as to what to expect. Continued fiscal support should be positive, but at the same time, we will be watching for any announcements that may impact specific sectors. We do not see any reason to be cautious at this point from a policy perspective.

Q: Nothing worrying as far as implications for oil and gas (O&G), financials with the Liberal win?

A: Nothing that wasn't known before. It remains to be seen if the government will be able to pass legislation on the financials. Again, the reaction is somewhat positive across sectors so that tends to be a signal of how the market sees the results. From an O&G perspective, any clean energy initiatives are still longer term and should not impact shorter term price movements.

Q: What ripple effects do you see from the Evergrande fallout in global markets?

A: While Evergrande will have, and already has, some major implications on the China real estate sector and real estate market as a whole, we don't see this as posing a systematic risk to the global market. This is obviously a fluid situation that we will need to monitor closely and depending on how the government reacts -- will they step in and bail them out, investor's reaction, the overall impact to the China real estate market, etc. there could be some further impact. With that said, we don't see this as an event that could spur a lot of contagion effects.

Q: Are there any changes you see warranted in asset allocation post Jackson Hole and with the upcoming U.S. Federal Reserve meeting?

A: Even prior to Jackson Hole, we were cautious on the bond market. We believe that the 10-year yield should trend higher which poses a risk to longer duration fixed income assets. Additionally, credit spreads across the capital structure are near long term lows, which doesn't provide much upside from a total return perspective.

Q: What about Canadian government debt, any parts of the curve that you like there?

A: When it comes to fixed income in a portfolio, a diversified global bond portfolio provides the most flexibility to generate yield. However, in this environment the bond portfolio should be used as a volatility dampener and not a return enhancer. Now is not the time to chase returns in fixed income. Within Canada, we have the same issue. We are likely to see the BoC continue to taper while the government continues to spend. That should result in a steeper yield curve which would again suggest a shorter duration posture. If you had to find opportunities in Canada, you are likely best off in provincials that offer a better yield.

Q: Where do you see the best opportunities for returns right now?

A: From a return perspective, there aren't many opportunities for outsized performance. In this phase of the post-recession recovery, we are starting to see earnings growth drive equity market returns. What that means is that we need to adjust our expectations for average returns for the broad market, still with risk to the upside. We believe that the environment going forward should favour active management and a bias toward quality, with companies that show sustainable, predictable earnings growth leading the way.

Q: What macro impact do you see from the ongoing chip shortage and supply chain slowdown?

A: First, these supply chain disruptions are unlikely going to end soon. Backlogs across industries remain extremely elevated. Longer term, companies may look at diversifying their supply chains and you may see more near shoring to reduce bottlenecks.

Q: What are your views on emerging markets (EM) - equities and debt in hard & local currency - especially if you don't expect too much contagion from Evergrande?

A: We think emerging market equities are very attractive longer term, provided you understand the risk of shorter-term volatility. Prior to Evergrande, we saw EM valuation offering a very nice discount to DM (developed markets), but we have to have a longer-term investment horizon. The fundamentals are supportive of EM. From a credit perspective, I think it is much the same situation. These market events often create dislocations that provide opportunity. At the same time, we need to analyze each issue in their own right as well as the potential currency move. Since, we are operating on behalf of Canadian investors, we need to look at how the CAD (Canadian dollar) will move direct to the local currency and the USD (U.S. dollar), to determine in which currency we should invest then we need to decide on the hedge.

Q: Any particular geographies in EM?

A: Not surprisingly Asia dominates from both an equity and fixed income perspective. However, South America can provide some attractive yield opportunities, but again each issue needs to be reviewed to ensure we understand the risks involved. It is also not just a buy decision either. We have to make sure liquidity exists for when we want to exit positions. We can't just be chasing yield.

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