Weekly Trends

PRIVATE CLIENT SOLUTIONS

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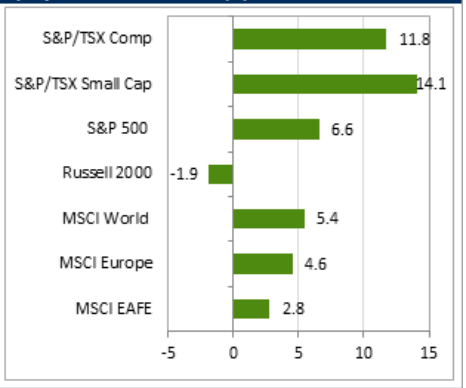
P/E x EPS = Price

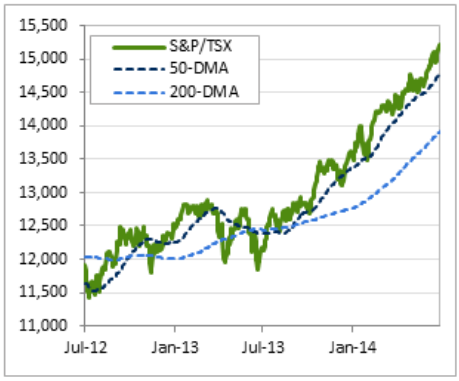
- In this week's report we focus on the two components of stock prices – equity valuations and corporate earnings.
- With the material gains seen in the North American (NA) equity markets since 2009, equity valuations (e.g., P/Es) have expanded markedly, with the S&P 500 Index (S&P 500) and S&P/TSX Composite Index (S&P/TSX) trading near 10-year highs. However, taking a longer term view, valuations are basically in-line with their long-term averages, implying the potential for further expansion. Overall, we would characterize the NA equity markets as fairly valued to moderately overvalued.
- US economic growth, and in turn, corporate earnings look set to reaccelerate, which could provide the fuel for the next leg up in this bull market.
- Consensus is looking for S&P 500 earnings to rise 4.7% Y/Y in Q2/14, however, given the recent trend for earnings to post a 3% earnings "surprise", we believe earnings growth could come in closer to 6-7%. Consensus is then looking for earnings growth to accelerate to 10.2% and 12.0% for Q3 and Q4, respectively.
- Stronger US economic growth and earnings are very important for the S&P/TSX given: 1) the important trade relationship between the two countries, with roughly 75% of total Canadian exports going to the US; and 2) the significant impact that the S&P 500 has historically had on S&P/TSX price returns.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	5.4	Market weight
Consumer Staples	2.7	Market weight
Energy	26.3	Overweight
Financials	34.4	Overweight
Health Care	2.7	Underweight
Industrials	8.0	Overweight
Information Technology	1.8	Overweight
Materials	12.4	Market weight
Telecom	4.4	Underweight
Utilities	1.9	Underweight

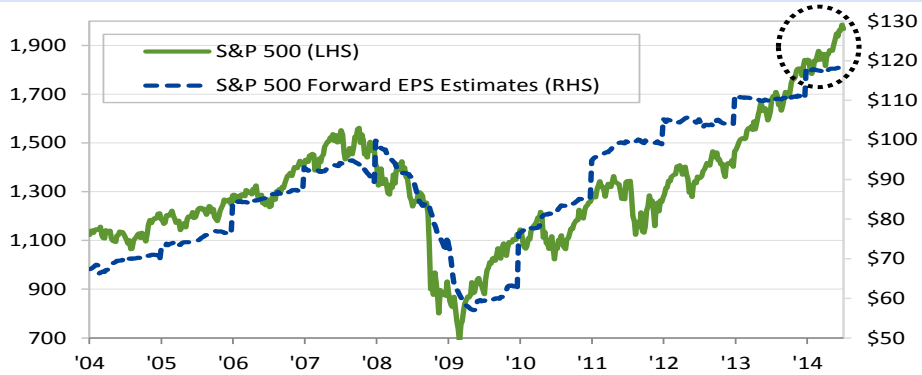
Technical Considerations	Level	Reading
S&P/TSX Composite	15,222.5	
50-DMA	14,885.4	Uptrend
200-DMA	14,035.3	Uptrend
RSI (14-day)	62.0	Neutral



Source: Bloomberg, Raymond James Ltd.

Chart of the Week

The S&P 500's Strong Advance Has Exceeded Forward Earnings Estimates, Leaving it Susceptible to Weakness Should Q2/14 Earnings and Outlook Disappoint



Source: Bloomberg, Raymond James Ltd.

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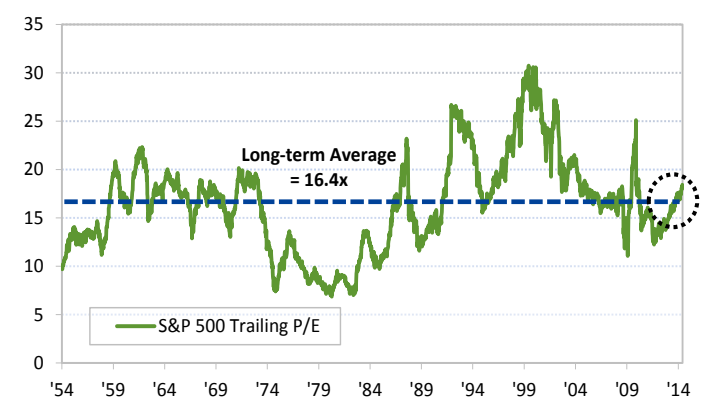
Equity Markets Look Fairly Valued

Since the financial crisis March 2009 low, the S&P 500 has experienced two significant rallies (or waves in technical analysis parlance). The first one spanned from March 2009 to May 2011, with the S&P 500 doubling over this period. The second began in October 2011 and continues today, with the S&P 500 gaining 80% over this period. As a result of these strong market gains, NA valuations have expanded markedly, with the S&P 500 and S&P/TSX trading near 10-year highs. However, taking a longer term view, valuations are basically in-line with their long-term averages. Currently, the S&P 500 is trading at 18.1x trailing earnings, which is a 10% premium to its 60-year average of 16.4x. On a forward basis, the S&P 500 is trading at a more reasonable 16.7x which is in-line with its 25-year average. The S&P/TSX is trading at a premium to the S&P 500 on a trailing basis, currently at 20.6x, which is a 9% premium to its long-term average. Overall, with equity valuations trading at or modestly above their long-term averages, we would characterize the NA equity markets as fairly valued to moderately overvalued. Given this market condition, some believe that further upside is limited, or worse yet, that the top is nigh. While we believe equity returns are likely to be more modest over the next few years, we do not subscribe to this view, and based on our fundamental and technical readings of the market, we see the potential for further gains in this current cycle. Some key factors/insights that support our continued constructive outlook include:

- We believe corporate earnings are set to reaccelerate, following a disappointing Q1/14.
- Most bear markets are triggered by central bank tightening, which leads to an inverted yield curve. We believe this is a 2015, or even 2016 event.
- The average (median) trailing P/E at major US market tops since 1950 is 20.5x (19.5x). If we exclude the tech bubble highs of 30.6x in March 2000, the average is still 19.3x, or roughly 1x above the current 18.1x.
- Global central banks continue to inject liquidity into the markets. The European Central Bank (ECB) may be next to follow, with some predicting that the ECB will initiate its own version of quantitative easing (QE) in Q3/14.
- Finally, from a technical perspective the S&P 500 and S&P/TSX remain in bullish long-term uptrends, while market breadth remains positive, with the NYSE Advance/Decline line making new highs.

S&P 500 Trailing P/E is Above its Long-Term Average



But Below its Typical Peak Level of 19x to 20x

Market Peak Date	S&P 500 Level At Market Peak	S&P 500 P/E (LTM) At Market Peak
12-Dec-61	72.6	22.4
9-Feb-66	94.1	18.0
29-Nov-68	108.4	18.0
11-Jan-73	120.2	19.5
28-Nov-80	140.5	9.1
25-Aug-87	336.8	22.5
17-Jul-98	1186.8	27.3
24-Mar-00	1527.5	30.6
12-Oct-07	1561.8	17.5
Average		**20.5**
Avg ex Mar 00		**19.3**
Median		**19.5**

Source: Bloomberg, Raymond James Ltd.

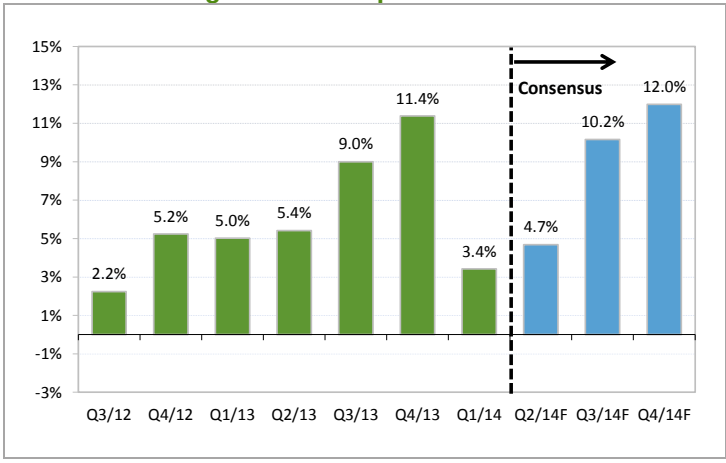
US Earnings Outlook

With equity valuations at elevated levels, where could additional upside come from? First, as already discussed, history shows that equity multiples could expand further. Second, and more likely in our opinion, is that corporate earnings begin to reaccelerate, providing the fuel for the next leg up in this bull market. Many leading economic indicators we track are pointing to an improving US economy, following a soft patch in Q1/14. If this continues, as is our expectation, this should lead to a reacceleration of corporate earnings. Moreover, we expect US corporations to maintain their aggressive share repurchase programs, which shrinks share count, and boosts EPS.

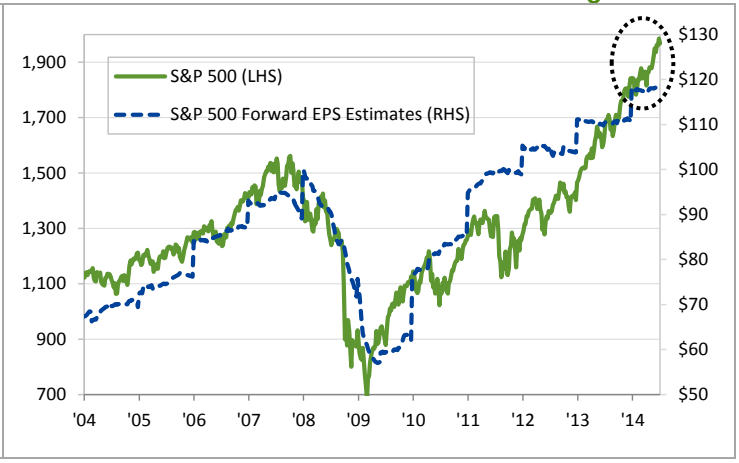
It is still early days in the quarter with just 66 (13%) companies in the S&P 500 having reported, but overall, results are coming in better-than-expected, particularly in the financials sector. Currently, consensus is looking for S&P 500 earnings of US$28.65/share, which would equate to growth of 4.7% Y/Y. In recent quarters we have seen a clear trend of estimates being lowered over the quarter, with companies then beating these lowered estimates by roughly 3%. We believe this trend could continue, and therefore see earnings growing in the 6-7% range for Q2/14. Analysts are then expecting earnings growth to accelerate to 10.2% and 12.0% for Q3 and Q4, respectively. We believe forward estimates are a bit optimistic, as they embed higher GDP growth rates than we are expecting, and therefore, we could see modest negative EPS revisions to Q3 and Q4 estimates. But nonetheless, the trend of improving earnings growth should be supportive to stock prices.

Finally, while we believe the earnings outlook is improving, if the Q2/14 earnings results and forward guidance come in below analyst's expectations, then this could leave stocks vulnerable to a pullback, as we believe the stock market has "prepaid" for some of this expected improvement in earnings. As seen in the accompanying chart, the increase in the S&P 500 over the last few months has exceeded the increase in forward earnings estimates. These two series typically track each other and with the S&P 500 exceeding its earnings estimates, it could make stocks vulnerable to disappointing results. In sum, we believe corporate earnings are set to improve, which could provide the fundamental support for stocks to move higher over H2/14 and into early 2015.

S&P 500 Earnings Growth Expectations for 2014



S&P 500 Has Exceeded the Increase in Earnings Est.



Source: Bloomberg, Raymond James Ltd.

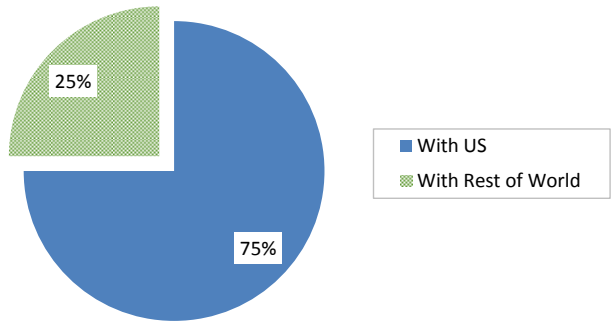
Impact on the S&P/TSX

Stronger US economic growth and corporate earnings are very important for the S&P/TSX given:

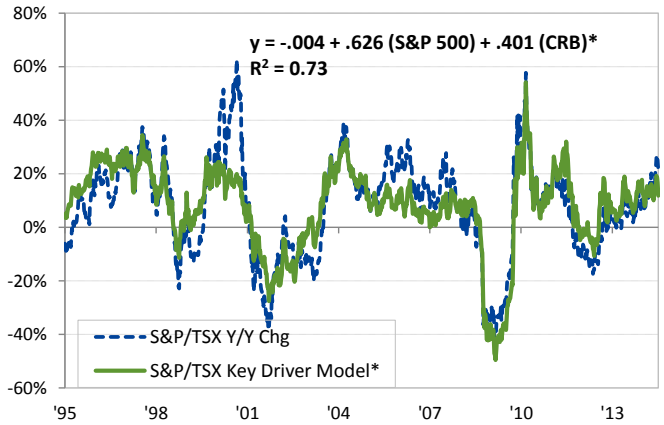
- The incredibly important trade relationship between the two countries, with roughly 75% of total Canadian exports going to the US; and
- The significant impact that the S&P 500 has on S&P/TSX price returns. In the accompanying chart, we illustrate the statistical impact of S&P 500 and commodity price returns (CRB Commodity Index) on S&P/TSX returns. Our analysis shows that these two factors explain 74% of the movement in the S&P/TSX, with the S&P 500 having a larger impact of the two.

Despite efforts by the Canadian government and corporations to reduce our dependence on US trade, the data clearly shows that the US economy remains a key driver of our economy and stock market.

Canadian Total Exports Breakdown



S&P 500 Is a Key Driver of S&P/TSX Performance



Source: Bloomberg, Industry Canada, Raymond James Ltd.

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