Weekly Trends

PRIVATE CLIENT SOLUTIONS

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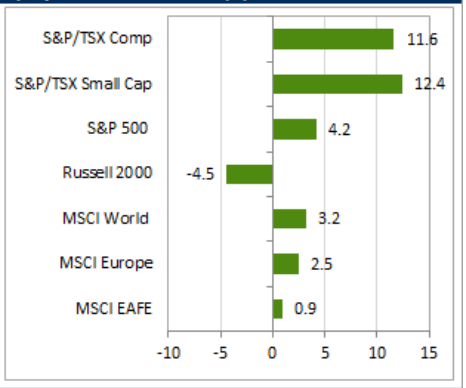
A Technical Look

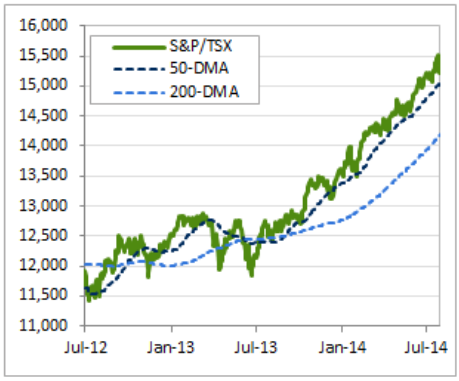
- This week we look at the North American (NA) equity markets from a technical perspective to see if the technicals confirm/conflict with our bullish fundamental view.
- The S&P/TSX Composite Index (S&P/TSX) broke out of a trading range in October 2013, and has been in a strong upward channel since its breakout. The index continues to trend higher with its rising 20-, 50- and 200-day moving averages (MA). The story is much the same for the S&P 500 Index (S&P 500), with the index in a well-defined uptrend, and above its rising 50- and 200-day MAs. Looking solely at the price action of the key NA equity indices, it's difficult to justify a bearish view, in our opinion.
- While the price action for the major NA indices remains bullish, there are some concerning secondary technical trends that are signaling a possible near-term pause/pullback in the equity markets. They include a notable "divergence" between the price action of the S&P 500 and the NYSE Advance/Decline (A/D) line and the recent underperformance of small caps relative to large caps.
- Overall, we remain bullish on equities, but see some secondary technical trends that are pointing to the potential for a pause/pullback in the equity markets.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	5.3	Market weight
Consumer Staples	2.8	Market weight
Energy	26.0	Overweight
Financials	34.7	Overweight
Health Care	2.7	Underweight
Industrials	8.1	Overweight
Information Technology	1.8	Overweight
Materials	12.3	Market weight
Telecom	4.5	Underweight
Utilities	1.9	Underweight

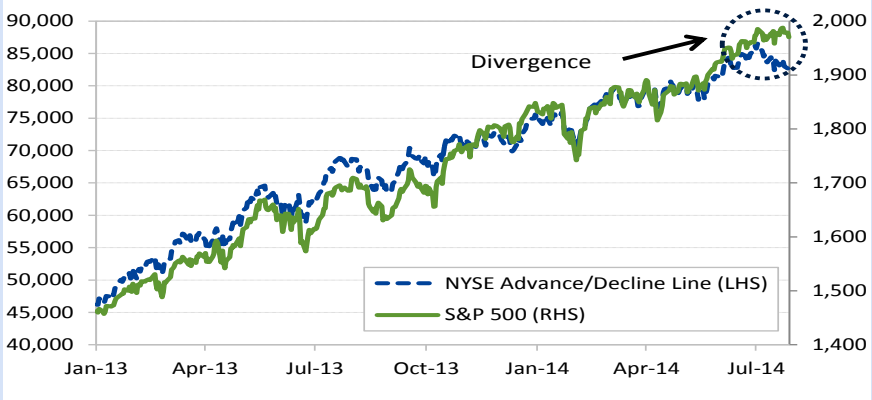
Technical Considerations	Level	Reading
S&P/TSX Composite	15,207.2	
50-DMA	15,053.3	Uptrend
200-DMA	14,175.9	Uptrend
RSI (14-day)	56.2	Neutral



Source: Bloomberg, Raymond James Ltd.

Chart of the Week

There has been a Notable Divergence Between the S&P 500 and NYSE Advance/Decline, Which Could Be Signalling a Short-term Pullback.



Source: Bloomberg, Raymond James Ltd.

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RAYMOND JAMES

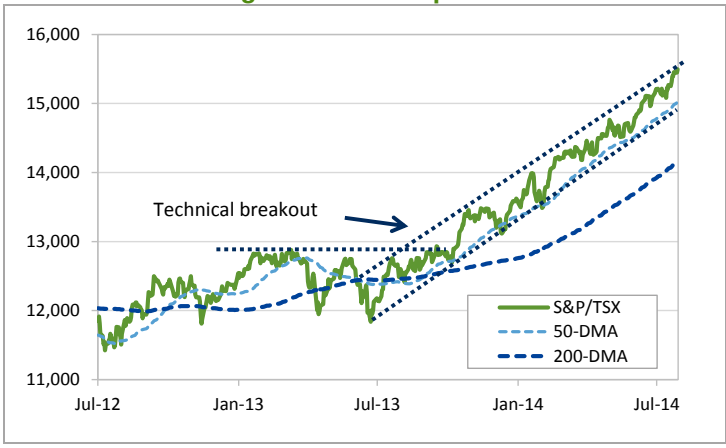
Price Action Remains Constructive

This week we look at the North American (NA) equity markets from a technical perspective. Our investment strategy framework is based on a multidisciplinary approach, combining our fundamental views of the markets/sectors with a technical overlay. In recent missives, we have articulated our continued bullish outlook for the NA equity markets, predicated on the view that the NA economy is rebounding from a Q1/14 slowdown, corporate earnings look set to reaccelerate, valuations, while elevated, are not at typical peak levels (20x trailing earnings for the S&P 500) and that the Fed is unlikely to hike interest rates till mid-2015. In this weeks report we examine the technicals of the NA equity markets to see if they confirm/conflict with our bullish fundamental view.

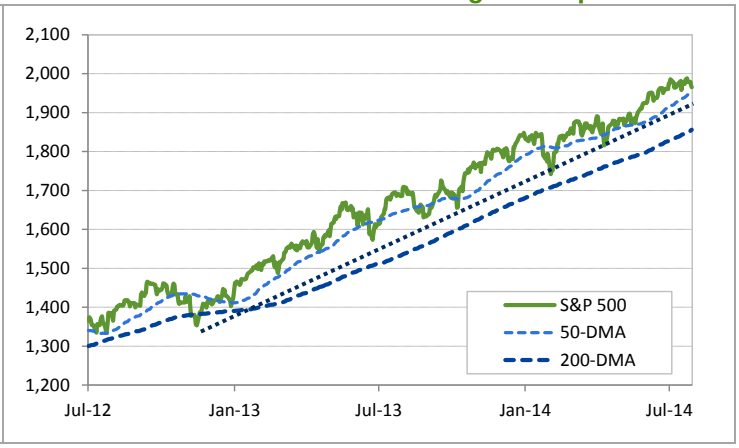
Looking first at the S&P/TSX, the index spent much of 2012 and 2013 in a tight trading range between roughly 11,300 and 12,800. The S&P/TSX broke out of this trading range in October 2013 and has been in a strong upward channel since its breakout. The index continues to trend higher with its rising 20-, 50- and 200-day moving averages (MA). However, with the recent run up in the S&P/TSX, the index registered an overbought condition with a Relative Strength Index (RSI) reading above 70. Additionally, the index was trading at its upper channel line. Given these two technical conditions, we expect some near-term backing and filling with the index possibly pulling back to a range between 15,275 (20-DMA) to 15,050 (50-DMA). A break below this range would be short-term bearish and could open the door for the S&P/TSX to retest its lower channel line, which currently intersects around 14,750. A break below this level would likely cause us to revisit our current bullish stance.

The story is much the same for the S&P 500 with the index in a well-defined uptrend and above its rising 50- and 200-day MAs. The S&P 500 is approaching the psychologically important (but not technically important) 2,000 level, which we suspect will provide some technical resistance. One important technical theory we follow is “Dow Theory”, which posits that the Dow Transports need to “confirm” the new highs on the Dow Industrials. With both indices making new highs in early July, we had another bullish Dow Theory “buy signal”. Looking solely at the price action of the key NA equity indices, it’s difficult to justify a bearish view, in our opinion.

S&P/TSX is Trading in a Bullish Upward Channel



While the S&P 500 Remains in a Long-term Uptrend



Source: Bloomberg, Raymond James Ltd.

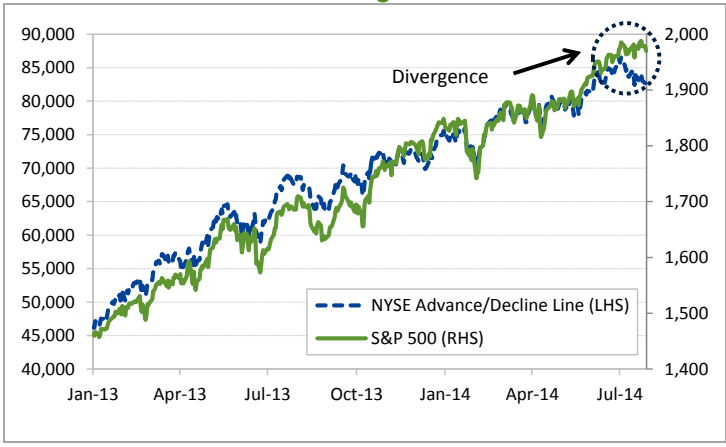
Secondary Technical Concerns

While the price action for the major NA indices remains bullish, there are some concerning secondary technical trends that are signalling a possible near-term pause/pullback in the equity markets. First, as our US Chief Investment Strategist Jeffrey Saut recently highlighted, there has been a notable "divergence" between the price action of the S&P 500 and the NYSE Advance/Decline (A/D) line. The NYSE A/D line is a measure of market breadth with it typically moving in tandem with the S&P 500 in market uptrends. Based on our research, we have found that the A/D line often peaks ahead of the peak in the S&P 500 and therefore can be a good early warning signal of a market top. Currently, the NYSE A/D line is diverging with the S&P 500, which is the first time we have witnessed this in many months. Now it's important to emphasize that: 1) the A/D line could soon resume its uptrend and catch up to the S&P 500, thus reversing the current divergence; and 2) history shows that the US equity markets can continue to rally for some time, with an NYSE A/D line divergence. The key point here is that for first time in some years breadth is beginning to wane, which, if it persists, could be an early warning signal of a pullback in the markets.

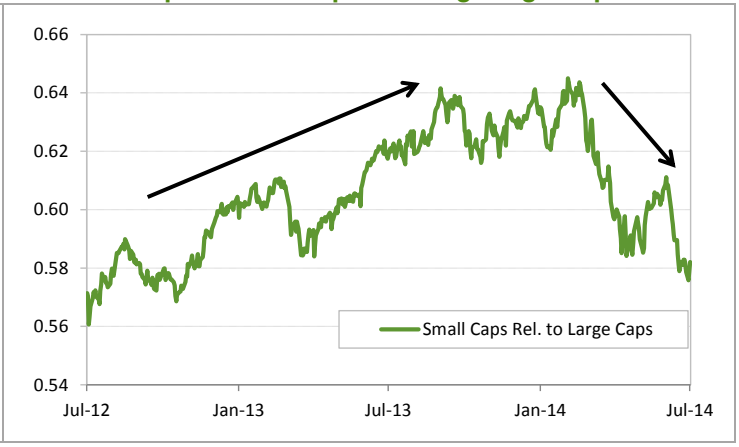
Our second short-term technical concern is the recent underperformance of small caps (Russell 2000) relative to large caps (S&P 500). In strong bull markets it's common for small caps to outperform large caps as: 1) they are more leveraged to an improving economy; and 2) it's a sign of bullish investor sentiment to the overall equity markets. Currently, small caps are materially underperforming large caps, which we view as a sign of technical weakness. This occurred in 2010 and 2011, which conincided with a sell-off in the overall equity markets.

Overall, we remain bullish on equities with price action of the major NA indices supporting our current stance. However, there are some secondary technical trends that are pointing to the potential for a pause/pullback in the equity markets. If correct, we would use the weakness to increase exposure to our preferred Canadian sectors, which we address on the following page.

NYSE Advance/Decline Divergence



US Small Caps Are Underperforming Large Caps



Source: Bloomberg, Raymond James Ltd.

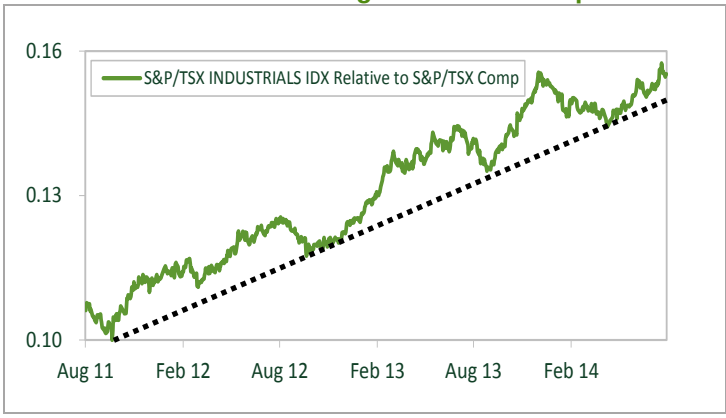
Sectors to Focus on in a Pullback

As evidenced by the recently announced robust Q2/14 US GDP rate of 4%, we believe the US economy is beginning to reaccelerate following a weather-impacted Q1/14 slowdown. Key leading indicators such as the ISM Manufacturing Index, nonfarm payrolls and global PMIs point to continued strength in the US and global economy. Given this view, we currently recommend a cyclical bias with an overweight in the industrials, financials, information technology and energy sectors.

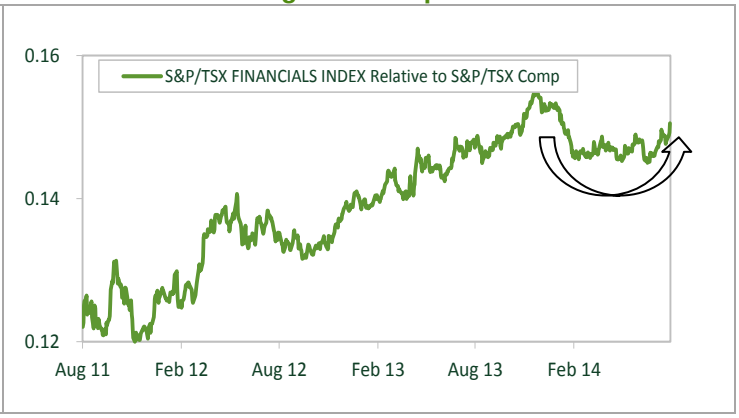
From a technical persective, the industrials sector remains in a long-term relative uptrend, while the financials are starting to reaccelerate following a lagged performance in Q1/14. We believe government bond yields are likely to grind higher in the coming months, which could provide a tailwind to the financials sector. The information technology sector is trading in a two-year price uptrend, while showing improved relative strength. Finally, the energy sector broke its long-term relative downtrend in Q1/14, which we believe signals a major bullish technical change in the sector.

Should the markets come under some near-term pressure, we would recommend investors focus on these areas of the market, as we believe they will continue to outperform on a 9-12 month basis.

Industrials Remain in a Long-term Relative Uptrend



Financials Are Starting to Turn Up on a Relative Basis



Source: Bloomberg, Raymond James Ltd.

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