Weekly Trends

PRIVATE CLIENT SOLUTIONS

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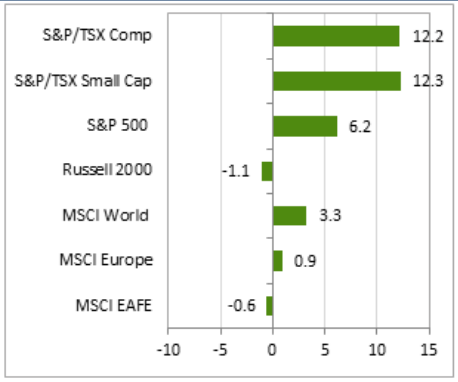
The Power of Earnings

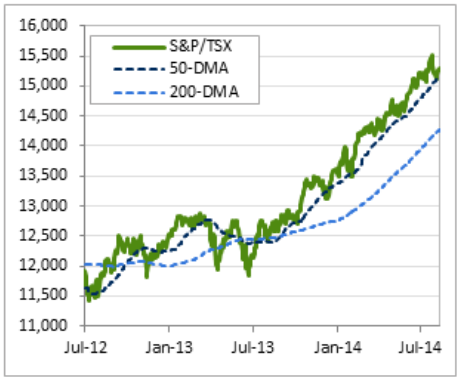
- Over the long term, equity returns are driven by earnings growth. In the short-term however, valuation tends to be the more important driver. In particular, we have found that the first phase of a bull market is largely driven by multiple expansion as investors grow more confident in the economic and stock market recovery.
- But then as multiples rise and the bull market matures, earnings growth becomes more important to returns. We believe the equity markets are transitioning into this second phase, where corporate earnings are likely to take on a more important role.
- Q2/14 earnings were robust with the S&P 500 Index (S&P 500) and S&P/TSX Composite Index (S&P/TSX) delivering y/y growth of 10.9% and 19.9%, respectively.
- Given our view that economic growth is beginning to reaccelerate, we believe earnings are set to improve, which could provide the catalyst to the next leg in this bull market.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	5.5	Market weight
Consumer Staples	2.8	Market weight
Energy	25.9	Overweight
Financials	34.6	Overweight
Health Care	2.6	Underweight
Industrials	8.1	Overweight
Information Technology	1.8	Overweight
Materials	12.3	Market weight
Telecom	4.4	Underweight
Utilities	1.9	Underweight

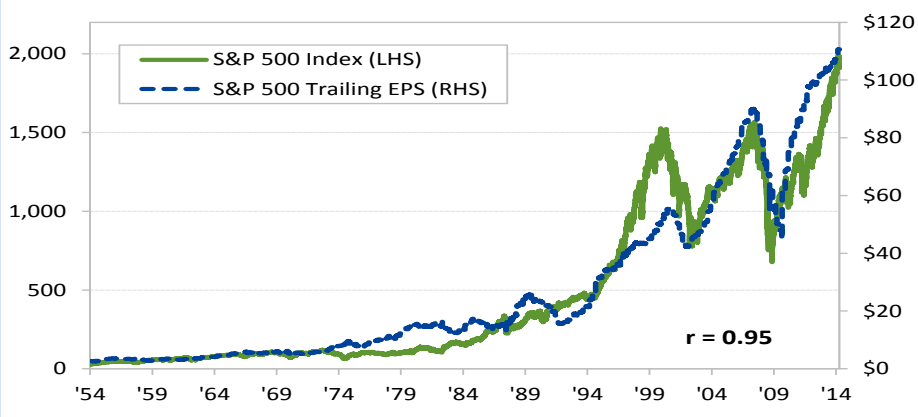
Technical Considerations	Level	Reading
S&P/TSX Composite	15,281.6	
50-DMA	15,153.4	Uptrend
200-DMA	14,266.5	Uptrend
RSI (14-day)	54.3	Neutral



Source: Bloomberg, Raymond James Ltd.

Chart of the Week

Over the Long Run, Stock Returns Track Earnings Growth



Source: Bloomberg, Raymond James Ltd.

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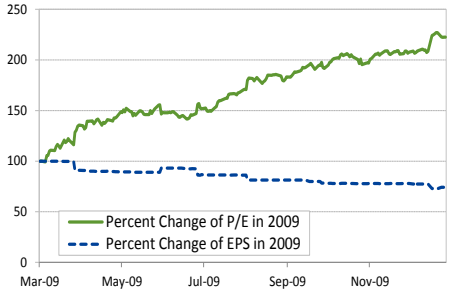
RAYMOND JAMES

Earnings, Earnings, Earnings

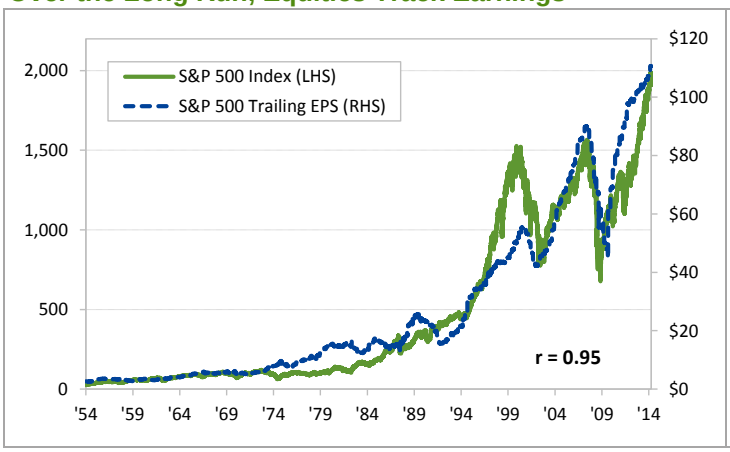
In real estate investing the mantra is location, location, location. In stock investing it should be earnings, earnings, earnings. This is particularly true over the longer term. Below we illustrate the important relationship between the S&P 500 and its earnings stream. Statistically, we show that the S&P 500 has a 0.95 correlation with its earnings stream over the long term. Moreover, we note that since the 1950s, the S&P 500 has retuned on average 8.2% per year (on a price return basis), which is very close to its average annual earnings growth rate of 7.5%. In the long-term, it is clear that earnings largely drive equity returns.

In the short-term however (i.e., over a market cycle), valuation tends to be the more important driver of equity returns. In particular, we have found that the first phase of a bull market is largely driven by multiple expansion as investors grow more confident in the economic and stock market recovery. For example, in 2009 as the equity markets recovered from the Great Financial Crisis, the S&P 500 rallied 64% off the March 2009 lows, with all of the gains coming from multiple expansion. Over this period the S&P 500 trailing P/E increased from 11.6x to 24.5x by the end of 2009, while trailing earnings continued to weaken. Similarly, the market gains in 2003 following the tech crash were largely driven by increases in the P/E multiple, which increased from 17.2x in March 2003 to 21.6x by year-end. But then as multiples rise and the bull market matures, earnings growth becomes more important to equity returns. We believe the equity markets are transitioning into this second phase, where corporate earnings are likely to take on a more important role, and possibly provide the next catalyst to market gains in this cycle. In this week's report we provide an update on the US and Canadian Q2/14 earnings season, an outlook for future earnings growth and what it could mean for potential equity returns going forward.

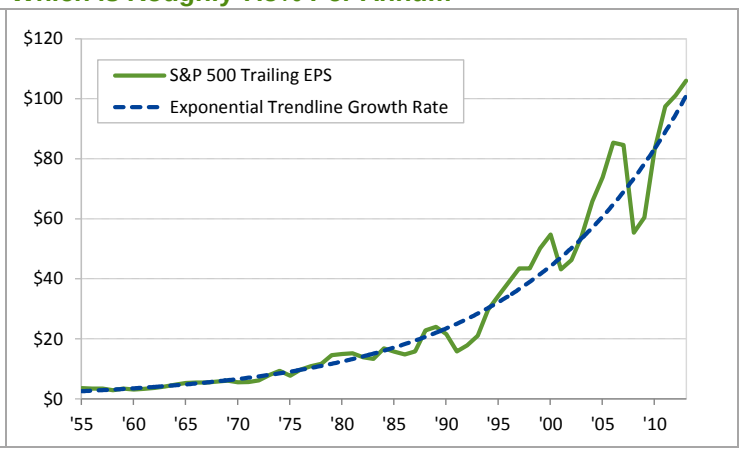
Early Part of a Bull Market is Driven by P/E Expansion (2009 S&P 500 Example)



Over the Long Run, Equities Track Earnings



Which is Roughly 7.5% Per Annum



Source: Bloomberg, Raymond James Ltd.

Q2/14 US Earnings Recap

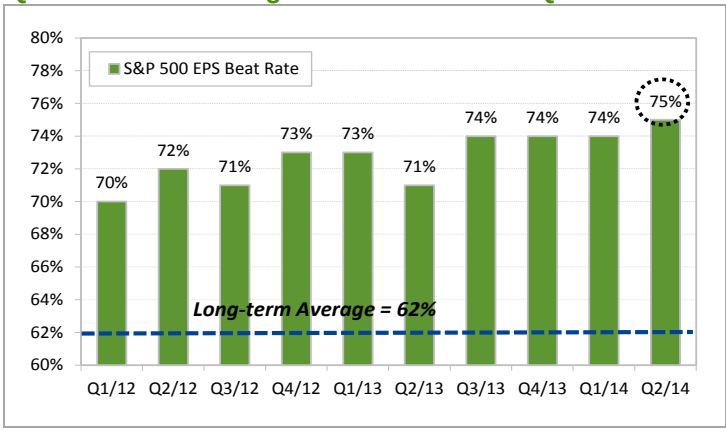
The Q2/14 US earnings season is just about wrapped up, with 456 companies in the S&P 500 having reported results. Overall, it was a very solid quarter with results coming in above expectations. Of the 456 companies to report results, 343 companies reported earnings above analyst's estimates, resulting in an EPS "beat rate" of 75%. This is well above the long-term average of 62% and continues the trend of strong EPS beat rates. Admittedly, given the continued "gaming" of earnings between corporate managers and analysts, the beat rate metric has lost some of its merit, but nonetheless, equity markets like positive surprises.

S&P 500 earnings for Q2/14 are projected to come in at US$29.37/share, which would equate to growth of 10.9% y/y. If realized, this would mark the strongest y/y growth rate since Q3/11. Results in the quarter surpassed analyst's estimates, with the S&P 500 posting a 2.6% earnings surprise. However, the bar was lowered with estimates being steadily revised lower over the quarter from US$29.13 on March 31st, to US$28.62 on June 30th (end of quarter). Other notable items from the Q2/14 earnings season include:

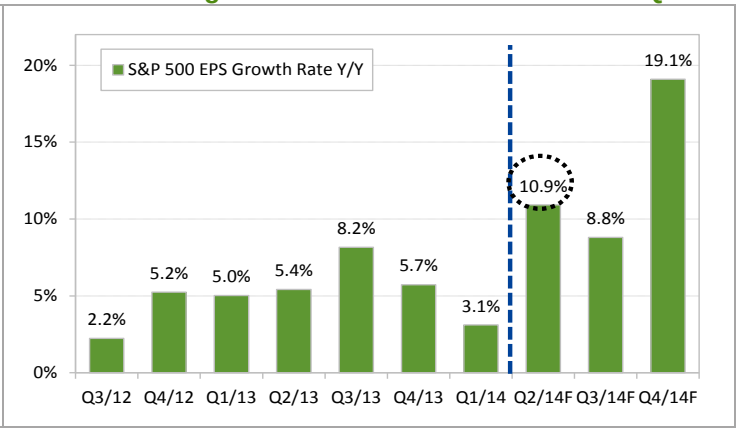
- Top-line y/y revenue growth bounced back in the quarter from -0.5% in Q1/14 to 4.4% in Q2/14. This was commensurate with the snap back in US economic growth, which rose 4% in Q2/14 (preliminary estimate) from -2.1% in Q1/14.
- With earnings growth exceeding sales growth, net margins expanded in the quarter from 9.6% in Q1/14 to 10.1% in Q2/14. Many believe margins are near a peak; however, we believe margins will be well supported until either interest rates rise significantly (much of the margin expansion has been driven by lower interest expenses) or employee wages/costs rise.
- Five of the 10 sectors posted double-digit EPS growth, with the telecom and health care sectors posting the strongest y/y growth rates of 20% and 16%, respectively. Financials posted the weakest results, with earnings up 1% y/y.

Overall, it was a very solid earnings quarter, which we believe marks an inflection point in this earnings cycle. Earnings growth slowed significantly through 2012 and 2013, but now looks to be on the upswing. Given our view that economic growth is beginning to reaccelerate, we believe earnings are set to improve with consensus estimates pointing to growth of 9% and 19% in Q3 and Q4, respectively. We see stronger earnings providing the catalyst to the next leg in this bull market.

Q2/14 Saw the Strongest Beat Rate Since Q2/11



S&P 500 Earnings Grew At the Fastest Rate Since Q3/11



Source: Bloomberg, Raymond James Ltd.

S&P/TSX Earnings Update

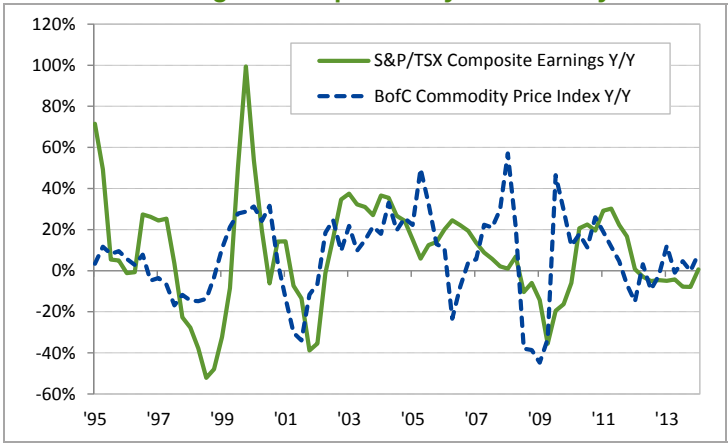
S&P/TSX earnings have been weak over the last few years, which has been one factor behind our preference for US over Canadian equities. For example, S&P/TSX trailing earnings peaked at $850/share in May 2012 and have trended consistently lower since then. The main contributing factor to the S&P/TSX's weak earnings profile has been commodity prices, which have been under pressure. The accompanying chart illustrates this relationship with the y/y change in the S&P/TSX trailing earnings generally tracking the y/y change in commodity prices. The good news is that this trend of weaker earnings looks to have reversed with trailing earnings beginning to rise and forward estimates now pointing to 10% EPS growth in the coming 12 months.

Looking at Q2/14 earnings for the S&P/TSX, results have been mixed, but earnings growth has been solid. Key highlights from the Q2/14 earnings season include:

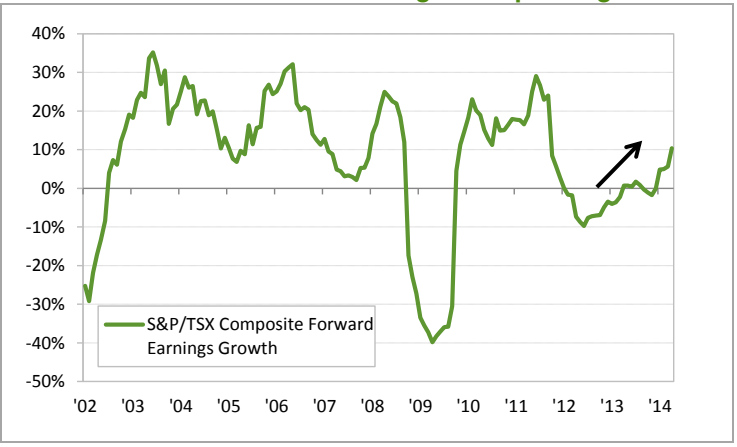
- Q2/14 earnings are projected to come in at $212.38/share, which if realized, would equate to growth of 19.9% y/y. While an impressive y/y growth rate, it is important to note that the comparisons were easy given poor Q2/13 earnings.
- Cyclical sectors are expected to deliver the highest y/y EPS growth rates, with the energy, industrials, and financials sectors posting solid results. This is one factor in our call to overweight these sectors.
- The EPS beat rate for the S&P/TSX was 49% with the defensive sectors, notably telecommunications and utilities dragging down the beat rate.

Similar to the US, Canadian companies delivered solid earnings growth in the quarter, which we believe can continue, thus providing an important support for the equity markets.

S&P/TSX Earnings Are Impacted by Commodity Prices



The Outlook for S&P/TSX Earnings Is Improving



Source: Bloomberg, Raymond James Ltd.

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