Weekly Trends

PRIVATE CLIENT SOLUTIONS

Ryan Lewenza, CFA, CMT, Private Client Strategist

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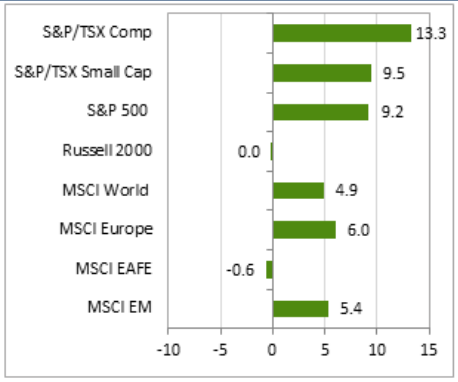
USD, China and the Materials Sector

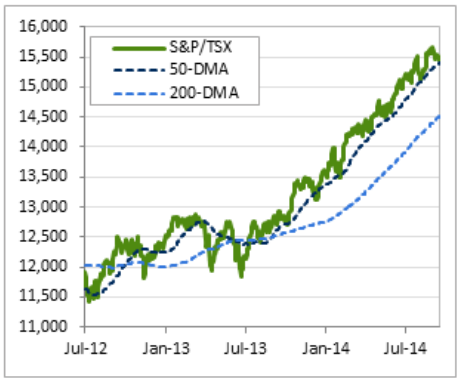
- Commodity prices have been under significant selling pressure in recent weeks, with the CRB Continuous Commodity Index (CCI) down roughly 13% since its April high. More importantly, with the recent weakness, the CCI index has broken below its long-term uptrend, possibly signaling the official end of the much touted commodity "supercycle".
- An important near-term contributor to the weakness in commodity prices has been the recent strength in the US dollar. We are bullish on the US dollar which, given the negative correlation with commodity prices, could provide a headwind to the space.
- Another concern we have with the commodity complex is the deceleration of emerging market economic activity over the last few years, particularly in China. The Chinese economy grew at an average of 9.4% in the 2000s, but has downshifted to roughly 7.5% over the last few years. We believe China's slowing economy and de-emphasis on investment spending is likely to be an additional headwind for the commodity complex.
- We remain market weight the materials sector as attractive valuations for the sector are offset by concerns over China's slowing economy and US dollar strength.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	5.6	Market weight
Consumer Staples	2.9	Market weight
Energy	25.8	Overweight
Financials	35.0	Overweight
Health Care	2.7	Underweight
Industrials	8.5	Overweight
Information Technology	1.9	Overweight
Materials	11.2	Market weight
Telecom	4.4	Underweight
Utilities	1.9	Underweight

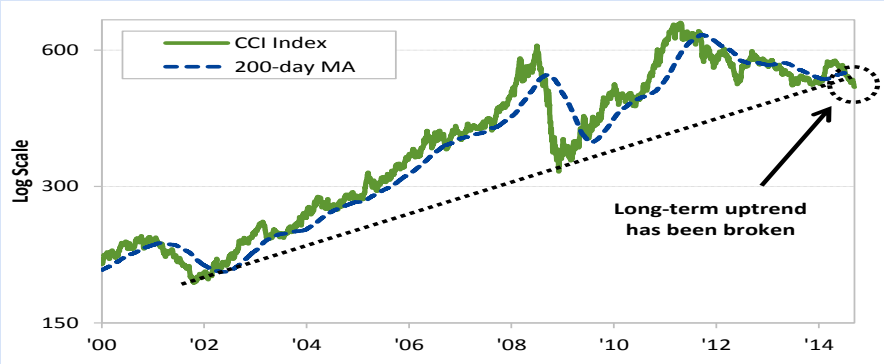
Technical Considerations	Level	Reading
S&P/TSX Composite	15,433.0	
50-DMA	15,393.5	Uptrend
200-DMA	14,522.1	Uptrend
RSI (14-day)	49.0	Neutral



Source: Bloomberg, Raymond James Ltd.

Chart of the Week

The Commodity "Supercycle" Could be Officially Over With the Continuous Commodity Index Breaking Below its Long-term Uptrend



Source: Bloomberg, Raymond James Ltd.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

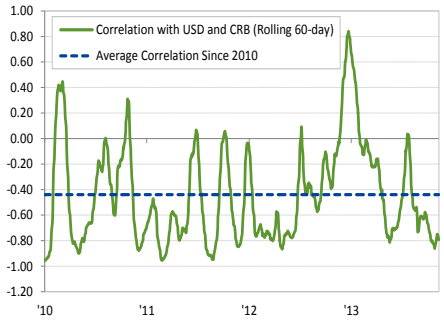
Commodities Under Pressure

Commodity prices have been under significant selling pressure in recent weeks, with the CRB Continuous Commodity Index (CCI) down roughly 13% since its April high. More importantly, with the recent weakness, the CCI index has broken below its long-term uptrend that has been in place since 2002, possibly signaling the official end of the much touted commodity "supercycle". The sell-off has been broad-based with weakness seen across the energy space, industrial and precious metals and the grain markets. We have held a cautious view of commodities, particularly in the industrial metals space, with this important technical breakdown further validating our cautious stance. In this week's report we outline the key driving factors behind the weakness in commodities and provide the rationale behind our cautious stance on the space and the materials sector.

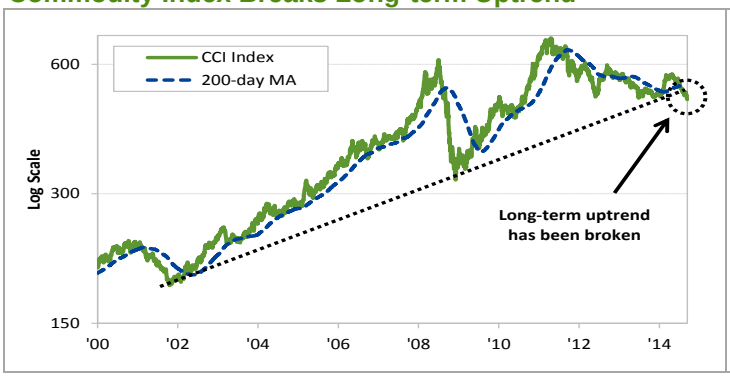
We believe an important near-term contributor to the weakness in commodity prices has been the recent strength in the US dollar, which has rallied sharply against the Euro, Yen and other important currencies. The US Dollar Index (DXY), which measures the performance of the US dollar against a basket of currencies, has been on a tear, up 5.5% since bottoming in early July. A number of factors have contributed to the US dollar strength including stronger economic performance for the US economy in absolute and relative terms, a narrowing US fiscal deficit and rising interest rate differentials. However, it is the prospect of the US Federal Reserve (Fed) ending quantitative easing (QE) in October and inevitably raising interest rates that has catalyzed this large appreciation in recent weeks.

With the large move in the US Dollar Index it has become technically overbought with a Relative Strength Index (RSI) reading of 74 (above 70 indicates overbought). Additionally, the Index is trading at horizontal price resistance around the 84.50 level. Given these technical factors we believe the US dollar could consolidate in the near-term. However, we remain US dollar bulls given: 1) the US economy is beginning to accelerate and outperform many other developed regions (e.g., Europe); 2) the extreme liquidity provided by the Fed has possibly reached its zenith with the Fed projected to end QE in October and likely adopt a more hawkish view in the coming year; 3) a more hawkish Fed should result in higher bond yields and, in turn, higher interest rate differentials; and 4) the European Central Bank (and possibly others) are likely to inject additional liquidity into their markets, thus attempting to weaken their respective currencies. All of this should support a further strengthening of the US dollar in our opinion, which given the negative correlation with commodity prices (sidebar), could provide a headwind to the space.

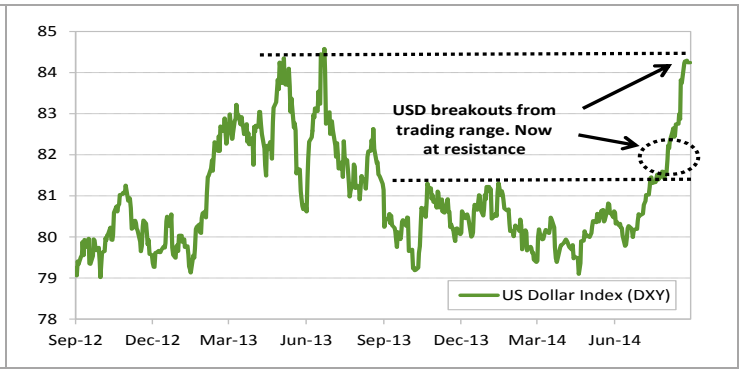
Commodities Are Negatively Correlated with the US Dollar



Commodity Index Breaks Long-term Uptrend



In Part Due to a Breakout in the US Dollar



Source: Bloomberg, Raymond James Ltd.

China and Its Impact on Commodity Prices

Another concern we have with the commodity complex is the deceleration of emerging market economic activity over the last few years, particularly in China. The Chinese economy grew at an average of 9.4% in the 2000s, but has downshifted to roughly 7.5% over the last few years. In fact, Bloomberg estimates that Q3/14 GDP growth could drop into the 6% range, which would be the lowest quarterly print since March 2009. We believe the slowing Chinese economy will have a significant impact on commodity demand and prices.

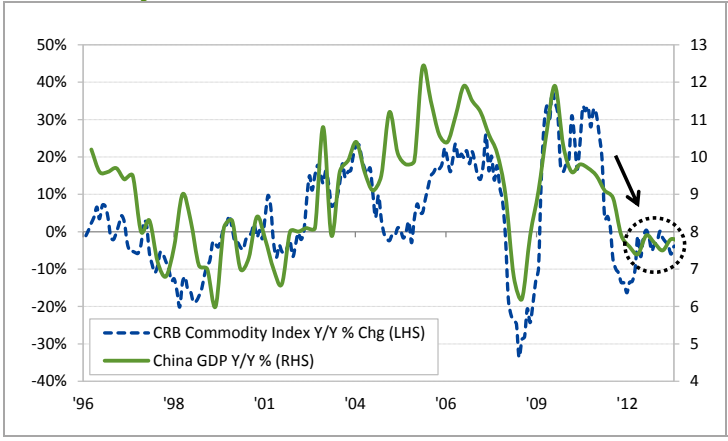
The rapid growth seen in China during the 2000s was in part driven by massive public and private investment projects. For example, investment as a percentage of GDP increased from 35% in 2000 to 48% today. This included such things as investment in infrastructure spending and office and residential buildings. However, this period of massive investment projects has likely peaked, which in our opinion could result in lower incremental demand for commodities like copper and steel. In the accompanying chart we illustrate the relationship between China GDP growth and commodity price changes. While not perfect, the chart does capture the positive correlation between China's GDP growth and Y/Y changes in the CRB Commodity Index. In the mid-2000s as China's economy was posting 10%+ growth, commodity prices experienced sizable gains over this period. Then as the financial crisis hit and China's economy slowed, commodity prices declined precipitously. More recently, as China's economy has moderated in this 7% range, commodity prices have been trending lower.

Chinese officials are attempting to transform their economy from a rapidly growing export/investment economy to a more sustainable economy driven by consumption spending. Consumption as a percentage of GDP has been on the decline, as officials have emphasized investment to help fuel their growth. However, this trend looks set to reverse, as officials have made boosting consumption demand their top priority in the coming years. This trend away from investment spending is likely to curb demand for commodities like cement and iron ore in the future. Overall, we believe China's slowing economy and de-emphasis on investment spending is likely to be a headwind for the commodity complex, hence our cautious view at present.

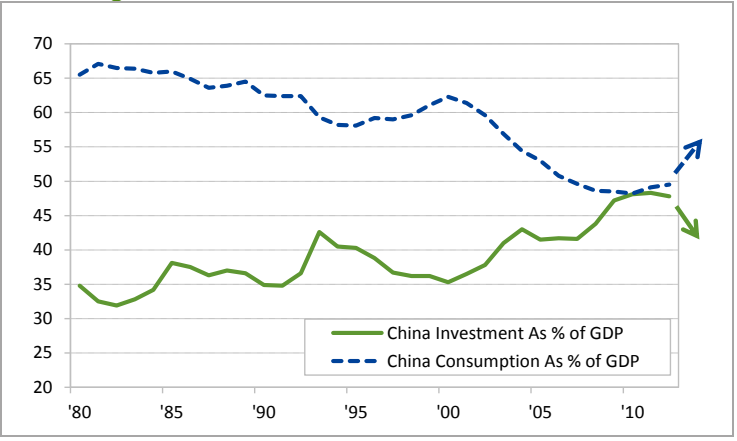
China's % of World Commodity Consumption (IMF 2010)

Commodity	China % of World
Cement	53%
Iron Ore	47%
Coal	47%
Steel	45%
Lead	45%
Zinc	41%
Copper	39%
Nickel	36%
Oil	10%

Commodity Prices Have Correlated with China Growth



Declining Investment Is a Headwind to Commodities



Source: Bloomberg, Raymond James Ltd.

Materials Sector at Market Weight

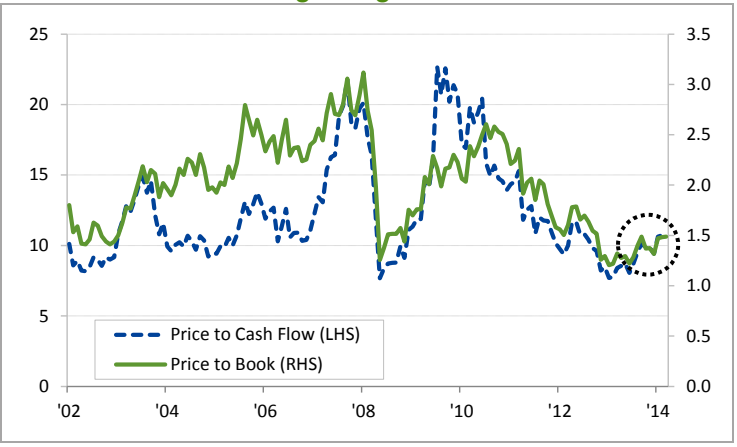
Within the resource-based sectors our preference is for the energy sector, as we are more constructive on oil prices than base metal prices. Our preference for oil is based on: 1) China consumes roughly 10% of global oil production, much lower than the 40 to 50% it consumes in most base metals; 2) oil prices are more likely to benefit from a geopolitical premium should tensions rise; and 3) OPEC tends to target an US$80 to $90/bbl floor in oil prices and could curb production to achieve this. As such, we are more constructive on the energy sector than materials, hence our overweight recommendation.

From a technical perspective, the S&P/TSX materials sector remains in a long-term relative downtrend, which supports our neutral fundamental view. Given our cautious view of China and bullish view of the US dollar some may wonder why we are not underweight the sector. With the sector performing poorly in recent years, valuations for the sector have become quite attractive with the sector trading at 1.4x P/B and 10x P/CF, both significant discounts to the sector's long-term average. In our opinion, the materials sector is already pricing in some of this expected slowdown in China.

In sum, we remain market weight the materials sector as attractive valuations for the sector are offset by the slowdown in China's economy and US dollar strength.

Materials Remain in Long-term Relative Downtrend

But Valuations Are Beginning to Look Attractive



Source: Bloomberg, Raymond James Ltd.

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