Weekly Trends

PRIVATE CLIENT SOLUTIONS

Ryan Lewenza, CFA, CMT, Private Client Strategist

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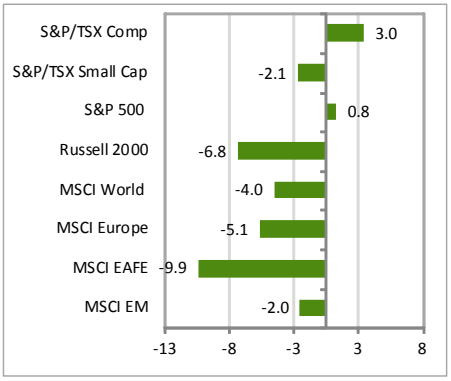
Correction…But Bear Market Unlikely

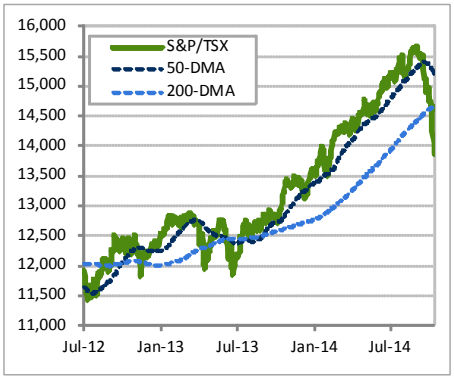
- Understandably, the recent weakness has led to some consternation among investors with the S&P/TSX Composite Index (S&P/TSX) experiencing triple-digit daily declines and the Index off 11% since its September highs. However, it's important to stand back, reflect and gain some perspective. Pullbacks (5-10%) and corrections (10-20%) are normal and even healthy in bull markets. Based on our analysis we have found that on average the S&P 500 Index (S&P 500) experiences three pullbacks and one correction each year.
- Three central factors have led to the recent market declines including: 1) the potential end of Quantitative Easing (QE); 2) expectations for weaker global growth; and 3) escalating concerns over the spread of the Ebola virus.
- We believe the North American economy and equity markets are in a transitionary period, from a Fed liquidity-driven economy/market to an economy supported and based on fundamentals. We believe that this transitionary period, while difficult in the short-term, will ultimately create a fundamental backdrop for equities to move higher in the coming years.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	5.8	Market weight
Consumer Staples	3.2	Market weight
Energy	24.3	Overweight
Financials	35.3	Overweight
Health Care	3.0	Underweight
Industrials	8.5	Overweight
Information Technology	1.9	Overweight
Materials	11.4	Market weight
Telecom	4.6	Underweight
Utilities	2.0	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,025.3	
50-DMA	15,198.6	Downtrend
200-DMA	14,651.4	Downtrend
RSI (14-day)	14.5	Oversold



Source: Bloomberg, Raymond James Ltd.

Chart of the Week

During These Difficult Times It's Important to Focus on the Long-term. History Shows that Long-term Investors in the S&P/TSX Have Been Rewarded With Solid Returns

Annualized Holding Period Returns for the S&P/TSX Total Return Index	1 year	5 year	10 years	15 years	20 years	25 years
Best	86.9%	27.8%	19.5%	16.6%	14.1%	13.8%
Worst	-39.2%	-1.9%	2.8%	5.6%	6.2%	7.0%
Average	11.3%	11.0%	10.9%	10.8%	10.6%	10.6%

Source: Bloomberg, Raymond James Ltd.

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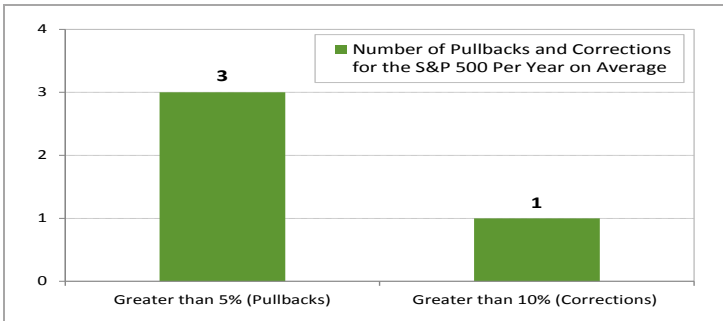
Markets Under Pressure

From the July 2013 lows to the September 2014 high, the S&P/TSX gained an impressive 33%, or roughly 5 years of "normal" equity returns (since the 1920s the S&P/TSX has returned on average 7% per year on a price basis). Over this period, the North American (NA) equity markets benefited from two major trends. First, the US Federal Reserve (Fed) injected billions of dollars of liquidity into the financial markets, which, as we have discussed in recent reports, has been very supportive to the stock market. The second trend has been the slowly improving fundamental backdrop, whether that be economic activity or corporate earnings. With the Fed expected to end its asset purchases, also known as quantitative easing (QE) in October, this removes an important support for the stock market and was one factor in our expectation for market weakness over the September/October period. We believe the NA economy and equity markets are in a transitionary period from a Fed liquidity-driven economy/market to an economy supported and based on fundamentals. We believe that this transitionary period, while difficult in the short-term, will ultimately create a fundamental backdrop for equities to move higher in the coming years. In this week's report we examine the factors behind the recent weakness, provide some historical perspective on market pullbacks/corrections and outline our expected roadmap for the stock market in the coming months. Our outlook is always evolving as we digest new information, but at present, our base case view remains that the NA and global economy continune to expand, while inflation remains muted, resulting in central banks maintaining highly accomodative policies. Historically, this backdrop has been supportive for equities.

Understandably, the recent weakness has led to some consternation among investors with the S&P/TSX experiencing triple-digit daily declines and the Index off 11% since its September highs. However, it's important to stand back, reflect and gain some perspective. Pullbacks (5-10%) and corrections (10-20%) are normal and even healthy in bull markets. Based on our analysis we have found that on average the S&P 500 experiences three pullbacks and one correction each year. We believe the steady gains realized since July 2013 lulled investors into a sense of complacency, with some forgetting that equities can be volatile, especially in the short term. In fact, when analyzing long-term rates of return for the S&P/TSX Total Return Index, we have found that when extending one's investment time horizon to 10+ years, the potential for a negative return is reduced/eliminated. For example, the worst five-year annualized return for the S&P/TSX is -1.9%, while the worst 10-year return is 2.8%. Moreover, as you increase your holding period in the S&P/TSX, your annualized returns converge to the long-term total return of roughly 10% annualized. It pays to focus on the long-term!

Pullbacks and Corrections Are Normal



Over the Long-Run Equities Deliver Solid Returns

Annualized Holding Period Returns for the S&P/TSX Total Return Index

	1 year	5 year	10 years	15 years	20 years	25 years
Best	86.9%	27.8%	19.5%	16.6%	14.1%	13.8%
Worst	-39.2%	-1.9%	2.8%	5.6%	6.2%	7.0%
Average	11.3%	11.0%	10.9%	10.8%	10.6%	10.6%

Source: Bloomberg, Raymond James Ltd.

Global Growth Scare

We believe what we are witnessing are the equity markets readjusting to the prospect of lower global growth rates. But lower global growth is very different than a global recession, which we do not see on the horizon. Given this view, we believe that the equity markets are experiencing an overdue pullback/correction, which after some consolidation could lead to another leg higher in this bull market. This remains our base case view at present. Consider this:

- The International Monetary Fund (IMF) "shaved" their global growth projections from 3.4% to 3.3% for 2014 and from 4% to 3.8% for 2015. These are modest reductions, with their projections pointing to flat growth Y/Y in 2014 and a modest rise in growth for 2015. We have long held the view that this recovery would be uneven and weak relative to previous recoveries, with IMF's numbers supporting our modest growth outlook. But, the key point is that we see continued positive economic growth into 2015, with a low probability of a NA or global recession.

- The benefit of slower economic growth is that inflation will likely be kept in check, which allows central banks to maintain their highly accommodative policies. With respect to the European Central Bank (ECB), slower growth will likely catalyze them to implement their own US-styled QE policies, while the Fed is likely to raise interest rates at a very slow and measured pace.

- The US economy is clearly bucking the trend as it continues to show improving momentum. For example, the Conference Board Index of Leading Economic Indicators (LEI) continues to trend higher and is up 6% Y/Y. We have found that on average the LEI is at -2.3%, -1.0%, and 0.3% one, three and six months, respectively, before a US recession. Currently at 6%, its pointing to an expanding economy, not one on the precipice of a recession.

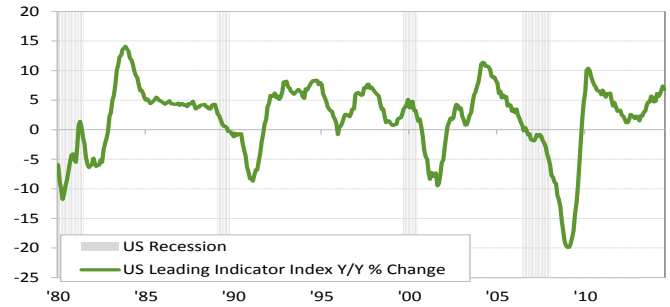
- One important wildcard to our outlook is the Ebola virus and whether it spreads and impacts economic activity. Our best guess is that it will be contained as officials step up measures and the fact that is not airborne. In the near term it is weighing on investor psychology but longer term we believe the economic impact will be minimal (the more important human toll aside).

All told, our readings for the NA and global economy signal a slowdown, rather than a full-blown recession, which we believe investors may be overreacting to.

IMF Forecasts Point to Continued Economic Expansion

			Projections (%)	
	2012	2013	2014	2015
World Output	3.4	3.3	3.3	3.8
Advanced Economies	1.2	1.4	1.8	2.3
United States	2.3	2.2	2.2	3.1
Euro Area	-0.7	-0.4	0.8	1.3
Japan	1.5	1.5	0.9	0.8
United Kingdom	0.3	1.7	3.2	2.7
Canada	1.7	2.0	2.3	2.4
Emerging Market Economies	5.1	4.7	4.4	5.0

US LEI Signals a Low Probability of a US Recession



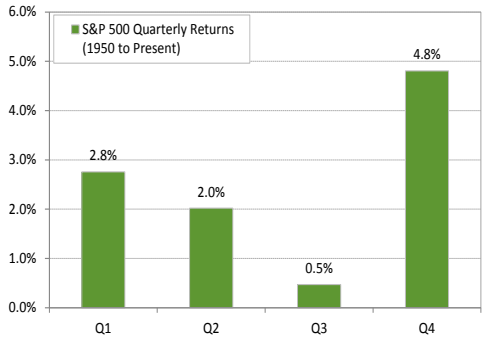
Source: Bloomberg, Raymond James Ltd, IMF.

Market Outlook

Having outlined our fundamental case for further economic growth, we now turn our attention to the technicals, which are undeniably short-term bearish and require close monitoring. That said, we see three key trends that augur for potential market strength into year-end.

- **Seasonality:** We are fast approaching the strongest seasonal period for the equity markets. From late-October to the end of Q1, the stock market tends to perform the strongest over the calendar year. Since 1950, the S&P 500 has posted an average Q4 and Q1 gain of 4.8% and 2.8%, respectively, versus Q2 and Q3 of 2% and 0.5%, respectively. Moreover, 78% of the time Q4 has posted a positive return.
- **Deeply oversold markets:** With the extreme selling pressure, the S&P/TSX has registered a deeply oversold technical reading with a Relative Strength Index (RSI) reading at 16. Anything below 30 indicates oversold, with the current reading the lowest level since July 2002. The S&P/TSX is even more oversold than it was in the 2008/09 bear market. Given this extreme oversold condition the S&P/TSX could be setting up for gains into year-end.
- **Presidential Cycle:** Finally, as part of our technical framework we incorporate market cycles into our work as history can often be a guide to the future. One prominent cycle we follow is the Presidential Cycle, which posits that the stock market performs strongly in year 3 and 4 of a President's term. In the accompanying chart we provide a stylized or average performance of the S&P 500 over the four-year Presidential term. Interestingly, its signals a potential low in October/November of year 2 (currently in) with strong gains indicated in the coming year. While cycles are not infallible, they can provide a potential roadmap for the stock market.

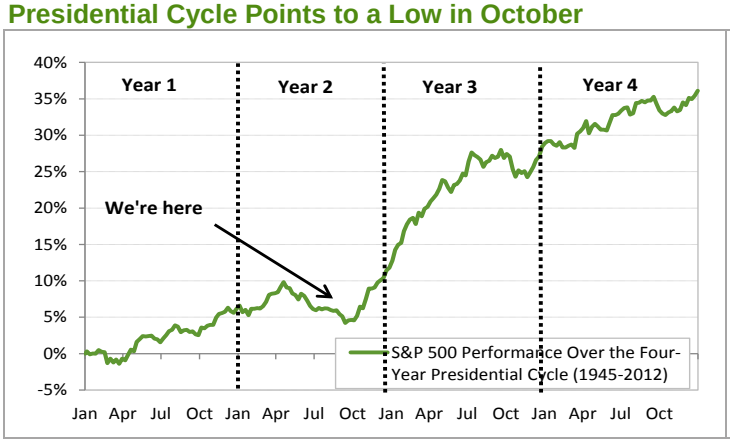
Seasonality Points to Q4 Strength



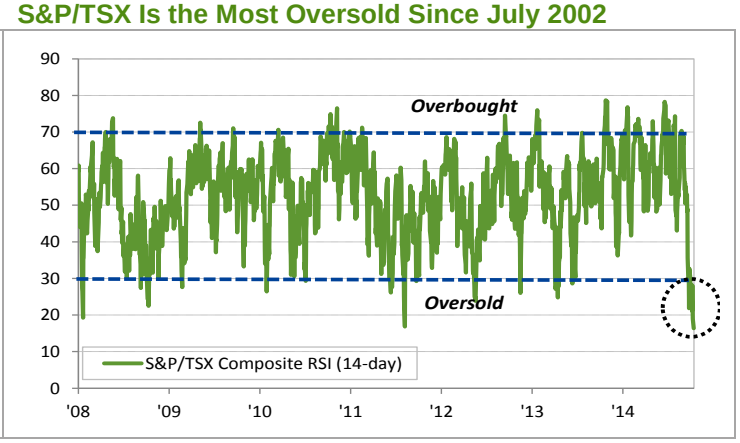
Conclusion

It has been a challenging few months as the equity markets digest a confluence of negative short-term events. However, our base case remains that the global economy is enduring a slowdown rather than a recession, inflationary trends remain low, which supports continued dovish central bank policies. All of which has historically been supportive for equities. Given fast approaching positive seasonal trends, we believe the stock market could be higher at year-end from current levels.

Presidential Cycle Points to a Low in October



S&P/TSX Is the Most Oversold Since July 2002



Source: Bloomberg, Raymond James Ltd.

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