Weekly Trends

PRIVATE CLIENT SOLUTIONS

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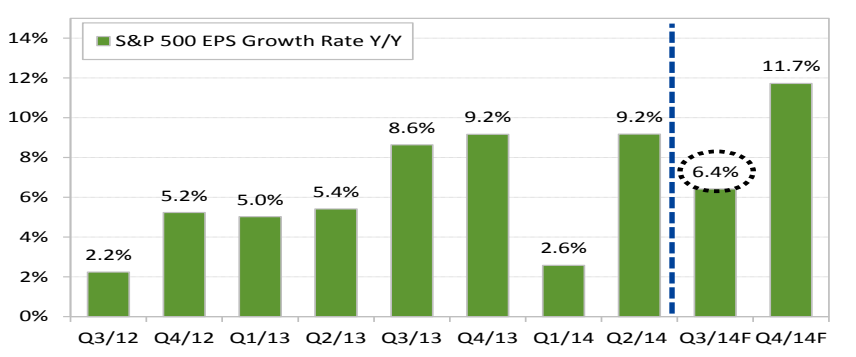
Earnings to the Rescue

- The Q3/14 earnings season is now in full gear with roughly 300 companies in the S&P 500 Index (S&P 500) reporting earnings over the next two weeks. So far, results have been solid, which we expect to continue over the reporting season.
- Of the 178 companies to report so far, 142 companies have reported earnings above analysts' estimates, resulting in a "beat rate" of 80%. This is well above recent quarters and the long-term average of 62%.
- S&P 500 Q3/14 earnings are forecasted to be US$29.03/share, which would equate to growth of 6.4% Y/Y. We believe the final growth rate may actually come in stronger, possibly in the 8-9% range, as we've witnessed a consistent trend of upside earnings surprises over the last year.
- More importantly, S&P 500 quarterly earnings are set to hit a new all-time high. While the "bears" like to claim that the Fed's quantitative easing (QE) policies are the only thing supporting the equity markets, they must not be looking at corporate earnings, which have been very strong and are hitting new all-time highs.
- We expect corporate earnings to remain healthy in the coming quarters, which should be supportive to equities.

Chart of the Week

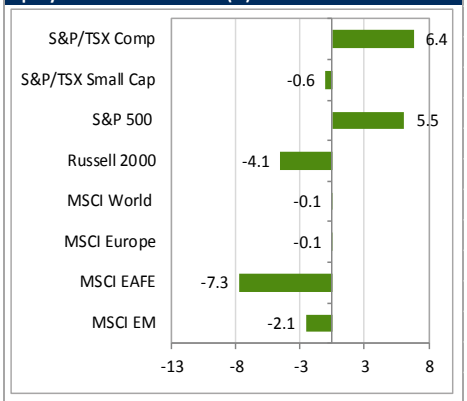
Q3/14 Consensus Estimates Are Pointing to 6.4% Y/Y Growth For The S&P 500.

We Believe Earnings Could Come In Closer To 8-9% Y/Y.



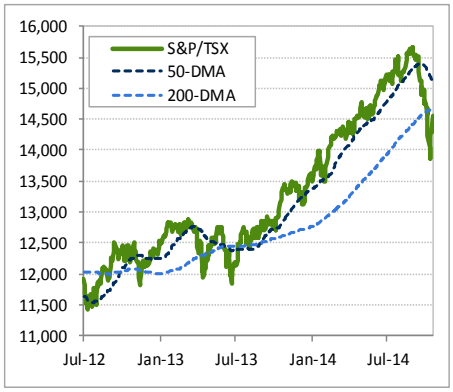
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	5.9	Market weight
Consumer Staples	3.1	Market weight
Energy	24.3	Overweight
Financials	35.4	Overweight
Health Care	3.1	Underweight
Industrials	8.7	Overweight
Information Technology	1.9	Overweight
Materials	10.9	Market weight
Telecom	4.6	Underweight
Utilities	2.0	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,486.8	
50-DMA	15,093.1	Downtrend
200-DMA	14,674.0	Downtrend
RSI (14-day)	45.0	Neutral



Source: Bloomberg, Raymond James Ltd.

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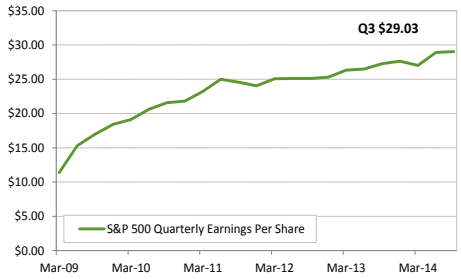
Q3/14 Earnings Update

The Q3/14 earnings season is now in full gear with roughly 300 companies in the S&P 500 reporting earnings over the next two weeks. So far, results have been solid, which we expect to continue over the reporting season. As we've conveyed in reports over the last few months, corporate earnings are likely to take on a more important role with valuations having expanded and the US Federal Reserve (Fed) likely to end its asset purchases at month-end. We believe the equity markets are slowly transitioning from one supported by the Fed's QE policies to one based on and driven by fundamentals. If, as we expect, corporate earnings continue to grow, then this should be supportive to equities. Highlights of the US Q3/14 earnings season include:

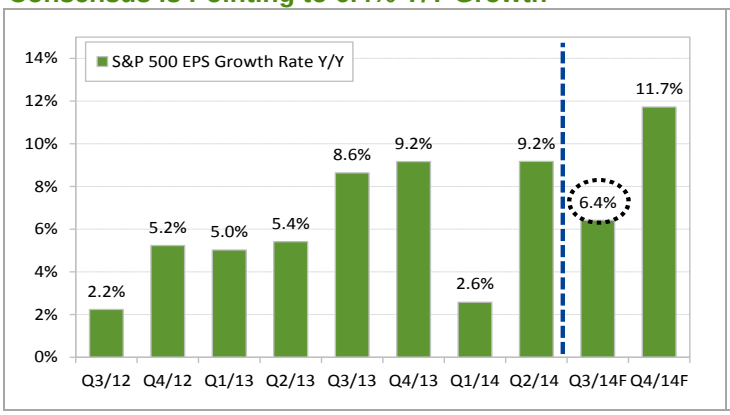
- While only a third of the way through the season, results have been above expectations. Of the 178 companies to report so far, 142 companies have reported earnings above analysts' estimates, resulting in a "beat rate" of 80%. This is well above recent quarters and the long-term average of 62%.
- S&P 500 Q3/14 earnings are currently forecasted to be US$29.03/share, which would equate to growth of 6.4% Y/Y. This follows the 9.2% growth rate for Q2/14 and continues the trend of positive earnings growth since the mid-2012 earnings slowdown. We believe the final growth rate may actually come in stronger, possibly in the 8-9% range, as we've witnessed a consistent trend of upside earnings surprises over the last year.
- More importantly, S&P 500 quarterly earnings are set to hit a new all-time high. While the "bears" like to claim that the Fed's QE policies are the only thing supporting the equity markets, they must not be looking at corporate earnings, which have been very strong and are hitting new all-time highs.
- From a sector perspective, nine of the 10 sectors are expected to post positive earnings growth, with the materials and health care sectors posting the highest growth rates.
- Potential headwinds to earnings that we are monitoring include the impact of a stronger US dollar and the deceleration of economic momentum in Europe and Asia. These factors could weigh on the large US multinationals.

In sum, Q3/14 corporate earnings are on track to post a high-single digit growth rate, which is supportive for equities and, in our opinion, not yet receiving the full attention it deserves by the financial media.

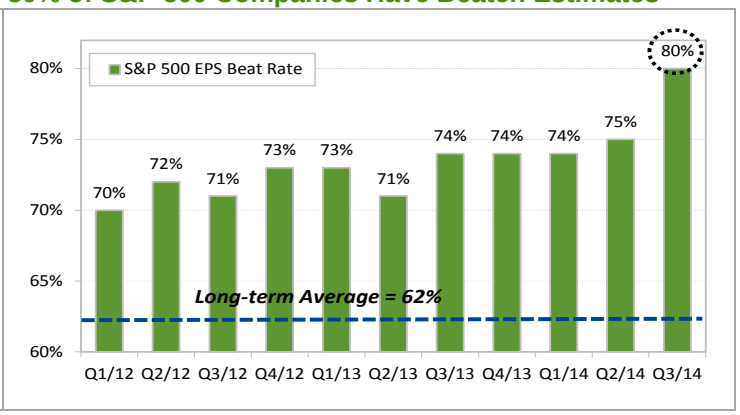
S&P 500 Earnings Are Projected To Hit a New All-Time High in Q3/14



Consensus is Pointing to 6.4% Y/Y Growth



80% of S&P 500 Companies Have Beaten Estimates



Source: Bloomberg, Raymond James Ltd.

Valuation Update

We also wanted to provide an update on where North American (NA) valuations currently stand. Overall, we would characterize the NA markets as fairly valued, with the S&P 500 and S&P/TSX Composite Index (S&P/TSX) trading in line with their long-term averages.

One technical approach that we employ is Elliot Wave, which posits that markets trade in repeatable patterns of five primary waves. Based on our Elliot Wave count, we believe that wave three commenced on September 2011. From that low, the S&P 500 gained 78%, with its trailing P/E increasing from 11.9x to 17.5x today. That is a sizable increase in the multiple, with some citing the current valuation as being worrisome for the equity markets. While we agree that valuations have expanded markedly, which is one factor in our call for more modest rates of return over the next few years, we do not agree with the assertion that markets are steeply overvalued and likely to peak soon. Consider this:

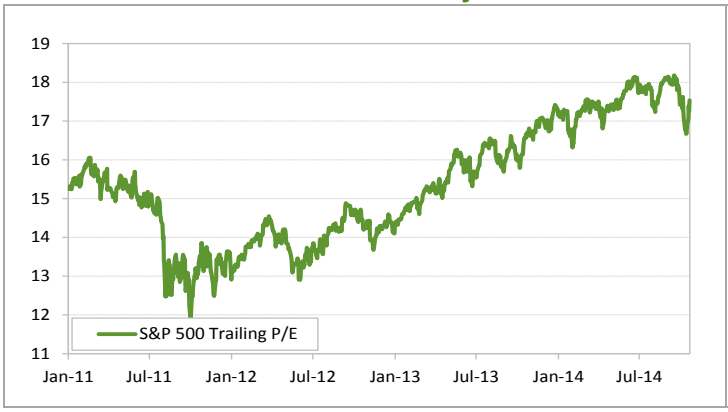
- While valuations have increased they are now just slightly above their long-term averages. For the S&P 500, the long-term average is 16.4x, with the current multiple just 1 point above the average. For the S&P/TSX, it currently trades 18.4x, which is just below its long-term average of 18.9x. Given valuations are trading in-line with their long-term averages, we would characterize the markets as fairly valued at present.
- On forward earnings estimates, the S&P 500 and S&P/TSX trade at more reasonable P/Es of 16.3x and 15.5x, respectively.
- We believe stocks are attractively valued when compared to bonds. Currently the earnings yield (inverse of the P/E) for the S&P 500 is 5.9% versus the 10-year Treasury yield of 2.3%, resulting in a historically high spread between the two.
- Finally, we note that equity markets rarely peak at their average, often overshooting to the upside. In fact, we have found that the S&P 500 has historically peaked in the 19x to 21x range. We believe further upside in equities will likely be driven by earnings growth, but we cannot rule out the potential for further multiple expansion based on historical trends.

Valuations have increased with this strong bull-run. However, they are currently just in line with their long-term averages and are below typical peak levels.

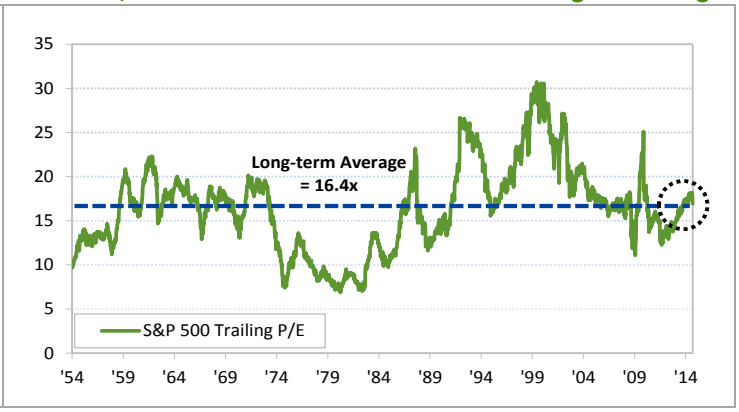
Historically the S&P 500 Has Peaked at an Average/Median of 20.5x/19.5x

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

S&P 500 P/E Has Increased Markedly to 17.5x



However, That is Just 1 Point Above the Long-term Avg



Source: Bloomberg, Raymond James Ltd.

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