Weekly Trends

PRIVATE CLIENT SOLUTIONS

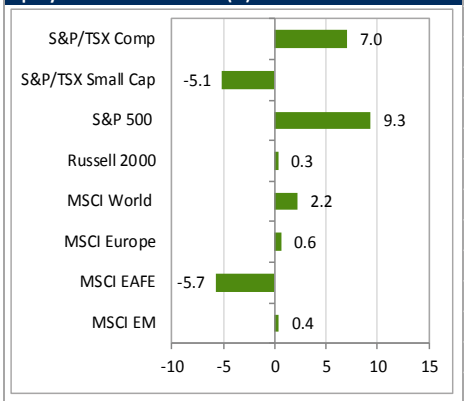
Ryan Lewenza, CFA, CMT, Private Client Strategist

November 5, 2014

The End of QE. Now What?

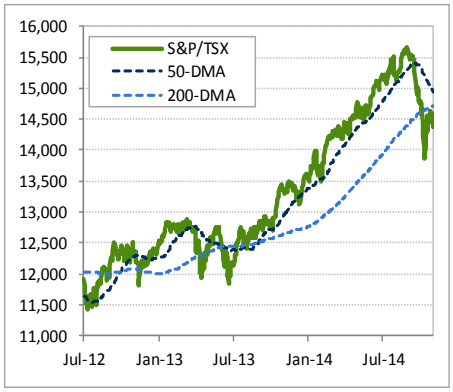
- Well, it's official. The US Federal Reserve (Fed) has finally removed the punch bowl from the liquidity party, by ending its asset purchases, also known as quantitative easing (QE), at its October 29th meeting.
- The Fed started QE3 in September 2012, with the Fed adding US$1.7 tln to its balance sheet over this period. This floodgate of liquidity has surely supported equities, as evidenced by the 0.97 correlation between the Fed's balance sheet and the S&P 500 Index (S&P 500). This tailwind for the equity markets now becomes a headwind.
- However, we believe the improving US economy and continued monetary stimulus provided by the Bank of Japan (BoJ) and European Central Bank (ECB), should be supportive to the global economic recovery and equity markets.
- Last week the BoJ announced that it was increasing the size of its asset purchase program from ¥60 - ¥70 tln to ¥80 tln or roughly US$700 bln per year. Furthermore, the ECB is likely to follow suit by significantly increasing its balance sheet in the coming months, as the ECB attempts to stimulate the European economy.
- The key point is that while the Fed has ended its asset programs, many other key central banks are continuing to increase their programs, which will keep the global liquidity spigot wide open.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	6.2	Market weight
Consumer Staples	3.3	Market weight
Energy	23.5	Overweight
Financials	36.1	Overweight
Health Care	3.3	Underweight
Industrials	8.8	Overweight
Information Technology	2.1	Overweight
Materials	10.0	Market weight
Telecom	4.8	Underweight
Utilities	2.1	Underweight

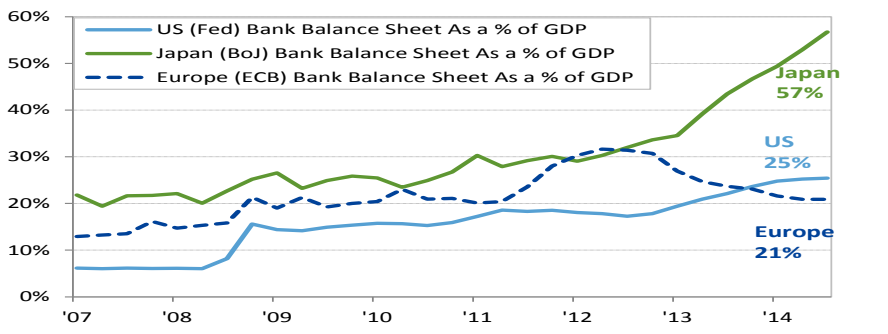
Technical Considerations	Level	Reading
S&P/TSX Composite	14,581.0	
50-DMA	14,949.9	Downtrend
200-DMA	14,705.6	Downtrend
RSI (14-day)	43.5	Neutral



Source: Bloomberg, Raymond James Ltd.

Chart of the Week

While The Fed Has Ended Its Asset Purchase Program, The BoJ And ECB Look Set To Increase Their Stimulus Plans By Further Expanding Their Balance Sheets



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.

RAYMOND JAMES

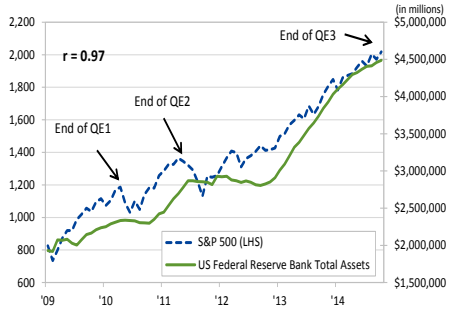
The End of QE3

Well, it's official. The Fed has finally removed the punch bowl from the liquidity party, with it ending its asset purchases at its October 29th meeting. According to the Fed press release, "the Committee judges that there has been a substantial improvement in the outlook for the labor market since the inception of its current asset purchase program. Moreover, the Committee continues to see sufficient underlying strength in the broader economy… Accordingly, the Committee decided to conclude its asset purchase program this month." The Fed started QE3 in September 2012, with the Fed adding US$1.7 tln to its balance sheet over this period. This floodgate of liquidity has surely supported equities, as evidenced by the 0.97 correlation between the Fed's balance sheet and the S&P 500 (sidebar). This tailwind for the equity markets now becomes a headwind. However, we believe the improving US economy, as cited in the Fed press release and continued monetary stimulus provided by the BoJ and ECB, should be supportive to the global economic recovery and equity markets. We believe the North American (NA) equity markets are transitioning from a liquidity-driven market to one driven by fundamentals. On that front, we highlight recent economic releases and market developments that reinforce our constructive view on the NA economy and, in turn, equity prices:

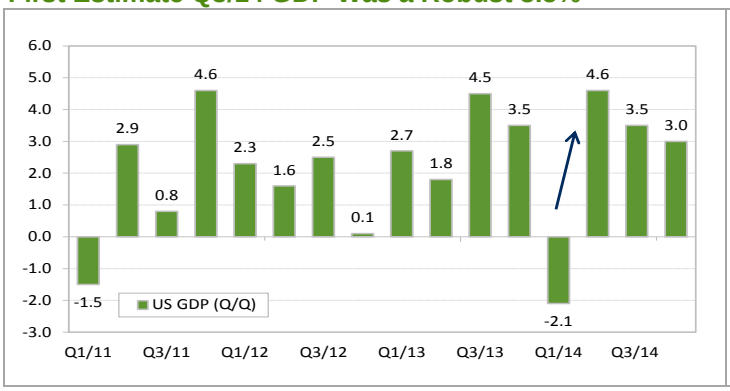
- The first estimate of Q3/14 US GDP showed economic activity expanded at 3.5% in the quarter with gains coming from consumer spending, exports and fixed investment. While growth was down from the 4.6% in Q2/14, the trend clearly remains to the upside and is in-line with our expectations for 3% growth in H2/14.
- The US manufacturing sector continues to strengthen with the Institute for Supply Management (ISM) Index rising to 59 in October, matching August for the highest reading since March 2011. New orders, a good leading indicator of future production, rose to 65.8 in the month. According to the Chairman of the ISM, "US manufacturing is firing on all cylinders."
- US jobless claims continue to decline, with the 4-week moving average hitting 281,000 last week, the lowest level in 14 years. The ADP payroll report showed this week that 230,000 jobs were created in October. We believe these data points bode well for the nonfarm payrolls release on Friday, with consensus pointing to job gains of 232,000 in October.

Overall, economic data is signaling an improving US economy, and potentially, an economy finally strong enough to grow without the need of monetary stimulus.

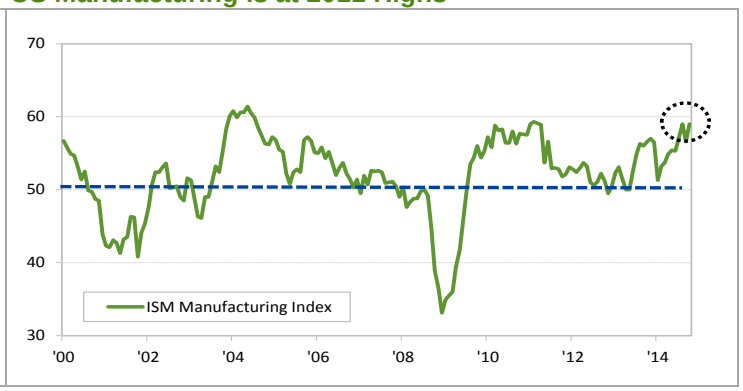
S&P 500 Has a 0.97 Correlation with the Fed Balance Sheet Since 2007



First Estimate Q3/14 GDP Was a Robust 3.5%



US Manufacturing is at 2011 Highs



Source: Bloomberg, Raymond James Ltd.

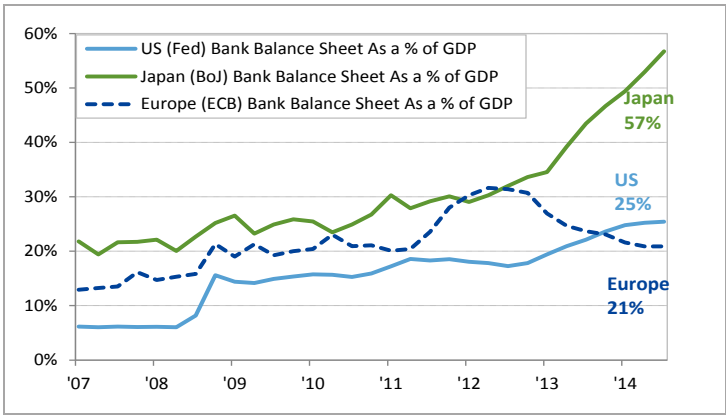
Global Stimulus in the Pipeline

While the Fed has ended its asset purchase programs and is now looking to the future on when they will begin to tighten monetary policy, their central bank peers are stealing a page from them by implementing their own QE policies. Last week the BoJ announced that it was increasing the size of its asset purchase program from ¥60 - ¥70 tln to ¥80 tln or roughly US$700 bln per year. Japanese officials are effectively throwing everything they can at the economy to help stimulate growth and inflation, which continues to stagnate. In fact, Japan has been far more aggressive in their stimulus plans with the BoJ balance sheet increasing to 57% as a percentage of GDP versus the US and Europe at 25% and 21%, respectively. With this large increase in additional stimulus, the BoJ's balance sheet is projected to rise to 70% (as a percentage of GDP) by 2020. Furthermore, the ECB is likely to follow suit by significantly increasing its balance sheet in the coming months, as it also tries to reflate the European economy. The key point is that while the Fed has ended its programs, many other key central banks are continuing to increase theirs, which will keep the global liquidity spigot wide open.

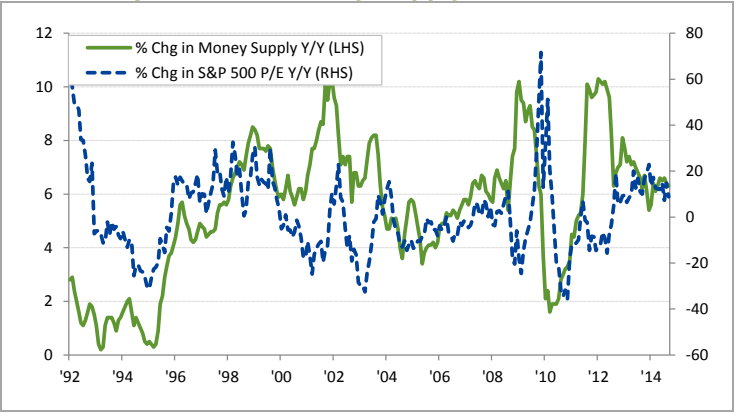
Why is this so important? Increasing money supply through low interest rates and unconventional policies such as QE, has been consistent with periods of rising stock valuations and prices. In the accompanying chart, we illustrate this by showing the historical positive relationship between the increasing US money supply Y/Y and rising S&P 500 P/Es. While the correlation is not perfect, the trend is clearly visible with stock P/Es generally ebbing and flowing with the money supply.

We believe the continued global monetary stimulus will benefit equity prices, possibly leading to further P/E expansion. Additionally, the improving US economy should result in stronger corporate earnings growth. Frankly, we're indifferent to how we realize gains (i.e., corporate earnings growth or multiple expansion), but we believe these conditions could set the stage for further equity gains into next year.

Global Central Banks Balance Sheets Relative to GDP



The Linkage Between Money Supply and Stock Gains



Source: Bloomberg, Raymond James Ltd.

Important Investor Disclosures

Complete disclosures for companies covered by Raymond James can be viewed at: www.raymondjames.ca/researchdisclosures.

This newsletter is prepared by the Private Client Services team (PCS) of Raymond James Ltd. (RJL) for distribution to RJL's retail clients. It is not a product of the Research Department of RJL.

All opinions and recommendations reflect the judgement of the author at this date and are subject to change. The author's recommendations may be based on technical analysis and may or may not take into account information contained in fundamental research reports published by RJL or its affiliates. Information is from sources believed to be reliable but accuracy cannot be guaranteed. It is for informational purposes only. It is not meant to provide legal or tax advice; as each situation is different, individuals should seek advice based on their circumstances. Nor is it an offer to sell or the solicitation of an offer to buy any securities. It is intended for distribution only in those jurisdictions where RJL is registered. RJL, its officers, directors, agents, employees and families may from time to time hold long or short positions in the securities mentioned herein and may engage in transactions contrary to the conclusions in this newsletter. RJL may perform investment banking or other services for, or solicit investment banking business from, any company mentioned in this newsletter. Securities offered through Raymond James Ltd., Member-Canadian Investor Protection Fund. Financial planning and insurance offered through Raymond James Financial Planning Ltd., not a Member-Canadian Investor Protection Fund.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual funds. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The results presented should not and cannot be viewed as an indicator of future performance. Individual results will vary and transaction costs relating to investing in these stocks will affect overall performance.

Information regarding High, Medium, and Low risk securities is available from your Financial Advisor.