Weekly Trends

PRIVATE CLIENT SOLUTIONS

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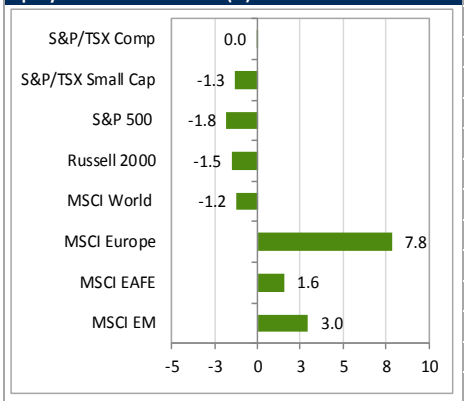
January 30, 2015

Europe's Turn

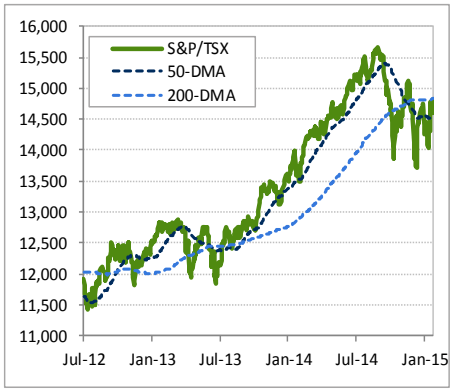
- The Quantitative Easing (QE) baton has been passed from the US Federal Reserve (Fed) to the European Central Bank (ECB), with the ECB's historic announcement that it will begin to purchase €60 billion per month in bonds. The asset purchase plan will begin in March and run through to September 2016. We estimate that this program will lead to a €1.4 tln increase in the ECB's balance sheet by September of next year.
- We believe that equity prices are greatly impacted by central bank stimulus. Based on our analysis, we have a found a clear linkage to increased liquidity and rising equity prices/valuations. Specifically, when there is excess liquidity, which we proxy as the difference between growth in the money supply and nominal GDP, stocks have tended to rise as a result of expanding multiples (see Chart of the Week).
- The ECB's expansion of their balance sheet should be supportive to European (and global) equities, and therefore we believe investors should consider adding some exposure to their portfolios.
- While we recommend investors look to add some European exposure, we believe investors should do so on a hedged basis, given our negative outlook for the Euro. We would recommend investors play this theme through the WisdomTree Europe Hedged ETF (HEDJ-N), which is hedged to the US dollar.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	6.4	Overweight
Consumer Staples	3.8	Market weight
Energy	20.8	Market weight
Financials	34.3	Overweight
Health Care	4.2	Underweight
Industrials	8.7	Overweight
Information Technology	2.4	Overweight
Materials	11.9	Underweight
Telecom	5.2	Market weight
Utilities	2.3	Underweight

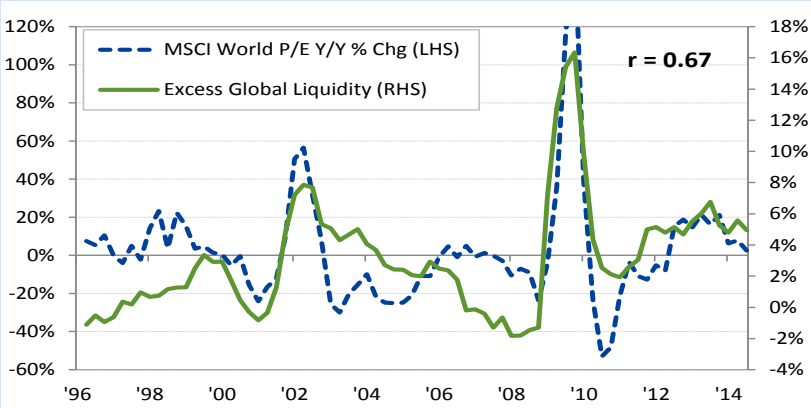
Technical Considerations	Level	Reading
S&P/TSX Composite	14,627.6	
50-DMA	14,502.5	Uptrend
200-DMA	14,829.0	Downtrend
RSI (14-day)	53.9	Neutral



Source: Bloomberg, Raymond James Ltd.

Chart of the Week

Excess Global Liquidity Is Consistent With A 10% Re-Rating Of Equities



Source: Bloomberg, Raymond James Ltd.

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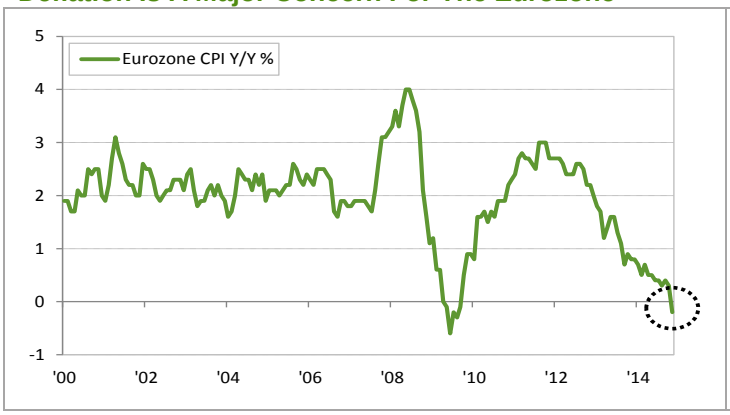
Europe's Turn

The QE baton has been passed from the Fed to the ECB, with the ECB's historic announcement (finally!) that it will begin to purchase €60 billion per month in bonds. The asset purchase plan will begin in March and run through to September 2016. We estimate that this program will lead to a €1.4 tln increase in the ECB's balance sheet by September of next year. While the program is projected to end in September 2016, the ECB did state that the program could be extended if they are unsuccessful at achieving its objectives. What are the likely objectives of this program? From our perspective we believe they are threefold:

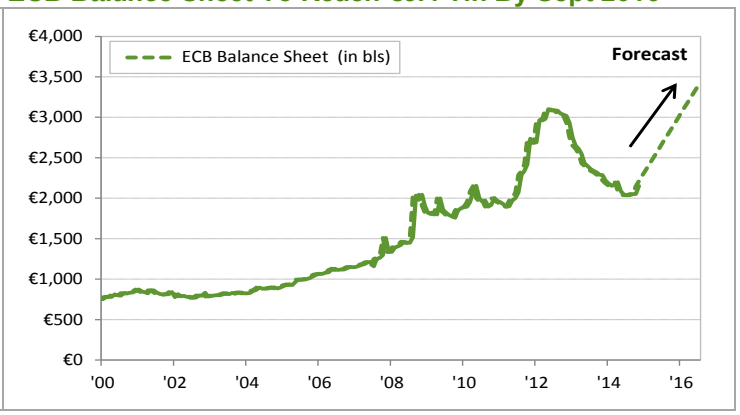
- **Combat Deflation:** Europe has been mired in a deflationary spiral with Eurozone CPI recently declining to -0.2% Y/Y in December. While inflation has been steadily declining, December's reading was concrete proof that the region is experiencing more than just disinflationary forces. More concerning to the ECB are market-based inflation expectations which have de-anchored from the ECB's long-term 2% inflation target. By increasing the money supply and lowering interest rates, the goal is to encourage spending (consumer and corporate) which could lead to a rise in inflation.
- **Stimulate Economic Growth:** The Eurozone has experienced very weak and uneven economic growth since the financial crisis, with quarterly GDP growth averaging just 0.1% since 2013. Lower interest rates could provide the stimulus for increased spending and economic activity. Additionally, the asset purchase program will likely lead to continued weakness in the Euro, which could provide an additional tailwind to exports.
- **Encourage Bank Lending:** Lastly, European banks have been reticent to increase lending given weak demand and increased pressure by regulators to improve capital ratios. The hope is that this program will lead to stronger credit growth.

It remains to be seen whether these objectives will be met with this program. Our view is that structural reforms (e.g., tax and labour reforms making the region more competitive globally) are as if not more important, to the European economy than lower interest rates. While the impact to the economy is less certain, the impact on equity prices is likely to be more meaningful in our opinion, based on the recent historical experience of Fed QE on US stock prices.

Deflation Is A Major Concern For The Eurozone



ECB Balance Sheet To Reach €3.4 Tln By Sept 2016



Source: Bloomberg, Raymond James Ltd.

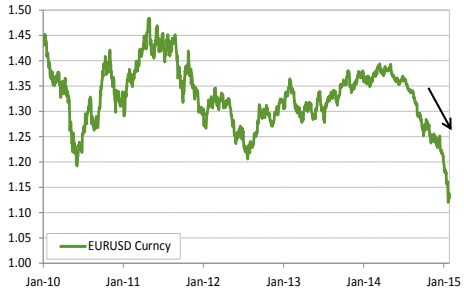
Impact On Equity Markets

We believe that equity prices are greatly impacted by central bank stimulus (e.g., low interest rates and QE). Based on our analysis, we have a found a clear linkage to increased liquidity and rising equity prices/valuations. Specifically, when there is excess liquidity, which we proxy as the difference between growth in the money supply and nominal GDP, stocks have tended to rise as a result of expanding multiples. Intuitively we know this. Lower interest rates and accommodative monetary policies help to spur economic activity while helping to restore and improve confidence. In the accompanying chart, we illustrate the relationship between excess global liquidity and P/E multiples. When money supply (M1) is greater than nominal GDP growth, global equities tend to experience an increase in P/E multiples. Moreover, the correlation between excess global liquidity and the change in P/E multiples is a decent 0.67. In summary, the ECB's expansion of their balance sheet should be supportive to European (and global) equities, and therefore, we believe investors should consider adding some exposure to their portfolios.

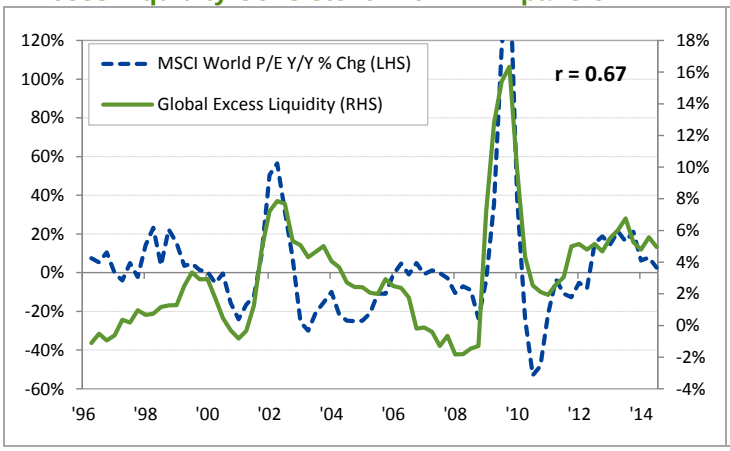
While we recommend investors look to add some European exposure, we believe investors should do so on a hedged basis, given our negative view of the Euro. As seen in the accompanying chart, the Euro vs. the USD has declined precipitously from €1.40/US last summer to €1.12/US currently. With the ECB to increase the money supply further, putting downward pressure on interest rates, we believe the Euro could decline further. Purchasing an unhedged ETF under this scenario would detract from returns. By purchasing an ETF that hedges out the currency, the returns will simply be the returns of the underlying equities and will not be impacted by the depreciation of the Euro. And since we're bullish on the US dollar vs. the CAD dollar, we believe having exposure to European equities in US dollars is the best way to play this investment theme. As such, we would recommend investors play this theme through the WisdomTree Europe Hedged ETF (HEDJ-N).

Finally, from a technical perspective we note that HEDJ broke above an important resistance level of $60 on heavy volume, following the ECB announcement. Despite the run up since the December lows, we believe there could be further upside in this ETF as the ECB begins to purchase €60 billion per month in bonds.

The Euro Is In Freefall And Possibly Heading Lower



Excess Liquidity Consistent With PE Expansion



HEDJ Breaks Out Following ECB Announcement

Source: Bloomberg, Raymond James Ltd.

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