Weekly Trends

PRIVATE CLIENT SOLUTIONS

Ryan Lewenza, CFA, CMT, Private Client Strategist

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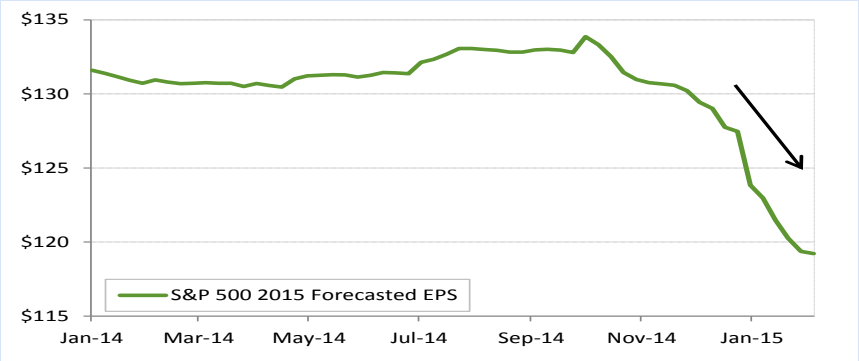
Q4/14 US Earnings Update – Oil and US Dollar Headwinds

- From our perspective the Q4/14 US earnings season has been disappointing, based on the three-quarters of S&P 500 Index (S&P 500) companies having reported results. S&P 500 earnings are projected to rise a modest 3% Y/Y to $28.97/share. This is well below the $31.28/share expected at the start of the quarter. Weak oil prices and a stronger US dollar were headwinds to US corporate profits in the quarter.
- Despite these headwinds, we still see S&P 500 earnings growing between 5-6% versus consensus currently at 4.6% Y/Y. We believe analysts may be overplaying the impact of the stronger US dollar and weak oil prices on full-year 2015 earnings. As such, earnings estimates may trough in the coming months.
- A strong US dollar does not derail the economy or stock market as some believe. Historically, there have been instances when multiples expanded with a rising US dollar. In fact, Ned Davis research shows that when the US dollar is up on a Y/Y basis, the S&P 500 P/E increases by 6.5% on average, more than offsetting the decline in earnings from the stronger US dollar.
- Key point is that while a stronger US dollar and weak oil prices are headwinds to corporate earnings, it should not spell disaster for the economic recovery and upward stock market trajectory. We continue to forecast gains this year for North American equities, but stress that it will be a more volatile year for the equity markets.

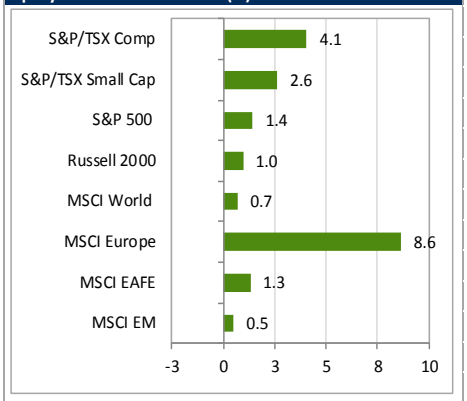
Chart of the Week

S&P 500 2015 Earnings Estimates Plunge In January



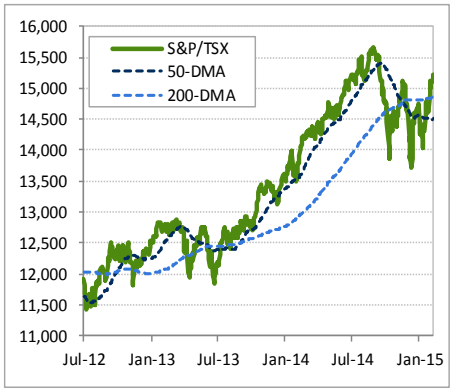
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	6.3	Overweight
Consumer Staples	3.6	Market weight
Energy	21.9	Market weight
Financials	34.4	Overweight
Health Care	4.2	Underweight
Industrials	8.7	Overweight
Information Technology	2.4	Overweight
Materials	11.5	Underweight
Telecom	4.8	Market weight
Utilities	2.2	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	15,228.5	
50-DMA	14,503.0	Uptrend
200-DMA	14,855.9	Uptrend
RSI (14-day)	66.5	Neutral



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.

Q4/14 US Earnings Update

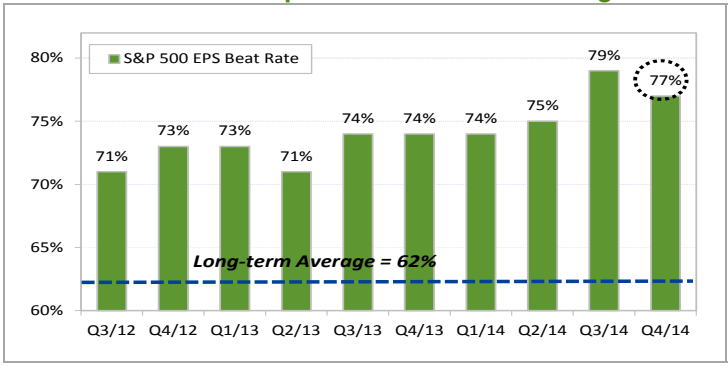
From our perspective the Q4/14 US earnings season has been disappointing, based on the three-quarters of S&P 500 companies having reported results. S&P 500 earnings are projected to rise a modest 3% Y/Y to $28.97/share. This is well below the $31.28/share expected at the start of the quarter. Earnings estimates have been slashed in recent months on the realization that a stronger US dollar and weak oil prices are going to weigh on US corporate profitability. In this week's publication we recap the Q4/14 US earnings season, provide our outlook for 2015 S&P 500 earnings and what it could portend for stock prices this year.

Starting with the positives for the quarter, 77% of S&P 500 companies have reported earnings results above analysts' expectations. On face value this is an impressive number, coming in well above the average 62% quarterly "beat rate." However, as mentioned, earnings estimates were materially lowered for Q4 (and 2015 estimates), providing a low bar to beat. The positive "beat rate" seems to be where the good news ends. Key negatives for the quarter include:

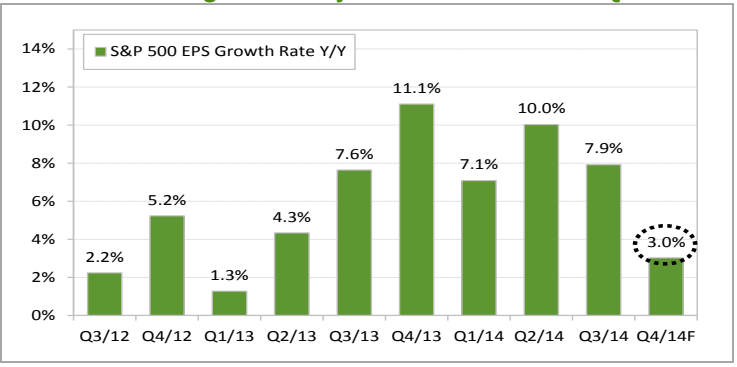
- **Revenue growth:** S&P 500 revenue growth was a modest 2.6% Y/Y as anemic economic growth in Europe, Japan etc. weighed on top-line results. With roughly 40% of S&P 500 revenues coming from outside the US, weak global growth will surely weigh on the top-line.
- **US dollar:** The strength in the US dollar is providing a significant headwind to corporate profits, with large US multinationals feeling the brunt of the US dollar gains. The US Dollar Index averaged 87.52 in Q4/14, which is up 9% Y/Y. Companies with significant overseas revenues are seeing weaker results as they translate those revenues back into the US dollar. Numerous CEO's noted that the strength in the US dollar negatively impacted results.
- **Oil weakness:** The most significant drag on S&P 500 earnings has been related to the weakness in oil prices. S&P 500 energy sector earnings are projected to decline 22% Y/Y in Q4/14, as a result of the lower oil prices. If oil prices do not improve from current levels, earnings from the energy sector should continue to weigh on overall S&P 500 profitability.
- **Weak guidance:** Finally, forward guidance was poor with 52 companies issuing negative guidance vs 10 companies issuing positive guidance.

With our expectation that upside in stock prices this year would come from corporate earnings growth, does the weaker earnings outlook derail our thesis of additional gains in 2015?

77% of S&P 500 Companies Beat Their Earnings Est.



S&P 500 Earnings Are Projected To Rise 3% In Q4/14



Source: Bloomberg, Raymond James Ltd.

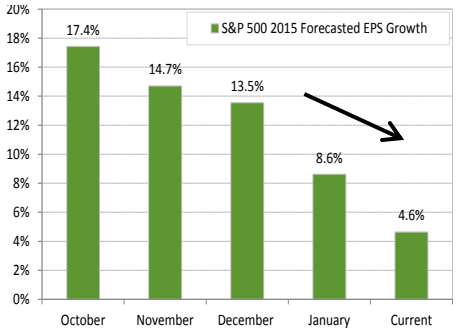
US Earnings Outlook

We have found that equity analysts often overestimate earnings when the economy is doing well, while underestimating earnings when the economic outlook is less certain. We believe this may be playing out once again, with analysts overplaying the negative impact of the stronger US dollar and weak oil prices on full-year 2015 earnings. Our continued bullish stance on US equities is predicated on the following:

- While earnings estimates have been slashed in recent months, consensus estimates are still pointing to 2015 earnings growth of 4.6% Y/Y (sidebar). This is down significantly from the 13.5% growth expected in December, but as we stated previously, we believe analysts were overestimating earnings growth at that time. Based on our expectations for GDP growth, margins, and stock repurchases, we believe S&P 500 earnings are likely to come in around the $120/share level, equating to growth of 5.3% Y/Y.
- We expect oil prices to firm-up in H2/15 as North American oil production declines. If this transpires then the headwind of lower oil prices on the energy sector and overall S&P 500 could abate throughout the year.
- Finally, our expectation this year was for multiples to remain roughly flat with upside in stock prices coming from earnings growth (we estimate 5.3% Y/Y). If we have underestimated the impact from the stronger US dollar in our models, and S&P 500 earnings disappoint, a case can still be made for additional upside. During the 2000s, the US dollar was weak which conditioned investors to believe that a strong US dollar was negative for the stock market through lower P/Es. However, if you look further back, there have been instances when a strong US dollar was supportive of expanding P/Es and equity gains. A strong US dollar generally reflects an improving economy, which is consistent will a rise in stock P/Es (see accompanying chart). Moreover, Ned Davis research shows that when the US dollar is up on a Y/Y basis, the S&P 500 P/E increases by 6.5% on average, more than offsetting the decline in earnings from the stronger US dollar.

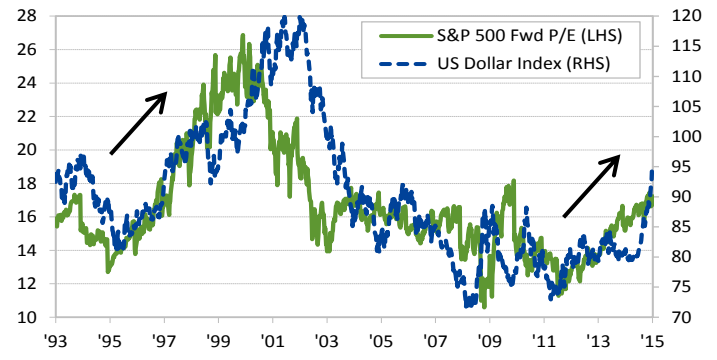
In conclusion, this US earnings season was disappointing due largely to headwinds from the stronger US dollar and weak oil prices. We believe analysts are overplaying these headwinds and as such, believe S&P 500 earnings will rise more than the current consensus estimate of 4.6% Y/Y in 2015. Even if we're wrong on the impact from these headwinds and corporate earnings disappoint, stocks can still rise this year on the back of multiple expansion, which is consistent with history.

S&P 500 Earnings Estimates Have Been Slashed In Recent Months



Source: Bloomberg, Raymond James Ltd.

The US Dollar And S&P 500 P/Es Can Move Together



S&P 500 P/Es Have Expanded With A Rising US Dollar

US Dollar Index 12-Month % Chg	S&P 500 EPS % Chg	S&P 500 P/E % Chg	Comment
When US Dollar 12-month chg is below 0	12.4%	-2.0%	Weak US dollar leads to stronger EPS but **lower** P/Es
When US Dollar 12-month chg is above 0	1.2%	6.5%	Stronger US dollar leads to weaker EPS but **higher** P/Es

Source: Bloomberg, Raymond James Ltd., Ned Davis Research Group

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