# Weekly Trends

PRIVATE CLIENT SOLUTIONS

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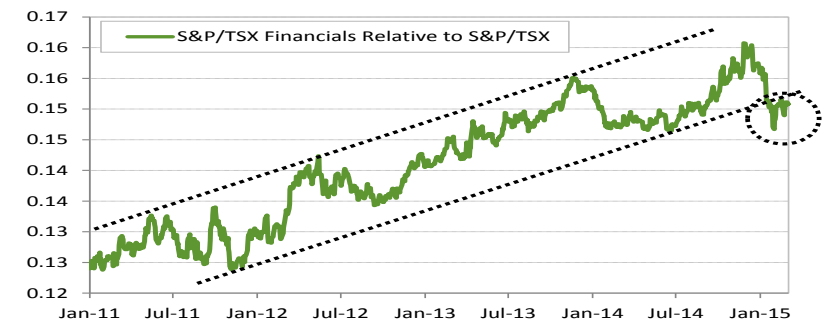
## Downgrading Financials On Half-Speed Canadian Economy

- The Q4/14 GDP report was released this week and it showed the Canadian economy grew at 2.4% annualized. On the surface the print was solid; however, digging into the numbers, a different picture arises. First, there was a significant build-up in inventories which accounted for three-quarters of GDP growth. Second, exports declined 1.6% annualized which, given the drop in the Canadian dollar, is concerning.
- Coming into the year our view was that economic growth would improve, with exports being an important driver. We were targeting a conservative 2.5% GDP growth rate for 2015, but we now see downside risk to this forecast.
- We expect a weaker H1/15 for the Canadian economy, followed by a stronger H2/15. Overall, we now expect GDP growth closer to 2% for the full year. Given our expectations for more modest economic growth we are downgrading the financials sector to market weight.
- The key factor behind the downgrade is our trepidation over bank earnings this year, and with the large weighting of banks within the financials sector, we believe it's prudent to tweak our sector recommendation and downgrade it to market weight. The banks remain great long-term investments given their solid long-term earnings profile and steady dividends. As such, we continue to see them as core holdings in portfolios. However, upside may be more limited this year. Within the financials sector our preference is for the insurance and asset management sub-industries for 2015.

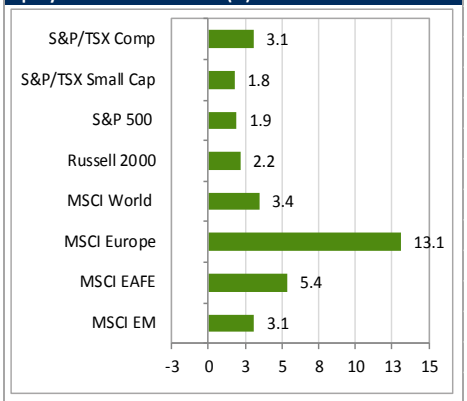
**Chart of the Week**

S&P/TSX Financials Breakdown From A Long-term Relative Uptrend



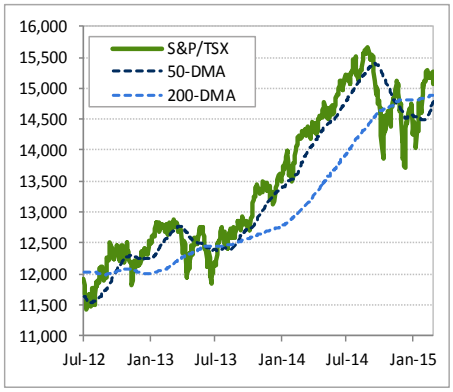

Source: Bloomberg, Raymond James Ltd.

**Equity Market YTD Returns (%)**




| Canadian Sector | Curr. Wt | Recommendation |
|---|---|---|
| Consumer Discretionary | 6.6 | Overweight |
| Consumer Staples | 3.7 | Market weight |
| Energy | 21.1 | Market weight |
| Financials | 34.5 | Market weight ↓ |
| Health Care | 4.9 | Underweight |
| Industrials | 8.6 | Overweight |
| Information Technology | 2.5 | Overweight |
| Materials | 11.2 | Underweight |
| Telecom | 4.8 | Market weight |
| Utilities | 2.2 | Underweight |

| Technical Considerations | Level | Reading |
|---|---|---|
| S&P/TSX Composite | 15,082.8 | |
| 50-DMA | 14,768.2 | Uptrend |
| 200-DMA | 14,893.7 | Uptrend |
| RSI (14-day) | 55.8 | Neutral |




Source: Bloomberg, Raymond James Ltd.



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## Half-Speed Canadian Economy

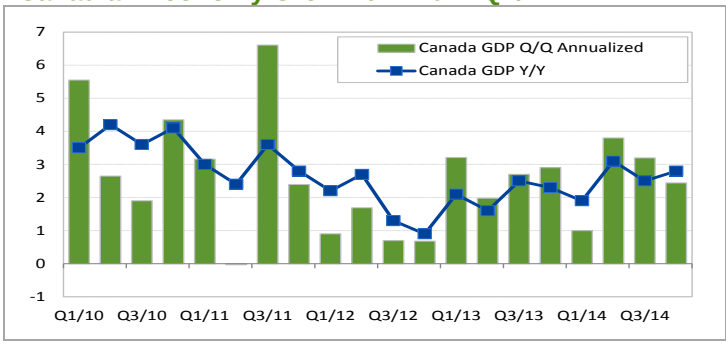
The Q4/14 GDP report was released this week and it showed the Canadian economy grew at 2.4% annualized. On the surface the print was solid; however, digging into the numbers, a different picture arises. First, there was a significant build-up in inventories which accounted for three-quarters of GDP growth. This can have a positive read-through for the economy, as it shows a willingness of producers to increase production in anticipation of increased future sales. However, in this case we believe it shows that businesses were caught offside with sales coming in below their expectations. We believe this increase could result in weaker future production and a drawdown of inventories over the next few quarters. Second, exports declined 1.6% annualized which, given the drop in the Canadian dollar, is concerning. Coming into the year our view was that economic growth would improve, with exports being an important driver. We were targeting a conservative 2.5% GDP growth rate for 2015, but we now see downside risk to this forecast. Given our expectations for more modest growth we are downgrading the financials sector to market weight.

We expect a weaker H1/15 for the Canadian economy, followed by a stronger H2/15. Overall, we now expect GDP growth closer to 2% for the full year. Our lower growth expectations are predicated on the following:

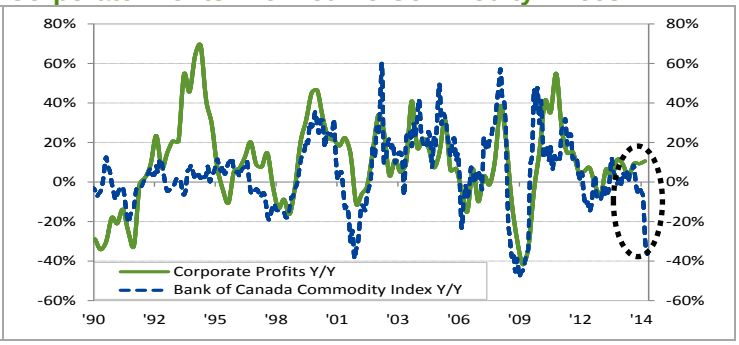
- While we expect WTI oil prices to firm up in H2/15, we still see the overall commodity complex remaining under pressure. This is critical to a heavy resource-based economy like Canada. Weak commodity prices weigh on our economy in a number of ways.
- First, weak commodities are surely to weigh on corporate profits this year. In the accompanying chart we illustrate the important relationship between corporate profits and commodity prices. With the Bank of Canada (BoC) Commodity Index down 35% Y/Y, we believe the outlook for corporate profits is likely to worsen.
- Second, the weakness in the commodity markets should then weigh on job growth and in turn, consumer spending.
- Finally, the housing sector could also be at risk. Our base-case view is that the housing market will hold up this year as mortgage rates remain at near-record lows. However, should the housing market worsen, it will weigh on the economy.

Commodity prices are incredibly important to our economy, having ramifications on many aspects of our economy. Nowhere is this clearer than in the financials sector.

**Canadian Economy Grew At 2.4% in Q4/14**




**Corporate Profits Are Tied To Commodity Prices**




Source: Bloomberg, Raymond James Ltd.

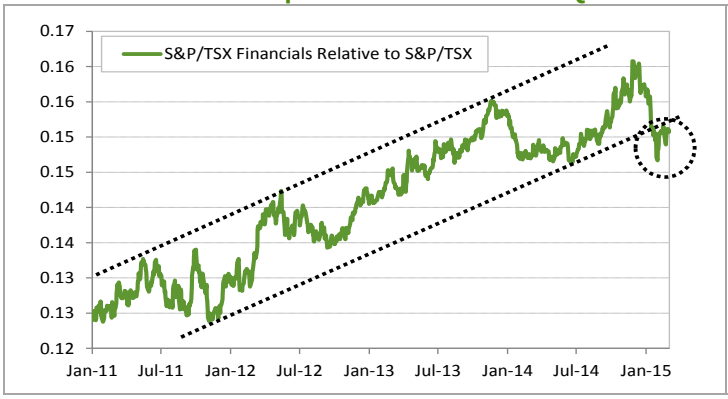
## Downgrade Financials To Market Weight

If there is a downshift in the economy, the banks are likely to encounter some headwinds to their operations. The key positive for financials, and in particular the banks, are that valuations remain attractive. Currently, the financials sector and bank sub-industry trade at 12.6x and 12x forward earnings, respectively. This will help to provide support to the sector in the case that earnings come under pressure in response to a weaker economy. Additionally, dividends yields and the potential for dividend growth are supportive to the sector. Our concerns over bank earnings are predicated on the following:

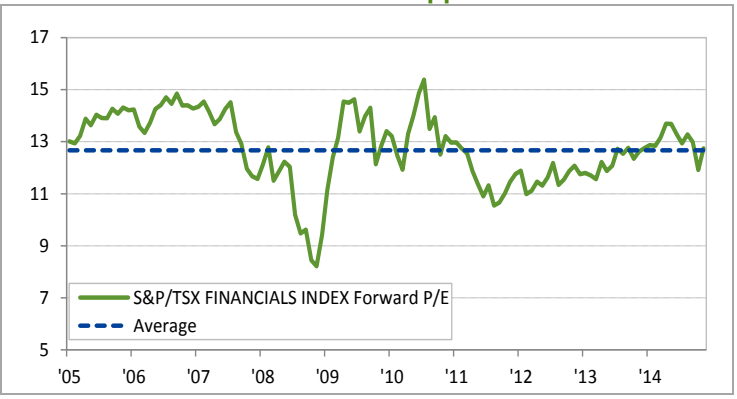
- **Lower NIMs:** The weakening outlook for the Canadian economy caused the BoC to cut interest rates in January by 25 bps. The market is pricing in another cut in the coming months. Declining bond yields is driving Net Interest Margins (NIMs) even lower which will weigh on profits.
- **Potential for higher credit provisions:** If the economy deteriorates further, especially in the energy sector, this could lead to higher provisions for credit losses which would negatively affect results.
- **Lower corporate earnings:** Given these factors we see the potential for weaker bank earnings this year than previously anticipated. Analysts have been revising estimates lower for the sector, with analysts now forecasting earnings growth of 4% Y/Y. We were expecting high-single digit EPS growth versus the 4% expected today.
- **Technicals:** An important factor in our bullish case for the financials sector in recent years has been the strong technicals. This changed early in the year, with the S&P/TSX Financials Index breaking down from a long-term relative uptrend.

Given our trepidation over bank earnings this year, and the large weighting of banks within the financials sector, we believe it's prudent to tweak our sector recommendation and downgrade the sector to market weight. The banks remain great long-term investments given their solid long-term earnings profile and steady dividends. As such, we continue to see them as core holdings in portfolios. However, upside may be more limited this year. Within the financials sector our preference is for the insurance and asset management companies sub-industries in 2015.

**Financials Relative Uptrend Was Broken In Q1/15**




**Attractive Valuations Provide Support To Sector**




Source: Bloomberg, Raymond James Ltd.

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