Weekly Trends

PRIVATE CLIENT SOLUTIONS

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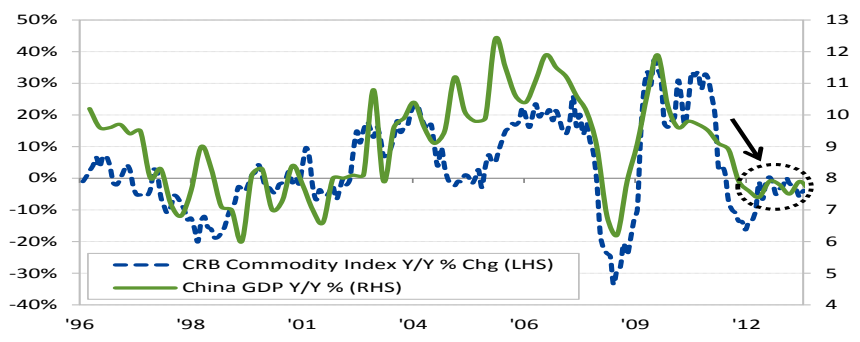
How Does Canada Fare In This Low Growth Environment?

- I was recently out west on a marketing trip with our Chief US Investment Strategist, Jeff Saut. His core message was that despite the US equity markets being overdue for a 10% correction, he remains long-term bullish on US stocks given that we're in a secular (i.e., multi-year) bull market. Our presentation focused on the weakening economic outlook for the emerging markets, and its implications for commodities and in turn Canada.
- The slowdown in China and across many of the emerging market countries is having a significant impact on commodity prices. China's economy for example has slowed from roughly 10% in 2010 to 7% today. As China and these emerging markets slow, demand for commodities has waned which explains the steep declines in copper, iron ore, etc.
- Resources represent nearly 20% of our economy's GDP. Therefore, lower demand for commodities is surely to provide a headwind to our economy. Indeed, the Canadian economy contracted by 0.6% (annualized) in Q1/15, and with April's -0.1% M/M reading we're off to a rough start for Q2/15.
- We believe investors should adjust their investment strategy to focus on investments which stand to benefit from this new market environment of lower commodity prices. These strategies include: 1) underweight resources in portfolios, particularly materials stocks; 2) overweight the consumer discretionary and information technology sectors; 3) overweight the US; and 4) invest more globally, with our preference for US and European equities.

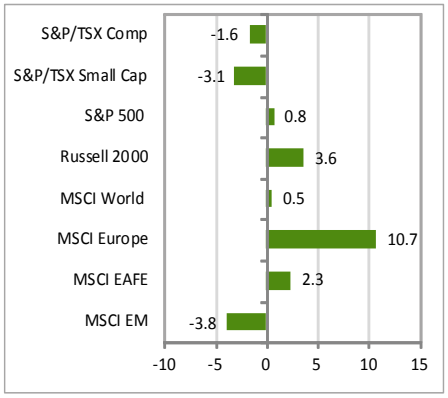
Chart of the Week

Slowing Chinese Economy Is Weighing On Commodity Prices



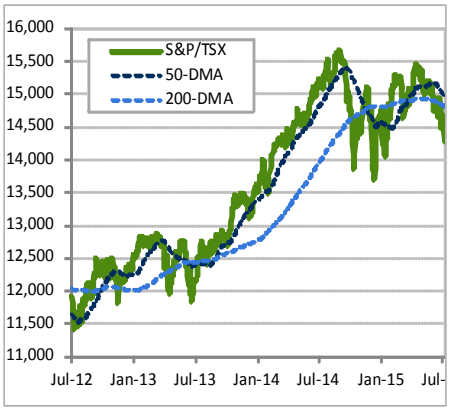
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	TSX Weight	Recommendation
Consumer Discretionary	6.9	Overweight
Consumer Staples	3.8	Market weight
Energy	19.8	Market weight
Financials	35.3	Market weight
Health Care	6.4	Market weight
Industrials	7.8	Overweight
Information Technology	2.5	Overweight
Materials	10.5	Underweight
Telecom	5.0	Market weight
Utilities	2.1	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,401.0	
50-DMA	14,934.7	Downtrend
200-DMA	14,815.1	Downtrend
RSI (14-day)	31.0	Neutral



Source: Bloomberg, Raymond James Ltd.

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RAYMOND JAMES

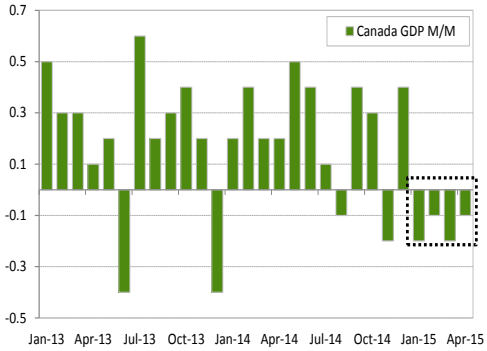
Commodities And Canada

I was recently out west on a marketing trip with our Chief US Investment Strategist, Jeff Saut. His core message was that despite the US equity markets being overdue for a 10% correction, he remains long-term bullish on US stocks given that we're in a secular (i.e., multi-year) bull market. We couldn't agree more as this has been a consistent theme of ours since the S&P 500 broke above its 2007 highs of 1,576 in early 2013. Our presentation focused on the weakening economic outlook for the emerging markets, and its implications for commodities and in turn Canada. With Canada posting its fourth consecutive negative monthly GDP print in April, we felt a review of this presentation and outlook would be timely for this week's publication.

The slowdown in China and across many of the emerging market countries is having a significant impact on commodity prices. As highlighted in the chart below, China, India and Brazil have seen their growth rates consistently trend lower since 2009 and 2010. China's economy for example has slowed from roughly 10% in 2010 to 7% today. As China and these emerging markets slow, demand for commodities has waned which explains the steep declines in copper, iron ore, etc. Illustrating this important relationship we overlay the Y/Y change in commodity prices with China's GDP below. While not perfect, it does show a good correlation between the two. China is key to the outlook for commodities as the country represents roughly 50% of global demand for commodities like steel, cement, copper, etc. With China embarking on a transformative change of their economy from an investment driven economy to a consumption/service based economy, this is resulting in weaker demand for commodities, a trend we expect to last for some time. As such, we believe the outlook remains challenged for commodities, which has significant implications for our economy and stock market.

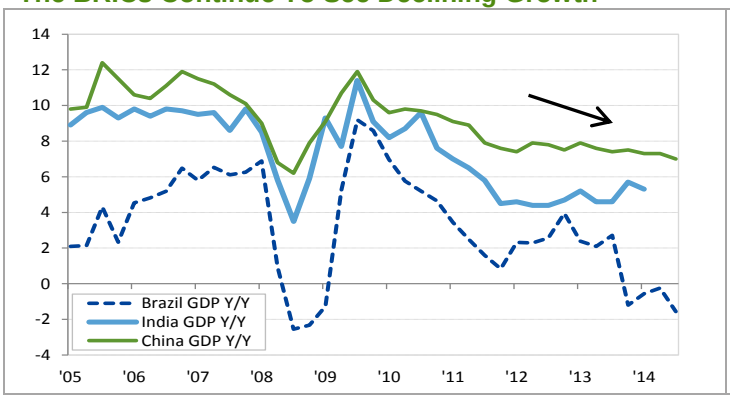
Including tangential industries, resources represent nearly 20% of our economy's GDP. Therefore, lower demand for commodities is surely to provide a headwind to our economy. This is in part why we forecasted that the Canadian economy would lag behind the US economy this year, and post below-trend economic growth. In our 2015 Market Outlook report we forecasted Canada GDP growth of 2.5%, but we now see downside risk to this forecast, expecting growth closer 1.5% to 2% for this year. Indeed, the Canadian economy contracted by 0.6% (annualized) in Q1/15, and with April's -0.1% M/M reading we're off to a rough start for Q2/15. Despite this we see the Canadian economy improving in the H2/15, as the US economy picks up and exports begin to improve on the weaker CAD dollar. On the following page we address the investment implications of lower commodity prices.

The Canadian Economy Contracted 0.1% M/M In April

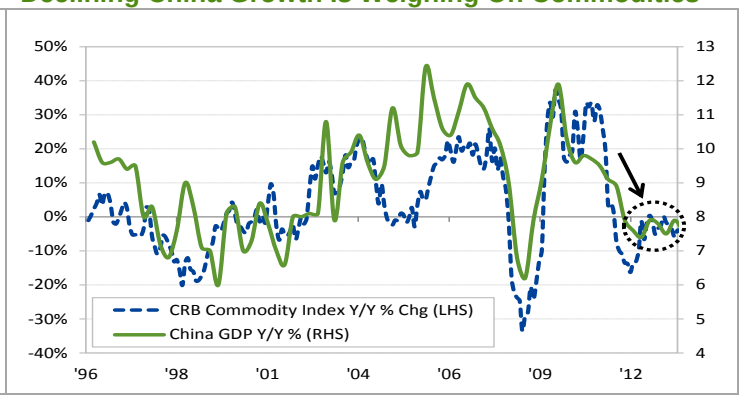


Source: Bloomberg, Raymond James Ltd.

The BRICs Continue To See Declining Growth



Declining China Growth Is Weighing On Commodities



Source: Bloomberg, Raymond James Ltd.

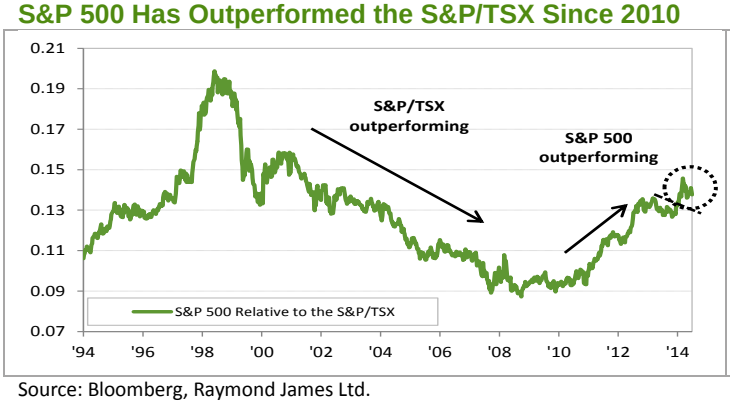
Investment Implications

In the 2000s when the commodity "supercycle" was in full gear, the S&P/TSX was the place to be. Even with the 2008/09 financial crisis the S&P/TSX posted an annualized price return (not including dividends) of 5.6%, significantly outperforming the S&P 500 which returned -1% annually. If you include the CAD dollar appreciation over this period the S&P 500 returned a negative 4% annually, resulting in annualized outperformance of 9.6% for Canadian equities. However, this period of sustained Canadian equity outperformance ended in this current decade with the S&P 500 posting an annualized 14.2% price return versus the S&P/TSX at 7%. This market dynamic change captures the end of the commodity "supercycle", in our opinion. We find that many Canadian investors continue to invest as if we're in the 2000s, holding significant exposure to resources. We believe investors should adjust their investment strategy to focus on investments which stand to benefit from this new market environment of lower commodity prices. These strategies include:

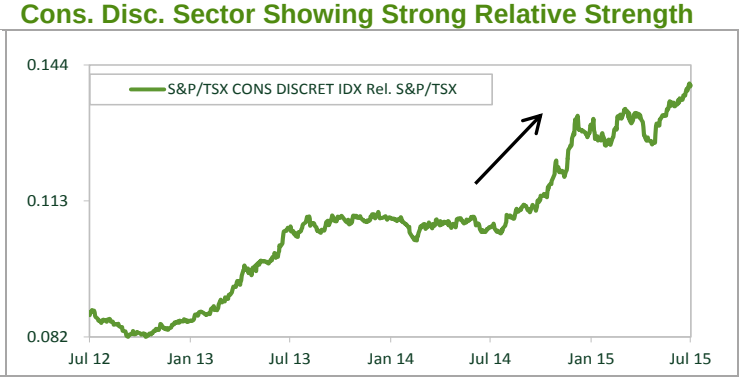
- **Underweight resources in portfolios, particularly materials stocks.** We have been cautious on the materials sector for some time given: 1) the weak outlook for commodities; 2) our expectation for continued US dollar strength; 3) a weak earnings outlook for the materials sector; and 4) poor relative strength for the sector.
- **Overweight the consumer discretionary and information technology sectors.** These sectors outperformed in H1/15, but we see further upside and outperformance from these sectors.
- **Overweight the US.** In recent years we have consistently preferred US to Canadian equities, in part due to our expectations for lower commodity prices. The S&P/TSX has a 21% larger weight in resource-based sectors, which is likely to drag on overall Canadian equity market performance. Additionally, we believe the US dollar will continue to appreciate versus the CAD, which would result in higher returns on US investments.
- **Go Global.** Finally, we recommend investors look increasingly outside of Canadian for their equity exposure. Despite the near-term headline risks with Greece, we remain bullish on European equities and would recommend investors establish/add positions on this pullback.

There will be a great time to aggressively buy resource stocks, as relative valuations compress due to their continued underperformance. However, we believe that is still some time away and for now recommend investors focus on other Canadian sectors and countries that stand to benefit from lower commodity prices.

S&P 500 Has Outperformed the S&P/TSX Since 2010



Cons. Disc. Sector Showing Strong Relative Strength



Source: Bloomberg, Raymond James Ltd.

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