Weekly Trends

PRIVATE CLIENT SOLUTIONS

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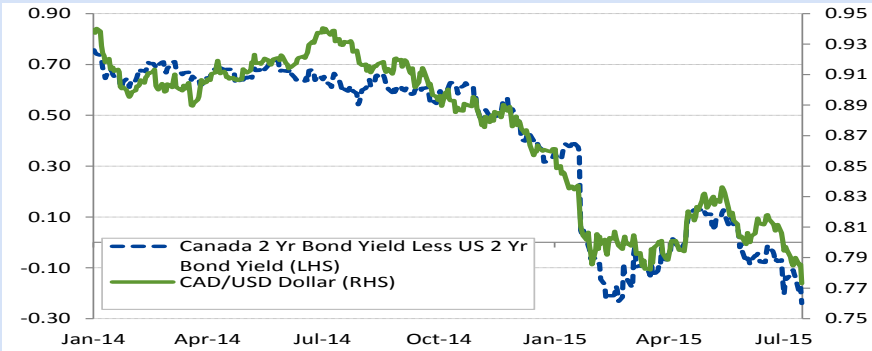
The BoC Cuts Rates…Again

- In last week's publication we highlighted the slowdown in the Canadian economy due in large part to the weakness in commodities. This very concern prompted the Bank of Canada (BoC) to lower the benchmark overnight rate again by 25 bps to 0.5%, following January's surprise interest rate cut.
- The steep decline in oil prices continues to weigh on our economy. Previously, the BoC believed that the impact of lower oil prces would be front-end loaded, with the economy bouncing back in Q2/15. As economic data for the second quarter continued to disappoint, it became clear that the economy was not recovering in line with their expectations, and that more was needed to be done to combat the impact of lower oil prices.
- The implications of the rate cut are: 1) the Canadian dollar declined by over a penny to $0.7744/USD ($1.2913/CAD) following the announcement. We believe that the BoC is targeting the Canadian dollar, attempting to drive it lower to help our exports sector. With our expectations for a widening divergence in monetary policies between Canada and the US, we believe the CAD will continue to decline; 2) Canadian benchmark bond yields declined in recent days, as the bond market began to price in the prospect of a rate cut. We believe the Canadian bond market will outperform the US bond market as the US Federal Reserve looks to hike rates later this year; 3) the housing market could get a boost from this rate cut, however the impact is likely to be muted as the Canadian banks did not follow through with a commensurate decline in prime lending rates; and 4) with the average Canadian consumer already maxed out with household debt to income at a record 166% we believe the appetite for further credit is limited.

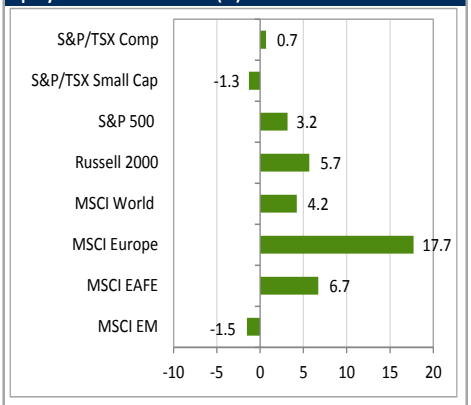
Chart of the Week

BoC Rate Cuts Are Bearish For CAD/USD



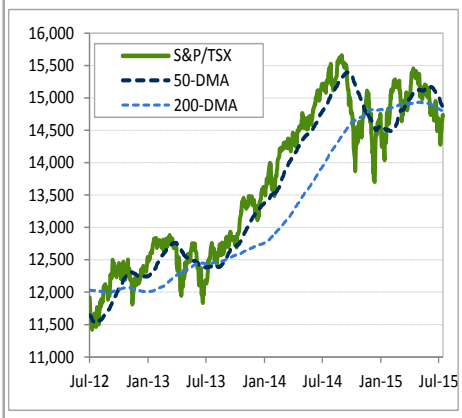
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	TSX Weight	Recommendation
Consumer Discretionary	6.8	Overweight
Consumer Staples	3.9	Market weight
Energy	19.6	Market weight
Financials	35.2	Market weight
Health Care	6.6	Market weight
Industrials	7.9	Overweight
Information Technology	2.6	Overweight
Materials	10.3	Underweight
Telecom	5.0	Market weight
Utilities	2.1	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,731.1	
50-DMA	14,864.4	Downtrend
200-DMA	14,804.1	Downtrend
RSI (14-day)	51.5	Neutral



Source: Bloomberg, Raymond James Ltd.

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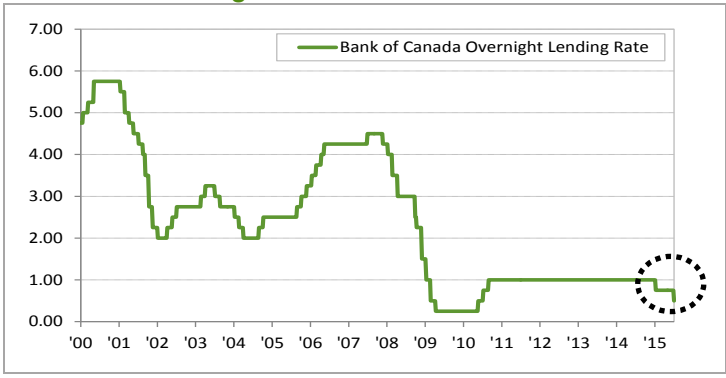
BoC Cuts Again

In last week's publication we highlighted the slowdown in the Canadian economy due in large part to the weakness in commodities. This very concern prompted the Bank of Canada (BoC) to lower the benchmark overnight rate again by 25 bps to 0.5%, following January's surprise interest rate cut. Along with the rate cut the BoC provided their updated outlook for the economy in their July Monetary Policy Report (MPR). In this week's note we summarize the highlights from the MPR and discuss the implications of the rate cut on the economy and markets.

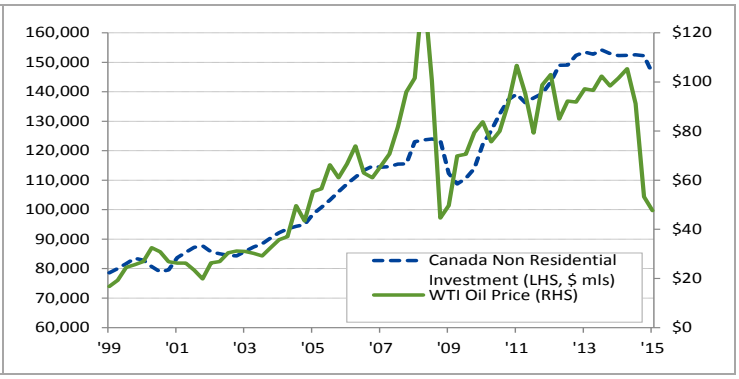
The steep decline in oil prices continues to weigh on our economy, which was likely the driving force behind the BoC's decision to cut rates. Previously, the BoC believed that the impact of lower oil prces would be front-end loaded, with the economy bouncing back in Q2/15. As economic data for the second quarter continued to disappoint, it became clear that the economy was not recovering in line with their expectations, and that more was needed to be done to combat the impact of lower oil prices. The BoC now sees the Canadian economy contracting by 0.5% annualized in Q2, resutling in two consecutive quarters of contraction. While BoC Governor Poloz was reluctant to use the word "recession", if Q2 growth is in fact negative, then that's exactly what we've got. With the BoC forecasting a weaker H1/15, they now see the economy growing at a tepid 1.1% in 2015, down considerably from their earlier forecast of 1.9%. The collapse in oil prices is also weighing on inflation in Canada, with headline CPI averaging just 1% this year. Given the combination of weaker economic growth, and low inflation readings, the BoC felt it was warranted to cut rates further, providing a much needed tonic for the economy.

Lower commodity prices impact our economy in a number of ways. First is the impact on business investment, as resource companies reduce capital spending. In the accompanying chart we illustrate this relationship between oil prices and Canadian non-residential investment. We note that business spending declined 16% in Q1/15, which we expect to remain under pressure until oil stabilizes. Second is the impact on corporate profits. The BoC noted in the MPR that corporate profits have declined by 15% since Q3/14. Third is job creation and income growth which has been negatively impacted, particularly out West, with the BoC noting that wages and salaries were down 3% in the resource sectors since Q3/14. Finally, exports also take a hit due to lower volumes and prices of commodities. Interestingly, even non-resource based exports have been impacted, which the BoC stated was "puzzling". Overall, the impact of lower commodity prices is having a more pronounced impact on our economy, which the BoC felt warranted further monetary stimulus.

BoC Cuts Overnight Rate To 0.50%



Canadian Investment Correlates With Oil Prices



Source: Bloomberg, Raymond James Ltd.

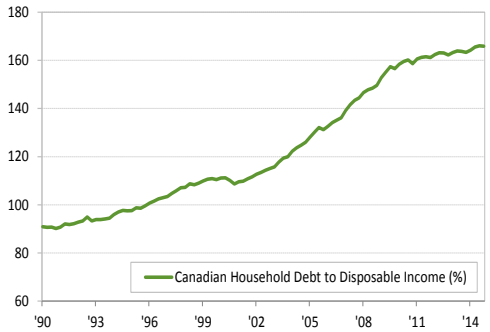
Market and Economic Implications

The implications of a rate cut are the following:

- **Canadian dollar.** The largest impact was felt on the Canadian dollar, which declined by over a penny to $0.7744/USD ($1.2913/CAD) following the announcement. We believe that the BoC is targeting the Canadian dollar, attempting to drive it lower to help our exports sector. Going forward we see the divergence in monetary policies between Canada and US largely driving CAD/USD. Below we illustrate this relationship, showing the strong correlation between the difference in Canada and US 2-year bond yields and CAD/USD. With our expectations for a widening divergence in policies between Canada and the US, we believe the CAD will continue to decline. This is an important factor in our recommendation to overweight US assets.
- **Bond market.** Canadian benchmark bond yields have declined in recent days, as the bond market began to price in the prospect of a rate cut. The Government of Canada 2 and 5 year bond yields are down 20 and 35 bps respectively since late June. We believe the Canadian bond market will outperform the US bond market as the US Federal Reserve looks to hike rates later this year, while we see the BoC on hold well into 2016. However, with our expectations for the US dollar to continue to gain versus the CAD, we still believe holding some US denominated bonds is prudent.
- **Canadian housing.** The housing market could get a boost from this rate cut, however the impact is likely to be muted as the Canadian banks did not follow through with a commensurate decline in prime lending rates. For example, TD Bank and Royal Bank dropped their prime rates (which some mortgages are priced off) by only 10 and 15 bps respectively, essentially allowing the banks to pocket the difference. Therefore, while the lower mortgage rates could provide a short-term boost, we don't expect it to have a material impact on the already overheated housing market.
- **Leveraged consumer.** Related to this is the fact, the average Canadian consumer is already maxed out with household debt to income at a record 166%. Given this we believe the appetite for further credit is limited.

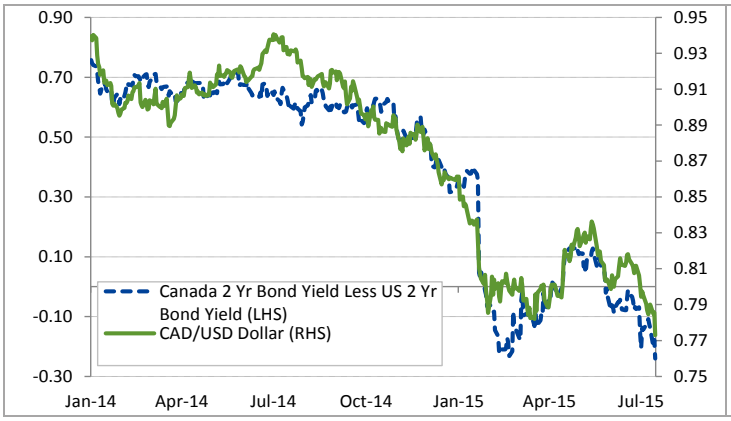
So there you have it. The Canadian dollar should continue to depreciate while Canadian bonds should do ok. We expect the impact to the economy however to be much more muted given the overleveraged Canadian consumer.

Impact To Economy Could Be Muted Given Overleveraged Consumer

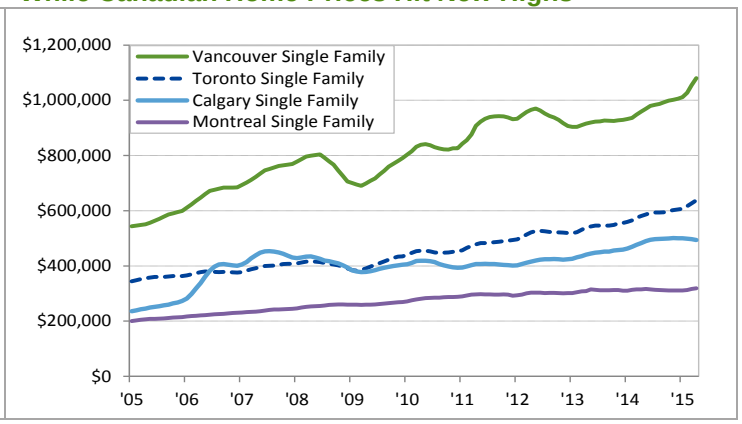


Source: Bloomberg, Raymond James Ltd.

CAD Dollar Hits New Lows



While Canadian Home Prices Hit New Highs



Source: Bloomberg, Raymond James Ltd., CREA

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