Weekly Trends

PRIVATE CLIENT SOLUTIONS

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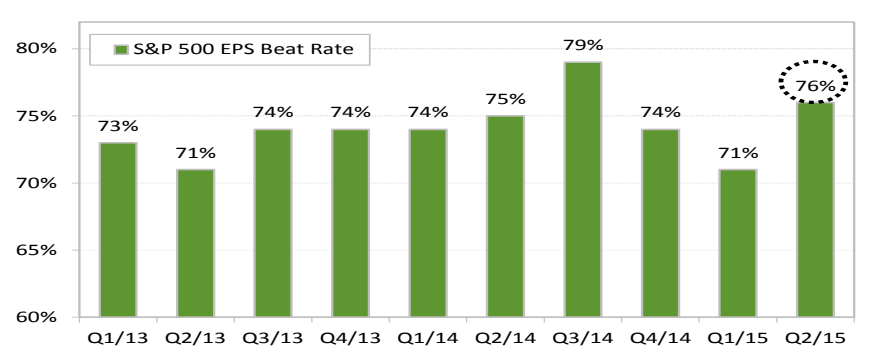
July 31, 2015

US Earnings Update

- Here we are just past the halfway mark for the year and the S&P 500 Index (S&P 500), for all the ups and downs, is basically flat. One key driver of the flat returns have been the disappointing corporate earnings results in recent quarters. Based on Bloomberg data, S&P 500 earnings growth averaged just 0.3% Y/Y in the last two quarters, as the strong US dollar, weak top-line sales and low energy prices weighed on results. The question, then, is whether corporate earnings have peaked in this current cycle or whether this is simply a pause within the context of a strong earnings upcycle.
- While only halfway through the US Q2 earnings season, results thus far have been ok and above analysts' expectations. Of the 262 companies within the S&P 500 to report so far, 199 or 76% have reported earnings above analysts' estimates. In aggregate, S&P 500 companies have reported a 5.5% earnings surprise, which is slightly above the historical quarterly average of 4%.
- Looking forward, analysts are forecasting S&P 500 earnings growth to improve slightly in Q3/15 to 1% Y/Y but then reaccelerate in Q4/15, with expectations currently for 10% Y/Y growth. Current consensus estimates align with our outlook as we believe the US economy is set to improve in the H2/15 which should support stronger earnings growth. We forecast S&P 500 earnings of roughly $120/share for 2015, slightly above current consensus estimates of US$118/share. If realized this would equate to earnings growth of 5% Y/Y. Our expectations for a mid-single digit increase in corporate earnings in 2015 drives our forecast of a mid-single digit return for the S&P 500 this year.

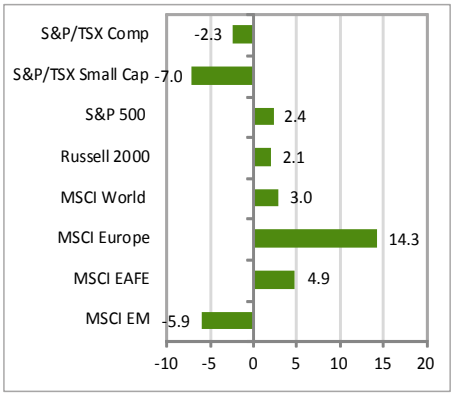
Chart of the Week

Q2/15 US Earnings Season Is Coming In Above Expectations



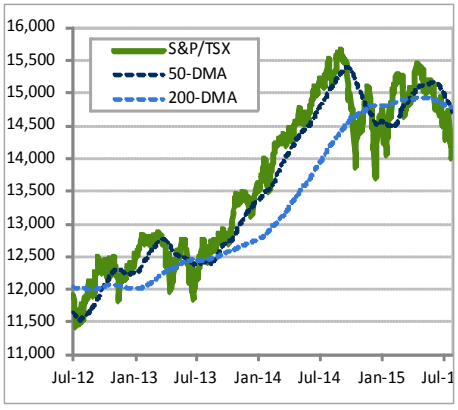
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	TSX Weight	Recommendation
Consumer Discretionary	7.1	Overweight
Consumer Staples	4.1	Market weight
Energy	19.2	Market weight
Financials	35.7	Market weight
Health Care	6.3	Market weight
Industrials	8.3	Overweight
Information Technology	2.7	Overweight
Materials	9.4	Underweight
Telecom	5.1	Market weight
Utilities	2.1	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,301.8	
50-DMA	14,721.7	Downtrend
200-DMA	14,787.1	Downtrend
RSI (14-day)	43.3	Neutral



Source: Bloomberg, Raymond James Ltd.

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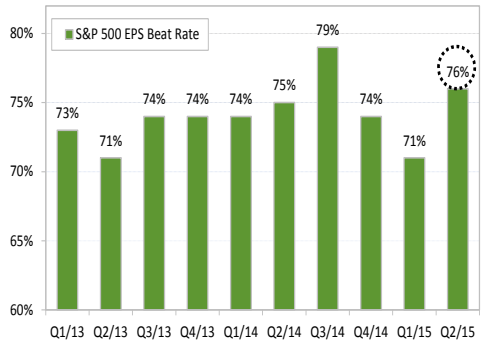
While only halfway through the US Q2 earnings season, results thus far have been ok and above analysts' expectations. Of the 262 companies within the S&P 500 to report so far, 199 or 76% have reported earnings above analysts' estimates. Admittedly, earnings estimates for Q2 were lowered over the quarter, with the S&P 500 Q2/15 estimate being revised from US$29.18/share on April 1 to $28.36/share on June 30. This lowered bar has made it easier for companies to beat estimates, a clear trend we've witnessed over the last few years. In aggregate, S&P 500 companies have reported a 5.5% earnings surprise, which is slightly above the historical quarterly average of 4%. The oil & gas and consumer staples sectors have reported the highest earnings surprises.

From a sector perspective, the health care, telecom, and financials sectors are expected to deliver the highest earnings growth in the quarter, up 10.6%, 8.4%, 8.1%, respectively. Conversely, the energy sector is expected to deliver the weakest earnings growth of -55% Y/Y.

Looking forward, analysts are forecasting S&P 500 earnings growth to improve slightly in Q3/15 to 1% Y/Y but then reaccelerate in Q4/15, with expectations currently for 10% Y/Y growth. Current consensus estimates align with our outlook as we believe the US economy is set to improve in the H2/15 which should support stronger earnings growth. We forecast S&P 500 earnings of roughly $120/share for 2015, slightly above current consensus estimates of US$118/share. If realized this would equate to 2015 earnings growth of 5% Y/Y.

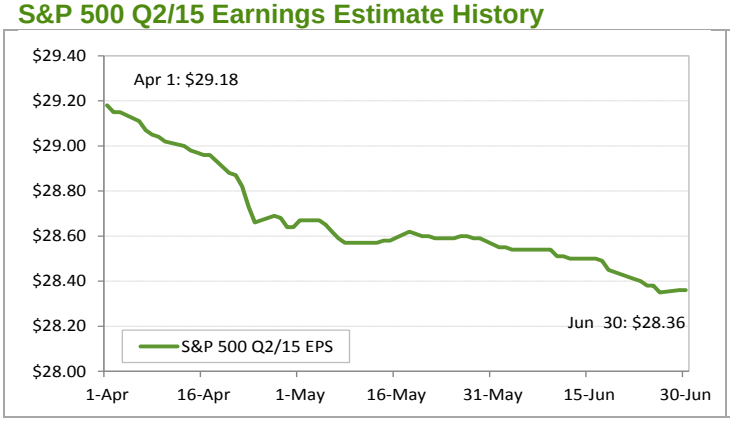
Overall, we expect earnings growth to trough soon and reaccelerate, thus turning from a headwind to a tailwind for stocks. Our expectation for a mid-single digit increase in corporate earnings in 2015 drives our forecast of a mid-single digit return for the S&P 500 this year.

Current S&P 500 EPS "Beat Rate" Is 76% For Q2/15

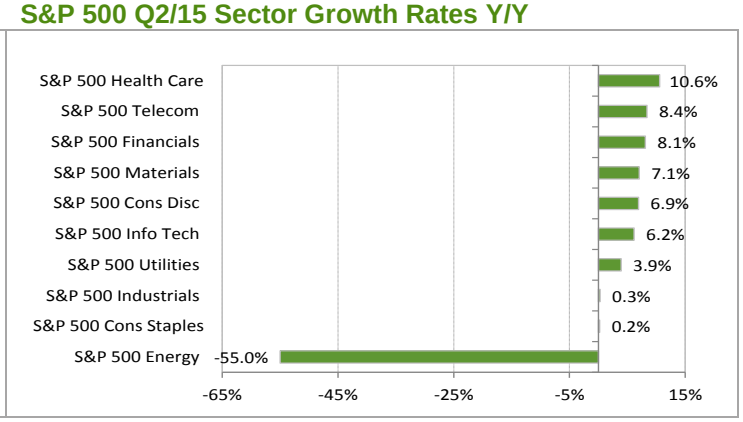


Source: Bloomberg, Raymond James Ltd.

S&P 500 Q2/15 Earnings Estimate History



S&P 500 Q2/15 Sector Growth Rates Y/Y



Source: Bloomberg, Raymond James Ltd., Factset

Other Headwinds

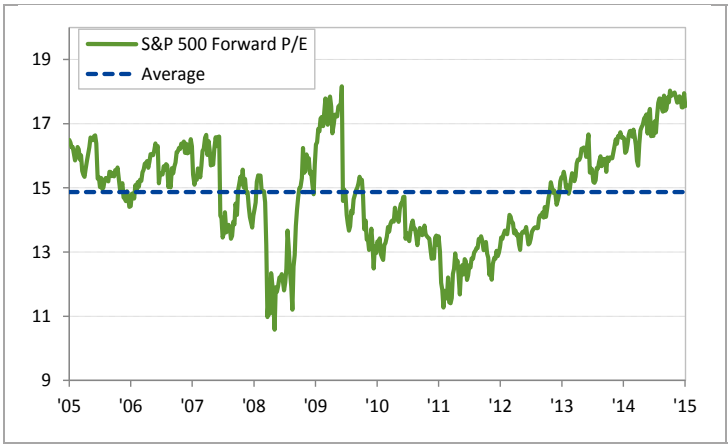
We believe it is paramount that earnings begin to reaccelerate in the coming quarters. If not, the equity markets could be vulnerable to a correction, which we have not experienced since October 2011. This view is predicated on three central factors:

- **Elevated valuations.** Slowing earnings in and of itself is not terribly concerning, however, slowing earnings at a time when equity valuations are elevated can be problematic. Currently, the S&P 500 is trading at 17.5x forward earnings, which is well above the 10-year average of 14.8x. We believe the current elevated valuations are warranted given the low level of inflation and interest rates, but they leave the equity markets susceptible to a pullback/correction if corporate earnings continue to disappoint.
- **Deteriorating technicals.** The technical profile of the US equity markets remains constructive with the S&P 500 trading above its 200-day moving average (MA) and the Nasdaq Index hitting new all-time highs. However, beneath the surface we are seeing some areas of concern, notably declining market breadth and a divergence between the Dow Jones Transports and Industrials. Overall, we maintain our bullish technical view for the US equity markets, but there some early warning signs that suggest a more vulnerable equity market.
- **Fed tightening.** Finally, we maintain our view that the US Federal Reserve (Fed) will hike rates later this year, which historically has resulted in equity weakness shortly following the first increase. Against a backdrop of poor corporate earnings, a Fed rate hike could leave the equity markets more vulnerable when the Fed does actually decide to hike rates.

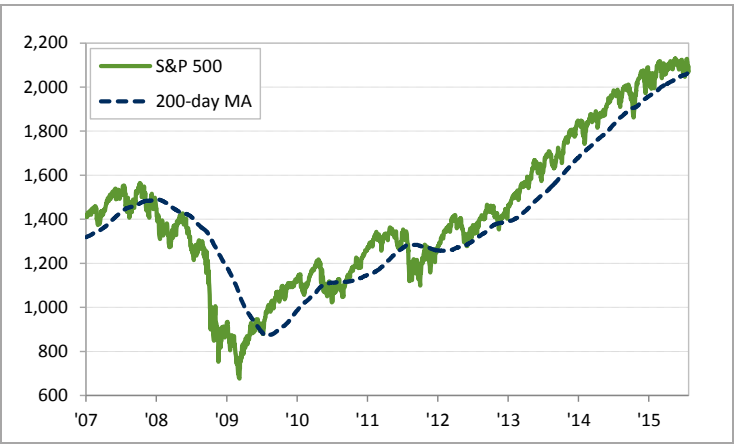
Conclusion

We continue to forecast equity gains this year, driven by an increase in corporate earnings. The H1/15 saw corporate earnings disappoint which in part explains the anemic returns to date. However, if we're correct on our call for the US economy to pick up in the H2/15, then we should see a contemporaneous uptick in earnings growth, offsetting the headwinds of elevated valuations, Fed tightening, and moderating technicals.

S&P 500 Forward P/E At An Elevated 17.5x



Technicals Are Bullish With S&P 500 Above Its 200 MA



Source: Bloomberg, Raymond James Ltd.

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