Insights & Strategies

PRIVATE CLIENT SOLUTIONS

September 6, 2013

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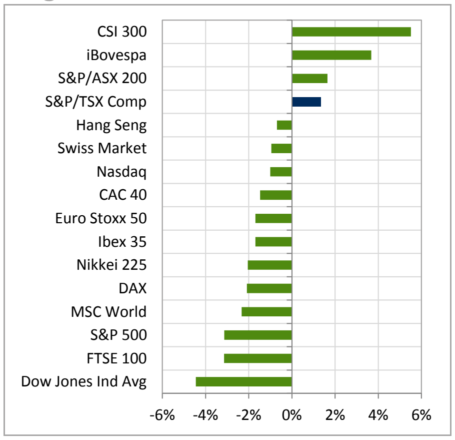
Look to China for Growth Catalysts

August 2013 Performance



Source: Bloomberg, Raymond James Ltd.

August marked something of a reversal for global equity markets. For the past several quarters, the developed markets have led equities higher, driven by a combination of declining macro risks and better than expected economic performance. At the same time, the emerging markets have been rocked by a combination of factors including spotty economic performance, currency pressure, and a poor environment for resource based equities. Through August, outperformance of the developed markets paused on the back of rising yields in the bond market, and a much needed consolidation to alleviate overbought conditions in the equity markets. In the emerging markets, a series of economic reports (especially from China) suggesting that economic growth was stabilizing helped drive commodity and equity prices higher.

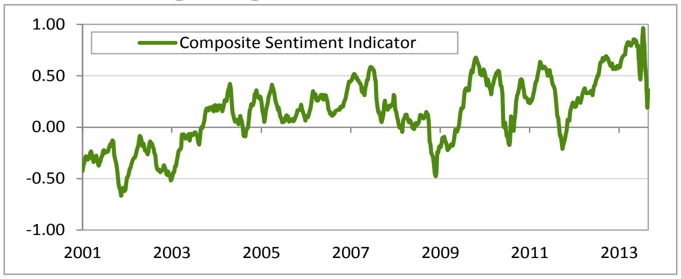
China was the standout performer on the month with a return of over 5.5%, closely followed by Brazil (another key emerging market) with a 3.7% gain. A combination of better than expected economic reports and deeply oversold equity market conditions led to the outperformance. Indications of an economic rebound in the emerging markets also took select developed markets along for the ride, especially those with a high degree of exposure to commodities. The Canadian market (with its 50% exposure to energy and materials) performed well, gaining almost 1.4% on the month while the Australian market rallied 1.6%.

The US market, in contrast, paused to digest recent gains and also to consider the impact of a potential 'tapering' of asset purchases. While the prospect of a less aggressive monetary stance by the Fed had an impact on the equity markets, the greater effect was felt in the bond market as yields continued to move higher. In a similar vein, the European markets also paused as the entire continent appeared to go on an extended vacation. In terms of sectors, performance was similar to the past several months, with cyclicals leading and interest sensitive defensives lagging. Utilities and Consumer Staples performed poorly in both Canada and the US on interest rate jitters, while Materials, Technology, and Energy continued to outperform from a relative perspective.

As we have for the better part of the past two years, we remain positive on the outlook for equities and are increasingly cautious on the outlook for bonds (especially government bonds). A combination of factors support our equity recommendation, including: accommodative global monetary policy, an improving global economy, reasonable valuations, and better than expected earnings. As for bonds, now that the Fed is willing to scale back its asset purchase program, yields (especially on US Treasury bonds) look set to move higher.

Going forward we note that two new themes for equities have recently begun to develop. The first is the US equity market is looking increasingly frothy after an extended rally, and the second is select emerging markets are indicating a much improved outlook.

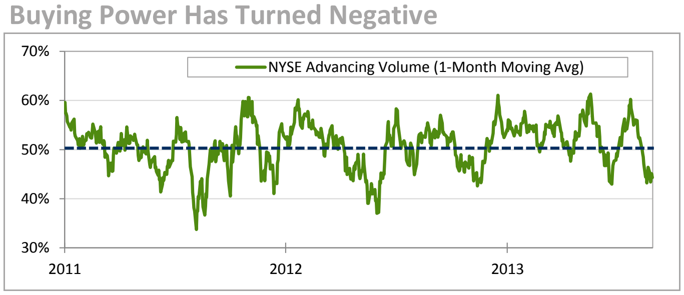
Sentiment Beginning to Rollover



Source: Bloomberg, Raymond James Ltd.

The composite sentiment measure for the US equity market has shown signs of deterioration over the past few weeks. While the measure is still in positive territory, it is pointing increasingly towards a decline in conviction towards equities. When combined with the reduction in buying power that has recently developed, the prospects for a continued rally look unlikely. As well, after the recent rally (since last November), much of the potential good news already appears to be priced into equities. Through the fall, the market will face a host of potential negatives including the prospect of reduced support from the Fed and the prospect of another budget / debt ceiling debate. This is not to say that we are expecting a material pullback in the US market but, given the deteriorating conditions, we feel that some degree of caution is warranted.

Buying Power Has Turned Negative



Source: Bloomberg, Raymond James Ltd.

In contrast, the outlook for select emerging markets seems to be improving. Evidence is increasing to support the view that the worst of the slowdown in China may be behind us as that economy is showing signs of turning around. Just recently the Purchasing Managers' Index, a measure of overall business activity, moved into expansion territory for the first time in several months. Importantly, the recovery is not only being driven by domestic demand (which should help the long term sustainability of the recovery), but is also getting a lift from the export sector which should lead to even higher levels of overall growth going forward. Possible upside to growth expectations could also come from a resurgence in housing together with an increase in local government investment activity. An improving Chinese economy, together with a steady recovery in Japan, should support a more broad-based rebound throughout Asia.

Chinese Growth Beginning to Return

Source: Bloomberg, Raymond James Ltd.

Recently, one major concern related to the emerging markets has been the extreme currency volatility in select emerging markets (especially India) and memories of the Asian crisis of 1997. We think that these concerns are overblown as the environment today is very different from 1997. These concerns tend to resurface (sending both equities and currencies lower) whenever the US begins to tighten monetary policy, which is now feared with increasing 'taper' talk. First of all, the extent to which we see a 'taper' will not constitute a tightening of policy, rather it will just become less accommodative. Secondly, net external debt in emerging markets is low and reserve positions are much higher than they were in 1998, providing a greater safety cushion.

Over the past several quarters, the performance of the emerging markets has lagged significantly as fears of a hard-landing scenario in China (and elsewhere) have dominated investors' concerns. This has not only negatively impacted the emerging markets but also the performance of the energy and materials sectors in more developed markets such as Canada. A sustained recovery in the emerging markets (especially in China) could also lead to a recovery in the commodity markets, as well as the materials and energy sectors. Considering the combination of low valuations and improving growth profile, we recommend that more risk tolerant investors increase exposure to the emerging markets, as well as the materials and energy sectors in Canada.

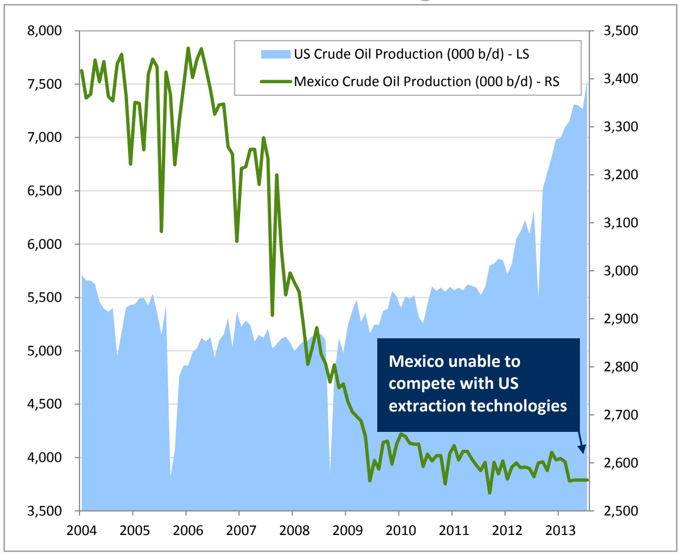
Andy MacLean, CFA
Private Client Strategist

Down Mexico Way

Our ETF and mutual fund analyst Jordan Benincasa recently highlighted the strengths of the Mexican economy (see *the Open* from May 7, 2013). Amongst the positives are favourable wage rates vs. China, better overall economic growth than many other emerging market countries, and reduced emigration. (Mexicans are now staying in Mexico.) A more recent development has been Mexican President Enrique Peña Nieto submitting a proposal to end Mexico's 75-year state oil monopoly. His proposal would allow foreign companies to more easily enter into joint ventures with Pemex, Mexico's state oil company, and give these companies more flexibility to refine and transport the oil. It would not, however, allow companies to own or outright operate the oil fields themselves. In other words, it was not the sweeping reform some analysts had been hoping for, but it was still a progressive start.

The impetus for the proposal was Mexico's declining long-term oil production, a result of inferior extraction and exploration expertise (as well as, to a certain extent, corruption). Nieto's strategy is to reverse this decline by introducing the know-how of foreign oil giants. While the country's production has been declining, its vast reserves are still stable. According to Pemex, Mexico's reserves stand at 13.87 billion barrels of crude-oil equivalent, consistent with last year's levels, and giving Mexico the third largest reserve base in Latin America. Further, the bulk of Mexico's production and reserves are unconventional—shale and off-shore deep waters—which explains the need for foreign skilled labour and more advanced technology.

Mexico's Oil Production Flat-Lining



Source: Bloomberg, Raymond James Ltd.

While there are literally dozens of companies both within and outside Mexico that could benefit from the reform, we focus on the major US players. Credit Suisse highlights the major

Potential Beneficiaries of Mexico Energy Reform

Company	Ticker	Mkt Cap (US$ blns)	Forward Cons P/CF	10-Yr Ann TR (%)	Approx. Mexico Rev (%)	Raymond James Rating	Credit Suisse Rating
South Texas (Eagle Ford Shale)							
EOG Resources Inc	EOG	42.8	5.8	23.0	N/A	outperform	neutral
ConocoPhillips	COP	81.1	5.2	16.2	N/A	underperform	neutral
Marathon Oil Corp	MRO	24.5	4.2	19.5	N/A	outperform	outperform
West Texas/New Mexico (Permian Basin)							
Pioneer Natural Resources	PXD	24.2	10.5	20.9	N/A	outperform	outperform
Devon Energy Corp	DVN	23.2	3.9	9.7	N/A	outperform	outperform
Concho Resources Inc	CXO	10.1	6.3	N/A	N/A	outperform	neutral
Apache Corp	APA	33.0	3.6	10.7	N/A	outperform	outperform
Chevron Corp	CVX	233.0	5.8	17.1	N/A	outperform	outperform
Occidental Petroleum Corp	OXY	71.1	5.6	20.8	N/A	outperform	outperform
ConocoPhillips	COP	81.1	5.2	16.2	N/A	underperform	neutral
Offshore							
Halliburton Co	HAL	44.0	8.1	16.5	4.0	market perform	outperform
Baker Hughes Inc	BHI	20.6	6.4	5.3	1.0	market perform	outperform
Schlumberger Ltd	SLB	107.2	10.2	15.1	5.0	outperform	neutral
Weatherford International	WFT	11.4	4.9	4.4	8.0	outperform	neutral
Noble Corp	NE	9.4	4.9	9.8	9.0	outperform	outperform
Ensco PLC	ESV	13.0	5.6	9.9	3.0	outperform	neutral
Average		**51.8**	**6.0**	**14.3**			

Source: Bloomberg, Raymond James Ltd. Priced: August 30, 2013 operators in the shale fields of Texas and New Mexico that may be eager to develop the nearby Mexican properties. The other major opportunity is for offshore oilfield services and drilling companies, particularly those that already have operations and revenue exposure to Mexico. A number of these companies may be interested in joint ventures with Pemex, according to Raymond James Financial. *Barron's* magazine also recently highlighted a number of equity ideas to gain exposure to Mexico's energy reform. We summarize all these key companies in the table on the previous page.

As of this writing, the negotiations between Nieto and the opposition parties continue. The proposal is by no means a slam dunk as it requires changes to the country's constitution and approval from both Nieto's Institutional Revolutionary Party and the conservative National Action Party. It would then have to be approved in 17 of the country's 32 state legislatures. The final details, of course, are also not known and, according to Raymond James Financial, "we like the idea, but the devil is in the details". While it is uncertain at this point if a meaningful compromise can be reached, it would open up substantial reserve markets for many international oil & gas companies.

Doug Rowat
VP, Research & Strategy

Whatever Floats Your Note

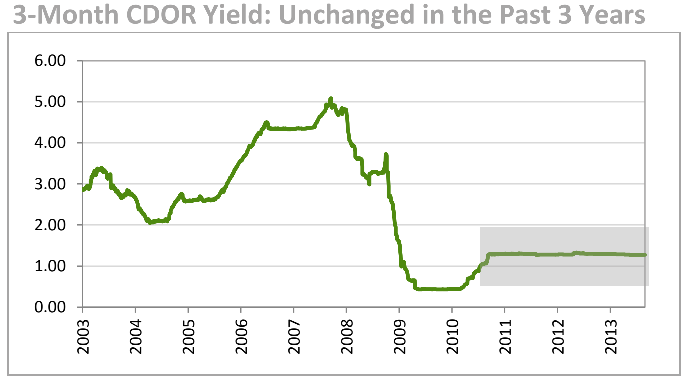
Rising bond yields have sent fixed income investors scrambling to find options to reduce interest rate risk in their portfolio. One option that has become very popular is a floating rate note (FRN) or "floater". An FRN is similar to a traditional fixed income instrument since it has a maturity date, but its variable cash flow distinguishes it from conventional bonds. The coupon of an FRN is based on a fixed spread above an interest rate benchmark such as the Canadian Dealer Offered Rate (CDOR) or London Interbank Offering Rate (LIBOR), and is adjusted quarterly in most cases. As rates increase, so will the coupon payment. This "floating" feature helps maintain the FRN's value when rates rise; whereas, conventional fixed rate bonds would decline in price. The Canadian and US markets offer a number of opportunities in the floating rate space but it is important to understand the differences between the two markets.

Canadian Floating Rate Market

The Canadian floating rate market is approximately C$82bln, with over 87% of the market comprised of government bonds and roughly 13% of investment grade corporate debt. Nine new deals came to market in August by eight different issuers for a total of almost C$5bln.

An FRN that we currently like is the three-year Bank of Nova Scotia note with a coupon that resets quarterly at CDOR + 50bps. Recent pricing of 3 month CDOR is at 1.22%. As such, the coupon is 1.72% (1.22% + 0.50%). If CDOR rose to 1.50%, by the next reset period, then the new coupon on the FRN would become 2.00%. This coupon reset feature effectively makes the duration of the security close to zero and reduces the interest rate sensitivity of any fixed income portfolio.

3-Month CDOR Yield: Unchanged in the Past 3 Years



Source: Bloomberg, Raymond James Ltd.

For diversified exposure to the Canadian floating rate market, consider **iShares DEX Floating Rate Note Index Fund (XFR-T)**, which seeks to provide income by replicating the performance of the DEX FRN Index net of fees. XFR is comprised of federal, provincial and high quality corporate floating rate debt, the majority of which are on a quarterly pay cycle (though the fund pays monthly). In order for an issue to be included in the Index, it must be priced in Canadian dollars with an outstanding face value of at least C$300m, a remaining term to maturity of at least three months, and be rated A or higher.

While interest rate risk is mitigated through FRNs, it's worth noting that they may underperform conventional bonds if short term rates are unchanged or decline. For instance, CDOR has barely budged since mid-September 2010, with rates fluctuating within a range of 1.27%-1.33% despite persistent chatter of rising rates. As a result, FRNs produced mediocre returns over this period while conventional bonds outperformed.

Not all floaters are the same. Most FRNs are issued with a coupon of CDOR plus a spread. However, the most recent federal issuance of Canada Housing Trust had the variable coupon at CDOR minus a spread of 5bps. In addition, there are differences in credit quality, particularly between FRNs issued in Canada and the US.

US Senior Bank Loans

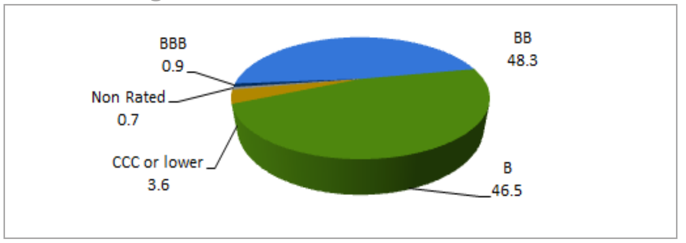
The US floating rate market is known as the senior bank loan market (also known as leveraged loan and senior secured). The market is approximately US$600 bln in size and is comprised of variable-rate loans issued by banks to non-investment grade companies such as donut chain Dunkin' Brands Inc. (DNKN-US) and casino operator MGM Resorts International (MGM-US). As the name implies, senior secured bank debt ranks senior to conventional high-yield bonds in the capital structure, and is secured by a company's assets (e.g. property, machinery, etc.). As such, these loans offer better recovery rates in the event of default. Creditors of bank loans typically recover 70% of the asset's value during bankruptcy or restructuring proceedings, which is roughly ten percentage points higher than recovery rates of conventional non-investment grade debt.

Men Who Stare At Notes

For US senior bank loan exposure, our top fund pick is **AGF Floating Rate Income**, subadvised by Boston-based Eaton Vance Management. The fund is managed by an experienced and cohesive investment team. Co-lead manager Scott Page has been analyzing senior bank loans since 1989 and running a floating rate fund since 2001. His partner Craig Russ has 16 years of investment experience specializing in this asset class. Page and Russ work with a team of nine credit analysts, three research assistants, a senior credit advisor, and a recovery consultant.

AGF Floating Rate Income's track record is fairly short as it was launched in May 2012. However, Eaton Vance Floating Rate Fund, a US-sold fund run by Page and Russ, has produced a five-year cumulative return of 29.6%, outperforming its category average by 179 basis points, and exhibiting slightly less volatility as measured by standard deviation. In other words, the fund stacks up very well on a risk-adjusted basis.

AGF Floating Rate Income: Credit Mix



Source: AGF Management. As at July 31, 2013

While US bank loans offer protection against rising rates and above-average yields, these securities exhibit higher credit risk than government bonds and investment grade debt. In addition, liquidity events can also create unexpected volatility and price declines. Such was the case during the financial crisis when the bank loan market dried up, perpetuated by hedge funds forced to sell positions in order to facilitate net redemptions and meet margin requirements. The average bank loan fund dropped 24.0% in Q4 2008. While the market promptly recouped all of its losses 11 months later, the financial crisis highlights the impact of illiquidity.

The recent rise of unfavourable deal terms is another risk related to the US bank loan market. In particular, a number of 'covenant-lite' deals have come to market with lenient restrictions on the amount of debt a company can borrow before covenants are breached. In addition, companies have been able to issue bank loans with no LIBOR floors, which are intended to protect against falling rates.

	Canadian FRN Market	US Senior Bank Loan Market
Interest Rate Risk	None to Low	None to Low
Yield	Low	Above-average
Credit Quality	High	Low
Correlation to Fixed Income	Medium	Negative to Low
Liquidity	High	Low to Medium

Source: Raymond James Ltd.

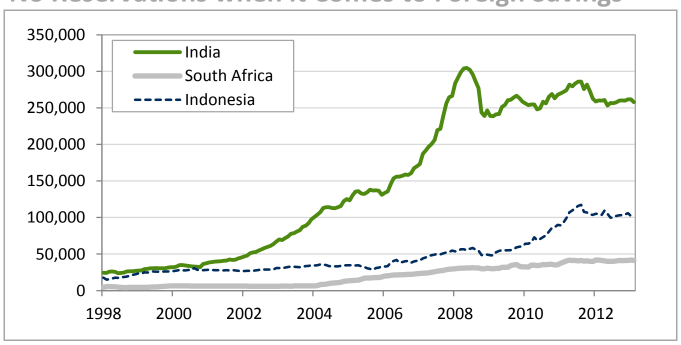
Anderson Lam,
Fixed Income

Jordan Benincasa, LL.B, MBA
Mutual Fund & ETF Research

Emerging Market Effects

Casual investors rarely look at price levels in the emerging market FX space, although it has been hard to ignore the developments taking place in exotic currencies over the last few weeks, as the news has had implications outside the confines of domestic markets. Currencies such as the Indian rupee (INR), South African rand (ZAR) and Indonesian rupiah (IDR) have all been under extreme selling pressure since May, as a slew of issues have come to the helm. Alongside a sharp rise in US yields, major emerging market pairs have shed up to 20% of their value over the last few months as balance of payment issues have been met with capital flight problems. With the beginning of the end for the US bond buying program now in sight, as well as a sharp rally in commodity prices coming to the helm, emerging market currencies remain under pressure, but are far from a currency crisis situation as seen in the '90s.

No Reservations when it Comes to Foreign Savings

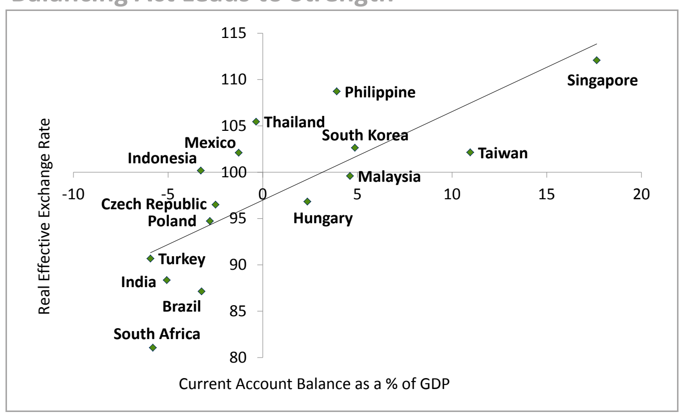


Source: Bloomberg, Raymond James Ltd.

While there are many external factors at play, the root of the issues in the emerging market FX space lies at home. Those countries hardest hit by a currency sell-off this year are all privy to a macroeconomic issue known as a current account deficit. Much like a corporation would, countries keep track of their finances with a balance sheet approach, managing revenues and expenditures. In the global marketplace, a country's revenue and expenditures can be equated to the amount of goods they are buying and selling, or their exports and imports. If a country is buying (importing) more than they are selling (exporting), they find themselves in a current account deficit. This type of situation is typical in emerging markets, as a balance of payments discrepancy can help spur economic growth. While this approach is practical in the short run, it often comes at the expense of currency risk and capital flight longer term which is now taking place.

In very basic economic mechanics, current account deficits put downward pressure on currencies. The process goes that as a nation buys more goods than it sells (the very definition of the misbalance), it has a higher demand for foreign coinage to meet the payments, resulting in a depreciation of the local currency. This downturn can be partially offset through capital inflows, as foreign investments help offset the downward pressure from excess supply of the domestic currency. Price action in emerging markets since the month of May has illustrated what happens when the supply of foreign investments dries up and even worse, starts to outflow. The hunt for yield by many investors throughout the latter years of the credit crisis led to investors parking a substantial amount of funds in emerging market products. As yields have risen in the US alongside expectations for a tapering of the QE program, the flow of funds has reversed out of EM markets, causing a sharp sell-off in their currencies.

Balancing Act Leads to Strength



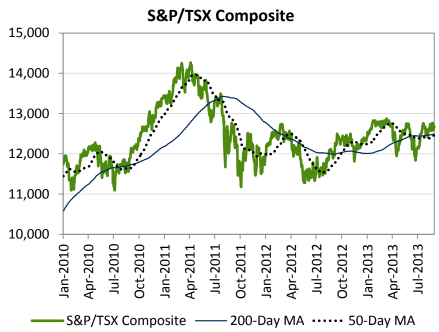
Source: Bloomberg, Raymond James Ltd.

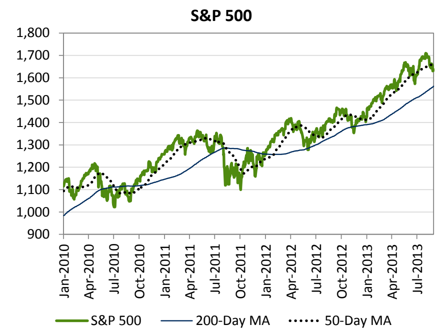
Emerging market currencies have been exposed to these types of price patterns before, most notably during the Asian Financial Crisis of 1997. While the depreciation in the currencies may be familiar, the fundamental backdrop of the countries involved is much sounder, leaving much less cause for concern. For the top three hardest hit currencies year to date (INR, ZAR, IDR), foreign debt-to-GDP ratios are down, foreign exchange reserves are higher, and national savings levels as a percent of GDP are mostly up (slightly lower for Turkey). Furthermore, many financial regulation safeguards that were put in place in the aftermath of the Asian Crisis have helped protect from any further fallout. Central bankers in the worst hit countries (India, Indonesia and Turkey) have a fair amount of work ahead of them to ensure their currencies and financial markets stabilize, but a much better fundamental footing will ensure emerging markets do not find themselves in another crisis type situation.

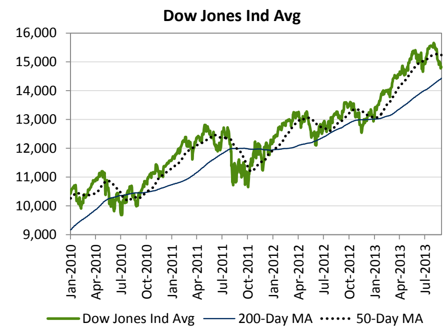
Matt Stastny
Foreign Exchange

Charts of Interest

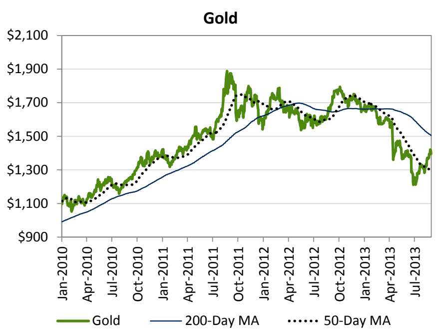
Markets

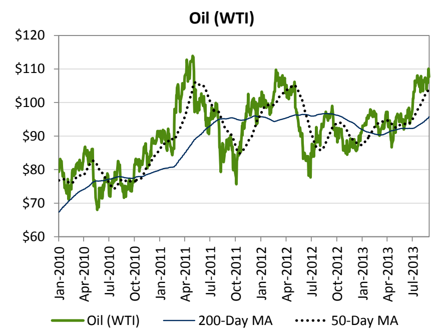


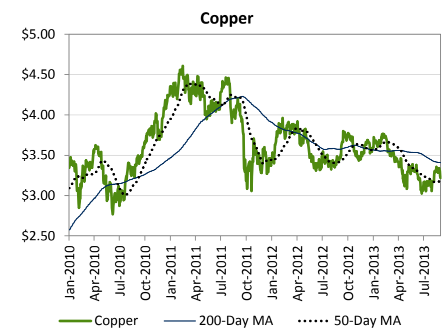




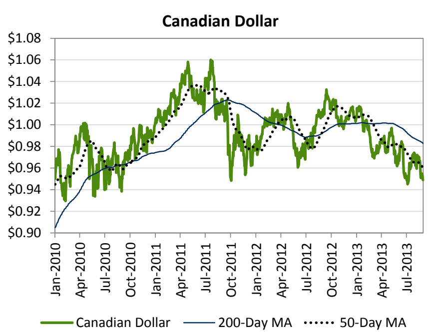
Commodities

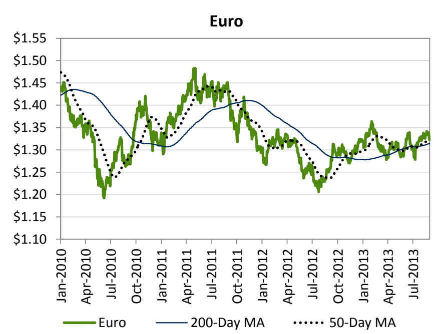


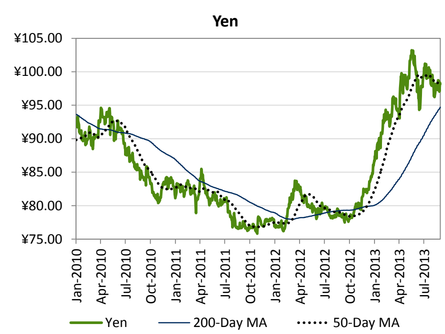




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at August 31, 2013.

Asset Class Weightings

Profile	Cash	Bond	Can. Equity	Intl. Equity	US Equity	Alternative
Income & Capital Preservation	40%	40%	20%	0%	0%	0%
Conservative	15%	65%	20%	0%	0%	0%
Moderate	5%	47%	15%	15%	15%	3%
Growth	0%	20%	20%	10%	40%	10%
Global Equity	0%	0%	20%	20%	45%	15%

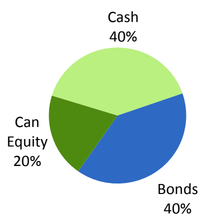
General Asset Class Ranges

	Cash	Bonds	Equities	Alternative
Income & Capital Preservation	40 – 75	15 – 40	0 – 20	0
Conservative	15 – 30	60 – 65	10 – 20	0
Moderate	5 – 10	45 – 65	25 – 45	0 – 5
Growth	0 – 5	15 – 40	50 – 70	10 – 15
Global Equity	0	0	80 – 85	15 – 20

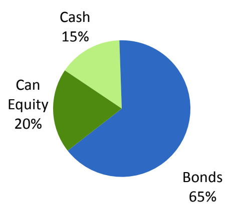
Profile Descriptions

	Description
Income & Capital Preservation	Virtually any loss is unacceptable. Investors' primary objective is to achieve a return that keeps pace with inflation. Fixed income and cash make up the largest portion of holdings.
Conservative	Losses can be tolerated, but erosion of regular income payments cannot. Stability of coupon or dividend is the primary concern as many investors will employ this income for cost-of-living expenses. Bonds tend to make up the largest proportion of holdings.
Moderate	Some higher risk positions tolerated but these are typically offset with blue-chip dividend paying equities or low-risk bonds.
Growth	Willingness to take speculative bond and equity positions though growth portfolios are typically biased towards equities. Strong earnings growth or high yields usually take preference over valuations. Some defensive constraints may be employed, but even these may be removed for highly risk-tolerant investors.
Global Equity	A willingness to ignore 'home-country bias' and allocate holdings internationally. International equities typically receive weightings equivalent to or greater than domestic securities. These investors recognize that Canada represents only ~3% of global equity markets and are willing to source investment opportunities outside our borders.

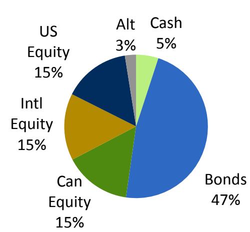
Income & Capital Preservation



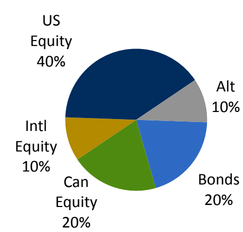
Conservative



Moderate



Growth



Global Equity