Weekly Trends

PRIVATE CLIENT SOLUTIONS

Ryan Lewenza, CFA, CMT, Private Client Strategist

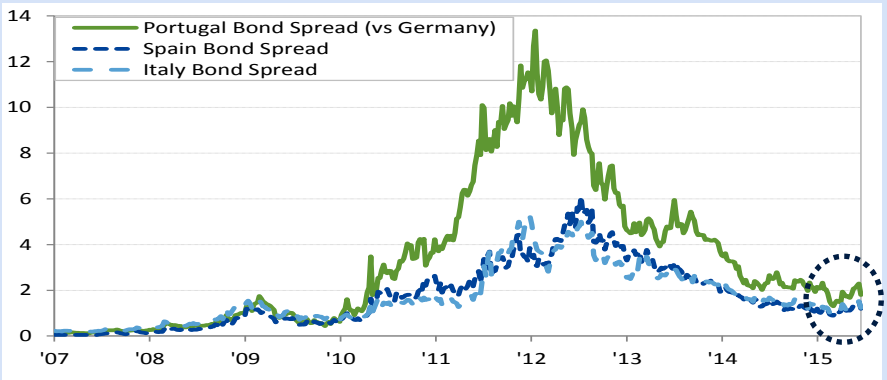
July 2, 2015

Greece – Noise Or The Canary In The Coal Mine?

- The Greek debt crisis is quickly coming to a head as Greece's citizens vote on a referendum over whether the country will stay in the Eurozone. More accurately, the Greeks will vote on Sunday July 5th on whether to approve the current proposal outlined by creditors (IMF, ECB, etc.). A "yes" vote is an acceptance of the proposal, and more broadly, is a vote for staying in the Eurozone. A "no" vote is a rejection to the proposal, which would in turn likely hasten the exit of Greece from the Eurozone, otherwise known as "Grexit".
- Our core belief is that a deal can still be struck following the referendum. We note that polls indicate a 70% Greek approval rating of staying in the Euro, and a 57% approval of staying in the Euro at the expense of further austerity.
- If however Greece votes "no", thus precipitating a potential exit, we would expect volatility to pick up and likely see equity market declines. But we believe the fallout will be contained and we do not envision financial contagion stemming from a "Grexit". This view is predicated on: 1) Greece represents just 0.3% of global GDP and 1.3% of European Union GDP; 2) European banks have limited exposure to Greek bonds; and 3) the ECB can and likely will provide liquidity to the capital markets in the event of a Greek exit.
- Subsequent to completing this report, news broke that Prime Minister Tsipras is again open to negotiating with creditors. We still see the referendum outcome determining the next steps in this Greek quagmire.

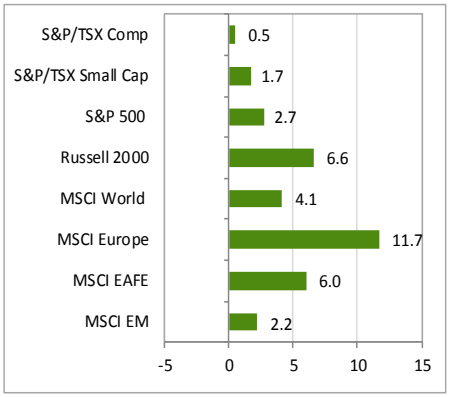
Chart of the Week

European Bond Spreads Remain Tight Despite The Potential Of A "Grexit"



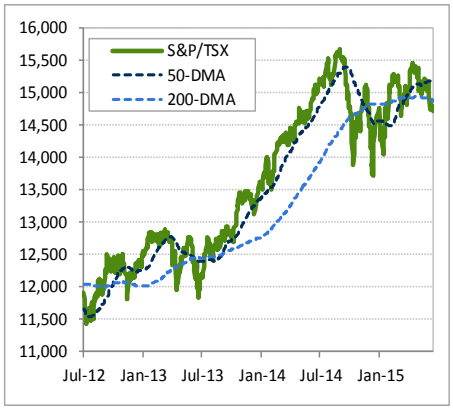
Source: Bloomberg, Raymond James Ltd.

Equity Market YTD Returns (%)



Canadian Sector	TSX Weight	Recommendation
Consumer Discretionary	6.8	Overweight
Consumer Staples	3.8	Market weight
Energy	20.2	Market weight
Financials	35.1	Market weight
Health Care	6.0	Market weight
Industrials	8.0	Overweight
Information Technology	2.4	Overweight
Materials	10.9	Underweight
Telecom	4.7	Market weight
Utilities	2.1	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,707.1	
50-DMA	15,134.0	Downtrend
200-DMA	14,872.3	Downtrend
RSI (14-day)	38.6	Neutral



Source: Bloomberg, Raymond James Ltd.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

RAYMOND JAMES

Greece On The Edge

The Greek debt crisis is quickly coming to a head as Greece's citizens vote on a referendum over whether the country will stay in the Eurozone. More accurately, the Greeks will vote on Sunday July 5th on whether to approve the current proposal outlined by creditors (IMF, ECB, etc.). A "yes" vote is an acceptance of the proposal, and more broadly, is a vote for staying in the Eurozone. A "no" vote is a rejection to the proposal, which would in turn likely hasten the exit of Greece from the Eurozone, otherwise known as "Grexit". Our core belief is that a deal can still be struck following the referendum. We note that current polls indicate a 70% Greek approval rating of staying in the Euro, and a 57% approval of staying in the Euro at the expense of further austerity. However, with the Greek Prime Minster Tsipras and Syriza party having walked away from negotiations, and Tsipras advising its citizens to vote "no" on the referendum, the odds of an exit have increased significantly over the weekend. The closure of Greek banks and implementation of capital controls could add to the possibility of a "Grexit", especially if the ECB stops providing capital to Greek banks, as is currently the case. So, the key questions are "will the Greeks agree to the conditions and stay in the Euro" and if not, "what are the broader implications to the economy and capital markets".

First, we still believe there is the potential for a last minute deal. Currently, Credit Suisse puts the odds of a "Grexit" at one and three. If however Greece votes "no", thus precipitating a potential exit, we would expect volatility to pick up and likely see equity market declines. But we believe the fallout will be contained and we do not envision financial contagion stemming from a "Grexit". This view is predicated on the following factors:

- Greece represents just 0.3% of global GDP and 1.3% of European Union GDP (sidebar). For perspective, in US dollar terms the Greek economy is approximately the size of the State of Alabama at roughly US$200 bln. Given its small size we do not foresee a significant contraction in Greece's economy – as will surely happen in a debt default and exit scenario – having a major impact on the global economy. The bigger question is whether Greece's exit results in financial contagion similar to the Lehman Brothers bankruptcy on the global financial markets in 2008.
- There are two key factors why we believe the impact to the financial markets will be muted. First, European banks have limited exposure to Greek bonds. As of December, European banks held roughly €27 billion, or 10% of total Greek debt, which is down 80% from its peak according to the Bank for International Settlements (BIS). The majority of debt is held by European governments and institutions, which will surely lose on a Greek default, but this is unlikely to filter directly into the financial markets.
- Second, the ECB can and likely will provide liquidity to the capital markets in the event of a Greek exit by either speeding up its current asset purchase programs, or by implementing Outright Monetary Transactions (OMT) whereby the ECB buys sovereign bonds in the secondary market. Based on our estimates, the ECB has another €900 bln left on its current asset purchase program which can be used if the Greek situation spills into the other sovereign bond markets.

While the risks of a "Grexit" have increased, resulting in short-term stress on the equity markets, we believe the long term impact will be modest given these factors.

Greece Represents 1.3% Of European Union GDP

Member State	% GDP of EU
Germany	21.0%
United Kingdom	16.0%
France	15.5%
Italy	11.7%
Spain	7.6%
Netherlands	4.7%
Sweden	3.1%
Poland	3.0%
Belgium	2.9%
Austria	2.4%
Denmark	1.9%
Finland	1.5%
Ireland	1.3%
Greece	**1.3%**
Portugal	1.3%
Czech Republic	1.1%
Romania	1.1%
Rest	3.2%

Source: IMF, Raymond James Ltd.

Indicators Suggest Greece Issues Are Isolated

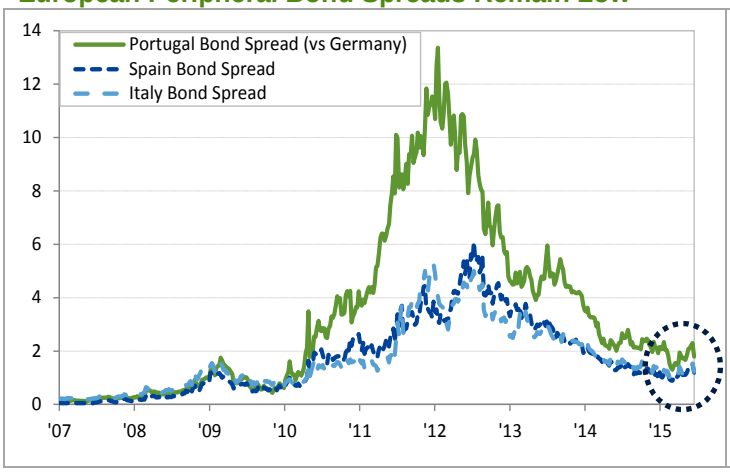
Following the news over the weekend that Greek leaders would put the current creditor proposal to a referendum for the Greek people to vote on, Greece 10-year bond yields spiked by over 400 bps to 15.5%. Clearly bond holders are pricing in a higher probability of a Greek default. Crucially, this has not lead to a significant decline in other peripheral European sovereign bonds, as seen during the 2011 European debt crisis. During that period sovereign bond spreads (over German bond yields) for peripheral nations like Spain, Portugal and Italy widened significantly as concerns over Greece spread to other countries. As illustrated in the accompanying chart, sovereign bond spreads have risen slightly but they remain well below the 2011 and 2012 levels. For example, Spain and Italy sovereign spreads (over Germany) rose 25 bps to 145 following the Greek news, but they remain well below the 300 to 600 bps seen in 2011 and 2012. If fears of a financial contagion over Greece were present, we would see it in the bond markets, which currently is not the case. This requires close monitoring, but for now, the bond markets are suggesting that Greece's problems are not a "canary in the coal mine" for other European nations.

Finally, we believe things are getting better not worse in Europe as key economic indicators are pointing to a firming economy. Recent manufacturing, GDP, industrial production and inflation readings are suggesting an improvement in the region. In particular, we highlight the rapid increase in European money supply (currently at 11.2% Y/Y) which historically has been consistent with GDP growth of 2%. While we could see a softening in economic data in the near-term as the uncertainty over Greece weighs on sentiment, we believe the economic trend in Europe remains positive.

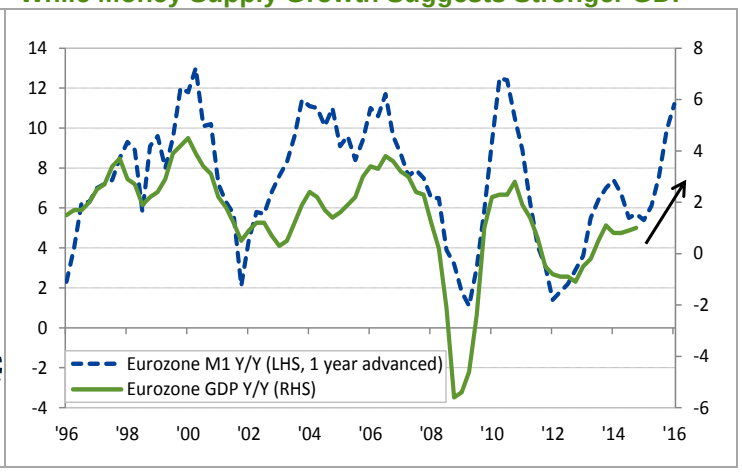
Conclusion

Over the next few days and weeks we will find out if our call for an 11th hour deal between Greece and its creditors will be realized. Central to this view is that we believe it is in both parties' best interest for Greece to remain in the Euro. However, if we are wrong and Greece experiences a default and exit from the Euro, we believe the negative knock-on effects will be short-lived as the European economy continues to strengthen, while having the ECB standing ready to inject liqudity should things deteriorate.

European Peripheral Bond Spreads Remain Low



While Money Supply Growth Suggests Stronger GDP



Source: Bloomberg, Raymond James Ltd.

Important Investor Disclosures

Complete disclosures for companies covered by Raymond James can be viewed at: www.raymondjames.ca/researchdisclosures.

This newsletter is prepared by the Private Client Services team (PCS) of Raymond James Ltd. (RJL) for distribution to RJL's retail clients. It is not a product of the Research Department of RJL.

All opinions and recommendations reflect the judgement of the author at this date and are subject to change. The author's recommendations may be based on technical analysis and may or may not take into account information contained in fundamental research reports published by RJL or its affiliates. Information is from sources believed to be reliable but accuracy cannot be guaranteed. It is for informational purposes only. It is not meant to provide legal or tax advice; as each situation is different, individuals should seek advice based on their circumstances. Nor is it an offer to sell or the solicitation of an offer to buy any securities. It is intended for distribution only in those jurisdictions where RJL is registered. RJL, its officers, directors, agents, employees and families may from time to time hold long or short positions in the securities mentioned herein and may engage in transactions contrary to the conclusions in this newsletter. RJL may perform investment banking or other services for, or solicit investment banking business from, any company mentioned in this newsletter. Securities offered through Raymond James Ltd., Member-Canadian Investor Protection Fund. Financial planning and insurance offered through Raymond James Financial Planning Ltd., not a Member-Canadian Investor Protection Fund.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual funds. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The results presented should not and cannot be viewed as an indicator of future performance. Individual results will vary and transaction costs relating to investing in these stocks will affect overall performance.

Information regarding High, Medium, and Low risk securities is available from your Financial Advisor.