

May 1, 2012

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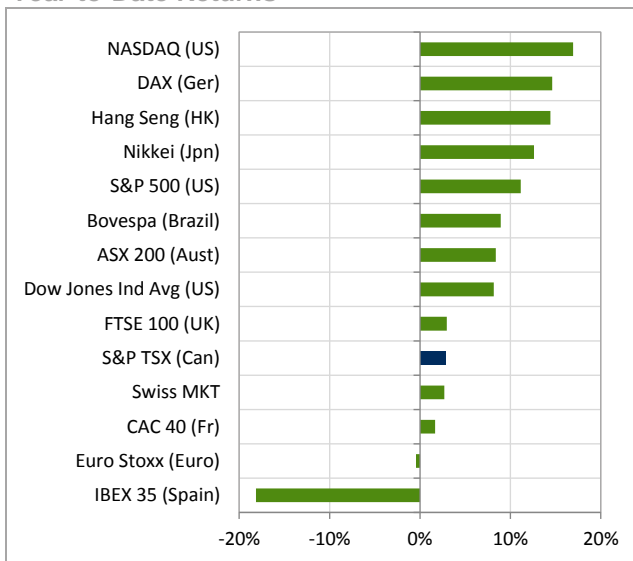
A Balancing Act

Global equity markets have been taking their cue from European bond markets for the better part of the past two months. Fears that sluggish economic growth in the region will only compound the debt problems has resulted in government bond yields in both Spain and Italy moving higher. On top of this, politics in the region are providing another source of concern, not only because of the surge that populist parties are seeing in the polls but also because many of these parties are questioning the efficacy of austerity and the undue (from their perspective) focus on debt. The initial round of the French presidential election, where the socialist challenger Hollande beat Sarkozy, seems to confirm this trend. The French results (especially voting amongst the young) resulted in Marine Le Pen’s far-right National Front party capturing 20% of the vote. Both Hollande and Le Pen are hostile to austerity programs and the impact they are having on growth. In the Netherlands the far-right Freedom Party (a coalition member of the centre-right minority government) refused to back deep budget cuts to meet EU deficit-cutting targets. If these recent political trends continue with European countries backing away from the need for austerity we should expect volatility in the Euro bond markets to persist with corresponding negative consequences for equities – especially European equities.

Also contributing to equity market weakness over the past several weeks has been softer-than-expected manufacturing data. In Europe, the data from Markit Economics showed business activity fell quicker than expected during April and to a five month low. In China, PMI data from HSBC indicated that production will contract for a sixth straight month, adding to the pressure on officials to continue stimulus programs. Adding fuel to the European fire, the U.K. confirmed that it along with the rest of Europe is now in recession –

its first double dip recession since the early 1970s. And in the US an ugly durable goods report together with downward February revisions signaled only an anemic recovery from January. While overall shipments and inventory data partially offset the decline, investors are becoming concerned about the growth trajectory of the US economy.

Year-to-Date Returns



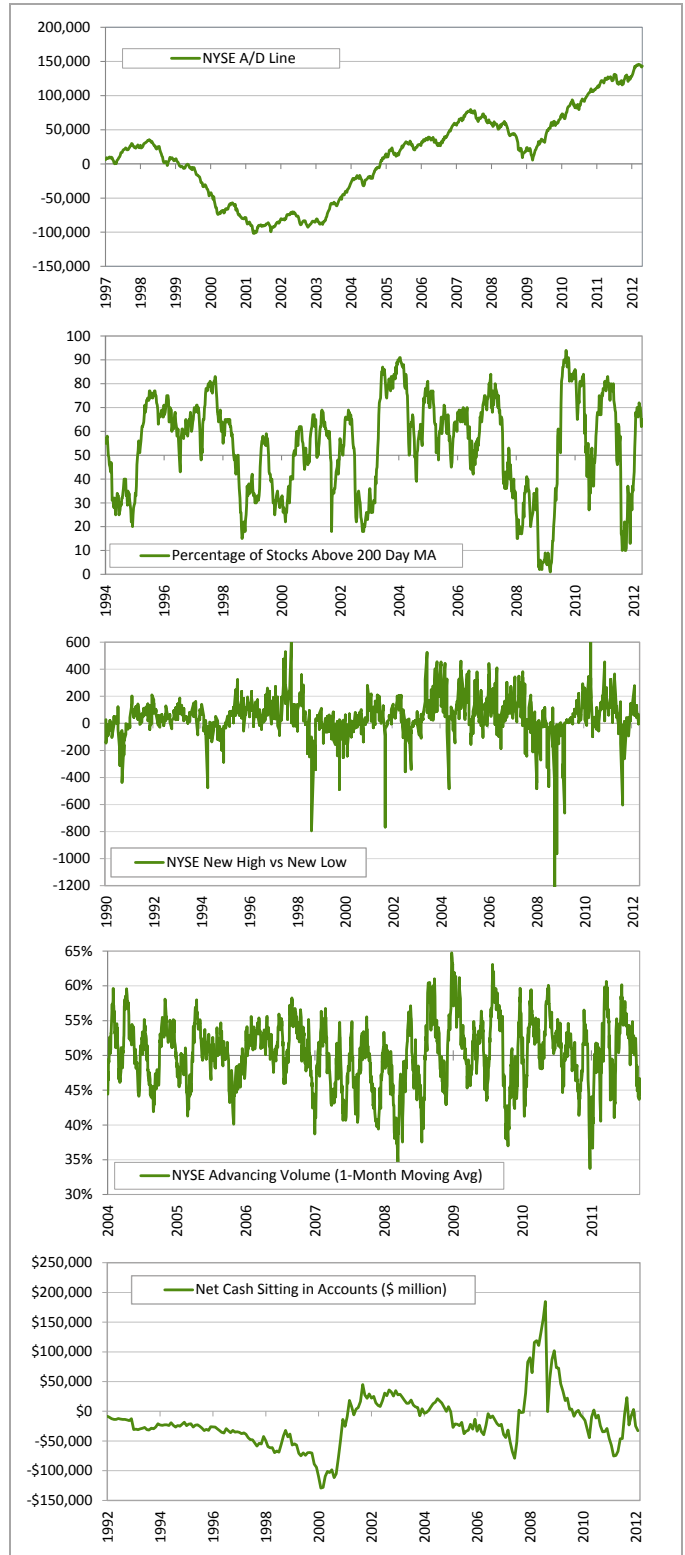
Source: Bloomberg, Raymond James Ltd. As at April 30, 2012

The combination of continuing European debt issues together with economic sluggishness has led to a broadening out of the recent pullback beyond European credits and stocks (especially financials) and the metals / miners (Canadian included) to include energy, telecom, and higher beta industrials. The pullback in these sectors is likely to have further legs (over the short-term) as liquidity dries up into summer, Europe's woes continue, global economic data remains spotty, and fears of a significant slowdown in China remain. But sentiment, we feel, is becoming a little too negative. Investors seem to be discounting a repeat of last year's correction where stocks pulled back over 20%. We don't think a repeat performance is likely as the US recovery appears to be on a firmer footing, the European banking system has been recapitalized, commodity prices have corrected resulting in lower inflationary pressures, and emerging market economies are loosening monetary policy rather than tightening. At most we see the possibility for a mild correction based on our technical indicators, relatively strong earnings, the fact that Europe's problems don't seem to be impacting the global financial system, and the overall trend in economic data (despite the recent soft patch).

Technical Indicators

Our technical indicators point to, at most, a correction of the rally that's been in place since early October 2011. To assess the technical picture we consider five indicators including the NYSE Advance Decline Line (A/D Line), Percentage of Stocks Above 200 Day MA (moving average), NYSE New High vs New Lows, NYSE Advancing Volume, and NYSE Net Cash in Client Accounts. None of these indicators are flashing any material warning signs. The NYSE Advance Decline Line, a measure of market breadth, is only showing some mild weakness and continues to be in the uptrend established after the 2007-2008 financial crisis. For anything more than a mild correction to get a foot hold on the market the A/D Line would have to rollover more decisively. The Percentage of Stocks Above 200 Day MA remains above 60%, well above the 40% level where material corrections take place. Although the NYSE New High vs. New Lows indicator is showing some weakness it has yet to turn definitively negative. NYSE Advancing Volume, although below the 50% reading, looks to be bouncing back. The NYSE Net Cash in Client Accounts measure is in negative territory indicating that investors are, on balance, willing to use margin to finance stock purchases.

Technical Indicators



Source: Bloomberg, Raymond James Ltd.

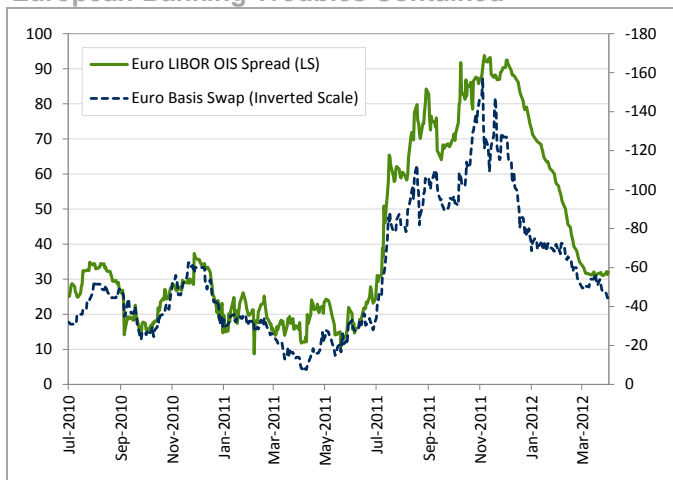
Earnings

We are currently about half way through the first quarter earnings reporting period for US companies (Canadian earnings come in a little later). So far earnings are showing decent growth up almost 10% year-over-year with most companies surprising on the upside. Only two of the ten sectors are showing an earnings contraction – Utilities (-13.5%) and Basic Materials (-17.3%). Technology is the strongest sector (+23.3%) followed by Industrials (+13.3%) and Financials (+11.4%). Sales are also confirming these trends with overall sales growth for the S&P 500 up almost 6%. Considering the overall strength of profit growth we would not expect this to be the catalyst for a material correction in the market.

European Credit Market Indicators

While Europe continues to suffer under the combined effects of slowing economic growth and high sovereign debt levels, the banking system in the region appears to be functioning after the LTRO (long-term refinancing operation) of earlier this year. Although slowing European growth will have an impact on global markets, it is likely to be rather muted. That could change if troubles begin to emerge once again in the region’s banking system, much like what occurred last summer. Our two key indicators to watch in this connection are the Euro Libor OIS Index Swap spread (a measure of the cost of short-term financing between banks) and the cost of obtaining US dollars by European banks (Euro Basis Swap Spread - a short-term measure of credit worthiness). Both these indicators (see chart below) suggest that the pressures in Europe are not set, at this time, to spill over beyond the region.

European Banking Troubles Contained



Source: Bloomberg, Raymond James Ltd.

Economic Data

The April FOMC announcement from the US came in as expected for the most part, as the Fed largely retained its cautiously optimistic tone on growth while acknowledging the recent patch of soft economic data. According to the Fed, moderate growth remains the new black (they increased their expectations for US growth), the unemployment rate continues to ease (lowered their projection), and as for global financial market strains they continue to see "significant downside risks." The overall guidance was that the Fed will maintain its commitment towards low rates "at least through late-2014". Despite the generally positive commentary from the Fed, investors continue to question the sustainability of the US recovery with many believing that the flash of growth recently was more a function of warm weather than improving fundamentals and that it will be choked off by rising oil prices. The overall trend of the economic data and comments by the Fed suggest that this assessment is too pessimistic. Canada’s central bank has also lifted its growth assumptions for the US. As for the global economy, Asian exports are growing and the region’s giants, China and India, have begun easing monetary policy. The ECB may prove slow, but we expect it to respond to rising financial stress in Spain and disappointing European growth with further policy easing. We also expect the BoJ to ease again in the next month or so. On balance the global economy, with the exception of Europe, continues to perform reasonably.

Considering the short-term shift in market sentiment of late we feel a mild correction may occur. However, given that our technical indicators do not reveal any material underlying weakness in the market; earnings growth remains positive; European credit indicators do not point to any major financial risks from that region; and the North American and Asian economies appear to be growing, we advocate no change to our investment stance at this time. We continue to favour stocks over bonds. For equities we suggest a balanced approach using our barbell strategy with an even split between defensives (for safety and income) and cyclicals (for growth). As we expect the economic data to steadily improve over the course of the summer, we are looking for an opportunity to increase our allocation to cyclicals as the group (especially materials and energy stocks) has come under selling pressure of late and valuations are improving. Specific themes and ideas in the cyclical sector are examined in more detail in the next section.

Andy MacLean, CFA
Private Client Strategist

Defensively Aggressive

Playing the equity market is a bit like playing poker: solid judgement, paying careful attention to the overall landscape and pure skill all help, but not all pitfalls can be fully anticipated. While we expect a rally for cyclical equities in the second half, risks persist. However, there are ways to remain ‘cyclical’—by cyclical we refer to the consumer discretionary, technology, materials, industrials and energy sectors—while limiting downside risk. In the following, we highlight criteria to allow investors to gain exposure to cyclical equities yet remain (relatively) protected if unknown variables negatively impact markets. The resulting equities amount to a solid bet on cyclicals but are defensive enough to allow investors to refrain from going ‘all-in’.

- **In Canada, larger capitalization doesn’t necessarily equal safety**

A common assumption during market corrections is that buying large cap stocks provides more downside protection. Our analysis of major S&P/TSX Composite corrections (of 10% or worse) over the past 12 years suggests that the large cap broader market doesn’t meaningfully outperform small cap stocks (as measured by the S&P/TSX Small Cap Index). Often a small number of heavily weighted large-caps (Nortel, Research In Motion, Teck Resources or financials during the credit crisis, for example) can drive significant underperformance. The key to being more defensive then is not necessarily to favour large caps, but rather, to avoid over-concentration. In other words, focus less on market cap and more on avoiding excessive overweights. For the screen below we set no market cap restrictions.

- **Strong balance sheets**

Speculating on an industrial or mining company is fine when the market and economy are stable, but investors will be

quick to abandon these companies if they are burdened with debt and don’t have the balance sheet strength to weather downturns. Teck Resources, for example, declined almost 91% in 2008-2009 from peak to trough because the market feared its debt levels (its debt to equity spiked above 100% in 2008). Below we screen for cyclicals with debt to equity levels of no more than 40%.

- **Profitability**

As our focus is cyclical stocks, we expected profitability to be variable over the past several years; however, we checked to ensure that annual earnings for the below companies had *always been positive* over each of the past four years—even during the credit crisis years. Earnings are also expected to be positive this year.

- **Beta check**

In last month’s *Insights & Strategies*, we focused on a low-beta defensive strategy. We’re less concerned with defensiveness this month, but we still used beta to run a quick check of each of the below companies’ ability to handle downturns. All of the cyclical stocks below recorded a below-market beta during the second half of 2008 (the worst part of the credit crisis) and the second half of 2011 (S&P/TSX: -10.1%).

- **A dividend is an added bonus**

Dividends don’t provide much price support for most cyclical stocks; however, getting paid a little while the market is struggling is still better than nothing. We screened for cyclical stocks with a minimum yield of 1.5%. Note that the stocks below provide meaningful yields of 4% on average.

Douglas Rowat
Equity Specialist

Cyclicals With Less Risk

Company	Ticker	Sector	Price (\$)	Market Cap (\$ million)	Debt to Equity (%)	Dividend Yield (%)	Beta H2 2008	Beta H2 2011
AASTRA TECH LTD	AAH	Information Technology	18.41	218	0.0	3.3	0.54	0.56
BIRD CONSTRUCTIO	BDT	Industrials	14.67	618	26.8	4.1	0.63	0.80
BLACK DIAMOND GR	BDI	Industrials	20.36	760	32.0	2.8	0.52	0.94
CANADIAN HELICOP	CHL/A	Industrials	33.66	440	35.1	3.3	0.48	0.90
CINEPLEX INC	CGX	Consumer Discretionary	30.08	1,757	31.6	4.4	0.61	0.59
HUSKY ENERGY INC	HSE	Energy	25.77	24,888	23.8	4.7	0.91	0.98
REITMANS LTD -A	RET/A	Consumer Discretionary	15.20	998	2.0	5.3	0.62	0.61
RITCHIE BROS	RBA	Industrials	20.90	2,224	23.7	2.1	0.77	0.96
TOROMONT INDS	TIH	Industrials	22.14	1,701	35.3	2.0	0.78	0.76
TORSTAR CORP -B	TS/B	Consumer Discretionary	10.26	816	28.9	4.5	0.59	0.85
WAJAX CORP	WJX	Industrials	49.88	829	30.5	4.3	0.70	0.93
WESTSHORE TERMIN	WTE-U	Industrials	24.69	1,833	0.0	7.2	0.78	0.81
Average				3,090	22.5	4.0	0.66	0.81

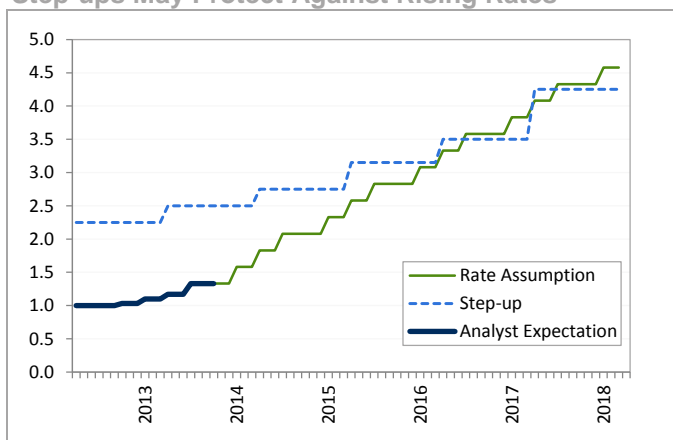
Source: Bloomberg. As at April 30, 2012

Step It Up a Notch

We may be experiencing some minor setbacks, but the Canadian economy appears to be continuing on its recovery. As a result, the Bank of Canada adopted a more hawkish stance in its most recent policy statement, suggesting that an interest rate hike would be coming sooner than previously projected. It cited better-than-expected economic momentum and a reduction in external headwinds as part of the reason for the change in tone. However, the Bank of Canada also mentioned that household debt remains a notable domestic risk, and issues surrounding the Eurozone and the United States are still a concern. Though the exact timing and pace of rate hikes are still unclear, analysts predict that the first rate hike will happen early next year. A rising rate environment presents some challenges to fixed income investing, but step-ups can provide some protection.

Inflation reflects growth in the economy, with prices rising as consumers and corporations spend. However, if it runs too hot, the Bank of Canada may attempt to moderate inflation and encourage saving to ensure a slower and more sustainable rise. One tool that central banks use is the overnight rate, which in turn affects short-term interest rates (and therefore bond yields and prices). As an open economy, the Bank of Canada must be more cognizant of the effect of rising interest rates on the economy as a whole. It was announced at the last FOMC meeting that the Fed would keep monetary policy accommodative into late 2014, which, along with the uncertainty in the European recovery, may cause the Bank of Canada to remain cautious over the removal of monetary policy stimulus.

Step-ups May Protect Against Rising Rates



Source: Raymond James Ltd.

In times where interest rates may be on the rise, step-up bonds are a good investment option due to their unique characteristics. They are structured such that at predetermined dates (if not called), the coupon on the issue can increase, or “step up”. This increase in the coupon compensates investors for continuing to hold the bond and offers some protection against rising interest rates. In the included graph, we have used analysts’ projections for overnight rate hikes to Q3 2013, and then assumed three 25 basis point hikes per year. Predicting interest rate movement is very difficult and thus this assumption is used as more of a guide rather than an actual belief in where rates may go, but we see this assumption as being moderately aggressive. Step-up bonds offer additional features that make them attractive: they provide higher rates than other fixed income products in the short end, and have a secondary market if liquidity is a concern. They are smaller issues, but with a secondary market, and with Tier 1 banks creating new step-ups frequently, there is often a good supply. Though offered in many final maturities, we believe that a 5- or 6-year step-up (a typical 6-year example is shown in the chart) may provide the necessary protection against rising rates over the upcoming years. Though many believe that they should stay short (under one year to 3 years), they are missing out on a higher yield in the beginning, and if higher rates don’t materialize, will miss out on those preferred yields entirely.

Investors who currently hold investment grade bonds but are concerned about losing value should evaluate the underlying reason of their purchases. If you initially invested in bonds to provide diversification to your portfolio or receive reliable cash flow, and intend on holding those bonds to their final maturity, then you should stay the course. The purchase yield will remain intact and upcoming changes in interest rates should not have an effect on your final outcome. Though bonds may show at lower prices in your portfolio or on a monthly statement, investors can expect to receive the bond’s par value at its maturity (though general bond investment risks will still exist).

To summarize, we suggest the purchase of step-up bonds to best prepare your portfolio for the upcoming investment environment. Ideally, we would look for step-ups with a maturity of 5 to 6 years. The structure of these instruments provides some protection against rising rates, while offering essential diversification and liquidity. Given our outlook of rising rates in the not-so-distant future, it may be time to step it up a notch and look at step-up bonds as a potential investment.

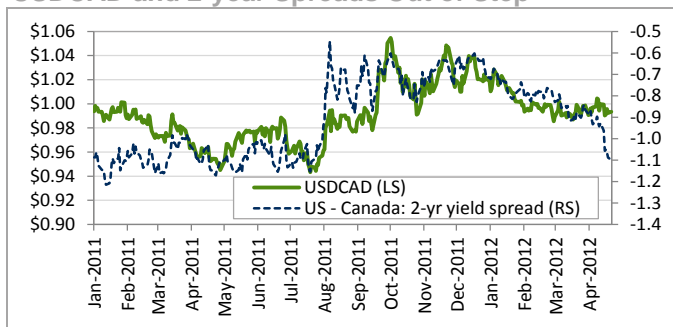
Charlotte Wong
Fixed Income

“Rating” FX Markets

Regardless of the many intricate layers of activity, millions of counterparties and varying degrees of sophisticated asset classes, capital markets operate in a surprisingly interconnected fashion. Functioning much like a natural ecosystem, shifts made in one corner of the market will be quickly reflected in the pricing of a related security or sector. The relationship between interest rates and currency pairs is a prominent example of this type of association. Domestic benchmark interest rates drive both cash and forward markets for currency pairs. As central banks around the globe shift their monetary policy focus, yield curves and interest rate forecasts have been forced to adjust. On a short term basis, these swings in expectations can lead currency pairs to deviate from values implied by yield levels. Longer term though, interest rates contribute significantly to the overall value of FX instruments.

The logic behind interest rates as a key driver for FX pairs is quite straightforward. In a perfect world, rational individuals would direct funds to investments with the greatest return and would therefore look to invest abroad if they would be able to earn a higher yield. Should an individual in the US want to invest in a Canadian dollar-denominated bond, they would need to first purchase Canadian funds. Following the laws of supply and demand, this transaction would cause the Canadian dollar to appreciate and the US dollar to depreciate. This relationship states that currency markets should adjust to reflect any interest rate differentials between countries. Simply put, if Canada has higher rates relative to the US, the loonie should appreciate.

USDCAD and 2-year Spreads Out of Step



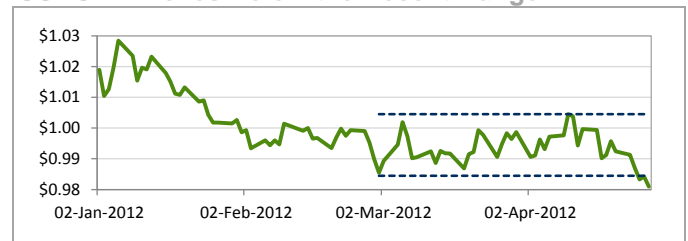
Source: Bloomberg, Raymond James Ltd.

Of course, the introduction of real world variables into this model typically causes FX rates to deviate from their interest rate implied levels on a short run basis. Individuals need to take into consideration factors such as political risk, current account balances and inflation when making global investment decisions. Regardless, charting USDCAD alongside two-year interest rate differentials between Canada and the

US illustrates that, while rates may not be an effective predictor of absolute future levels, they remain beneficial in helping to map price action. Furthermore, the sharp divergence between short term rates and USDCAD since April reflected in the preceding chart implies that further strength in the loonie is in store as long as rates in Canada remain at inflated levels against the US.

Forecasts surrounding the future path of interest rates would also drive price action in currency markets as participants would be willing to reward currencies whose rates are expected to rise. As key central bank lending rates act as the benchmark for all other interest rate products, monitoring expectations for shifts in central bank policies is beneficial to helping map the path of interest rates and in turn that of currencies. Following the slightly more hawkish rhetoric from last month’s Bank of Canada policy meeting, markets have been quick to move forward their expectations with regards to the next rate hike from the BoC. Opposite Canada was last Wednesday’s Federal Reserve statement at which the Fed reiterated its commitment to keep rates low, likely through to 2014. The divergence in policies has put the interest rates complex in both countries at odds with the CAD coming out as the clear winner.

USDCAD Moves Below the Recent Range



Source: Bloomberg, Raymond James Ltd.

The employment of interest rates to help forecast future price action in currency markets is a well-accepted practice but like any indicator it has its flaws. While the theory supports FX markets adjusting to reflect any yield differential, the existence of friction effects means that currencies can trade above or below their interest rate implied value for an extended period. Furthermore, the rates being used to project currency pair movements are a projection in and of themselves. While the most recent rhetoric from the Bank of Canada is certainly being interpreted as hawkish, the tone of the Bank is in no way set in stone. In general though, the relative current levels of short-term interest rates between Canada and the US combined with an increased focus on central bank policy should help underpin the loonie going forward.

Matt Stastny
Foreign Exchange

Marrying Growth and Income

Investors continue to flock in droves to balanced funds. According to Investment Funds Institute of Canada (IFIC), year-to-date net sales for balanced funds totalled C\$10.5 billion, while equity funds have experienced net redemptions to the tune of C\$2.94 billion. Investors' strong appetite for balanced funds speaks to the product's ability to provide better downside protection while allowing for capital growth and income. Balanced funds also provide instant diversification to equity and fixed income markets, making them an ideal core holding in your portfolio.

When assessing the merits of a balanced product, we're particularly fond of funds that are overseen by experienced portfolio managers, provide exposure to various asset classes, distribute a reasonable and sustainable level of income, and have the flexibility to adjust the asset mix in order to take advantage of market opportunities. On that note, we highlight two balanced funds that deserve a place in your portfolio.

CI Signature Income & Growth

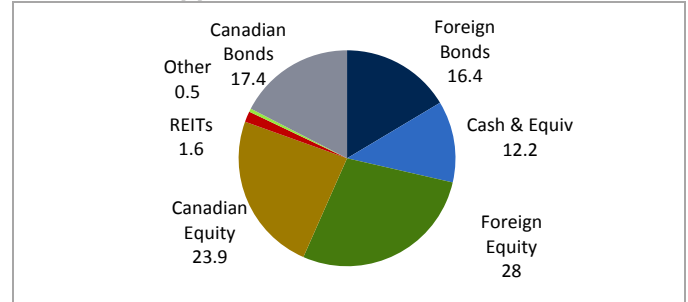
Lead manager Eric Bushell and his investment team at Signature Global Advisors look for opportunities in a multitude of asset classes such as stocks, income trusts, currencies, investment grade credit, and government bonds. The team will also add value by making tactical adjustments to the portfolio's asset mix.

We view Signature's organizational structure and investment process as a competitive advantage. In particular, the Signature team is organized so that team members are specialists in specific equity sectors or fixed-income asset classes. This specialist model allows the analyst or portfolio manager to have a deeper understanding of his or her area of coverage as compared to a generalist covering a large number of sectors and asset classes.

While individual security selection is the responsibility of the specialist, asset allocation decisions ultimately lie with lead manager Eric Bushell, who is also Signature's Chief Investment Officer. Bushell determines the fund's asset mix by assessing the macro environment and taking into account key economic indicators such as GDP growth and CPI metrics. Bushell has been the recipient of a number of industry awards since joining the Signature team in 1999, including Morningstar's Manager of the Decade Award at the 2010 Canadian Investment Awards. In turn, unitholders have been rewarded with strong performance. Over the past decade, the fund has generated an average annual return of 6.4% while its category median was only able to post a 3% gain over the same time period.

The fund has a targeted annual distribution of 6% that is paid out monthly to unitholders. The targeted distribution yield is reviewed annually for sustainability.

Diversified Approach to Income



Source: Morningstar, as at March 31, 2012

Dynamic Dividend Income

This balanced fund maintains a diversified portfolio, providing exposure to four income-generating asset classes: (1) dividend-paying stocks, (2) preferred equity, (3) income trusts, and (4) corporate bonds.

Oscar Belaiche is lead manager of the fund's equity sleeve. Prior to joining Dynamic in 1997, Belaiche oversaw commercial real estate properties at The Prudential Insurance Company of America for several years. This experience has been put to good use here given that real estate investment trusts (REITs) play a key role in achieving the fund's income objectives.

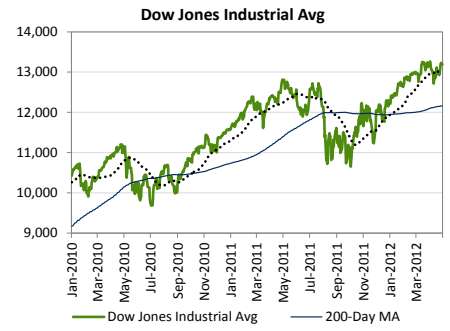
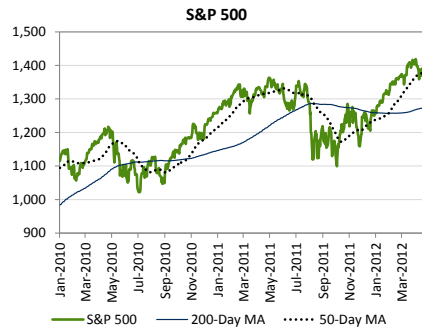
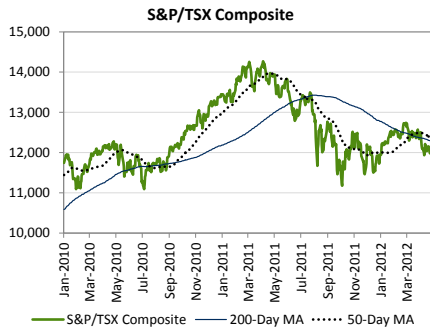
The fixed income sleeve is managed by Michael McHugh, a proven portfolio manager who has demonstrated a knack for picking undervalued corporate bonds. McHugh has over 24 years of investment experience under his belt, beginning his investment career in 1986 as an equity research analyst at Walwyn Stodgell Cochrane Murray. In 1989, McHugh joined the Hospitals of Ontario Pension Plan, where he managed private debt and equity portfolios and, in 1993, he managed fixed-income portfolios for the Ontario Hospital Association Investment Management Inc.

Unlike other funds that combine independently-managed sleeves to construct balanced portfolios, Belaiche and McHugh work closely together to ensure that the themes being expressed in their respective sleeves are consistent with each other. The fund has benefitted from these collaborative efforts, generating strong long-term results. For example, the fund's 8% annualized return over the past 9 years (longest measurable time period) is ranked 1st quartile among 366 balanced funds.

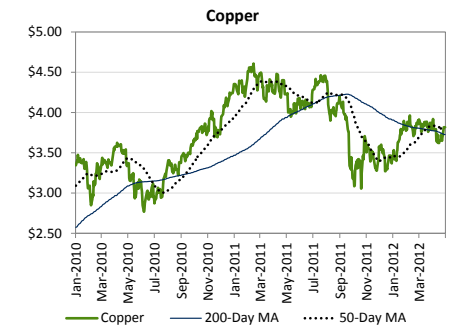
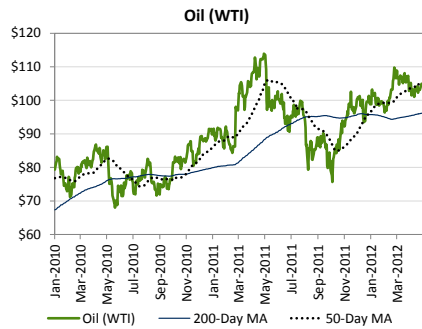
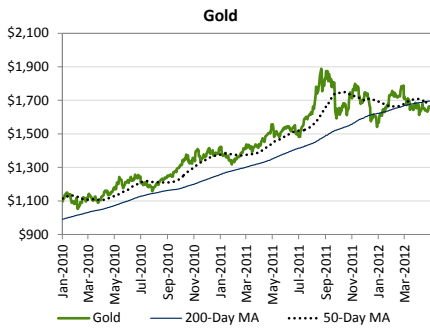
Jordan Benincasa, LL.B, MBA
Mutual Fund & ETF Research

Charts of Interest

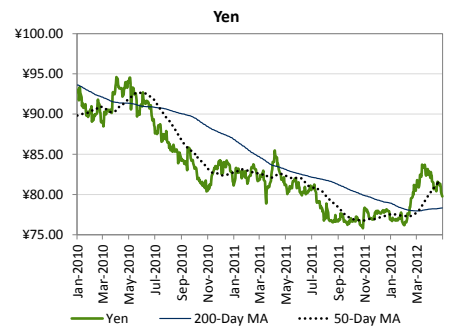
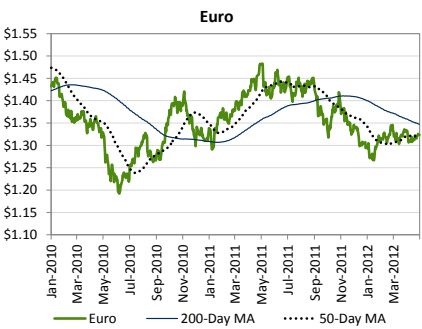
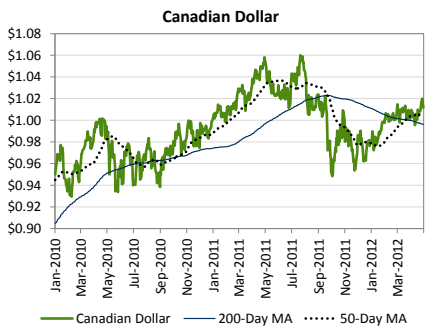
Markets



Commodities



Currencies



Source: Bloomberg, Raymond James Ltd. Performance as at April 30, 2012.

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