Weekly Trends

PRIVATE CLIENT SOLUTIONS

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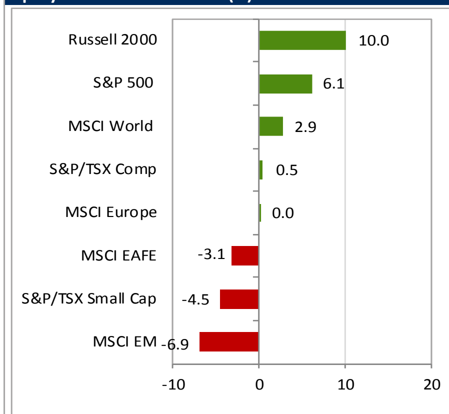
August 10, 2018

What Trade War?

If there is a silver lining in the ongoing trade dispute between Canada and the US, it's that it underlines the fact Canada needs to diversify its export market. Not that this is a new revelation, but the escalating tensions with our largest trading partner reminds us that that relying on one nation is not a winning strategy and that diversification is key.

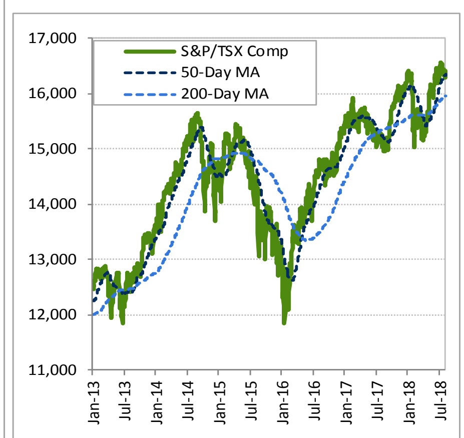
- This relationship has only grown closer over the years with the introduction of: the Canada–United States Automotive Products Agreement in 1965 which led to the integration of the Canadian and US auto industries; the implementation of the Canada–United States Free Trade Agreement in 1989 that phased out a wide range of trade restrictions over a ten-year period; and finally the North American Free Trade Agreement (NAFTA) in 1994 creating the world's largest free trade zone.
- Surprisingly, the most recent trade data has shown little evidence that the Canadian/US trade dispute is negatively impacting trade. In fact, last week Statistics Canada reported that the merchandise trade deficit shrank to the smallest amount in 17 months thanks to a surge in exports. Exports jumped 4.1% m-o-m in June, the biggest one month gain since November 2016.
- With the chances of a NAFTA deal growing, increasingly the near-term growth prospects appear poised to surprise to the upside. In a clear indication of the underlying positive economic momentum, the Citigroup Canada Economic Surprise Index turned positive for the first time in 7 months. Given the positive momentum, possible near-term trade catalysts and attractive valuation within the Canadian market we stand by our S&P/TSX year-end target of 17,650, or 8.2% upside from current levels.

Equity Market YTD Returns (%)



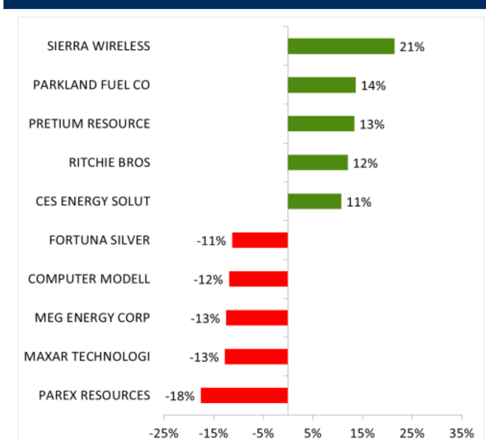
Canadian Sectors	Weight	Recommendation
Consumer Discretionary	5.6	Market weight
Consumer Staples	3.4	Underweight
Energy	19.6	Overweight
Financials	33.7	Market weight
Health Care	1.3	Market weight
Industrials	10.4	Overweight
Technology	4.0	Market weight
Materials	11.0	Overweight
Communications	4.4	Market weight
Utilities	3.8	Underweight
Real Estate	2.9	Market weight

Technical Considerations	Level	Target
S&P/TSX Composite	16,288	17,650



Source: Bloomberg, Raymond James Ltd.
Sectors are based on Bloomberg classifications

S&P/TSX Top 5 Gainers/Laggards*



S&P/TSX Market Internals

Weekly Advance	133	53%
Weekly Decline	108	43%
Advance-Decline	25	
New 52 wk high	17	7%
New 52 wk low	5	2%
No. Stocks Above 50-d	112	45%
No. Stocks Above 200-d	118	47%
Arms Weekly Index	1.15	Neutral
RSI (14-day)	52.4	Neutral
50-DMA	16,335	Downtrend
200-DMA	15,947	Uptrend

*Source: Bloomberg, Raymond James Ltd; * 5-day price return*

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RAYMOND JAMES

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If there is a silver lining in the ongoing trade dispute between Canada and the US, it's that it underlines the fact Canada needs to diversify its export market. Not that this is a new revelation, but the escalating tensions with our largest trading partner reminds us that that relying on one nation is not a winning strategy and that diversification is key.

From an investor's perspective, if one is investing in a company that generated a significant percentage of revenue from one customer you'd surely push management to broaden their customer base or discount the price you're willing to pay in order to compensate for the concentration risk. This is one of the reasons we believe the Canadian market is cheap relative to a number of developed countries. But the fact remains the US is our largest trading partner and has been for well over a century.

This relationship has only grown closer over the years with the introduction of: the Canada–United States Automotive Products Agreement in 1965 which led to the integration of the Canadian and US auto industries; the implementation of the Canada–United States Free Trade Agreement in 1989 that phased out a wide range of trade restrictions over a ten-year period; and finally the North American Free Trade Agreement (NAFTA) in 1994 creating the world's largest free trade zone.

But over the past decade, Canada has taken steps to diversify its export markets. In 2009, Canada established a free trade agreement with the European Free Trade Association, a goods-only agreement with an emphasis on tariff elimination; in 2013 Canada negotiated trade agreements with China, Japan and South Korea in the area of information and communication technologies, enterprise solutions and mobile applications and medical imaging; and in 2018 the Trans-Pacific Partnership (renamed the Comprehensive and Progressive Agreement) was signed by 11 countries committed to the eliminate tariffs. If ratified, the agreement would be the second largest trade agreement following NAFTA. Given Canada's reliance on trade (~40% of GDP can be attributed to exports) opening up additional markets outside of the US is an important driver to reduce overall economic volatility.

Until that time, Canada's economic prospects remain closely tied to the US, as such one would have assumed the recent trade protectionist measures and increased trade rhetoric would have surely weighed on trade between the two nations. Surprisingly, the most recent trade data has shown little evidence that the Canadian/US trade dispute is negatively impacting trade. In fact, last week Statistics Canada reported that the merchandise trade deficit shrank to the smallest amount in 17 months thanks to a surge in exports. Exports jumped 4.1% m-o-m in June, the biggest one month gain since November 2016. Trade between Canada and the US rose 2.5% despite the US had imposed tariffs on steel and aluminum on June 1st. It appears the weaker Canadian dollar helped absorb some of the added costs, but also US importers may have been attempting to front run additional tariffs on other targeted goods. Trade between Canada and the US was remarkably resilient in June, but what was more impressive was trade with non-US markets. Canadian exports to countries other than the US jumped 8.7%. If we are correct in our assumption that trade is a factor resulting in the Canadian market trading at a discount, surely the resent trade data should remove some of these concerns.

Canadian Exports Moving Higher Despite Protectionist Headwinds

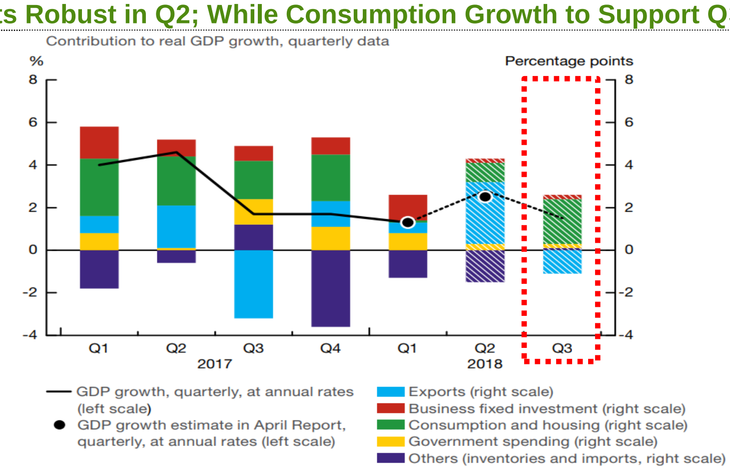
Source: Bloomberg, Raymond James Ltd.

Further, the strong data also implies Q2/18 Canadian GDP forecasts will need to be revised higher, which we did start to see this week. The stronger growth outlook will further support the Bank of Canada's (BoC) rate hike intentions; the market is now predicting a 28% chance of a rate hike by September and 73% by October. Interestingly, the BoC had anticipated a stronger contribution from exports as in the July Monetary Policy Report:

> *"The composition of growth is shifting: the contribution from household spending is expected to be smaller than in 2017 while that from exports and business investment is anticipated to be larger…The Bank estimates that business investment and exports were stronger in the first half of 2018 than anticipated in the April Report. Spending on computer equipment, software, and research and development was particularly robust. Because the strength of export growth in the first two quarters mainly reflected a faster-than-expected rebound in oil exports after temporary pipeline shutdowns in late 2017, export growth in the third quarter is expected to slow."*

The bank is anticipating the US tariffs on steel and aluminum to reduce the level of real Canadian exports by ~0.6%, felt mostly in the second half of 2018, but admittedly the impact of the tariffs may be more muted. By that time, the BoC is anticipating housing and consumption growth will have picked up to help offset the decline.

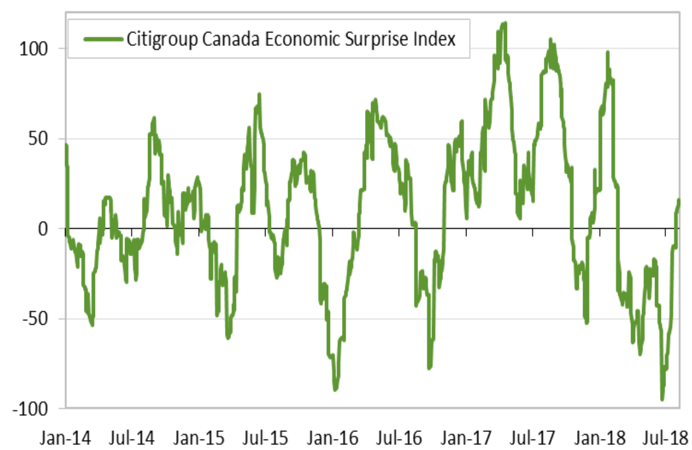
Exports Robust in Q2; While Consumption Growth to Support Q3



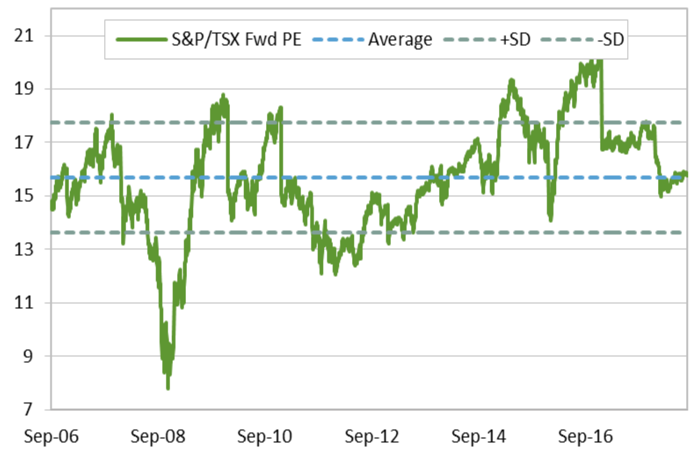
Source: Bank of Canada July MPR

Despite the headwinds facing the Canadian economy, growth has been remarkably resilient. With the chances of a NAFTA deal growing, increasingly the near-term growth prospects appear poised to surprise to the upside. In a clear indication of the underlying positive economic momentum, the Citigroup Canada Economic Surprise Index turned positive for the first time in 7 months. Given the positive momentum, possible near-term trade catalysts and attractive valuation within the Canadian market we stand by our S&P/TSX year-end target of 17,650, or 8.2% upside from current levels.

Canadian Economic Surprise Index Turns Positive…



…S&P/TSX Remains Attractively Valued



Source: Bloomberg, Raymond James Ltd.

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