Investment Strategy

PRIVATE CLIENT SOLUTIONS

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2016 Market Outlook

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Highlights

- Economists see the global economy picking up modestly in 2016 with expectations of 3.4% global GDP growth, up from 3% in 2015. While we also see the global economy improving, and see little signs of a US/global recession, the downside risks to the economy and our outlook are considerable, making this year one of the more challenging years to forecast in our careers.
- For the US economy we're expecting similar growth to 2015, with our US Economist forecasting GDP growth of 2.3%. We see consumer spending continuing to be the main driver of economic growth. We see the Canadian economy recovering but with economic growth remaining below-trend, and trailing the US economy once again in 2016.
- Corporate earnings disappointed last year as the strong US dollar and oil prices weighed on US earnings, while weak commodity prices weighed on Canadian profits. However, we expect some of the headwinds for earnings to fade, and as such, are forecasting a return to positive earnings growth in 2016. We forecast S&P 500 Index (S&P 500) 2016 earnings of US$123.96/share, which equates to 5.9% Y/Y growth. Multiplying our US$123.96/share earnings estimate by our projected 17.5x P/E multiple, we derive a year-end price target of 2,170, which if realized would equate to an 8% total return.
- Our S&P/TSX Composite Index (S&P/TSX) 2016 price target is 14,220, which if realized would equate to a 12% total return. Based on our target prices, we are projecting higher returns from the S&P/TSX in 2016; however, this does not take into consideration the US dollar, which we see further gains in. Like last year, we see a stronger US dollar contributing to Canadian returns on US assets, and therefore continue to prefer US to Canadian equities.
- There are always risks to market forecasting and investing, but this year we find the potential risks to our outlook particularly elevated. Our base case view is that equity markets will be able to work through these issues, but in the event that one of these risks intensifies, we must be prepared to shift to the evolving market conditions.
- We are maintaining our selective cyclical bias with an overweight in the information technology and industrials sectors. We also recently upgraded telecom to overweight. We are downgrading consumer discretionary to market weight in line with the financials, consumer staples, health care and energy sectors. Materials and utilities sectors remain at underweight.

Please read domestic and foreign disclosure/risk information beginning on page 9

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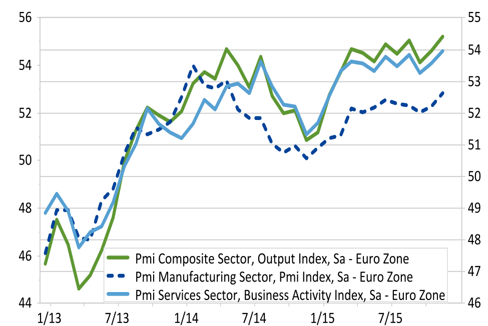
Economic Outlook

The global economy lost momentum in 2015, with China and the emerging markets (EM) weighing on global growth. Within the developed nations the US, UK and the Eurozone held up better, while Japan's economy disappointed. For 2016 economists see the global economy picking up modestly with expectations of 3.4% global GDP growth, up from 3% in 2015. While we also see the global economy improving, and see little signs of a US/global recession, the downside risks to the economy and our outlook are considerable, making this year one of the more challenging years to forecast in our careers. Below we outline our expectations for the key regions:

- **Europe:** Europe continues to surprise to the upside with Eurozone unemployment at a four-year low, manufacturing and industrial production picking up, and services remaining healthy. While we're not expecting robust growth from Europe, we still expect growth to pick up on central bank stimulus, a weaker Euro and pent-up demand. Economists are forecasting growth of 1.7% in 2016, up from an expected 1.5%.
- **EM and China:** China and EM, particularly Russia and Brazil, remain the weak links for the global economy. EM tends to underperform when the US dollar is strong, so the outlook for the dollar is key. We see more limited upside in the US dollar following a strong 2015, so this headwind should ease in 2016. Also Chinese growth should stabilize in 2016, as recent stimulus begins to work through the economy.
- **US:** We're expecting similar growth to 2015, with our US Economist forecasting GDP growth of 2.3%. We see consumer spending continuing to be the main driver of economic growth driven by strong job gains (2.3 mln jobs created in 2015), nascent wage growth, improving consumer confidence, low gasoline prices, and record US net worth (US$85 tln). Other positives include an improving housing sector and strong services. However, we expect exports to remain a drag on growth due to the strong dollar, and business investment to remain under pressure. One area of concern for us is the material weakness seen in manufacturing. The ISM Manufacturing Index dropped below 50 in November which signals contraction. Our expectation is that manufacturing will stabilize and possibly move higher in 2016 as oil prices recover. However, if this continues and begins to drag services lower (78% of US economy), this could put the US economy at risk.

Overall, our expectation is for continued, but modest economic growth in 2016. That said there are numerous risks to the global economy that require close monitoring.

Eurozone Continues To Improve

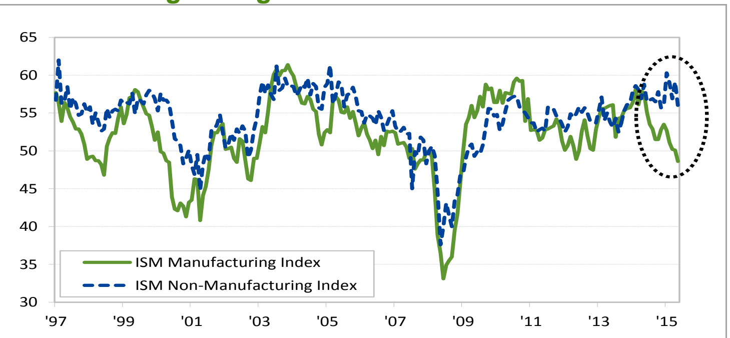


Source: Factset, Raymond James Ltd.

Economists Growth Expectations

Consensus GDP Outlook				
Country/Region	2014	2015E	2016E	2017E
US	2.4	2.5	2.5	2.5
Canada	2.5	1.1	2.0	2.2
Eurozone	0.9	1.5	1.7	1.7
China	7.3	6.9	6.5	6.3
Japan	-0.1	0.6	1.1	0.7
Global	3.4	3.0	3.4	3.4

Manufacturing Diverges From Services



Source: Bloomberg, Raymond James Ltd.

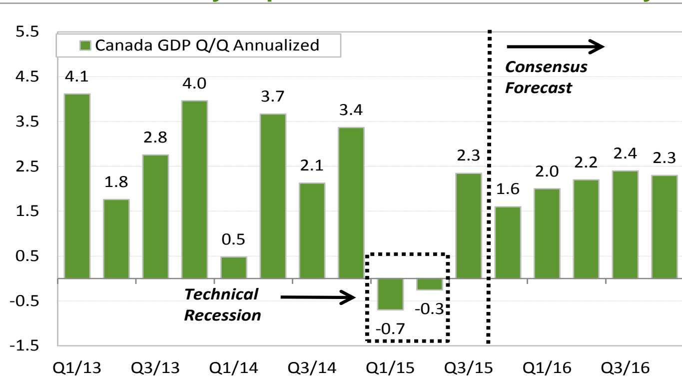
Canadian Outlook

The Canadian economy was hit hard in 2015 as declining oil prices significantly weighed on business investment. In fact, our economy experienced a mild recession in H1/15 with two consecutive quarters of negative growth. If there was any doubt that our economy is overly reliant on commodities, this was put to rest last year. Oil prices rebounded in August and September, helping our economy to post Q3/15 GDP growth of 2.35%. With oil prices under pressure again, our economy could see some further weakness in the coming quarter or two. Despite the potential for some near-term weakness, we do see the Canadian economy recovering in 2016, but with economic growth remaining below-trend, and trailing the US economy. Our tempered view of the Canadian economy is predicated on these key trends:

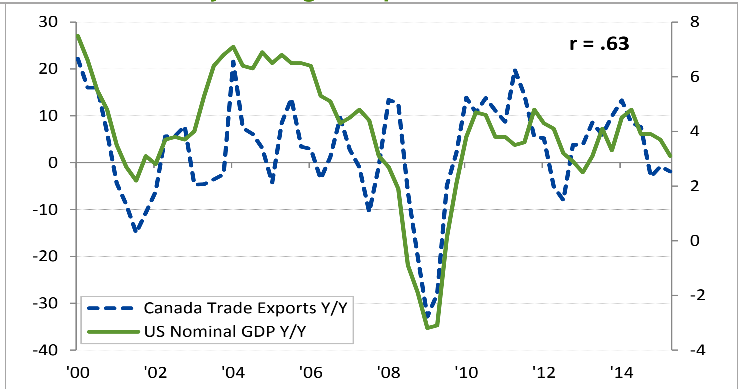
- Despite lackluster employment growth, consumer spending has held up, averaging 2% annualized over the last two quarters. Similar to the US, we expect consumer spending to be the main driver of economic growth, supported by continued job gains, low interest rates, and the strong housing market. We have significant concerns for the Canadian housing market longer term, but expect it to hold up in 2016, with interest rates remaining low. But as the Bank of Canada (BoC) begins to tighten monetary policy later in 2016 and into 2017, this will likely bring about a correction in the housing market. For now it remains supportive to consumer spending and the overall economy.
- The weakness in the Canadian dollar should support continued strength in exports which rose at an impressive 9.4% annualized in Q3/15. Below we illustrate the positive relationship between US economic growth and Canadian exports. We see higher exports in 2016 driven by the weaker Canadian dollar and stronger US growth.
- Business investment has been the main drag on growth as a result of the steep declines in oil and commodity prices. For example, business investment declined 3% and 7.3% in Q3 and Q2, respectively. With our expectations for oil prices to recover in 2016, we see this drag on growth waning.

We see a modest recovery in the Canadian economy in 2016, driven by healthy consumer spending and exports. However, given lackluster global growth and weak commodities, we expect our economy to continue to lag behind the US.

Modest Recovery Expected For Canadian Economy



Driven In Part By Stronger Exports



Source: Bloomberg, Raymond James Ltd.

Fundamental Outlook

Corporate earnings disappointed last year as the strong US dollar and oil prices weighed on US earnings, while weak commodity prices weighed on Canadian profits. For example, S&P 500 earnings are projected to be flat Y/Y in 2015 at roughly US$117/share, based on Factset data. This largely explains the flat performance for the S&P 500 in 2015. However, we expect some of the headwinds for earnings to fade, and as such, are forecasting a return to positive earnings growth in 2016.

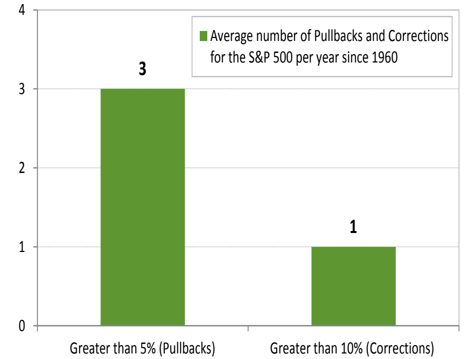
We expect the US economy to deliver modest growth in 2016 of 2.3%, with inflation ticking higher to 1.5%. Incorporating our 2016 macro forecasts into our S&P 500 sales regression model, we estimate that S&P 500 sales will grow by 4.5% in 2016. A major concern among some analysts is the current record net income margins. Currently, S&P 500 net income margin is at 10.6% versus the 15-year and 25-year averages of 9.5% and 7.3%, respectively. Consensus earnings estimates for 2016 signal further margin expansion to 11%, which we believe is too high. We are modelling for a slight margin compression of roughly 35 bps to 10.25% as higher wages and interest expense negatively impact margins.

Applying our 10.25% net income margin estimate, and 1% for stock buybacks, we forecast S&P 500 2016 earnings of US$123.96/share, which equates to 5.9% Y/Y growth. Given our more modest economic growth expectations, our earnings estimate is roughly $3/share lower than current consensus of US$126.52/share.

Another concern among analysts are the current stretched valuations. Currently the S&P 500 is trading at 18.7x trailing earnings, which is two multiple points above the long-term average of 16.5x. Assuming no multiple compression, that would equate to a 2016 year-end price target of 2,320, on our forecasted EPS. However, given the prospect of Fed tightening and other potential risks to the economy/stock market, we expect some P/E compression in 2016, and therefore are using a P/E target multiple of 17.5x. Multiplying our S&P 500 US$123.96/share earnings estimate by our projected 17.5x P/E multiple, we derive a year-end price target of 2,170. If realized, this would equate to an 8% total return, including a 2% dividend yield.

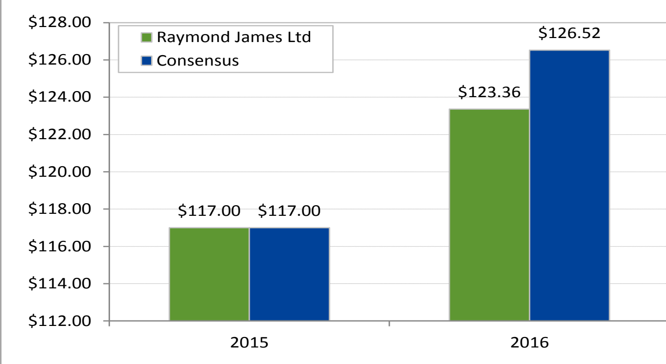
Further supporting our call for positive gains in 2016 is history, which suggests positive price returns following flat years like 2015. We analyzed S&P 500 performance following flat years (0 to 3%) and found that the S&P 500 returned on average 9.2% in subsequent years 75% of the time. Given our expectations for the economy and corporate profits to improve, along with historical tendencies, we believe the S&P 500 will deliver single digit returns in 2016.

Expect Volatility…Its Normal

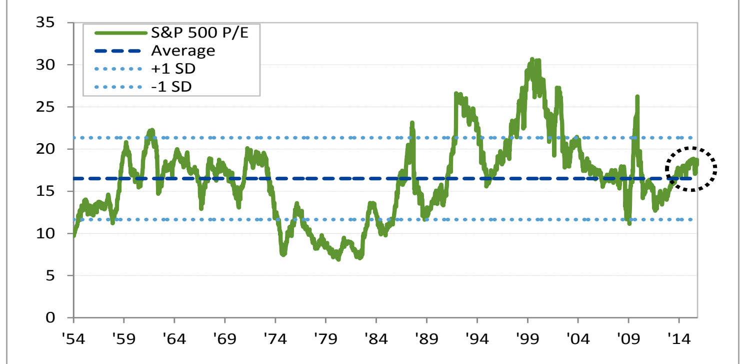


Source: Bloomberg, Raymond James Ltd.

S&P 500 Earnings To Grow 5.9% Y/Y In 2016



S&P 500 Trailing P/E At 13% Premium To LT Average



Source: Bloomberg, Factset, Raymond James Ltd.

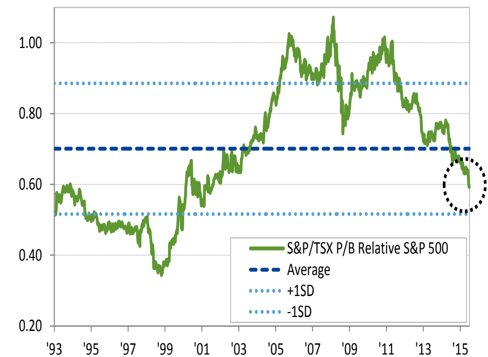
S&P/TSX Forecast

We have preferred US to Canadian equities during this market cycle, in part due to our cautious view of commodities and the Canadian dollar. With the S&P/TSX underperforming the S&P 500 for the fifth consecutive year, should we consider reversing this position and begin to move money back to the Canadian market? History suggests that we should. Since 1930 there have been five instances where the S&P/TSX has underperformed the S&P 500 for three consecutive years or more. In every instance the S&P/TSX outperformed in the subsequent year (average of 7%). Despite this, we are sticking with our call to overweight US stocks in 2016. Readers of our work know that we employ a multi-disciplined approach incorporating fundamentals and technical analysis into our calls. Until these trends change we will stick with our preference for US equities. Key points supporting our call include:

- With the strong US dollar, weak demand, and an oversupply of some key commodities, commodity prices continue to trend lower. The Bloomberg Commodity Index declined 26% in 2015, and is back at 1999 lows. For us to become more constructive on Canadian equities we would need to see a conclusion bottom in commodity prices. As a result of weak commodity prices, S&P/TSX earnings trends remain negative, especially relative to the S&P 500 – an important factor in our preference for US equities.
- The technicals validate the weak relative fundamentals, with the S&P 500 in a long-term relative uptrend. Until we see these well-established trends reverse, we will maintain our overweight in US stocks.
- Our S&P/TSX 2016 price target is 14,220, which if realized would equate to a 12% total return. In determining our price target we took the average of our four financial models (see table). Based on our target prices, we are projecting higher returns from the S&P/TSX in 2016; however, this does not take into consideration the US dollar, which we see further gains in. Like last year, we see a stronger US dollar adding to Canadian returns of US stocks, and therefore continue to prefer US to Canadian equities.
- That said, we believe there will be a great opportunity over the next year or two, to reduce US equity exposure and repatriate funds back into Canada, as the Canadian dollar bottoms. Additionally, Canadian stocks are now trading at sizable discount to the US stocks (sidebar), which will create a good long-term buying opportunity. For now we're sticking with the US, but we will likely reverse this call over the next year or two.

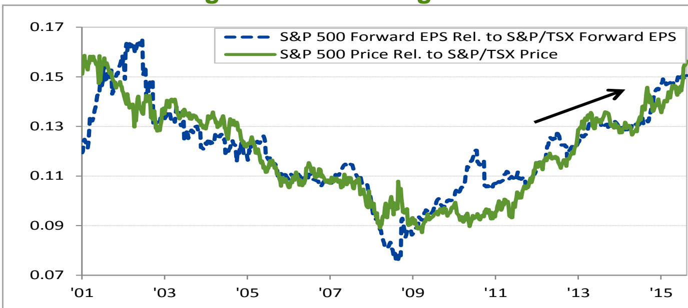
Overall, we see positive gains for the S&P/TSX in 2016, but for US equities to outperform (in Canadian dollars) for the sixth consecutive year.

S&P/TSX Is Trading At A P/B Discount To The S&P 500



Source: Bloomberg, Raymond James Ltd.

S&P 500 Earnings Remain Stronger Than S&P/TSX



Source: Bloomberg, Raymond James Ltd.

S&P/TSX 2016 Target Is 14,220

S&P/TSX Forecast Model	Type	Year-End Target	Upside
Macroeconomic Regression	Fundamental/Economic	14,200	9%
Dividend Discount Model	Fundamental/Valuation	14,903	15%
Normalized Earnings	Fundamental/Valuation	14,017	8%
Price Momentum	Technical	13,764	6%
	Average	**14,221**	**9%**

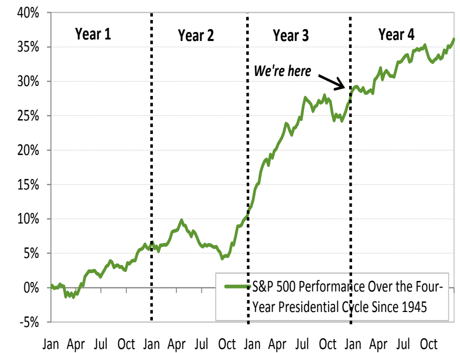
Technical Considerations

Turning to the technicals, some view the flat 2015 performance for the S&P 500 as a sign of a market top and see the bull market coming to an end. While S&P 500's technical profile has changed from positive to neutral, we believe it is too early to declare a market top, and from our perspective, the preponderance of technical evidence suggests a pause in the rally, rather than a market top. Below we discuss the technical evidence that supports our continued constructive view:

- **S&P 500:** From the European debt crisis lows in 2011, the S&P 500 continues to trade in a long-term uptrend. This was an important market event which is why we use this starting point to isolate the trend in the market. Currently the uptrend intersects around 1,925. Additionally, during the Q3/15 sell-off the S&P 500 did not close below the October 2014 lows, so the S&P 500 has yet to experience a "lower low", which is what defines the start of a downtrend. We view the August 2015 low of 1,867 as a key technical support level. We will continue to maintain our bullish technical view, as long as the S&P 500 remains above the key 1,925 to 1,867 range.
- **S&P/TSX:** S&P/TSX's technical profile remains bearish, which is one of the factors in our preference for US equities. We need to see the S&P/TSX break above its downtrend to become more bullish on the Canadian market.
- **Market Cycles:** Most of the key market cycles that we track remain supportive for 2016. They include:
  - Secular: We believe the S&P 500 started a new secular bull market in 2013, when the S&P 500 broke above the 2007 high of 1,576. Secular bull markets tend to last 13 to 15 years, which we believe still has years to play out. Now nothing goes straight up, and corrections will occur, but we still believe that this should result in above-average US returns in the years ahead.
  - Presidential Cycle (PC): The PC posits that stocks are influenced by the four year presidential term. 2016 is an election year and is the fourth year in the cycle. Since 1945, the S&P 500 has returned on average 6.1%, with positive price returns 76% of the time in years four.
  - Business Cycle: We also follow the important four year business cycle. It posits that stocks typically make an important low every four years. This is not expected to "hit" until 2018.

While there are some concerning technical developments (e.g., deteriorating momentum), the weight of technical evidence suggests a continuation of the uptrend and bull market for the US equity markets.

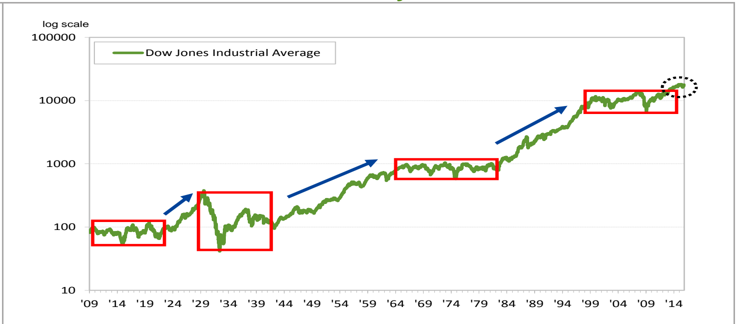
Presidential Cycle Is Positive For 2016



Source: Bloomberg, Raymond James Ltd.

S&P 500 Remains In A Long-Term Uptrend

And Is In A New Secular Bull Cycle



Source: Bloomberg, Raymond James Ltd.

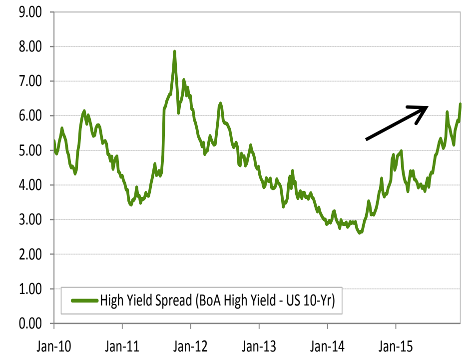
Risks To Outlook

There are always risks to market forecasting and investing, but this year we find the potential risks to our outlook particularly elevated. In this section we outline the key risks which could weigh on the economy and stock market. Our base case view is that equity markets will be able to work through these issues, but in the event that one of these risks intensifies, we must be prepared to shift to the evolving market conditions. Key risks include:

- **Fed tightening:** The Fed hiked rates in December for the first time in nine years. We believe the Fed will be gradual in hiking rates, with just a few 25 bps hikes in 2016. However, if they tighten too fast, this could have a negative impact on the economy and stock market. Aggressive Fed tightening would likely lead to an inverted yield curve, which often presages recessions.
- **High yield market:** Bond markets typically price in recessions and/or downturns before the stock market. We've seen this recently with high yield bond spreads widening dramatically. While the widening spreads is concentrated in the energy sector, the concern is that this extends to higher quality issues, having a destabilizing impact on the broader capital markets. Given our expectation for oil prices to firm up in 2016, we believe this risk will fade, but we must monitor this very closely.
- **Emerging markets and China:** Related to this is the slowdown in the emerging markets and China. As the US dollar rises, this puts negative pressure on commodities and EM. EM economic growth is at the lowest level since 2008. Should this continue, it could put the recovery at risk.
- **Peak in stimulus:** Global central banks have flooded the capital markets with liquidity to help spur growth and fight deflation. We believe we are in the 7th inning of this story. As investors begin to price in a peak in stimulus, likely in 2016 or 2017, this could put the equity markets at risk.
- **Terrorism/Geopolitics:** With the series of recent tragedies around the world, terrorism and geopolitics are likely to remain in focus. Further events could impact sentiment and destabilize the global economy. However, we note that many nations are currently uniting with an increased commitment to combating the various terrorist organizations, primarily ISIS, responsible for these attacks.

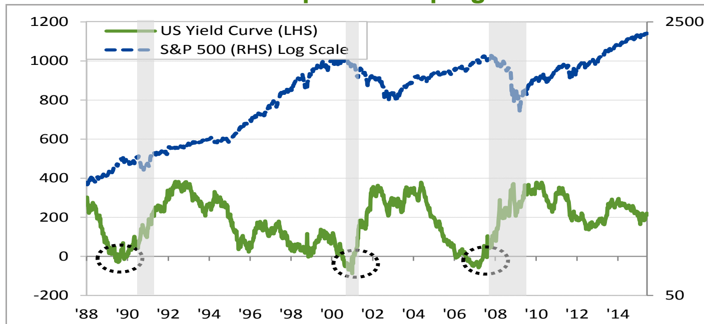
Overall, we believe the economy can work through these issues, but we must remain vigilant and flexible in managing portfolios through a bumpy 2016.

High Yield Bond Spreads Are On the Rise

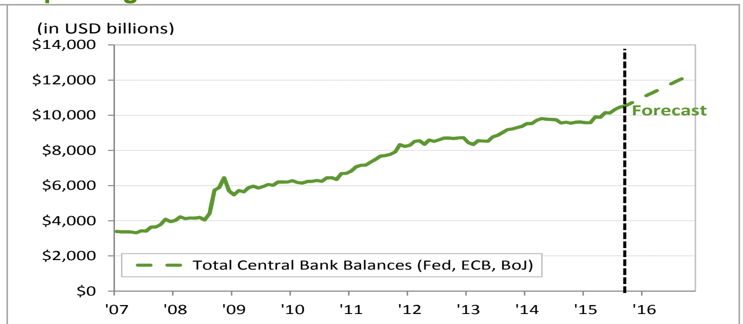


Source: Bloomberg, Raymond James Ltd.

Yield Curve Remains Upward Sloping



Expecting A Peak In Stimulus In 2016/17



Source: Bloomberg, Raymond James Ltd.

Positioning

With our expectations for continued economic growth in 2016 we are maintaining our selective cyclical bias in our sector recommendations. Moreover, we believe the global economy will transition from mid-cycle to late-cycle in 2016. Fed tightening is evidence of this changing market dynamic. As such, we are recommending investors overweight the late-cycle industrials and information technology sectors for 2016. Interestingly, the Canadian telecom sector has historically outperformed in the first year following the start of Fed tightening. This combined with better earnings growth lead us to upgrade the sector to overweight in November. The sector did sell-off following news that Shaw Communications was acquiring Wind Mobile, on concerns of increased competition in the wireless space, but we believe the sell-off was overdone and would use the weakness to increase exposure.

We are downgrading the consumer discretionary sector to market weight on concerns that the sector could face headwinds from Fed rate hikes. Consumer discretionary joins our other market weight sectors – financials, consumer staples, health care, and energy.

We maintain our underweight in the utilities sectors which typically underperforms when rates rise, and the materials sector, with the strong US dollar and weak commodity prices. Below we outline our rationale for our sector recommendations.

S&P/TSX Sector Recommendations For 2016

Sector	Canada (S&P/TSX)	
	Stance	Rationale
Financials	Market weight	• Sector should deliver steady earnings growth - consensus for 7% in 2016 • Valuations are attractive at 11.5x forward earnings and 1.5x P/B • But maintaining sector at market weight given concerns over economy, housing etc.
Consumer Discretionary	Market weight (↓ Overweight)	• Sector is expected to deliver solid EPS growth of 14% in 2016 • However, we are downgrading sector to market weight as sector could face headwinds from Fed rate hikes
Industrials	Overweight	• Industrials should benefit as economy shifts from mid-cycle to late-cycle • Sector is attractively valued at 14.7x forward earnings
Information Technology	Overweight	• Sector is expected to deliver solid EPS growth of 10% in 2016 • Sector typically outperforms when interest rates rise • Positive technical trends
Energy	Market weight	• Stronger US dollar and weak emerging market growth is a headwind for the sector • OPEC decision not to cut production was a game changer for oil prices • Attractive valuations (on P/B) and weak 2015 performance should limit downside
Consumer Staples	Market weight	• Sector could face headwinds from Fed rate hikes • Sector is expensive at 20x forward earnings • However positive technical trends support market weight recommendation
Telecom Services	Overweight	• Earnings growth has begun to improve following weak 2012 - 2013 period • Positive technical trends • Sector typically outperforms in first year following the start of Fed rate hikes
Materials	Underweight	• Higher US dollar and slower emerging market growth are headwinds to commodities • Commodity indices remain in long-term downtrend • Negative technical trends
Utilities	Underweight	• Sector is likely to be negatively impacted by rising interest rates • Sector remains expensive at 22x forward earnings • Negative technical trends
Health care	Market weight	• Lots of uncertainty in the sector given ongoing concerns over Valeant • However sector is attractively valued at 12x forward earnings

Source: Raymond James Ltd.

Conclusion

We see 2016 as an important inflection year as the economy and stock market begins to transition away from central bank stimulus, and the underlying fundamentals take on a larger role. This inflection point should result in higher volatility as the markets digest Fed rate hikes, a potential peak in central bank stimulus, and uncertainty over corporate earnings. When all is said and done, we see further gains in 2016, but believe that investors need to be vigilant and flexible in managing their portfolios, as the markets work through these issues.

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