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Market Bulletin

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Commentary – No shortage of Buy candidates as markets stage strong recovery

TSX is outperforming S&P 500 YTD and over past six months

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The TSX yesterday broke through stiff resistance at the 14,000 level, bringing its YTD gains to 3.2%, compared with the S&P 500's 0.5% decline. The TSX is not only outperforming the S&P 500 by 3.7 percentage points so far this year, but has also outperformed over the past six months (11.2% vs. 9.1%, ahead by 2.1 percentage points).

We continue to hold the view posited in our 2014 Outlook report (released December 17, 2013) that the TSX may outperform the S&P 500 this year for the first time in four years, finally making amends to some extent for its marked lag since 2011. Note that the Canadian index still lags the S&P 500 over the past 12 months by more than 10 percentage points (10.5% vs. 20.9%).

We also believe the Canadian dollar may recover in the months ahead from its plunge earlier this year. As can be seen in Figure 1, the loonie and the TSX have been rising in tandem over the past couple of weeks, reverting to the historical positive correlation between the two that had broken down since May 2013. A number of analysts expect the loonie to finish the year at a level of around 1.10 to the US dollar, little changed from present, although some bears see it falling as far as 1.20 over the next two years.

The loonie's projected moves have important implications for portfolio positioning by Canadian investors. The S&P 500 surged 38.5% in Canadian dollar terms in 2013, compared with a 9.6% gain for the TSX. This massive divergence in performance – capping the third straight year of underperformance for the TSX – has undoubtedly skewed geographical asset allocations for Canadian investors.

For example, a Canadian investor whose equity portfolio was weighted 70% to Canadian equities and 30% to US equities at the beginning of 2013 would have seen that exposure shift to about 65% Canadian and 35% US by the end of the year, using the TSX and S&P 500 as proxies for the Canadian and US equity components respectively.

Portfolio management principles mandate that investors rectify such "drift" from target allocations, which generally involves trimming over-exposure to a market or sector and adding to positions where the exposure is less than desired. **This would necessitate taking some money off the table in red-hot US equities and ploughing the proceeds into the Canadian equity space, which is slowly but surely warming up**.

We should point out that this strategy is not without its risks, since it is tantamount to jettisoning the best performers in a portfolio and adding to positions in the worst performers. In mid-November, for instance, we recommended getting out of positions in **Nvidia (NVDA, $17.91)**, **Stryker (SYK, $83.35)** and **Precision Drilling (PD, $11.44)**; these three stocks have advanced by an average 12% in the three months since then. However, with average returns of 42% in these three stocks when we had advised exiting the positions, our view was that better investment opportunities could be found elsewhere.

It is getting difficult to find attractively-valued stocks in the US equity space. While the January correction briefly brought many US stocks back into buying range, the broad gains of the past two weeks has taken many of them right back up. Fortunately, there seems to be no shortage of Buy candidates in Canada, and we have highlighted a few of them in this Bulletin.

Most of these may be considered stodgy names, but it is precisely these dependable stocks that should form the foundation of diversified portfolios. In our opinion, these are opportune levels to perhaps add to existing holdings if an investor already holds these stocks, or to fill in gaps in sector exposure within a diversified portfolio.

Figure 1: TSX and S&P 500 vs. C$ – One year (Source: Bloomberg)

We recommend that investors consider the following five Canadian blue chips, which offer an attractive combination of income through solid dividend yields, and long-term growth. Four of these five were also recommended as our Top Five RRSP/TFSA ideas for 2014.

- **Fortis (FTS, $30.71, dividend yield 4.2%)** – The largest investor-owned gas and electric distribution utility in Canada, Fortis last week reported 2013 net income attributable to shareholders of $353 million, up 12% from a year ago, while EPS rose 5% to $1.74. FTS also increased its quarterly dividend by 3.2% to $0.32, the 41st consecutive year that it has hiked its annualized dividend, a record for a Canadian public company. The pending acquisition of Arizona-based UNS Energy should help drive future growth.

- **Manulife Financial (MFC, $21.41, dividend yield 2.4%)** – Manulife this week reported a 20% increase in Q4 net income as asset-management revenue rose in North America. AUM of $599 billion rose to a record level for the 21st straight quarter. The stock surged 55% last year for the No.5 performance on the TSX-60, and could add to those gains this year if equity markets hold up and bond yields tick higher.

- **Suncor (SU, $36.72, dividend yield 2.5%)** – Suncor has been the victim of lofty expectations lately. After last year's huge 54% dividend increase, investors were looking for a bigger boost than the 15% hike that Suncor announced earlier this month. While Q4 EPS of $0.66 was well short of analysts' average $0.77 estimate, average oil-sands production rose almost 20% in the quarter to 409,600 boe/d. Suncor's integrated model, which enables it to capture Brent-based pricing on most of its oil-sands output through refining, and its solid long-term growth prospects, make SU a core portfolio holding.

- **Teck Resources (TCK/B, $26.25, dividend yield 3.4%) –** Teck had traded above $28 on Wednesday but tumbled 6.7% yesterday, its biggest one-day drop in almost eight months. The decline occurred after the company reported Q4 EPS that missed estimates and forecast higher costs to mine coal. Coal is Teck's biggest business segment, accounting for more than 40% of its sales and profits. It forecast coal mining costs for 2014 of $55-$60 per metric ton, up from $52 in Q4, due to longer haulage distances and rising fuel prices. We continue to hold the view that current levels are a great entry point for this diversified resource giant, as it should benefit from faster global growth over the next couple of years.

- **TransAlta (TA, $14.90, dividend yield 7.8%)** – TransAlta seems to be turning around, with its 10.5% gain YTD making it the best performer on the 12-member TSX Utility index. On a technical basis, the stock had a bullish crossover on January 31, with the 20-day MA crossing above the 200-day MA, the first such occurrence since August 2011. Recent business initiatives in Australia and last year's spin-off of TransAlta Renewables bode well for the company's future. TransAlta reports Q4 results on February 20.

Market Snapshot

At close on Friday, February 14, 2014

S&P TSX	14054.76	+53.11	Commodities			Yields (%)	Can.	US
TSX Venture	996.35	+9.90	Canadian $ (US cents)	91.10	+0.00	90 Day T-Bill	0.87	0.01
DJIA	16154.39	+126.80	Gold (Spot)-US$	1318.69	+15.79	2-Year Bond	1.01	0.31
S&P 500	1838.63	+8.80	Oil (WTI-March)	100.40	+0.05	10-Yr.Bond	2.46	2.74
NASDAQ	4244.03	+3.36	CRB Index	293.24	+0.67	30-Yr. Bond	3.04	3.70

Thought for the Day

"Love is a canvas furnished by Nature and embroidered by imagination." – Voltaire

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(1) The analyst and/or a member of the analyst's household have a long position in the following stocks discussed in this report – **Manulife**, **Suncor, TransAlta**

Research Rating System
Strong Buy: Expected total returns of 20% or more over the next 6 – 12 months.
Buy: Expected total returns of 10% to 20% over the next 6 – 12 months.
Speculative Buy: Significant gains expected over the next 6 – 12 months, but entire investment may be at risk.
Hold: Expected total returns of 0% to 10% over the next 6 – 12 months.
Reduce: Expected total returns of up to -10% over the next 6 – 12 months.
Sell: Expected total returns of over -10% over the next 6 – 12 months.

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