The Bigger Picture

A weekly snapshot of the markets

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Commentary – How did we get here and where are we going

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Key Take-Aways:

- **Week In Review:** A brief review of need-to-know market events from last week including US economic data, Argentinean debt concerns and the Portuguese banking crisis
- **How Did We Get Here:** up to this point, we see the current rally as being justified by improved corporate balance sheets and sustained EPS growth
- **Where Are We Going:** we note several warning signs which lead us to believe that further upside in equities could be limited in the short term

Week In Review:

North American stock indices began last week near record highs, but continuing geopolitical tensions, Argentinean debt concerns, a growing Portuguese banking crisis and mixed US economic data gave investors some pause. The TSX finished last week down 1.48% and the S&P 500 was down 2.71%.

- US Payrolls last Friday showed employers added 209,000 jobs for the month of July. While it was the sixth month in a row of 200,000+ job additions, July came in below expectations of 230,000 and well below an upward revised 298,000 print for June. Wages remained unchanged and while the unemployment rate rose slightly to 6.2% from 6.1%, it potentially indicates more people starting to look for work again.

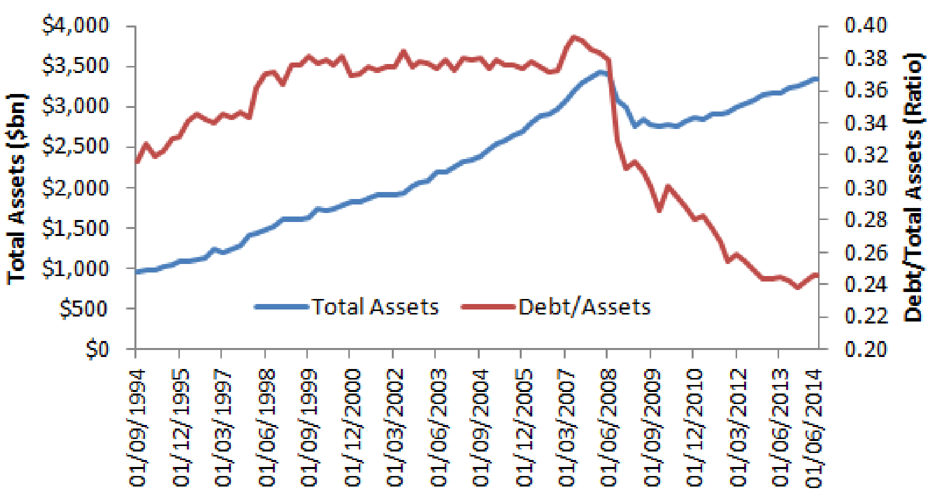
- Argentina missed a $539 million interest payment on July 30th and was the first nation to trigger default swaps since Greece restructured its debt in 2012. A sovereign debt default appears ominous for global markets but traders may be taking it in stride because Argentina actually made the payment to its bond trustee, but the trustee was unable to legally release the funds without a resolution of a dispute with the country and hedge funds lead by Elliot Management which sued Argentina for $1.5 billion.

• One of Portugal's largest lenders, Banco Espirito Santo, reported a record US$4.8 billion first half loss last week fueled by loan losses to its parent companies in the Espirito Santo Group which have filed for creditor protection. The loss cut the bank's Tier 1 capital ratio to 5%, well below the 7% minimum set by the country's regulator and meant the lender needed to immediately raise capital to shore up its balance sheet and comply with regulators. However, because of the precipitous fall in the Banco Espirito Santo's shares last week, Portugal's central bank was forced to step in and rescue the lender over the weekend. This crisis for now appears contained, but the broader concern for investors (especially last Friday) was the potential for it to spread to peripheral nations like the Greek debt crisis did in 2012.

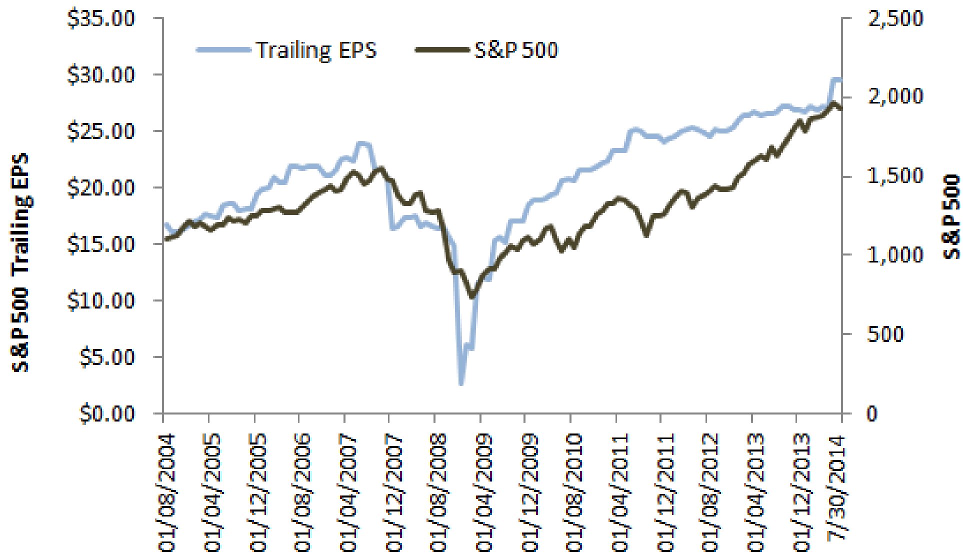
How Did We Get Here:

Last week, the TSX touched an all-time high of 15,524 (a rise of 75.8% since March 2009). The week before that, the S&P 500 touched an all-time high of 1,987 (a 108.9% rise since March 2009). MSNBC might call this the most hated bull market of recent memory, but we view the gains seen thus far as justified and fueled primarily by improved corporate balance sheets and EPS growth.

• **Improved Balance Sheets:** Since the financial crisis of 2008, companies have notably improved their balance sheets. At its peak, debt used to comprise nearly 40% of the capital structure of S&P 500 companies, but has since dropped to around 24%. Despite the fall in corporate debt levels, total balance sheet asset holdings have recovered to 2008 levels. Given that companies are now more liquid and much better equipped to withstand another downturn, it in part explains some of the share price gains we've seen.



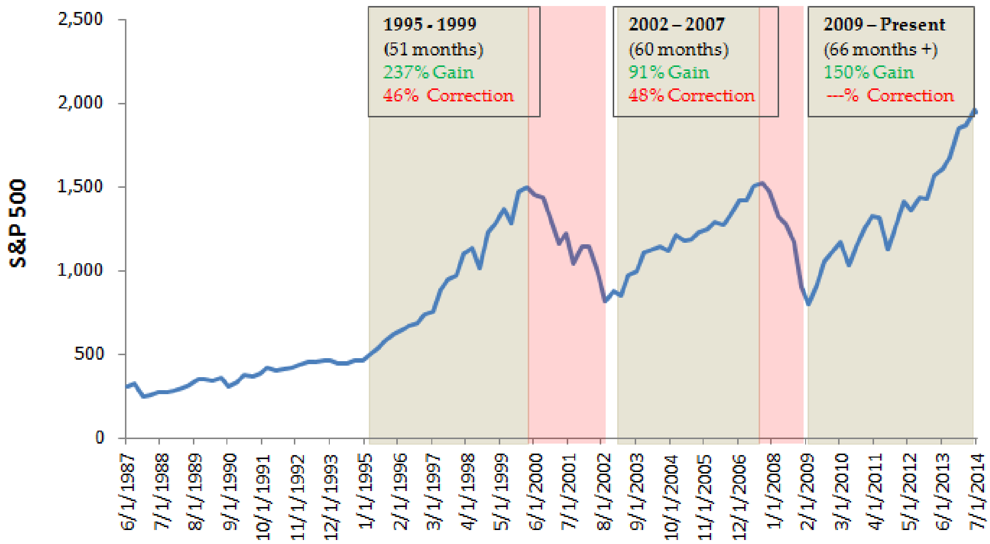
• **EPS Growth:** From our perspective, there is a clear correlation between the rise in the S&P 500 and the rise in Earnings Per Share (EPS). From its trough in early 2009 to today, S&P 500 Trailing Quarterly EPS have risen from $5.83 to $29.57. Although somewhat enhanced by corporate share buy-backs, we view higher EPS levels as indicative of improved profitability for companies and shareholders. We view EPS growth as the primary fundamental catalyst justifying the share price returns we've seen in this current bull market.



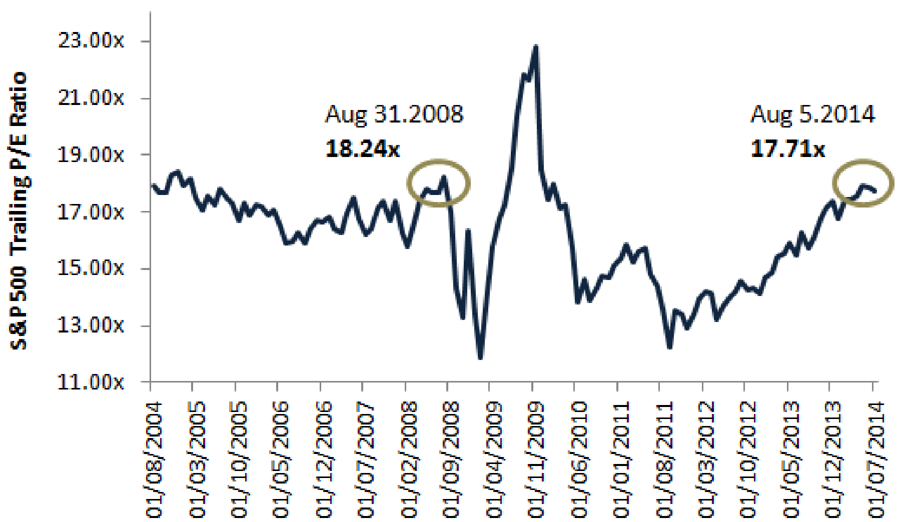
Where Are We Going:

While we view current bull market gains as being justified by EPS growth and improved corporate balance sheets, the extended length of this bull market cycle, valuation levels and trading indicators make us more cautious of continued gains going forward.

- **Bull Market Cycle Starting To Look Stretched:** The current bull market began in February 2009 and has stretched to 66+ months, providing ~150% in gains so far during this period. The previous two bull market cycles lasted between 51-60 months providing between 91%-237% in gains from trough to peak. The previous two bull markets ended with corrections between 46%-48%. While we view a major correction as less likely, we view what is now a 66+ month bull market as a headwind for continued gains.

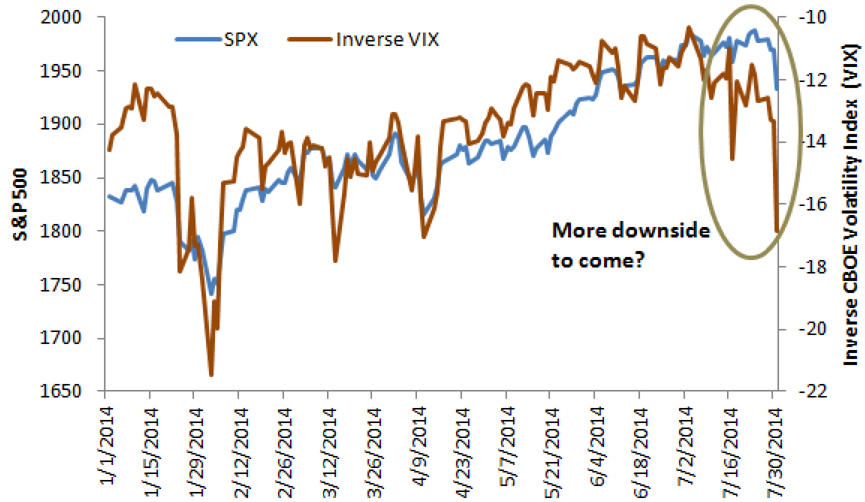


• **Valuations Nearing 2008 Levels:** While we view the rise in EPS we've seen over the last 5 years as meriting higher equity prices, we are beginning to get cautious at the pace at which shares have risen relative to EPS. We note that the current trailing Price to Earnings Ratio for the S&P 500 is approaching 2008 levels. Given that broader economic conditions are still mixed (a stronger economy could be a catalyst for elevated valuations), we view current valuation levels not necessarily as overvalued but approaching fair value.



• **VIX Signalling Near Term Downside For Equities:** The CBOE Volatility Index (VIX) measures implied volatility of near money S&P Options. Practically speaking, the VIX can be viewed as the cost to insure against a fall in equity prices. We have provided a chart below of inverse VIX (VIX and equities move in opposite directions) and S&P 500.

The notable gains in the VIX over the last two weeks indicate to us further downside potential for equities in the short term.



Market Snapshot

At close on Friday, August 1, 2014

S&P TSX	15215.26	-115.48	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	1000.63	-0.89	Canadian $ (US cents)	91.62	-0.0009	90 Day T-Bill	0.939	0.02
DJIA	16493.37	-69.93	Gold (Spot)-US$	1293.61	+11.02	2-Year Bond	1.07	0.47
S&P 500	1925.15	-5.52	Oil (WTI-Sept.)	97.62	-0.56	10-Yr.Bond	2.11	2.49
NASDAQ	4352.64	-17.13	CRB Index	292.48	-1.96	30-Yr. Bond	2.65	3.28

Thought for the Day

"All money is a matter of belief."– Adam Smith

DISCLAIMER

IMPORTANT RESEARCH DISCLOSURES

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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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