The Bigger Picture

A weekly snapshot of the markets

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Summary

Chart of the Day: TSX breaks 15,000 for first time in six years; 15,500 – 16,000 seems attainable.
The Week Ahead: FOMC rate decision on June 18; Blackberry reports Q1 results June 19.
Commodity Outlook: Heightened risk premium in crude oil may not last for very long.

Commentary – M&A Mania Setting In

Global M&A activity exceeds $1 trillion in this quarter for first time since Q3 of 2007
Does rising merger activity signal the final stages of this five-year rally?
Elvis Picardo, CFA

Global mergers & acquisitions activity has picked up markedly this year, with YTD deals of $1.9 trillion at the highest level since 2007. The number of M&A deals has surged recently, with activity exceeding $1 trillion so far in Q2 for the first time since Q3 of 2007, but total merger activity is still short of the 2007 peaks. Deals struck last week include –

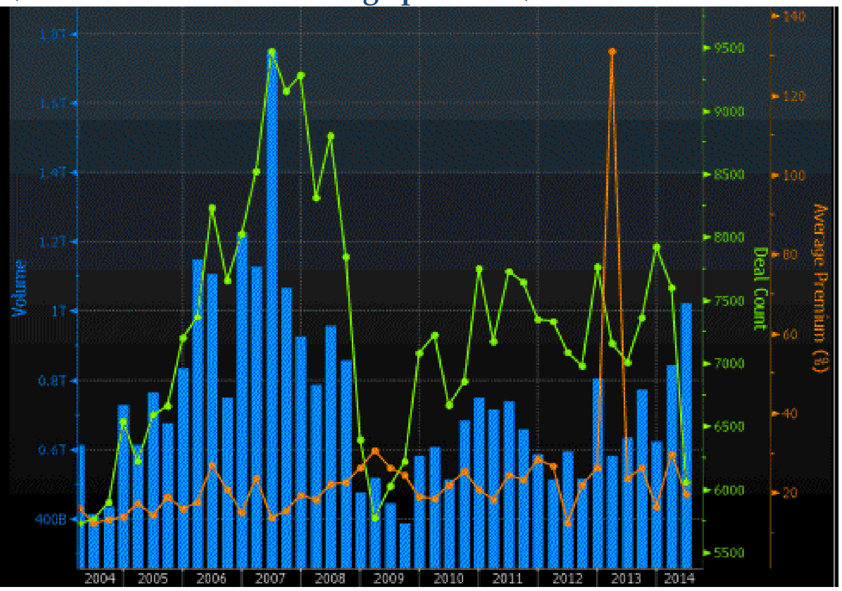
- Merck's acquisition of Idenix Pharma for $3.85 billion or $24.50 per share, almost four times the stock's 30-day average price and the richest premium for a health-care deal;
- Priceline's purchase of OpenTable for $2.6 billion or $103 per share in cash, a 53% premium to the stock's 20-day average price, the highest for a deal involving a North American Internet company since 2007;
- Amaya Gaming's acquisition of privately-held PokerStars for $4.9 billion to create the largest publicly held online gambling company.

Other large deals in the pipeline include Valeant Pharma's hostile $54-billion bid for Botox-maker Allergan, and General Electric's $17-billion offer for Alstom SA's energy assets. While we have posited previously that runaway merger activity could mark the final phase of this massive global equity rally, M&A activity does not seem to be at that stage yet. For one thing, the average deal premium of 19.52% is well within the range of the past 10 years (Figure 1). For another, the average deal size so far this year is about $170 million, well above the norm in recent years and even above the average deal size of $160 million in the first two quarters of 2007, which means that the companies engaged in recent M&A activity are larger and better capitalized. **The final, maniacal phase of M&A activity may still be a few months away, but in the interim, we expect heightened merger activity to be market-supportive**.

Figure 1: Global M&A Activity (with total deals and average premium) – 2004 to Present

11) Industry View
12) Region View
13) Overview

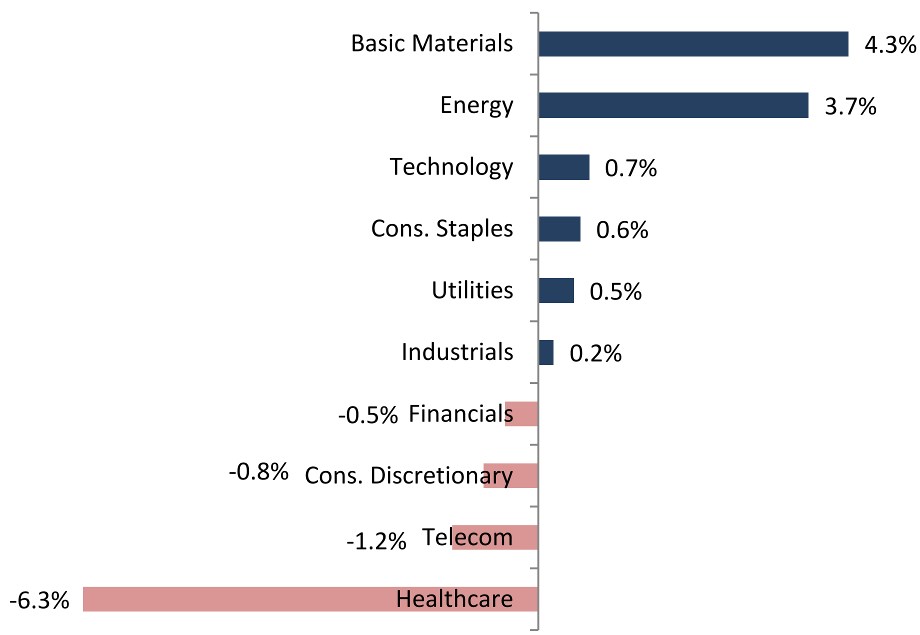
Period	Deal Count	Volume	Average Premium
2014 Q2	6,055	1.02T	19.52%
2014 Q1	7,599	844.47B	29.70%
2013 Q4	7,920	622.07B	16.50%
2013 Q3	7,361	771.94B	26.29%
2013 Q2	7,006	634.41B	23.58%
2013 Q1	7,159	580.40B	131.15%
2012 Q4	7,766	802.98B	26.33%
2012 Q3	6,978	515.65B	21.81%
2012 Q2	7,084	593.46B	12.28%
2012 Q1	7,332	511.42B	26.80%
2011 Q4	7,344	584.99B	28.35%
2011 Q3	7,645	657.54B	23.31%
2011 Q2	7,731	737.39B	24.49%
2011 Q1	7,170	714.49B	18.16%
2010 Q4	7,753	749.23B	20.67%
2010 Q3	6,859	683.22B	25.26%
2010 Q2	6,669	511.44B	21.82%



Source: Bloomberg

TSX Sector Watch (Source: Bloomberg)

Weekly change for TSX sectors (week ended June 13, 2014)



The escalating violence in Iraq caused crude oil futures to surge 4.1% and gold to rise 1.4% last week. As a result, the Materials and Energy groups led the TSX, with double-digit gains posted by a number of gold and energy producers. Valeant led the Healthcare index lower.

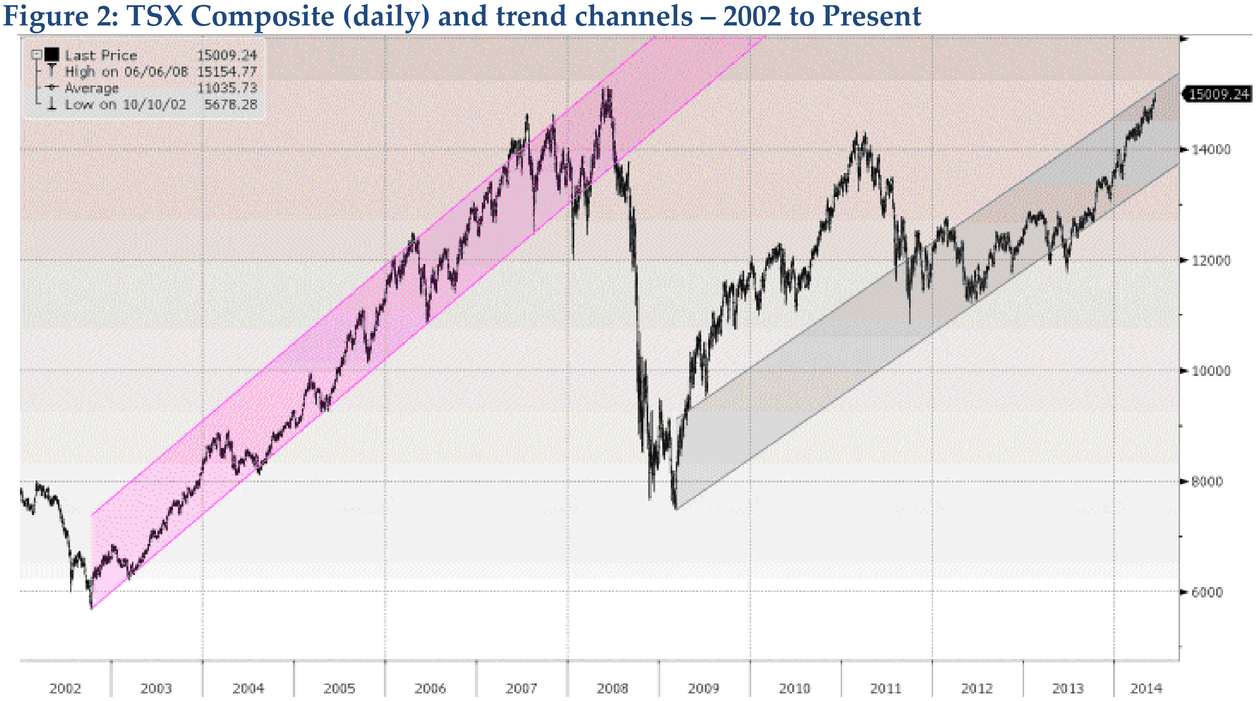
Chart of the Day

TSX cracks 15,000 barrier for first time since June 2008

We believe TSX gains are more sustainable this time; index may set a new record imminently

The TSX closed above 15,000 on Friday for the first time since June 2008. The Canadian benchmark is now +10.1% YTD and +22.2% over the past year, outperforming the S&P 500 by about 5.4 and 3.9 percentage points respectively over these periods. The TSX advance is being led by the surging Energy group (+20.0% YTD, +31.5% past year), and Industrials (+10.7% YTD, +33.3% past year). <u>In our opinion, the TSX advance looks much more sustainable this time than it did in June 2008, when the index was reaching new highs even as the global macroeconomic environment was rapidly deteriorating</u>. As can be seen from Figure 2, the TSX ascent from the lows of October 2002 to the highs of June 2008 was at a slightly steeper angle than the current advance. <u>That's because this advance was significantly moderated by the 24% plunge endured by the index in 2011, after its parabolic 91% surge within two years of hitting multi-year lows in March 2009</u>. The TSX is trading at 16.2x forecast FY14 EPS of $925 – which is comparable with the S&P's forward P/E of 16.4x – but that forecast is predicated on 24% earnings growth for the TSX, compared with just above 8% for the S&P 500. While earnings forecasts for the TSX are rebounding as the global economy strengthens, whether those estimates are too optimistic remains to be seen. In any case, the TSX has a great deal of room to make up in comparison to the S&P 500, which has soared 24% past its 2007 high. **While our view is that a level of 15,500 to 16,000 now seems attainable for the TSX in the months ahead, we advocate a degree of caution as the index edges up into uncharted territory**.

Figure 2: TSX Composite (daily) and trend channels – 2002 to Present



Source: Bloomberg

The Week Ahead

Economy Watch

All eyes on the Federal Reserve

- **FOMC rate decision on June 18 at 11:00 PST** – The FOMC rate decision this week has assumed even greater importance than it normally does, as investors speculate the Fed may be poised to raise interest rates sooner than forecast. Speculation picked up steam after Bank of England Governor Mark Carney signalled last week that the BoE may raise its key interest rate earlier than markets anticipate. The US Treasury yield curve last week approached the flattest level in almost five years, with the difference between five-year and 30-year yields contracting to a low of 168 basis points, the smallest since September 2009. Expect the Fed to stay the course for now, as incoming data have been somewhat mixed – while May payroll numbers were robust, economic indicators released last week including retail sales, wholesale prices and consumer confidence were all on the softer side.

Stocks to Watch

Blackberry, Federal Express, Amazon.com,

- **Blackberry (TSX:BB, $8.57) reports fiscal Q1 results June 19** – Blackberry reports Q1 results on Thursday, with the consensus estimate calling for a loss of $0.26 per share. CEO John Chen said last month that the odds of turning around the company have risen to 80:20, which is much higher than the 50:50 odds he had assigned to a recovery when he was appointed CEO in November 2013. Chen said in April that he was giving the company six to eight quarters to replace sliding hardware sales with higher-margin software revenue. Research firm IDC estimates that Blackberry's smartphone shipments will plunge 50% this year to about 9.7 million, giving it only 0.8% of the global market. Its operating system accounted for 1.9% of the global market in 2013, only one-tenth of the 19% it had as recently as late-2010.

- **Federal Express (NYSE: FDX, $140.27)** – FedEx reports fiscal Q4 results on Wednesday, with the consensus EPS estimate at $2.36. FedEx has a 10% weight in the Dow Jones Transportation Index and is widely considered to be a bellwether stock that provides an accurate reading on the US economy.

- **Amazon.com (NASDAQ: AMZN, $326.27)** – The online retailing giant is reported to be planning the debut of its first smartphone in Seattle.

- **Markit Ltd. IPO** – Financial information provider Markit is seeking to raise $1.14 billion in an IPO, which would value it at $4.5 billion. Expected to list on Nasdaq under the symbol MRKT and commence trading on June 19.

Commodity Outlook

Heightened risk premium in crude oil may not last for very long

WTI futures rose 4.1% and Brent crude surged 4.4% last week, their biggest gain this year, as the rapid advance of Islamist fighters in Iraq triggered concerns the nation may slide back into civil war. The previously little-known group known as Islamic State in Iraq and the Levant (ISIL) overran Iraqi army positions in Mosul – Iraq's second-largest city – last week and rapidly advanced on Baghdad. ISIL fighters forced a halt to repairs from the Kirkuk oil field to Ceyhan in Turkey when they captured Mosul, and there are conflicting reports about whether Baiji – the site of Iraq's biggest refinery – may have fallen as well. Iraq is the second-biggest oil producer in OPEC, and produced 3.3 million barrels per day of crude last month. However, the fighting has not yet spread to the south of Iraq, where three-fourths of the nation's oil output is located. Notwithstanding Iraq's importance to the global oil market and the growing risk of supply disruptions, we remind our readers that surging risk premiums in oil prices arising out of geopolitical events seldom last for very long. <u>Given the fluidity of the Iraq situation, it makes sense to retain overweight energy exposure for now, but add positions only on a selective basis</u>.

Figure 3: Map of Iraq Source: www.lonelyplanet.com

Market Snapshot

At close on Friday, June 13, 2014

S&P TSX	15001.61	+91.98	Commodities			Yields (%)	Can.	US
TSX Venture	997.33	-0.64	Canadian $ (US cents)	92.12	0.00	90 Day T-Bill	0.92	0.03
DJIA	16775.74	+41.55	Gold (Spot)-US$	1276.89	+3.44	2-Year Bond	1.09	0.45
S&P 500	1936.16	+6.05	Oil (WTI-July)	106.91	+0.38	10-Yr.Bond	2.31	2.60
NASDAQ	4310.65	+13.02	CRB Index	309.98	+1.37	30-Yr. Bond	2.83	3.41

Thought for the Day

"I'm attracted to soccer's capacity for beauty. When well played, the game is a dance with a ball." – Eduardo Galeano (Uruguayan writer)

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