# The Bigger Picture

## A weekly snapshot of the markets

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## Summary

**Economic Analysis:** June was the fifth straight month of 200,000+ job gains for U.S. economy.
**Chart of the Day:** Shiller's CAPE ratio for S&P 500 now at 26.06, nearing 2007 high of 27.54.
**Investment Ideas:** Two mid-cap stocks with above average dividend yields – Valener and AGF.

## Commentary – So what could sink this record rally?

*An assessment of risk factors is necessary as we move further into uncharted waters*
**Elvis Picardo, CFA**

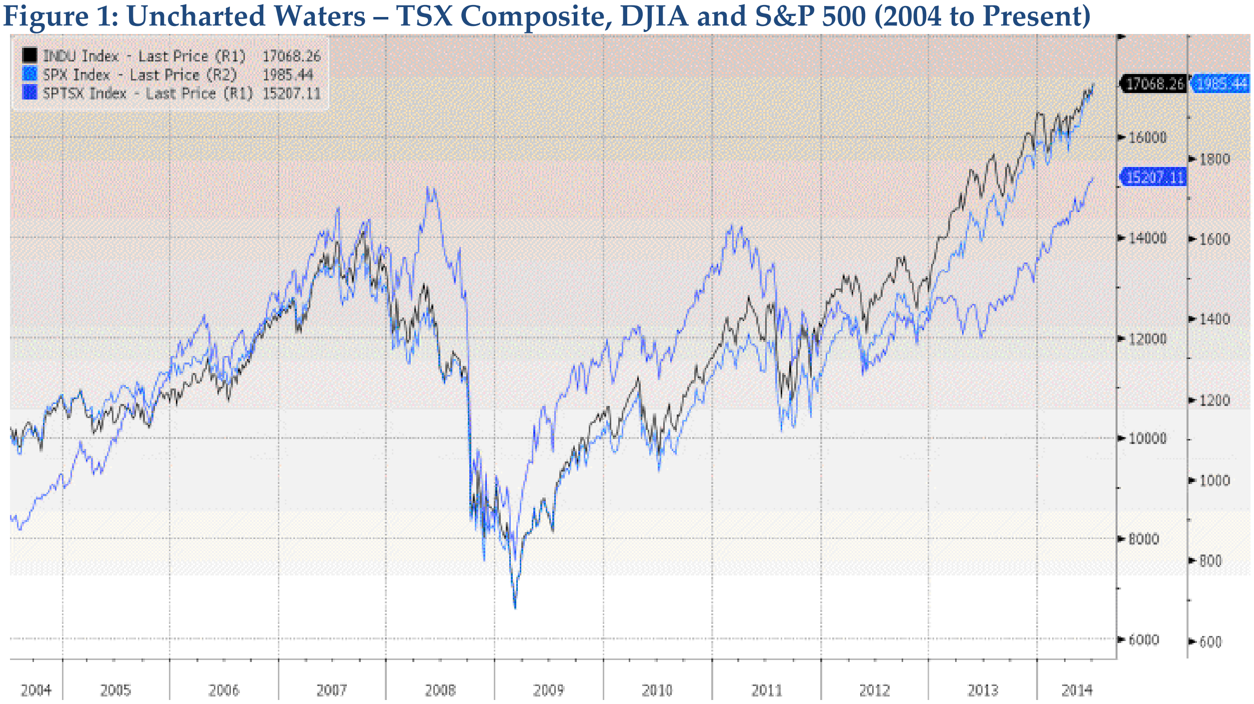
After posting record closing highs on a few days last month, the TSX finally breached its intra-day record of 15,154 (set in June 2008) last week, trading above 15,200 with a measure of conviction. The TSX has now joined the S&P 500 and Dow Jones Industrial Average in uncharted waters (Figure 1). While it has been relatively smooth sailing for U.S. indices since they breached their 2007 highs and broke through into new territory more than a year ago, we believe an evaluation of risk factors is necessary to assess whether global markets sink or swim going forward. Here are three key risks, ranked in order of their likelihood and market impact –

- **Tighter Monetary Policy**: Central bankers around the world still seem obsessed by the spectre of deflation, rather than the possibility of inflation. However, recent data may be causing market participants to rethink their assumptions of when central banks will commence tightening monetary policy. We saw this in Canada over the past couple of weeks, after a June 20 report showed Canadian CPI rose 2.3% in May from a year earlier. In the U.S. the latest unemployment numbers (see "Economic Analysis" section below) may be causing a similar reassessment, after the jobless rate fell to 6.1% in June, a level that Federal Reserve officials did not expect to see before year-end. <u>As a result, some economists are advancing their forecasts for the Fed's first interest-rate hike since 2006 to Q1 or Q2 of 2015</u>. Note that Fed officials had predicted last month that the federal funds target rate would be 1.13% at the end of 2015 and 2.5% a year later. Not everyone is convinced that the Fed will advance its tightening timetable. This includes bond guru Bill Gross, who thinks lacklustre wage growth that is keeping inflation below the Fed's 2% target will lead it to raise rates slowly and at a below-average pace. Nevertheless, with global central banks' largesse having played a huge role in this rally, we believe the prospect of monetary policy being tightened sooner than expected may represent a key risk for equity markets.

- **Valuations**: Based on estimates compiled by Bloomberg, index EPS for the TSX is forecast to increase 26.3% to $921 this year, which gives it a forward P/E of 16.5x. For the S&P 500, index EPS is forecast to increase 9.5% to $118.54 this year, giving it a forward P/E of 16.8x. On the basis of actual (trailing 12-month EPS), the TSX is trading at a P/E of 20.7x, while the S&P 500 is at 18.2x. Those EPS numbers suggest that the indices may be close to fair value (also see CAPE ratio in "Chart of the Day"), and may not be egregiously overvalued if forecasted earnings growth is achieved. But if earnings growth comes in well below estimates, valuations may become a concern.

- **Geopolitical Risk**: Global equities have taken periodic regional flare-ups in stride so far in 2014, as they have for years now. Pockets of risk continue to exist around the world. In Israel, a fragile truce with Hamas is under threat after the abduction and killing of three Israeli teenagers last month; in Ukraine, government troops have retaken control of the majority of districts in the war-torn east; and in Iraq, the gains made by the ISIS (Islamic State of Iraq and Syria) militia in northern and western Iraq may reshape the boundaries of that embattled nation. But unless these conflicts threaten to spread to a broader arena, they may pose little threat to global equity markets.

**Figure 1: Uncharted Waters – TSX Composite, DJIA and S&P 500 (2004 to Present)**




**Source: Bloomberg**

# TSX Sector Watch

## YTD change for TSX sectors (period ended July 3, 2014)


**Source: Bloomberg)**

As of July 3, 2014, the TSX was up 11.64% for the year. As we had expected, the index's double-digit gains have been led by the cyclical groups, Energy and Materials. Despite the desire for dividend-yielders, defensive groups like Telecoms and Utilities have lagged the advance. Overall, the broad participation in the TSX advance – with all 10 sectors up for the year – and the improving outlook for the global economy bode well for additional gains.

# Economic Analysis

## Strong gains in U.S. jobs cause unemployment rate to dip to 6.1% in June

The U.S. economy added 288,000 jobs in June, well above economists' average forecast of 215,000, while payroll increases for April and May were revised higher by a total of 29,000. The unemployment rate fell to 6.1% (from 6.3% in May), the lowest since September 2008, despite the labour force increasing by 81,000 as more people looked for work. The participation rate was unchanged at 62.8%.

Other labour market metrics showed similar improvement. The number of long-term unemployed (jobless for at least 27 weeks) fell to a five-year low of 32.5% of total unemployed, compared with 34.6% in May. The U-6 underemployment rate fell to a multi-year low of 12.1%; average hourly earnings rose 2.0% over the past year to $24.45.

U.S. job growth continues to be driven almost wholly by the private sector, although government jobs did contribute 26,000 positions or 9% of total job creation in June, compared with nil in May. In the private sector, job growth continues to be especially strong in service industries such as professional & business services, education & health services, retail trade and leisure & hospitality.

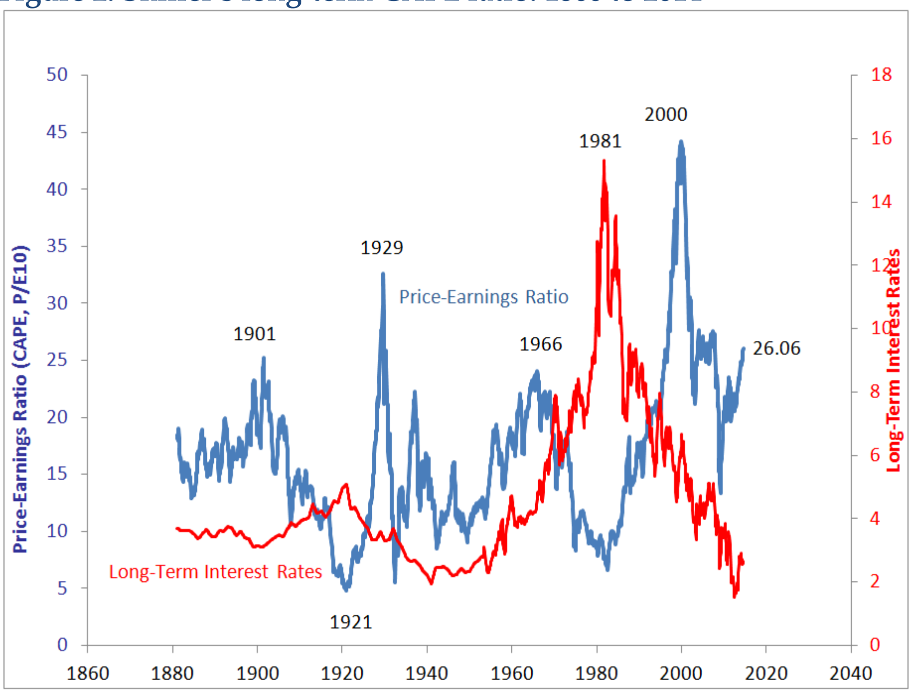
With June the fifth straight of 200,000+ job gains for the U.S., optimism for an economic rebound over the rest of 2014 from the weather-induced Q1 slowdown seems justified.

# Chart of the Day

## Robert Shiller's CAPE ratio approaching 2007 high of 27.54

Robert Shiller's cyclically adjusted P/E (CAPE) ratio uses real per-share earnings over a 10-year period instead of 12-month EPS, thus eliminating earnings fluctuations caused by variation in profit margins over a business cycle. The CAPE ratio for the S&P 500 – which closed at a new record of 1,985.44 on Thursday – was last at 26.06, compared with 24.86 at the beginning of the year. The ratio is approaching a 10-year high of 27.54 reached in May 2007, but is still well away from the "bubble" peak of 44.20 seen in December 1999.

**Figure 2: Shiller's long-term CAPE ratio: 1860 to 2014**




**Source: Robert Shiller, Yale University**

# The Week Ahead

## Economy Watch

- **July 9: Federal Reserve releases minutes of June 17-18 FOMC meeting**.
- **July 11: Canadian jobs data** – Canada is expected to have added 26,000 jobs in June (+25,800 in May), with the jobless rate expected to remain unchanged at 7.0%.

## Stocks to Watch

- **July 8: Alcoa kicks off earnings season –** Alcoa reports Q2 earnings after market close on Tuesday, July 8. The consensus EPS forecast is 12 cents. Alcoa is up 41% YTD, and has almost doubled over the past year.

## Investment Ideas

### Two mid-cap stocks with above-average dividend yields

**Valener (TSX: VNR, $15.81, market cap $600 million, dividend yield 6.3%)** – formerly known as Gaz Metro LP – has an economic interest of about 29% in Gaz Metro. Gaz Metro has more than $5 billion in assets; it is the largest natural gas distribution company in Quebec, and is also a power producer and distributor of gas and electricity to more than 300,000 customers in Vermont. Valener also owns a 24.5% indirect interest in the Seigneurie de Beaupre Wind Farms developed with Gaz Metro and Boralex; the 272-MW Phase I unit has been in service since December 2013.

Valener's portfolio is well diversified by geography and business segment. Utility stocks like Valener have fared well over the past year due to the prevailing low interest-rate environment, although they have periodically been affected by concerns about rising rates. In fiscal Q2 ended March 31, Valener reported net income of $29.1 million or $0.77 per share, up 21% from a year ago. The company benefited from higher natural gas and electricity deliveries in Quebec and Vermont, operating synergies, and the weaker Canadian dollar.

Valener pays a quarterly dividend of $0.25, for an indicated yield of 6.3%. The stock's beta (vs. the TSX) of 0.37 indicates that it exhibits little price volatility.

Our second idea is **AGF Management (TSX: AGF/B, $12.58, dividend yield 8.6%)**, one of Canada's leading investment management firms. AGF is a riskier play than Valener, as it is more volatile (beta = 1.12) and is more leveraged to the economic cycle.

While the stock has been affected by huge retail outflows, the situation seems to be stabilizing, as net redemptions were 17% lower in fiscal Q2 (ended May 31) from a year earlier. Total assets under management (AUM) as of June 30 amounted to $36.2 billion, up 0.8% from May and marginally lower from $36.3 billion a year ago.

The company reported Q2 EPS from continuing operations of $0.17, compared with a loss of $0.12 a year ago. Excluding one-time charges, EPS rose 31% in the quarter. Revenue from continuing operations fell 6% from a year ago to $119.1 million.

AGF could benefit from renewed retail investor interest in the current favourable environment for equities. With a market cap of only $1.1 billion, the stock could also be a takeover target for a larger institution. AGF pays a quarterly dividend of $0.27 and is a member of the S&P Canadian Dividend Aristocrats index.

## Short Takes

- **Feel like jolting yourself out of boredom? You are not alone**: A study conducted by the University of Virginia found that two-thirds of men and a quarter of women would prefer to give themselves mild electric shocks rather than sit quietly for a few minutes with nothing to do. Researchers initially asked a group of 146 college students to sit in an empty room without any distractions including books and mobile phones. The students were instructed to simply remain in their seats, stay awake and entertain themselves with their own thoughts for 6 to 15 minutes. Most students reported that their minds wandered or that they were bored. The researchers then evaluated whether volunteers would prefer an unpleasant activity like an electric shock to no activity at all. When participants were left alone in a room with access to a device that would deliver an electric shock from a 9-volt battery, 12 men or 67% of the group and 6 out of 24 women gave themselves between one and four shocks, giving new meaning to the phrase "jolting oneself out of boredom."
- **Doritos launches "Roulette" chips**: PepsiCo recently launched its "Doritos Roulette" chips, in which most of the chips are the usual nacho cheese flavoured but a few are "insanely hot", according to those who have tried them. As with anything of this nature, the chips have become an online sensation, with hundreds of people posting videos of themselves consuming the chips on YouTube.
- **China bans insurers from selling "World Cup Heartbreak Insurance**": China's Insurance Regulatory Commission announced last week that it would ban insurance companies from developing and selling products related to gambling. The ban came after An Cheng Insurance sold "heartbreak insurance" to lessen the sting for soccer fans whose favourite teams faced an early exit from the World Cup. Another insurance company, Zhong An, continues to sell World Cup-related insurance products like "Soccer Hooligan Insurance," "Foodie Insurance" (for sudden stomach ailments) – and even "Getting Drunk Insurance" – as these are not associated with gambling.

## Market Snapshot

**At close on Friday, July 4, 2014**

| **S&P TSX** | 15214.96 | +7.85 | **Commodities** | | | **Yields (%)** | **Can.** | **US** |
|---|---|---|---|---|---|---|---|---|
| **TSX Venture** | 1037.76 | -0.03 | Canadian $ (US cents) | 93.87 | -0.16 | 90 Day T-Bill | 0.92 | 0.01 |
| **DJIA** | 17068.26 | Closed | Gold (Spot)-US$ | 1320.55 | +1.02 | 2-Year Bond | 1.13 | 0.51 |
| **S&P 500** | 1985.44 | Closed | Oil (WTI-Aug.) | 103.77 | -0.29 | 10-Yr.Bond | 2.33 | 2.64 |
| **NASDAQ** | 4485.93 | Closed | CRB Index | 306.74 | -0.40 | 30-Yr. Bond | 2.84 | 3.47 |

## Thought for the Day

"There is a coherent plan in the universe, though I don't know what it's a plan for."
– Fred Hoyle

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