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INVESTMENT STRATEGY

2014 OUTLOOK & PORTFOLIO STRATEGY

TSX may outperform S&P 500 in 2014 for first time in four years

End-2014 targets: TSX 14,400, S&P 500 1,895

Canada "Uncool" no longer as prospects improve next year

December 17, 2013
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Index Levels	
TSX	13184.41
TSX-Venture	890.66
DJIA	15884.57
S&P 500	1786.54
Nasdaq	4029.52
MSCI World	1,598.21
Risk Metrics	
VIX	16.03
TED Spread	0.18%
FAIL®	1.07
Interest Rates & Commodity Prices	
Canada T-Bll (90 days)	0.92%
US T-Bill (90 days)	0.06%
Canada 10-yr Govt.	2.67%
US 10-yr. Treasury	2.88%
CRB Index	280.50
Spot Gold	$1241.50
Crude Oil (Jan.)	$97.32
Canadian Dollar	94.38 US cents
USD/Euro	1.3761
USD/JPY	103.05

Priced as at Dec 16, 2013
Source: Bloomberg

- The divergence in global equities that was already apparent at mid-year became more pronounced in the second half of the year. The TSX-Venture index was the worst performer of the 15 indexes we track for the third successive year. The TSX Composite index has fared better, having advanced 5.6% YTD, but lags the S&P 500 by 19 percentage points.
- Canada's golden period has indeed drawn to a close, as we had surmised in last year's Outlook report. But as we look ahead to 2014, we reiterate the view expressed in our June report that the worst is over for the TSX. **We believe that the TSX's exposure to the global economy may enable the index to outperform the S&P 500 for the first time in four years**.
- In our opinion, the Canadian economy is arguably in better shape now that it was a year ago, having emerged from a soft patch in the middle of 2013 and with improving prospects on the horizon.
- The IMF forecasts that the global economy will accelerate to a 3.6% growth pace in 2014, from an estimated 2.9% in 2013. Growth for the advanced economies is forecast to expand at a 2% pace in 2014, up from 1.2% in 2013, driven by a stronger US economy, a reduction in fiscal tightening (ex-Japan), and accommodative monetary conditions.
- **Key risks to our outlook** – disorderly Fed exit from QE; rising bond yields; BRIC issues; Canadian housing correction.
- **Sector Calls – Outperform**: Industrials, Diversified Miners; **Underperform**: Gold Miners, Utilities, REITs, Telecoms; **Market Perform**: Energy, Financials.
- **Our end-2014 index targets: TSX 14,400; S&P 500 1,895**
- **Recommended Asset Allocation: Stocks 65% (no change), Bonds 15% (-2.5%), Cash 20% (+2.5%).**

Charts and Tables – Gint Austrins, Analyst

Please see disclosures at the end of this report

Market Review

TSX lags as global equity markets diverged significantly in 2013

While global equity markets scaled the proverbial "Wall of Worry" with ease last year, 2013 marked a period when some of them slipped back down as investors turned more discerning. The divergence in global equities that was already apparent at mid-year, as noted in our Mid-Year Outlook report of June 26, became more pronounced in the second half of the year. The obvious catalyst for this divergence – speculation about the timing of the Federal Reserve's winding down of its massive quantitative easing (QE) program.

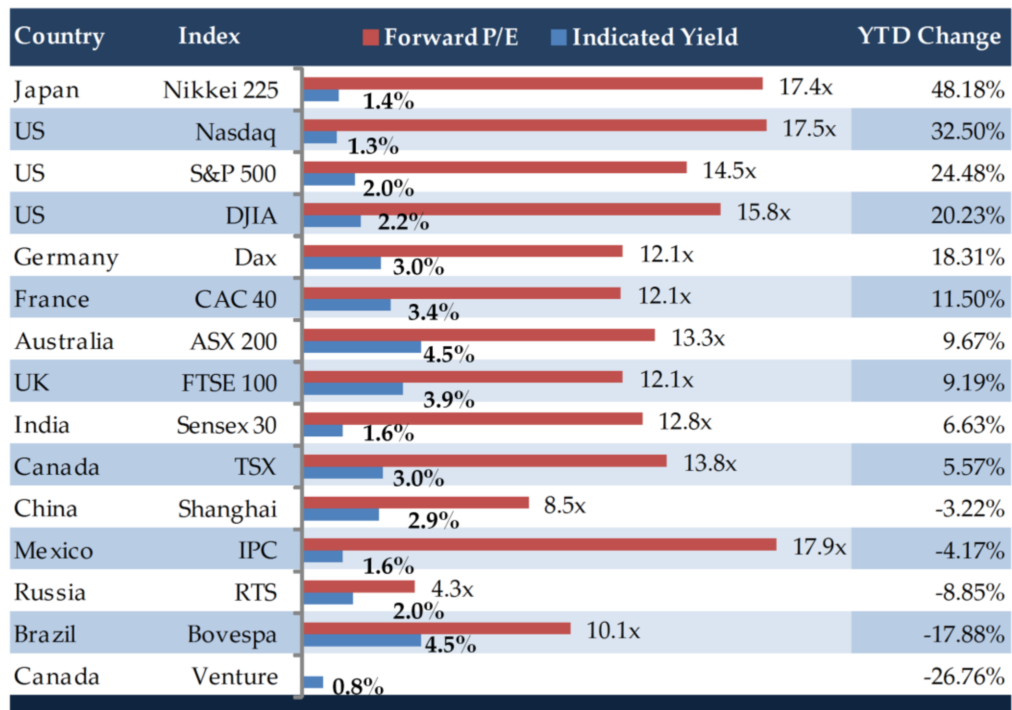
The average 8.4% YTD gain posted by the 15 major markets shown in Figure 1 masks a great deal of variance in individual market returns. The best performer so far this year has been Japan's Nikkei; while "Abenomics" has resulted in the index surging 48.2% YTD, that return is halved in USD terms due to the yen's depreciation. U.S. indexes capture the next few spots for performance this year, led by the Nasdaq Composite's 32.5% advance that has resulted in it trading over 4,000 for the first time in 13 years, while the S&P 500 is on track for its best showing since 2003. European bourses have also had a solid year, led by an 18.3% increase in Germany's DAX index.

At the other end of the performance spectrum, the BRIC giants have been notable laggards, with only India's Sensex in positive territory for the year. However, the TSX-Venture index gets the wooden spoon for the third successive year. The TSX-V has declined 26.8% YTD, after falling 17.7% and 35.1% in the previous two years (although it should be noted that these declines occurred after the index had almost tripled in the preceding two years). The TSX Composite index has fared much better, having advanced 5.6%; however, it lags the S&P 500 by almost 19 percentage points, a margin of underperformance that is almost double its average 10 percentage-points lag of the previous two years.

Canada's golden period has indeed drawn to a close, as we had surmised in last year's Outlook report. That period spanned most of the previous decade, from the start of the commodity boom to the early stages of the recovery from the 2008-09 global credit crisis, when the Canadian economy was first out of the gate. The relative disdain currently for Canadian assets is best summed up in an article last month in *The Economist* titled "Uncool Canada."

But as we look ahead to 2014, we reiterate the view expressed in our June report that the worst is over for the TSX. Given the prospects for faster global economic growth next year and the improvement in risk appetite, we believe that the TSX's exposure to the global economy may enable the index to outperform the S&P 500 for the first time in four years.

Figure 1: Major equity indexes – YTD performance and valuations

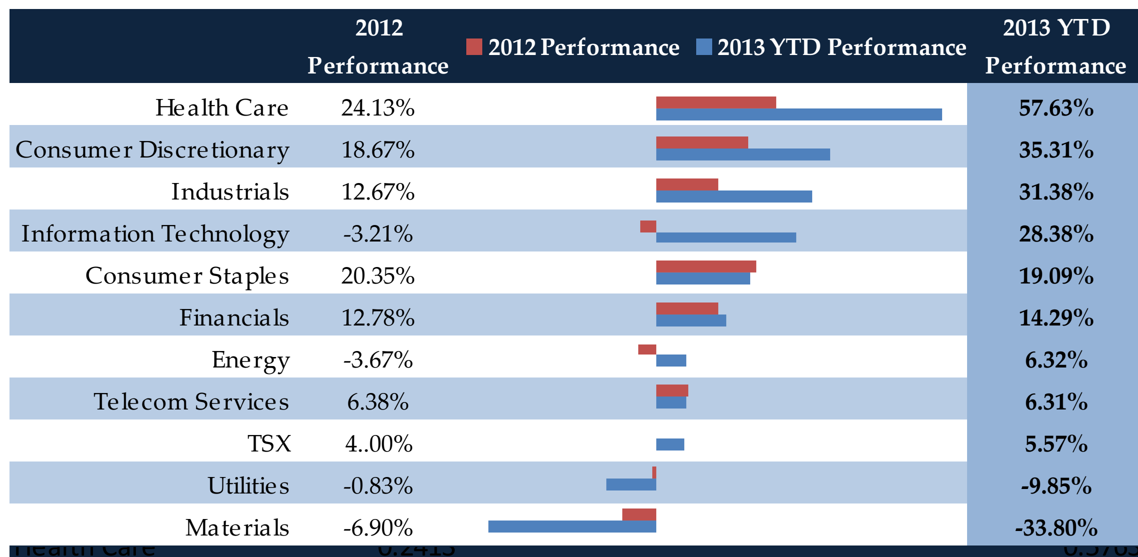


Country	Index	Forward P/E	Indicated Yield	YTD Change
Japan	Nikkei 225	17.4x	1.4%	48.18%
US	Nasdaq	17.5x	1.3%	32.50%
US	S&P 500	14.5x	2.0%	24.48%
US	DJIA	15.8x	2.2%	20.23%
Germany	Dax	12.1x	3.0%	18.31%
France	CAC 40	12.1x	3.4%	11.50%
Australia	ASX 200	13.3x	4.5%	9.67%
UK	FTSE 100	12.1x	3.9%	9.19%
India	Sensex 30	12.8x	1.6%	6.63%
Canada	TSX	13.8x	3.0%	5.57%
China	Shanghai	8.5x	2.9%	-3.22%
Mexico	IPC	17.9x	1.6%	-4.17%
Russia	RTS	4.3x	2.0%	-8.85%
Brazil	Bovespa	10.1x	4.5%	-17.88%
Canada	Venture		0.8%	-26.76%

*Forward P/E based on 2014 estimates

Source: Global Securities Research, Bloomberg

Figure 2: TSX Group Performance – 2012 and 2013 YTD



	2012 Performance	2012 Performance / 2013 YTD Performance	2013 YTD Performance
Health Care	24.13%		57.63%
Consumer Discretionary	18.67%		35.31%
Industrials	12.67%		31.38%
Information Technology	-3.21%		28.38%
Consumer Staples	20.35%		19.09%
Financials	12.78%		14.29%
Energy	-3.67%		6.32%
Telecom Services	6.38%		6.31%
TSX	4..00%		5.57%
Utilities	-0.83%		-9.85%
Materials	-6.90%		-33.80%

Source: Global Securities Research, Bloomberg

Economic Fundamentals

Canada – "Uncool" no longer as prospects improve in 2014

In our opinion, the Canadian economy is arguably in better shape now that it was a year ago, having emerged from a soft patch in the middle of 2013 and with improving prospects on the horizon.

On December 4, the Bank of Canada said while maintaining its overnight rate target at 1% that underlying growth in the Canadian economy was broadly in line with its recent *Monetary Policy Report* projections. In its October MPR, the Bank had forecast real GDP growth of 1.6% in 2013, increasing to 2.3% in 2014 and 2.6% in 2015, with the pickup in the economy expected to be driven by a rebound in contributions from net exports and business investment. The Bank noted in its rate announcement earlier this month that while Canadian real GDP growth of 2.7% in Q3 was stronger than what it expects, its composition did not yet indicate a rebalancing towards exports and investment.

In its *Financial System Review* that was also released earlier this month, the Bank of Canada discussed at length the two most important risk factors to the Canadian economy – specifically, the high level of household indebtedness and imbalances in segments of the housing market. The Bank notes that the ratio of household debt to disposable income (which reached a record 163.7% in Q3 of 2013) has been relatively stable over the past year. As well, the household credit-to-GDP gap has continued to decline, reflecting the marked decline in total household credit growth since 2008, partly due to stricter mortgage insurance rules and underwriting guidelines. The Bank expects imbalances in household credit to unwind gradually, as the high level of indebtedness makes Canadian households more cautious; this caution is reflected in a savings rate that is well above the average of the past decade.

The Bank also said it continues to expect a soft landing in the housing market, although it notes in the FSR that stretched housing valuations and the large number of units under construction could (still) lead to a sharp correction. However, a number of factors support the case for a soft landing –

- While home ownership for the under-35 age group (which accounts for a sizeable share of first-time homebuyers) in Canada has risen significantly since 2001, most of the increase has occurred among higher-income households, which are less risky.
- CMHC data for insured high-ratio mortgages shows that the distribution of credit scores for new borrowers was stable until 2008, and then shifted towards households with higher credit scores.

- Total "non-prime" loans (which are riskier than loans made to prime borrowers) accounted for only about 7% of outstanding mortgages in Canada in 2012, according to CIBC. This is up from 5% in 2005, but is well below the estimated 20% level before the US housing crisis.

The Canadian dollar, currently trading near a three-year low of 94.38 US cents, reflects the general perception that the yield differential between Canadian and US debt instruments will continue to narrow, as BoC Governor Stephen Poloz keeps rates on hold even as stronger US economic growth forces yields higher south of the border. Although the currency has historically had a tight correlation with the TSX Composite, this relationship has broken down this year (Figure 3). While Canada's export juggernauts will welcome the weaker loonie, we think that the historical relationship between the TSX and C$ could reassert itself in 2014. This implies that the loonie could strengthen marginally next year, since it currently trades well within the lower half of its trading range of US $0.92 to US$1.06 since 2010.

Canada's solid financial foundation is underlined by the fact that it remains the only G-7 nation with a top credit rating from S&P and Moody's. While there is little risk of the economy turning red-hot next year, 2014 may be the year when Canada sheds the "uncool" label that it has unfairly been tagged with since 2011.

Figure 3: TSX Composite vs. C$ and Global GDP growth (%) – 2009 to 2013

Source: Global Securities Research, Bloomberg

The U.S. – Back on the growth track

The world's largest economy is looking good as we head into 2014, as the fiscal retrenchment that hindered growth this year eases, and major drivers of the economy such as housing, employment, consumer confidence and manufacturing continue to strengthen. According to the median forecast of economists in a Bloomberg survey, the US economy is expected to expand 2.6% in 2014, compared with 1.7% this year, although some economists are calling for growth of as much as 3% in each of the next two years.

Incoming data continue to suggest robust economic growth. Federal Reserve data released yesterday showed US factory production rose 0.6% last month, after a gain in October that was revised upward to 0.5%. Total industrial production rose 1.1%, the most in a year, while capacity utilization increased to 79% in November, the highest since June 2008. Earlier this month, the ISM manufacturing index advanced to 57.3, the highest since April 2011.

The housing recovery is also gathering momentum, with the latest reading from the S&P/Case-Shiller index showing that the US National Home Price Index rose 3.2% in Q3. The 11.2% increase in the index over the last four quarters is the strongest performance since the housing boom peaked in 2006. Average home prices across the country are now back to their Q2 2004 levels. US employment also continues to be in the sweet spot, albeit a little on the weaker side for this late stage of the recovery, with the US economy adding an average of 193,000 jobs monthly from September to November, while the unemployment rate declined to a five-year low of 7.0% last month.

Some progress has also been made in budget negotiations, with a bipartisan deal announced last on December 10 that would ease automatic spending cuts by about $60 billion over the next two years and reduce the deficit by $23 billion over the next decade. While the deal is very small in scope, it is a step in the right direction in terms of removing a major – and unnecessary – stumbling block for the US economy.

The trillion-dollar question now is exactly when the Federal Reserve will begin tapering down its $85-billlion monthly bond-buying program. It had lost an opportunity to do so in September, when market participants had already braced themselves for Fed tapering. However, the renewed wrangling over the US debt ceiling in subsequent weeks and the two-week government shutdown in October in retrospect proved that the Fed's decision to delay tapering was the right one. While the Fed is now expected to announce a timetable for winding down its asset purchases on December 18 or at the latest by March, it is widely expected to hold off on raising short-term rates until 2015.

Global Economy – Poised to grow faster despite challenges

In its *World Economic Outlook* report released in October, the International Monetary Fund forecast that the global economy would accelerate to a 3.6% growth pace in 2014, from an estimated 2.9% in 2013. For the first time in years, the growth impulse is expected to emanate from the advanced economies rather than emerging markets. Growth for the advanced economies is forecast to expand at a 2% pace in 2014, up from 1.2% in 2013, driven by a stronger US economy, a reduction in fiscal tightening (except in Japan), and very accommodative monetary conditions. Emerging markets are forecast to expand by 5.1% in 2014, up from an estimated 4.5% in 2013. While these growth rates are much faster than those of the advanced economies, they are well below recent highs due to cyclical and structural reasons.

In Europe, the euro zone returned to growth in the second quarter of 2013 after six quarters of recession. The IMF noted that while indicators suggest that economic activity is beginning to stabilize in the peripheral economies and recover in the core economies, unemployment continues to remain high. Overall, the euro zone is forecast to stage a modest rebound in growth next year, with real GDP expanding at a 1.0% pace in 2014 after contracting 0.4% in 2013. Germany is expected to lead the region's growth next year as it expands 1.4%, almost triple its 0.5% growth pace this year.

Asia slowed down in the first half of this year due to a more rapid slowdown in China and supply-side constraints in India. The region was hit by increased financial volatility in recent months with capital outflows in countries such as India and Indonesia precipitated by the imminent turning point in US monetary policy. Nevertheless, the IMF expects growth in Asia to remain solid in 2014, with China expected to post marginally slower growth of 7.3% next year (compared with 7.6% this year), and India forecast to accelerate to a 5.1% pace (from 3.8%), as supply bottlenecks ease and exports strengthen.

With Britain set to expand at its fastest pace in seven years in 2014 and most of the PIIGS nations clambering out of the hole, every major economic bloc is forecast to be in growth mode next year, except for Japan. (The IMF expects growth in Japan to decelerate from 2.0% this year to 1.2% next year because of fiscal stimulus withdrawal and the increase in a consumption tax). **This growth scenario should benefit the TSX Composite, which is a good proxy for global economic expansion as can be seen in Figure 3 on page 5, which demonstrates the positive relationship between the index and global GDP growth**.

Outlook

Confluence of favourable factors, sector rotation may aid TSX in 2014

The TSX is presently virtually unchanged from its closing level on October 21, when we had noted in our Market Bulletin that further gains may be in store for the TSX as the stars finally get into alignment for the index. The index did get to a 29-month high of a little over 13,500 last month, but that technical level has proved to be an area of formidable resistance.

Our bullish outlook from a couple of months ago was based on a favourable confluence of as many as seven factors that could propel the TSX higher, a number of which have already been discussed in this report. These include –

- a substantial decline in macroeconomic concerns;
- global economic growth;
- interest rates on hold for most of 2014;
- a pushback in the Fed's taper plans (although that assessment has since changed);
- an improving Canadian economy;
- upward momentum in corporate earnings (more about that later); and
- last but not least, the possibility of sector rotation into Energy and Materials (which together constitute 37% of the TSX Composite).

The current US expansion is now 54 months old from the time it commenced in June 2009, which is just a little short of the average 58.4-month expansion of 11 economic cycles from 1945 to 209, according to the NBER. However, the three most recent US expansions (Nov.1982-July 1990, March 1991-March 2001, and November 2001-December 2007) have averaged 95 months or almost 8 years each, well above the historical norm. If that pattern of longer expansions holds, then the current expansion may still have room to run, making the current phase a late-stage expansion that is a little away from the cyclical peak.

According to Fidelity Asset Allocation Research, the Energy and Materials groups typically outperform in the late-cycle phase, based on an analysis of US equity market returns from 1962 through 2010. If that's the case, the TSX Materials group may be poised to bounce back from its 33% plunge this year, while the Energy sector may also benefit from faster global growth. Note that the Materials group (+14.9%) is presently the second-best performer on the S&P 500 since end-June, but is second from bottom (-2.8%) on the TSX.

Figure 4: TSX Groups – Forecast EPS Change in 2014 and Valuations

TSX Group	Indicated Dividend Yield	Forward Index P/E**	Forecast EPS Change (%)*
Info Tech	1.0%	19.8x	39.6%
Health Care	0.1%	13.3x	38.9%
Industrial	1.7%	15.8x	26.7%
Energy	3.3%	16.7x	18.5%
Consumer Discretionary	2.2%	13.6x	15.4%
Consumer Staples	1.7%	14.9x	12.8%
TSX	3.0%	13.8x	12.8%
Financials	3.6%	11.5x	8.9%
Telecom Services	4.5%	14.3x	7.5%
Utilities	5.0%	17.4x	7.4%
Materials	2.4%	14.5x	5.4%

* Forecast EPS change in 2014 ** Forward P/E based on 2014 EPS estimates

Source: Global Securities Research, Bloomberg

Earnings Estimates – Setting the bar too high

Our experience over the past years shows that forward index earnings estimates invariably come down over the course of the year, and 2013 has been no exception to this trend. Earnings estimates for the TSX Composite – based on "bottom-up" earnings estimates from analysts for all index constituents – are currently at $845 for 2013 and $953 for 2014. While the 2014 EPS estimate for the TSX is down 6.6% since April, the EPS estimate for 2013 is down by almost twice that number or 12.8% since December 2012.

The question is whether the earnings bar is being set too high for TSX earnings over the next two years, based on the projected growth rate over this timeframe. TSX index earnings declined about 5% in 2012 and grew by an estimated 7% this year, from $790 in 2012 to $845 in 2013. Earnings are projected to rise 12.8% in 2014 to $953, and surge 14% to $1,086 in 2015.

The earnings outlook for the four biggest groups on the TSX – Financials, Energy, Materials and Industrials – for 2014 is somewhat mixed (Figure 4). 2014 earnings growth is forecast to be led by Industrials (+26.7% EPS growth) and Energy (+18.5%), followed by Financials (+8.9%) and Materials (+5.4%).

The performance of the Financials group, which now makes up more than 35% of the TSX, will continue to be critical to the fortunes of the TSX. The big banks are expected to continue delivering solid earnings growth in 2014, while insurance company earnings, which improved substantially this year

thanks to higher bond yields and rising equity markets, are also forecast to grow in 2014. However, REIT earnings are forecast to be a drag on Financial sector earnings for the second successive year, with EPS expected to decline 13.2% in 2014 after plunging by an estimated 47.0% this year.

Energy group earnings may be at risk of downward revision over the year ahead, given the energy glut in the US market and the widening spread between WTI and Canadian crude oil. Canadian crude presently trades at a $28 discount to WTI, compared with $16.75 in June. Pipeline capacity constraints (with Keystone XL approval far from a certainty) may continue to force Canadian crude to trade at a discount. However, the booming crude-by-rail trade, as well as a stronger global economy that may result in triple-digit crude oil, may alleviate some of the downward pricing pressure.

In the Materials group, earnings for the besieged gold group are forecast to decline 9.7% in 2014, after plunging at almost thrice that rate in 2013. Earnings for diversified miners are forecast to rebound 51% in 2014 after plummeting by an estimated 44.4% this year, driven by higher metal prices.

The weaker loonie should provide a temporary tailwind for TSX earnings, especially for sectors like Industrials. Overall, our estimate for 2014 TSX EPS is $925, or about 3% below consensus. As the year progresses, we should get a clearer indication on whether projected EPS growth of 14% in 2015 is achievable, or is destined for sharp downward revision.

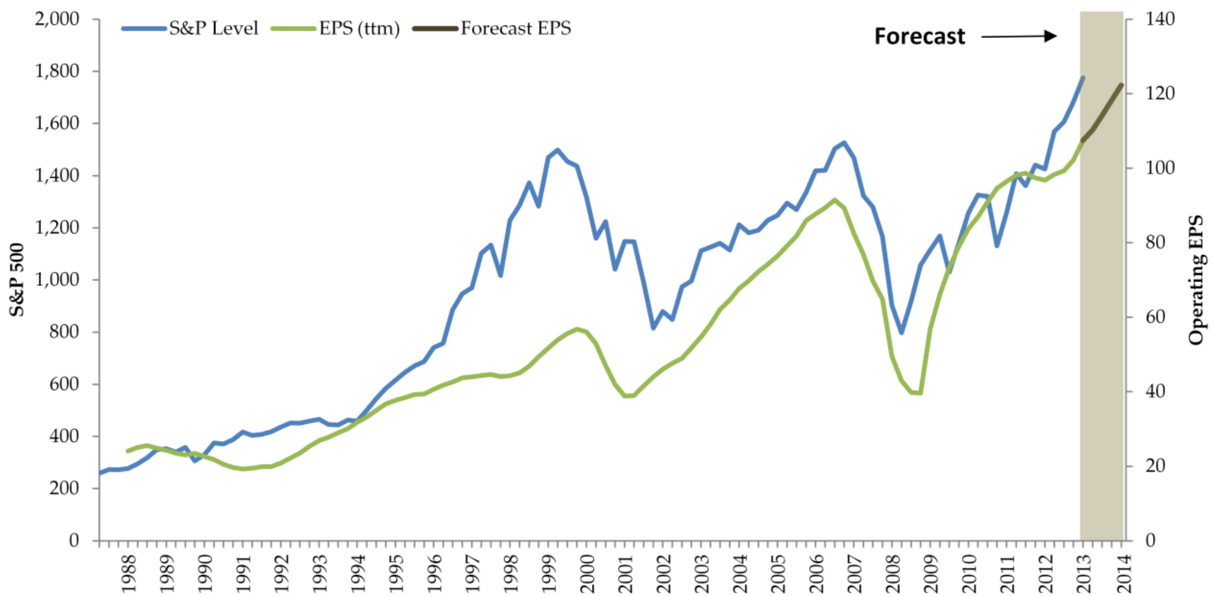
The current 2013 EPS estimate for the S&P 500 is at $107.45 (Fig.5), which is a downward revision of 4.9% over the past year (compared with 12.8% for the TSX). While the 2013 EPS forecast represents growth of 11% from 2012 EPS of $96.82, earnings growth for the index is projected to accelerate further to a 13.8% pace in 2014, when index EPS is forecast at $122.29. 2014 earnings growth for the S&P 500 is expected to be led by the Materials, Telecoms, Information Technology, and Consumer Discretionary groups. The S&P 500 is likely to have exceeded $100 in 4-quarter EPS for the first time in Q3 2013.

Figure 5: S&P 500 Quarterly Operating EPS Estimates

Period	2012-A	% Change	2013-E	% Change	2014-E	% Change
Q1	$24.24	7.4%	$25.77	6.3%	*$28.62*	*11.1%*
Q2	$25.43	2.3%	$26.36	3.7%	*$30.16*	*14.4%*
Q3	$24.00	-5.1%	$26.91	12.1%	*$31.08*	*15.5%*
Q4	$23.15	-2.4%	*$28.41*	*22.7%*	*$32.43*	*14.1%*
Total	**$96.82**	**0.4%**	***$107.45***	***11.0%***	***$122.29***	***13.8%***

Source: Standard & Poor's

Figure 6: S&P 500 vs. 4-quarter op.EPS – 1988 to 2014 (forecast)



Source: Global Securities Research, Standard & Poor's

Valuations – At elevated but reasonable levels

The TSX Composite presently trades at a trailing earnings multiple of 17.4x 12-month EPS of $758, and at a forward multiple of 13.8x 2014 estimated EPS of $953. These valuations are higher than the trailing multiple of 14.6x and forward multiple of 12.8x that the index was trading at a year ago.

Likewise, the S&P 500 presently trades at valuations of 18.0x 12-month EPS of $99.28, and at 14.6x 2014 forecast EPS of $122.29 (compared with 14.4x and 12.7x respectively a year ago).

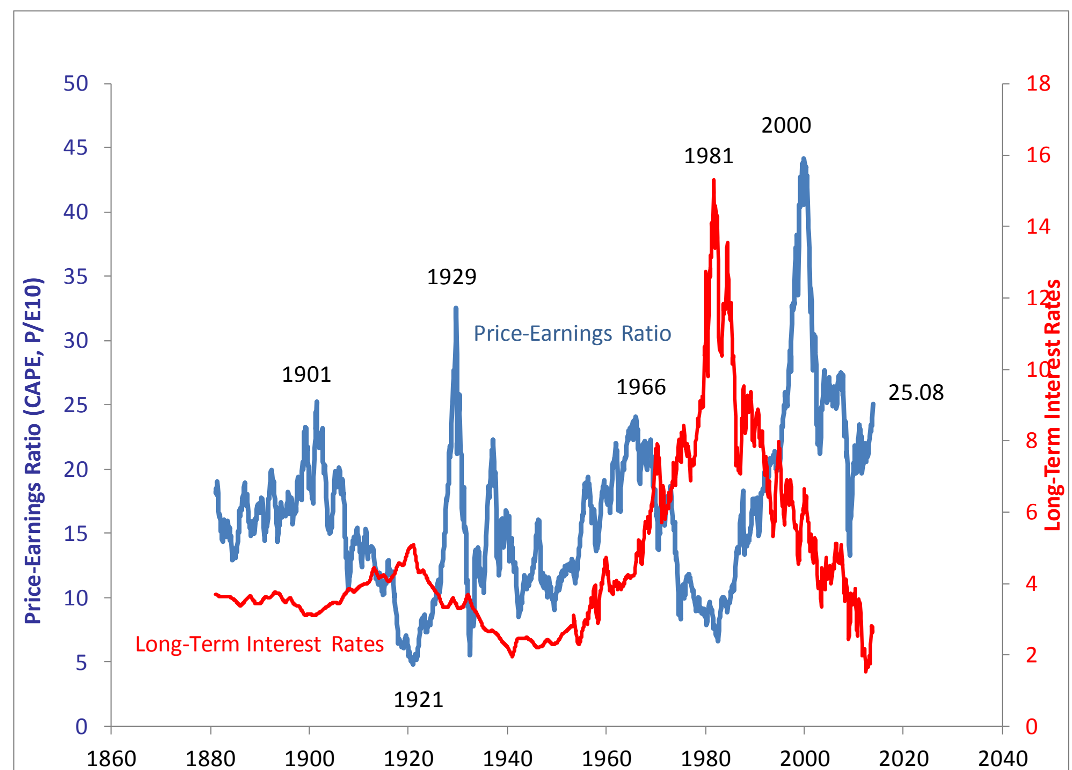
In our opinion, based on expected earnings growth of an average 12%-13% over the next couple of years, an earnings multiple of 15.5x would be appropriate for both indexes, the TSX and the S&P 500. Accordingly, on the basis of a 15.5x multiple applied to our 2014 TSX EPS forecast of $925, our end-2014 target (rounded off) for the TSX Composite is **14,400**. Our target implies upside of 9.2% from current levels, and combined with the index's 3.0% dividend yield, should generate total returns of 12.2% in 2014.

For the S&P 500, a 15.5x multiple applied to the 2014 index EPS estimate of $122.29 resullts in an end-2014 target of **1,895**. This index target implies upside of 6.1%, and combined with an indicated dividend yield of 2%, implies total expected returns of 8.1% in 2014.

How do our end-2014 targets stack up against the consensus? According to a Reuters poll of 40 market analysts, the median TSX end-2014 target is 14,363, so we are within the ballpark. For the S&P 500, the median estimate of strategists surveyed by Bloomberg is for an index level of 1,930 by end-2014, so our target is a little below consensus.

While the TSX still has some way to go before reaching new all-time highs, the S&P 500 has been in uncharted waters for a few months now. The obvious question is whether S&P 500 valuations are inching into "bubble" territory. Judging by Robert Shiller's cyclically adjusted P/E (CAPE) ratio, which uses real per-share earnings over a 10-year period instead of 12-month EPS, the answer is "No," or at least "Not yet." As can be seen in Figure 7, the CAPE ratio was at 25.08 as of November, about 10% away from its highest levels of 27.65 over the past 10 years, and well away from the peak of 44.20 reached at the height of the dot-com mania in December 1999.

Figure 7: Long-term CAPE Ratio: 1860 to 2013



Source: Robert Shiller, Yale University

The S&P 500 is being driven higher by a potent combination of record earnings, hefty dividends, and huge buybacks. S&P index analyst Howard Silverblatt estimates that operating margins for the S&P 500 reached a record 9.63% in Q3, exceeding the previous high of 9.60% set in Q3 of 2006, and may set a new record in Q4. Operating margins are being aided by contained costs for inputs such as labour and raw materials, and with little inflation or upward wage pressures in sight, this favourable environment should continue for a while.

In our June 26 Mid-Year Outlook, we had called for the TSX to outperform the S&P 500 – albeit by a slim margin – over the rest of 2013. The Canadian benchmark did come close to accomplishing this difficult task, having advanced 10.3% from June 26 to December 16, compared with a gain of 11.4% for the S&P 500. Factor in the 1% dividend differential between the two indexes, and the gap between total returns for the two indexes over this timeframe shrinks even further. The TSX may outperform the S&P 500 in 2014 if two basic conditions are fulfilled – one, that the index meets earnings expectations, and two, that risk appetite improves sufficiently for investors to invest in the riskier cyclical groups.

Risks to our Outlook

The key risks that could have a negative impact on our forecasts are summarized below –

- **Disorderly Fed exit from QE**: Concern about the implications of the Fed's proposed move to exit QE roiled financial markets in summer, and could well do so again, weighing down equities.

- **Rising bond yields**: Rising yields may presage higher borrowing costs for consumers and corporations, which could have a negative impact on the economy.

- **BRIC problems**: The BRIC giants – Brazil, Russia, India and China – are all grappling with major issues, and a slowdown in these nations could have a significant effect on global growth.

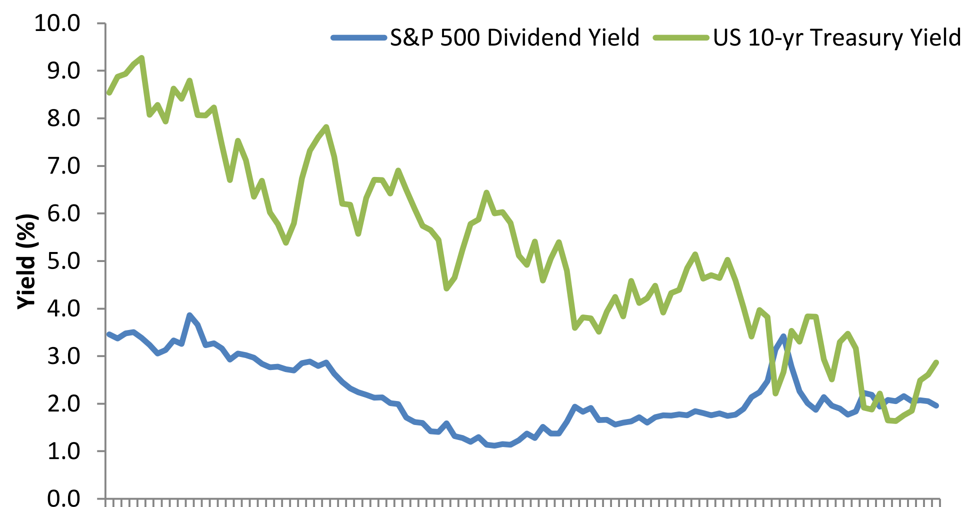
- **Housing correction in Canada:** Although present indications are that the Canadian housing sector is headed for a soft landing, stretched valuations and potential oversupply mean that the risk of a hard landing – while low – cannot be ignored altogether.

Portfolio Strategy

We recommend these portfolio strategies and investment themes for 2014.

1. **Stick with stocks for now**: While 10-year Treasury yields exceed dividend yields in the US, the anomalous reverse situation continues in Canada. The 2.88% yield on the 10-year Treasury exceeds the 1.96% dividend yield on the S&P 500 by 92 basis points (Figure 8), up from 41 basis points in June. In Canada, the 2.67% yield on 10-year Canadas is 33 basis points below the 3.0% yield on the TSX Composite; this gap has narrowed from 76 basis points in June and 115 basis points in December. Given the growth outlook and double-digit total return potential, stocks remain preferable to bonds, especially in a rising yield environment.

Figure 8: S&P 500 div. yield vs. 10-year Treasury yield: 1988 to 2013



Source: Global Securities Research, Standard & Poor's

2. **Add cyclical stocks to the equity barbell**: If this economic cycle has a couple of years before it peaks, it might be an opportune time to add cyclical stocks to the stable dividend payers in your equity portfolio.
3. **Monitor payout ratios for dividend payers**: Many companies with juicy dividend yields have heavy debt loads, and in an environment of rising yields, their dividend payout ratios may deteriorate. Dividend cuts may be in store for financially stretched companies.
4. **Trim exposure to US equities**: In C$ terms, the S&P 500 is about 33% higher from a year ago, which may result in investors having a higher

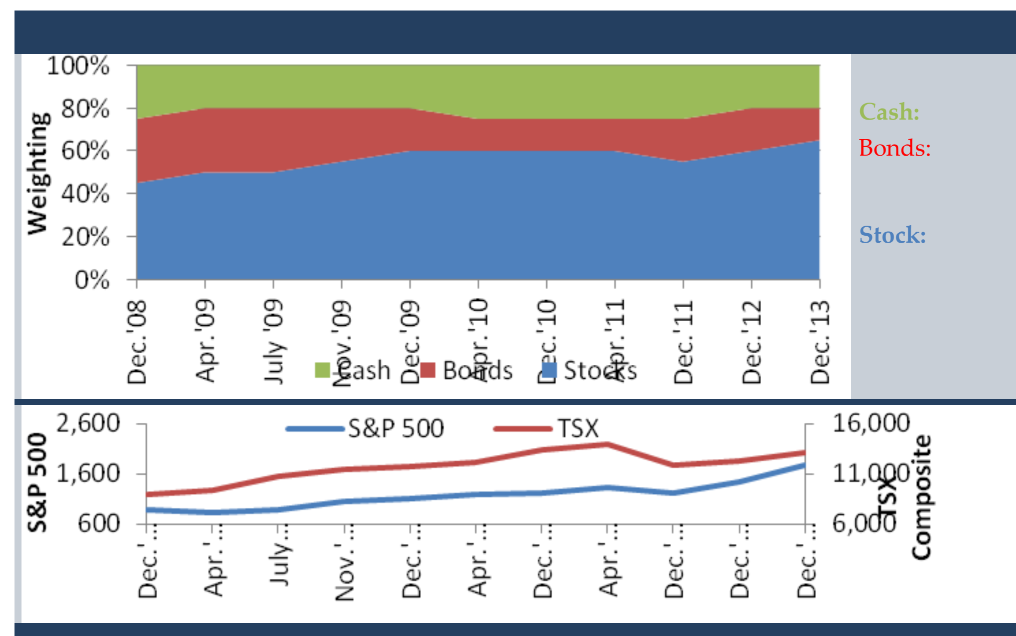
degree of exposure to US stocks than their comfort level. Investors should trim US equity exposure if they are over-weighted in their portfolios in relation to their investment objectives.

5. **Need to be nimble**: The risk-reward payoff deteriorates with every day that equity indexes head higher, especially when they are at record levels. In this environment, investors need to be nimble in order to hedge risk and add alpha.
6. **Use options to hedge risk and speculate**: Our view is that market volatility will rise in 2014 from current depressed levels, which means that going long puts and calls are a relatively inexpensive way to hedge risk and engage in measured speculation.
7. **Sector Calls**: Sectors that could **outperform** the broad market in 2014 – **Industrials, Diversified Miners**
   Underperform – Gold Miners, Utilities, REITs, Telecoms
   Market Perform – Energy, Financials

Asset Allocation

Based on the foregoing analysis, we are leaving the equity allocation in our recommended asset mix unchaged at 65%, while reducing the fixed income component by 2.5 percentage points and increasing the cash component by the same amount. Our recommended asset allocation (Figure 9) is therefore – **Stocks 65%, Bonds 15%, and Cash 20%.**

Fig. 9: Recommended Asset Allocation and changes since December 2008



Source: Global Securities Research

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