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INVESTMENT STRATEGY

2015 OUTLOOK & PORTFOLIO STRATEGY

2015 could be first down year for TSX since 2011

End-2015 targets: TSX 13,500, S&P 500 2,200

Global bull is running out of breath and breadth

December 23, 2014

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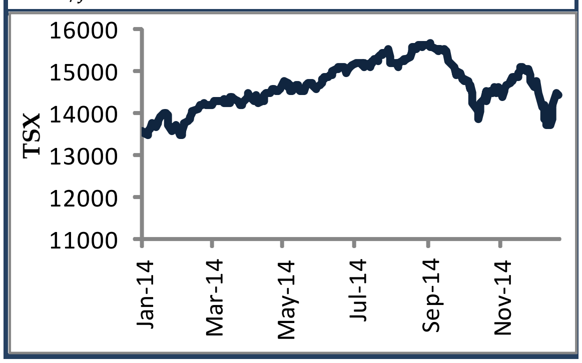
Index Levels	
TSX	14432.38
TSX-Venture	668.36
DJIA	17959.44
S&P 500	2078.54
Nasdaq	4781.42
MSCI World (MXWD)	420.15
Risk Metrics	
VIX	15.25
TED Spread	0.23%
FAIL®	1.26
Interest Rates & Commodity Prices	
Canada T-Bll (90 days)	0.89%
US T-Bill (90 days)	0.02%
Canada 10-yr Govt.	1.79%
US 10-yr. Treasury	2.16%
CRB Index	236.60
Spot Gold	$1176.45
Crude Oil (Jan.)	$55.26
Canadian Dollar	85.99 US cents
USD/Euro	1.223
USD/JPY	120.05



Priced as at Dec 22, 2014
Source: Bloomberg

- Sentiment for the TSX reversed abruptly less than three weeks after the index peaked on September 3; the decline accelerated in Q4, led by energy producers as crude oil prices plunged 48% from their June highs.
- The TSX outperformed the S&P 500 in the first three quarters of 2014, but is now lagging and may under-perform the S&P 500 for the fifth straight year in 2015.
- The oil plunge could make a dent in Canada's real GDP in 2015, impacting it by 0.33 to 0.50 percentage point.
- Two risks identified by the Bank of Canada are elevated household indebtedness and a housing market estimated to be overvalued by 10% to 30%.
- Divergence in the economic outlook and monetary policy between Canada and the U.S. could force the loonie lower from its current level, to between 80 and 83 cents in 2015.
- The IMF's October forecast for global growth of 3.8% may need to be revised lower, given the issues facing major economies like Russia, Japan and China.
- **Key risks to our outlook include** – Faster normalization of U.S. monetary policy; unexpected U.S. slowdown; continued decline in crude oil prices; stronger U.S. dollar; deflation; geopolitical risk; valuations.
- **Portfolio strategy points** – stocks preferable to bonds but hard to find; retain cyclicals, add defensive stocks; position for higher volatility; stick with best-of-breed stocks; take money off the table; avoid momentum plays.
- **Our end-2015 index targets: TSX 13,500; S&P 500 2,200**.
- **Recommended Asset Allocation: Stocks 60%, Bonds 15%, Cash 25%**.

Charts and Tables – Gint Austrins

Please see disclosures at the end of this report

Market Review

TSX Composite in 2014 – in like a lion, out like a lamb

The TSX Composite flattered to deceive in 2014, a year in which it reached a new record high that may prove to be a high-water mark for some time to come. After a choppy start to the year, the index took off from February, adding 2,000 points over the next six months. In fact, at the time we issued our *Strategy Update* report on July 31, the TSX was up 14% for the year, the second-best performer among major global equity markets as it outperformed the S&P 500 by more than seven percentage points.

But sentiment for the TSX underwent an abrupt reversal less than three weeks after the index peaked on September 3, as jitters about global growth resurfaced to take a steep toll on commodity prices. The pullback in the index accelerated in the fourth quarter as energy producers endured their biggest decline in years, precipitated by a 48% plunge in crude oil prices from their June highs. By December 15, with bank shares also coming under selling pressure as most of the Big Six failed to live up to lofty earnings expectations, the year's gains for the index had been all but wiped out.

The 14% slide in the TSX over a 3½-month period was finally halted last week by a combination of factors – the bid for Talisman Energy from Repsol SA (which provided much needed support to the energy group on M&A speculation), stabilization in crude oil prices, and a pledge from the Federal Reserve that it would be patient on the timing of the first U.S. interest-rate increase since 2006. As a result, the TSX surged 5.4% in the week ended December 19, its biggest weekly advance since July 2009.

Last week's advance has pared the index's decline from its September 3 high to 8%, leaving it up close to 6% for the year, a middle-of-the-pack performance among the major markets we track (Figure 1). To borrow a weather-related phrase, after literally coming into 2014 like a lion, the index is now going out like a lamb.

The S&P 500 is currently outperforming the TSX Composite by 6.5 percentage points YTD in local currency terms. In US dollar terms, the U.S. benchmark is trouncing its Canadian counterpart by almost 16 percentage points, a result of the loonie's decline this year. A year ago, we were optimistic that the TSX could outperform the S&P 500 in 2014 for the first time in four years. **While that prognostication looked good in the first three quarters of this year, it has been totally upended by the recent rout in the energy sector. On current evidence, it now appears as though the TSX could underperform the S&P 500 for the fifth straight year in 2015**.

Global bull running out of breath – and breadth

The average YTD change for the 15 indices shows in Figure 1 is +3.7%, which is less than half the 8.4% gain a year ago. That smaller average advance can largely be attributed to the slump in the Russian RTS and the TSX-Venture indices. The Russian index has plunged more than 40%, as the economy has been hit by economic sanctions and plunging oil prices. The TSX-Venture index, which was up 8.5% for the year as of July 31, now ranks second from bottom after being the worst performer for the three previous years. While Brazil joins Russia in the bottom three, the other two BRIC giants are among the best performers. China's Shanghai Composite tops the list with a 47.8% surge YTD – with half of that gain coming after the government eased investment restrictions on November 17 – followed by India, where the formation of a pro-business government with a strong majority has pushed the Sensex into record territory. US equity indices have also posted solid performances this year, but Europe has struggled. Overall, we believe that this divergence in index performance will widen in 2015. As global equity gains are restricted to a shrinking number of markets, it appears that the global bull is running not just out of breath, but also out of breadth.

Figure 1: Major equity indexes – YTD performance and valuations

Country	Index	Forward P/E	Indicated Yield	YTD Change
China	Shanghai	11.8x		47.80%
India	Sensex 30	14.7x		30.85%
US	Nasdaq	19.8x		14.48%
US	S&P 500	16.2x		12.45%
US	DJIA	15.3x		8.34%
Japan	Nikkei 225	17.0x		8.25%
Canada	TSX	15.0x		5.95%
Germany	Dax	12.6x		3.28%
Australia	ASX 200	14.3x		1.68%
Mexico	IPC	17.9x		0.34%
France	CAC 40	13.5x		-0.97%
UK	FTSE 100	13.6x		-2.55%
Brazil	Bovespa	10.6x		-2.69%
Canada	Venture			-28.29%
Russia	RTS	5.0x		-43.79%

*Forward P/E based on 2015 estimates

Source: Global Securities Research, Bloomberg

Economic Fundamentals

Oil plunge could make noticeable dent in Canada's real GDP in 2015

In its *Monetary Policy Report (MPR)* released in October, the Bank of Canada forecast that real GDP growth for the Canadian economy would average close to 2.5% over 2015, before slowing gradually to around 2% by the end of 2016. It judged the outlook for growth in Canada to be relatively unchanged since July, with the strengthening U.S. economy and weaker Canadian dollar providing support for Canada's non-energy exports, but lower global crude oil prices and resulting weaker terms of trade expected to reduce Canadian incomes and weigh on household and business spending.

Downside risks to the Canadian economy have increased since that assessment was made two months ago, largely because crude oil prices have continued to plummet. A gauge of consumer confidence fell to a 10-month low last week, and confidence in the prairie provinces including Alberta reached the lowest since June 2013. While the Bank of Canada estimates lower oil prices could reduce GDP growth by one-third of a percentage point in 2015, some economists estimate the hit to GDP at 0.5 percentage point. The oil-rich provinces of Alberta, Newfoundland & Labrador and Saskatchewan have been among the fastest-growing provinces in recent years , but the oil rout could have a significant impact on their economies in 2015. On the positive side, some of that drag could be offset by better prospects for the manufacturing powerhouses of Ontario and Quebec, which stand to benefit from lower energy pices and the weaker loonie.

On the inflation front, the Bank said earlier this month while maintaining its overnight rate target at 1% that inflation has risen by more than it expected due to the temporary effects of a lower loonie and some sector-specific factors. The Bank said that although underlying inflation has edged up, it remains below its 2% target, apart from whch weaker oil prices pose an important downside risk to the inflation outlook.

The Bank has noted recently that stronger exports are beginning to be reflected in increased business investment and employment. However, exports remain weak relative to previous cycles, reflecting factors such as the weakness of the recovery in the rest of the world, competitiveness challenges, and structural issues. The Bank estimated in its October MPR that when compared with a scenario in which non-energy exports would have risen in line with foreign activity, there was a gap equivalent to about $30 billion by 2013, or a 7% total reduction in total non-energy exports that year. **In other words, the lower loonie can only boost non-energy exports to a limited extent, since other factors can offset a weaker domestic currency**.

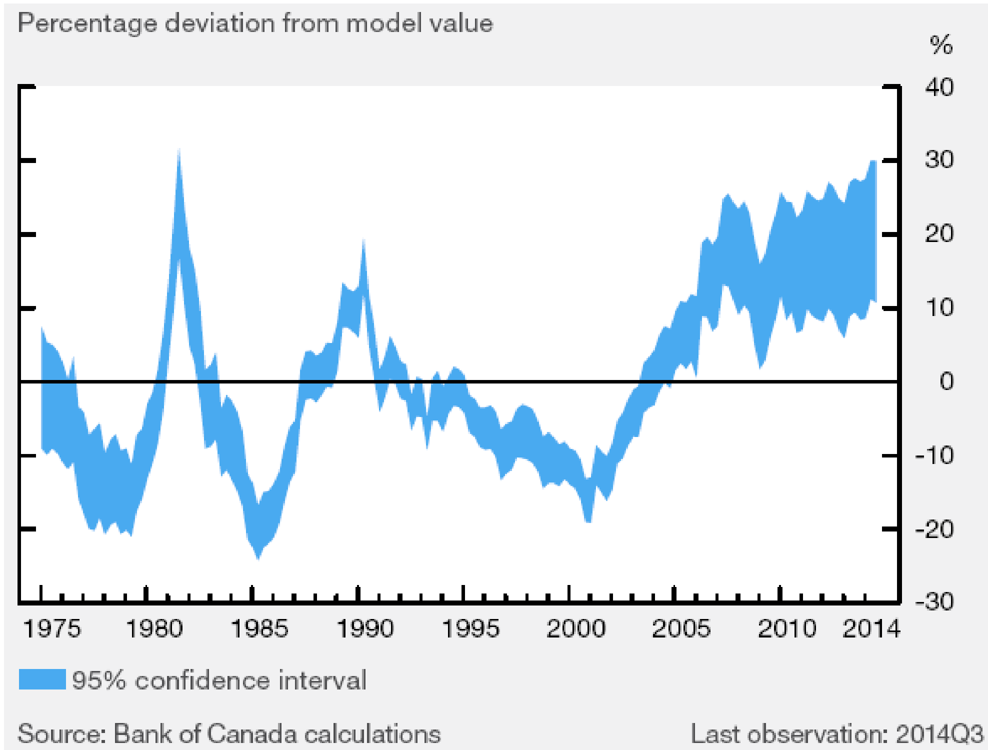
In terms of the employment picture in Canada, the consensus seems to be for modest growth in 2015. The economy lost net 10,700 jobs in November, as a decline of 45,600 private sector jobs more than offset gains of 22,600 public-sector jobs and an increase of 12,300 in the number of self-employed. Last month's jobs loss was viewed as a necessary pause after the Canadian economy added a total of 117,200 jobs in the preceding two months. While the unemployment rate rose by 0.1-percentage point from a six-month low of 6.5% in October, it was still down by 0.3-percentage point y/y.

What about the risks faced by the Canadian economy? The Bank of Canada highlighted three key financial risks to financial system stability in its *Financial System Review* released on December 10:

- **Elevated level of household indebtedness** – this has been an issue for a few years now. Canada's household debt-to-income ratio rose to a record 162.6% in Q3, up from a revised 161.5% in Q2, and well above the comparable U.S. figure of 135.6%. **BoC Governor Stephen Poloz says that the most important risk facing the Canadian economy is the difficulty highly indebted households would face in servicing their debt loads if their income levels were to decline sharply or interest rates were to rise substantially**.
- **Imbalances in the housing market – BoC researchers estimate that the Canadian housing market is overvalued by 10% to 30%** (Figure 2). According to their model, the Canndian housing market has been overvalued by over 10% since at least 2007, and the upward creep in housing prices has been modest since 2009. Their view is that a soft landing for the housing market is the most likely outcome, as it is supported by the stronger Canadian economy while houshold imbalances gradually diminish.
- **Investor risk taking and illiquidity in financial markets** – Globally and in Canada, exceptional monetary stimulus continues to create incentives for increased risk taking in financial markets.

Economic prospects for Canada and the U.S. are poised to diverge significantly in 2015, as does monetary policy. While yields on Canadian short-term government bonds have been higher than those on U.S. Treasuries, the gap between yields on two-year government securities has now narrowed to 36 basis points, from 63 basis points in October. This is because traders are pricing in a rate hike by the Federal Reserve in the first half of 2015 even as expectations for a rate increase by the Bank of Canada get pushed out to 2016. This divergence could force the loonie – already trading at a 5½-year low of 86 U.S. cents – down to a low between 80 cents and 83 cents in 2015.

Figure 2: Bank of Canada estimate of housing market overvaluation



U.S. expected to rebound in 2015

The U.S. economy is firing on all cylinders, as the twin pillars of employment and housing continue to rebound, boosting consumer confidence. U.S. employers have added 2.65 million workers to their payrolls so far this year, making it the biggest yearly expansion in the job market since 1999. The unemployment rate of 5.8% is at its lowest levels since mid-2008, and is within striking distance of the 5.2%-5.5% rate that the Federal Reserve considers to be full employment. The S&P/Case-Shiller Home Price Indices showed year-over-year gains of 4.8%-4.9% in September, although U.S. home prices are rising at a slower pace. And although wages for American workers continue to grow at a glacial pace, plunging fuel prices are bolstering their spending power.

The U.S. economy grew at a revised 5.0% annual pace in Q3, the fastest growth pace since Q3 of 2003, following a 4.6% advance in Q2. The Federal Reserve projects that the U.S. economy will grow at a 2.6%-3.0% pace in 2015 and at 2.5-3.0% in 2016, compared with 2.3%-2.4% this year. The Fed also expects the unemployment rate to fall to 5.2%-5.3% next year and to 5.0%-5.2% in 2016.

Recent data show the U.S. economy is thriving despite uncertainties in major Asian and European economies. The economy added 321,000 jobs last month, the biggest increase in almost three years; retail sales rose 0.7% for the fastest increae in eight months and the service sector expanded at the second-fastest pace in over nine years.

This increased economic momentum means that the Federal Reserve's inclination to raise interest rates in 2015 is a given. Although many market participants were apprehensive about the timing of the first rate hike since 2008, the Fed signalled in its policy announcement on December 17 that it would be patient on the timing of a rate increase. Fed chair Yellen said that the central bank is unlikely to begin the monetary policy normalization process for at least the next couple of meetings, which suggets that the Fed is unlikely to move before April. The median projection for the federal funds rate by the end of 2015 is 1.125%, a quarter percentage point reduction from the previous estimate.

Rising number of economic trouble spots could drag down global growth

The IMF lowered its estimates for global growth yet again in its *World Economic Outlook* released in October, as it has done so often over the past three years, largely because the result of legacies of the 2008-09 global financial crisis – such as debt overhangs and high unemployment – have been more difficult to resolve than expected.

The IMF lowered its global growth projection for 2014 by 0.1 percentage point to 3.3%, as growth in the first half was slower than expected. It also trimmed its estimate for 2015 GDP growth by 0.2 percentage points to 3.8%. **But those global growth estimates may need to be revised even lower, given the issues facing major economies such as Russia, Japan, and China. This could potentially be offset by the boost to global growth from lower oil prices, estimated by IMF researchers at 0.3%-0.7% in 2015 and 0.4%-0.8% in 2016.**

Russia's central bank last week raised interest rates by the most in 16 years to support the collapsing ruble. Crippling sanctions imposed on Russia as a result of its invovlement in the Ukraine situation, combined with plunging oil price, may cause the economy to contract 4.5% in 2015 if oil stays at $60 per barrel. In Japan, the economy contracted at a 1.9% annualized rate in Q3, with an increase in the consumption tax from 5% to 8% widely blamed for tipping the economy into recession. China is growing at its slowest pace in years, as the economy registered a growth pace below 7% for the third straight month in October.

Outlook

Earnings estimates for TSX only partly reflect challenging environment

In our July 31 Portfolio Strategy Update report, we had noted that the 2014 index EPS estimates for the S&P 500 and TSX Composite (based on analysts' "bottom-up" earnings estimates for all index constituents) had only come down by 2% to 3% since December 2013. In our experience, forward index earnings estimates generally come down over the course of the year, but the TSX EPS downward revision of 2.7% was low by historical standards, and much less than the 10.3% lower estimate we had seen in mid-2013. It may have been a reflection of the excessive optimism that was pervasive at the time, but the latest EPS estimates show that the reality of a challenging earnings environment for the cyclical sector-dominated TSX is sinking in, albeit slowly

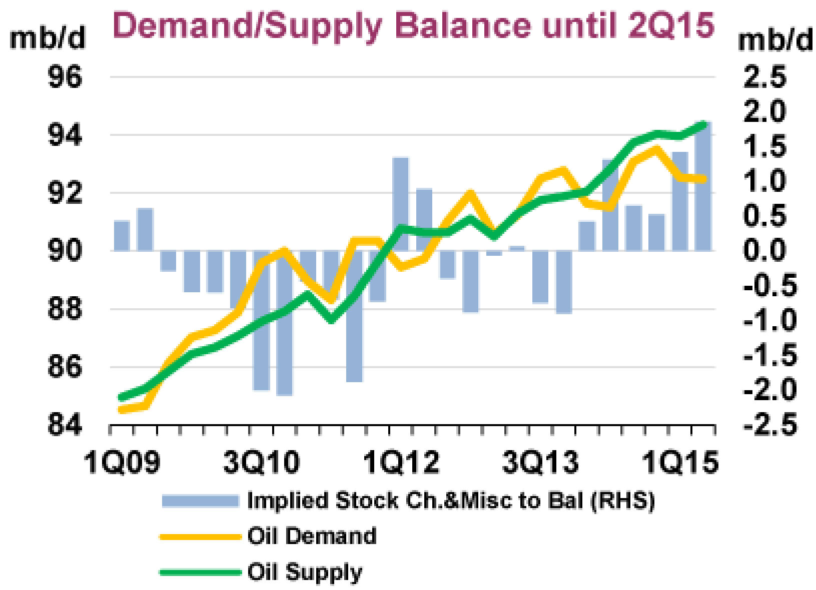
The TSX is now expected to post index EPS of $924 (as of December 19, 2014) for full-year 2014, representing year-on-year earnings growth of a whopping 28.5%. Index EPS for 2015 is forecast at $962.70, for y/y growth of a much more modest 4.2%.

In July, the 2014 EPS estimate for the TSX was at $928, so the downward revision for this year is currently only 0.4%. But the downward revision for 2015 EPS is substantial, at 8% (i.e. $962.70 now vs. the July estimate of $1048). In our opinion, these revisions are not sufficient, and while we look for 2014 EPS to be about 3% below consensus, we believe 2015 EPS for the TSX will be as much as 6.5% below current expectations.

Our pessimism about current EPS estimates for the TSX is based on the fact that earnings forecasts – especially for 2015 – seem unrealistic. Compared with earnings estimates in July, the biggest downward revisions have been for the Energy (-41%) and Materials (-15%) sectors. Earnings for the Energy sector have yet to come down to earth; they were forecast to surge 76% in July, but that lofty growth estimate has been trimmed to 52% for 2014, with an EPS decline of 25% forecast for 2015. But with global supply expected to outpace demand for the next few quarters (Figure 3), additional cuts to earnings estimates for energy producers are quite possible.

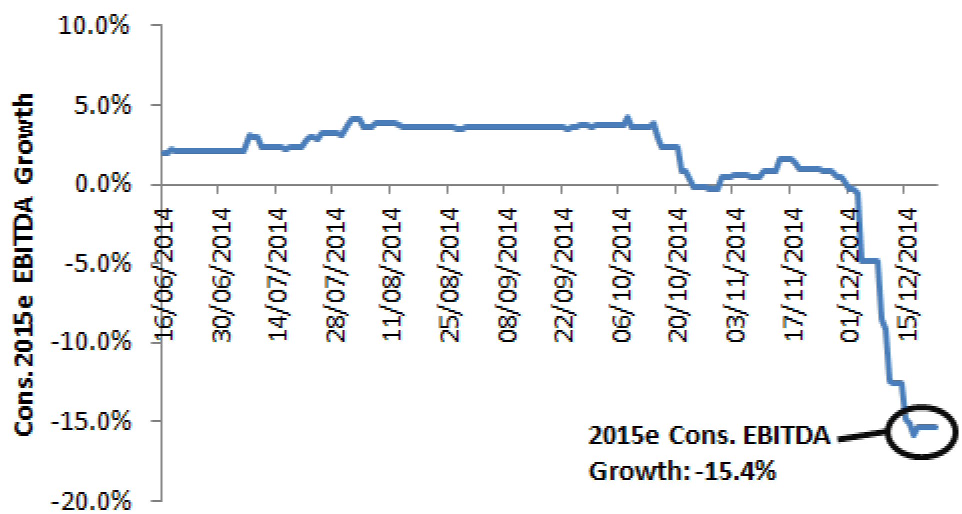
Crude oil (WTI) has traded at an average price between $94 and 98 annually since 2011. Even after its recent skid, the average 2014 price for crude oil (to December 19) was $94. Crude now trades near $55, almost $40 below the 2014 average price. Analysts have begun lowering forward EBITDA (Figure 4) and cash flow estimates for energy producers, but the process may have only begun.

Figure 3: Crude oil demand / supply balance



Source: International Energy Agency

Figure 4: Change in 2015 est. EBITDA growth for select Canadian energy producers



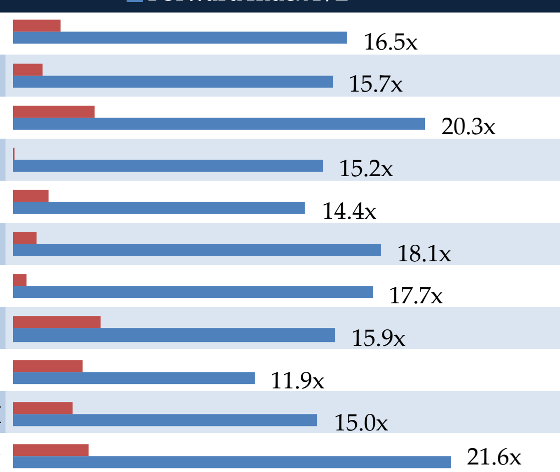
Source: Bloomberg, Global Securities
Notes: Energy basket is comprised of: SU, IMO, CNQ, HSE, CVE, CPG, ARX

EPS for the Materials group is forecast to decline about 21% this year, and rebound 38% in 2015. But that looks implausible against a backdrop of potentially tepid global growth, which will continue to impede a sustained recovery in commodity prices.

The heavyweight Financials group – which accounts for more than one-third of the TSX – has a significant bearing on index earnings. Sector earnings are forecast to grow 17% this year and about 5% next year (Figure 5). Royal Bank was the only one of the Big Six to match earnings expectations in the most recent quarter, so perhaps the days of the banks consistently beating consensus forecasts are over. The banks have done a commendable job of offsetting lower net interest margins with growth in other areas like wealth management and consumer banking. That said, there is a limit to how much profitability they can squeeze out given that the yield curve continues to be quite flat, while loan demand may be hampered by record consumer debt. As for insurance companies, earnings may be constrained by volatile equity markets and bond yields that have trended unexpectedly lower in 2014.

Our forecast for 2014 index EPS for the TSX is $900 (2.6% below the consensus forecast), and staying at that level in 2015 (6.5% below the consensus forecast).

Figure 5: TSX Groups – Forecast EPS Change in 2014 and Valuations



TSX Group	Indicated Dividend Yield / Forward Index P/E**	Forecast EPS Change (%)*
Materials	16.5x	37.5%
Industrials	15.7x	24.8%
Utilities	20.3x	23.5%
Health Care	15.2x	20.4%
Consumer Discretionary	14.4x	16.4%
Consumer Staples	18.1x	14.2%
Information Technology	17.7x	11.1%
Telecom Services	15.9x	5.9%
Financials	11.9x	4.7%
TSX	15.0x	**4.1%**
Energy	21.6x	-24.6%

Source: Global Securities Research, Bloomberg

For the S&P 500, the downward revision in index EPS is much less than that for the TSX Composite, perhaps reflecting its much smaller weighting in resource-based sectors. The S&P 500 is now forecast to post record EPS of $116.79 this year (Figure 6) – down 2.6% from the July estimate – representing an increase of 8.8% from the previous all-time high of $107.30 in 2013. For 2015, the EPS estimate has had a downward revision of 3.6%, with earnings now estimated at $131.54.

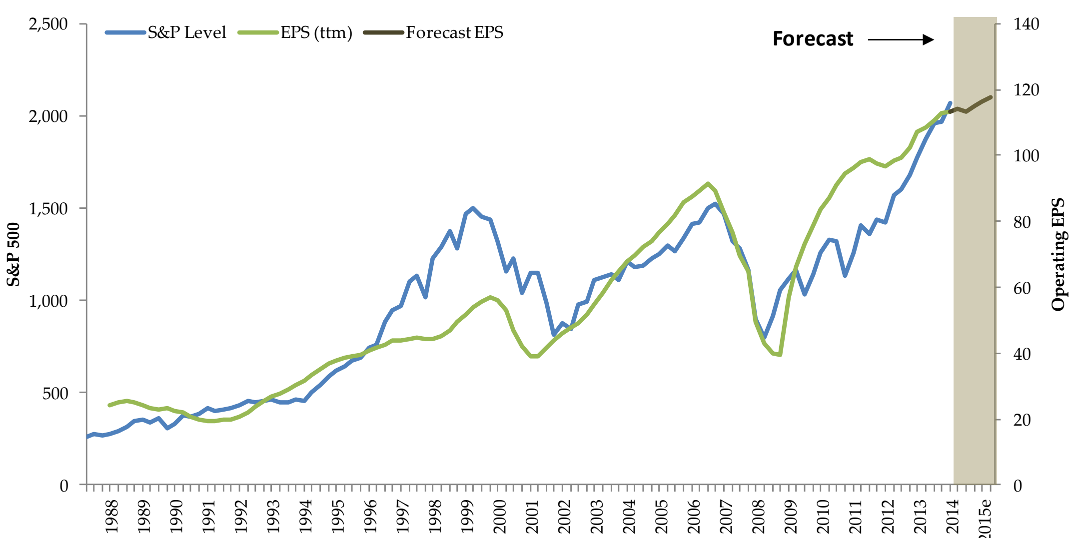
The S&P 500's foray into new territory is being fuelled by record S&P earnings (Figure 7), which are in turn being driven by operating margins that exceeded 10% for the first time in Q2 and Q3 of 2014, according to S&P index analyst Howard Silverblatt. It remains to be seen how long the drivers of these record operating margins – improved productivity, contained costs for raw materials, little wage inflation – can stay in place.

Figure 6: S&P 500 Quarterly Operating EPS Estimates

Period	2013-A	% Change	2014-E	% Change	2015-E	% Change
Q1	$25.77	6.3%	$27.32	6.0%	*$30.70*	*12.4%*
Q2	$26.36	3.7%	$29.34	11.3%	*$32.39*	*10.4%*
Q3	$26.92	12.2%	$29.59	9.9%	*$33.50*	*13.2%*
Q4	$28.25	22.0%	*$30.54*	*8.1%*	*$34.95*	*14.4%*
Total	**$107.30**	**10.8%**	***$116.79***	***8.8%***	***$131.54***	***12.6%***

Source: Standard & Poor's

Figure 7: S&P 500 vs. 4-quarter op.EPS – 1988 to 2015 (forecast)



Source: Global Securities Research, Standard & Poor's

Valuations – not cheap any longer

The TSX Composite presently trades at a trailing earnings multiple of 18.4x past 4-quarter EPS of $783, compared with a 21.2x multiple in July. It also trades at a forward multiple of 15.6x 2014 estimated EPS of $924. The S&P 500 trades at a trailing multiple of 18.2x past 4-quarter EPS of $114.50, and at 17.8x 2014 forecast EPS of $116.79.

Looking forward to 2015, the TSX is forecast to post earnings growth of 4.2% next year, a sharp deceleration from the 28.5% earnings increase expected this year. Meanwhile, the S&P 500 is estimated to grow earnings at a 12.6% clip, triple the EPS growth rate of the TSX, and faster than the 8.8% increase forecast this year.

In our July forecast, we had opined that the TSX was fairly valued on the basis of its 16.7x forward mutiple at the time, and had assigned an end-2014 target for the index of 15,500, little changed from current levels, and a 7.6% increase from our December 2013 target of 14,400. The index subsequently peaked at 15,685 on September 3. Our view was that the S&P 500 was also trading close to fair value, and based on a 16.5x multiple applied to FY14 EPS of $119.87, our end-2014 target was 1,975, an upward revision of 4.2% from our December 2013 target of 1,895.

Given the expected sharp deceleration in TSX earnings and a muted outlook for global growth, we believe a multiple contraction for the index may be in order. Accordingly, we are assigning a 15x forward multiple to our 2015 index EPS estimate of $900, giving us an end-2015 TSX target of 13,500. The forward multiple is a little above the average 14.4x over the past 10 years. For the S&P 500, based on a forward multiple of 16.7x applied to forecast 2015 EPS of $131.54, our end-2015 target of 2,200.

How do our forecasts stack up against the Street consensus? For the TSX, we are as much as 10% or almost 1,500 points below the average forecast of 14,990 obtained from a Reuters poll of strategists and market analysts (in which we participate). For the S&P 500, our 2,200 forecast is in line with the median estimate in a Bloomberg poll.

Our end-2015 target for the TSX is 6.5% below current levels, and is meant to convey our directional bias (downward) for the index, as well as the possibility that the S&P 500 could outperform it for the fifth straight year. The TSX had outperformed the S&P 500 for seven successive years prior to 2011, from 2004 to 2010. The S&P 500 has tripled over this bull run, which commenced in March 2009, while the TSX is only up 90%. Over the past 10 years, however, total returns for the indices are quite similar, at 7.6% annually for the TSX and 7.9% for the S&P 500.

Risks to our Outlook

There are a plethora of risks that could derail our Outlook. The increase in the number of risks reflects our view that we may be in for some negative surprises in 2015.

- **Faster than expected normalization of monetary policy in the U.S.**: If the U.S. economy continues to pick up steam, the Federal Reserve may have no choice but to normalize monetary policy faster than market participants currently expect. While the median forecast for the end-2015 federal funds rate is presently 1.125%, some FOMC members see it as high as 1.875% by end-2015 and at 4.00% by end-2016. Rate increases at that pace would represent dramatic tightening by the Federal Reserve, and cause a very adverse reaction in equity markets, given that easy money has been a major reason why equities are at record highs.
- **Unexpected slowdown in the U.S.**: The U.S. has once again emerged as the lynchpin on which the global economy is pinning its hopes. If there is an unexpected slowdown in the U.S. economy, concerns about a slowing global economy would escalate.
- **Continued decline in crude oil prices**: If crude oil continues to plummet, it would have a negative impact on the economies of net oil exporters, as companies rein in capital spending and cut jobs.
- **Stronger US dollar**: The greenback is currently trading at its best levels against the yen in seven years, and is at a near three-year high against the euro. If the dollar continues to surge, it may put considerable pressure on emerging-market currencies and cause problems for companies with large USD-denominated debt.
- **Deflation**: The plunge in crude oil prices has heightened the concern of deflation in Europe and elsewhere, a possibility about which market gurus like Bill Gross and Prem Watsa have warned. Last week, the difference between Treasury two-year notes and comparable maturity TIPS turned negative for the first time since the aftermath of the 2009 global financial crisis. The measure is seen as a gauge of investors' expectations for inflation over the life of the securities.
- **Geopolitical issues**: There is no shortage of geopolitical hotspots around the world, including Russia-Ukraine, the Middle East and Nigeria. The recent spate of "lone-wolf" attacks in Canada, Australia and France is another troubling development.
- **Valuations**: Although market valuations do not appear unduly stretched at present, they could become an issue if the markets continue to move higher and EPS growth decelerates. Earlier this year, Fed chair Yellen and the Federal Reserve expressed concern about stretched valuations in “pockets” like leveraged loans and lower-rated corporate debt, as well as equity valuations of smaller companies, social media firms and biotech enterprises.

Portfolio Strategy

We recommend the following portfolio strategies and investment themes for 2015, which are quite similar to the ones in our July 2014 report.

1. **Stocks continue to be preferable to bonds, but are getting very hard to find**: Bond yields have declined substantially in both Canada and the U.S. this year. As a result, the anomalous situation of dividend yields (2.87% for TSX) exceeding 10-year government bond yields (1.91%) has cropped up again in Canada. Stocks remain preferable to bonds in this global environment of unrestrained stimulus by a number of major economies (except for the U.S.). But they are especially hard to find for the Canadian investor who is looking to add U.S. stocks to a portfolio, given that U.S. indices are trading at record highs and the loonie is at a 5½-year low against the USD.
2. **Review your portfolio at the earliest**: Review your portfolio as soon as you can in order to make changes before the increase in volatility that we expect next year.
3. **Add defensive stocks but retain cyclical stocks for the eventual turnaround**: Energy and Materials are the bottom two sectors on the TSX YTD (Figure 8), but judiciously adding to positions can work out well for long-term investors. We advise holding on to high-quality cyclical stocks in anticipation of the eventual rebound in the global economy, and would recommend adding stocks in defensive sectors like Utilities that are trading at attractive valuations and offer healthy dividend yields. This strategy has worked for our Model Portfolio introduced on March 3; with a total return of 6.07%, the Portfolio is outperforming the TSX Composite by more than two percentage points.
4. **Volatility may pick up in 2015**: We believe the two bouts of volatility we have had since mid-September presage more market gyrations next year. Accordingly, we would be buyers of volatility, especially for hedging purposes.
5. **The "shorts" may finally have their day in 2015**: It has been a difficult environment for short sellers, but they may finally have an opportunity next year to recoup losses inflicted by the relentless bull market.
6. **Avoid / short China?** Chinese equities are on a tear at a time when the economy is poised to grow at its slowest pace since 1990, an undesirable combination.
7. **Stick with best-of-breed stocks**: The steep selloff in energy and commodity stocks is an opportunity to initiate new positions or add to existing positions in best-of-breed stocks that have visionary management and strong balance sheets.
8. **Avoid momentum plays:** As 2015 may be a difficult year for momentum plays due to their high valuations, stocks in hot sectors like biotech and social media should be avoided as they may decline precipitously in a correction.

Figure 8: TSX Group Performance – 2013 and 2014 YTD

	2013 Performance	2014 YTD Performance
Consumer Staples	21.37%	**43.36%**
Information Technology	36.23%	**32.13%**
Health Care	71.71%	**30.57%**
Consumer Discretionary	39.52%	**25.50%**
Industrials	34.92%	**17.79%**
Telecom Services	8.07%	**10.50%**
Utilities	-8.61%	**9.79%**
Financials	19.05%	**8.67%**
TSX	9.55%	**5.95%**
Materials	-30.60%	**-8.05%**
Energy	9.86%	**-8.94%**

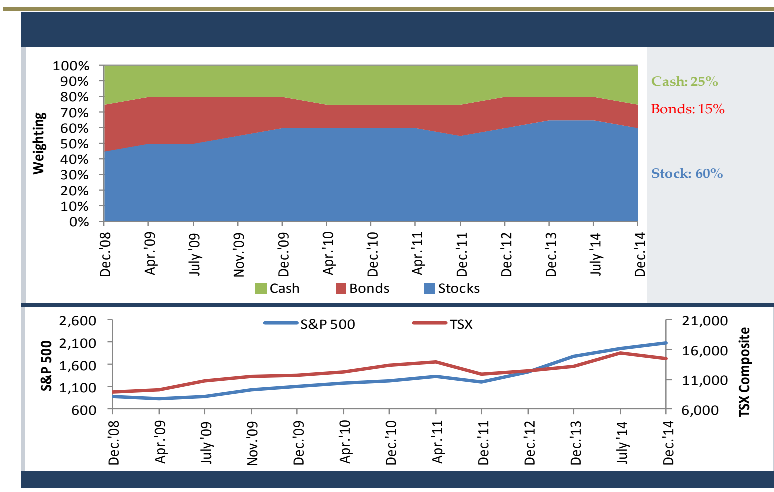
Source: Global Securities Research, Bloomberg

9. **Take some money off the table**: The easy money has been made on equities, and as solid returns are going to be more difficult to generate, take some money off the table on big winners.
10. **M&A activity could pick up**: 2014 is on track to surpass 2006 as the second-best year for M&A activity (after 2007), and 2015 could be another good year for mergers as well.

Asset Allocation

Based on the foregoing analysis, we are trimming our equity allocation by five percentage points and moving it to cash. Our revised asset allocation is therefore – **Stocks 60%, Bonds 15%, and Cash 25%** (Fig.9).

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



Source: Global Securities Research, Bloomberg

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Speculative Buy: Significant gains expected over the next 6 – 12 months, but entire investment may be at risk.
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