Market Bulletin

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Commentary – Further gains in store for the TSX as stars get into alignment

Index surged past our 2013 target of 13,000 last week, trading at 27-month high
Sector rotation into energy and materials may boost TSX

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It's been a while since we have been this bullish on the prospects for the TSX Composite. Our positive outlook is buttressed by the fact that the stars finally seem to be aligning for the Canadian benchmark, which has been weighed down by soft commodity prices and global macroeconomic concerns for the better part of the past two years. Since the beginning of 2012, the TSX has underperformed the S&P 500 by almost 29 percentage points (9.8% vs. 38.6%). While the S&P 500 has been marching steadily to newer highs this year, the TSX currently languishes about 2,000 points or 13.4% below its record high set in June 2008.

But the tide may finally be turning in favour of the TSX, and in fact, over the past three months, it has managed to outperform the S&P 500 by 93 basis points (4.16 % vs. 3.23%). A slim margin, admittedly, but one that suggests the TSX may finally be in a position to narrow the performance gap with its US counterpart.

Here are seven factors that may propel the TSX higher in the months ahead:

- ***Macroeconomic concerns have receded substantially***: Since the TSX is highly leveraged to global growth prospects, the plethora of macroeconomic concerns that have erupted over the past two years – such as the "fiscal cliff" and debt ceiling impasse in the US, its credit downgrade in August 2011, and sovereign debt issues in the European Union – have taken a severe toll on the index. At the present time, most of these risks have receded; in fact, investors in US equities were unfazed by the posturing and brinkmanship that accompanied the recent 16-day government shutdown.

- ***The global economy is poised to grow***: As noted in last week's Bulletin, the global economy is forecast to grow at a 3.6% clip in 2014, up from an estimated 2.9% this year, according to the IMF. Faster global growth translates to higher demand for energy and commodities, sectors that together constitute 38% of the TSX.

- ***Interest rates may be on hold for most of 2014***: Economic data released on Friday showed that Canadian consumer prices rose 1.1% for the second straight month in September, while the core CPI rate remained at 1.3%. Inflation is currently at the bottom of the Bank of Canada's 1% - 3% target range, and is forecast by the Bank to stay below 2% until Q2 of 2015. Most economists expect the Bank of Canada to refrain from raising interest rates until Q4 of 2014. More clarity on this front can be expected on October 23, when the Bank announces interest rates and releases its Monetary Policy Report.

- ***Fed's taper plans pushed back***: The Fed's unexpected decision to leave its bond-buying program unchanged in September has turned out to be the right move, as the recent US government shutdown has had a negative impact on the US economy. Standard & Poor's estimates that the closure shaved at least 0.6% from US GDP growth in Q4. According to the median estimate of 40 economists in a Bloomberg survey, the Fed is now expected to taper only in March, compared with earlier expectations that it would do so in December of this year. "Taper talk" had erased $4 trillion from global stocks within a month after Bernanke first broached the subject on May 22, so any delays that keep the stimulus program going can be construed to be positive for global growth prospects, and by extension, for the TSX.

- ***Sector rotation into Energy and Materials***: These two sectors typically take off in the latter stages of an economic expansion (see Figure 1, courtesy Fidelity Asset Allocation Research), as confidence builds about the ability of the US and global economies to keep growing. The present US expansion – which commenced in June 2009 – is 53 months old, which is less than 6 months short of the average 58.4-month expansion period of 11 economic cycles from 1945 to 2009, according to the NBER. However, the previous three US expansions (Nov. 1982 to July 1990, March 1991 to March 2001, and November 2001 to December 2007) have averaged 95 months or almost 8 years. If that pattern of longer economic expansions than the historical norm holds true, we would seem to be in a late-stage expansion and still some way away from the peak of the cycle. Investors already seem to be making the move into the Energy and Materials sectors on the TSX, which are up 8.3% and 2.2% respectively since June 30, 2013 (Figure 2). These sectors still have a long way to go, given that the Energy group is only up 7.4% YTD, while the Materials group is down 30%.

- ***Canadian economy is on the mend***: The Canadian economy has pulled itself out of the soft patch it was mired in earlier this year. Recent housing data has been quite robust, allaying earlier concerns about a potential housing crash. Investors seem to be optimistic about the outlook for the Canadian economy, if the performance of the largest Canadian banks is any indication, with the Big Five either at or near record highs. Royal Bank today became the first Canadian bank to surpass $100 billion in market cap.

- ***Corporate earnings have momentum***: TSX earnings, based on Bloomberg estimates, may grow 10.6% this year and 13.4% in 2014. Unless those estimates are way off the mark, the TSX may benefit from faster earnings growth over the year ahead.

The icing on the cake would be if China's economy also gains traction, since the Asian giant has such a tremendous influence on commodity prices. Data released on Friday showed that the Chinese economy accelerated in Q3 for the first time this year, growing at a 7.8% pace.

<u>Overall, we remain bullish on Canadian equities and the TSX. As we had noted in our Bulletin two weeks ago, this would seem to be the wrong time to abandon Canadian stocks</u>.

Figure 1: Sector performance by business cycle phase

Sector	Early	Mid	Late	Recession	Sector	Early	Mid	Late	Recession
Financials	+				Cons Staples			+	+
Cons Disc	+		−	−	Health Care			+	+
Technology	+	+	−	−	Energy	−		+	
Industrials	+	+		−	Telecom	−			+
Materials	+	−	+		Utilities	−	−	+	+

Source: Fidelity Asset Allocation Research https://www.fidelity.com/viewpoints/how-to-use-business-cycle

Figure 2: TSX Group Performance – June 30, 2013 to October 18, 2013

Source: Bloomberg

Equity Screens

Commodity and energy stocks with double-digit earnings growth potential in 2014

This week's screen looks at Canadian commodity and energy stocks that are expected to post double-digit earnings growth in 2014, but which have appreciated less than 10% YTD and offer a solid dividend yield. Our criteria were set as follows -

- Eligible sectors: TSX Composite – Basic Materials, Oil & Gas
- **FY2014 EPS growth (year-on-year) > 10%**
- Current market cap > $1 billion
- YTD Price Change < 10%
- Current Dividend Yield > Between 2% and 7%

21 stocks made the cut (Table 1), many of which are familiar names. Note that the outsized EPS growth expected for some stocks such as HudBay, Trican, Talisman and Sherritt is due to a very low EPS number for 2013. Please note that equity screens such as these are only a starting point for further analysis, and we strongly recommend that readers conduct their own due diligence.

Table 1: Canadian commodity and energy stocks with double-digit EPS growth in 2014

Ticker	Short Name	Last Px	Est. EPS Gwth:2014 (%)	YTD Chg.(%)	Dvd Yld(%)	Est EPS-2014	Fwd. P/E
ARX	ARC RESOURCES	$27.34	10.2	8.0	4.4	$0.96	28.5
TLM	TALISMAN ENERGY	$12.53	435.5	7.6	2.2	$0.22	57.0
IPL	INTER PIPELINE L	$25.69	62.5	4.9	4.2	$1.16	22.1
TCW	TRICAN WELL SERV	$14.23	1961.5	3.6	2.1	$1.01	14.1
ALA	ALTAGAS LTD	$35.69	12.6	2.4	4.0	$1.61	22.2
CPG	CRESCENT POINT	$40.17	30.6	1.6	6.9	$1.16	34.6
BTE	BAYTEX ENERGY CO	$43.83	23.2	-2.2	6.0	$1.72	25.5
ENB	ENBRIDGE INC	$43.43	13.0	-3.6	2.8	$2.05	21.2
PRE	PACIFIC RUBIALES	$22.79	50.3	-4.7	2.3	$2.73	8.3
RUS	RUSSEL METALS	$27.88	31.1	-4.8	5.0	$1.97	14.2
TRP	TRANSCANADA CORP	$46.03	12.6	-6.8	3.9	$2.50	18.4
CCO	CAMECO CORP	$18.89	22.1	-7.7	2.1	$1.05	18.0
CVE	CENOVUS ENERGY	$31.04	11.1	-10.4	3.0	$1.94	16.0
LIF	LABRADOR IRON OR	$30.30	14.4	-14.9	5.0	$2.57	11.8
HBM	HUDBAY MINERALS	$8.31	2755.6	-20.4	2.4	$0.29	28.7
TCK/B	TECK RESOURCES-B	$28.26	21.8	-24.8	3.2	$2.00	14.1
G	GOLDCORP INC	$25.05	33.3	-33.3	2.3	$1.25	20.0
S	SHERRITT INTL	$3.58	408.2	-39.0	4.5	$0.27	13.3
YRI	YAMANA GOLD INC	$9.67	21.4	-44.3	2.8	$0.55	17.6
CG	CENTERRA GOLD IN	$4.85	18.7	-50.3	3.4	$1.19	4.1
AEM	AGNICO EAGLE MIN	$25.66	61.5	-51.2	2.5	$0.77	33.3

Source: Global Securities Research, Bloomberg

Market Snapshot

At close on Friday, October 18, 2013

S&P TSX	13136.00	+99.64	Commodities			Yields (%)	Can.	US
TSX Venture	950.97	-0.61	Canadian $ (US cents)	97.13	-0.05	90 Day T-Bill	0.91	0.02
DJIA	15399.65	+28.00	Gold (Spot)-US$	1316.05	-4.29	2-Year Bond	1.17	0.31
S&P 500	1744.50	+11.35	Oil (WTI-Nov.)	100.86	+0.19	10-Yr.Bond	2.53	2.58
NASDAQ	3914.28	+51.13	CRB Index	286.92	+0.50	30-Yr. Bond	3.10	3.65

Thought for the Day

"An investment in knowledge pays the best interest." – Ben Franklin

DISCLAIMER

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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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