Market Bulletin

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Summary

Commentary A sudden eruption of risks caused a sell-off in emerging markets last week. Things have come full circle since 2007-08, when strength in the emerging markets was expected to offset weakness in the advanced economies. Now it's the reverse.

Insights 5%-10% upside predicted for TSX and S&P 500 at CFA Vancouver Forecast Dinner.

Chart of the Day TSX reached 14,000 last week. Target on next leg up could be 14,325.

Economic Analysis C$ at 4½-year low of 89.50 US cents; analysts target 87 US cents (C$1.15).

Commentary – Big dose of reality roils markets

China's PMI, Argentina peso devaluation, emerging markets sell-off, earnings misses by US bellwethers…. have financial markets become more dangerous overnight?

Elvis Picardo, CFA

Global equities and emerging market assets posted big declines last week as rampant optimism was tempered by a big injection of reality. The turmoil began on Wednesday after a preliminary reading of China's Purchasing Managers' Index (PMI) came in at 49.6 for January, below analysts' average forecast of 50.3 and December's final reading of 50.5. (The PMI level of 50 is critical as readings above it indicate expansion, and readings below it signal contraction).

On Thursday, Argentina devalued its peso by 11.7%; the currency's 15% plunge last week was its biggest weekly drop since 2001, when peso devaluation followed the nation's record sovereign default. Emerging markets were further pressured by a deteriorating financial situation in Turkey – with the lira sliding to a record low against the US dollar as intervention by its central bank failed to support the currency – and a political crisis in Ukraine that led the European Union to warn anti-government protests in the nation could escalate into civil war.

The MSCI Emerging Markets Index retreated 1.4% on Friday, extending its decline for 2014 to 5.2%, the worst start to a year since 2009. The Dow Jones Industrial Average, S&P 500 and Nasdaq Composite tumbled 2% on Friday. The DJIA's 3.5% decline last week is its worst weekly loss since at least May 2012, while the S&P's 2.6% drop for the week took its YTD performance to -3.1%, the worst start to a year since 2008.

(The January Barometer, which holds that US markets follow the trend set in January for the year as a whole, is not looking too good at the moment. But this indicator has a few flaws and is not totally reliable, as will be discussed in next week's Bulletin).

Although the sudden downdraft in equities and the explosion of emerging-market risks are disconcerting, this is a much-needed reality check for the markets, given their sustained rise in recent months. US markets in particular marched from strength to strength last year with hardly a hint of a correction, but that performance may be exceedingly difficult to replicate in 2014. Earnings misses from bellwethers such as Intel and IBM already suggest that the outlook for earnings growth may be more challenging this year.

Given the growing disconnect in the outlook for emerging markets and advanced economies this year (see discussion of IMF World Economic Outlook in "Economic Analysis" section), it remains to be seen whether strength in the latter is sufficient to offset weakness in the former. In that sense, things have come full circle since 2007-08, when the hope was that emerging market strength could offset growing fragility in advanced economies (of course, the savage global recession of 2008-09 swiftly dispelled those hopes). While the TSX is presently in the unusual position of outperforming the S&P 500 by almost four percentage points YTD (+0.71% vs. -3.14%), whether it manages to hang on to this lead for the rest of the year depends a great deal on the global economy's ability to surmount this sudden eruption of challenges.

Insights – Modest upside for TSX and S&P 500 predicted by presenters at CFA Vancouver's 36th Annual Forecast Dinner

Index gains of 5% to 10% expected in 2014, bond yields seen higher

The three presenters at CFA Vancouver's 36th Annual Forecast Dinner held on January 21 were almost uniform in their assessment of the markets and outlook for this year, with modest upside for equities and higher bond yields expected. We summarize below some of the main points made by the presenters – Avery Shenfeld of CIBC World Markets, Jim Gilliland of Leith Wheeler Investment Counsel, and John Mauldin of Millennium Wave Advisors. Their end-2014 forecasts and long-short ideas are shown in Tables 1 and 2 respectively.

Avery Shenfeld

- Global growth may exceed 4% in 2014, the best performance since 2010.
- Risks are smaller than they were a year ago.
- The biggest risk for Canada is that it does not get the anticipated lift from global growth.
- Should be a good year for the TSX, which has outperformed S&P 500 on the last six occasions when global growth exceeded 4%.
- TSX should benefit from better earnings growth than S&P 500 in 2014, and a smaller weighting for precious metals.

- Expects C$ to trade down to 89 US cents, before closing the year at 92 US cents.
- Long idea – Canadian forestry stocks (index or ETF) because of leverage to US housing.
- Short idea – US utilities, due to tougher government policies on coal and investors' move to growth-oriented stocks.

Jim Gilliland

- Europe is stabilizing – Economists on the Continent are more positive about the European economy than economists elsewhere.
- **China may be an issue – The Chinese government wants to rein in $6 trillion "shadow banking" industry, therefore investors may be forced to take losses on "wealth management products" like the "Credit Equals Gold No.1 " product, a three-year note that matures January 31** (see Bloomberg link below for background on this topic). http://www.bloomberg.com/news/2014-01-17/will-china-s-shadow-banking-craze-slow-down-.html
- Real rates are going up in 2014, which is not positive for gold.
- Investors are still not bearish enough on gold stocks.
- Long idea – Capital Power Series 5 4.5% Preferred Shares, which were trading at about 85 cents on the dollar and had a current yield of 5.2%. If called, would provide yield of 6% to 8%. (These preferred shares reset in June 2018 at 5-year GoC yield + 315 bps).
- Short idea – Canadian utility Emera Corp. Hedge ratio of 4:1 (long CPX Preferred shares, short EMA stock).

John Mauldin

- US dollar may get a lot stronger over the next five to seven years.
- Maintains that we are still in a secular bear market, which usually have three major corrections, and we have had two so far. S&P 500 may dip 15% this year, but should end the year up 10%.
- Long idea – Global Robotics & Automation Index ETF (Nasdaq: ROBO).
- Short idea – Japanese yen, French bonds.

Table 1: End-2014 forecasts by presenters at the CFA Forecast Dinner

	Levels (Jan.21)	Gilliland	Mauldin	Shenfeld
TSX Composite	13,951.77	*14,500*	*Not Provided*	*+10%*
S&P 500	1,843.80	*1,935*	*+10%*	*+5%*
10-year yields – GoC	2.51%	*2.75%*	*Not Provided*	*3.00%*
US Treasury	2.83%	*3.00%*	*2.50%*	*3.25%*
Gold	US$ 1,241.41	*US$ 1,200*	*US$ 1,240*	*US$1,150*
C$	US$ 0.9117	*US$ 0.88*	*US$ 0.95*	*US$ 0.92*

Table 2: Long-short ideas by presenters at the CFA Forecast Dinner

	Gilliland	Mauldin	Shenfeld
LONG	*Capital Power Series 5 Preferred (TSX: CPX E, $21.73)*	*Robo-Stox Global Robotics & Automation Index ETF (NASDAQ: ROBO, $27.41)*	*Canadian forestry stocks index*
SHORT	*Emera (TSX: EMA, $31.32)*	*Japanese Yen France bonds*	*US Utilities*

* Prices as of January 21, 2014

Chart of the Day – TSX reaches 14,000 for first time since May 2011

Near-parabolic gain of 19% over past seven months, marginally outperforming S&P 500

The TSX touched the 14,000 mark last week for the first time in more than 2½ years. The many market-watchers expressing angst at the dismal state of affairs in Canada – as exemplified by the loonie's 4.2% decline YTD, the second-worst performance of the world's major currencies after the South African rand – may be surprised to note that at last week's high of 14,002, the TSX was up 19% from its June 24 low, marginally better than the S&P 500's 18.6% advance over the same period. The index has had a near parabolic increase over the past seven months (blue line in Figure 1), so a pullback is overdue. The long-term trend line that has been tested on a number of occasions since 2012 seems in little danger at this point, although a 5% plunge in the index would necessitate that a revisit of that view. If the TSX breaks convincingly through 14,000 on the next leg up, the logical target would seem to be the double-top around 14,325.

Figure 1: TSX Composite – 2009 to Present **(Source: Bloomberg)**

Economic Analysis

Bank of Canada's stance pushes Canadian dollar to 4½-year low

The Canadian dollar fell as much as 1.9% last week as it reached a low of 89.50 US cents (US$1 = C$1.1174) on Thursday. The currency's decline picked up steam after the Bank of Canada left its benchmark overnight interest rate unchanged and said that the loonie's strength is hurting exports. In its quarterly Monetary Policy Report, the Bank said that despite its recent depreciation, the Canadian dollar remains strong (by historical standards) and continues to affect the competitiveness of Canada's non-commodity exports.

The Bank said in its interest rate announcement that the Canadian economy will return gradually to capacity over the next two years, with real GDP growth projected to increase from 1.8% in 2013 to 2.5% in both 2014 and 2015. On the subject of risks to the economy, the Bank said that downside risks to inflation have grown in importance. The Bank noted, however, that recent data have been consistent with its expectation of a soft landing for the housing market and stabilizing household debt relative to income.

Bearish bets against the loonie are mounting. CFTC data show a net-short position in the C$ of 67,345 contracts as of January14, a reversal of the year-ago net-long position of 68,668 contracts. **A number of currency strategists and analysts now have the C$1.15 level (87 US cents) as the next downside target for the currency**.

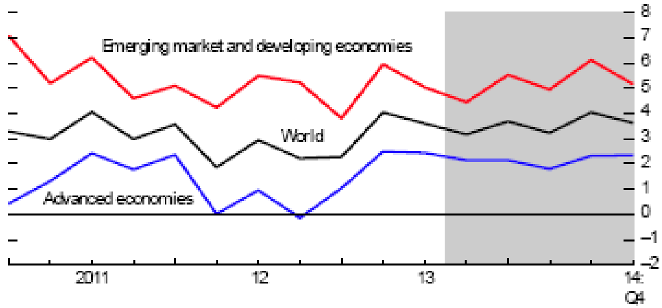
Bank of Canada's stance pushes Canadian dollar to 4½-year low

The International Monetary Fund, in its World Economic Outlook update released on January 21, marginally raised its forecast for 2014 GDP growth (Figure 2) to 3.7% (from 3.6%), and left its 2015 GDP growth forecast unchanged at 3.9%. The 2014 increase is attributed to faster growth of 2.2% (2.0% earlier) in the advanced economies, led by 2.8% growth in the US.

Growth in the emerging market and developing economies is unchanged from its previous 2014 forecast at 5.1% (led by China's 7.5% and India's 5.4% growth rates respectively). The IMF noted that although domestic weaknesses remain a concern in these economies, their growth should be boosted by stronger external demand from the advanced economies.

In terms of risks, the IMF said that increased volatility in financial markets and capital flows in emerging markets remain a concern, as the Federal Reserve will commence tapering early this year. **With the next FOMC announcement scheduled for January 29, expect emerging market volatility to continue unabated in the near term**.

Figure 2: Global GDP Growth (q/q % annualized)



Source: IMF

Market Snapshot

At close on Friday, January 24, 2014

S&P TSX	13717.76	-215.21	Commodities			Yields (%)	Can.	US
TSX Venture	967.31	-16.08	Canadian $ (US cents)	90.21	+0.12	90 Day T-Bill	0.89	0.05
DJIA	15879.11	-318.24	Gold (Spot)-US$	1270.07	+5.93	2-Year Bond	0.96	0.34
S&P 500	1790.29	-38.17	Oil (WTI-March)	96.64	-0.68	10-Yr.Bond	2.39	2.72
NASDAQ	4128.17	-90.70	CRB Index	282.54	+1.25	30-Yr. Bond	2.97	3.63

Thought for the Day

"Success isn't permanent, and failure isn't fatal." – Mike Ditka

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