OUTLOOK & PORTFOLIO STRATEGY UPDATE

Little upside seen for TSX and S&P 500 from current levels
End-2014 target for TSX is 15,500 (up 7.6% from 14,400 previously)
Global growth could reach 4% in 2015 as headwinds abate

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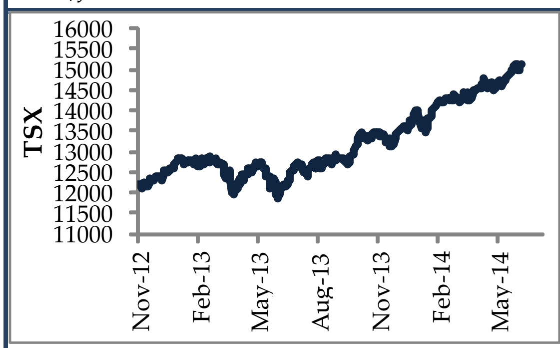
Index Levels	
TSX	15524.82
TSX-Venture	1011.10
DJIA	16880.36
S&P 500	1970.07
Nasdaq	4462.90
MSCI World	1,744.20
Risk Metrics	
VIX	13.33
TED Spread	0.22%
FAIL®	2.75
Interest Rates & Commodity Prices	
Canada T-Bll (90 days)	0.94%
US T-Bill (90 days)	0.03%
Canada 10-yr Govt.	2.15%
US 10-yr. Treasury	2.56%
CRB Index	490.36
Spot Gold	$1297.13
Crude Oil (Sep)	$100.27
Canadian Dollar	91.71 US cents
USD/Euro	0.7466
USD/JPY	102.82



Priced as at July 30, 2014
Source: Bloomberg

- Raging bull or aging bull? The former is indisputable but as the global rally enters its sixth year, the trillion-dollar question is whether the end is nigh for this aging bull.
- The TSX has benefited from the global rotation into cyclical groups like energy and commodities to record the second-best performance YTD among major markets.
- Our assessment in December that the main risk factors to the Canadian economy appear to be moderating has proved to be correct. The Bank of Canada said this month that housing appears to be on course for a soft landing, while the ratio of household debt to disposable income is expected to stabilize. It expects real GDP growth in Canada to average about 2¼% during 2014-2016.
- The IMF lowered its 2014 global growth forecast by 0.3 percentage point to 3.4% due to a weak Q1, but expects the global economy to rebound to 4% growth in 2015.
- We believe the TSX and S&P 500 are fairly valued at current levels, and see little upside from here. Our index targets mean that investors can expect few incremental returns apart from dividends at these levels.
- **Key risks to our outlook** – Faster than expected normalization of monetary policies in key economies; geopolitical risk; valuations; macro risk resurgence.
- **Portfolio strategy points** – stocks continue to be preferable to bonds; retain cyclicals, add defensive stocks; time for stock picking, not indexing; commence building hedges to protect gains; avoid momentum plays.
- **Our end-2014 index targets: TSX 15,500; S&P 500 1,975**
- **Recommended Asset Allocation (**no change from December 2013**): Stocks 65%, Bonds 15%, Cash 20%.**

Charts and Tables – Gint Austrins

Market Review

(R)Aging Bull

A CNBC newscast on March 7, 2014 – almost five years to the day since the commencement of this global rally – pondered the subject of whether this is a raging bull or an aging bull. That this has been a raging bull market is indisputable. Over the course of this rally, the TSX Composite has doubled and the S&P 500 has almost tripled from their multi-year lows of March 2008, and a number of stock indices around the world have set new records. But as the global rally continues well into its sixth year, the obvious trillion-dollar question is whether the end is nigh for this aging bull.

There are compelling arguments that can be made to support both the bull thesis and the bear case. A continuation of the rally is supported by a number of factors – monetary policy that remains extraordinarily stimulative in many major nations, double-digit earnings growth forecasted at least to 2015 for the TSX and S&P 500, tremendous breadth that has seen most sectors participating in the rally, and rising mergers & acquisitions activity (global M&A exceeded $1 trillion in Q2 for the first time since Q2 of 2007). Factors that support the bear case include "stretched" valuations in certain sectors (as noted recently by Janet Yellen), an undue sense of complacency reflected by record low volatility, and an upsurge in geopolitical risk this year. We analyze these factors in some detail in the following sections.

So far into 2014, indices of resource-rich economies are among the best performers. The TSX has benefited from the global rotation into cyclical groups like energy and commodities to capture the No.2 spot for YTD performance behind India, where the benchmark Sensex has surged to new highs following the ushering in of a pro-business government. Brazil's Bovespa and the TSX-Venture index take the next two spots, with Australia's ASX 200 in seventh place (Figure 1).

The average YTD gain of 4.34% posted by the 15 markets we track masks some variance in individual market returns, but this is much less than the divergence seen last year. Gains in U.S. markets are moderating after their spectacular performance in 2013, but that has been enough to send the S&P 500 and Dow Jones Industrial Average into record territory. Japan was the best performer among global equity indexes last year, but is in the red YTD. European bourses had a solid 2013, but are barely in positive territory this year. The worst-performing equity market is Russia, which is down more than 15% as sanctions imposed by the U.S. and European Union on the nation because of Moscow's support for rebels in Ukraine take a toll on the economy.

Figure 1: Major equity indexes – YTD performance and valuations

Country	Index	Forward P/E	Indicated Yield	YTD Change
India	Sensex 30	13.9x		23.22%
Canada	TSX	14.8x		13.97%
Brazil	Bovespa			10.43%
Canada	Venture	28.6x		8.49%
US	Nasdaq	18.0x		6.86%
US	S&P 500	14.8x		6.58%
Australia	ASX 200	14.3x		5.06%
Mexico	IPC	18.1x		3.71%
China	Shanghai	7.7x		3.08%
US	DJIA	13.8x		1.83%
Germany	Dax	11.9x		0.43%
France	CAC 40	12.9x		0.38%
UK	FTSE 100	13.1x		0.36%
Japan	Nikkei 225	15.8x		-3.96%
Russia	RTS	4.9x		-15.27%

Source: Global Securities Research, Bloomberg

Economic Fundamentals

Global recovery is tenuous, but could reach 4% in 2015 as headwinds abate

Modest growth forecast for Canada to 2016, U.S. expected to rebound in 2015

Global market capitalization, currently at a record $65.5 trillion (as of July 30), surpassed the previous peak of $62.5 trillion set in 2007 in the seocnd quarter of this year. This record-breaking performance of equity markets may lead one to think that the global economy is motoring along at a 4%+ growth rate, like it was in the boom years before the Great Recession. But that is hardly the case. As the International Monetary Fund (IMF) and Bank of Canada have noted in recent repots, this has been an uneven, tenuous recovery.

The optimistic view of the global economy would be that concerted monetary stimulus from central banks around the world has fulfilled its objective; as major economies continue firmly on the recovery path, withdrawal of stimulus (starting with the Fed) in the years ahead should not have an adverse effect on growth. The pessimistic view would be that the global recovery has been modest at best despite unprecedented amounts of stimulus. Normalization of monetary plicies in key economies (see "Risk Factors" below) could therefore have unintended – largely negative – consequences.

In its World Economic Outlook Update released last week, the IMF lowered its global growth projection for 2014 by 0.3 percentage points to 3.4% because of a weak Q1 – particularly in the U.S. – and a less optimistic outlook for several emerging markets. Global growth is expected to rebound from Q2, and with stronger growth expected in some advanced economies next year, the IMF left its 2015 forecast at 4%.

In the U.S., gains in consumer spending and business investment in Q2 helped the economy rebound more than expected from the Q1 slump. GDP in Q2 rose at a 4% annualized rate, the highest since Q3 of 2013, after contracting 2.1% in Q1.

Concern that the GDP data could cause a hawkish tone in the Federal Reserve's FOMC statement on July 30 proved to be unfounded. The Fed tapered its monthly bond buying by $10 billion for the sixth consecutive meeting to $25 billion, keeping it on track to end the purchase program in October. The Fed noted that slack in the labour market is persisting even as the economy picks up. It also reiterated its intention to keep interst rates low for a "considerable period" after the asset purchase ends. On an interesting note, Philadelphia Fed President Charles Plosser dissented with this guidance, saying that "such language is time dependent and does not reflect the considerable economic progress that has been made toward the Committee's goals."

U.S. consumer confidence surged this month to its highest level in almost seven years on optimism about job prospects. Reflecting this confidence, consumer spending rose 2.5% in Q2, as durable goods purchases recorded the biggest gain in almost five years. The U.S. economy could pick up momentum in the second half of this year, which could carry over into 2015. The IMF forecast in its update that the U.S. economy will rebound to a 3.0% growth rate in 2015, from an expected 1.7% this year.

As for the Canadian economy, our asessment in our December Outlook report that the main risk factors to the economy seem to be moderating proved to be correct. The Bank of Canada said in its Monetary Policy Report this month that recent developments in the housing market have been consistent with a soft landing, while the ratio of household debt to disposable income is expected to stabilize. On July 16, the Bank maintained its overnight rate target at 1%, and said that with the global economy on a lower growth track – which it characterized as " a serial disaapointment" – it was forecasting growth in Canada that was a little weaker than previously forecast. However, the Bank still expects the lower Canadian dollar and a rebound in global demand to translate into a pickup in Canadian exports and business investment. The Bank expects real GDP growth in Canada to average about 2 ¼% during 2014-2016.

Outlook

Earnings Estimates for TSX, S&P 500 only down 2%-3% since December

The 2014 index EPS estimate for the TSX Composite (based on analysts' "bottom-up" earnings estimates for all index constituents) has come down since December – as is generally the case – but the present decline of 2.7% is low by historical standards, and much less than the 10.3% downward revision we had seen in mid-2013. If analysts were bullish on TSX earnings prospects for 2014 at the end of last year, they are only slightly less bullish now.

The biggest downward revisions since December 2013 have been for the Materials (-30%) and Utilities (-11%) sectors. Materials is the only sector forecast to post negative earnings growth (-11%) this year, after posting a 37% drop in earnings last year (on the positive side, earnings are forecast to rebound 45% in 2015). The earnings decline is expected to be led by a 17% slump in profits for diversified miners. Optimism at end-2013 that this group's earnings would rebound 50% this year after slumping 44% in 2013 has proved to be misplaced, as metal prices have not recovered fully.

The Health Care sector, which is a minor component of the TSX, is expected to record exponential earnings growth in 2014, while an earnings surge is also forecast for Information Technology. But what drives the TSX is the earnings outlook for the four biggest groups – Financials, Energy, Materials, and Industrials. Apart from Materials, the profit prognosis looks good.

Energy is forecast to be the standout performer, with earnings growth of 76% (Figure 2), compared with forecasted growth in December of one-fourth that figure. The earnings rebound in the Energy group follows declines of 10% and 25% respectively in the preceding two years, when Canadian crude oil pieces were among the lowest in the world due to limited pipeline capacity that constrained oil transportation to refineries, and natural gas was mired in a slump. That situation has since reversed, as record crude-by-rail shipments have alleviated pipeline constraints and significantly narrowed the discount between Canadian and global crude prices.

Earnings for the Financials group are forecast to grow 10% this year, as a positive earnings outlook for banks and insurers offsets a 10% decline in REIT sector profits. The big banks have offset lower net interest margins with solid growth in other areas like wealth management and consumer banking, while insurance company earnings are benefiting from buoyant equity markets and bond yields that are stable but with an upward bias. The REIT sector was buffeted by the prospect of higher interest rates last year (leading to a 42% plunge in profits) but those concerns as well as fears of a major correction in the Canadian real estate sector have subsided to a large extent.

The earnings outlook also looks solid for Industrials, the fourth-biggest group on the TSX, as major constituents like the railroads report record profits and sector earnings get a lift from the weaker Canadian dollar.

Overall, EPS for the TSX Composite is forecast to increase almost 27% this year to $928, which is close to our December forecast of $925. As we had expected, forecast EPS has come down from $953 at end-2013. However, the current earnings growth rate estimate is twice the earlier expectation largely because 2013 EPS for the TSX eventually came in at only $731, as much as 13.5% below the earlier consensus estimate of $845.

It remains to be seen whether the TSX manages to meet those lofty earnings growth expectations for 2014. Note that the TSX EPS estimate for 2015 is also down 3.5% from end-2013 levels to $1048, but the expected earnings growth rate is little changed at 13%.

For the S&P 500, the downward revision in index EPS is also relatively minor at 2%. Unlike the TSX, the divergence between actual 2013 EPS ($107.31) and the December consensus forecast of $107.45 was marginal. The S&P 500 had posted index EPS between $96 and $97 in 2011 and 2012, before breaking through $100 in 2013.

The S&P 500 is now forecast to post record EPS of almost $120 this year (Figure 3), up 11.7% from the previous all-time high of $107.31 in 2013. The divergence in forecast EPS growth for individual sectors is not as wide as it is for the TSX, with seven of the 10 groups expected to report double-digit EPS growth, led by the Health Care and Materials sectors. (The marked divergence in earnings prospects for the Materials groups in the S&P 500 and TSX is due to the abundance of chemicals and paint companies – which are posting record profits – in the former, while the TSX Materials sector is largely resource-based). The Consumer Staples and Financials groups are forecast to report profit growth in the mid-single digits, while the Telecoms sectors is the only one expected to report a decline in earnings (-6%).

Record S&P earnings (Figure 4) are being driven by operating margins that have expanded for five straight quarters and probably reached a new high of 10% in Q2, according to S&P index analyst Howard Silverblatt. The drivers of these record operating margins – improved productivity, contained costs for raw materials, little wage inflation – may stay in place into 2015, but not for much longer after that.

Figure 2: TSX Groups – Forecast EPS Change in 2013 and Valuations

TSX Group	Indicated Dividend Yield / Forward Index P/E**	Forecast EPS Change (%)*
TSX	14.8x	26.8%
Financials	12.7x	10.5%
Energy	16.4x	76.0%
Materials	17.9x	-11.2%
Industrial	16.2x	31.4%
Consumer Discretionary	13.8x	33.1%
Telecom Services	15.0x	5.0%
Consumer Staples	15.6x	16.0%
Health Care	13.0x	1632.3%
Utilities	18.6x	12.1%
Info Tech	16.9x	172.9%

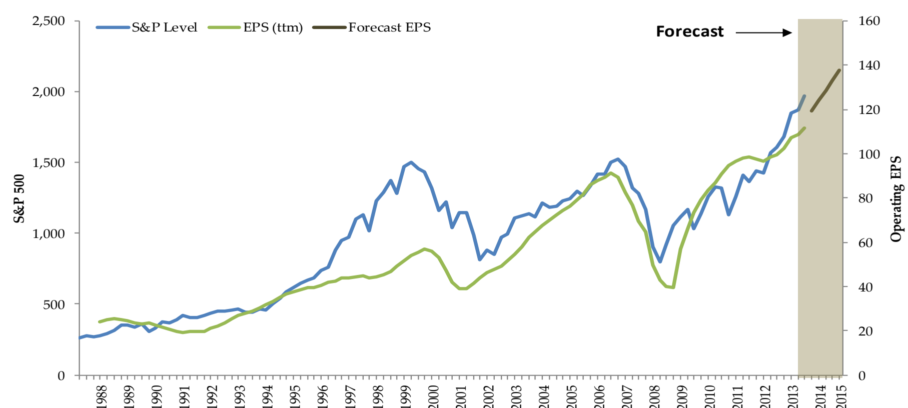
Source: Global Securities Research, Bloomberg

Figure 3: S&P 500 Quarterly Operating EPS Estimates

Period	2012-A	% Change	2013-A	% Change	2014-E	% Change	2015-E	% Change
Q1	$24.24	7.45%	$25.77	6.31%	$27.32	6.01%	$31.89	16.73%
Q2	$25.43	2.29%	$26.36	3.66%	$29.47	11.80%	$33.57	13.91%
Q3	$24.00	-5.10%	$26.92	12.17%	$30.56	13.52%	$34.48	12.83%
Q4	$23.15	-2.44%	$28.25	22.03%	$32.51	15.08%	$36.45	12.12%
Total	**$96.82**	**0.39%**	**$107.31**	**10.83%**	**$119.87**	**11.70%**	**$136.39**	**13.78%**

Source: Standard & Poor's

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



Source: Global Securities Research, Standard & Poor's

Valuations – getting rich but supported by expected earnings growth

The TSX Composite presently trades at a trailing earnings multiple of 21.2x past 4-quarter EPS of $729, compared with a 17.4 x multiple in December. It also trades at a forward multiple of 16.7x 2014 estimated EPS of $928. The S&P 500 trades at a lower trailing multiple of 18.1x past 4-quarter EPS of $109, and at a similar 16.4x 2014 forecast EPS of $119.87.

The TSX and S&P 500 are forecast to post earnings growth of about 13%-14% in 2015, which represents a slightly faster pace of earnings growth for the S&P 500 but is about half of this year's earnings growth rate for the TSX.

In our opinion, the TSX appears fairly valued on the basis of its 16.7x forward mutiple, and as a result, our end-2014 target is **15,500**, little changed from current levels. That target implies that the index is trading at a more reasonable multiple based on next year's earnings, or 14.8x 2015 forecast EPS of $1,048.

Our end-2014 TSX target of 15,500 represents a 7.6% increase from our December target of 14,400, and is a little above the median 15,300 forecast in a recent Reuters poll. The TSX has gained almost 14% YTD and 23.4% over the past year, and while it certainly has momentum on its side, gains of that magnitude are difficult to sustain indefinitely.

Our view is that the S&P 500 is also trading close to fair value, and based on a 16.5x multiple applied to FY14 EPS of $119.87, our end-2014 target is **1,975**, very marginally higher from its current level. Our new target represents an upward revision of 4.2% from our December target of 1,895.

Our index targets mean that investors can expect few incremental returns apart from dividends at current levels.

We have been calling for the TSX to outperform the S&P 500 in 2014, the first time it would do so in four years. The TSX is handily outperforming the S&P 500 YTD (by 739 basis points) and over the past year (by 654 bps). In fact, since reaching a taper tremor-induced low on June 24, 2013, the TSX has surged 32%, outperforming the S&P 50- by about 570 basis points.

There is a lesson here, and a disconcerting one at that. In the two previous global bull markets that terminated in 2000 and 2007, the TSX only peaked months after the S&P 500. Our view is that equity indices may have more upside next year, but if the performance divergence between the TSX and S&P 500 continues to widen, it may be a sign that the bull's days are numbered.

Risks to our Outlook

- **Faster than expected normalization of monetary policies in key advanced economies**: The IMF noted recently in its 2014 Spillover Report that with self-sustaining recoveries becoming apparent in the U.S. and U.K., their central banks will soon begin gradually unwinding extraordinarily accommodative monetary policies that were required after the 2008-09 global recession. Current market expectations are that the Federal Reserve will embark upon its first rate hike since 2006 either in Q1 or Q2 of 2015. Although the Fed / Yellen have repeatedly asserted rates will remain low for a "considerable period" after asset purchases end, we think dissenting voices such as Plosser's (as well as St. Louis Fed President James Bullard, who does not vote on Fed policy this year) should be viewed as a sign that there may be rising opposition to the Fed's "low for long" interest-rate philosophy. If the Federal Reserve is forced to accelerate the pace of normalization, equity markets might react quite adversely, given that easy money has been a major reason why equities are at record highs. U.S. interest rates may peak below historical highs because they are starting from a near-zero base, but that is counterbalanced by the fact that U.S. equities are already at all-time highs.

- **Geopolitical issues**: Equity investors have taken the resurgence of geopolitical risk this year in stride, but this equanimity could be shattered if the situation deteriorates in Ukraine or the Middle East. Despite sanctions imposed upon Russia, the fighting in Ukraine continues unabated. In the Middle East, Israel's ground offensive against Hamas in Gaza has triggered some of the fiercest fighting in years, while Iraq appears to be on the brink break-up. The combination of these geopolitical issues could lead to a spike in crude oil prices, which if it persists, could be a drag on the global economy.

- **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. Fed chair Janet Yellen said recently in Senate testimony that while price equity ratios and other measures are presently not outside historical norms, some asset values may be on the high side and valuations are becoming stretched in "pockets" like leverage loans and lower-rated corporate debt. The Federal Reserve, in a report accompanying Yellen's testimony, also expressed concern about equity valuations of smaller companies, as well as social media and biotech firms.

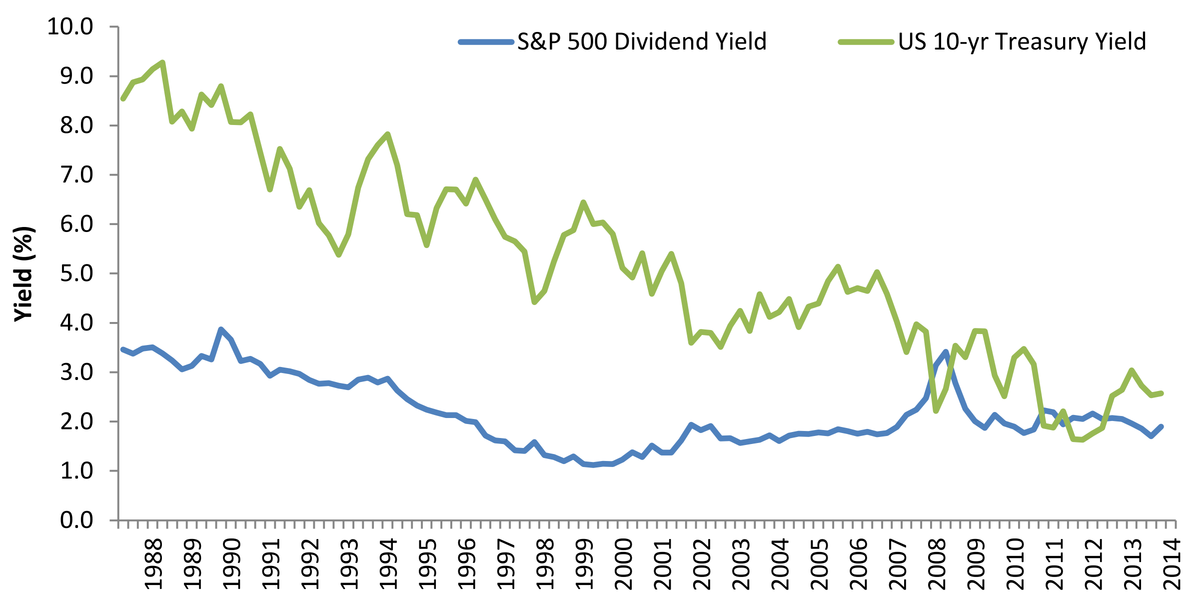
- **Resurgence of macroeconomic risk**: Argentina's debt default today has rattled global equities, as investors assess whether there may be a resurgence of macroeconomic risk.

Portfolio Strategy

We recommend the following portfolio strategies and investment themes for the remainder of this year.

1. **There's no question – stocks continue to be preferable to bonds in this environment**: Bond yields have backed off in both Canada and the U.S. this year, while the anomalous and infrequent situation of dividend yields exceeding 10-year Treasury yields has resolved itself in the US, it has not done so in Canada. The 2.56% yield on the 10-year Treasury now exceeds the 1.91% dividend yield on the S&P 500 by 65 basis points (Figure 5), down from a spread of 92 bps in December. In Canada, the 2.65% dividend yield on the TSX Composite exceeds the 2.16% yield on 10-year Canadas by 76 basis points, compared with 33 bps in December. Given the growth outlook, stocks remain preferable to bonds.

Figure 5: S&P 500 div. yield vs. 10-year Treasury yield: 1988 to mid-2014



Source: Global Securities Research, Standard & Poor's

2. **Retain cyclical stocks, but add defensive stocks as well**: Our call to rotate into cyclical stocks has worked out so far this year, with Materials and Energy the top two sectors on the TSX YTD (Figure 6). While we recommend holding on cyclical stocks as the global economy rebounds, we would suggest also adding stocks in defensive sectors like Utilities that are trading at attractive valuations and offer healthy dividend yields.

Figure 6: TSX Group Performance – Past 12 months and 2014 YTD

	2013 Performance	2014 YTD Performance / 2013 Performance	2014 YTD Performance
TSX	9.55%		13.97%
Materials	-30.59%		18.78%
Energy	9.86%		18.35%
Consumer Staples	21.37%		16.47%
Industrials	35.00%		16.36%
Information Technology	36.23%		12.06%
Financials	19.05%		11.49%
Consumer Discretionary	40.00%		11.18%
Health Care	72.00%		7.96%
Utilities	-8.60%		7.12%
Telecom Services	8.00%		3.50%

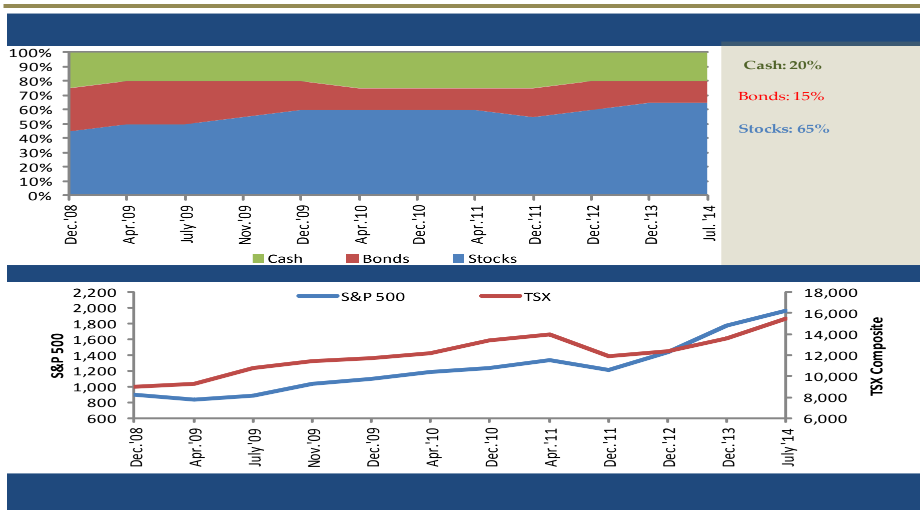
Source: Global Securities Research, Bloomberg

3. **This is a time for stock picking, not indexing**: With indices at all-time highs, we believe the risk-reward on broad indices is not as attractive as that available on specific stocks that have been lagging the advance.
4. **Commence building hedges to protect gains**: Thanks to low volatility, hedging is not expensive right now. The combination of stocks at record highs and low volatility is the ideal environment for building hedges such as covered calls, collars and straddles / strangles to protect gains and mitigate downside risk.
5. **Avoid momentum plays:** Skyrocketing stocks in hot areas like biotech may appear tempting, but should be avoided due to their high volatility, since they may be the first victims of the inevitable correction.

Asset Allocation

Based on the foregoing analysis, we are leaving our asset allocation unchanged from our December 2013 recommendation – **Stocks 65%, Bonds 15%, and Cash 20% (**Fig.7).

Fig. 7: Recommended Asset Allocation and changes since December 2008



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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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