The Bigger Picture

A weekly snapshot of the markets

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Highlights

Economic Analysis: Unexpected strength in Canada's jobs data for September.
Chart of the Day: TSX bounced off support today at 14,000; next support lies at 13,500.
Week ahead: 55 S&P 500 companies (representing 20% of market value) report this week.

Commentary – Four reasons why this correction may be overdone

Fastest global growth since 2011, surging U.S economy, valuation support, little inflation
Robust U.S. economy may bode well for Canada, given tight correlations between them
Elvis Picardo, CFA

The current market correction has taken on a life of its own, led by especially steep declines in small-caps and energy/commodity producers. The ferocity of the recent selloff has led to plunges of more than 20% – the precise definition of a bear market – for numerous stocks, raising the obvious question of whether this 5 ½-year bull market is well and truly over.

Like many market-watchers, we had been bracing ourselves for the seasonal bout of volatility that inevitably seems to hit markets in September and October. But far from the measured decline we had been hoping for, this is turning into a savage correction that was last witnessed in late-summer 2011. Back then, the triggers for the 21.5% correction in the S&P 500 (and -22.5% for the TSX Composite) from May to October 2011 were Standard & Poor's unexpected downgrade of the U.S. credit rating, and escalating concerns about European and U.S. sovereign debt. The current decline (-10.5% for TSX, -7% for S&P 500) has been precipitated by another fundamental macroeconomic issue, that of the outlook for global growth.

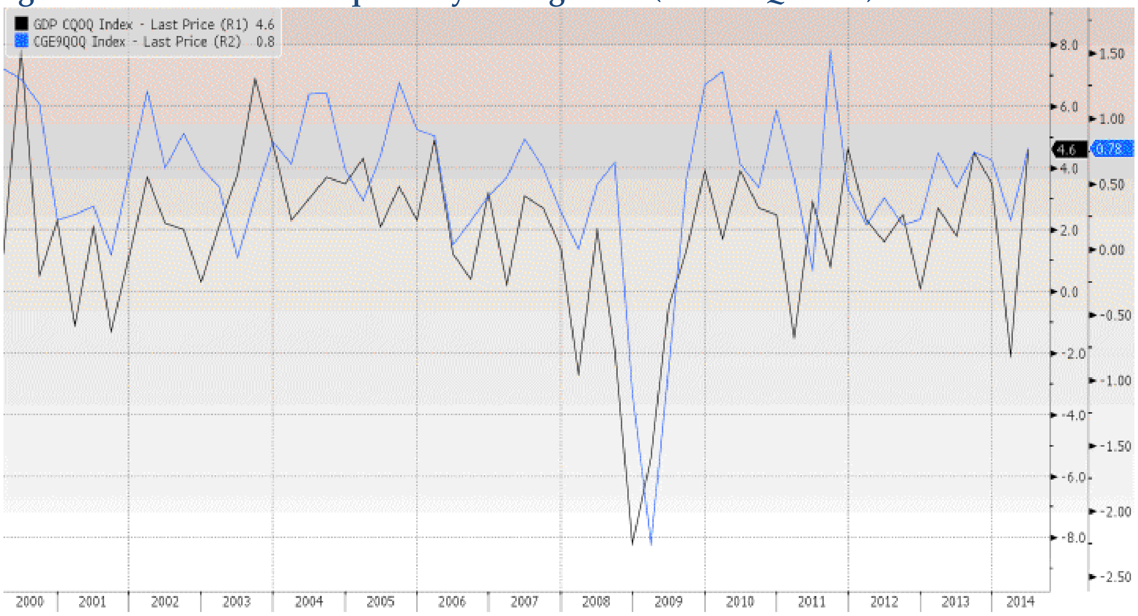
Niggling concerns about the growth outlook for a number of key economies in Europe and Asia had been percolating for months; in fact, accelerating price declines in commodities led to a 4.3% decline in the TSX last month. But it took the International Monetary Fund's World Economic Outlook (WEO) released on October 7 to coalesce these nebulous concerns, effectively providing a tough reality check to complacent markets and investors. Although the WEO is an authoritative document, it seldom has such an impact on equity markets as this one did.

Here are four reasons why we think the recent correction may be overdone –

- **The global economy is still expected to accelerate in 2015**: The IMF lowered its estimates for global growth from its July update, by 0.1-percentage point to 3.3% for 2014 and 0.2-percentage point to 3.8% for 2015. However, global GDP growth of 3.8% next year would be the fastest since 2011's 3.9%. Growth is forecast to be led by the U.S.; despite its economic woes, Europe is forecast to expand by 1.3% in '15 (from 0.8% in '14).
- **The U.S. is firing on all cylinders**: The IMF forecasts the U.S. economy will grow 3.1% in '15, compared with 2.2% in '14, which has also been the average annual growth rate for the economy since the recession ended in June 2009. Recent data confirm that the U.S. economy is close to firing on all cylinders, thanks to steady improvement in the job market, household wealth boosted by $15 trillion over the past two years, and robust corporate profits. The boost to consumer spending from the recent plunge in oil prices should also benefit the U.S. economy. Morgan Stanley estimates that a 15% drop in pump prices increases U.S. consumer spending by $60 billion. A solid U.S. economy bodes well for the Canadian economy, given the tight correlation between them (Fig.1).
- **Valuations remain equity-supportive**: Earnings for the S&P 500 are forecast to increase about 10% in Q3, after rising at a similar clip in Q2. Recent earnings reports from bellwethers like Alcoa and Intel suggest that these estimates are not overly optimistic. The S&P 500 currently trades at 15.8x estimated FY'14 EPS of about $119, while the TSX trades at 15.3x forecast FY'14 EPS of $920. Although those EPS estimates may be subject to significant downward revision (due to the impact of the stronger US dollar for S&P 500 companies, and lower crude oil prices for TSX energy producers), those valuations are equity-supportive even if actual earnings come in below forecasts.
- **Inflation is not a concern at present in the U.S.**: The recent market slide has had a favourable side-effect in the form of squashing U.S. inflation expectations. U.S. two-year notes last week rallied the most in four years, as traders lowered the odds of the Fed raising the federal funds rate by July 2015 to 33%, compared with 59% on September 18, the day after the last FOMC announcement. Minutes of that meeting released last week revealed that the Fed is concerned about the potential risks posed by weak global growth to the U.S. outlook, which makes the case for a U.S. rate hike less compelling. Other indicators also suggest that U.S. inflation is not a current concern. The PCE deflator has fallen short of the Fed's 2% goal for 28 straight months. As well, the five-year forward break-even rate that projects annual price increases during a five-year period beginning in 2017, fell to a three-year low of 2.14% on October 7, compared with an average of 2.7% over the past decade.

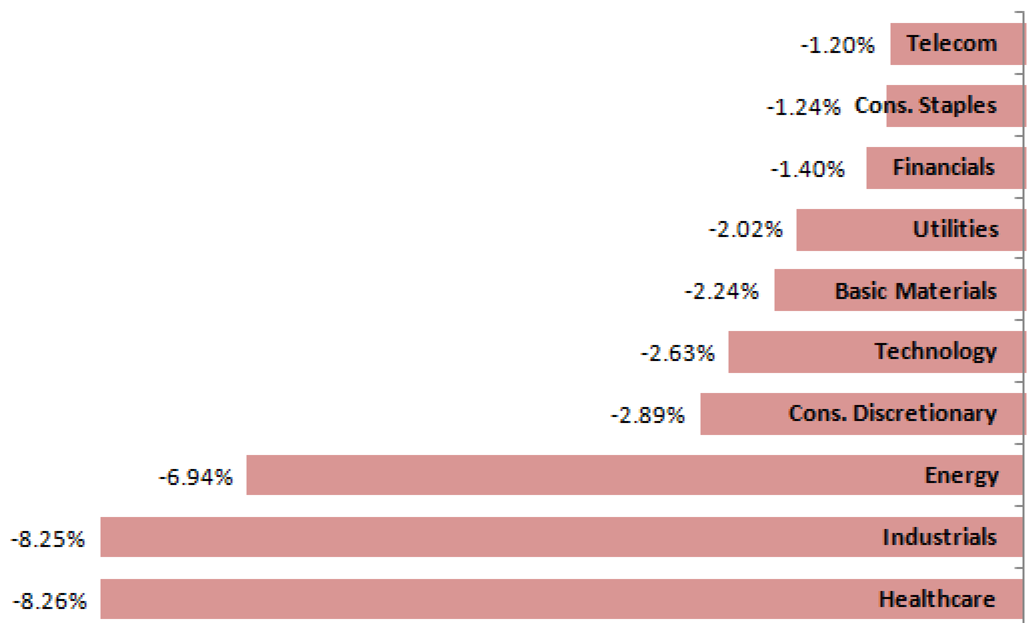
Bottom-Line: **In our opinion, current concerns about global growth – which we believe have been intensified by the Ebola scare – may dissipate by end-October as solid corporate earnings and valuation support enables investor optimism to reassert itself**. While further downside in major indices cannot be ruled out, there are some compelling opportunities to add to existing positions (or initiate new ones) in sectors like energy and materials.

Figure 1: US vs. Canadian quarterly GDP growth (2000 to Q2 2014)



Source: Bloomberg

TSX Sector Watch – Weekly change for TSX sectors (week ended October 10, 2014)



The TSX tumbled 3.8% last week – its sixth straight weekly decline – after falling 1.6% in each of the preceding two weeks. Last week's rout was broad-based, with the Energy group's 7% plunge exceeded by declines of over 8% for Industrials and Healthcare. Defensive groups like Telecoms and Consumer Staples fared a little better. After today's 1.34% drop, YTD gains for the TSX have been pared to 3.05%, compared with 15.15% at its September 3 record high.

Economic Analysis

Canadian economy had unexpectedly strong job creation in September

Gains driven by record private-sector jobs growth of 123,600, offsetting August's record decline
Canadian dollar traded today at new five-year low, as crude oil rout offsets volatile jobs data

Canada's always volatile jobs numbers produced another surprise on Friday, with payroll growth of 74,100 in September soaring past analysts' average 20,000 estimate, and more than making up for the 11,000 jobs lost in August. The unemployment rate fell to 6.8% (from 7.0%), the lowest in almost six years. Job growth was driven by a record 123,600 positions created in the private sector, which reversed a record decline of 111,800 in August.

In another surprise, most of the jobs created were in the full-time category (+69,300), as part-time jobs accounted for only 4,800 or 6.5% of the total. Also unexpected was the fact that most of the jobs created were in the goods-producing sector (+60,200), rather than the services sector (+13,800) that typically drives employment growth. In the former category, natural resources and construction created almost 28,000 and 30,000 jobs respectively. Among service providers, job gains of 48,000 in accommodation/food services and 21,000 in finance, insurance & real estate offset job losses of 44,200 in educational services and about 13,000 trade positions. In B.C., the economy created net 9,600 jobs, as an increase of 20,600 full-time positions offset a decline of 11,000 temporary jobs; the unemployment rate was unchanged at 6.1%.

After the strong U.S. jobs numbers that were reported a week earlier, the question is whether U.S. economic strength is rubbing off on Canada. The U.S. economy created 248,000 jobs in September, while the unemployment rate fell to 5.9%, the lowest since July 2008.

While Friday's jobs data provided a temporary respite to the sliding loonie, that support proved to be short-lived, as traders overlooked the volatile jobs numbers to focus instead on the ongoing rout in crude oil. The loonie traded today at a low of 88.40 to the U.S. dollar, its lowest levels since July 2009.

Screen Shots

No shortage of value candidates in the TSX Energy sector

Following the steep declines in the energy patch, we looked for Canadian producers that satisfied the following criteria:

- Membership: TSX Energy index
- Current dividend yield >=3%
- Forward estimated 12-month EV to EBITDA <=5%
- 3-month price change <=-10%

Nine stocks made the cut, as shown in the Table below (ranked by Consensus Upside, based on analysts' average target price). These stocks share common characteristics, in that most of them have manageable debt loads (based on net debt/EBITDA), trade at reasonable valuations (based on forward 12-month EV/EBITDA) and offer above-average dividend yields. Most of these stocks have also plunged at least 20% over the past three months (with the exception of Husky Energy); the average decline of almost 30% may enhance their appeal to value-oriented investors.

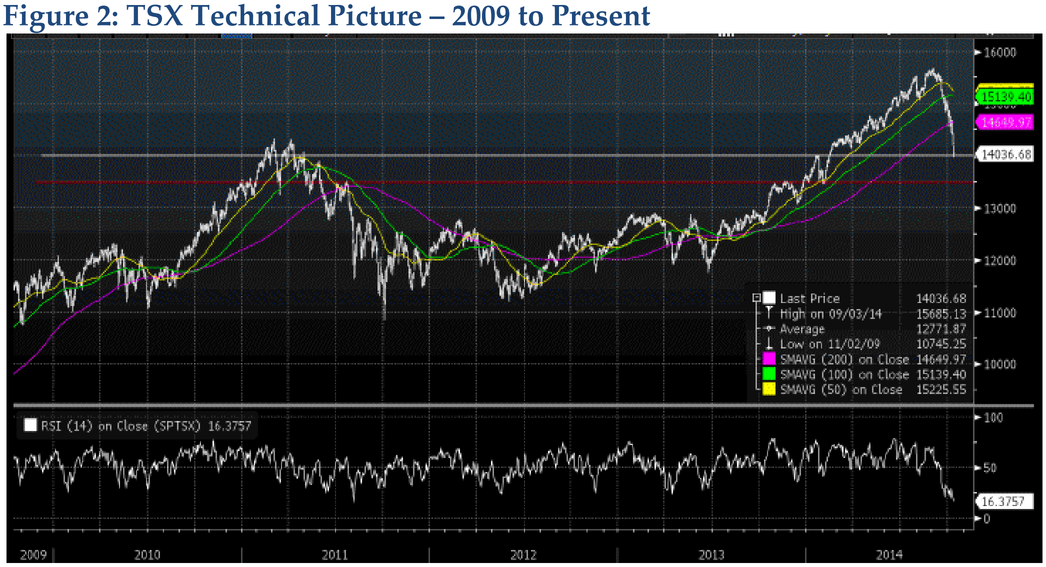
Name	Ticker	Price	EV/ Fwd EBITDA	Net Debt/ EBTIDA	Dividend Yield	3 Month Price Change	Consensus Upside
Canyon Services	FRC	$10.43	4.76x	0.36x	5.42%	-39.6%	98.72%
Calfrac Well Services	CFW	$13.31	4.97x	3.01x	3.60%	-33.6%	91.59%
Talisman Energy	TLM	$7.46	4.18x	1.63x	3.65%	-24.2%	73.71%
Penn West	PWT	$5.40	4.49x	1.82x	9.62%	-40.2%	72.09%
Enerplus Corp	ERF	$16.56	4.64x	1.03x	6.21%	-31.9%	69.89%
Savanna Energy	SVY	$6.38	4.43x	1.66x	5.60%	-22.8%	47.73%
Pacific Rubiales	PRE	$15.91	2.70x	1.45x	4.61%	-25.5%	47.00%
Husky Energy	HSE	$27.11	4.55x	0.67x	4.29%	-17.8%	41.47%
Ensign Energy	ESI	$13.41	4.45x	1.23x	3.44%	-21.6%	39.08%
		Average:	**4.35x**	**1.43x**	**5.16%**	**-28.6%**	**64.59%**

Chart of the Day

TSX bounced today off support at 14,000

Overwhelming bearish sentiment means that support for the TSX at 14,000 is unlikely to hold. As Figure 2 shows, the next support level lies in the 13,500 region (red line). The index looks oversold, with an RSI of 16.4, but has broken through its longer-term (20-day and 100-day) and shorter term (50-day) moving averages. With a decline of 10.5% from its record high of September 3, the TSX is now officially in correction territory.

Figure 2: TSX Technical Picture – 2009 to Present



The Week Ahead

U.S. corporate earnings will be in the focus this week. A number of major S&P 500 companies have already reported quarterly results. Today, heavyweights including JP Morgan Chase, Johnson & Johnson, Citigroup, Wells Fargo, and Intel kicked off a week in which more than 50 S&P 500 firms (representing ~20% of market value) report results.

The following key U.S. companies report this week:

- **October 15** – BlackRock, Bank of America, Netflix, American express, eBay
- **October 16** – Philip Morris, Goldman Sachs, Schlumberger, Google, Xilinx, Delta Air
- **October 17** – Honeywell, GE, Morgan Stanley

Market Snapshot

At close today

S&P TSX	14036.68	-190.68	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	803.17	-23.96	Canadian $ (US cents)	88.52	-0.78	90 Day T-Bill	0.86	0.02
DJIA	16315.19	-5.88	Gold (Spot)-US$	1232.54	-2.99	2-Year Bond	0.98	0.37
S&P 500	1877.70	+2.96	Oil (WTI-Nov.)	82.34	-3.40	10-Yr.Bond	1.94	2.20
NASDAQ	4227.17	+13.52	CRB Index	273.90	-2.82	30-Yr. Bond	2.49	2.95

Thought for the Day

"Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it."– Warren Buffett

IMPORTANT RESEARCH DISCLOSURES

Research Rating System

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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