Global Securities CORPORATION

Equity Research
1 (800) 455-5778
www.globalsec.com

The Bigger Picture

A weekly snapshot of the markets

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Looking ahead – Some stock ideas based on our 2015 Outlook

Elvis Picardo, CFA

Two overarching themes could drive portfolio performance in 2015, in our opinion – (a) the potential outperformance of the S&P 500 compared to the TSX Composite for the fifth year running, and (b) the likely decline in the Canadian dollar. We have discussed this in detail in our 2015 Outlook report released December 23, and offer below some stock ideas based on these primary themes.

The TSX has historically had a close positive correlation with global growth. We were optimistic until quite recently that the global economy could expand in 2015 at a rate close to 4%. In fact, the IMF's October estimate for global GDP growth of 3.8% in 2015, while representing a downward revision of 0.2 percentage points from its previous forecast, would still be the fastest growth pace since the 3.9% rate achieved in 2011.

However, as noted in our Outlook report, we now believe global growth estimates may need to be lowered again – despite the potential boost to global growth from lower oil prices – given the issues facing major economies such as Russia, Japan, and China.

Data released today show that the Russian economy contracted in November for the first time in five years, foreshadowing a recession in 2015. The economy contracted 0.5% last month from a year ago as economic sanctions begin to bite, and oil and the ruble continue to plunge. Although analysts forecast the Russian economy will shrink 1.4% next year, Russia's Finance Minister estimates GDP will contract about 4% in 2015 if crude oil is at $60 per barrel.

The Japanese economy contracted at a 1.9% annualized rate in Q3, with an increase in the consumption tax that was pushed through by Prime Minister Abe widely blamed for tipping the economy into recession. As for China, while one wouldn't suspect it going by the 50% surge in the Shanghai Composite YTD, the economy's projected 7.1% growth rate in 2015 would be the slowest since 1990.

Other trouble spots are erupting. Argentina, for instance, contracted 0.8% in Q3, while the steep decline in oil prices is creating economic stress for oil exporters like Venezuela, Nigeria and other OPEC members.

In a global environment that looks increasingly bleak, the U.S. stands out as a beacon of prosperity. The economy grew at a 5% annualized pace in Q3, the fastest growth pace in more than a decade, after expanding at a 4.6% pace in Q2. **The risk here is that if U.S. growth keeps accelerating, the Federal Reserve's avowed patience on the timing of rate increases may be tested; in this case, an aggressive tightening schedule could cause severe disruption in financial markets**. While the Fed is very likely to raise the federal funds rate in the first half of 2015 for the first time since 2006, the Bank of Canada is unlikely to do so before 2016 at the earliest.

The Canadian economy may grow at about a 2.5% pace in 2015, according to the Bank of Canada. However, that forecast may be at risk if the oil-rich western provinces are impacted by lower oil prices, in our view.

This divergence in monetary policy and economic prospects may push the loonie down to a low between 80 to 83 U.S. cents in 2015, in our opinion. Other forces may also contribute to a lower loonie next year – the currency's tight correlation with crude oil prices (Figure 1), and Bank of Canada Governor Poloz's preference for a weaker Canadian dollar because of the boost it provides to exports.

Figure 1: Canadian dollar vs. crude oil (WTI 1st month) – One year

Source: Bloomberg

Based on the above, here are some stock ideas for 2015 –

- **Canadian investors may continue to benefit from exposure to U.S. stocks and broad ETFs, despite the loonie trading at a 5½-year low**: The S&P 500 closed today at a new record high of 2090.57, and although our value orientation makes

us reluctant to buy aggressively at these levels, Canadian investors could conceivably generate 10% total returns by investing in an unhedged U.S. ETF like the **SPDR S&P 500 ETF Trust (SPY: $208.72)**. Our 2015 S&P 500 target of 2,200 implies total returns of about 7% (including 1.8% from dividends), with expected C$ depreciation adding another 3%. Conversely, our 2015 target of 13,500 for the TSX implies total returns for the Canadian benchmark of approx. *negative* 5% (including dividends of 2.9%).

- **Consider U.S. stocks that are leveraged to U.S. growth**: **General Electric (GE, $25.70),** one of the components of our Model Portfolio, is down 8.3% YTD but could turn around in 2015, given its long-standing status as a proxy for the U.S. economy. Our target price on GE of $30, if attained, could result in total returns of about 20% (incl. 3.6% in dividends). U.S. banks like **Bank of America (BAC, $18.11)** also look interesting, especially as Canadian banks may find it difficult to replicate their record performance for most of 2014 next year. That said, **TD Bank (TD, $55.70)** remains our pick among Canadian banks because of its greater exposure to the U.S. economy than its peers.

- **Strike a balance between cyclical and defensive stocks**: The best values currently seem to be in cyclical sectors like energy and materials. But at this extended stage of the economic cycle (5½ years), it is difficult to justify going full-tilt into cyclicals, although we continue to recommend selective additions in these sectors. For example, consider **Teck Resources (TCK/B, $15.86)**, which trades at compelling valuations but necessitates a long-term view. In the energy space, as noted in earlier issues of this publication, our top picks are best-of-breed companies like **Suncor Energy (SU, $37.40)** and **Crescent Point Energy (CPG, $28.74)**, although the 20% to 30% bounce in these stocks from their recent lows may make it advisable to wait for a pullback before making new purchases. In defensive sectors, while it is getting difficult to find reasonably-priced stocks in Canada, U.S. stocks like **AT&T (T, $34.11)** seem like better value.

- **Avoid the high-fliers, momentum names, China**: 2015 could well see elevated volatility compared with the measured advance in equity indices seen over the past three years. In our opinion, we could see a repeat of the periodic sell-offs witnessed this year, and therefore recommend staying away from high-beta names that could be in the forefront of a broad market decline. **Sectors that we think are the most vulnerable in this regard are biotechs, social media, solar power and airlines**. We also suggest reviewing portfolios with a view to identifying stocks that were big winners in 2014 so as to take some profits in these positions. Figures 2 and 3 show the best and worst performers YTD for the TSX and S&P 500. 2015 may also be a year when short sellers finally recoup some of the losses inflicted by the relentless bull market. China's slowing economy and surging stock market may make it a favoured target for short sellers yet again in 2015, with their preferred vehicles for shorting likely to be ETFs like the **SPDR China ETF (GXC, $79.36)** and **iShares China Large-Cap ETF (FXI, $41.59)**.

Figure 2: TSX best and worst performers - 2014 YTD

Figure 3: S&P 500 best and worst performers - 2014 YTD

Disclosure: The analysts and/or members of their households may have long or short positions in a number of stocks discussed in this report, including SPY, CPG, and SU.

Market Snapshot

At close today

S&P TSX	14663.92	+54.67	Commodities			Yields (%)	Can.	US
TSX Venture	681.61	+7.29	Canadian $ (US cents)	85.93	-0.07	90 Day T-Bill	0.89	0.00
DJIA	18038.23	-15.48	Gold (Spot)-US$	1183.29	-12.71	2-Year Bond	1.03	0.71
S&P 500	2090.57	+1.80	Oil (WTI-Feb.)	53.61	-1.12	10-Yr.Bond	1.83	2.20
NASDAQ	4806.91	+0.05	CRB Index	233.24	-1.40	30-Yr. Bond	2.38	2.77

Thought for the Day

"May the best day of your past be the worst day of your future."– Irish toast

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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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