Market Bulletin

Issue No. 227
October 28, 2013

Summary

Chart of the Day

- Bullish MACD crossover in TSX could augur more gains ahead.

Recommendation

- TransAlta – Reiterate Buy ahead of Q3 earnings report on October 31.

Commentary – Implications of the Bank of Canada dropping its rate-hike bias

Monetary Policy Report trims growth forecast, but flags higher global growth as upside risk

Elvis Picardo, CFA

The Bank of Canada last week left its overnight target rate unchanged at 1%, as widely expected, for the 25th consecutive meeting. It also eliminated the reference to an eventual increase in interest rates which had been included in its rate announcement for the past 18 months. We summarize below the market implications of this dovish move –

- The Canadian dollar fell by almost a cent against the US dollar on October 23, and declined by more than 1½ cents against the greenback last week. The loonie seems to be on course to test support in the 94.50-95.00 US cents region in the short-term. Further out, the currency could find support from a turnaround in energy and commodity price as the global economy strengthens.

- Interest rate hike expectations have been pushed out by one calendar quarter. Economists surveyed in a Bloomberg survey now expect a rate increase only in Q1 of 2015, compared with the previous forecast for a rate hike in Q4 of 2014.

- Rate-sensitive sectors in Canada – REITs, utilities, telecoms and pipelines – which had already been in recovery mode since the Federal Reserve announced on September 18 that it would delay its tapering program, have reacted positively to the BoC news, adding to recent gains and boosting the TSX.

The Bank also released its Monetary Policy Report on October 23. While the BoC marginally trimmed its growth forecasts for Canada and the world, the MPR contained a couple of nuggets that could bolster the bullish case for the TSX, as summarized below –

- The Bank said that although the global economy is expected to expand modestly in 2013 (Figure 1), "the near-term dynamic has changed and the composition of growth is now slightly less favourable for Canada." The Bank noted that while the U.S. economy is softer than expected, growth should accelerate through 2014 and 2015 as fiscal headwinds dissipate and household deleveraging ends.

- In Canada, uncertain global and domestic economic conditions are delaying the pick-up in exports and business investment, resulting in a lower level of economic activity than the Bank had been expecting. Real GDP growth in Canada is projected to increase from 1.6% this year to 2.3% in 2014 and 2.6% in 2015.

- Total CPI and core inflation are expected to return more gradually to 2% around end-2015, when the economy is also expected to return to full production capacity.

- The Bank identified more robust growth than projected in the advanced economies as one of two important external risks (the other being a more protracted euro-area recovery), that could present an upside risk to Canadian inflation. It said that **greater global demand would translate into higher Canadian exports and rising commodity prices, which would support higher consumer incomes and spending**.

- It also identified three domestic risks (one upside and two to the downside). **The upside risk is that domestic momentum builds faster than expected as confidence returns**. The Bank noted that business sentiment could improve rapidly as the recovery in foreign demand becomes more entrenched and domestic demand continues to grow at a moderate pace.

- "Disorderly unwinding of household sector imbalances" remains a key domestic downside risk, given the elevated level of household debt and stretched valuations in some segments of the housing market.

With regard to the last point, the risk posed by near-record household debt-to-income levels is somewhat mitigated by the fact that debt-service ratio is very low (Figure 2), in our opinion. The Bank expects debt-service ratios to rise gradually but remain low. This appears to be a likely scenario as the Bank remains on hold with regard to rate hikes through next year.

The TSX seems to be gaining upside momentum as a number of factors seem to be coming together for the first time in a couple of years (see our October 21 Commentary – "Further gains in store for the TSX as stars get into alignment"). The index rose 2% last week, outperforming the S&P 500 (+0.88%) by more than a percentage point for the week, and is up 7.77% YTD. The path of least resistance for the TSX at this point appears to be upward.

Figure 1: Bank of Canada's projections for global economic growth

	Share of real global GDP[a] (per cent)	Projected growth[b] (per cent)			
		2012	2013	2014	2015
United States	20	2.8 (2.2)	1.5 (1.7)	2.5 (3.1)	3.3 (3.2)
Euro area	14	-0.6 (-0.5)	-0.4 (-0.8)	1.0 (0.8)	1.3 (1.3)
Japan	5	2.0 (1.9)	1.8 (1.9)	1.5 (1.3)	1.0 (1.2)
China	15	7.7 (7.8)	7.7 (7.4)	7.4 (7.3)	7.2 (7.5)
Rest of the world	47	3.2 (3.1)	2.8 (2.9)	3.4 (3.6)	3.7 (3.8)
World	100	3.1 (3.0)	2.8 (2.8)	3.4 (3.5)	3.6 (3.7)

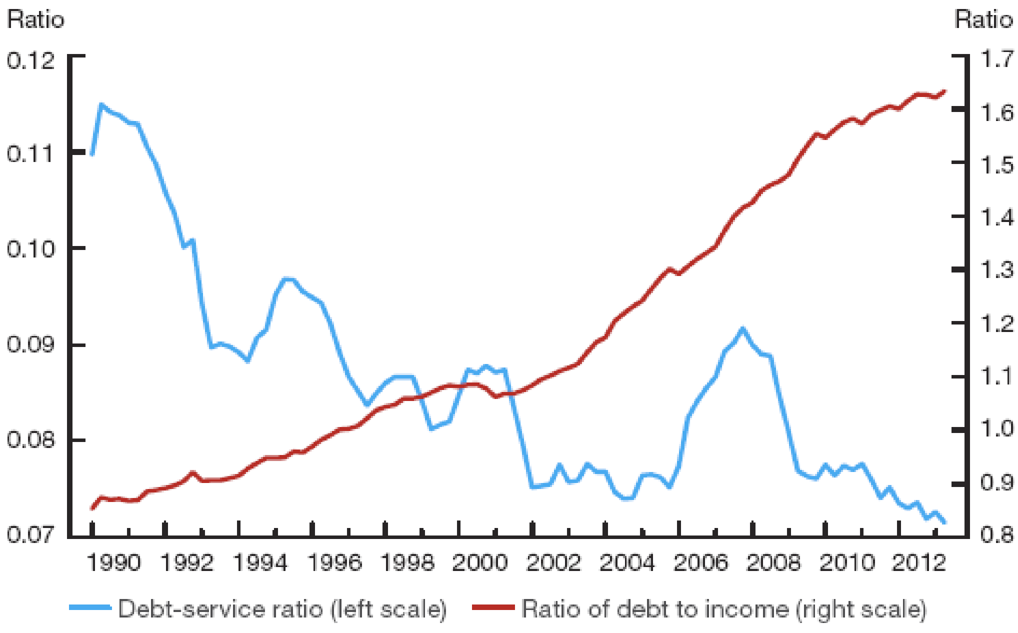
a. GDP shares are based on International Monetary Fund (IMF) estimates of the purchasing-power-parity (PPP) valuation of country GDPs for 2012. The individual shares may not add up to 100 owing to rounding.

Source: IMF, *World Economic Outlook*, October 2013

b. Figures in parentheses are projections used for the July 2013 *Monetary Policy Report*.

Source: Bank of Canada – Monetary Policy Report October 2013

Figure 1: Canadian households' debt-to-income and debt-service ratios



Source: Statistics Canada

Last observation: 2013Q2

Chart of the Day

Bullish breakout for TSX Composite
Index up 3.6% since MACD crossover signal on October 15

Figure 1 shows a bullish crossover in the Moving Average Convergence-Divergence (MACD) Indicator for the TSX Composite that developed on October 15. The crossover enabled the TSX to surge past the 12,800-12,900 area of strong resistance that had capped its advances on a number of occasions over the past two years. The index has surged 468 points or 3.6% from its October 15 close, and the strength of the move could augur additional gains as we head into the last two months of the year.

Figure 1: TSX MACD

Source: Global Securities Research, Bloomberg

Recommendation

(Update) TransAlta – Reiterate Buy ahead of Q3 earnings report on October 31
Stock should find support from 8.1% yield as dividend payers attract renewed interest

TransAlta (TSX: TA, $14.29) has managed to work its way higher over the past three weeks after finding solid support at the $13.25 level. We reiterate our Buy rating on the stock, with a $16 target.

TransAlta completed the spin-off of its Renewables business in August but has failed to get much traction from it. The company continues to hold an 80.7% stake in **TransAlta Renewables** (TSX: RNW, $10.22, dividend yield 7.3%), which last week announced the acquisition of a 14 megawatt wind farm in Wyoming for US$102 million. The wind farm is fully operational and has a power purchase agreement in place until 2028. The acquisition is expected to be accretive to RNW's cash available for distribution by about 2%-3%.

TransAlta is forecast to report Q3 EPS of $0.18 on revenues of $565.5 million later this week. The stock has reacted adversely to most earnings reports in recent quarters, the latest being a 5% decline on July 20 – the biggest one-day drop in four years – after it missed Q2 EPS estimates by a mile. While the risk of another earnings disappointment does exist, we expect TransAlta to be supported by its solid dividend yield of 8.1%.

Market Snapshot

At close on Friday, October 25, 2013

S&P TSX	13399.42	+74.66	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	973.58	+0.88	Canadian $ (US cents)	95.69	-0.29	90 Day T-Bill	0.90	0.03
DJIA	15570.28	+61.07	Gold (Spot)-US$	1350.80	+4.02	2-Year Bond	1.08	0.30
S&P 500	1759.77	+7.70	Oil (WTI-Dec.)	97.85	+0.74	10-Yr.Bond	2.42	2.51
NASDAQ	3943.36	+14.40	CRB Index	282.56	+0.89	30-Yr. Bond	3.02	3.60

Thought for the Day

"The reward of a thing well done, is to have done it." – Ralph Waldo Emerson

IMPORTANT RESEARCH DISCLOSURES

(1) The analyst and/or a member of the analyst's household have a long position in the following stocks discussed in this report – **TransAlta**

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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