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The Bigger Picture

A weekly snapshot of the markets

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Commentary – TSX closed at record last week, more gains likely

Top three reasons why index gains are likely to be sustainable this time (unlike in 2008)

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Global equities have responded in unequivocal fashion to the Federal Reserve's assertion in the FOMC announcement last week that interest rates will remain low for a considerable period. The TSX finally joined the S&P 500 and Dow Jones Industrial Average in closing at new highs last week, with the worldwide rally sending global market capitalization above $65 trillion for the first time. The current situation is markedly different from the previous period when the TSX reached a record high, viz. June 2008. Here are three reasons why the Canadian benchmark's gains are much more likely to be sustainable this time –

1. **Monetary policy remains extraordinarily stimulative**: Fed chair Janet Yellen said in the post-FOMC press conference that most FOMC participants see the federal funds rate remaining well below longer-run normal values at the end of 2016 for reasons such as the residual impacts of the financial crisis and lower potential growth rate of the U.S. economy. Earlier this month, the Bank of Canada and European Central Bank highlighted the risks posed by low inflation to their economies. With monetary policy remaining stimulative, equities should continue to do well, with the TSX in particular a major beneficiary of central bank largesse because of its exposure to the global economy.
2. **Very robust earnings growth**: TSX index earnings are forecast to surge 26% to $925 this year, led by a stunning 75% rebound in earnings for the Energy group. In the U.S., S&P 500 EPS is forecast to increase 9% to $118.21 this year, while earnings growth for the more broad-based Russell 3000 index is estimated at 12%.
3. **A very broad-based advance**: There is broad participation in the TSX advance this time, unlike previous episodes that were driven by one or two groups. As can be seen in Figure 1 – which shows normalized returns for the TSX and its four biggest groups since its previous high in June 2008 – this rally has been driven by the Financials and Industrials groups, with the Energy sector a big driver in recent months. If the lagging Materials group turns around, gains for the TSX could accelerate.

As noted last week, a level of 15,500 to 16,000 now seems attainable for the TSX going forward. The Canadian stock market now accounts for 3.5% of global market capitalization (Fig. 2), and we expect this share to grow as the TSX continues to gain.

Figure 1: TSX Sector Drivers – 2008 to Present (Normalized) (Source: Bloomberg)

Figure 2: Canadian to global market cap. – 2004 to 2014 (Source: Bloomberg)

Chart of the Day

Canadian dollar rises more than 0.5 US cent on inflation data

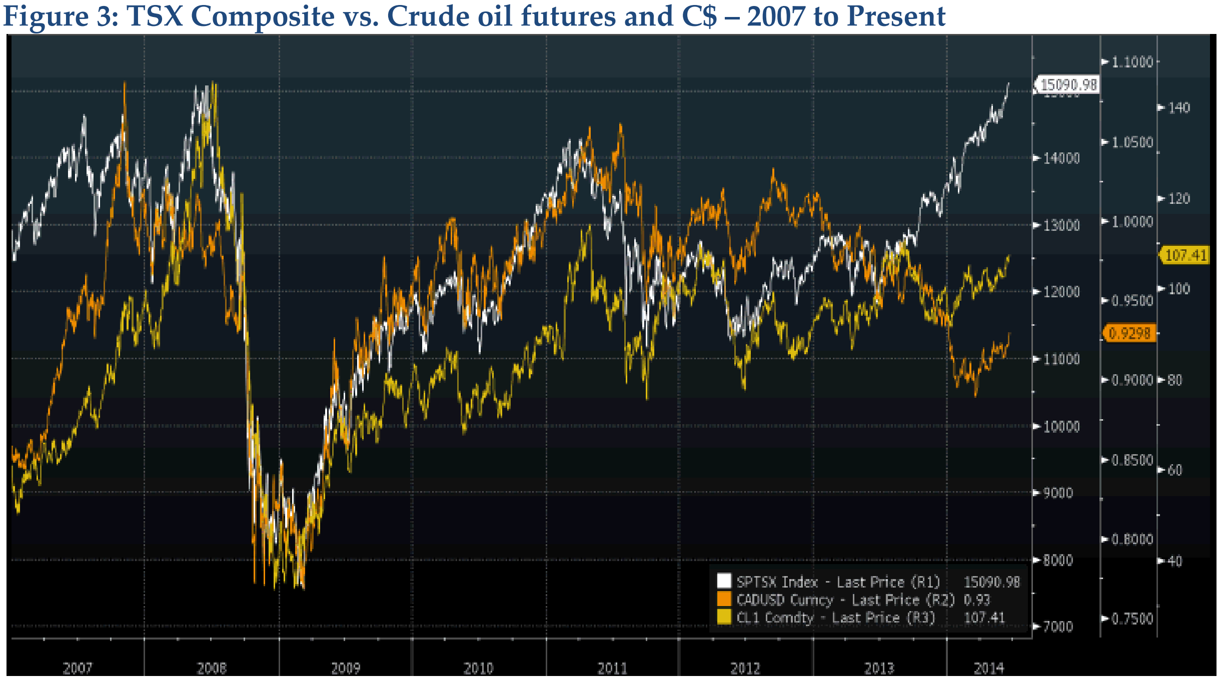
Strong positive correlation between TSX and loonie reasserting itself

The Canadian dollar surged more than 0.5 US cent on Friday after reports showed the CPI rose more than expected last month and retail sales rose faster than forecasts in April. The consumer price index rose 2.3% in May from a year earlier, after increasing at a 2.0% pace in the previous month. <u>The core rate increased 1.7% in May after a 1.4% gain in April</u>. Retail sales increased 1.1% to $41.6 billion, exceeding the highest forecast in a Bloomberg survey and well above the median estimate of a 0.6% increase.

The headline inflation number exceeded the Bank of Canada's 2% target for the first time in over two years. Bank of Canada Governor Stephen Poloz had left the benchmark lending rate unchanged at 1% on June 4, saying that the risk of persistent low inflation remains despite the temporary effect of higher energy prices. However, the latest data has stirred speculation that Poloz may have to rethink his view of core inflation remaining below 2%.

We have noted in previous issues that the historical positive correlation between the TSX Composite and Canadian dollar had broken down since last year, with the index heading higher even as the loonie fell against the U.S. dollar. That historical relationship is now reasserting itself, with the TSX and C$ moving up in sync, as can be seen in Figure 3. The loonie bears watching due to the significant impact it has on Canadian corporate earnings.

Figure 3: TSX Composite vs. Crude oil futures and C$ – 2007 to Present



Source: Bloomberg

The Week Ahead

Economy Watch

- **US GDP data on June 25** – The Commerce Department's third and final revision of Q1 GDP may show that the U.S. economy contracted in the quarter at the fastest pace in five years. While the previous estimate was for a 1% contraction, economists have since ratcheted their estimates lower to -1.8%, after a survey showed Americans spent less than expected on health care. Given that this data is backward-looking and has largely been discounted by market participants due to the unusually harsh winter, the GDP report is expected to have limited market impact.

Stocks to Watch

- **Companies reporting quarterly earnings next week include** – Micron Tech (June 23), Shaw Communications (June 26), Nike Inc. (June 26)

Market Snapshot

At close on Friday, June 20, 2014

S&P TSX	15108.97	-3.25	Commodities			Yields (%)	Can.	US
TSX Venture	1026.37	+4.31	Canadian $ (US cents)	92.96	+0.52	90 Day T-Bill	0.92	0.01
DJIA	16947.08	+25.62	Gold (Spot)-US$	1314.85	-5.54	2-Year Bond	1.13	0.46
S&P 500	1962.87	+3.39	Oil (WTI-Aug.)	106.67	+0.62	10-Yr.Bond	2.29	2.61
NASDAQ	4368.04	+8.71	CRB Index	312.93	+1.18	30-Yr. Bond	2.83	3.43

Thought for the Day

"Luck is what you have left over after you give 100 percent." – Langston Coleman

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