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The Bigger Picture

A weekly snapshot of the markets

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Commentary – Complacency reigns as geopolitical risk takes a backseat

Ability of markets to shake off concerns either smacks of unwarranted complacency, or unmatched resilience

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After a period of calm that lasted for three months, financial markets finally encountered some temporary turbulence last Thursday, caused by a spike in geopolitical risk. This risk spike was triggered by news of a Malaysia Air plane crash in Ukraine – the U.S. government says the commercial jet was brought down by a surface-to-air missile launched from rebel territory in eastern Ukraine – and the commencement of a ground operation by Israel against Palestinian militants in the Gaza Strip. The S&P 500 lost 1.2% on the day – its first decline of over 1% since April 10 – while U.S. Treasuries, gold, and the Japanese yen rallied on safe-haven buying.

But on Friday, it was business as usual, with the S&P 500 up 1% as concerns eased about the crises in the Middle East and Ukraine. We had noted in our July 7 Bulletin that of the three major risks that could derail the global equity rally, geopolitical concerns pose the smallest risk unless present conflicts threaten to spread to a broader arena.

Of the two other risk factors we had mentioned in our Bulletin – tighter monetary policy and valuations – the former does seem to be crystallizing as a more serious concern. This is despite Fed chair Janet Yellen's reassurances last week in her semi-annual testimony to the House Financial Services Committee that interest rates are likely to stay low for a "considerable period" after the Fed's bond purchases end. The Fed has scaled back its monthly pace of bond purchases by $10 billion for the last five FOMC meetings; currently at $35 billion per month, Yellen said the purchases could terminate after the FOMC meeting in October. Yellen also said that the Fed's bond holdings will support lower long-term rates even after QE is completed.

But there are some rumbles of dissent with this "low for long" interest-rate philosophy. Last week, St. Louis Fed President James Bullard noted that if macroeconomic conditions continue to improve at the current pace, the normalization process (of monetary policy) may need to begin sooner rather than later. Bullard said that while relatively low inflation and weak labour markets have suggested a later start to the normalization process until now, stronger-than-expected data, rising inflation and a rapid improvement in labour markets may force a change in these assumptions going forward. Bullard said that he believes the Fed should raise the federal funds rate at the end of Q1 2015, although economic data could change his view.

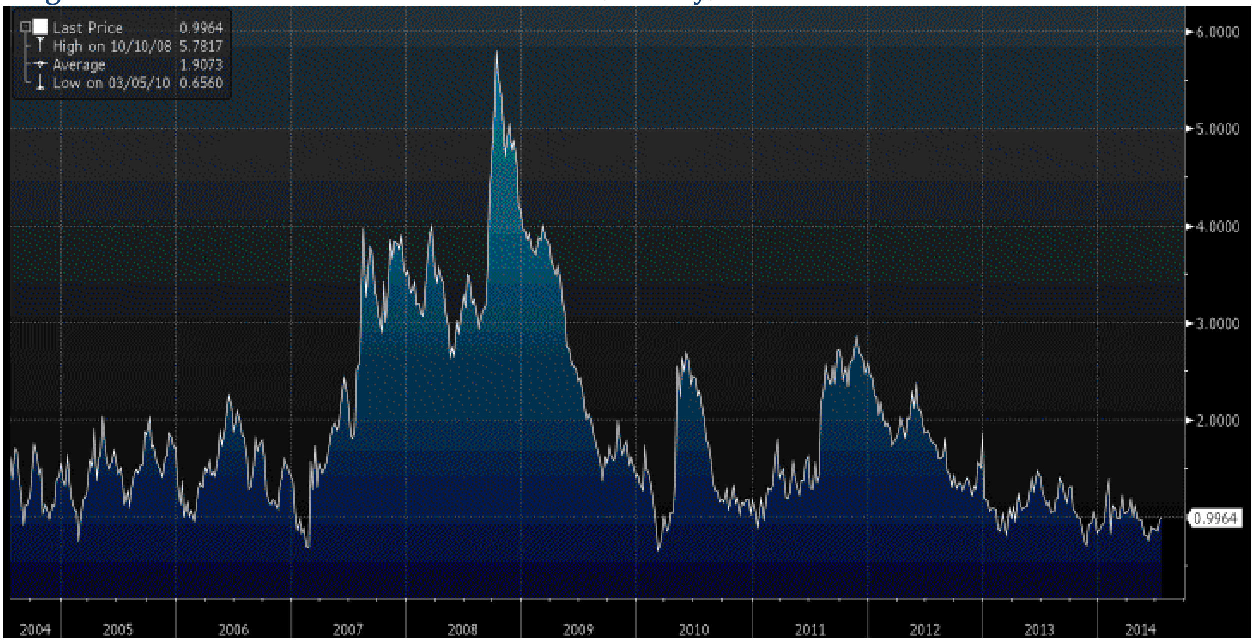
Hedge-fund manager Stanley Druckenmiller also said at a conference last week that the Fed's policy of keeping interest rates near zero for so long was risky and as "baffling" as it was in late-2003, when the Fed said that its target rate would stay at 1% for a "considerable period" (that phrase again!) even as growth was picking up. (Note that the Fed subsequently embarked on a tightening cycle from 2004 onwards that pushed the federal funds rate to 5.25% by 2006). Druckenmiller countered Yellen's remarks in her Senate testimony that the Fed needs to press on with record monetary stimulus because of persistent job market weakness, by pointing out that an easy monetary policy could do more harm than good in the present environment, where average net worth per household is above 2007 levels, unemployment is falling, industrial production is at a new high, and deflation is nowhere in sight.

The Federal Reserve also took the unusual step of weighing in on market valuations last week. During her testimony on July 15, Yellen said that while some asset values may be on the high side and valuations are becoming stretched in some "pockets" (such as leveraged loans and lower-rated corporate debt) in general price equity ratios and other measures are not outside historical norms. The Fed specifically raised concern about equity valuations of smaller firms, as well as social media and biotechnology firms, in a report alongside Yellen's testimony.

In terms of valuation, the TSX – which set a new closing record of 15,266.57 on Friday – and S&P 500 are trading at very similar forward multiples of about 16.5. The TSX is expected to post EPS growth of 9% in Q2, while earnings growth for the S&P 500 is projected at about 6%. Although this represents solid earnings growth, it is well below 2014 forecast earnings growth of 26% and 12% for the TSX and S&P 500 respectively, which implies that analysts expect corporate profits in the second half to make a disproportionate contribution to 2014 earnings.

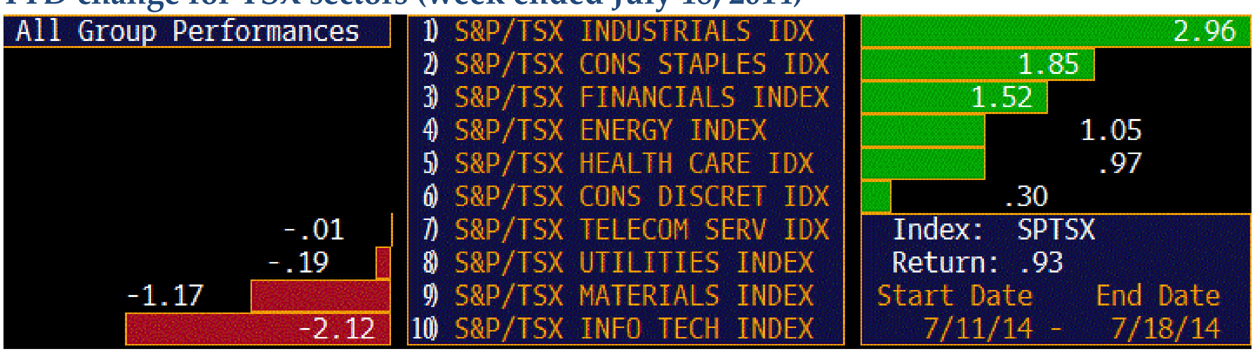
So does the markets' ability to shake off concerns about geopolitical risk, valuations *et al* smack of a dangerous sense of investor complacency, or is it an indication of their unmatched resilience? To gauge the level of complacency, we have had to dust off our proprietary FAIL® indicator; as can be seen (Figure 1), the indicator has dipped below 1, suggesting a heightened level of complacency. As noted in our July 7 Bulletin, given that global central banks' largesse has played a huge role in this rally, the likelihood that the Federal Reserve may tighten monetary policy at a pace that is significantly faster than market participants currently anticipate could represent a key risk for equity markets next year. So although the party continues for now, it may be prudent to keep an eye on the exits.

Figure 1: FAIL® Indicator – 2004 to Present (Weekly)



TSX Sector Watch

YTD change for TSX sectors (week ended July 18, 2014)



Source: Bloomberg

The TSX gained 0.93% last week, good enough to take it into new record territory. The Industrials sector was the best performer, led by Canadian Pacific and Canadian National Rail, as both railroads reached record highs on CP's strong earnings report. Materials and Info Tech were among the laggards last week. Overall, the TSX is up 12.1% YTD, the second-best performance among the world's developed markets. While all 10 sectors are up for the year, the defensive Telecoms, Health Care and Utilities groups are lagging the index advance, perhaps reflecting the willingness of investors to assume more risk as the rally continues.

The Week Ahead

Economy Watch

- **July 24**: **IMF releases updated World Economic Outlook –** Managing Director Christine Lagarde signaled a cut in the IMF's global growth forecasts earlier this month due to weak investment and lingering risks in the U.S. economy. In its April WEO update, the IMF had forecast global growth of 3.6% in 2014 and 3.9% in 2015.

Stocks to Watch

Next week is the busiest one of the U.S. earnings season, with dozens of companies reporting. A handful of TSX-60 companies report earnings as well.

- **July 21**: Companies reporting earnings include CN Rail and Netflix
- **July 22**: Coca-Cola, McDonald's, Verizon, Apple, Microsoft
- **July 23**: Boeing, AT&T, Facebook
- **July 24**: Rogers Comm., Teck, EnCana, Husky Energy, Potash, Loblaw, Caterpillar

Short Takes

- **Looking for a job? Try a "Resum-Ale"**: Graphic designer Brennan Gleason of Abbotsford came up with an ingenious idea to market his skills to prospective employers. Instead of typing up a conventional resumé, Gleason printed his resumé on a four-pack of home-brewed beer, dubbed it "Resum-Ale," and sent the four-packs out to agencies in Vancouver. Gleason subsequently received three job offers and accepted one with a digital marketing agency.
- **Art, like beauty, lies in the eyes of the beholder**: British artist Tracey Emin's artwork titled "My Bed" sold for 2.5 million pounds on July 1 at Christie's in London. The piece consists of an unmade bed with rumpled sheets, empty vodka bottles, underwear and cigarette packets. The price tag was more than 10 times the $255,000 paid by Charles Saatchi for it in 2000. "My Bed" had sparked intense debate about the meaning of art when it was first exhibited in London.

Market Snapshot

At close on Friday, July 18, 2014

S&P TSX	15266.57	+62.09	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	1012.24	+6.48	Canadian $ (US cents)	93.13	+0.21	90 Day T-Bill	0.92	0.01
DJIA	17100.18	+123.37	Gold (Spot)-US$	1311.10	-8.14	2-Year Bond	1.08	0.48
S&P 500	1978.22	+20.10	Oil (WTI-Aug.)	103.13	-0.06	10-Yr.Bond	2.16	2.48
NASDAQ	4432.15	+68.70	CRB Index	297.42	-0.51	30-Yr. Bond	2.71	3.29

Thought for the Day

"When you drink the water, remember the spring."– Chinese Proverb

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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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