NATIONAL BANK
FINANCIAL MARKETS
A division of National Bank of Canada

MONTHLY EQUITY MONITOR

Economics and Strategy

October 2015

Highlights

- Global equities continue to struggle. In Q3, the MSCI AC index is down for a second consecutive quarterly decline – a first in four years. A deteriorating earnings backdrop is exacerbating the downward pressure on the index.

- We still think earnings growth is possible in 2016, provided of course that a few things go right. First, the global economy needs to get out of its funk. After a challenging first half of the year, world industrial output is picking up. Otherwise, USD appreciation needs to be kept in check to break the disinflationary trend that is currently dogging the earnings outlook. The threat of a Fed rate hike notwithstanding, there are policies that could offset USD strength. One would be to include the Chinese yuan in the IMF's basket of reserve currencies.

- Our asset mix is unchanged this month, with equities still overweighted relative to bonds and a regional bias towards the United States. The key to avoidance of a bear market is a combination of continued U.S. growth and a low-inflation environment that allows the path of monetary normalization to be gradual. That is the environment today and in our view it is likely to persist for some time. We would reconsider our asset mix if credit market spreads were to increase to the point of undermining the 2016 profit outlook.

- Our sector allocation for the S&P TSX is unchanged this month. We remain comfortable with our current recommendation to overweight bank stocks as the economy is growing again and recent gains in full-time employment continue to support the housing market.

Stéfane Marion
stefane.marion@nbc.ca

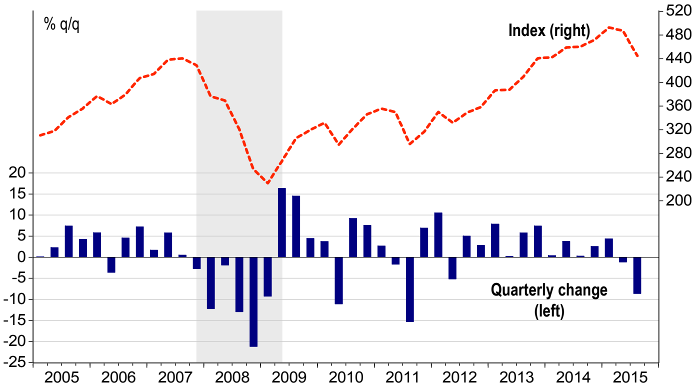
Matthieu Arseneau
matthieu.arseneau@nbc.ca

MONTHLY EQUITY MONITOR

Will profits rebound?

Global equities continue to struggle. In Q3, the MSCI AC index is down for a second consecutive quarterly decline – a first in four years.

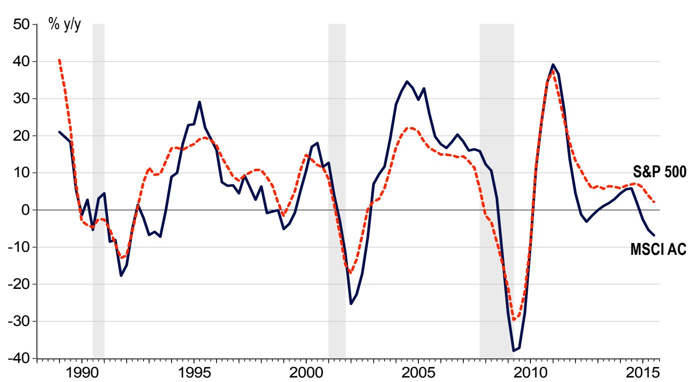
World: Equities down two quarters in a row
MSCI AC



NBF Economics and Strategy (data via Bloomberg)

A deteriorating earnings backdrop is exacerbating the downward pressure on the index. As the next chart shows, 12-month trailing earnings are currently 7% down from a year earlier, matching the all-time worst performance outside a recession (1993 Q3). Incidentally, that mark of 22 years ago came on the eve of the Fed's 1994 tightening campaign. History seems about to repeat itself. Fed chair Janet Yellen admitted for the first time last week that she is indeed part of the majority of FOMC members that expect to raise the fed funds rate later this year. She did say the move would be "followed by a gradual pace of tightening thereafter."

World: Earnings since 1988
Change in trailing earnings, MSCI AC and S&P 500



NBF Economics and Strategy (data via Datastream)

A Fed tightening phase is normally accompanied by volatility, even more so when a strong USD is sapping the earnings outlook. The bottom-up consensus currently sees an earnings rebound of 7.4% for the constituents of the S&P 500 over the next 12 months (table) and about 8% for the MSCI AC. But will it come?

S&P 500 composite index: EPS Performance

	2014	2015	2016	2017	12 forward growth
S&P 500	7.6	1.0	9.6	12.5	7.4
ENERGY	0.9	-58.9	10.0	43.8	-20.6
MATERIALS	8.0	-1.9	15.5	13.0	11.0
INDUSTRIALS	11.6	3.5	7.9	10.4	7.0
CONS. DISC.	6.9	11.8	15.2	14.5	14.5
CONS. STAP.	4.5	-0.1	7.4	10.0	6.5
HEALTH CARE	17.2	10.0	10.5	12.2	10.4
FINANCIALS	-0.4	16.9	8.9	10.2	10.7
IT	12.2	7.5	9.1	11.8	7.7
TELECOM	11.2	8.9	4.5	3.0	5.5
UTILITIES	8.1	-0.3	4.5	3.7	3.3

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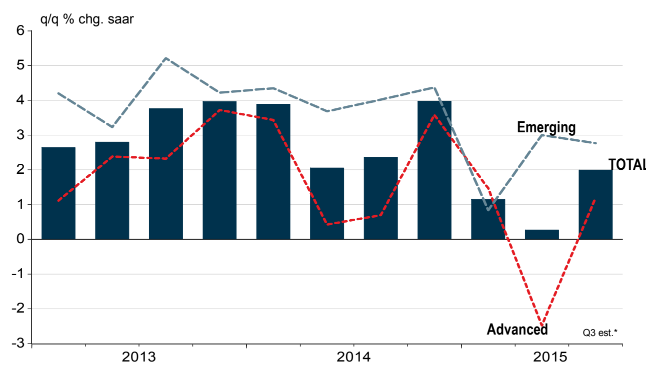
NBF Economics & Strategy (data via Datastream)

We think earnings growth is possible in 2016, provided of course that a few things go right. First, the global economy needs to get out of its funk. After a challenging first half of the year, world industrial output is picking up (chart). CPB reports healthy gains in July, putting Q3 world industrial production on track for the strongest quarterly growth since last year. The observed rebound in OECD industrial activity, thanks to the U.S. and the euro zone, is certainly helping.

World: Industrial output on the rise
World industrial production

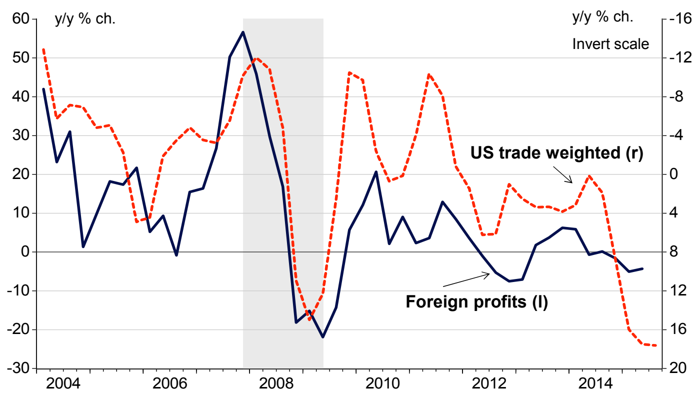


* *Assuming no change in August and September and no revisions in prior months*
NBF Economics and Strategy (CPB data via Datastream)

CNY as a reserve currency?

Second, USD appreciation needs to be kept in check to break the disinflationary trend that is currently dogging the earnings outlook (chart).

U.S.: Strenghtening dollar a headwind for profits
U.S. Trade weighted dollar and foreign profits



NBF Economics and Strategy (data via Datastream)

The threat of a Fed rate hike notwithstanding, there are policies that could offset USD strength. One would be to include the Chinese yuan in the IMF's basket of reserve currencies. After U.S. President Barack Obama and Chinese President Xi Jinping met in Washington September 25, the two sides issued a statement saying the U.S. supports the inclusion of the CNY in the IMF's Special Drawing Rights (SDR) basket, "provided the currency meets the IMF's existing criteria in its SDR review."

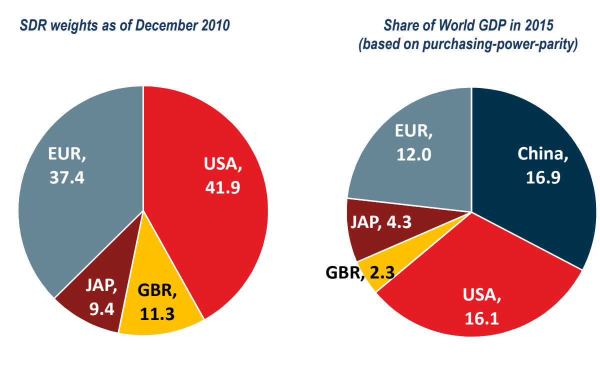
The IMF formally reviews the composition and valuation of the SDR basket every five years. The next review is expected to be completed by the end of this year, with any decisions affecting the current SDR basket (currently composed of USD, EUR, JPY and GBP) to become effective in October 2016.

So how does a currency get included in the SDR? According to the IMF:

> The criteria, last updated in 2000, establish that the SDR basket comprises the four currencies that are issued by members or currency unions whose exports of goods and services had the largest value over a five-year period, and have been determined by the Fund to be "freely usable." The export criterion aims to ensure that currencies that qualify for the basket are those issued by members/currency unions that play a central role in the global economy.
>
> The requirement for currencies in the SDR basket to be also freely usable was incorporated in 2000 to reflect the importance of financial transactions in valuing the SDR basket. The concept of a freely usable currency concerns the actual international use and trading of currencies, and it is distinct from whether a currency is either freely floating or fully convertible. *In other words, a currency can be widely used and widely traded even if it is subject to some capital account restrictions*. On the other hand, a currency that is fully convertible may not be necessarily widely used and widely traded (due to the size and relative importance of that economy in international transactions).

By these criteria, we expect the IMF to decide this year to give the yuan reserve-currency status. It is abnormal for China to be excluded from the SDR when it accounts for almost 20% of the global economy. We would argue that the weighting of the CNY should be at least that of the JPY and the GBP (chart).

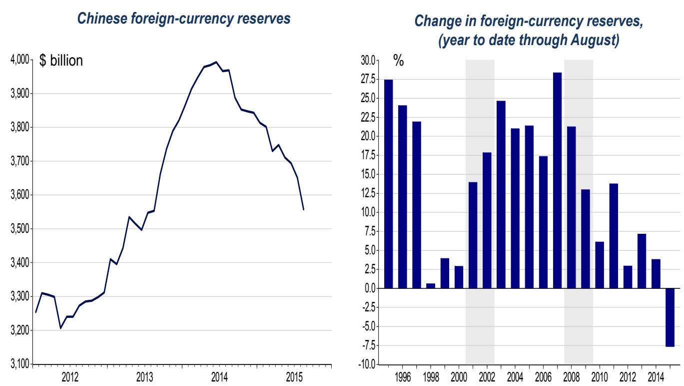
Abnormal for China to be excluded from the SDR



NBF Economics and Strategy (data via IMF)

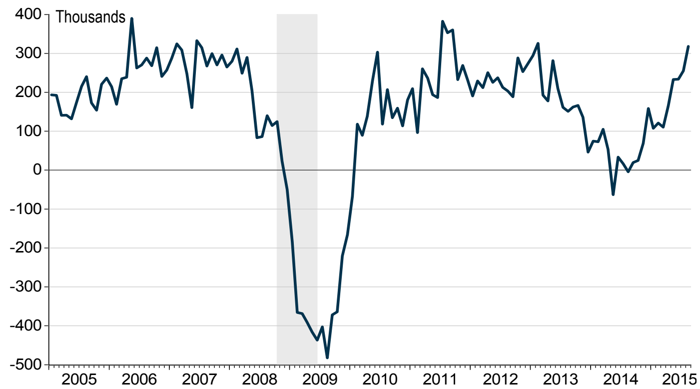
Failure to add China to the SDR basket could trigger another round of currency devaluation. The country continues to spend heavily to defend its currency – $100 billion in August alone. As the next chart shows, its foreign-currency reserves shrank 7.5% in the first eight months of the year, the worst decline on record.

China: Defending the currency is not cheap



NBF Economics and Strategy (data via Datastream)

Canada: Labour market remains sound
12-month change in full-time employment

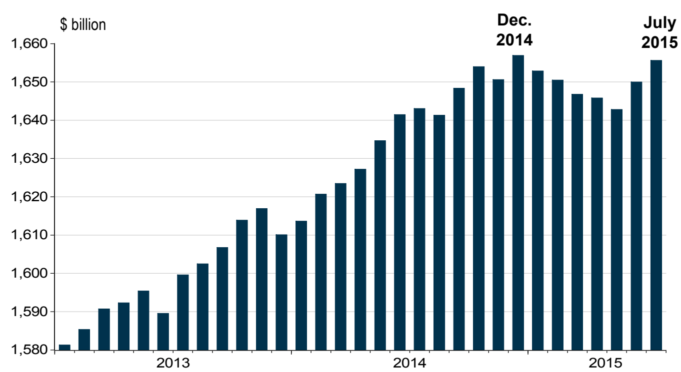


NBF Economics and Strategy (data via Statistics Canada)

Canada: Recession or expansion?

Much ink has been spilled in recent weeks in efforts to characterize the state of the Canadian economy. If the country was ever in a recession in H1, it definitely came out of it in Q3. Thanks to a solid rebound in goods producing industries and the continuing resilience of the services producing industries, GDP in Canada was essentially back to its peak in July (chart).

Canada: essentially back to an all-time high
Monthly real GDP

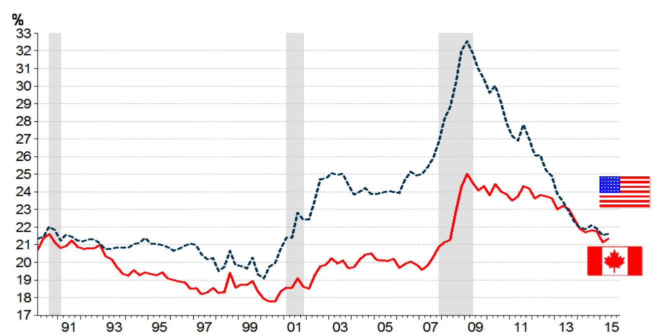


NBF Economics and Strategy (data via Statistics Canada)

A strong labour market – more than 300,000 net full-time positions added in the last year – coupled with resurgent U.S. demand is lifting both domestic consumption and exports.

Against this backdrop, fears of a Canadian economic meltdown and surging credit losses triggered by weak energy prices are exaggerated. While household indebtedness is higher than in the U.S., the ratio of debt to net worth is not. In other words, the balance sheet of Canadian households is sound by historical and international standards.

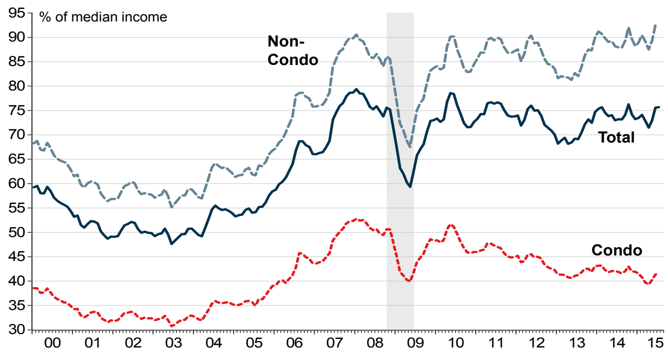
Debt to net worth
Households & non-profit organizations



NBF Economics and Strategy, data from Statistics Canada and Federal Reserve.

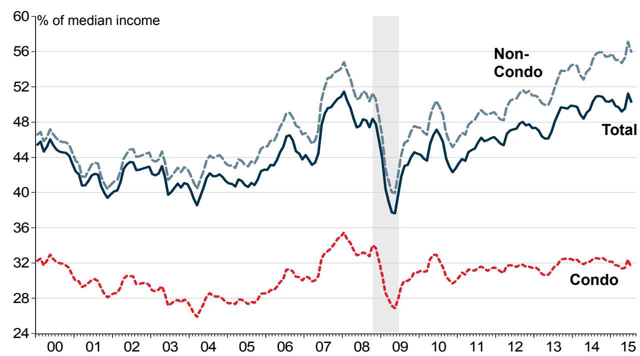
But what about the argument that cities such as Vancouver and Toronto have become so unaffordable that a correction is inevitable? While single-family homes have increased in price quite significantly in recent quarters on the strength of strong demand from economic immigrants and limited supply, the same is not true for condos. By our calculation, condos (the main market for first-time homebuyers) remain affordable by historical standards in both Vancouver and Toronto (charts).

Vancouver: perspective on housing affordability
Monthly mortgage payment on average-priced home (25-year amortization)



NBF Economics and Strategy (data via Statistics Canada, CREA, Teranet-National Bank)

Toronto: perspective on housing affordability
Monthly mortgage payment on average-priced home (25-year amortization)



NBF Economics and Strategy (data via Statistics Canada, CREA, Teranet-National Bank)

In the circumstances, we remain comfortable with our current recommendation to overweight bank stocks.

Asset allocation

Our asset mix is unchanged this month, with equities still overweighted relative to bonds and a regional bias towards the United States. The key to avoidance of a bear market is a combination of continued U.S. growth and a low-inflation environment that allows the path of monetary normalization to be gradual. That is the environment today and in our view it is likely to persist for some time. We would reconsider our asset mix if credit market spreads were to increase to the point of undermining the 2016 profit outlook.

U.S.: Credit markets still receptive
BoA Merrill Lynch BBB option-adjusted spread to Treasuries

NBF Economics and Strategy (data via St. Louis Fed)

S&P TSX composite index: EPS Performance

	2014	2015	2016	2017	12 forward growth
S&P TSX	13.1	-3.8	8.7	6.9	5.7
ENERGY	12.4	-19.7	11.5	11.9	2.3
MATERIALS	1.3	-0.5	6.0	6.7	4.3
INDUSTRIALS	9.0	3.1	4.2	5.5	4.0
CONS. DISC.	7.6	2.7	6.5	5.1	5.5
CONS. STAP.	6.2	7.0	4.9	5.2	5.2
HEALTH CARE	19.0	28.5	21.9	7.6	23.2
FINANCIALS	29.5	-5.2	12.5	6.1	8.6
BANKS	8.2	3.8	5.6	3.8	5.4
IT	-7.9	-0.2	4.5	0.1	3.1
TELECOM	3.0	3.0	2.1	1.8	2.4
UTILITIES	13.5	2.5	10.3	16.6	8.5

9/30/2015

NBF Economics & Strategy (data via Datastream)

Sector rotation

Our sector allocation is unchanged this month.

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	20	
U.S. Equities	20	26	
Foreign Equities (EAFE)	5	7	
Emerging markets	5	5	
Fixed Income	45	37	
Cash	5	5	
Total	100	100	

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NBF Market Forecast *Canada*			
		Actual	***Q3 2016 (Est.)***
Index Level		**Sep-30-15**	***Target***
S&P/TSX		13,307	15,000
Assumptions			Q3 2016 (Est.)
Level:	Earnings *	829	870
	Dividend	430	451
PE Trailing (implied)		16.0	17.2
			Q3 2016 (Est.)
Treasury Bills (91 days)		0.42	0.46
10-year Bond Yield		1.43	2.03

** Before extraordinary items, source Thomson*

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NBF Market Forecast *United States*			
		Actual	***Q3 2016 (Est.)***
Index Level		**Sep-30-15**	***Target***
S&P 500		1,920	2,200
Assumptions			Q3 2016 (Est.)
Level:	Earnings *	117	122
	Dividend	44	46
PE Trailing (implied)		16.4	18.0
			Q3 2016 (Est.)
Treasury Bills (91 days)		-0.01	1.07
10-year Bond Yield		2.06	2.54

** S&P operating earnings, bottom up.*

NBF Fundamental Sector Rotation - October 2015

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Market Weight**	**18.5%**
Energy Equipment & Services	Market Weight	0.7%
Oil, Gas & Consumable Fuels	Market Weight	17.8%
Materials	**Market Weight**	**9.0%**
Chemicals	Underweight	2.7%
Containers & Packaging	Market Weight	0.4%
Metals & Mining *	Market Weight	1.7%
Gold	Market Weight	3.8%
Paper & Forest Products	Overweight	0.5%
Industrials	**Market Weight**	**8.3%**
Capital Goods	Overweight	1.7%
Commercial & Professional Services	Underweight	0.8%
Transportation	Market Weight	5.9%
Consumer Discretionary	**Underweight**	**7.2%**
Automobiles & Components	Underweight	1.8%
Consumer Durables & Apparel	Overweight	0.7%
Consumer Services	Underweight	0.9%
Media	Market Weight	2.3%
Retailing	Underweight	1.5%
Consumer Staples	**Underweight**	**4.4%**
Food & Staples Retailing	Underweight	3.8%
Food, Beverage & Tobacco	Underweight	0.7%
Health Care	**Market Weight**	**4.9%**
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	4.7%
Financials	**Overweight**	**37.2%**
Banks	Overweight	22.8%
Diversified Financials	Market Weight	1.6%
Insurance	Overweight	7.4%
Real Estate	Market Weight	5.3%
Information Technology	**Overweight**	**2.8%**
Software & Services	Overweight	2.3%
Technology Hardware & Equipment	Market Weight	0.5%
Telecommunication Services	**Underweight**	**5.4%**
Utilities	**Underweight**	**2.3%**

** Metals & Mining excluding the Gold Sub-Industry.*

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ECONOMICS AND STRATEGY

Montreal Office
514-879-2529

Toronto Office
416-869-8598

Stéfane Marion
Chief Economist & Strategist
stefane.marion@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Warren Lovely
MD, Public Sector Research and Strategy
warren.lovely@nbc.ca

Paul-André Pinsonnault
Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Matthieu Arseneau
Senior Economist
matthieu.arseneau@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

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