NATIONAL BANK
FINANCIAL MARKETS
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MONTHLY EQUITY MONITOR

Economics and Strategy

February 2016

Highlights

- The beginning of 2016 has turned out to be extremely testing for investors. Global equities plummeted in January after ending 2015 on a promising note. A number of indexes have fallen into bear market territory, rekindling fears of a global recession. China, Fed action and the widening of corporate bond yield spreads remain the focus of attention.

- At the halfway point of the U.S. fourth-quarter reporting season, the news has been encouraging despite the challenges posed by a surging currency. Though aggregate Q4 earnings are still expected to come in lower than a year earlier, much of that decline is concentrated in commodity-related industries.

- Prospects for a sizeable fiscal stimulus from Ottawa, coupled with an accommodative monetary policy and fairly strong U.S. consumer demand, are likely to help the Canadian economy get out of its funk. The outlook for overall earnings in 2016 is still one of improvement.

- Our asset allocation is unchanged this month. Since we don't think global growth is compromised, we are maintaining our recommendation to overweight equities relative to our benchmark. We continue to expect some softness in the USD, implying some lift for commodity prices in the coming months.

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MONTHLY EQUITY MONITOR

Global recession?

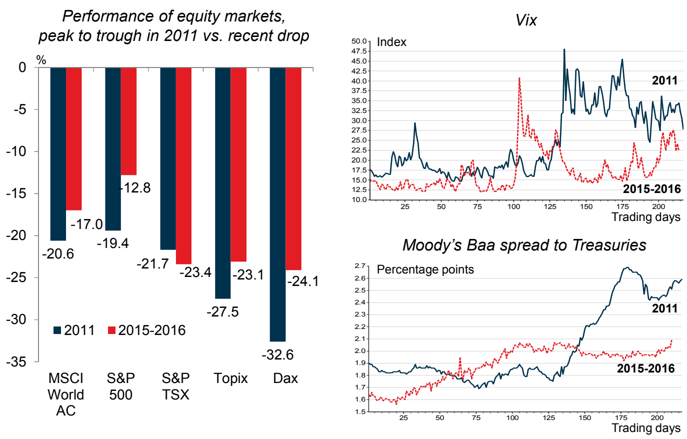
The beginning of 2016 has turned out to be extremely testing for investors. Global equities plummeted in January after ending 2015 on a promising note. A number of indexes have fallen into bear market territory, rekindling fears of a global recession. China, Fed action and the widening of corporate bond yield spreads remain the focus of attention.

Global equities plunged in January
MSCI AC index

NBF Economics and Strategy (data via Datastream)

The last time markets were as concerned about the global economy was 2011. At that time too, a number of indexes dropped into bear market territory, for a few weeks in that case. Concern about a euro-induced liquidity crunch was the main factor behind the erosion of investor confidence. Fast forward to 2016, and although there are similarities to 2011 in the amplitude of decline of some equity benchmarks, volatility on the S&P 500 and in corporate credit spreads does not show the same stress as in 2011. Despite the January pullback of global stock markets, financial-market stress appears less threatening to the global economy than it was in 2011.

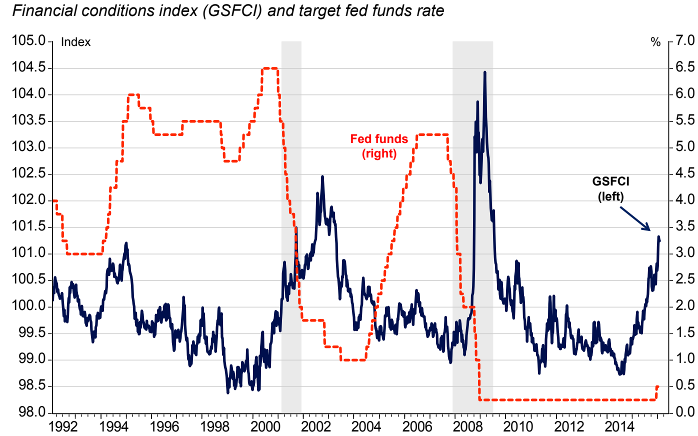
World: The last time markets were this nervous was in 2011



NBF Economics and Strategy (data via Bloomberg) 2016-01-15

This is not to say investor nervousness is unjustified. Since last December, when the Federal Reserve initiated its first tightening cycle in a decade, financial conditions have deteriorated. We argued last month that a Fed rate hike need not be detrimental to the economic outlook if financial stress abates against the backdrop of an improving economy. As the chart below shows, financial stress has not abated, mainly because of continuing appreciation of the U.S. dollar.

U.S.: The Fed's dilemma
Financial conditions index (GSFCI) and target fed funds rate

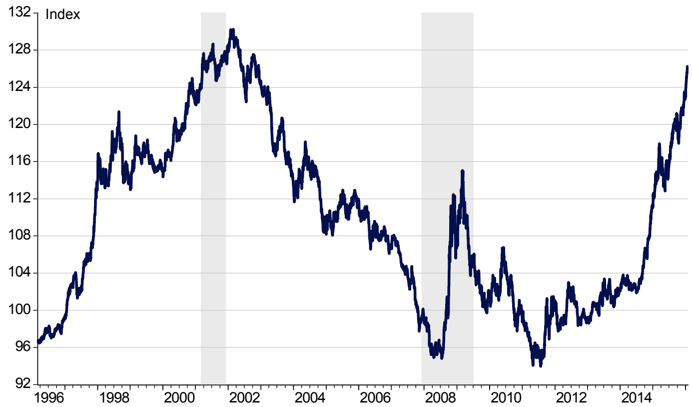


NBF Economics and Strategy (data via Bloomberg and Datastream)

Though we don't consider current financial conditions overly restrictive, a further increase could be. In other words, the Fed needs to tread very carefully. At its January 27 meeting, as expected, the FOMC left its policy rate unchanged. But it noted that it was "closely monitoring global economic and financial developments." In other words, the FOMC did not commit itself. In our view, the fed funds rate is unlikely to be raised again before June at the earliest.

But for even a June hike to happen, the U.S. dollar needs to stop appreciating. We argued last month that a further rise of the greenback could crimp emerging economies in general.

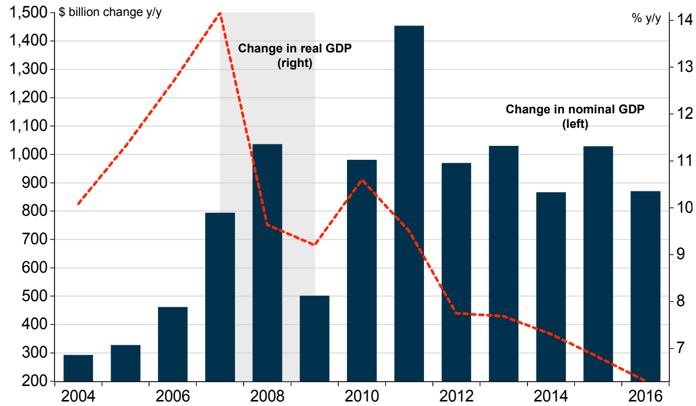
U.S.: The greenback refuses to come down
Broad USD index (vs. 26 currencies)



NBF Economics and Strategy (data via Datastream)

In particular, USD strength hinders China's ability to stem capital outflows. After all, Beijing's policymaking has not been reassuring so far. Neither has it been helped by poor communications with markets. The concern is that, left to the markets, the yuan could sink too far too fast, sapping confidence in the currency and creating a global deflation spiral. So what is Beijing to do? Perhaps it could impose capital controls while making it clear that they are temporary. That would not only stem the yuan's descent but would buy China time to come up with a strategy to address underlying weakness in its economy, i.e. to ensure that the 5-year plan to be launched in March will be ambitious and aggressive. We continue to hope the politburo will rely on fiscal stimulus rather than currency devaluation to solidify China's growth prospects. We note that, given the country's economic growth over the last nine years, real Chinese GDP growth of 6% would now add just as much to world GDP, in dollar terms, as 12% growth did in 2007-2008 (chart).[1]

World: Chinese growth in perspective
Annual % change in real GDP and annual dollar change in nominal GDP



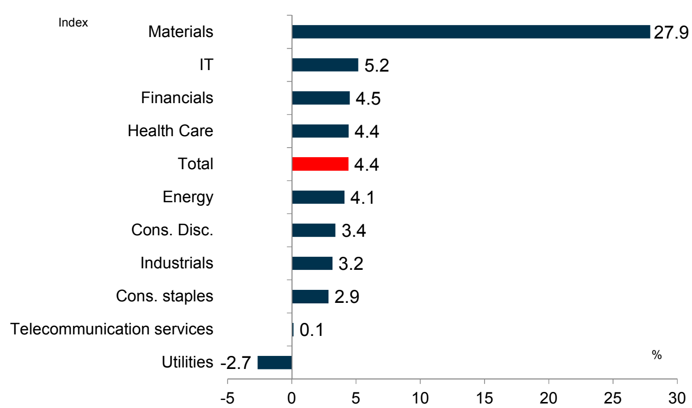
NBF Economics and Strategy (data via Datastream)

So it's important to keep things in perspective. Chinese growth of 6% is nothing to fret about.

S&P 500: Earnings not so bad

At the halfway point of the U.S. fourth-quarter reporting season, the news has been encouraging despite the challenges posed by a surging currency. Close to 80% of the corporations reporting so far have beaten profit expectations, a proportion well above the long-term average of 63%. Aggregate S&P 500 earnings are running 4.4% above estimates, compared to a long-term average surprise factor of 3%.

S&P 500: Earnings surprising on the upside
Earnings surprise factor in 2015Q4



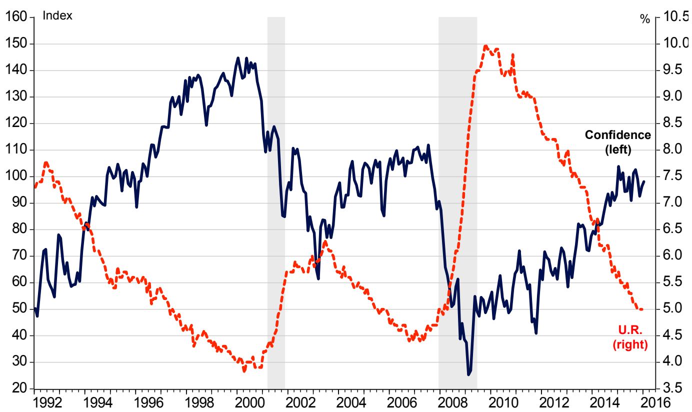
NBF Economics and Strategy (data via Bloomberg)

Though aggregate Q4 earnings are still expected to come in lower than a year earlier, much of that decline is concentrated in commodity-related

[1] According to the IMF, the size of China's economy has more than doubled since 2007 (from $8.9 trillion to $19.5 trillion).

industries. For five of the 10 major sectors of the S&P 500, earnings are coming in higher than a year earlier. In consumer-related sectors the growth is in double digits, thanks to the willingness of U.S. households to spend more on discretionary purchases as the labour market improves (chart).

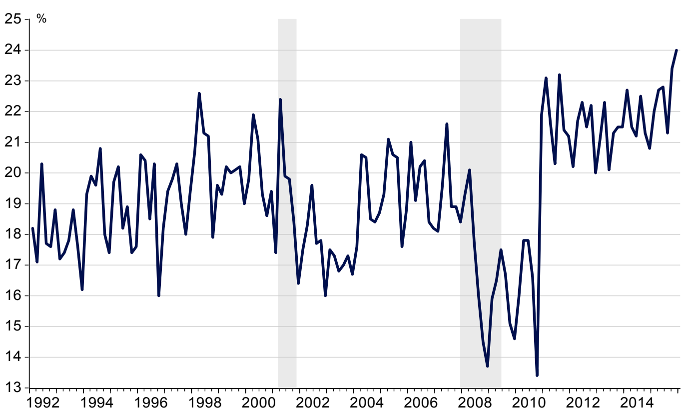
U.S.: Domestic backdrop is fine
Consumer confidence and unemployment rate



NBF Economics and Strategy (data via Bloomberg and Datastream)

For instance, the latest consumer confidence survey showed a record percentage of respondents intending to take air-travel vacations in the next six months (chart).

U.S.: Consumers remain upbeat
% of confidence survey respondents who intend to vacation by air travel within 6 months



NBF Economics and Strategy (Conference Board data via Datastream)

If global credit conditions do not worsen, U.S. households are likely to continue supporting the profit expectations of equity analysts, who currently anticipate aggregate earnings growth in Q2. We do not see this as irrational exuberance. In our view, the 5.1% growth expectation for calendar 2016 could be surpassed. In other words, we do not see the current forward P/E of 15.6 as an obstacle to further advance of the S&P 500.

S&P 500 Composite Index: EPS performance

	2014	2015	2016	2017	12 forward growth
S&P 500	7.7	0.2	5.1	13.1	6.3
ENERGY	0.8	-59.9	-31.5	88.5	-24.2
MATERIALS	7.5	-7.6	5.2	16.2	7.2
INDUSTRIALS	12.0	3.5	4.8	9.7	5.5
CONS. DISC.	6.8	11.7	14.0	13.7	14.2
CONS. STAP.	4.5	-0.2	5.1	9.5	6.6
HEALTH CARE	17.1	11.2	9.3	11.7	9.4
FINANCIALS	0.3	13.8	6.2	9.8	6.6
IT	12.2	6.3	4.8	12.5	7.0
TELECOM	11.2	11.1	1.9	3.2	2.0
UTILITIES	7.9	-0.4	3.9	3.5	3.8

1/29/2016

NBF Economics and Strategy (data via Datastream)

S&P/TSX: Is the worst behind?

With the Q4 2015 reporting season just getting under way in Canada, analysts are projecting an end to the S&P/TSX earnings bloodbath of the past year[2]. They currently see Q4 earnings growth of 2.1% in the aggregate and 7.2% excluding resources (table). Their expectation that six of the 10 sectors will show net income up from a year earlier suggests that the combination of a cheap currency and a resilient labour market is keeping the Canadian economy afloat.

Net Income Growth (%, Q_t/Q_{t-4}) : S&P TSX and Sector Indexes

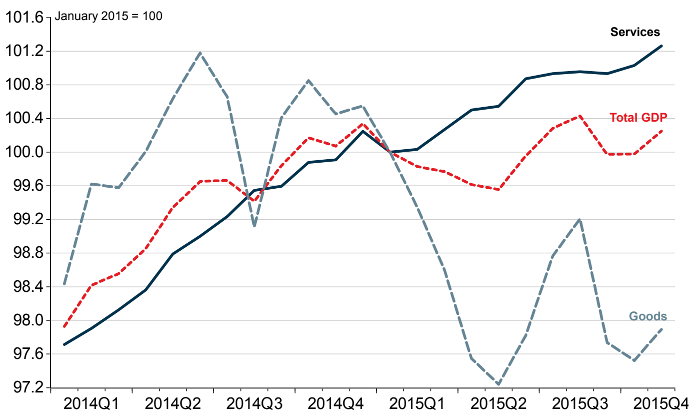
	Reported Net Income Q4 2014 ($M)	Blended Estimate of Net Income Q4 2015 ($M)	% Change
S&P/TSX	23387	23866	2.1
S&P/TSX EX. FINANCIALS	10849	11359	4.7
S&P/TSX EX. ENERGY	22195	22789	2.7
S&P/TSX EX. RESOURCES	20462	21932	7.2
S&P/TSX EX. FIN. & RES.	7925	9425	18.9
S&P/TSX CONS DISCRET IDX	1172	2495	112.9
S&P/TSX CONS STAPLES IDX	1374	1380	0.4
S&P/TSX ENERGY INDEX	1192	1077	-9.6
S&P/TSX FINANCIALS INDEX	12538	12508	-0.2
S&P/TSX BANKS INDEX	8558	8990	5.0
S&P/TSX HEALTH CARE IDX	888	942	6.1
S&P/TSX INDUSTRIALS IDX	2182	2233	2.3
S&P/TSX INFO TECH INDEX	615	636	3.4
S&P/TSX MATERIALS INDEX	1733	857	-50.5
S&P/TSX TELECOM SERV IDX	1311	1309	-0.1
S&P/TSX UTILITIES INDEX	383	430	12.5

NBF Economics & Strategy (data via Bloomberg)

[2] For more details, see "S&P TSX index: Earnings Season Report" published on January 28th 2016

Prospects for a sizeable fiscal stimulus from Ottawa, coupled with an accommodative monetary policy and fairly strong U.S. consumer demand, are likely to help the Canadian economy get out of its funk. The latest indicators do not show virulent contagion from lower energy prices to the rest of the economy. Service-sector GDP reached an all-time high in November. Though we have reduced our GDP growth expectation for 2016, our downward revisions were for the most oil-exposed provinces The outlook for overall earnings in 2016 is still one of improvement. Of course the amplitude of the rebound depends on the outlook for commodities.

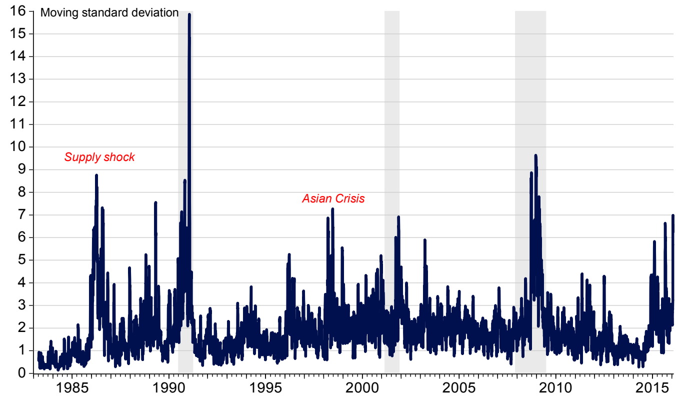
Canada: Service-sector output at an all-time high
Real monthly GDP



NBF Economics and Strategy (data via Statistics Canada)

If there is one commodity that is currently hard to forecast, it is oil. The volatility of the WTI price has surged in recent weeks to levels seen only once before outside a severe demand shock – during the mid-1980s supply shock. And the outcome of a supply shock is inherently difficult to forecast.

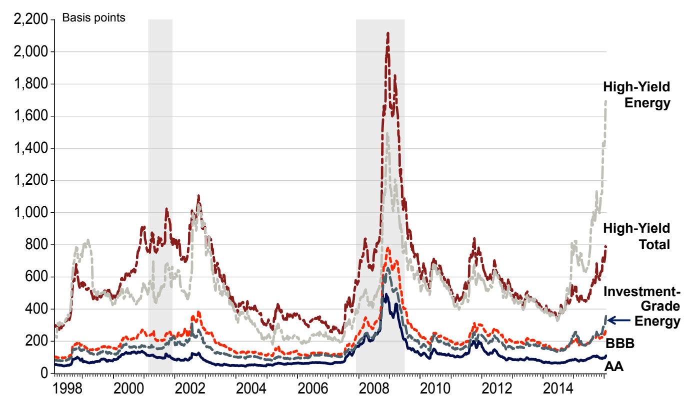
World: Oil price volatility is surging
West Texas Intermediate (WTI)



** 10-day moving standard deviation of daily percentage changes*
NBF Economics and Strategy (data via Datastream)

We expect U.S. oil output to be crimped by the drop in prices and by the severe widening of spreads for energy-company bond yields (chart). The Dallas Fed reports that more bankruptcies have been occurring in the U.S. petroleum industry than at any time since 2008-09.

U.S.: Corporate spreads under pressure
Option-adjusted spreads, BofA Merrill Lynch indexes



NBF Economics and Strategy (data via Bloomberg)

Prospects for lower U.S. output, coupled with speculation that OPEC and Russia could meet to discuss production, have helped oil prices rebound from their most recent lows. We will see how things unfold in the coming weeks. For now, we continue to expect a significant divergence between metals prices and oil prices – an indication that oil prices remain driven more by supply than by demand.

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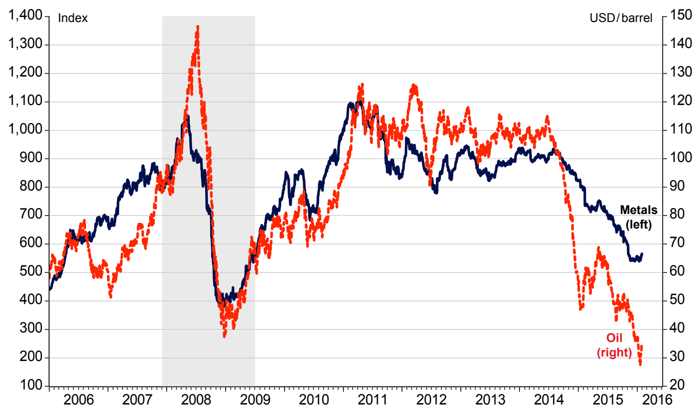
World: Commodity prices likely to stabilize
CRB Metals and Brent oil



NBF Economics and Strategy (data via Datastream)

Asset allocation

Our asset allocation is unchanged this month. Since we don't think global growth is compromised, we are maintaining our recommendation to overweight equities relative to our benchmark. With the recent tightening of financial conditions, we doubt the FOMC will be in a position to deliver anywhere near the four rate hikes in 2016 that it reported in December as the median expectation of its participants. We accordingly continue to expect some softness in the USD, implying some lift for commodity prices in the coming months. That would be good news for Canadian and emerging-market equities. Given our outlook for the U.S. dollar and our view that oil output will be reined in somewhat, our current forecast assumes WTI at $40 by the end of 2016.

Sector rotation

Our sector allocation for the S&P TSX is unchanged this month. We remain comfortable with our current recommendation to overweight bank stocks as gains in full-time employment continue to support the housing market, preventing a discernible deterioration of household creditworthiness.

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	23	
U.S. Equities	20	20	
Foreign Equities (EAFE)	5	7	
Emerging markets	5	8	
Fixed Income	45	37	
Cash	5	5	
Total	100	100	

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NBF Market Forecast
Canada

		Actual	*Q4 2016 (Est.)*
Index Level		**Jan-29-16**	***Target***
S&P/TSX		12,822	14,700
Assumptions			Q4 2016 (Est.)
Level:	Earnings *	782	850
	Dividend	427	464
PE Trailing (implied)		16.4	17.3
			Q4 2016 (Est.)
Treasury Bills (91 days)		0.48	0.46
10-year Bond Yield		1.22	1.73

** Before extraordinary items, source Thomson*

NBF Economics and Strategy

NBF Market Forecast
United States

		Actual	*Q4 2016 (Est.)*
Index Level		**Jan-29-16**	***Target***
S&P 500		1,940	2,200
Assumptions			Q4 2016 (Est.)
Level:	Earnings *	117	126
	Dividend	45	48
PE Trailing (implied)		16.6	17.5
			Q4 2016 (Est.)
Treasury Bills (91 days)		0.32	0.83
10-year Bond Yield		1.93	2.36

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

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NBF Fundamental Sector Rotation - February 2016

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Market Weight**	**18.8%**
Energy Equipment & Services	Market Weight	0.6%
Oil, Gas & Consumable Fuels	Market Weight	18.2%
Materials	**Market Weight**	**9.4%**
Chemicals	Underweight	2.5%
Containers & Packaging	Market Weight	0.4%
Metals & Mining *	Market Weight	1.5%
Gold	Market Weight	4.5%
Paper & Forest Products	Overweight	0.5%
Industrials	**Market Weight**	**8.1%**
Capital Goods	Overweight	1.7%
Commercial & Professional Services	Underweight	0.8%
Transportation	Market Weight	5.6%
Consumer Discretionary	**Underweight**	**6.6%**
Automobiles & Components	Underweight	1.4%
Consumer Durables & Apparel	Overweight	0.6%
Consumer Services	Underweight	0.9%
Media	Market Weight	2.3%
Retailing	Underweight	1.3%
Consumer Staples	**Underweight**	**4.6%**
Food & Staples Retailing	Underweight	3.9%
Food, Beverage & Tobacco	Underweight	0.8%
Health Care	**Market Weight**	**2.9%**
Health Care Equipment & Services	Market Weight	0.2%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	2.7%
Financials	**Overweight**	**38.2%**
Banks	Overweight	23.5%
Diversified Financials	Market Weight	1.6%
Insurance	Overweight	7.6%
Real Estate	Market Weight	5.4%
Information Technology	**Overweight**	**3.1%**
Software & Services	Overweight	2.6%
Technology Hardware & Equipment	Market Weight	0.5%
Telecommunication Services	**Underweight**	**5.7%**
Utilities	**Underweight**	**2.5%**

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

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