# Market Cycle Update

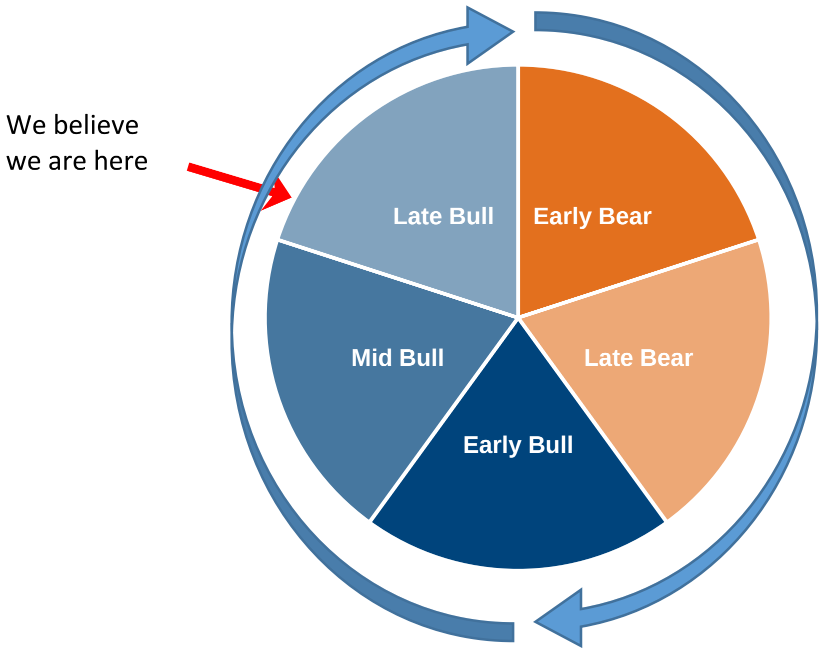
30 April 2015

## Encouraging Signs

The majority of the news and signals from our Market Cycle indicators have improved over the past few months. This provides additional support that the current bull market has legs. Of note is a significant improvement for indicators following the global economy. A few months back these were largely negative but are now about 50/50. This bodes well for global cyclicals, a natural benefit for the TSX. U.S. economic indicators have softened but remain in the positive camp.

Based on the weighted evidence from our Market Trender, Rates, Fundamentals U.S Economic and Global Economic indicators, we continue to believe we are in the early stages of the Late Bull phase of the market cycle. The good news is we remain in a bull market. The bad news is this looks like the last phase of the cycle. However, given the last recession was a credit driven one, which flattened the recovery trajectory due to deleveraging, we believe this to be an elongated cycle. So we are not ringing any alarm bells yet.

We remain tactically overweight equities at the expense of bonds. This overweight is tilted more towards international equities across our investor profiles (HERE).




**Connected Wealth** is Richardson GMP's asset management service that provides client centric, transparent and objective asset allocation and investment advice. We strive to help investors better understand and connect with their wealth.

**Market Cycle Asset Allocation (MCAA)** is a continuously updated and open framework incorporating the asset management team's research and analytics across various asset classes. MCAA incorporates key themes, tilting and adjusting traditional asset allocation investor profiles. This process incorporates many asset classes and investment strategies.

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### *Market Cycle Approach – brief synopsis*

*Similar to seasons, the market tends to move in cycles while traditional asset allocation ignores the market cycle and is based on a static approach. We believe sometimes seasons warrant change. The Market Cycle approach is based on the foundation of traditional asset allocation but incorporates tactical tilts to take advantage of different phases of the market cycle. While this is not an exact science as every cycle is different, there are often more similarities than differences and we believe this creates an opportunity to add value to the asset allocation process.*

*The Market Cycle Asset Allocation (MCAA) framework breaks the cycle into five phases – Early Bear, Late Bear, Early Bull, Mid Bull and Late Bull. The duration of the cycle varies from one to the next, there are a number of commonalities that impact the performance of different asset classes at different cycle phases. There are also a number of sector implications from this model as different industries perform well during some phases and poorly during others. For a full report on Market Cycle Asset Allocation click **HERE**.*

## The Signals

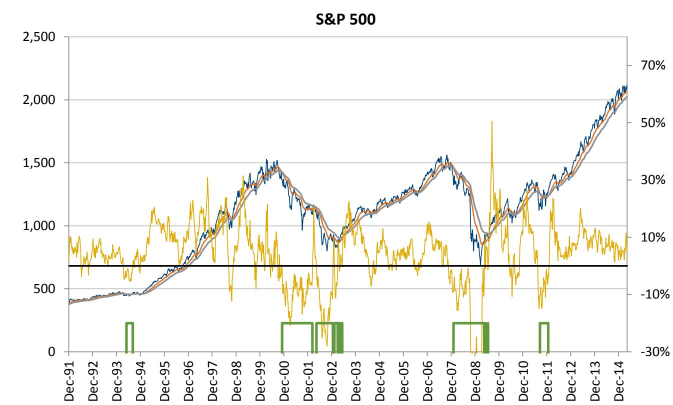
At Connected Wealth we believe in providing transparent and clear asset management services. Below, we share the primary indicators in our Market Cycle asset allocation framework. Many are U.S. focused however, as we find these to be better indicators for both Canadian and the U.S. markets given our proximity, integration and quality of data. While the indicators highlighted are not exhaustive, the majority have been included.

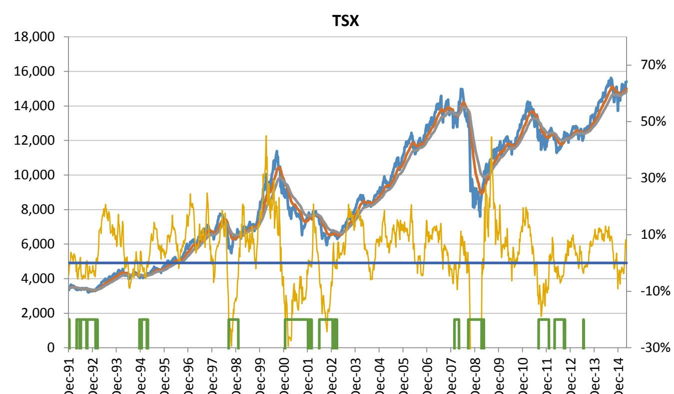
## Market Trender

This is a technical indicator we use for both the Canadian and U.S. equity markets. On the right, we have included the longer charts going back to the early 1990s. Periods when this model has been bearish on equities are represented by the green boxes at the bottom of each chart. A sell signal is generated when the 20-week exponential moving average (EMA) drops below the 40-week EMA and the six-month rate of change is negative. Essentially we are looking for a change in direction for the market itself.

We have not seen a negative signal in Canada or the U.S. in a couple years. However, the Canadian market has gotten very close during the past few months. Currently, both model remain in the bullish camp. We do place significant weight in this model as it rarely gives false signals.

*Positive for Canada & the U.S.*




*Source: Richardson GMP Asset Management, Bloomberg*

## Rates

These inputs are largely based on monetary policy and the bond market. The big three we focus on include the Fed Funds overnight rate, the slope of the U.S. yield curve and the 3-month change in the U.S. yield curve. Fed Funds either declining or remaining flat are positive for the markets. Raising rates is a characteristic of the Late Bull phase of the market.

The yield curve has proven to be one of the more reliable leading indicators for the U.S. economy, measuring the difference in yield between the 10-year and 3-month Treasuries. We view this indicator as positive when 2% or higher. The change in the slope over the past 3 months is also an input.

Currently all three of these indicators are bullish on the economy and equities.

## U.S. Economy

Our Market Cycle framework incorporates nine indicators based off the U.S. economy. For our equity markets, both for the U.S. and Canada, this is the economy that matters most.

On the more timely side we track U.S. Leading Indicators, 3 and 6-month changes. Leading Indicators Index is a basket of 10 data points that have a track record of signalling changes in economic growth. We also track Purchasing Managers Indices, both the aggregate and new orders. All four of these are positive.

Less timely but more fundamental to the U.S. economy we track consumer confidence (6-month changes), car sales, home sales and credit creation. Confidence, cars and credit are all supportive while home sales are not. We also include capacity utilization as a guide to which phase of the cycle we are in.

The U.S. data remains very supportive of the economy and market with an 8 out 9 score. However the strength of the data has softened over the past few months.

## Global Economy

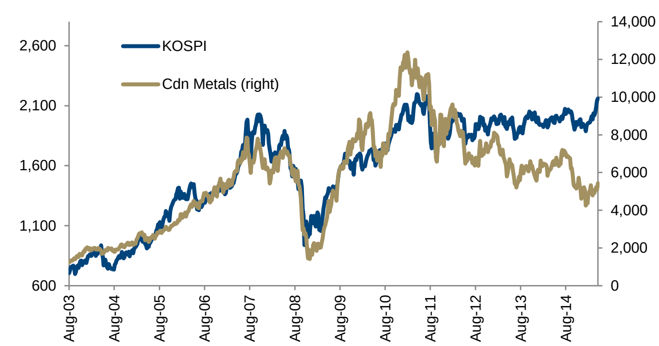
The global picture was very negative a few quarters ago but has been improving nicely. We track a number of indicators for the global economy and for global trade. These tend to be important drivers for global cyclical companies, such as Energy and Materials with clear implications for Canadian equities.

Of our seven indicators, three are commodity price related. These include the overall CRB Index, Oil and Copper. All three are negative for the global economy even when adjusting for currency.

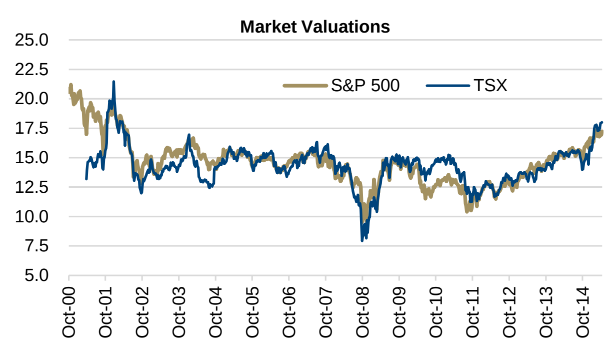
Beyond the commodities we track the Baltic Freight Index, KOSPI, Emerging Market Share Prices and Global Purchasing Managers Index. The Baltic Freight tracks shipping costs to move goods around the world. This index lost its efficacy due to oversupply for a few years but with better balance in the market it is a useful indicator once again. Currently it is negative, but has improved. The KOSPI is the Korean stock market. Given the composition of their market, it is one of the most sensitive to changes in global trade and global economic activity. There is an uncanny correlation between the KOSPI and diversified mining companies that warrants paying attention to. The accompanying chart includes the KOSPI and Canadian diversified mining companies. While the lines have diverged, the direction tends to be very similar and the KOSPI often leads our mining sector. Emerging markets are the price change in this group and provides a global risk aversion metric. Finally, Global PMI is a basket of purchasing manager index readings from most major manufacturing centres.

Three of these seven are positive which is much better than months past. The trend is certainly improving.

***KOSPI & Canadian Diversified Mining sub-industry – a strong correlation and worth noting the recent rise of the KOSPI***




***Valuations are elevated – a key characteristic of the Late Bull phase***




*Source: Richardson GMP Asset Management, Bloomberg*

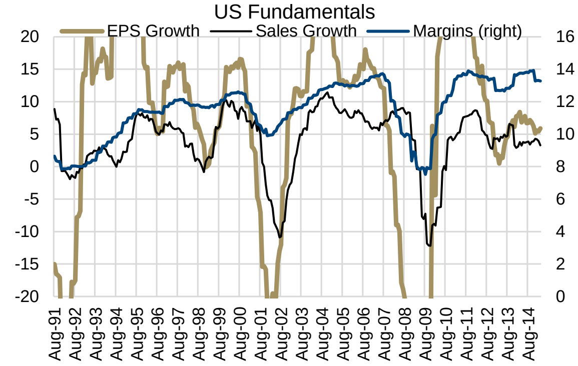
## Fundamentals

From the macro fundamental perspective we use both valuations, growth and margins. Valuations are somewhat expensive at 17.2x forward 12-month consensus earnings estimates for the S&P 500 and 18.0x for the TSX. These are higher valuations than the entire last cycle and is an area of concern. That being said it also supports the Late Bull phase as this typically sees multiple expansion.

Turning to growth, earnings are expanding at high single digits with sales growth in low single digits. Neither are very exciting considering valuations. The higher valuations with lackluster earnings growth is certainly being supported by the low interest rate environment; this does pose a risk. On the positive side margins and corporate health is very high.

One area that we will focus increasingly on as an early warning of the end of this bull cycle is margins. We typically see margin erosion ahead of bear markets.

***Earnings and sales are growing slowly, margins remain very high***




*Source: Richardson GMP Asset Management, Bloomberg*

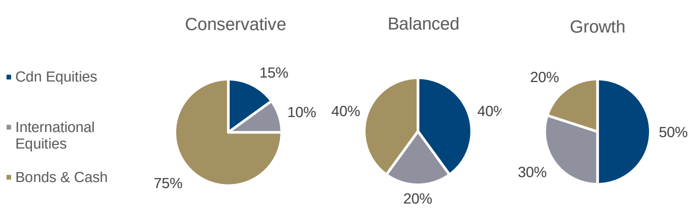
## Summary

| Market Trender | | Rates | | Fundamentals | |
|---|---|---|---|---|---|
| TSX | Bullish | Fed Funds | Bullish | Valuation TSX | Bearish |
| S&P | Bullish | Yield Curve | Bullish | Valuation S&P | Bearish |
| Consumer Model | Bullish | Yield Curve change | Bullish | Earnings Growth | Mildly Bullish |
| | | | | Sales Growth | Neutral |
| | | | | Margins | Bullish |

| U.S. Economy | | Global Economy | |
|---|---|---|---|
| Leading Ind (3m) | Bullish | CRB | Bearish |
| Leading Ind (6m) | Bullish | Oil | Bearish |
| PMI | Bullish | Copper | Bearish |
| PMI New Orders | Bullish | Baltic Freight | Neutral |
| Cons Confidence | Bullish | KOSPI | Bullish |
| Cars | Bullish | Emerging Mkts | Bullish |
| Homes | Bearish | Global PMI | Bullish |
| Credit | Bullish | | |
| Cap Utilization | | | |

Based on our team's combined work and analysis, we continue to believe we are in the very early stages of the Late Bull phase of the cycle. As a result, we are overweight equities, favouring international markets, and underweight bonds. Below is our baseline allocations for three investor profiles and the current tactical tilts based on our Market Cycle asset allocation framework.

**Baseline**




**Including Tactical Tilts**