October 31, 2016

MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Inflections and Dissonance

Derek Benedet, CFP, CIM, CMT

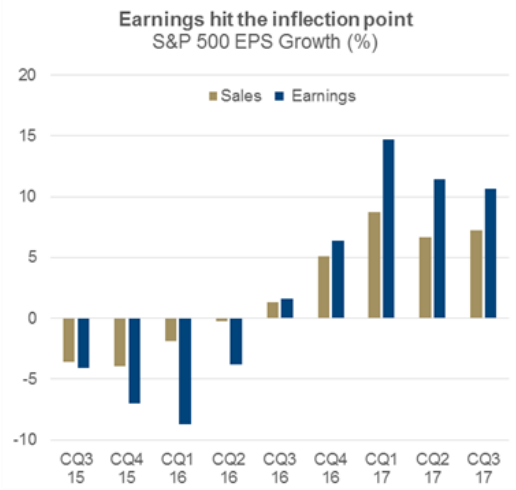
Though October historically is one of the most volatile months of the year, even short term traders are likely disappointed at the lack of any meaningful market pullbacks. Both the TSX and SPX look to be rather comfortable meandering just below the near term highs. Volatility has largely been contained with the VIX managing to stay below 20 for the month, hitting a low of 12.2. A week before U.S. elections, there remains an odd calm to the markets. Election day might be stormy, but we hope it passes without much damage.

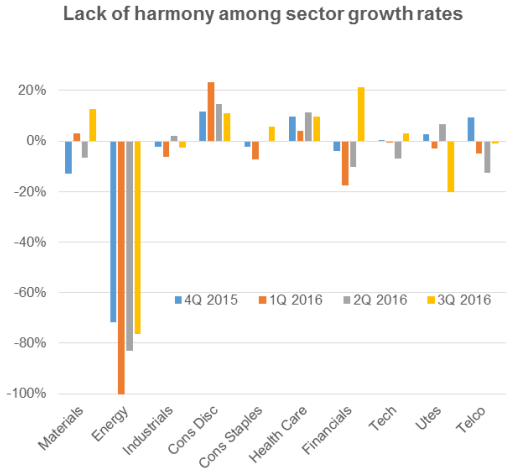
So far over the course of the month the S&P 500 is down 1.3%, compared the TSX rising +0.7%. Ten-year bond yields have charted an impressive rally. U.S. yields have risen 26bps from 1.59% as of the end of September to 1.85% today. Canada as well has seen bonds rise 24bps, from 1% to 1.24%. Interestingly despite the divergence in central bank policy the spread between the two has remained fairly stable. Even with spreads staying flat and crude rising about $5/bbl, the loonie has lost a few cents. Remember, currencies like equites trade on future expectations, not necessarily the day-to-day moves in the usual drivers.

U.S. earnings season continues to push through, with roughly 60% of companies having reported. Overall, it's fair to say that so far we've been modestly impressed. Companies are solidly beating expectations, we're looking at about a 78% beat rate this quarter. On average, we're seeing a 6% beat vs consensus estimates. Cynics would be quick to point out that either analysts don't know anything (no comment), targets had been revised lower over the quarter making them easier to beat (they were), and companies for the most part are very good at managing expectations (they are).

Beating expectations is one thing, but actually growing profits is important. A bright spot worth noting is earnings growth is on track to be modestly positive for the quarter. This will mark the end of the mid-cycle 'earnings recession' which started a year ago. Looking ahead, this will lead to easier comparables and higher growth rates throughout 2017.

Growth isn't uniform however. Energy remains a drag on the index. Most companies within the sector are missing expectations by a rather





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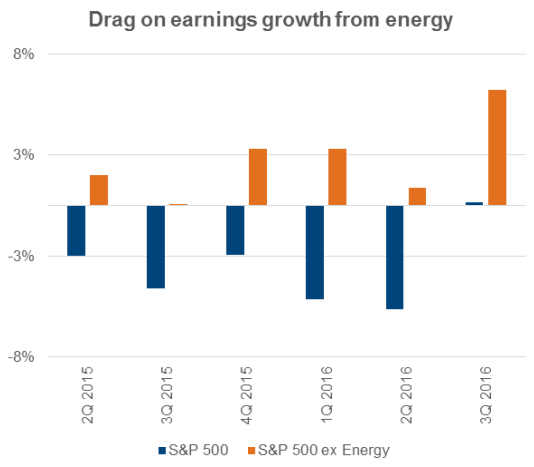
large margin. So far, with just half of the companies reporting, earnings per share are down -76% YoY. We hear a lot about cost cuts, and efficiency improvements, but companies can only do so much when it remains such a tough operating environment. Ex energy, earnings for the index are growing at 5.7%, a pretty decent clip. Looking at the chart to the right, you can see that this earnings recession was energy driven.



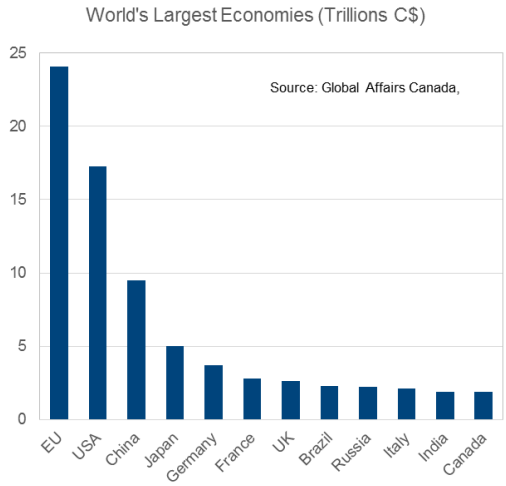
Financials are looking most impressive, solidly beating expectations and rising 21% YoY. The common theme for all the big banks was an earnings beat on fixed income securities trading revenue. When money is as cheap as it is, why wouldn't companies move to have their fill. Corporations continue their bond binge. Leverage is on the risk, fueling M&A (also good for the banks) as well as stock buybacks. While our view on rates is that they will continue to rise which will also be a positive for the sector where they can finally see some net interest margin expansion.

While not good enough to really drive strong stock performance, earnings season has not been negatively impacting the market either. Overall, with growth likely in the area of 1% range, investors seem rather complacent. The market has entered a rather tight trading range the past few weeks, and we don't expect this to change with one week to go before the elections.

Canada – European Union Free Trade

Gareth Watson, CFA

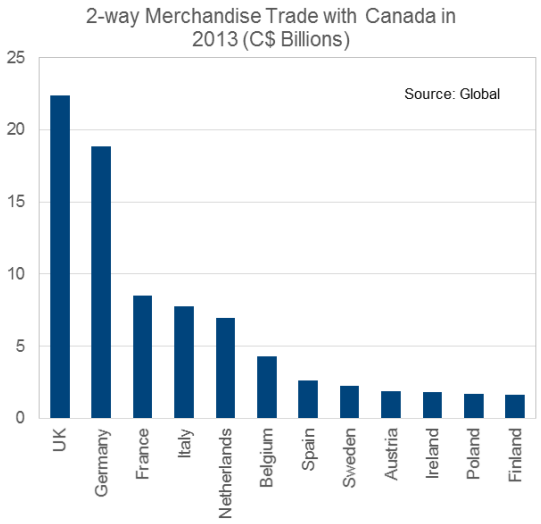
This past week was supposed to mark the signing ceremony for a landmark Comprehensive Economic and Trade Agreement (CETA) between Canada and the European Union (EU). While such a ceremony did not happen thanks to officials in Wallonia, a region of Belgium, eventually calmer heads prevailed and all 28 EU countries are on board with the deal. As such, it's expected that Prime Minister Trudeau will soon make his way to Brussels to sign an agreement that was seven years in the making, and one that will make Canada the only country in the world to have guaranteed preferential access to the EU and the United States. Considering the significance of this deal we thought we'd let you know some of the benefits to Canada.



The European Union is the largest economy in the world, and this agreement gives Canada access to 28 EU member states, 500 million people, and an economy that generates approximately $18 trillion in economic activity annually. Bureaucrats are estimating this deal will eliminate almost all tariffs for Canadian goods and services. Based on data from Global Affairs Canada, of the EU's more than 9,000 tariff lines, approximately 98 percent will be duty-free on the first day this agreement comes into effect which could be as soon as 2017. Tariffs on manufactured goods will be eliminated altogether and Canadian businesses will be given preferential access to the EU's $3.3 trillion government procurement market. This is particularly significant

considering how influential the services industry has become as manufacturing has declined.

Bureaucrats also estimate this deal will provide a 20 percent boost in bilateral trade and a $12 billion annual increase to Canada's economy. In 2013, two-way merchandise trade between Canada and the EU was estimated to be approximately $86 billion. Below we list the top 12 of the 28 EU countries we have traded with historically. Naturally, these trade numbers are only expected to increase once CETA is signed.



Admittedly the deal has not been officially signed yet, but it looks like a signing ceremony is forthcoming. The numbers we have presented above are supportive for the Canadian economy and for businesses of all sizes. However, one important result from this agreement will be that Canada will have the opportunity over time to diversify its international exposure when it comes to trade. Currently our country is heavily dependent on the United States as we do about three quarters of our trade with our southern neighbour. Such a relationship is helpful when the U.S. economy is growing, but can be detrimental when the U.S. hits a recession. As such, it's beneficial for economic cycle stability for our country to expand trade outside of the United States. CETA appears to be the starting point for Canada to start that diversification process.

Charts are sourced to Bloomberg unless otherwise noted.