NATIONAL BANK FINANCIAL MARKETS
A division of National Bank of Canada

Monthly EQUITY MONITOR

June 2013

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Highlights

- The U.S. equity market still has the wind in its sails. In May, the S&P 500 is up 2.1% for a year-to-date climb of 14.3%, its best start of the year since 1997. Europe has also been doing well, with MSCI Europe up 1.8% month to date. These strong showings have led the MSCI All Country World index to a gain of 1.0% in May, a seventh straight month of advance. Such a positive sequence has not been observed since 2006-2007. The S&P TSX outperformed the global benchmark, registering a 1.6% rise in May.
- It is true that low inflation, together with U.S. dollar strength continues to crimp the appreciation of bullion. However, we think the recent fire sale leaves the yellow metal oversold as a number of central banks have recently stepped in by lowering interest rates to accommodate overindebted governments or/and to stem currency appreciation. We mentioned last month that a better dosage of fiscal austerity was a necessary condition to allow better transmission of monetary policy. Some developments in the Euro zone could put a temporary hold on USD appreciation and allow bullion to recover some of the lost ground. We would use this opportunity to lower exposure to the gold sector as long-term fundamentals continue to favour the greenback.
- Indicators released over the past month remain consistent with an economic slowdown in Q2. Early in the quarter, our seasonally adjusted proxy for U.S. manufacturing sales shows not just a slowdown but a contraction from Q1. A quarterly decline would be the first since 2009. There are signs the consensus is about to scale back its optimism. Of Q2 EPS preannouncements issued by S&P 500 companies so far, 98 have been negative and only 14 positive.
- We are modifying our asset allocation this month, reducing our fixed income position to 38% (from 40%) and increasing our cash position to 7% from our previous benchmark allocation of 5%. In sector rotation, we are making a few changes this month to reflect our more cautious view on fixed income. We are downgrading utilities, telcos and staples to underweight and upgrading energy to overweight. We believe that earnings of Canadian energy producers will find support from the recent depreciation of the Canadian dollar.

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Onward and upward

The U.S. equity market still has the wind in its sails. In May, the S&P 500 is up 2.1% for a year-to-date climb of 14.3%, its best start of the year since 1997. Europe has also been doing well, with MSCI Europe up 1.8% month to date. These strong showings have led the MSCI All Country World index to a gain of 1.0% this month, a seventh straight month of advance. Such a positive sequence has not been observed since 2006-2007. Some regional indexes are doing less well than others. MSCI Pacific posted a pullback (-2.0%) after a spectacular rise earlier in the year. The difficulties of Latin American markets seem persistent.

U.S. equities lead global markets in May
Regional indexes: May, quarter to date, year to date

Region	MTD %	QTD %	YTD %
S&P 500 COMPOSITE	2.1	3.9	14.3
MSCI NORTH AMERICA	1.9	3.4	13.2
MSCI AC EUROPE	1.8	2.9	8.9
S&P/TSX COMPOSITE INDEX	1.6	-0.8	1.7
MSCI WORLD	1.1	3.7	13.2
MSCI AC WORLD	1.0	3.2	11.4
MSCI EM	0.4	0.0	-0.8
MSCI EAFE	0.0	4.0	13.3
MSCI BRIC	-1.0	-0.4	-3.9
MSCI EM LATIN AMERICA	-1.6	-3.4	-4.9
MSCI AC PACIFIC	-2.0	4.1	13.5

NBF Economy & Strategy (data via Datastream) 05-31-2013

Gains are also uneven among sectors. Investors are now firmly on the cyclicals bandwagon – Consumer Discretionary stocks are up 3.6%, IT 3.3%, Industrials 3.2%, Materials 1.3% and Energy 1.1%, all beating the MSCI All Country World index. More-defensive sectors have been losing favour. Utilities are down 5.3%, Telecommunications Services 3.5%.

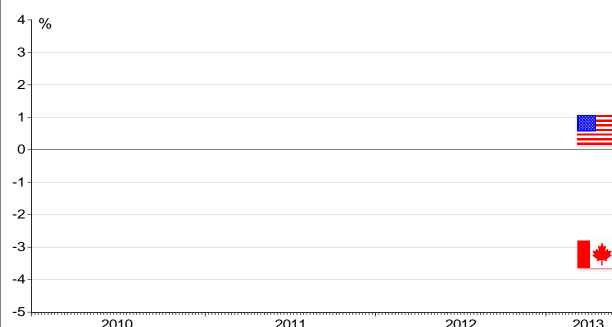
Cyclicals in the lead
Sector indexes: May , quarter to date, year to date

MSCI AC WORLD SECTOR PERFORMANCE (%)			
SECTORS	MTD %	QTD %	YTD %
MSCI AC WORLD	1.0	3.2	11.4
CONS DISCR	3.6	7.1	18.5
IT	3.3	4.8	10.2
INDUSTRIALS	3.2	3.5	13.3
MATERIALS	1.3	-1.2	-4.2
ENERGY	1.1	0.5	5.3
HEALTH CARE	0.8	4.2	19.9
FINANCIALS	0.8	5.0	13.2
CONS STAPLES	-1.9	0.1	13.0
T/CM SVS	-3.5	1.5	7.7
UTILITIES	-5.3	-0.1	6.7

NBF Economy & Strategy (data via Datastream) 05-31-2013

Higher demand for cyclicals has benefited the S&P TSX which outperformed the global benchmark in May, registering a 1.6% rise. This, however, erases only a portion of the widening gap between the Canadian and global equity benchmark (the MSCI AC index outperformed the S&P/TSX in five of the past six months). This situation largely reflects the more challenging environment for profits in Canada. Downward revisions of forward earnings, significant since the beginning of the year, have accelerated in the last month. Though the sharpest downgrades have been in Materials stocks, prompted by declines in commodity prices, analysts have also lowered their expectations for five other sectors in Canada.

One-month change in 12-month forward earnings (1)
U.S. vs. Canada



NBF Economy & Strategy (data via Datastream)

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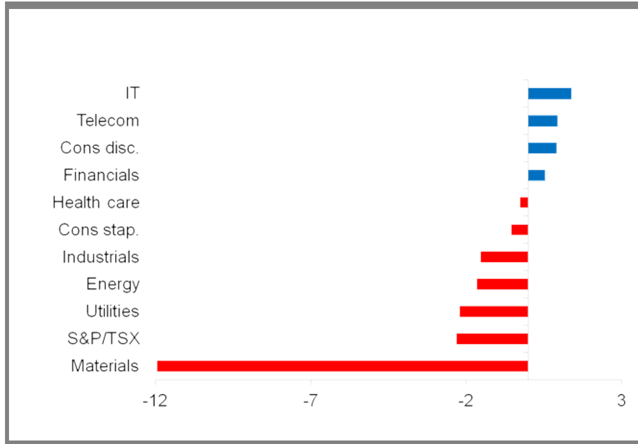


Gold losing lustre?

The S&P/TSX has languished this year (+3.0%) as the S&P 500 has climbed 15.4% (total return). The doldrums of the Canadian market are due above all to the slide of Materials stocks. This sector, which accounted for 18.6% of the index at the beginning of the year, has declined 20.0% since then. The debacle is especially pronounced in gold mine equities, down 30.3%. That's almost twice the decline of the underlying commodity (−16.2%).

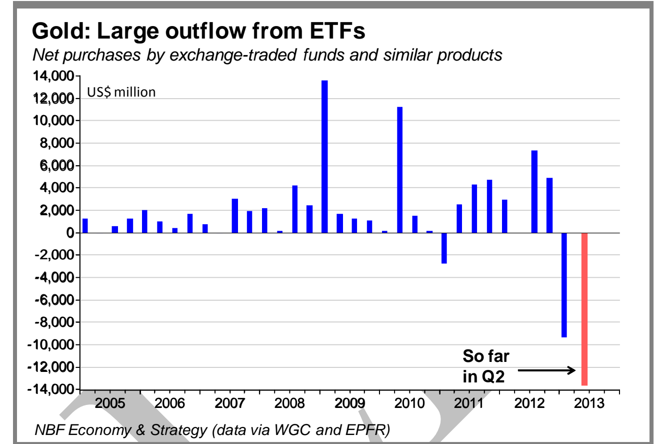
S&P/TSX Composite – Total return
May, quarter to date, year to date

Canadian S&P/TSX Equity Sector Returns				
		MTD	QTD (Q4)	YTD
S&P/TSX		1.8	-0.3	3.0
HEALTH CARE	1	11.5	14.1	40.2
INDUSTRIALS	2	5.4	2.4	17.0
CONS. DISC.	3	4.8	5.3	18.6
MATERIALS	4	3.2	-10.8	-20.0
ENERGY	5	1.2	-0.1	4.1
FINANCIALS	6	0.9	1.6	5.8
CONS. STAPLES	7	0.4	5.3	11.2
TECHNOLOGY	8	-1.3	9.1	28.2
TELECOM	9	-1.4	-1.8	9.7
UTILITIES	10	-3.5	0.0	0.4

NBF Economy & Strategy (data via Datastream)

Gold has been victim to portfolio movements since the beginning of the year. The World Gold Council reports bullion demand in Q1 down 16% from a year earlier, mainly because of a 51% drop in investment demand. For the first time in eight quarters, exchange-traded funds and similar products became net sellers of gold in Q1. The volume of the selloff is phenomenal, greater than at any time since the Council began compiling data (chart). And preliminary data from EPFR show net outflow in the first two months of the second quarter exceeding that of the first quarter.

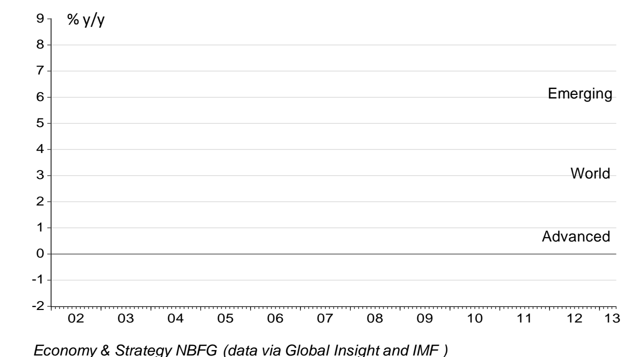
Gold: Large outflow from ETFs
Net purchases by exchange-traded funds and similar products



NBF Economy & Strategy (data via WGC and EPFR)

It is ironic that bullion has been correcting so sharply just as Japan has announced a quantitative easing of unprecedented scale, especially since central banks in a number of other countries could ease further to maintain their competitiveness relative to Japan. Global inflation data seem to have reassured those who thought central banks had been doing too much. Inflation in the developed economies is currently the lowest since October 2010.

Inflation not a concern for now
Consumer price index inflation (y/y)



Economy & Strategy NBFG (data via Global Insight and IMF)

It is true that low inflation, together with U.S. dollar strength continues to crimp the appreciation of bullion. However, we think the recent fire sale leaves the yellow metal oversold as a number of central banks have recently stepped in by lowering interest rates to accommodate overindebted governments or/and to stem currency appreciation.

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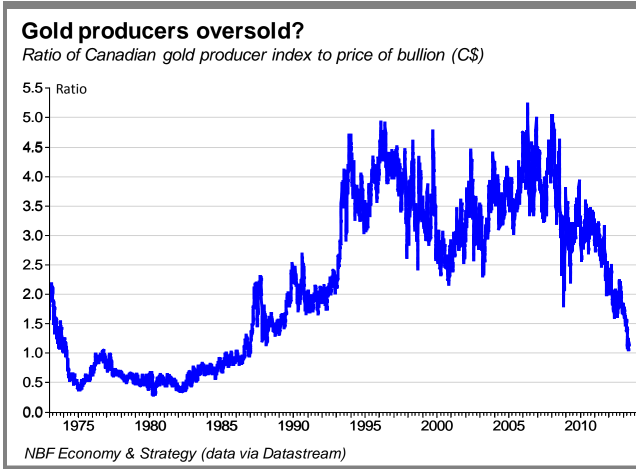
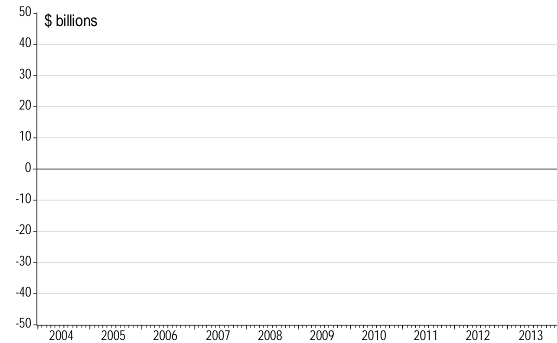
There is another reason to think this is not the time to throw in the towel on gold miners: not since the late 1980s has their equity index been so low relative to the price of bullion (chart).



At the same time, we note that net long speculative positions on the U.S. dollar are the most extreme since June 2012 when fears of a euro collapse were rampant. We mentioned last month that a better dosage of fiscal austerity was a necessary condition to allow better transmission of monetary policy. On May 29, the European commission announced that a number of countries (France, Spain, Poland, Portugal, the Netherlands and Slovenia) would be given more time to complete their austerity programs. Germany also revealed a joint investment plan with Spain to spur investment and financing of Spanish small and medium companies. These developments could put a temporary hold on USD appreciation and allow bullion to recover some of the lost ground. We would use this opportunity to lower exposure to the gold sector as long-term fundamentals continue to favour the greenback.



A soft Q2

Indicators released over the past month remain consistent with an economic slowdown in Q2 (we see U.S. GDP growth of about 1% annualized). U.S. retail sales beat expectations in April, but their growth rate for the quarter is likely to be less than half the 4.3% annual pace of Q1. This sluggishness, coupled with lagging overseas demand (most of the euro zone remains mired in recession – chart) and the hit from the federal government sequester, are taking a toll on manufacturing. U.S. factory output fell in April for a second straight month.

May looks little better. The US ISM manufacturing index fell below 50 for the first time since June 2009 during the month. Not only is output pausing in Q2 but prices are declining, courtesy of the surging USD. Early in Q2, our seasonally adjusted proxy for U.S. manufacturing sales shows not just a slowdown but a contraction from Q1. A quarterly decline would be the first since 2009 (chart).

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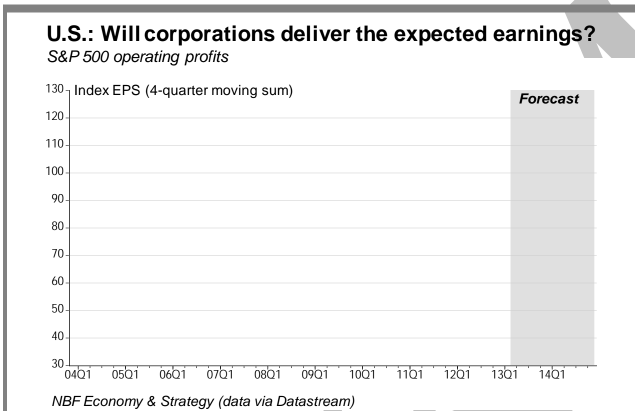
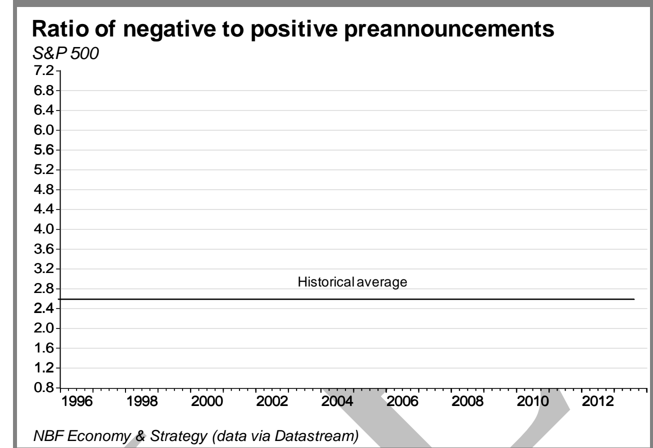
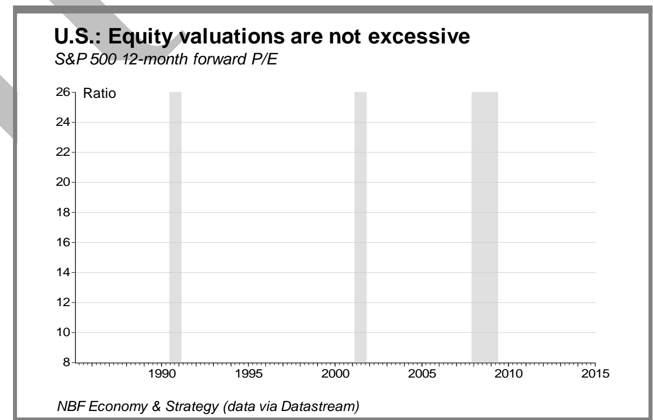
This picture points to a more challenging Q2 profit season than the market currently anticipates. At this writing the bottom-up consensus expects earnings to rebound strongly in Q2 and trend up robustly through 2014 (chart).



There are signs the consensus is about to scale back its optimism. Of Q2 EPS preannouncements issued by S&P 500 companies so far, 98 have been negative and only 14 positive as reported by Thomson One. The negative-to-positive ratio of 7.0 compares to a ratio of 3.4 at the same point a year ago and a long-term average of 2.6 (chart).



So in essence, the continued rise of equity markets comes from P/E expansion. The S&P 500 is currently trading at about 14.6 times forward earnings (next chart). This is still below the historical average and we think P/E multiples should remain relatively stable despite our forecast for higher interest rates which will still be low on an historical basis.



Energy remains a driver of U.S. growth

One thing to note about U.S. industrial output: Factory production may be down in Q2 but energy production remains strong. As the next chart shows, U.S. oil and gas production has surged this quarter to the highest in four decades. U.S. politicians appear to be adjusting to the possibility that the U.S. will become an exporter rather than an importer of energy. In May the Energy Department authorized the retooling of a terminal near Freeport, Texas to ship liquefied gas to non-FTA trading partners. This important decision provides a new outlet for rising U.S. production of shale gas (the

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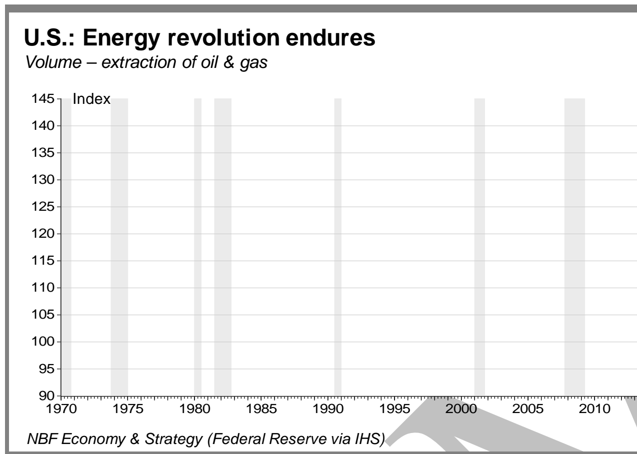
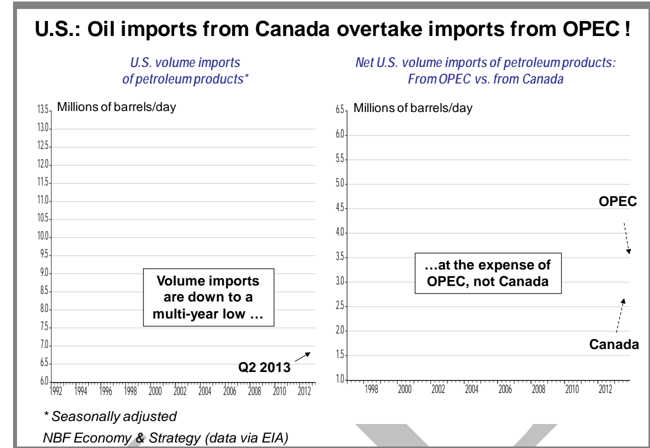
DoE sees the U.S. becoming a net exporter of natural gas by 2020). The Freeport terminal began as an import facility about five years ago when authorities were worried about North American energy shortages. The Washington Post reports that Japan has agreed to buy all of the LNG from the first of three phases of the Freeport project for 20 years.[1] The facility is conditionally authorized to export up to 1.4 billion cubic feet a day. That may not be much, but it opens the door to new export markets for gas trapped in North America, a door that could open wider if British Columbia follows through with construction of export terminals.



As for oil, we note that U.S. volume imports of crude plummeted in Q2 to the lowest since 1996. At this juncture most of the decline has been at the expense of OPEC. As the chart below shows, net U.S. volume imports from the oil cartel have dropped more than 40% since 2007. Canadian exports have fared much better, reaching an all-time high of more than 3 million barrels a day in recent months. And in May, Canada supplanted OPEC as the main supplier of petroleum products to the United States.



The energy revolution in the U.S. has important implications for financial markets. It limits the downside for the U.S. dollar by reducing the current-account deficit and the potential for a flare-up of inflation. This dynamic should facilitate the Federal Reserve's eventual exit strategy.

Asset allocation

We are modifying our asset allocation this month, reducing our fixed income position to 38% (from 40%) and increasing our cash position to 7% from our previous benchmark allocation of 5%.

The contraction of U.S. factory output over the last two months has been more severe than we expected and inflation has been much tamer. Despite these developments, the yield of 10-year U.S. Treasuries jumped almost 40 basis points in May to just above 2.1%. Much of the rise has been due to fear that the Fed will announce an imminent tapering of quantitative easing. While we too expect such an announcement, we doubt it will come before September. If we are right and Q2 GDP turns out softer than is currently expected, job creation will decelerate. That would limit the potential for a summer rout in Treasuries and could lead instead to lower rates and a correction of equity markets. Such a development could be an opportunity to further rebalance our asset mix away from bonds and add to equities.

As noted in our Fixed Income Monitor, the term premium on 10-year zero-coupon bonds has been crushed into negative territory for the past three years – an unprecedented development. Absent continued disinflation and external shocks, we think the path of

[1] http://articles.washingtonpost.com/2013-05-17/business/39338282_1_lng-exports-freeport-terminal-quintana-island

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least resistance for bond yields will be a slight increase to 2.7% by year end as the Fed begins to disengage from QE3. That would leave interest rates still low enough to keep the U.S. recovery on track. The two most recent episodes in which the 10-year bond yield approached 3% (early 2009 and 2011) were characterized by a lacklustre labour market and home-price deflation. These conditions no longer apply. In fact the continued improvement of loan performance at U.S. commercial banks – delinquency rates on C&I and consumer loans have fallen to historical lows – argues for more vigorous lending in the second half of 2013 and stronger GDP growth. The U.S. economy seems healthy enough to put aside its QE crutches.

Sector rotation

We are making a few changes this month to reflect our more cautious view on fixed income. We are downgrading utilities, telcos and staples to underweight and upgrading energy to overweight. We believe that earnings of Canadian energy producers will be supported by the recent depreciation of the Canadian dollar (about 80% of revenues are referenced in USD vs. only about 10% for costs).

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	30	27	
U.S. Equities	10	16	
Foreign Equities (EAFE)	10	6	
Emerging markets	5	6	
Fixed Income			
Canadian Bonds	30	30	-2.0
Foreign Pay Bonds	0	3	
Real Return Bonds	10	5	
Cash	5	7	+2.0
Total	100	100	

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NBF Market Forecast

Canada

Index Level	Actual May-30-13	Q4 2013 (Est.) Target
S&P/TSX	12,747	12,900

Assumptions			Q4 2013 (Est.)
Level:	Earnings *	873	860
	Dividend	405	399
PE Trailing (implied)		14.6	15.0
PE Forward			14.8
			Q4 2013 (Est.)
Treasury Bills (91 days)		1.01	0.98
10-year Bond Yield		2.07	2.65

* Before extraordinary items, source Thomson

NBF Market Forecast

United States

Index Level	Actual May-30-13	Q4 2013 (Est.) Target
S&P 500	1,654	1,650

Assumptions			Q4 2013 (Est.)
Level:	Earnings *	105	108
	Dividend	36	37
PE Trailing (implied)		15.7	15.3
PE Forward			15.3
			Q4 2013 (Est.)
Treasury Bills (91 days)		0.04	0.09
10-year Bond Yield		2.12	2.73

* S&P operating earnings, bottom up.

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NBF Fundamental Sector Rotation - June 2013

Name (Sector/Industry)	Recommendation	S&P/TSX weight
Energy	**Overweight**	**24.7%**
Energy Equipment & Services	Overweight	1.1%
Oil, Gas & Consumable Fuels	Overweight	23.7%
Materials	**Overweight**	**14.7%**
Chemicals	Overweight	3.8%
Containers & Packaging	Market Weight	0.1%
Metals & Mining *	Market Weight	3.6%
Gold	Overweight	6.9%
Paper & Forest Products	Overweight	0.3%
Industrials	**Market Weight**	**7.0%**
Capital Goods	Market Weight	1.8%
Commercial & Professional Services	Market Weight	0.4%
Transportation	Market Weight	4.8%
Consumer Discretionary	**Underweight**	**5.3%**
Automobiles & Components	Market Weight	1.2%
Consumer Durables & Apparel	Underweight	0.4%
Consumer Services	Underweight	0.6%
Media	Underweight	2.3%
Retailing	Underweight	0.9%
Consumer Staples	**Underweight**	**3.0%**
Food & Staples Retailing	Underweight	2.5%
Food, Beverage & Tobacco	Underweight	0.6%
Health Care	**Market Weight**	**2.5%**
Health Care Equipment & Services	Market Weight	0.8%
Pharmaceuticals, Biotechnology & Life Sciences	Market Weight	1.8%
Financials	**Market Weight**	**33.7%**
Banks	Market Weight	21.7%
Diversified Financials	Market Weight	1.3%
Insurance	Market Weight	6.2%
Real Estate	Market Weight	4.5%
Information Technology	**Market Weight**	**1.7%**
Software & Services	Market Weight	1.1%
Technology Hardware & Equipment	Market Weight	0.5%
Telecommunication Services	**Underweight**	**5.5%**
Utilities	**Underweight**	**2.0%**

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