Weekly Trends

PRIVATE CLIENT SOLUTIONS

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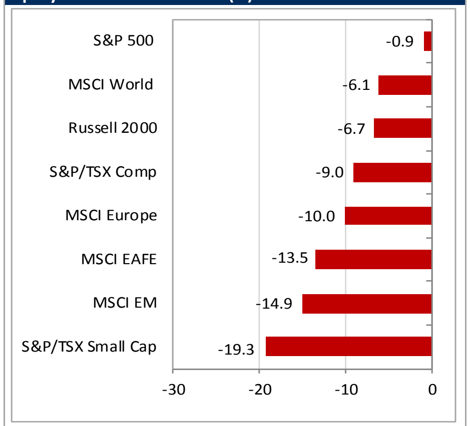
December 14, 2018

Fading Year-End Rally

Today's market is increasingly headline-driven, resulting in wild intraday swings. We attribute this to machines/algorithms responding to the latest headline, while the bull and bear camps attempt to make sense of the fast-shifting narratives on interest rates, trade and geopolitics. The large intraday reversals we've experienced over the past few weeks underline investor uncertainty and these doubts have trapped US and Canadian markets in a trading range.

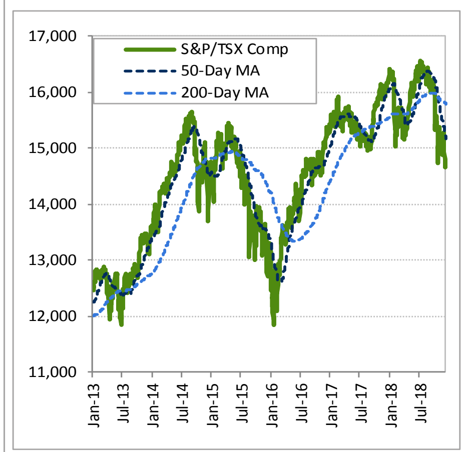
- As noted in previous publications, we've become more cautious on equities in the near-term and believe investors should use any year-end rally to adjust their overall asset allocation.
- In addition to decreasing equity allocation to neutral and increasing our cash to overweight, we have been advocating that investors increasingly focus on higher quality stocks to mitigate risk within equities.
- Within our newly introduced *Sector Report* we took the opportunity to upgrade defensive sectors from underweights to neutral while downgrading cyclical sectors from overweight to neutral. We stopped short of moving defensives sectors to an overweight as many were technically overbought. However, as we review our sector recommendations again in January we will re-evaluate for an opportunity to move some sectors to an overweight.
- Our US recession watch list has had a number of indicators move into neutral territory (the most recent being high yield spreads which have widened), but they have not turned outright negative. As such, we do not believe a US recession will occur within the next 12 months.

Equity Market YTD Returns (%)



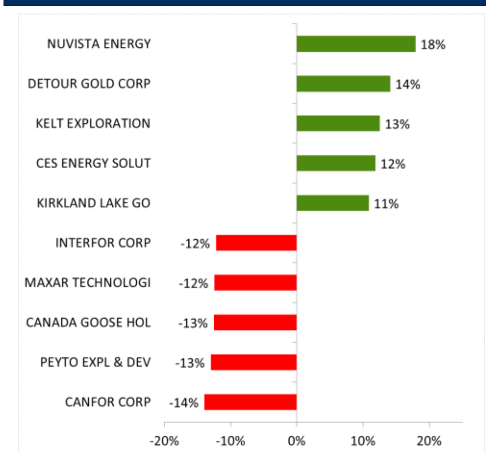
Canadian Sectors	Weight	Recommendation
Consumer Discretionary	4.2	Underweight
Consumer Staples	4.0	Market weight
Energy	18.0	Market weight
Financials	33.0	Market weight
Health Care	1.6	Underweight
Industrials	10.9	Market weight
Technology	4.1	Market weight
Materials	10.8	Market weight
Communications	6.0	Market weight
Utilities	4.2	Market weight
Real Estate	3.2	Overweight

Technical Considerations	Level	Target
S&P/TSX Composite	14,750	17,650



Source: Bloomberg, Raymond James Ltd.
Sectors are based on Bloomberg classifications

S&P/TSX Top 5 Gainers/Laggards*



S&P/TSX Market Internals

Weekly Advance	83	33%
Weekly Decline	160	64%
Advance-Decline	-77	
New 52 wk high	5	2%
New 52 wk low	25	10%
No. Stocks Above 50-d	75	30%
No. Stocks Above 200-d	66	26%
Arms Weekly Index	0.81	Neutral
RSI (14-day)	38.5	Neutral
50-DMA	15,177	Downtrend
200-DMA	15,793	Downtrend

*Source: Bloomberg, Raymond James Ltd; * 5-day price return*

Please read domestic and foreign disclosure/risk information beginning on page 5

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As noted in previous publications, we've become more cautious on equities in the near-term and believe investors should use any year-end rally to adjust their overall asset allocation:

> *"… the bounce experienced from the October lows has lacked the breadth (the number of stocks participating in the rally is below average) and volume (volume on up days below average total volume) one would have expected to see following a correction of that magnitude. We also highlight a noticeable shift in leadership from cyclical to defensive areas of the market, as well as stocks having difficult rallying on good news/earnings beats. The recent market price action increases our concern in the short-term that the market may be more vulnerable to further weakness. As such, we believe it prudent to use the typical year-end rally to reduce equity exposure."*
>
> ~November 15: Asset allocation Update

In addition to decreasing equity allocation to neutral and increasing our cash to overweight, we have been advocating that investors increasingly focus on higher quality stocks to mitigate risk within equities:

> *"…members discussed ways to mitigate risk within that class such as rotating from growth to value and focusing on quality and/or companies with low earnings variability."*
>
> ~August 3: Q318 Asset Allocation report

Within our newly introduced *Sector Report* we took the opportunity to upgrade defensive sectors from underweights to neutral while downgrading cyclical sectors from overweight to neutral. We stopped short of moving defensives sectors to an overweight as many were technically overbought. However, as we review our sector recommendations again in January we will re-evaluate for an opportunity to move some sectors to an overweight.

Today's market is increasingly headline-driven, resulting in wild intraday swings. We attribute this to machines/algorithms responding to the latest headline, while the bull and bear camps attempt to make sense of the fast-shifting narratives on interest rates, trade and geopolitics. The large intraday reversals we've experienced over the past few weeks underline investor uncertainty and these doubts have trapped US and Canadian markets in a trading range. Beneath the day-to-day gyrations, markets are attempting to come to terms with:

- **Slower global growth.** Over 40% of global equity markets are trading below their 200-day moving average and some have entered bear market territory. Price momentum has turned decidedly negative for global equities amid a softening growth outlook over the past 2-3 quarters. Within this current economic expansion we have experienced two notable slowdowns, 2011 and late 2015. Both resulted in double-digit peak to trough losses for both the S&P 500 and S&P/TSX. While we anticipate some near-term weakness, once there are indications growth has stabilized, markets should resume their upward trajectory. Under this assumption of growth reaccelerating, EM, and by extension the Canadian market, may offer double-digit returns.

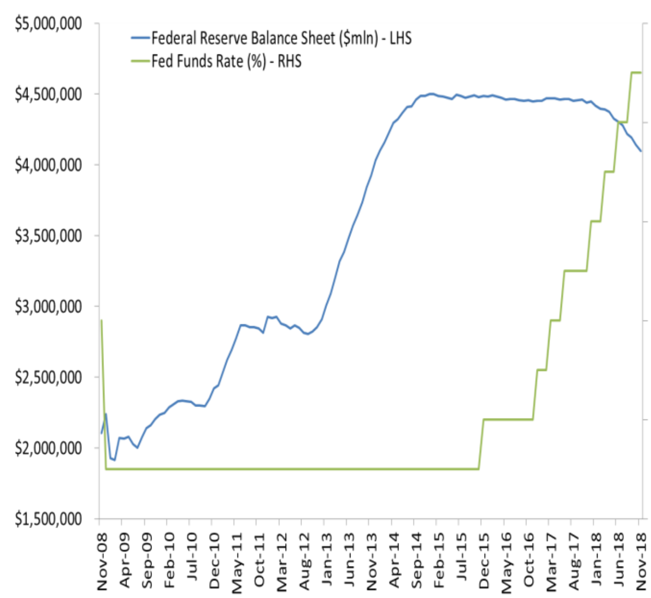
S&P 500 A Few Stumbles Along the Way…

…Same Goes For the TSX, But With Deeper Corrections

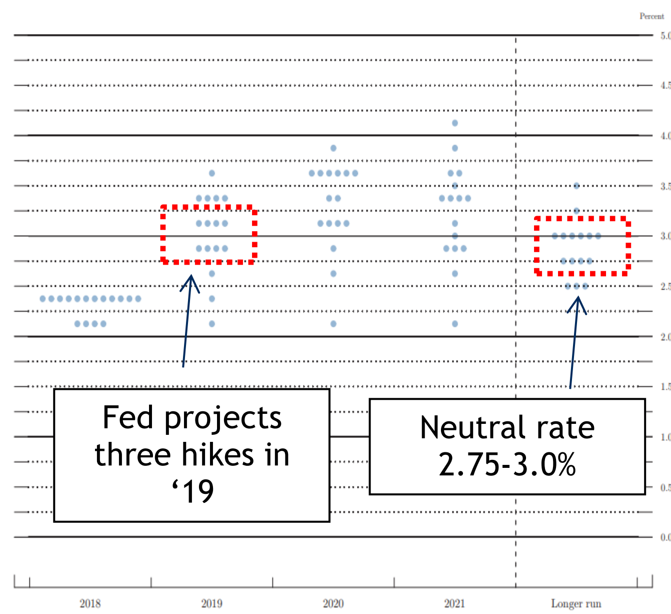
Source: Bloomberg, Raymond James Ltd.

- **Monetary policy.** The Dot plot (a graphical illustration of the Fed members' fed funds forecast) indicates the US Federal Reserve will raise rates 3 more times next year, which will bring the fed funds rate to the neutral range of 2.75-3.0%. However, the market is pricing in less rate hikes given the growth outlook and Powell's more dovish tone of late. Regardless, the Fed appears hell-bent on getting to neutral so the chances of a policy mistake within the next 12 months have risen, in our view. In addition, more than 50% of central banks around the world are tightening monetary policy, creating headwinds for asset prices particularly during periods when economic activity is decelerating like today.

Fed Balance Sheet & Fed Funds Rate…



…Fed Dot Plot Calls for 3 More



Source: Bloomberg, Raymond James Ltd, Federal Reserve: September 26, 2018 Economic Projections

- **Slowing corporate earnings growth.** Next year's US corporate earnings growth will pale in comparison to 2018; current consensus is for 8.1%, which will likely be revised lower as is the typical pattern. Additional headwinds may come in the form of margin pressure due to higher interest rates, rising wages, and lower share buyback activity, which will fail to match the record levels achieved this year. In short, weak earnings momentum is not often associated with strong equity market returns.
- **Europe.** We wonder if there will ever be a day when Europe isn't mentioned as a risk. We have Brexit, the Italian budget deficit plan and rising EU populism all to manage in 2019.
- **US debt ceiling.** We also wonder if there will ever be a day when US politics isn't mentioned as a risk. Remember that pesky debt ceiling issue that pops up every so often? Well, the US government will need to raise the debt ceiling this coming spring, but with Treasury resorting to "extraordinary measures" to finance the government this will put the actual deadline sometime in the summer. With Trump already threatening to shut down the government over the border wall, the debt ceiling debate will provide markets with some gut wrenching moments. The last debt ceiling standoff was in 2011 and resulted in the S&P issuing its first ever government credit downgrade. Equity markets did not respond well to the standoff, as the S&P 500 fell nearly 300 points from July to October.
- **Technicals.** As mentioned, breadth has been lacking on up days, we haven't experienced extreme pessimism on down days and market leadership has shifted to defensive sectors. We also note it is somewhat unusual to have market weakness during a seasonally strong period for equities. We'll be watching these dynamics, as well as other market indicators for clues of a bottoming process. Once the market has found a firm footing we anticipate the defensive rotation to run its course and money to move back into the deeply oversold cyclical sectors.

Defensive/Cyclical Ratio

Source: Stockcharts.com, Raymond James Ltd.

As the market fully digests the above, we believe there will be an opportunity to put cash to work possibly in H1/19. While we're looking for further weakness in equity markets, at this time we don't believe the market will experience a more severe correction, which is typically associated with US recessions. Our US recession watch list has had a number of indicators move into neutral territory (the most recent being high yield spreads which have widened), but they have not turned outright negative. As such, we do not believe a US recession will occur within the next 12 months.

US Recession Watch; A Few More Indicators Move to Neutral

Start of Recession	Yield Curve	Inflation Trend	Labour Market	ISM Manufac.	Housing Market	Hi Yield Spread
Nov-73	▼	▼	▼	▼	▼	▼
Jan-80	▼	▼	▼	▼	▼	▼
Jul-81	▼	▲	▲	▼	▼	▼
Jul-90	▼	▼	▼	▼	▼	▼
Mar-01	▼	▼	▼	▼	◀▶	▼
Dec-07	▼	▼	◀▶	▼	▼	▼
Current	◀▶	◀▶	▲	▲	◀▶	◀▶

Key: ▼ Recessionary ▲ Expansionary ◀▶ Neutral

Source: Raymond James Ltd.

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