Weekly Trends

PRIVATE CLIENT SOLUTIONS

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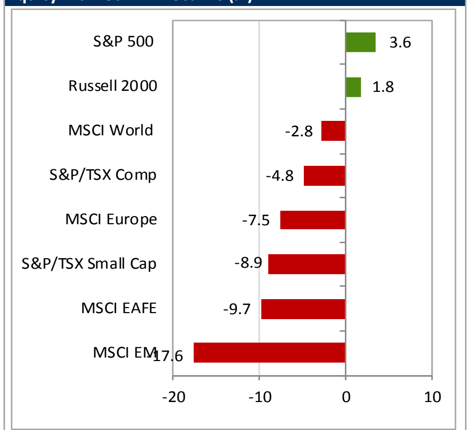
October 12, 2018

October Can Be a Scary Month

October has started off in its typical fashion as it has historically been the most volatile month of the year. This week's selloff appears to be driven by several factors. First, the speed of the recent backup in long-term government bond yields has taken the market by surprise, placing selling pressure on growth and momentum stocks.

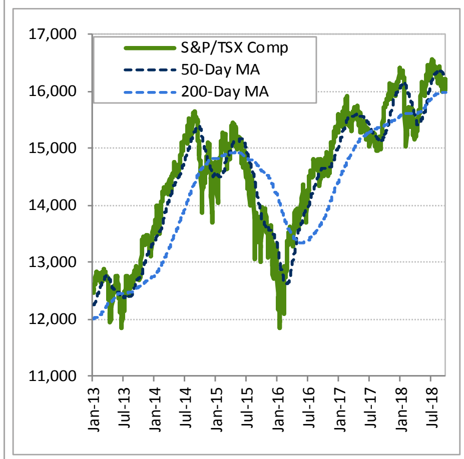
- On Thursday, the S&P/TSX bumped up to its support level of 15,350-15,400, but by the end of the session the index closed at the low. The next level of support will take the S&P/TSX to 15,000, although we prefer to see a couple days of trading to confirm the current support level will not be held.
- As of this week, S&P 500 earnings are anticipated to grow 19.2% yoy for the third quarter. Earnings estimates through Q3 have remained relatively stable, as we typically see negative earnings revision lower by 3-5%. However, since June 30th, S&P 500 earnings have been revised lower by only 1.1%, even though the number of companies providing negative guidance this quarter has been higher than usual.
- The S&P 500 recorded a 7.2% gain in the third quarter, but the markets are clearly taking a pause at the moment as they adjust to higher long-term interest rates. Considering bottom-up estimates for S&P 500 companies, analysts see further upside over the next 12 months. On October 4, the bottom-up target price for the S&P 500 was 3,205, which is about 12.5% upside from current levels.

Equity Market YTD Returns (%)



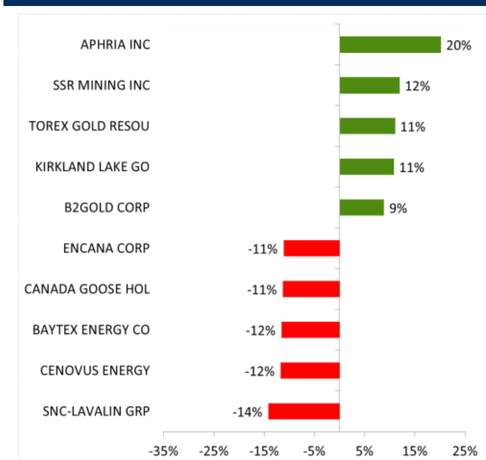
Canadian Sectors	Weight	Recommendation
Consumer Discretionary	4.4	Market weight
Consumer Staples	3.4	Underweight
Energy	19.1	Overweight
Financials	33.9	Market weight
Health Care	2.1	Market weight
Industrials	10.5	Overweight
Technology	3.8	Market weight
Materials	10.6	Overweight
Communications	5.3	Market weight
Utilities	3.8	Underweight
Real Estate	3.0	Market weight

Technical Considerations	Level	Target
S&P/TSX Composite	15,435	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	76	30%
Weekly Decline	168	67%
Advance-Decline	-92	
New 52 wk high	2	1%
New 52 wk low	55	22%
No. Stocks Above 50-d	46	18%
No. Stocks Above 200-d	68	27%
Arms Weekly Index	0.73	Neutral
RSI (14-day)	18.6	Oversold
50-DMA	16,179	Downtrend
200-DMA	15,972	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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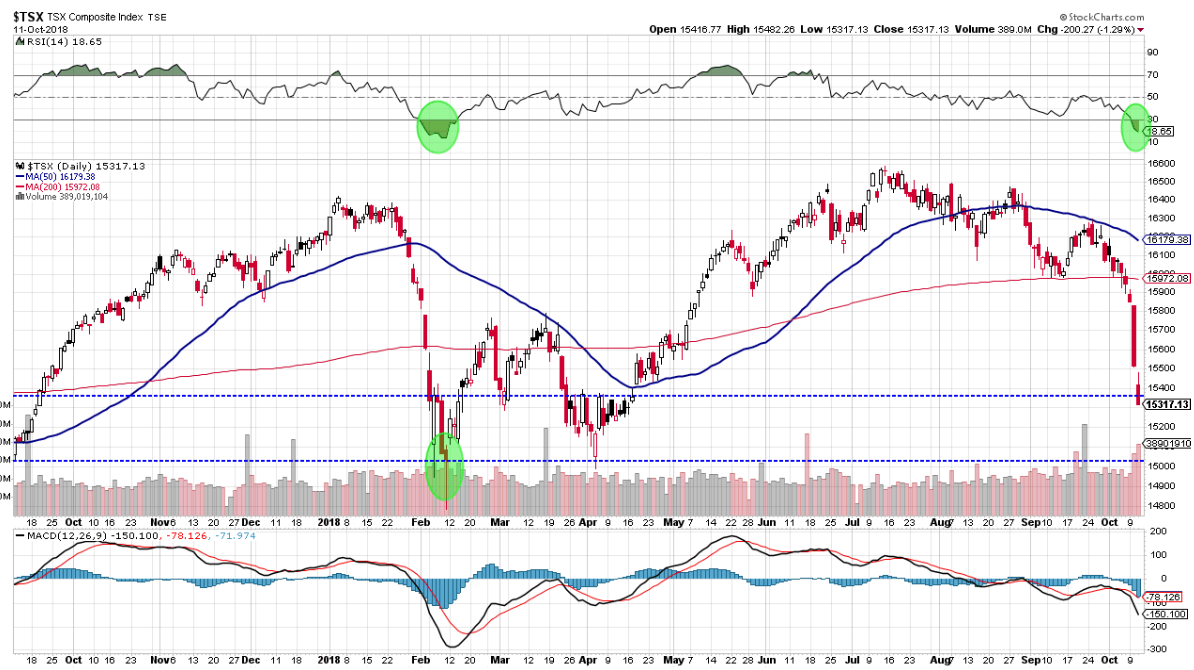
October has started off in its typical fashion as it has historically been the most volatile month of the year. This week's selloff appears to be driven by several factors. First, the speed of the recent backup in long-term government bond yields has taken the market by surprise, placing selling pressure on growth and momentum stocks. Federal Reserve Chairman Jerome Powell commented that "interest rates are still accommodative, but we're gradually moving to a place where they will be neutral…we may go past neutral, but we're a long way from neutral at this point, probably." This has not help the situation, as it implies continued and potential faster increase in short-term rates.

Other contributing factors have been comments made from firms about softer China demand despite the fact the Chinese government has taken some steps to counter trade tensions. We're also in the Q3 earnings season buyback blackout period, where corporates are prohibited from buying back their own stock, which removes a natural buyer from the market.

On Thursday, the S&P/TSX bumped up to its support level of 15,350-15,400, but by the end of the session the index closed at the low. The next level of support will take the S&P/TSX to 15,000, although we prefer to see a couple days of trading to confirm the current support level will not be held. The market is currently oversold and we're looking to bounce this morning, but we note that the market is not as oversold as it was at the February lows. If we can hold the current level, we anticipate some consolidation over the next couple weeks. We will watch for a pullback in bond yields as a potential catalyst for our typical year-end rally. From a seasonality standpoint, October usually starts off strong while ending on a weak note. It appears we're setting up for a reversal in this monthly pattern.

S&P/TSX Finding Support?



Source: Stockcharts.com, Raymond James Ltd.

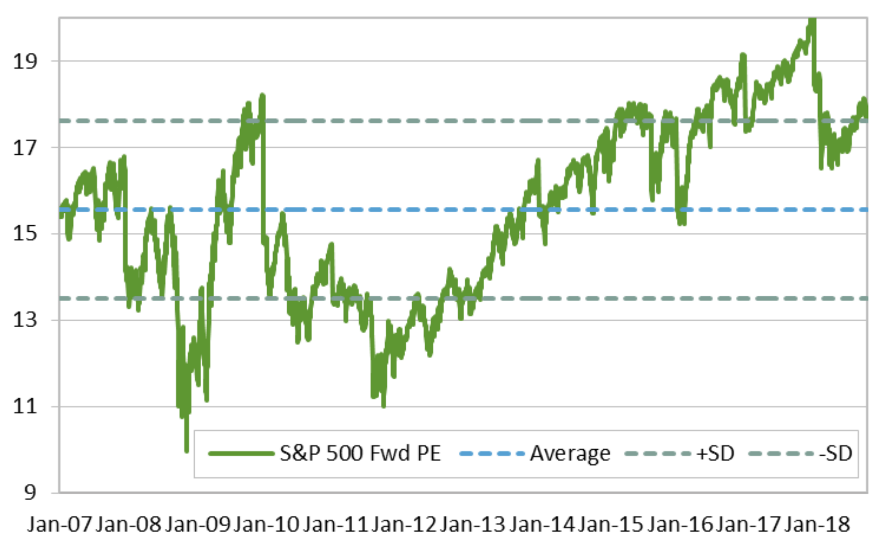
US Earnings Q3 Preview

As of this week, S&P 500 earnings are anticipated to grow 19.2% yoy for the third quarter. Earnings estimates through Q3 have remained relatively stable, as we typically see negative earnings revision lower by 3-5%. However, since June 30th, S&P 500 earnings have been revised lower by only 1.1%, even though the number of companies providing negative guidance this quarter has been higher than usual.

As we progress through the quarter, based on historical earnings surprise data, the actual Q3 growth rate will likely be closer to 23% yoy. If the index achieves earnings growth of greater than 20% it will mark the third straight quarter of 20% plus growth, an achievement that typically only occurred as the economy exited the depths of a recession. Obviously, the US corporate tax cuts from 35% to 21%, which were the largest in a generation, has had a meaningful impact on 2018 corporate earnings. While growth will level off in 2019, the regulatory changes implemented in the US may have an even bigger long-term impact on future economic growth and will help to sustain equity markets in the coming quarters.

For the full year 2018, bottom up earnings growth is 20.3% on revenue growth of 8.1%. Looking to calendar year 2019, analysts project earnings growth of 10.4% on revenue growth of 5.3%. From a valuation perspective, the S&P 500 is trading at 17.7x this years estimated earnings, one full standard deviation above its 10 year average. On a forward 12-month basis, the PE ratio is 16.7x, which is above the 5-year average of 16.3x and 10-year average of 14.5x.

S&P 500 Price to Earnings Ratio



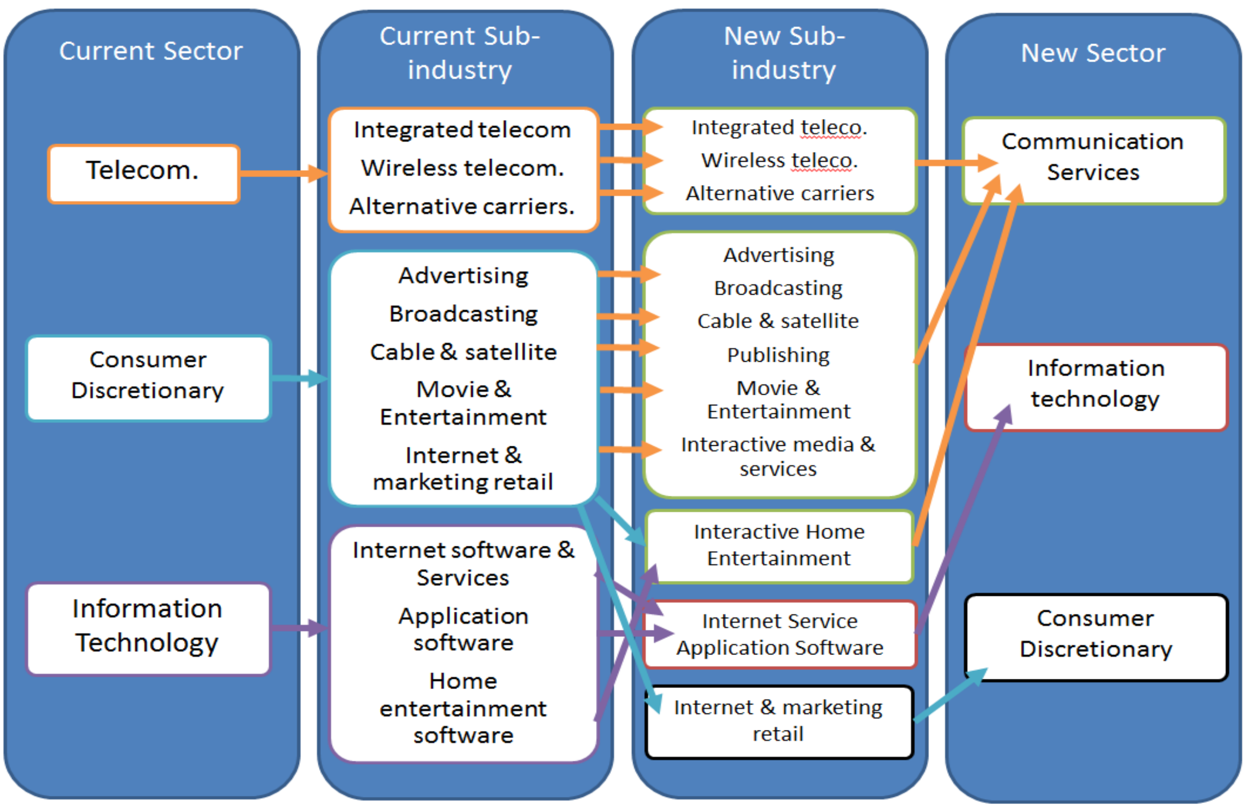
Source: Bloomberg, Raymond James Ltd.

From a sector perspective, communication services and materials rank among the sectors that will experience the best earnings growth in Q3. The GICS sector changes implemented in September plays a big part the reason the newly created communications services (formally telecommunications) will show strong growth. The sector reclassified some heavy weights technology firms, such as Facebook, Alphabet Inc and Netflix, within the new sector.

The communications services sector is clearly the biggest winner in the reclassification as it sees its weighting with the S&P 500 increase from roughly 2% to 10%. Information technology's weighting in the index decreases from approximately 26% to 20% and consumer discretionary from 13% to 10%.

The reclassification, however, complicates apple-to-apples comparisons particularly for communications services. Going forward the index tracks the new scheme, but the old scheme prior to September 24, 2018. For example, we can no longer assume that the sector will exhibit the same defensive characteristics, which in the past allowed investors to hide out during periods of market stress, as the new constituents will change the sector's price behaviour. The reclassification also alters the revenue, earnings, valuation and dividend profile making historical comparisons impractical.

GICS Sector Reclassification Overview: Communication Services the Big Winner



Source: Bloomberg, Raymond James Ltd.

And the Survey Says…

The S&P 500 recorded a 7.2% gain in the third quarter, but the markets are clearly taking a pause at the moment as they adjust to higher long-term interest rates. Considering bottom-up estimates for S&P 500 companies, analysts see further upside over the next 12 months. On October 4, the bottom-up target price for the S&P 500 was 3,205, which is about 12.5% upside from current levels.

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