



EQUITY RESEARCH

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INVESTMENT STRATEGY

Outlook & Portfolio Strategy – Quarterly Update

Near-term upside limited for TSX

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Index Levels

TSX	14270.53
TSX Venture	2354.34
DJIA	12393.90
S&P 500	1332.63
Nasdaq Composite	2791.19
MSCI World Index	346.91
Risk Metrics	
VIX	17.25
TED Spread	0.23%
FAIL[®]	1.37

Prices and levels as at close on April 5, 2011

Interest Rates & Commodity Prices

Canada T-Bill (90 days)	0.95%
US T-Bill (90 days)	0.07%
Canada 10-year Govt.	3.37%
US 10-year Treasury	3.48%
Canada 30-year Govt.	3.77%
US 30-year Treasury	4.51%
CRB Index	363.11
Spot Gold	US\$1455.75
Crude Oil (WTI-May)	US\$107.96
Canadian Dollar	103.76 US cents
USD/Euro	1.4225
USD/JPY	84.84

Source: Bloomberg

Summary

- Global equities easily surmounted a rising wall of worry to record a solid performance in Q1.
- While the TSX is less than 1,000 points from its record high set in June 2008, we are not too sanguine about its near-term prospects. A major reason for our caution is the increasing correlation between most asset classes and global financial markets in recent years. With commodity prices sensitive to swings in global growth outlook, the commodity-heavy TSX is especially vulnerable to such swings.
- Risk factors that could affect our forecast include deterioration in US consumer confidence, a slowdown in China, sovereign debt risk, and geopolitical risk.
- We are raising our end-2011 forecast to 13,750 (from 13,125) for the TSX Composite, and to 1,400 (from 1,350) for the S&P 500.
- We believe that Materials and Energy appear the most attractive on the basis of forward P/E to expected earnings growth.
- We are leaving our asset allocation unchanged from our previous update in December 2010 – Stocks 60%, Bonds 15%, and Cash 25%.

Table 1: Major equity indexes – Q1 change

Country	Index	Q1 change
Canada	TSX	5.0%
Canada	TSX-Venture	0.4%
US	DJIA	6.4%
US	S&P 500	5.4%
US	Nasdaq Comp.	4.8%
Mexico	IPC	-2.9%
Brazil	Bovespa	-1.0%
UK	FTSE 100	0.2%
Germany	DAX	1.8%
France	CAC 40	4.9%
Russia	RTS Index	15.5%
Japan	Nikkei 225	-4.6%
Australia	ASX 200	2.0%
India	Sensex 30	-5.2%
China	Shanghai Comp.	4.3%

Source: Bloomberg, Global Securities Research

MARKET REVIEW**A solid performance in Q1**

Global equities easily surmounted a rising wall of worry to record a solid performance in Q1. The 15 major equity indexes shown in Table 1 posted an average increase of 2.5% in Q1; North American indexes (excluding the TSX Venture) gained 5.4% on average. Notable under-performers included the Nikkei 225, with the Japanese economy continuing to feel the aftershocks of the massive March 11 earthquake / tsunami. India's Sensex 30 was the biggest decliner, as Asia's third-largest economy struggled to stem rising inflation with eight interest rate hikes over the past year. Russia's RTS Index led all equity markets with a 15.5% surge in Q1.

It was not all smooth sailing in the quarter, however, as geopolitical risk made a comeback, fueled by developments in the Middle East and North Africa. Other issues that weighed on investor sentiment during the quarter were European sovereign debt risk, soaring costs for food and fuel, and the nuclear debacle subsequent to the Japanese earthquake.

The global rally has now taken the MSCI World Index to its highest levels since mid-2008. Global market capitalization, currently at US\$54.7 trillion, is up 115% from the March 2009 lows and less than 13% away from the record level of US\$ 62.6 trillion reached in October 2007.

OUTLOOK

The TSX has now recouped almost all of its losses from the 2008/09 bear market. Having advanced approximately 90% from its March 2009 lows, the index is presently less than 1,000 points away from its record high set in June 2008. While the index may be within striking distance of new highs, we are not too sanguine about its near-term prospects.

A major reason for our caution is the increasingly tight correlation between most asset classes and global financial markets in recent years. Sudden shocks that emanate from distant shores – such as a regime change in the Middle East, a debt default by a small European nation, or any unexpected development that could impede Chinese growth – may have a significant negative impact on global growth expectations. Commodity prices are sensitive to swings in the outlook for global growth, and the TSX Composite – with its near-50% weight in commodities (including energy) – is especially vulnerable to such swings.

This phenomenon was apparent on occasion in Q1, when the TSX floundered even as crude oil traded into the triple digits, with concerns about the impact of an oil shock on the global economy outweighing the positive impact of higher oil prices on earnings of Canadian producers. While the Energy group outperformed the broad index by a significant margin in Q1, the Materials sector under-performed the index (Table 2). The impact of commodity prices at a two-year high was diluted by the stronger Canadian dollar, which rose to its highest in more than three years against the greenback.

Table 2: TSX Group Performance in Q1

TSX Group	Q1 Performance
Health Care	51.0%
Financials	8.2%
Industrials	8.2%
Energy	8.1%
Telecom Services	2.8%
Consumer Staples	2.2%
Information Technology	0.9%
Utilities	0.1%
Materials	-1.6%
Consumer Discretionary	-2.5%
TSX	5.0%

Source: Bloomberg

Earnings Estimates

Fiscal 2011 index EPS estimates for the TSX Composite – based on analysts' "bottom-up" earnings estimates for all index constituents – have declined 1.2% since our December update, from \$917 to \$906. This may partly be attributed to the 5% rise in the Canadian dollar over the past four months, which has undoubtedly cut into corporate earnings.

Since December, the sectors with the biggest downward revisions in analysts' average earnings estimates are the Consumer Discretionary (-6.9%), Financials (-5.2%), and Industrial (-4.2%) groups. Apart from Healthcare – which has had the biggest positive earnings revision of +13.4% – analysts have also revised their EPS estimates higher for the Materials (+3.5%) and Energy (+2.8%) groups.

The consensus EPS number of \$906 for fiscal 2011 represents earnings growth of 34.5% from 2010 index EPS of \$674. As can be seen in Table 3, earnings growth this year is expected to be led by the Healthcare, Materials and Energy groups.

Our forecast TSX index EPS for 2011 remains at \$850, or 6% below the consensus number, based on our view that analysts' estimates for this year may prove to be too optimistic in the face of mounting headwinds for the global economy.

Table 3: TSX Groups – Forecast EPS change in 2011 and Valuations

TSX Group	Forecast EPS change (%)*	Forward Index P/E**	Indicated Dividend Yield
Consumer Discretionary	11.5%	13.3	2.7%
Consumer Staples	8.2%	14.2	2.6%
Energy	53.0%	21.2	2.5%
Financials	21.1%	13.0	3.5%
Health Care	300.2%	22.3	2.2%
Industrial	10.4%	17.0	1.9%
Info Tech	14.7%	9.3	0.1%
Materials	74.6%	16.8	0.5%
Telecom Services	21.6%	12.5	4.8%
Utilities	2.4%	19.1	4.6%
TSX	34.5%	15.7	2.4%

Earnings growth this year is expected to be led by Healthcare, Materials and Energy.

*Forecast EPS change in 2011

** Forward P/E based on 2011 EPS estimate

Source: Global Securities Research, Bloomberg

For the S&P 500, earnings estimates have increased 2.3% since our December update. This puts forecast EPS growth for the S&P 500 this year at 15.4%, a significant moderation from earnings growth of 47.3% in 2010 (Table 4).

Table 4: S&P 500 Quarterly Operating EPS

Period	2010-A	% Change	2011-E	% Change
Q1	\$19.38	91.7%	\$22.13	14.2%
Q2	\$20.90	51.3%	\$23.90	14.4%
Q3	\$21.56	36.6%	\$24.68	14.5%
Q4	\$21.93	27.8%	\$25.95	18.3%
Total	\$83.77	47.3%	\$96.66	15.4%

Source: Standard & Poor's

Valuations

Our end-2011 target for the TSX is now 13,750 (up from 13,175 previously) and 1,400 for the S&P 500 (up from 1,350 previously).

The TSX presently trades at a forward multiple of about 16.8x our 2011 index EPS forecast of \$850. On the basis of a 16x multiple applied to that EPS forecast, our end-2011 target for the TSX is now 13,750, an upward revision of 4.4% from our December target of 13,175.

The S&P 500 trades at a significantly lower earnings multiple – compared with the TSX – of 13.8x the 2011 consensus EPS figure of \$96.66. Based on a 15x multiple applied to our EPS estimate of \$93, our end-2011 forecast for the S&P 500 is 1,400, up 3.7% from our previous target of 1,350.

Risks to our Outlook

- **Deterioration in consumer confidence:** Surging energy and food costs in the face of flat wage growth and a soft job market may have a detrimental effect on US consumer confidence.
- **China:** The possibility of China being ground zero for the next global shock cannot be ignored, given its increasing influence on the global economy and the determination of its central bank to engineer a slowdown in order to prevent the economy from overheating.
- **Sovereign debt risk:** This risk remains on the table, and has the potential to cause periodic disruptions in financial markets whenever it comes to the forefront.
- **Geopolitical risk:** After being dormant for a few years, geopolitical risk is back in a big way and is likely to stay elevated in the near to medium term.

STRATEGY

Materials and Energy appear the most attractive on the basis of forward P/E to earnings growth.

We compare the forward earnings multiple to forecast EPS growth in 2011 to derive an approximate PEG (P/E to Growth) ratio for the TSX groups. On that basis, the groups that look the most attractive are Materials and Energy. Barring unexpected shocks, the underlying fundamentals look solid for these two groups. In the energy group, we believe natural gas producers look attractive on the basis of valuations and long-term fundamentals. Uranium producers appear oversold but may be subject to significant volatility in the short term. We also continue to favour the senior gold producers, which are finally showing signs of playing catch up as gold rises to new highs. We continue to advocate taking profits in speculative positions and rotating into high-quality stocks. Dividend payers have lost none of their appeal, and in this category, we favour select stocks in the Canadian telecom sector, as well as US utilities and pharmaceuticals.

Our recommended asset allocation is unchanged from our previous update in December 2010 – Stocks 60%, Bonds 15% and Cash 25%.

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