Insights & Strategies

PRIVATE CLIENT SOLUTIONS

June 8, 2017

Inside this Issue

Volatility: Where For Art Thou?

Understanding market volatility, what causes volatility, how it is measured and why there seems to be a lack of volatility in the current marketplace are not the simplest concepts to understand. William of Ockham, an English philosopher, is widely credited with developing the principle that, among competing hypotheses, the one with the fewest assumptions should be selected. This is referred to as Ockham's Razor. We often look for complex answers to questions, but 9 times out of 10, a simpler explanation will often suffice. There are many different competing theories about why market volatility has diminished in recent years; we will look at the one that makes the fewest assumptions.

The most popular and widely recognized measure of market volatility is the CBOE's Volatility Index (VIX). The VIX measures the market's expectation of 30-day volatility and is often referred to as the "investor fear gauge." The index uses S&P 500 options to assess the potential for the market to make an abnormal move over the next 30 days. For example, a VIX reading of 30 implies the S&P 500 may move 8.6% in either direction, while a reading of 10 suggests the market may experience only a 2.8% move. VIX values greater than 30 are generally associated with a large amount of volatility as a result of investor fear or uncertainty, while values below 20 generally reflect less stressful times or even complacency in the markets. An increase in the VIX can be caused by any number of events, be it a geopolitical event like Brexit or the bankruptcy of a systemically important company like investment bank Lehman Brothers. The uncertainty surrounding these events often causes investors to buy downside protection (i.e., using S&P 500 puts) out of fear, which ultimately results in a spike in the VIX.

Although some investors may think volatility is on the rise, the current reading on the VIX does not support that view. Another way to measure the lack of volatility is to simply look at daily returns on the S&P 500. The S&P 500 is experiencing very few daily 1%+ moves relative to historical standards. The lack of volatility is hard to believe when you consider the sheer number of political surprises, geopolitical tensions and recent terrorist attacks. Although the world is seemingly more unstable, it is not reflected in market volatility. Perhaps in a world with Twitter, Facebook, and 24/7 news cycles, events halfway around the world take on great meaning and their occurrences seem more frequent because of increased coverage. Yes, our world is more complex today than it was 30 years ago, but the world has always faced challenges; those challenges are simply more visible today than in the past. Normally, challenges tend to show up as an increase in market volatility, but that is not the case today as implied and realized market volatility is much less than we may anticipate. So what is driving this level of complacency in the market; what is the simple answer to our complex question?

Please read domestic and foreign disclosure/risk information on Page 9.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
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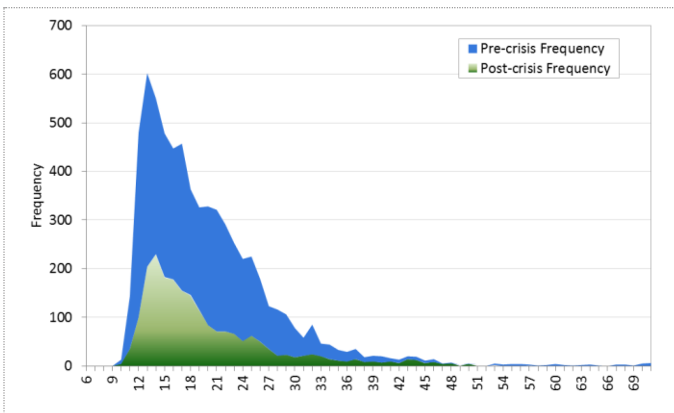
A simple answer to the lack of volatility is central banks or, more specifically, monetary policy. Since the financial crisis, the US Federal Reserve took extraordinary measures to protect the economy and the market with multiple rounds of quantitative easing and cutting interest rates to zero. Other major central banks also acted very aggressively to support the global economy. Globally, central bank actions have been a tailwind at the market's back for almost a decade and market participants are clearly aware of this. Investors know that central banks are willing to do whatever it takes to support the economy and market. In Japan, the Bank of Japan (BoJ) has gone so far as to actively buy Japanese equities. In fact, as of last year, the BoJ was a top-five owner of 81 companies in Japan's Nikkei 225 Stock Average. The Fed has not gone down this road, preferring to buy bonds to suppress borrowing costs and promote lending. Regardless of their actions, the market understands that central banks stand ready to support the market, and as time passes, this notion has become institutionalized and altered behaviour. Today, as markets slump due to some unexpected events, the "Buy the Dip" mentality kicks in as the perceived downside risks are limited thanks to the past actions taken by central banks.

VIX – Pre- & Post-Fed Intervention

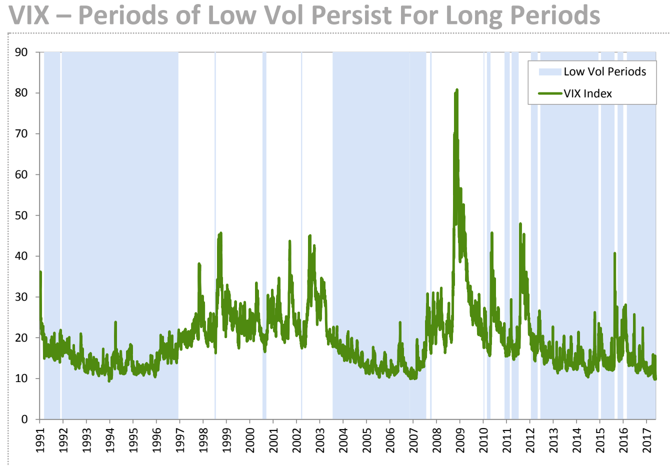


Source: Bloomberg, Raymond James Ltd.

To back this qualitative assessment, we segment the VIX into two sample groups - pre- and post-Fed intervention. Prior to the Fed's intervention, the volatility of the VIX was greater in the pre-Fed period and spikes in the VIX index took longer to revert back to a normal level. Finally, if you love stats, we can see the distribution of the VIX is not a standard distribution (which would look like the Bell curve we all knew in school). The VIX has very many observations skewed to one side in the 10 to 30 range, but a limited number of extreme values. However, in comparing the two sample periods, we conclude that the pre-Fed sample has more extreme observations, while the post-Fed has fewer. In plain English, the pre- and post-periods appear different and we believe the central banks, particularly the US Fed, are the primary reason for this variance.

Most recently the VIX touched a low of 9.81, a level rarely visited. In fact, there has been only 13 times over the last 27 years that the VIX traded below 10. We often look at stocks in a way that is counter to how the world works. For example, we worry about buying into a stock that has rallied significantly over the past few months fearing we're jumping in at the top. However, in the real world, we know once something is set in motion it tends to remain in motion. The market is no different; positively (negatively) trending stocks remain positively (negatively) trending longer than most investors expect. The same can be said about volatility; periods of complacency and fear tend to last longer than we'd normally expect. We looked at past periods of lower stress, which we'll define as VIX less than average (<19.4), and found periods of low volatility have persisted for 385 days, on average, over the past 27 years. Applying this logic to volatility suggests we're in a period of low volatility or complacency that may persist longer than investors expect even though the world around us appears to be in constant flux. This level of complacency may persist amid central banks' continued efforts to support economic growth, but as they become less accommodative, markets will transition to a period of higher volatility.

VIX – Periods of Low Vol Persist For Long Periods



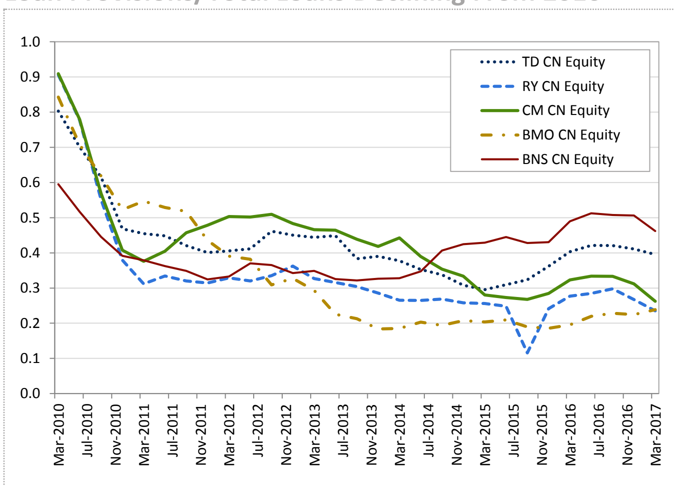
Source: Bloomberg, Raymond James Ltd.

Jason Castelli, CFA
VP, Portfolio Manager

High Five to the Big Five

The Big Five posted strong results this FQ2/17, beating EPS consensus estimates by an average of 3.8% and showing solid year-over-year (yoy) growth. The Canadian banks delivered an average 10.8% yoy EPS growth with TD, RY and BMO posting the highest EPS growth of 12%, 11% and 11%, respectively; BNS and CM came in at 10%. Following the energy scare last year, many investors were watching credit quality, especially provisions for credit losses (capital set aside/earmarked as an allowance for bad loans). This past quarter, the Big Five posted a stable metric with an average of 0.32%. BNS and TD both had above-average provisions (as % of total loans) at 0.49% (versus 0.64% last year) and 0.35% (versus 0.44%), respectively. Looking at the trend below, we see that the Big Five have been decreasing loan provisions since their recent peak in 2016, which is a good sign.

Loan Provisions/Total Loans Declining From 2016



Source: Bloomberg, Raymond James Ltd.

Beneath the headline numbers, all segments were positive. Wholesale profits averaged 22.4% yoy growth driven by underwriting & advisory. BNS had, by far, the strongest wholesale profit growth at 60%, driven by trading, followed by RY at 15% yoy, driven by underwriting & advisory. Wealth Management profits grew at an average 18% compared to last year. CM had the best wealth management net income growth at 35%, followed by BMO at 18%. As for retail banking, the Big Five averaged 4.2%, with TD and RY boasting above-average profit growth at 7% and 6%, respectively. Retail loan growth averaged 5.8%, led by CM at 11%. As for dividend increases, BMO raised their dividend by 2% sequentially and 5% yoy to C$0.90 per common share. The rest left their dividends unchanged. The Big Five currently yield an average of 4.0%, with CM yielding the highest and TD/RY the lowest.

Big Five Deliver Solid FQ2/17

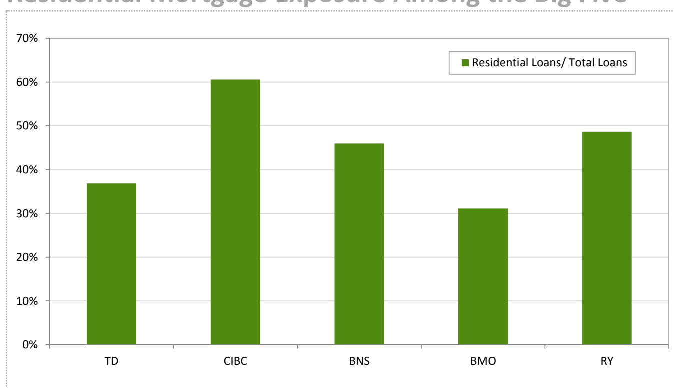
Ticker	Quarterly EPS	EPS Surprise	YoY EPS Growth	Dividend Yield	Div Change
TD-T	$1.32	7.5%	11.7%	3.6%	No change
RY-T	$1.85	4.7%	10.5%	3.7%	No change
CM-T	$2.63	2.5%	10.0%	4.8%	No change
BMO-T	$1.86	-0.3%	11.0%	3.9%	Increase 2%
BNS-T	$1.62	4.6%	10.1%	4.0%	No change

Source: Bloomberg, Raymond James Ltd.

Valuation levels for the Big Five have become more attractive in recent weeks, as the group now trades at 11.2x forward earnings, in line with the 5-year average of 11.0x. For the banks to re-rate higher, we'll be looking for positive EPS revisions and an improved outlook on the Canadian housing market.

While energy may not be in the spotlight as much as last year, investors are now eyeing the housing situation in the country. To evaluate this new focus, we looked into the Big Fives' exposure to the housing market. The chart below clearly places CM as the bank with highest residential mortgage loan exposure relative to its total loans at 61%, while most have less than 50% on the balance sheet.

Residential Mortgage Exposure Among the Big Five



Source: Bloomberg, Raymond James Ltd.

While dividend and earnings growth remain solid and valuations are more attractive, there have been some recent concerns regarding capitalization, or ability to absorb losses, compared to their US and European counterparts. Looking at metrics such as common equity Tier 1, or CET1 (which measures how much capital banks put aside to absorb unexpected losses) and leverage ratios (Tier 1 capital to total assets), the Big Five seem to be well capitalized. While the Canadian banks exceed the Basel Framework's minimum requirements for a CET1 ratio of 4.5% and leverage ratio of 3%, they continue to lag their global peers. In fact, regulators around the world have been much more strict on banks as a way to prevent a recurrence of the 2008 financial crisis. In the

US, regulators are requiring a leverage ratio of 5%, making certain banks overcapitalized. When comparing US and Canadian banks using the CET1 ratio, there doesn't seem to be much of a difference. However, the CET1 is asset risk weighted, which may differ depending on the country or even the type of loan. For instance in Canada, insured mortgages backed by the CMHC are assigned a weight of near zero; so no capital is held up against these loans. In looking at the leverage ratio, it is clear that the Big Five are at the bottom of the pack, meaning they employ far more leverage relative to their peers due to the structure of our mortgage market and CMHC backing. The fact that global peers continue to become better capitalized shows how important this has become to regulators and investors. As US and European peers continue to raise capitalization levels, this may put more pressure on Canadian regulators and on the Big Five to do the same. As more capital is put aside, less is available for dividends and earnings growth. If regulators decide to change the rules or reduce CMHC exposure to insured mortgage loans by charging higher premiums or sharing risk with the banks, this may increase the cost of funds for the Big Five or the amount of capital the banks need to post up against each mortgage. In fact, in October 2016, the Finance Department began consulting with individuals and organizations regarding risk-distribution in the mortgage sector. On the bright side, however, while higher capitalization could impact profitability, it may also reduce the inherent risk in banks.

European and US Banks Better Capitalized

Name	Ticker	Country	CET1	Leverage Ratio
Swedbank Ab - A Shares	SWEDA	SW	24.2	NA
Svenska Handelsbanken-A Shs	SHBA	SW	23.8	NA
Skandinaviska Enskilda Ban-A	SEBA	SW	18.9	NA
Nordea Bank Ab	NDA	SW	18.8	NA
Dnb Asa	DNB	NO	17.4	NA
Hsbc Holdings Plc	HSBA	GB	14.3	NA
Lloyds Banking Group Plc	LLOY	GB	14.3	NA
Royal Bank Of Scotland Group	RBS	GB	14.1	NA
Barclays Plc	BARC	GB	12.5	4.6
Credit Agricole Sa	ACA	FR	11.9	5.0
Bnp Paribas	BNP	FR	11.6	NA
Societe Generale Sa	GLE	FR	11.6	NA
Banco Bilbao Vizcaya Argenta	BBVA	SP	11.0	6.7
Banco Santander Sa	SAN	SP	10.7	5.4
Ubs Group Ag-Reg	UBSG	SZ	14.1	10.9
Bb&T Corp	BBT	US	10.1	10.0
Citigroup Inc	C	US	12.8	10.0
Pnc Financial Services Group	PNC	US	11.1	9.9
Capital One Financial Corp	COF	US	10.3	9.9
Us Bancorp	USB	US	11.5	9.1
Wells Fargo & Co	WFC	US	11.7	9.1
Bank Of America Corp	BAC	US	11.0	8.8
Jpmorgan Chase & Co	JPM	US	12.4	8.4
Intesa Sanpaolo	ISP	IT	12.9	6.4
Standard Chartered Plc	STAN	GB	13.8	5.9
Credit Suisse Group Ag-Reg	CSGN	SZ	11.7	5.2
Unicredit Spa	UCG	IT	11.5	4.9
Ing Groep Nv	INGA	NE	14.5	4.5
Bank Of Nova Scotia	BNS	CA	11.3	4.5
Bank Of Montreal	BMO	CA	11.3	4.3
Royal Bank Of Canada	RY	CA	10.6	4.3
Danske Bank A/S	DANSKE	DE	15.4	4.1
Can Imperial Bk Of Commerce	CM	CA	12.2	4.1
Deutsche Bank Ag-Registered	DBK	GE	11.9	4.0
Toronto-Dominion Bank	TD	CA	10.8	3.9
AVERAGE			13.4	6.6

Source: Bloomberg, Raymond James Ltd.

Larbi Moumni, CFA
Equities Specialist

Low Vol ETFs: A Deeper Look

Beginning in 2014, low volatility ETFs garnered a lot of attention and investor funds due to strong performance, with many low volatility products significantly outpacing the broad markets. For example, the S&P 500 low volatility index outpaced the S&P 500 by 3.8% in 2014 and again by 2.96% in 2015. Even better results were seen in the Canadian market.

Calendar Year Returns

	2016	2015	2014	2013
S&P 500 Low Vol (USD)	10.4%	4.3%	17.5%	23.6%
S&P 500 (USD)	12.0%	1.4%	13.7%	32.4%
S&P/TSX Composite Low Vol	15.8%	0.6%	16.6%	12.3%
S&P/TSX Composite	21.1%	-8.3%	10.6%	13.0%

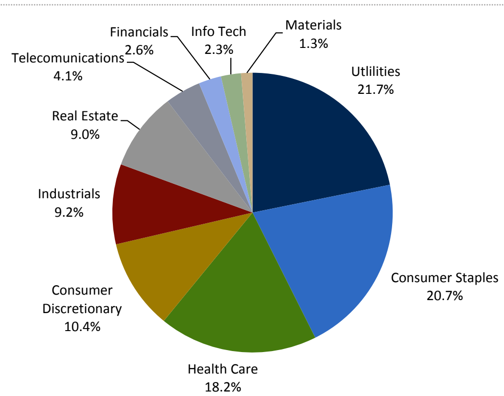
Source: Bloomberg. Raymond James Ltd.

It was a bit of a different story in 2016. Low volatility was performing well for most of the year; however, in the backend of the year, low volatility strategies gave up significant ground versus the broad market and even more so against the high beta, cyclical strategies. We'll take a look at why.

Index Construction

Low volatility ETFs should not be confused with managed volatility strategies that can be found in the mutual fund space and have more consideration for sector diversification. Most indices, and ETFs in turn, simply sort the broad market by lowest standard deviation or lowest beta which results in significant concentration issues in the defensive sectors which have historically displayed lower volatility. For example, the utilities, consumer staples, health care and real estate sectors represent nearly 70% of the BMO Low Volatility US Equity ETF.

Defensive Sectors Dominate: ZLU-T



Source: BMO Global Asset Management

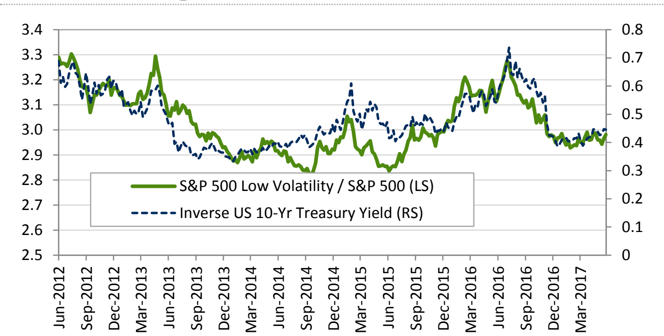
Is This Simply a Rates Trade?

In our view, low volatility strategies are simply an interest rates trade. Defensive sectors are very interest rate sensitive, and tend to perform well in a declining rate environment and tend to underperform when rates rise. Declining interest rates seen in the US between 2014/15 were a large reason low volatility strategies performed so well. Towards the end of 2016, rates spiked significantly higher sending low volatility sharply lower. You can see in the chart below that low volatility outperforms the S&P 500 in falling rate environments, and underperforms in rising rate environments, using the US ten year treasury as a proxy for rate moves.

Putting it Altogether

The index construction of low volatility ETFs results in significant defensive sector concentration. This isn't necessarily a bad thing, but should be considered in overall portfolio construction. They are very useful tools to express a view on falling interest rates when the defensive sectors tend to outperform. On the other hand, they are also great satellite positions to help diversify a Canadian concentrated portfolio which typically has very little exposure to defensive sectors. The utilities, consumer staples, health care and real estate sectors represent only 11% of the TSX. An ETF such as ZLU is a great product to help round out sector exposure in this case. However, for those using this type of product as a core holding, it is our belief that interest rates bottomed in the summer of 2016 and will slowly move higher over the coming years. This could present some significant headwinds for low volatility ETFs over the next leg of the economic cycle.

Low Vol Strategies Track Interest Rates



Source: Bloomberg, Raymond James Ltd.

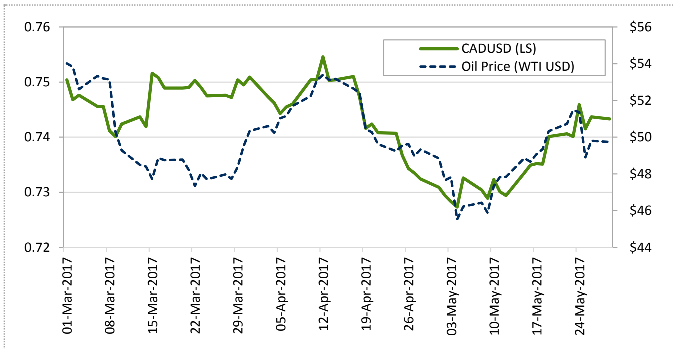
Andrew Clee, CFA, PM
Mutual Fund & ETF Specialist

Volatility FX

While there are several factors that affect cross rates among currencies, certain factors have a greater influence than others. For example, as one would expect, oil exporting countries (e.g. Canada and Australia) have currencies that are heavily tied to crude price movements. Geo-political activity plays a role on currencies as well. The recent election in France helped to stabilize the Euro while closer to home, the USD walks a tight-rope on Trump's sometimes erratic comments and tweets. In this article, we review three currency pairs: CADUSD, EURUSD and GBPUSD and discuss what moved the currencies over the past three months.

CADUSD

CAD Hand-in-Hand with Crude



Source: Bloomberg, Raymond James Ltd.

As mentioned above, the CAD is heavily tied to the movement in the price of oil. With crude fluctuating over the past three months (down ~12%), it's no surprise the CAD was the second worst performing currency in the G10 over the period (just ahead of the AUD). When looking at the CADUSD, we notice a strong correlation between the cross rate and the price of oil (see the chart above). With crude prices mixed in the quarter, the CAD was volatile as well, with a three month peak in crude in mid-April corresponding to a quarter-high for the CADUSD (at 0.7546). On May 24, the BoC left rates untouched at 0.5% and indicated the adjustment to lower oil prices is largely complete. This should be positive for the CAD moving forward. While rates will likely remain untouched for the next year or so, we feel the BoC's stance on a low CAD in an effort to boost exports will likely fade in favour of cooling the housing market and inviting foreign investment.

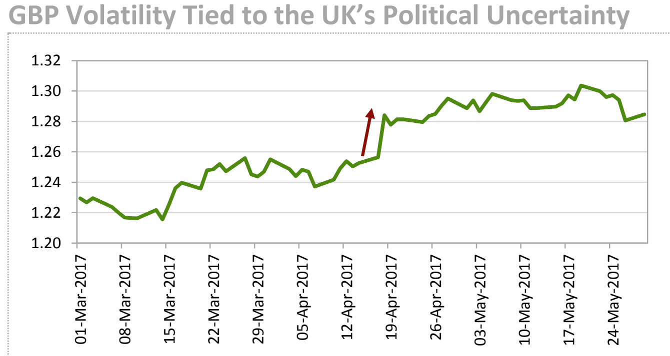
EURUSD

The Euro is experiencing its strongest levels in six months and was the best performing currency of its G10 counterparts over the past three months. This can be attributed primarily to France's election of Centrist Emanuel Marcon as President and solid economic data. Marcon's nomination helps to stabilize geopolitical risk in a region which has been plagued by uncertainty since Brexit last year. This should turn investor attention back to economic fundamentals, at least until the German election later this year. Given the overall positive EUR trend over the past quarter, we note there were not any significant Euro-led volatility events during the past three months.

GBPUSD

Conversely, the worst performing currency over the past three months has been the British Pound. This is linked to the region's political uncertainty, with the Labour party narrowing the voting gap between the Conservatives (at the time of this writing). The Conservatives were largely viewed to have a majority government, which would help to smooth the Brexit process. However, a narrowing gap now throws into question a majority, resulting in a weakening GBP. The role of UK politics on currency volatility is illustrated below. On April 18, in a surprising move, Prime Minister May called for a snap-election, sending political shockwaves and pushing up the GBPUSD overnight from 1.256 to 1.284 (which at the time, was a six-month high). As can be observed, while there has been an overall upward trend in the GBPUSD, the GBP spiked several times during the past three months. We anticipate vulnerability in the GBP will remain until the Brexit fallout is resolved.

GBP Volatility Tied to the UK's Political Uncertainty



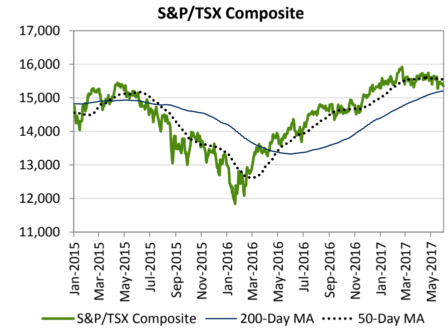
Source: Bloomberg, Raymond James Ltd.

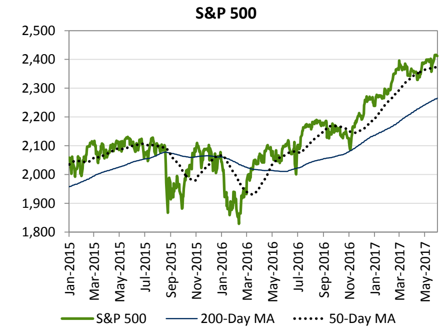
Going forward, we expect these same forces to affect the above mentioned regions and currencies over the course of the year. In terms of Canada, with the BoC indicating the adjustment to oil prices is behind us and the potential for rates to raise next year, we expect the CADUSD to be 0.730 - 0.735 through the end of 2017.

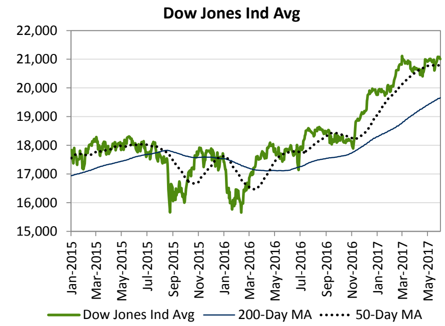
Razi Hasan, CFA
Fixed Income & Foreign Exchange

Charts of Interest

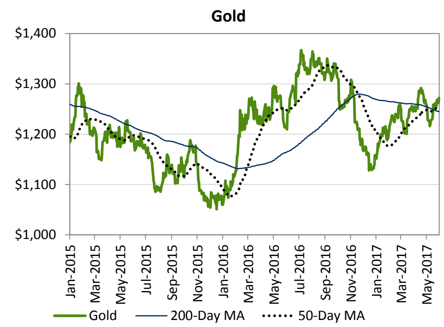
Markets

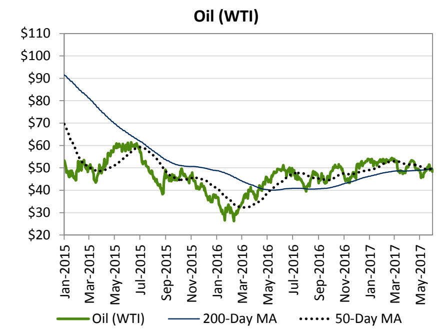


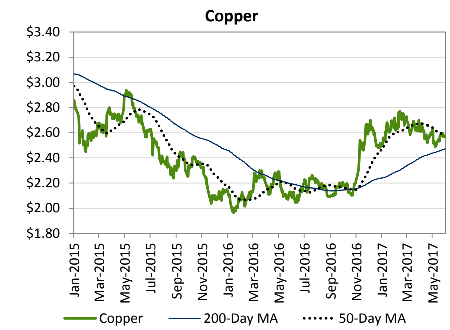




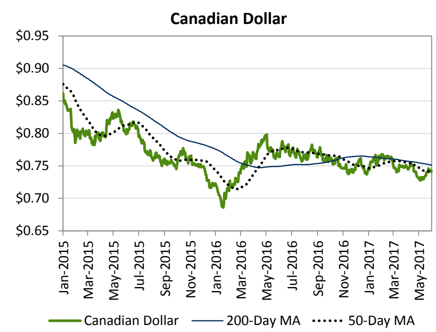
Commodities

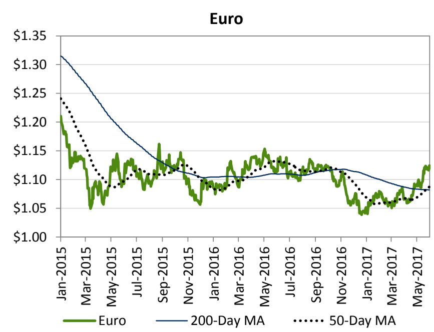


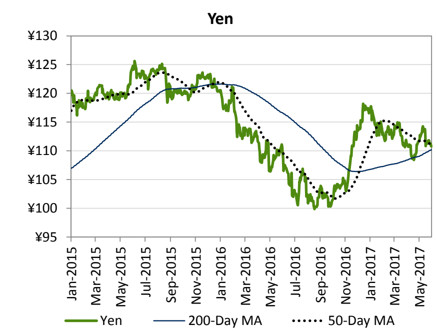




Currencies





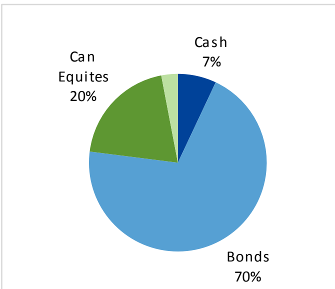


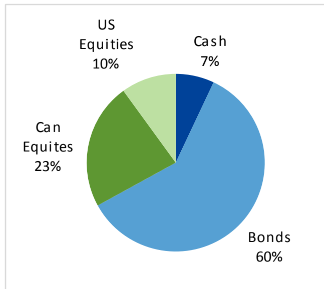
Source: Bloomberg, Raymond James Ltd. Performance as at May 31, 2017.

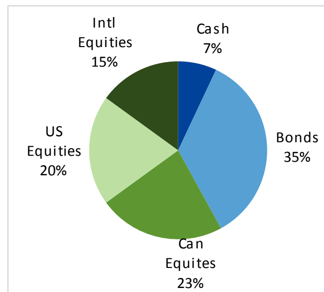
Investor Profiles and Asset Class Weightings

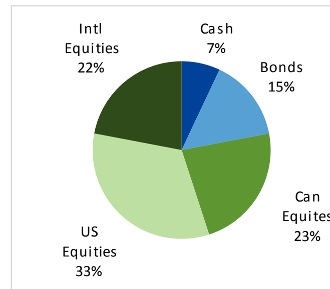
Recommended Asset Allocation

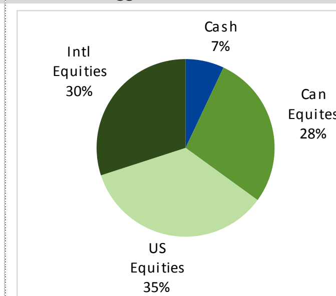
	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth











	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	7%	7%	7%	7%	7%
Bonds	70%	60%	35%	15%	0%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100

Description

Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Important Investor Disclosures

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