Insights & Strategies

PRIVATE CLIENT SOLUTIONS

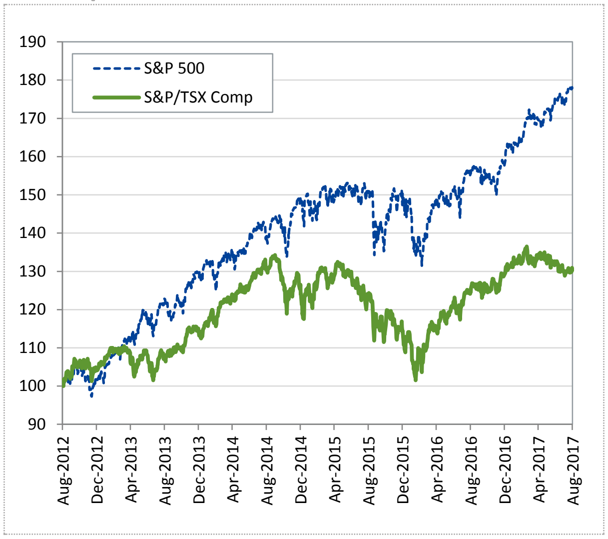
August 10, 2017

Inside this Issue

Time to Go Shopping in Europe

For Canadian investors, properly diversifying an investment portfolio using the S&P/TSX is a more difficult process than our neighbours to the south due to the concentration in our economy. Looking at the stock market, the S&P/TSX is not only highly concentrated in three industries (financials, energy and materials make up 2/3 of the index) it also has immaterial exposure to massive global industries like technology and health care. To maximize diversification, it is advisable that equity investors look to broaden their exposure through non-Canadian markets and sectors of the global economy that are under-represented at home.

US Outperforms Canada in the Past 5 Years



Source: Bloomberg, Raymond James Ltd.

The US is understandably the 'go to' market due to its size, breadth and familiarity. This typically makes it the largest non-domestic holding for the average Canadian regardless of the economic cycle. Holding US equities over the past five years has been a smart and profitable trade for Canadian investors as the S&P 500 has outperformed the S&P/TSX by a wide margin in local terms. That said, looking at the current global economic picture, we believe now is a good time for investors to consider expanding beyond the US. We feel the European stock market is the next best thing to the S&P 500 as it is developed, diverse and deep with high quality, global companies. Examples of Europe's largest publicly traded stocks are well known names like: Royal Dutch Shell, Volkswagen, Siemens, HSBC and Nestle.

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We believe Canadian investors with a large US bias should consider diversifying some of their non-Canadian holdings into Europe. We break down our rationale into three points:

- Economic & Political Fundamentals
- Central Bank Policy
- Relative Valuation

Economic & Political Fundamentals

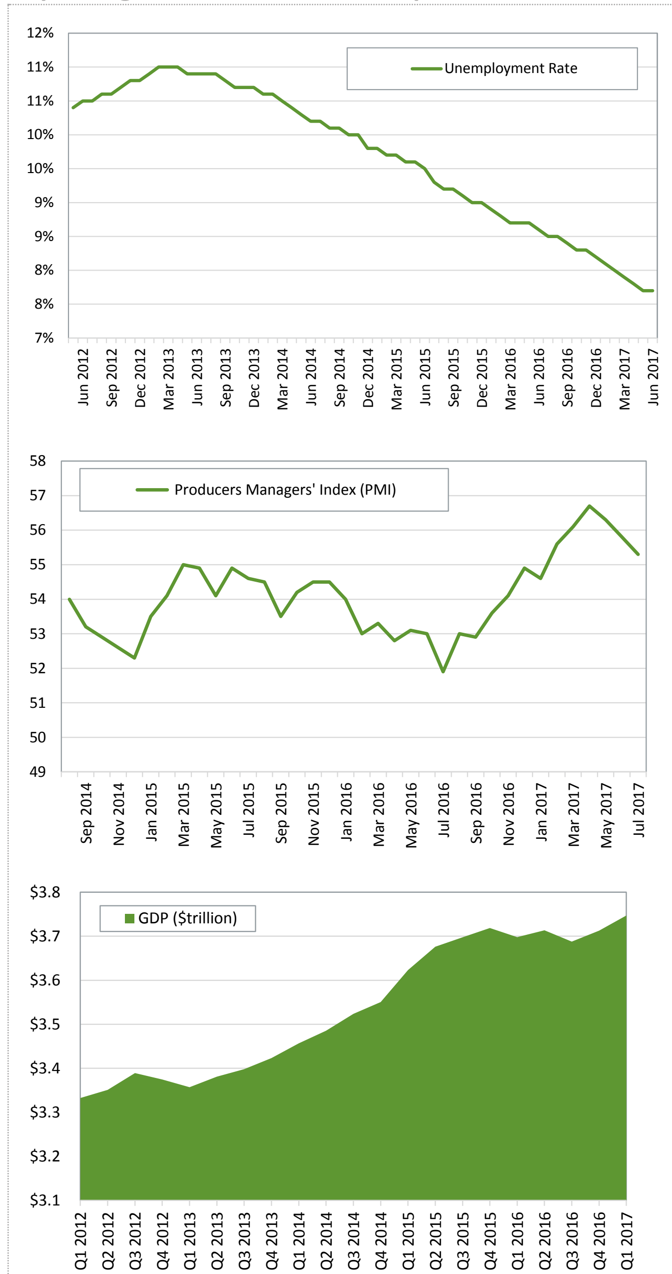
In many ways Europe was devastated more by the 2008 credit crisis than the US. The broader European economy was already in a high-debt, low-growth funk going into the crash. The aftermath exposed the weaker parts of the EU common market and culminated in the 2011-2012 sovereign debt crisis when pejorative acronyms like “PIIGS” (Portugal, Ireland, Italy, Greece and Spain) dominated financial headlines. The plight of these economies brought to question the sustainability of the European common market and its currency, leading many global investors to flee European markets for the relative safety of the US and Canada. It wasn’t until Mario Draghi took hold of the European Central Bank (ECB) and convinced the world that he would prop-up the EU members under any financial circumstances that some semblance of calm and confidence returned to the European market. This was threatened to be upended again by the surprise win of UK ‘Brexiteers’ in 2016 but what we have seen following the vote underlines the growing strength in the European economy: steady and rising markets, pro-EU election victories in France and the Netherlands and generally positive economic fundamentals (PMI, employment, debt levels). Looking at Europe in 2017, it appears to be the first time since 2008 that investors seem to be feeling greater comfort investing in Europe.

Central Bank Policy

A big part of that comfort level is the actions and rhetoric coming out of the ECB. Chairman Draghi has shown that he has the will to use all tools at his disposal to protect and grow the European economy (including prolonged low interest rates and quantitative easing) and just as importantly, he also has the political backing of key member states (most importantly Germany) that these policies will be supported. When we put that into context with what is happening in the US (Fed raising rates and planning the unwinding of quantitative easing), we see a stark comparison between a central bank that is actively aiding economic expansion and another that is tempering it.

Moreover, we can see a fairly strong correlation between central bank policy and equity market performance going back to 2008. It should not be a big surprise that accommodative and stimulative central bank policies are a

Improving Economic Data in Europe



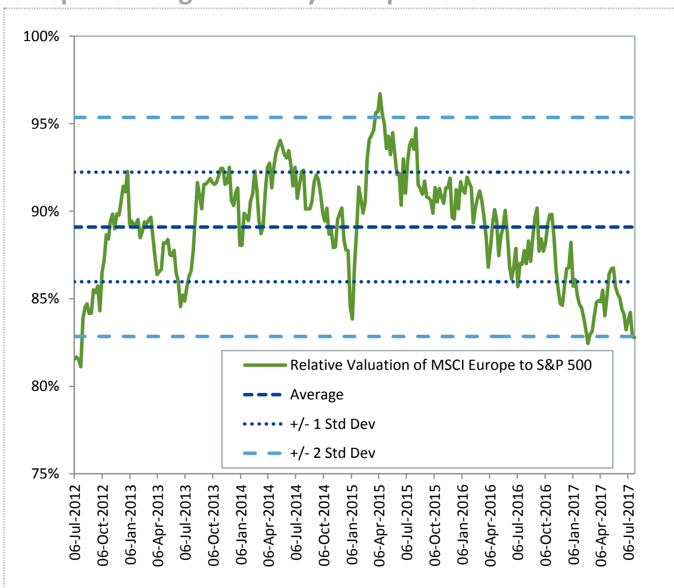
Source: Bloomberg, Raymond James Ltd.

tailwind to the markets and create an uneven playing field in terms of performance. With the US and Europe central banks’ monetary policy diverging a distinct advantage is given to European businesses over their US counterparts.

Relative Valuation

The potential for this is further supported by the relative valuation between the US and European markets. The PCS Investment Strategy group has written fairly extensively about valuation in the US market but not as much about Europe and the other major markets. In the US, price to earnings multiples have swelled to historically high levels but have been justified by improving economic fundamentals, leading corporate growth rates and the hope for pro-growth policies from the federal government (specifically tax reform). We acknowledge that there is more risk in the current US equity market valuations due to the fact that the Fed's easy-money spigot is being turned off; however, corporate earnings have been robust thus far which has justify the lofty multiples.

Europe Looking Relatively Cheap



Source: Bloomberg, Raymond James Ltd.

In Europe, there are arguably more systematic risks to the economy's positive momentum (due to the nature of running a collective economy made up of 28 sovereign states) but nonetheless, the outlook is heartening. When we look at fundamentals in the context of relative valuation versus the US, the argument becomes even stronger as the European economy looks like it is earlier in the cycle. Using the US as a template, we can foresee a period of economic growth married with an expanding valuation multiple leading to outperformance against the US market. This is reflected in the chart above, which plots the historical valuation of the US (S&P 500) versus European (MSCI Europe) stock markets. The MSCI Europe is currently 8% lower than the average discount to the S&P 500 and at a two standard deviation differential (dotted lines) this strongly favouring the European market over the US from a relative valuation perspective.

Risks

Our thesis does not come without risk. The aforementioned 28 members bring with them potential for a higher number of negative surprises but we do take some comfort that most of the electoral risks are now behind the EU (the Italian election in either late 2017 or early 2018 being the most significant). But we have also seen a resiliency of the block following a major shock like Brexit. Issues with immigration, terrorism and domestic unrest will likely remain much more acute than in the US but these are also issues that the EU has long history of living and dealing with.

Conclusion

In conclusion, we believe it is always good investment practice for Canadian investors to maintain diversification in their portfolios amongst asset classes, industry sectors and geographies. Although the US will always provide a natural and solid option for geographic diversification, we see the relative advantages of further diversification into the European market especially attractive at this time.

Robert Mark, CFA
Portfolio Manager

EUR in for a Treat

Canadian Equities with European Exposure

In this section, we search for TSX-listed stocks that generate at least 20% of their revenues from Europe and may benefit from a strengthening European economy. Our favorite names include **Open Text (OTEX-T)**, **Linamar (LNR-T)**, **CCL Industries (CCL.B-T)**, **Northland Power (NPI-T)**, **Alimentation Couche-Tard (ATD.B-T)** and **Dream Global REIT (DRG.UN-T)**.

Ticker	Name	% Europe Revenue
ASR	ALACER GOLD CORP	100
DRG-U	**DREAM GLOBAL REAL ESTATE INV**	**100**
DDC	DOMINION DIAMOND CORP	94
TSGI	AMAYA INC	91
PLI	PROMETIC LIFE SCIENCES INC	67
ENGH	ENGHOUSE SYSTEMS LTD	64
BLX	BORALEX INC -A	50
MNW	MITEL NETWORKS CORP	49
BBD/B	BOMBARDIER INC-B	47
GWO	GREAT-WEST LIFECO INC	42
ATA	ATS AUTOMATION TOOLING SYS	40
GRT-U	GRANITE REAL ESTATE INVESTME	39
MG	MAGNA INTERNATIONAL INC	35
OTEX	**OPEN TEXT CORP**	**33**
LNR	**LINAMAR CORP**	**33**
HBC	HUDSON'S BAY CO	33
PWF	POWER FINANCIAL CORP	31
POW	POWER CORP OF CANADA	31
CSU	CONSTELLATION SOFTWARE INC	30
LUN	LUNDIN MINING CORP	29
CCL/B	**CCL INDUSTRIES INC - CL B**	**28**
CAE	CAE INC	28
GIB/A	CGI GROUP INC - CLASS A	27
NPI	**NORTHLAND POWER INC**	**25**
MX	METHANEX CORP	23
OSB	NORBORD INC	23
FM	FIRST QUANTUM MINERALS LTD	22
AC	AIR CANADA	22
DII/B	DOREL INDUSTRIES-CL B	21
ATD/B	**ALIMENTATION COUCHE-TARD -B**	**20**

Source: Bloomberg, As at August 3, 2017.

- **Northland Power (NPI-T)**

NPI is an independent power producer (IPP) that generated around 25% of its 2016 revenue from wind turbines in Europe. The IPP has two offshore wind projects including the 600 MW Gemini located in the Dutch side of the North Sea and the 332 MW Nordsee One located in the German side. Gemini was completed ahead of schedule and under its total budget of €2.8 bln at end of April while Nordsee is expected to reach full commercial operations by end of 2017. The next big wind project, which the company acquired in March, is the 252 MW Deutsche Bucht located offshore Germany. The project is entitled to receive a fixed feed-in tariff subsidy for 13 years. We believe the current forward PE multiple of 18.1x makes the stock extremely attractive supported by EPS growth of 62% expected for 2017 and 40% for 2018.

- **Open Text (OTEX-T)**

Another favourite from the adjacent list is OTEX, a software company that helps businesses find, utilize and share information from any device. The company generated 84% of its revenue from recurring streams including their cloud services, subscriptions, customer support and professional services. The company grows both organically and through M&A. Over the last 10 years, OTEX deployed US$3.7 bln in acquisitions. From an organic growth standpoint, the company targets to spend 10%-12% of revenues on R&D and over the last three years spent US$567 mln. The company generated ~33% of its 2016 revenue from Europe, trades at an attractive 13.2x forward PE multiple and has solid growth prospects of roughly 16% over the next two years.

- **Linamar (LNR-T)**

We also remain constructive on LNR, the auto parts maker. While we do acknowledge that auto sales have been slowing, we believe a growing focus on light-weighting and the anticipated increase in infrastructure spending may benefit the company going forward. The manufacturing company is expected to see low single-digit EPS and revenue growth over the next two years whilst trading at an 8.1x forward PE multiple. LNR generates a solid ~33% of its revenue from Europe.

- **CCL Industries (CCL.B-T)**

CCL provides manufacturing services and specialty packaging products to the non-durable consumer market. The company benefits from improving consumer trends as well as weaker commodity prices. Given that it generated ~30% of its 2016 revenues from Europe, a strengthening economy there presents solid upside for the name. CCL grows primarily through acquisitions, having spent $1.7 bln over the past 10 years. The company also has a solid dividend that grew at 23.8% annually over the past five years and is set to grow given that the current payout ratio is around 20%.

- **Alimentation Couche-Tard (ATD.B-T)**

ATD is a convenience store operator with roughly 20% if its revenues coming from Europe where it operates a retail network comprising 2,754 service stations across Scandinavia, Ireland, Poland, the Baltic countries and Russia. The company has been making accretive acquisitions, closing almost $7 bln in deals over the past 10 years. We continue to like the name given the strong management team and ability to deleverage post-acquisitions. The stock trades at 16.8x forward PE with sell-side analysts expecting EPS to grow by 9% and 17% in 2017 and 2018, respectively.

- **Dream Global REIT (DRG.UN-T)**

And finally, clients looking for a European pure-play could consider DRG. The REIT is 100% exposed to the European economy with all of its properties located in Germany, Austria and Belgium. However, around 98% of its properties are located in Germany, a country exhibiting strength in Europe with a favorable business environment. Real estate in Germany continues to see strong demand from both local and international investors driven by low interest rates and the perception of Germany being a safe harbor. Most of the REIT's 173 properties comprising ~13 mln sqft are strategically located in major city and town centers in a central square close to a train/bus station and have access to major streets and shopping areas. Sell-side analysts expect adjusted funds from operations to grow by 20% in 2017 and 7% in 2018 despite the stock trading at a P/B multiple of 1.0x.

Larbi Moumni, CFA
Equities Specialist

Europe Focussed Managed Solutions

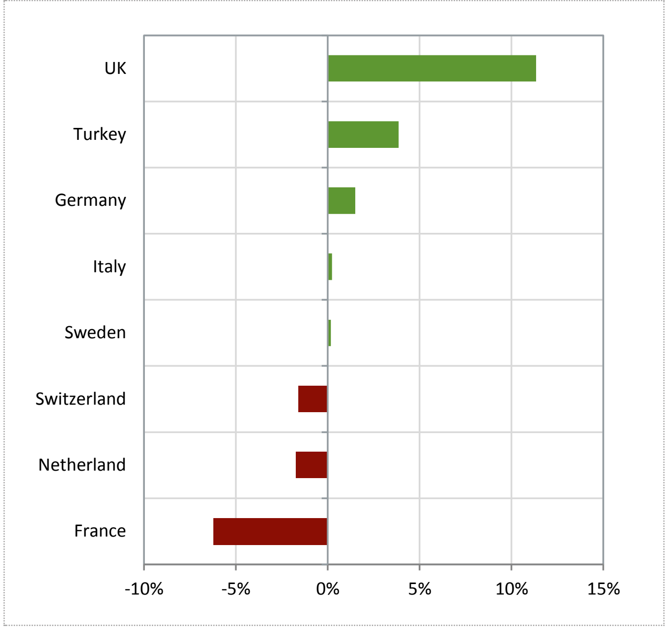
Picking stocks can be burdensome, especially in foreign countries that have different business practices and sometimes different accounting standards. Lucky for us, there a number of managed money products that can help round out a portfolio's international exposure.

- **Invesco European Growth Fund**

With the focus now on Europe as a major future driver of global growth, Invesco European Growth should be on the radar of investors. The fund is managed by five portfolio managers: Matt Dennis, Borge Endresen, Jason Holzer, Richard Nield and Class Olsson, who have worked together as a cohesive unit for over a decade. Very few management teams can make that claim. The team also manages Invesco International Growth Class (also a member on the Raymond James MF Focus List) using a fundamental bottom-up approach with top-down inputs to maximize its exposure to the most attractive countries, sectors and companies.

Olsson, and his team tend to hold between 60-80 names in a well-diversified portfolio that tends to run a lower beta than the broad European index. The result is that they tend to lag the benchmark in bull markets, but offer downside protection in markets like 2011 when they outperformed the benchmark by nearly 3%. The fund's current asset mix finds the team favouring the UK and Turkey and significantly underweight France.

Invesco European Growth Relative Country Weights



Source: Morningstar, Raymond James Ltd.

- **Passive European ETFs**

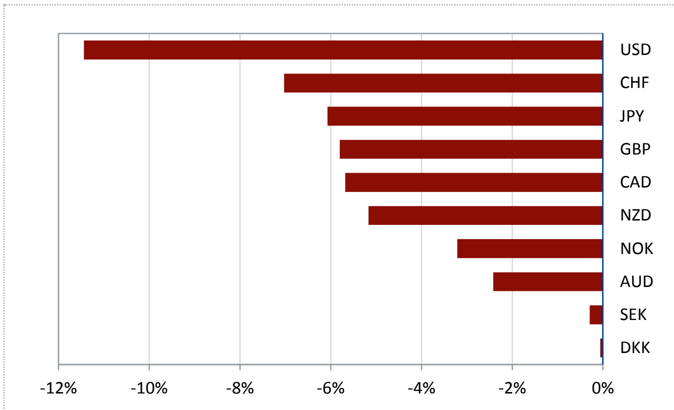
For those looking for a little more torque on the upside, consider a passive ETF like BMO MSCI Europe High Quality Hedged to CAD ETF (ZEQ-T). ZEQ removes currency risk, giving pure play exposure to European equity markets. The ETF invests in Euro equity while screening for high ROE, stable earnings growth and low financial leverage to help avoid some of the lower quality companies.

Andrew Clee, CFA, CMT
MF/ETF Specialist and PM

EUR Ahead of the Pack

Over the past few months, the EUR has been front and centre given its dominance against all G10 currencies year-to-date (please see chart below). More specifically, the EUR has outperformed the USD by 11.44% and the CAD by 5.68% since the beginning of the year. Much of this strength can be attributed to the region's economic growth and relatively stable political climate with the market now focusing on fundamentals, rather than geopolitical risk. We highlight a few factors which helped to strengthen the EUR this year. As the EURUSD is a major currency pair, we will focus on it here.

EUR vs. G10 currencies: YTD



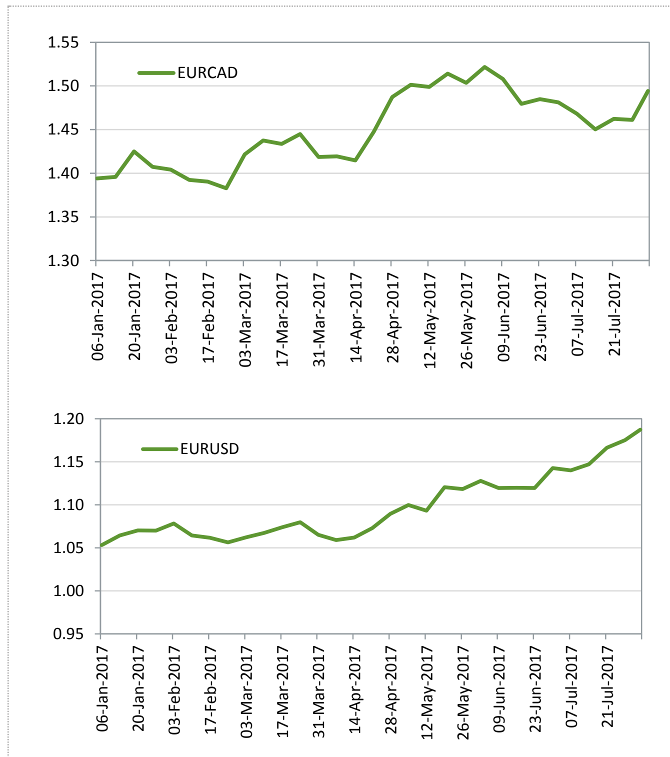
Source: Bloomberg, Raymond James Ltd.

As mentioned above, the EUR has been the strongest performing currency in 2017 and EURUSD is close to breaking through the 1.20 level for the first time in more than two and a half years. This can be attributed in part to the eurozone's path towards normalization with a solid current-account surplus. These factors help to alleviate the two-plus year pressure on the currency pair. The EUR could be further boosted, should the ECB announce an early tapering in the fall.

While a rising EUR could stand to dampen equity returns, it's important to consider a stronger EUR would reduce input costs (i.e., energy and commodities) as well as act to suppress inflation, favourably affecting wage growth. Overall, the European economy is improving at its best pace over the past five years, with GDP recently growing 2.1% Y/Y. With the economy performing well, it further points to a scenario where the ECB could begin to taper asset purchases earlier than expected.

We have written in the past that one of the strongest catalysts for the relative strength in the EUR was the election of centrist Prime Minister Emmanuel Macron over alt-right candidate Marine Le Pen in France, as well as the outcome of the Dutch election. These electoral wins significantly helped to stabilize the volatile political climate in Europe, which began with the UK's decision to leave the EU. As a result, it appears the market is now evaluating the region based on hard fundamentals, rather than potential for further political turmoil. What's more interesting, it appears the political risk has now shifted from the EU towards the US, given the recent instability in Washington. Aside from the "circus at the White House", Trump's pro-growth promises have not yet come to fruition, led by the failure to repeal Obamacare.

EURCAD and EURUSD- YTD



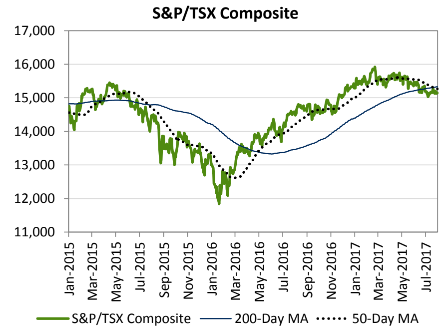
Source: Bloomberg, Raymond James Ltd.

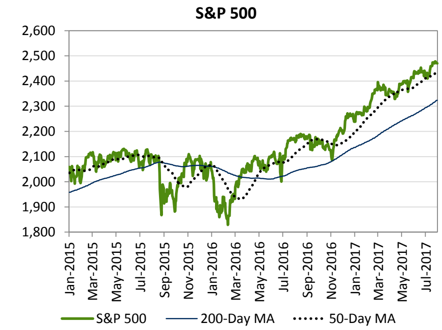
While there will remain fears of a EUR reversion, it's important to remember the EU is nearing "normality" after a tumultuous 24-36 months. A healthy eurozone, backed by encouraging GDP growth and stable inflation are all positive signs for the region. The EURUSD passing the 1.17 mark is significant given that it has ran sideways over the last two-and-a-half years. That said, the currency has accelerated fairly quickly over the past three months, increasing roughly 9%, which brings into question higher risk of consolidation. Though the currency pair has now reached 1.18, at a faster rate than expected, we believe the likelihood of hitting 1.20 is much more realistic than earlier this year.

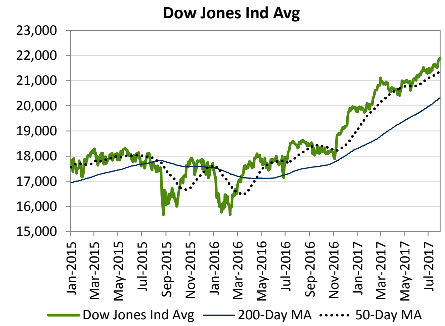
Razi Hasan, CFA
Fixed Income & Foreign Exchange

Charts of Interest

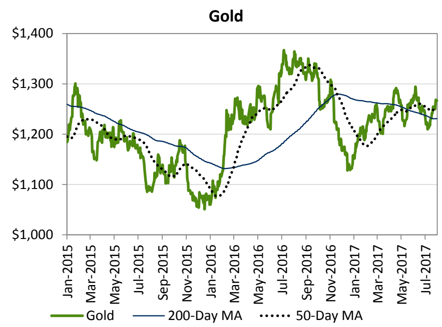
Markets

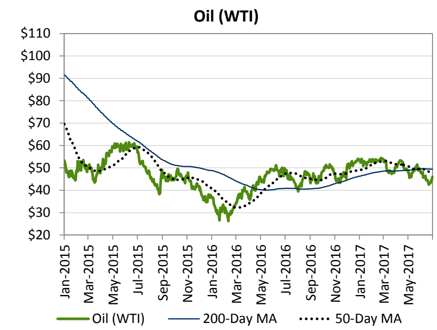


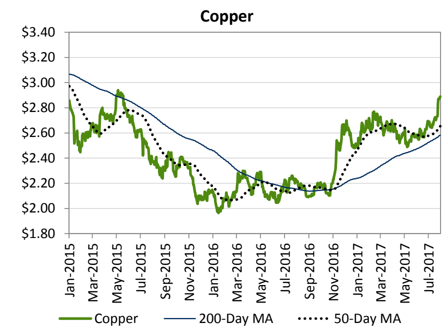




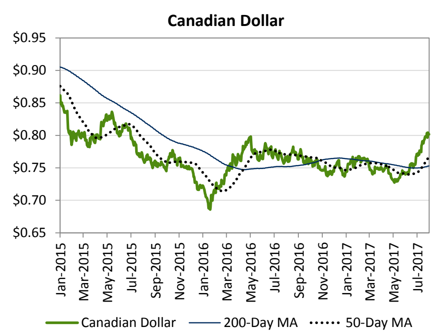
Commodities

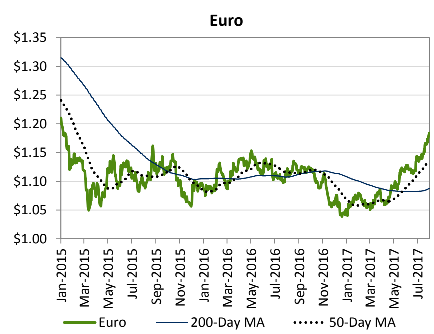


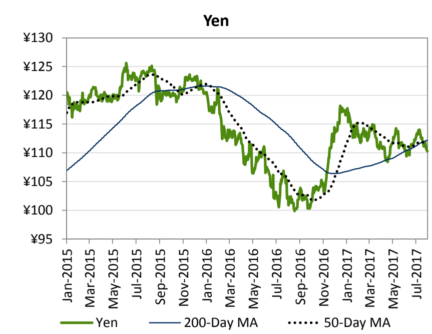




Currencies



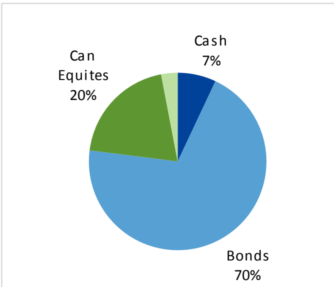


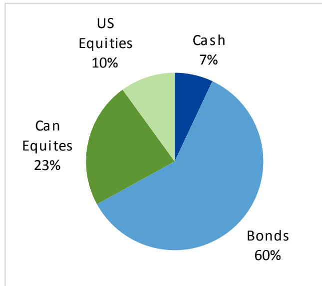


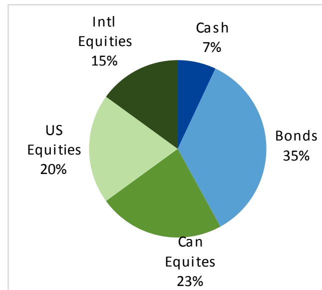
Source: Bloomberg, Raymond James Ltd. Performance as at July 31, 2017.

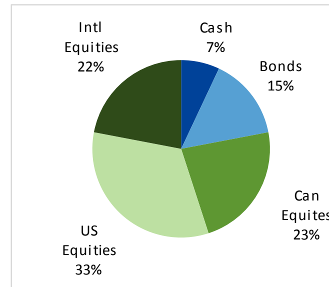
Investor Profiles and Asset Class Weightings

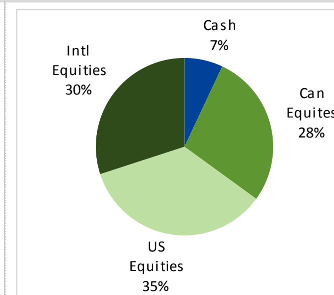
Recommended Asset Allocation











	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					
	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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