Insights & Strategies

PRIVATE CLIENT SOLUTIONS

May 10, 2017

Inside this Issue

"From Far and Wide…" Buy Canadian

On April 18th, President Trump signed an executive order directing government agencies to buy and hire American. Though not a new law in and of itself, an executive order is a directive in how to interpret existing laws and, in this case, told federal agencies how they should oversee the use of their resources. In response, the PCS investment strategy team recommends our readers "Buy Canadian".

Section 1: Definitions

a) **"Buy Canadian"** refers to Canadian publicly-listed companies. Preference should be given to companies trading at a valuation discount to their historical average; those that can be defined as high quality; and those that exhibit above-average dividend growth.

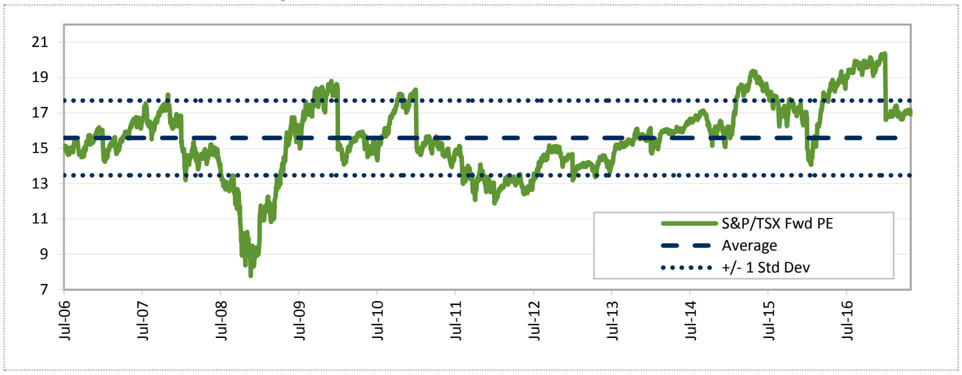
b) **"Sectors"** refers to the 11 sectors as defined by the Global Industry Classification Standard (GICS). Preference should be given to those sectors that are sensitive to economic activity, such as industrials, energy and financials; while in defensive sectors, a preference should be given to those sectors showing good relative strength, such as real estate and consumer staples.

Section 2: Policy

We suggest that investors buy Canadian for the following reasons:

(a) **Valuation.** A sharp recovery in Canadian corporate earnings has made the Canadian equity market look relatively attractive. While both Canadian and American companies have experienced an earnings recovery, the change in Canadian corporate earnings has outpaced that of our American peers. With a healthy rebound in profits, the valuation level for the S&P/TSX has improved. At the end of 2016, the S&P/TSX traded at 20.2x forward earnings, or 2-standard deviations above the 10-year average.

S&P/TSX Valuation Improved

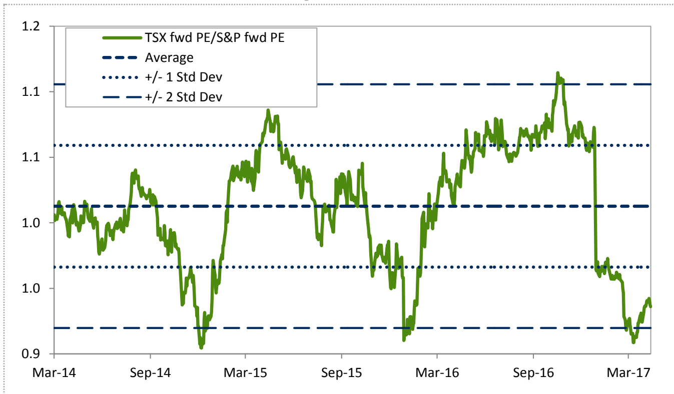


Source: Bloomberg. Raymond James Ltd.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
2200-925 West Georgia Street | Vancouver BC Canada V6C 3L2.

As of the end of April, the S&P/TSX was trading at 17.0x forward earnings. Comparing the S&P/TSX to the S&P 500, on a 12-month forward earnings basis, Canadian equities are unusually cheap, trading 2-standard deviations below the 3-year average. The last time Canadian equities were this cheap relative to the US was at the beginning of 2016, a year that saw the S&P/TSX finish as one of the best performing developed markets.

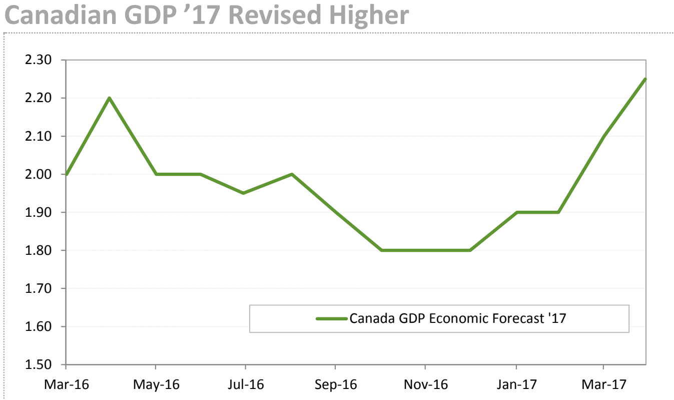
S&P/TSX Looks Relatively Attractive



Source: Bloomberg, Raymond James Ltd.

(b) **Economic momentum.** Canadian economic activity has experienced a notable pickup over the past 4 months, which we can see in the change in Canadian GDP growth estimates. At the end of November 2016, economists forecasted 2017 GDP growth of 1.8%; today, economists predict annual growth of 2.2%. The positive revisions have been on the back of solid Canadian consumption growth and a robust housing market that has continued to surprise to the upside. Both of these factors, plus a moderate uptick on oil and gas investments, have contributed positively to overall GDP.

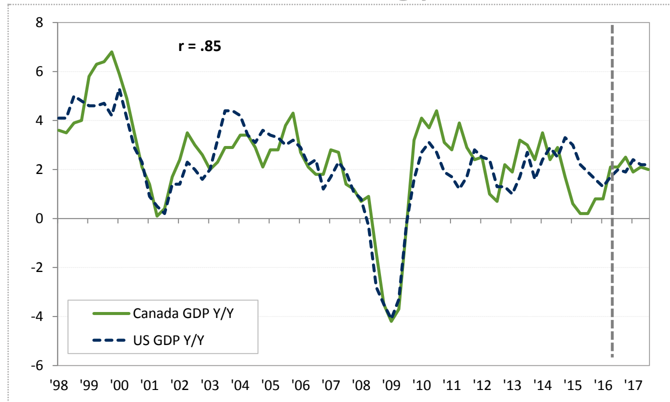
Canadian GDP '17 Revised Higher



Source: Bloomberg, Raymond James Ltd.

There are soft spots in the economy (lackluster wage growth, weak export growth and soft inflation) that will keep the Bank of Canada on the sidelines for 2017, and there are the persistent worries about an elevated housing market, but we believe economic activity in Canada will remain supportive for the rest of 2017. Further, Canadian and US GDP growth exhibits a strong correlation (0.85) and, given the broadly supportive economic data coming out of the US, we view this as a positive for future economic activity in Canada.

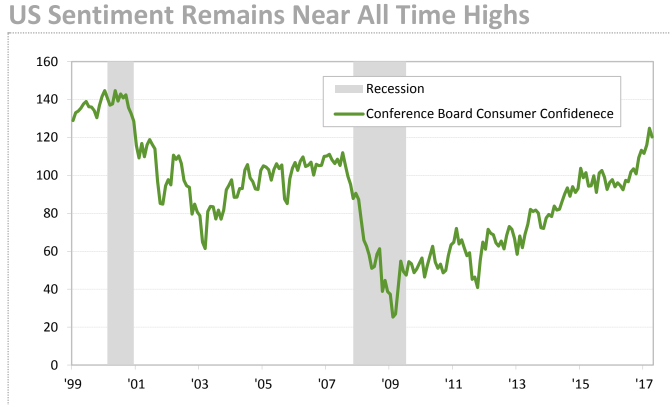
US & Canada GDP Growth Strongly Correlated



Source: Bloomberg, Raymond James Ltd.

(c) **Sentiment.** US sentiment indicators, or "soft" survey data, have been running well above actual "hard" economic data for most of this year. The divergence has been cited as a source of skepticism for the sustainability of the stock market strength; however, soft data at times can be a more important driver of equity market returns than hard data. In the current case, the fiscal "carrot" the Trump administration is waving in front of corporate America may result in hard data catching up to soft data.

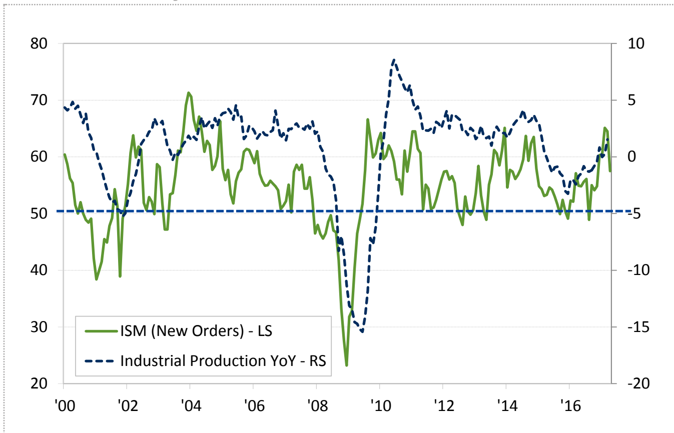
US Sentiment Remains Near All Time Highs



Source: Bloomberg, Raymond James Ltd.

However, the most likely case in our view is a convergence of soft and hard data somewhere in the middle. US investor sentiment most likely will weaken throughout the summer months, while economic data should pick up. The ISM manufacturing New Orders index is a good leading indicator of future economic activity and at current levels suggests industrial production will continue to expand throughout 2017.

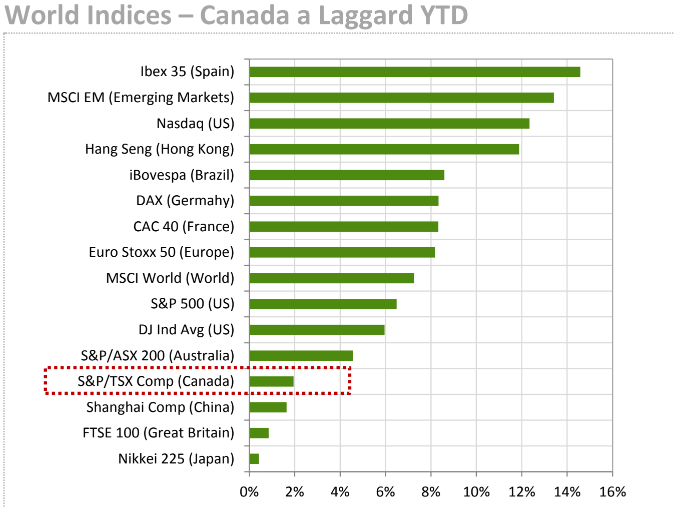
ISM New Orders In Expansionary Territory Positive For Future Activity



Source: Bloomberg, Raymond James Ltd.

(d) **Catch up trade.** Canadian equities have been a laggard year to date. Perhaps our market is taking a breather after the S&P/TSX ranked as the best performing developed market in 2016 but, despite our lagging equity market, the outlook for economic and corporate profits continued to improve in Q1/17.

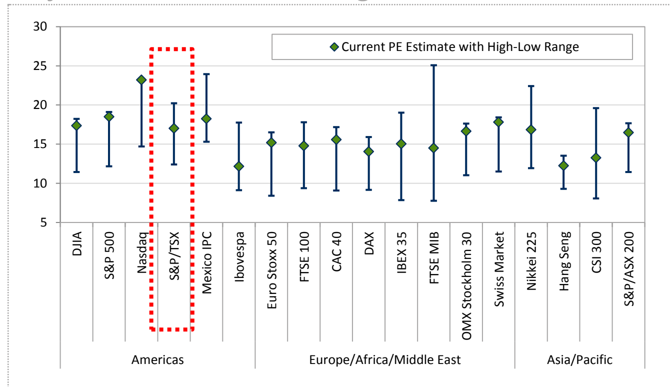
World Indices – Canada a Laggard YTD



Source: Bloomberg, Raymond James Ltd.

Emerging markets have been the best performing markets year to date, an indication market participants are willing to take on a certain amount of risk. Given the Canadian markets' exposure to commodities, we find it unusual that our market has not participated in this risk-on positioning. As our market plays catch up, we believe it will carry the S&P/TSX to our year-end target of 16,500 or a 6% return from current levels.

Major Market Valuation Ranges



Source: Bloomberg, Raymond James Ltd.

As we highlighted earlier, we have a preference for cyclical sectors given our view economic momentum will continue throughout the year. One standout sector is industrials. Modest Canadian fiscal infrastructure spending that will be put to work in 2017 and stronger US economic growth will act as tailwinds for the sector. We favour industrials with exposure in the US, and on an industry level, we favour Construction & Engineering, Railroad and Trucking.

Canadian Sectors	Weight	Recommendation
Communications	5.0	Underweight
Consumer Discretionary	5.4	Market weight
Consumer Staples	4.0	Market weight
Energy	21.1	Overweight
Financials	34.1	Overweight
Health Care	0.6	Underweight
Industrials	9.3	Overweight
Materials	11.5	Market weight
Real Estate	3.0	Market weight
Technology	3.0	Market weight
Utilities	3.1	Market weight

Source: Bloomberg, Raymond James Ltd. As at May 4, 2017

Jason Castelli, CFA
VP, Portfolio Manager

Toques, Moose, Poutine and CP Rail

Canadian Pacific Railway (CP-T) is a quintessential Canadian company. Incorporated in 1881 to build the transcontinental railway, CP was instrumental in linking east and west in the newly established Canadian confederation. The last spike was laid on November 7, 1885, and 132 years later, CP remains a vital transportation link within Canada as well as the northern United States. In 2016 the company's 19,000 km of track moved 2.5 million carloads of freight, from cars to grain to crude oil. CP is one of the six largest publicly-traded North American railroads that make up the "Class I" group.

We expect 2017 will be a good year for railroad investments and CP, in particular. The industry is emerging from a two-year downturn in freight traffic, which hit a bottom in 2016 with volumes down across most major business segments. However, in 2017 headwinds are turning to tailwinds as railroads have restructured their costs, general economic activity is picking up, and key bulk sectors like oil, grain and fertilizers are bouncing back. After two years of revenue declines for the industry, the consensus forecast is for 5.1% growth in 2017.

Class I Railroad Revenue & Earnings

	2014	2015	2016	2017E	2018E
Sales ($mm)	64,944	68,249	63,670	59,673	62,307
Growth	7.9%	-5.1%	-6.8%	5.1%	4.5%
EBIT ($mm)	20,622	22,949	21,775	20,939	22,652
Growth	14.5%	-3.3%	-4.4%	9.1%	8.3%
EPS	$38.73	$44.08	$43.14	$42.35	$46.77
Growth	12.1%	13.5%	-3.2%	-5.8%	13.6%

Source: Factset

As the table below shows, we expect CP to be at or near the top of the Class I railroad group on most financial metrics for the year. CP's traffic growth had lagged its key competitor, CNR, for much of 2017 but as Raymond James analyst Steve Hansen pointed out in his May 2 Industry Brief, CP exceeded CNR for the first time in week 17 and is *"poised to outperform in the coming weeks/months".*

Class I Railroad Comp Table

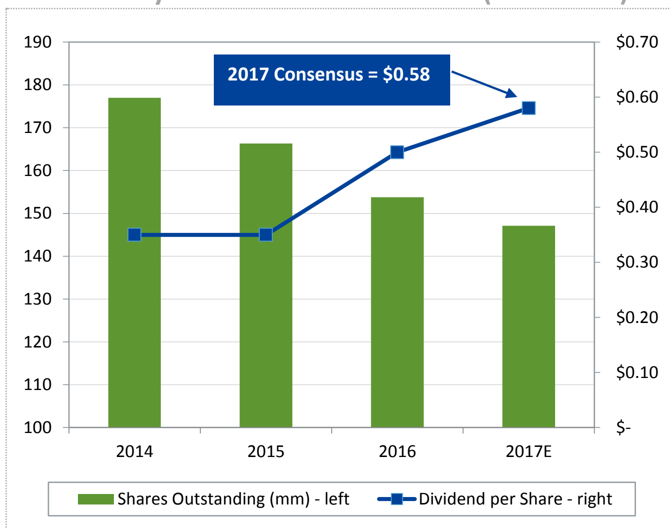
	2016 Op. Ratio	2017e EBITDA Margin	2017e EPS Growth	P/E	Free Cash Flow Yield
Average	***64.0%***	***47.6%***	***14.1%***	***18.6x***	***3.1%***
CP	**58.6%**	**52.9%**	**11.6%**	**17.6x**	**3.4%**
CNR	55.9%	54.1%	9.2%	19.0x	3.6%
CSX	68.2%	43.1%	19.8%	21.1x	1.9%
KSU	66.0%	47.4%	18.4%	17.0x	2.7%
NSC	68.9%	41.4%	12.4%	18.0x	3.1%
UNP	66.4%	46.6%	13.1%	18.8x	3.9%

Source: Bloomberg

Canadian National Railway (CNR-T) remains the gold standard for the Class I peer group and continues to post the best EBITDA margin and operating ratio (lower is better). However, CP is not far behind and trades at the second-lowest P/E ratio. With CP on-track to outpace CNR in earnings growth, while trading at a lower valuation, we believe the stock has the better upside for 2017.

Finally, we are always attracted to free cash flow stories (cash flow net of capital expenditures and dividends), and CP should see its free cash continue to grow through the year after posting a $765 million surplus in 2016. Excess cash is expected to be returned to shareholders through dividend increases (CP raised its dividend by 43% in 2016 and consensus expectations are for a 15% increase in 2017) and share buybacks (CP has repurchased 17% of its shares over the past three years).

CP Share Buybacks & Dividend Growth (2014-2017)



Source: Bloomberg, Raymond James Ltd.

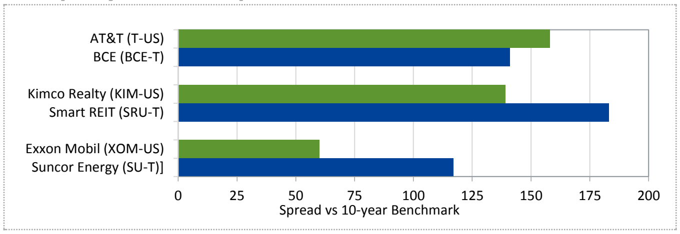
Robert Mark, CFA
Portfolio Manager

Canada vs. US Corps

With several macro forces weighing on the Canadian Dollar (CAD), including escalating trade disputes with the US and a pullback in oil prices, we compare Canadian and US public company bonds and look at the foreign exchange impact on relative valuation. In general, there is a trend towards tighter credit spreads among US companies versus their Canadian counterparts. We highlight three sectors in this report: Energy, REIT's and Telecoms, and compare companies from each country below.

Canadian energy player Suncor Energy's (SU-T) 10-year bond spread over the Government of Canada's 10-year bond is currently 117 bps (see chart). This is almost double the spread compared to Exxon Mobil's (XOM-US) spread over the 10-year US treasury (+60 bps). As Suncor is more of a growth company than Exxon with lower geographical and operational diversification, the risk lies with the former (Baa1 vs. Aaa credit rating according to Moody's). The risk is further amplified given falling oil prices, leading to greater uncertainty, but also greater upside potential. Although the operational risk lies with Suncor, given our view of a roughly flat US Dollar (we see USDCAD between \$1.36-\$1.38), the greater upside potential, thanks to its stronger growth profile and the significantly wide spread between the two bonds, we would recommend sticking with Suncor.

Company 10 Year Spread Differentials



Source: Bloomberg, Raymond James Ltd.

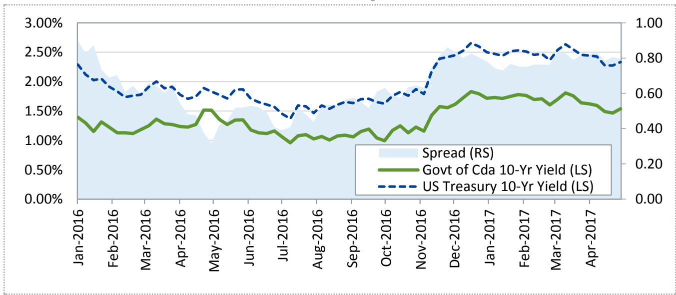
A similar trend towards tighter spreads among US and Canadian companies can be seen in the REIT space. Smart REIT's (Canadian) 10 year bond spread is currently +183 bps versus the benchmark, while Kimco Realty is +139 bps against the US treasury. Both operate in retail and have similar risk ratings (BBB/BBB+) and therefore offer a good apples-to-apples comparison. With Smart REIT boasting roughly a 45 bps spread over Kimco in addition to our view on the direction of the USDCAD, we consider Smart REIT the better relative value.

The one difference in our group regarding the theme of tighter spreads in US vs. Canada is Canadian telecom provider BCE (BCE-T). The company's 10 year bond spread over the Government of Canada's 10 year is currently +141 bps. This is narrower than US telecom giant AT&T's (T-US) 10-year bond spread (+158 bps over the US Treasury 10 year). The Canadian telecom space is less fragmented than the US, with BCE among "the big 3" telco's in Canada, essentially an oligopoly in the space. As a result, the company is likely viewed a safer bet than its US peers. In terms of return, given the wider spread held by AT&T and the potential for an appreciating US currency, we would recommend AT&T's bond over BCE's.

Our outlook on currencies marginally favours the USD. The spread between the government of Canada 10-year bonds and the 10-year US treasury has remained wide since the US Presidential election and is inching towards early 2016 highs (chart below). Trump's recent rhetoric against NAFTA, including talk of implementing taxes on soft-lumber and arguments against Canada's dairy industry, coupled with subdued oil prices, has further pressured the CAD year to date. Furthermore, the countries are on a diverging rate path, with the BoC to remain on the sidelines possibly in an attempt to boost exports, while the Fed is likely to raise rates two to three more times. As a result, we expect CAD to remain roughly flat over the course of the year. Should the BoC provide any hints of a rate hike related to housing concerns or an overall upbeat economic outlook, we would re-consider our position at that time.

In the market overall, we are witnessing tighter spreads among publicly-traded companies in the US versus Canada. Furthermore, depending on the industry, there is greater risk to the upside, e.g., uncertainty in oil prices commanding a greater risk premium and with that a greater opportunity of return. Given our view of a flat USDCAD, with wider spreads favouring Canadian companies, we would argue that better relative value lies with CAD bonds. That said, we recommend reviewing each bond on a case-by-case basis on differing macro and company-specific growth catalysts.

Gov. of Canada vs. US Treasury 10-Year Differentials



Source: Bloomberg, Raymond James Ltd.

Razi Hasan, CFA
Fixed Income & Foreign Exchange

Investing Responsibly

How often do we consider the environmental and social impacts of our investments? Typically, investors care most about performance and management style. While those are good questions to be asking, it doesn't mean we can't expand our criteria, especially as Canadian investors look for ways to reduce their societal impact. As a nod to Earth Day (April 22), we highlight the section of the Canadian mutual fund space that emphasizes socially and environmentally responsible/ sustainable companies.

What does ethical investing mean

Socially Responsible Investing (SRI) or Environment, Social and Governance (ESG) funds (Responsible Investing, or RI) screen for companies with an additional set of criteria related to social, environmental, or governance-related issues. It is probably fair to say that many folks know this. However, what isn't as obvious is that funds are beginning to include RI-based criteria regardless of whether they also carry the RI banner in their prospectus. Fundamentally, this translates to looking at companies that have progressive management ideas and those that are considering the long term sustainability of their actions in their decision making processes.

There are generally two distinct types of management styles for RI funds: *inclusive* mandates that screen companies on a list of positive factors, and *exclusive* mandates that screen out companies based on a list of negative factors. RI is often viewed as the latter type of fund, e.g., no oil/gas, nuclear, firearms, tobacco, etc. The negative screening process is appropriate for investors who are looking to ensure their money isn't supporting companies or industries they do not support in their personal lives. On the other hand, positive screens often focus on industry-leading companies or companies making a tangible effort to improve their sustainability.

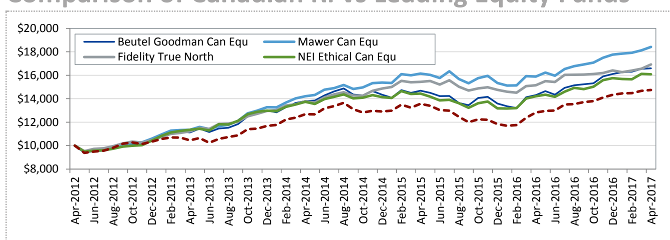
What ethical investing doesn't mean

Responsible investing now accounts for almost $23 trillion globally (GSIA Report, 2016). RI funds have been able to grow to this level of AUM not just out of sheer curiosity and the good will of a few, though that may have helped initially but, more importantly, by delivering returns that are in line with or beating their peers. An exhaustive literature review by Viviani (2015)[1] analyzed the performance and costs associated with RI over 25 years. The study showed RI returns were in line with their peers while also providing both diversification benefits and positive social and environmental outcomes. In a Canadian context, the diversification benefit can be pronounced when you reduce energy and financials, making a nice complement to a traditional Canadian-heavy equity portfolio (energy and financials represent ~55% of the TSX).

What our own quantitative screens say

We produced a list of top screening funds based on Morningstar's Sustainability rating for Canadian Equity Funds. We compared the results to our proprietary quantitative screen for Canadian Equity funds to see if there was overlap, and there was. The chart below highlights two industry-leading Canadian Equity funds (Mawer and Fidelity True North) with two top screening RI funds, NEI Ethical (by design) and Beutel Goodman (by holdings). As you can see, all four funds outperform the S&P/TSX Composite index over the long term providing superior risk adjusted returns. You will notice that RI funds, specifically those that have less exposure to the oil sector, will not participate in major energy rallies but will also avoid the volatile drawdowns. This can result in significantly different performance from the benchmark given the TSX's large weighting in energy.

Comparison of Canadian RI vs Leading Equity Funds



Source: Bloomberg, Raymond James Ltd.

How to pick the right fund for you

Selecting the right RI fund begins with a simple question; do you want your investment manager to follow a strict set of investment parameters, e.g., no oil and gas funds? If so, there are many strong performing fund companies that provide this option with extensive track records. NEI in general and their Ethical Canadian fund come to mind.

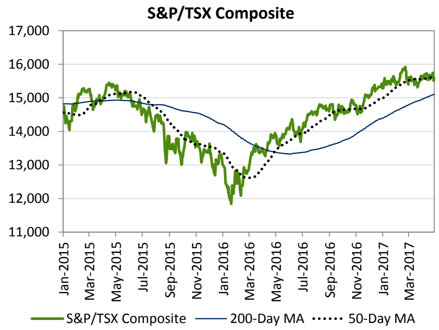
Alternatively, if you do not feel as strongly about excluding specific industries but rather want to invest in companies that are improving their sustainability or are leaders within their industry, the options are broader. There are a growing number of funds that are now including positive ESG or SRI screens in their security selection process. RBC GAM is an interesting example in this case, where the company is striving to include some component of RI in their entire fund line-up within the next few years. RBC's approach is to challenge their fund managers to include RI within the investment process in a way that adds value, not from a cookie-cutter perspective.

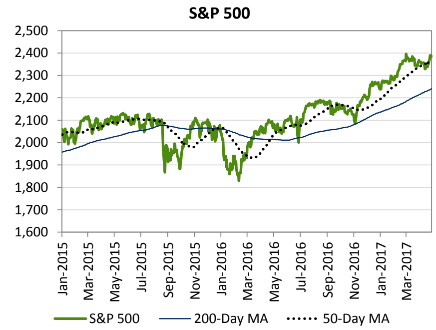
Spencer Barnes, M.Sc
Analytics Specialist

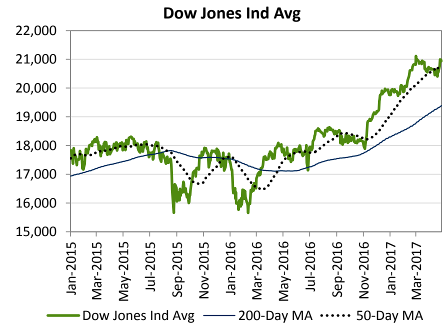
[1] Viviani, J.-L. (2015). Financial performance of socially responsible investing: What have we learned? A meta-analysis. Business Ethics, 1-28.

Charts of Interest

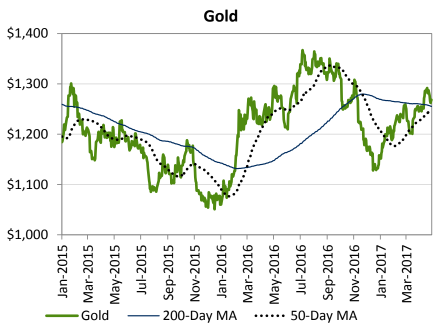
Markets

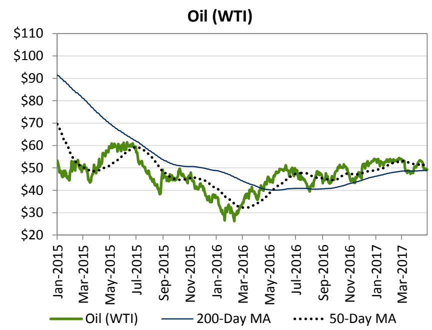


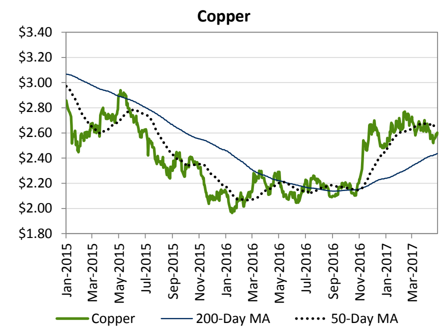




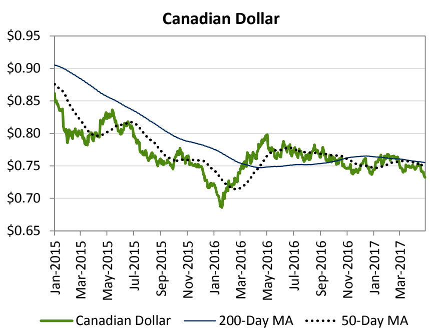
Commodities

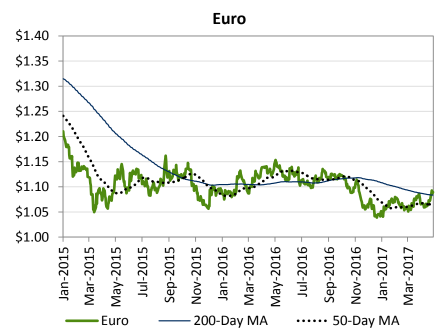


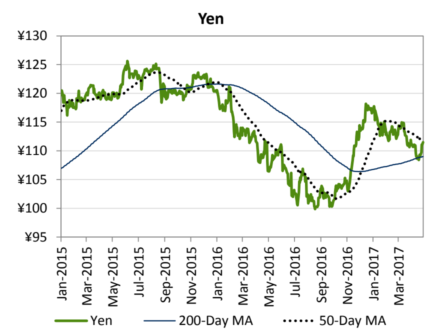




Currencies



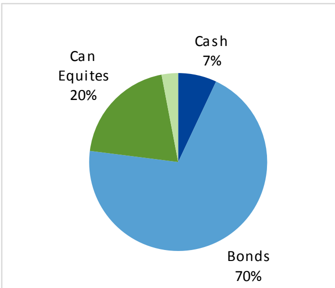


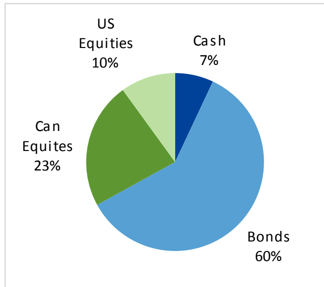


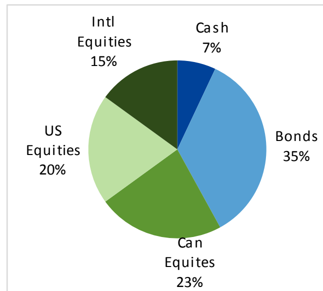
Source: Bloomberg, Raymond James Ltd. Performance as at April 30, 2017.

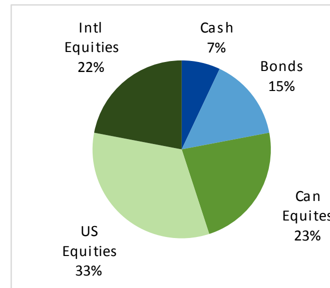
Investor Profiles and Asset Class Weightings

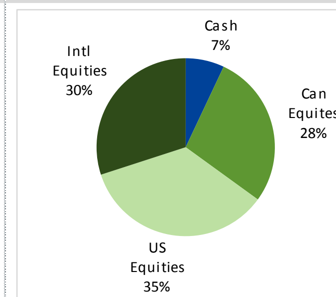
Recommended Asset Allocation











	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	7%	7%	7%	7%	7%
Bonds	70%	60%	35%	15%	0%
Can Equities	20%	**23% (+3%)**	**23% (+3%)**	**23% (+3%)**	**28% (+3%)**
US Equities	3%	**10% (-3%)**	**20% (-3%)**	**33% (-3%)**	**35% (-3%)**
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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