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AGF MARKET INSIGHT

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From the desk of...

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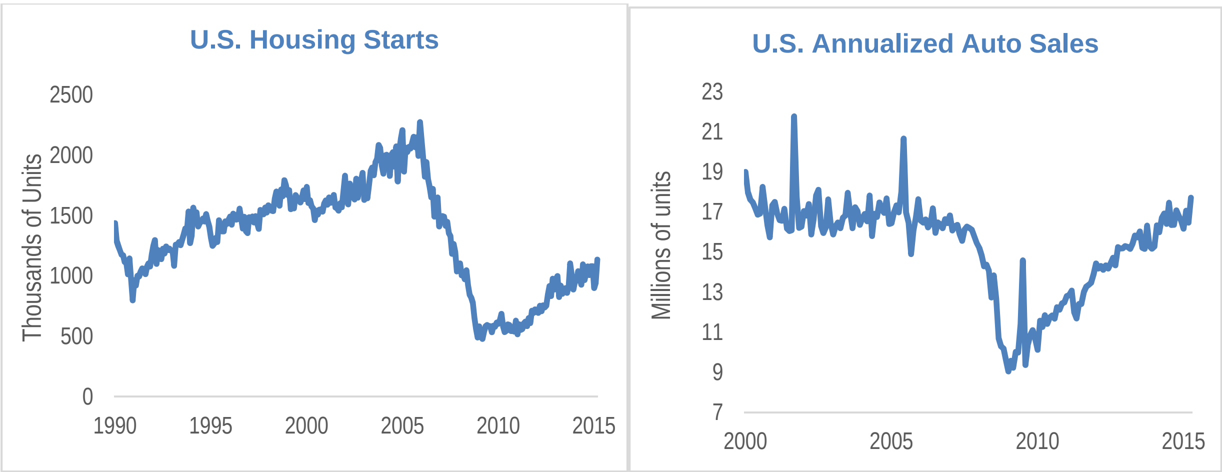
Q3 2015 U.S. Equities Outlook

EXPECTING ECONOMIC GROWTH TO REMAIN SUPPORTIVE OF EQUITIES

After a soft patch in the first quarter of 2015, the U.S. economy appears to have rebounded and is well positioned entering the second half of the year. In our view, factors supporting ongoing real GDP growth include:

- Continued gains in the labour market, both from rising payrolls and wages
- Sustained housing market growth, supported by cyclical factors and encouraging demographics (see Figure 1 below)
- Auto sales remaining at an elevated level with replacement demand and purchases by millennials (see Figure 1 below)
- A rebound in consumer spending resulting from the improvement in labour conditions
- The boost provided by lower energy prices and the wealth effect from rising equity levels and home prices
- Prospects for accelerating capital expenditures given high capacity utilization levels
- Increasing federal government expenditures and some acceleration at the state and local levels
- An improving economy overseas in Europe, helping the trade deficit

Figure 1 – U.S. Housing Starts and Auto Sales

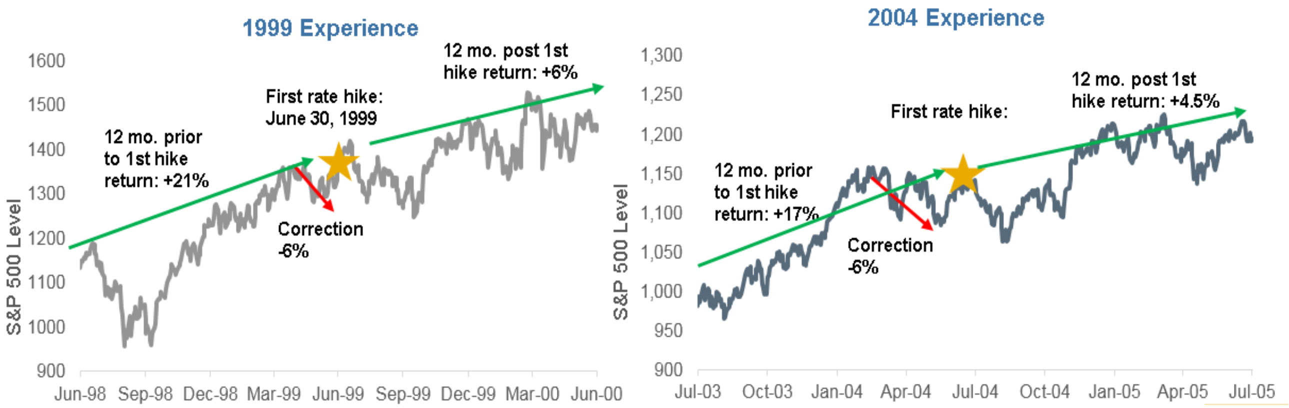


Source: Bloomberg, as of May 31, 2015

DON'T FEAR THE FED

As such, we expect U.S. equities to continue to move higher over the course of the next 12 months, though a summer correction could transpire ahead of an increase in interest rates by the U.S. Federal Reserve Board (the Fed), currently expected for September 2015. Indeed, the past two instances of initial rate increases at the beginning of tightening cycles happened in June 1999 and June 2004 and, in both instances, there were modest 6% corrections slightly ahead of the actual rate decision.

Figure 2 – S&P 500 Performance and Initial Interest Rate Hikes



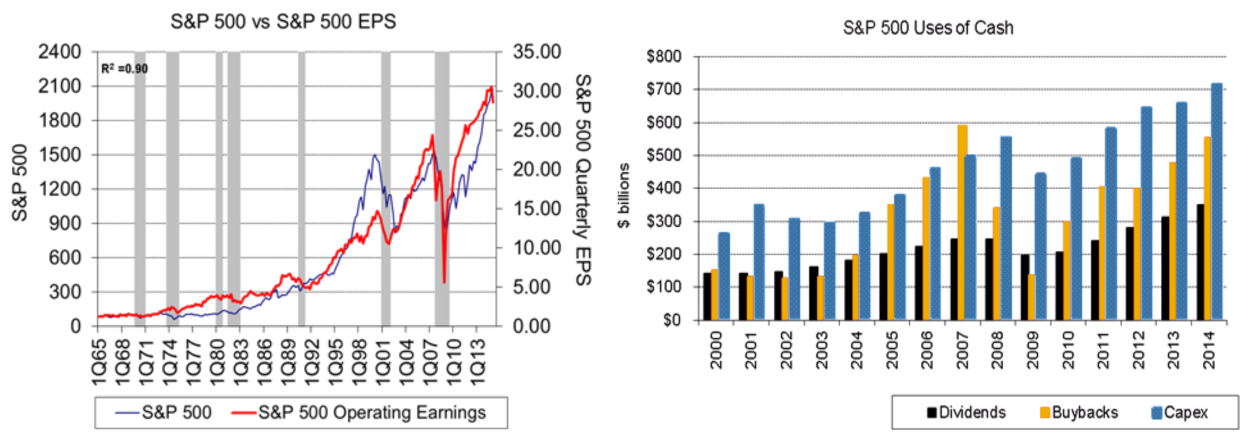
Source: Bloomberg, as of June 2015

However, in both cases, U.S. equities have moved higher in the following 12 months, as the first rate increase has historically not derailed bull markets. We expect a similar experience this time around, with market gains for the next 12 months and beyond primarily fueled from ongoing earnings growth.

The deceleration in earnings growth during the first quarter should prove to be temporary with earnings expected to pick up during the balance of the year and into 2016, based on the following factors:

- Weakness from weather, port strikes and a steep drop in energy prices that impacted the first quarter are not expected to continue
- A supportive economic backdrop in the United States and international economic growth acceleration, benefiting exporting companies and foreign operations
- Continued elevated margins, which should remain strong as we do not believe downward pressures will emerge until 2016
- Continued share buybacks a priority deployment choice for free cash flow

Figure 3 – S&P 500 Earnings Growth and Uses of Cash

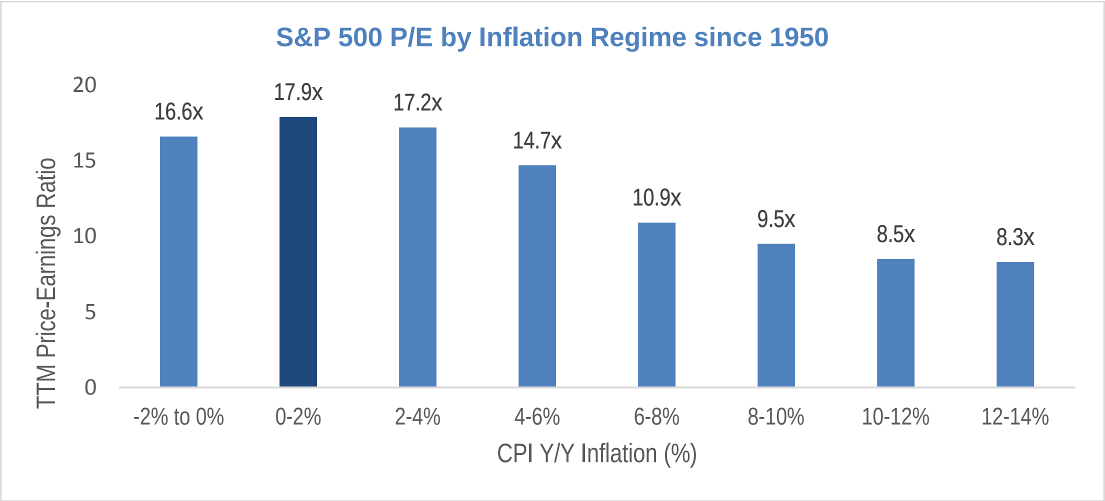


Source: Citi Research, as of May 31, 2015

A countering force to earnings growth is U.S.-dollar strength, which we expect to stay firm as we get closer to the first Fed rate hike. In addition, the Energy sector will continue to show year-over-year weakness in profits reflecting lower realizations. However, the rate of change should abate later into the year as comparisons become more favourable.

From a valuation perspective, the U.S. market is expected to remain at elevated levels with the scope for some modest expansion. To illustrate, the S&P 500 Index is currently valued at a P/E of 17.6x estimated 2015 earnings and in a year's time, it is reasonable to assume a slight expansion of the multiple to 18.0x estimated 2016 earnings. This forecast is consistent with historical valuations both from looking at (a) past relationships of valuations in comparison to inflation regimes as well as (b) absolute levels seen in the market over the last 25 years.

Figure 4 – S&P 500 P/E by Inflation Regime since 1950



Source: Strategas Research, as of April 30, 2015

Additional influences supporting U.S. equities include more encouraging flows, as retail inflows into U.S. domestic active funds look encouraging and augment existing flows into U.S. ETFs. We also remain optimistic for a return of international flows into U.S. equities. Further, we believe M&A activity will likely accelerate as historically we have seen greater acquisition activity in the latter stages of a cycle.

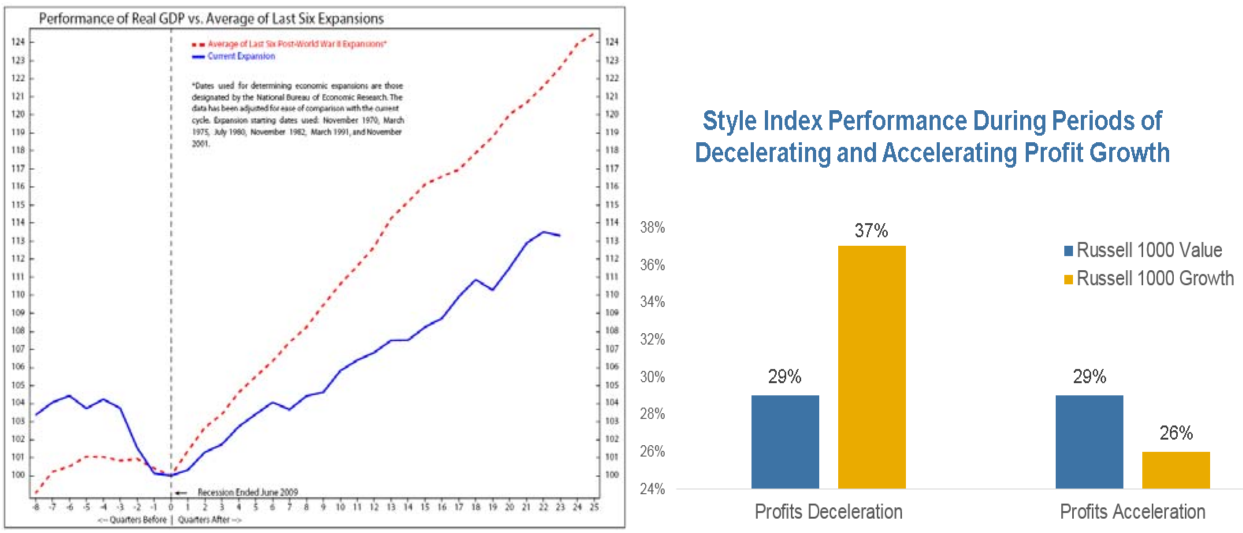
Potential market risks that we remain cognizant of include:

- A more aggressive track of rate increases than the market expects by the Fed, reflecting unanticipated inflation
- Troubling developments within the European Union, whether from Greece or elsewhere
- Economic weakness from China
- Geopolitical risks emanating from the Middle East or Russia

A LONGER CYCLE

Overall, we believe the bull market in U.S. equities remains intact, with the current cycle likely to be longer than average given the slower GDP expansion that has occurred since the 2008 trough. Further, we believe that as we enter the latter stages of the cycle, the prospects for outperformance by growth-oriented investment philosophies is promising given that, historically, growth has tended to outperform in periods of profit deceleration as companies exhibiting fundamental growth become more scarce and command greater premiums.

Figure 5 – Current Real GDP vs Average of Last Six Expansions (LHS), Style Performance (RHS)



Source: Ned Davis Research (LHS), Bank of America Merrill Lynch (RHS), as of May 31, 2015

For more information on U.S. equities, please visit AGF.com/US and contact your Financial Advisor.

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