

Yuanting More

Equity markets fell this week despite an initial Monday burst on news that China would enhance the flexibility of the yuan. After sprinting out of the gate, the S&P 500 wilted as the week wore on, ultimately falling 3.8% by noon Friday as concerns about the pace of economic recovery remained at the forefront—dismal U.S. housing numbers were a major culprit, and the new U.S. financial reform bill also weighed. Cyclical (industrials, cons. discretionary and transports) continue to struggle relative to the broad market,

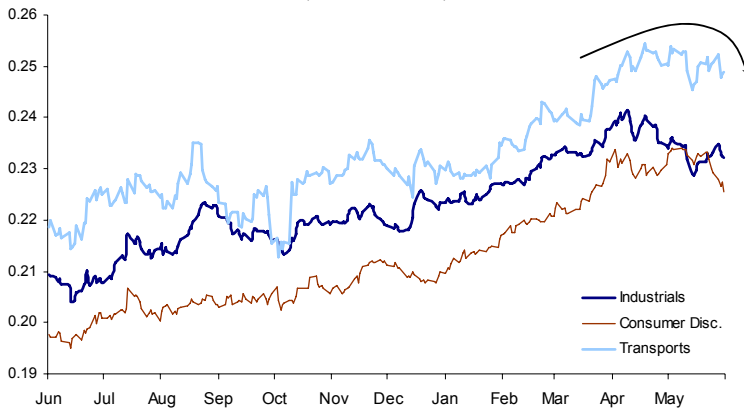
hinting that growth expectations are gearing down. The TSX fell 1.9%, weighed down by an uninspiring earnings report from RIM.

EarningsWatch... The Q2 earnings season is just a few weeks away, and the consensus view is now for 27% y/y growth in S&P 500 profits, down from 57.4% y/y in Q1. Materials (+94%), energy (+67%) and technology (+52%) are expected to lead, while telecom and utilities are the only sectors expected to see earnings below a year ago. The consensus forward-year earnings estimate for the S&P 500 is now \$81.2, the highest level since September-08.

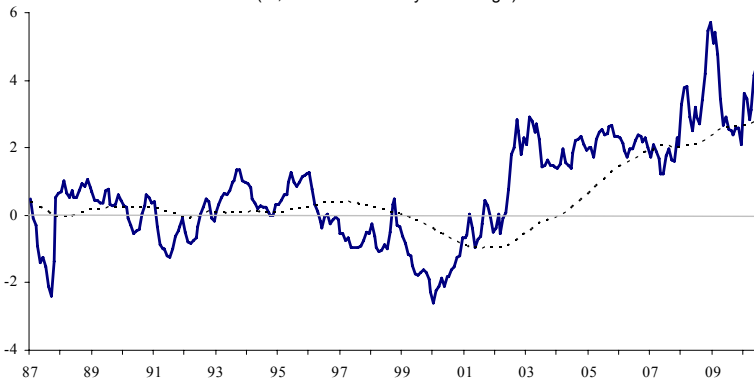
Valuation check... The recent selloff in stocks has lifted earnings yields relative to bond yields. The forward-year earnings yield on the S&P 500 is now a hefty 7.6%, based on the latest consensus, well above the 3.1% yield on 10-year Treasuries (note: even if you believe the consensus has run 10% ahead of reality, the earnings yield remains a still-favourable 6.8%). In fact, the gap between the two is now the widest since March-09, when stocks began their impressive post-recession rally. After dipping below the 5-year average earlier in the year, the yield gap is now comfortably back above it, suggesting that some near-term relative value can be found in stocks. Meantime, the earnings yield on the TSX (6.7%) also remains well above 10-year GoC bond yields, with the gap also now back above the 5-year average. Still, the relative value of Canadian stocks versus bonds is nowhere near where it was in late-08, when the yield gap reached nearly 8%.

Longer-term valuation metrics, like the price-to-trend earnings ratio, market cap-to-GDP and Tobin's Q all suggest stocks are on the expensive side of historical norms.

Relative Strength
(Ratio vs. S&P 500)



S&P 500 Earnings Yield minus 10-year Bond Yield
(%, dashed line is 5-year average)



TSX Earnings Yield minus 10-year Bond Yield
(%, dashed line is 5-year average)



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