This report was prepared by an analyst(s) employed by BMO Nesbitt Burns Inc., and who is (are) not registered as a research analyst(s) under FINRA rules. For disclosure statements, including the Analyst's Certification, please refer to pages 40 to 41.
- Technology-heavy Nasdaq and small cap Russell 2000 indices fell below their 50dMA to fresh 1m lows, while the broader market stabilized. Global sectors were confined to a -0.5%/+0.3% range.
- The yield on the U.S. T-bill maturing on Oct 17 surged 20bps, while yields on other Oct/Nov maturities rose only a few bps. Safe-haven 10y yields were little changed to higher. U.S. corporate default risk pulled back from a 6w high.

Levels*

<table>
<thead>
<tr>
<th>Currencies (USD per)</th>
<th>Commodities</th>
<th>Government 10- Yr Benchmark</th>
<th>Equity Indices &amp; Sentiment</th>
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<td>%Chg</td>
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<td>WTI Oil 101.44 -2.0%</td>
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<td>CHF</td>
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<td>U.K. 2.68 -0.01</td>
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<td>Gold 1,304.8 -1.1%</td>
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<td>Silver 21.84 -2.1%</td>
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<tr>
<td>CAD</td>
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<td>NZD</td>
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<td>CMMX Cu 322.65 -2.0%</td>
<td>Portugal 6.40 0.06</td>
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<td>BRL</td>
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<td>LME Al 3m 0.84 -0.4%</td>
<td>Greece 9.21 -0.02</td>
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<td>LME Zn 3m 0.86 0.1%</td>
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Moves

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<td>France</td>
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Sectors

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Source for all data and graphics in this publication: BMO Capital Markets, Bloomberg, Thomson

* H/L = at a new closing 52- wk High/Low; / = within 10% of the 52- week High/Low; Colour codes are inverted for bond and sentiment indications.
Daily Charts

3-Month View with 26-Day Bollinger Bands and 150-, 200- and 50-Day Moving Averages

Currencies
- U.S. Dollar Index

Commodities
- DJ-UBS Commodity Price Index
- Gold (Spot)

Bonds
- U.S. 10-Yr Bond

Equities
- MSCI World Index
- S&P 500
- S&P/TSX Composite

Asia Dollar Index
- Natural Gas (NMX)

Canadian Dollar
- Copper (CMX)

Canadian Dollar
- German 10-Yr Bund

Austalian Dollar
- Nickel (LME 3Mo)

Italian 10-Yr Bond

CDX North American Inv. Grade Index

VIX

DOOM: 1M Yen IV (AUD, EUR, USD)
Intra Day Charts
2-Day 1-Minute View
Daily Sector Charts
3-Month View with 26-Day Bollinger Bands and 150-, 200- and 50-Day Moving Averages

- **Canada** – at a 52-week high: Industrials.
- **Europe** – at a 52-week high: Utilities.
### Market Elements

#### Market Movers – Largest Daily Percentage Moves

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<th>Chg</th>
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<td>GAS SQ</td>
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<td>Exelon Corp</td>
<td>EXC</td>
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<td>Veolia Environnement SA</td>
<td>VE FP</td>
<td>3.4%</td>
<td>Edison International</td>
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<tr>
<td>Electricite de France SA</td>
<td>EDF</td>
<td>2.3%</td>
<td>Enel</td>
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<td>Tepco</td>
<td>-0.8%</td>
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<td>DRX LN</td>
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<td>EDP - Energias de Portugal SA</td>
<td>EDP PL</td>
<td>-2.1%</td>
<td>AES Corp VA</td>
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</table>

**Bold** = move of more than 5%

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<td>Sumitomo Corp</td>
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**Bold** = move of more than 5%
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<td>MWV 37.52</td>
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<td>-0.5%</td>
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</tbody>
</table>
| H/L = at a new closing 52-wk HighLow; © = within 10% of the 52-wk HighLow; Bold = move of more than 5%
## Canadian Market Movers

### Energy
- **Symbol H/L Last %Chg**
  - PD 10.33 -1.2%
  - GGL 7.85 -1.9%
  - CVX 65.12 -0.4%
  - TTR 4.87 -0.4%
  - TNG 2.87 -0.4%
  - DML 1.04 -0.4%

### Materials
- **Symbol H/L Last %Chg**
  - SRQ 8.65 0.6%
  - PGM 3.33 0.6%
  - TUG 6.66 0.4%
  - BCT 6.03 -0.5%

### Industrials
- **Symbol H/L Last %Chg**
  - BDB/B 4.85 1.4%
  - BMR 24.57 -0.8%
  - VOX 1.22 -0.4%
  - LOR 2.50 -0.4%

### Consumer Discretionary
- **Symbol H/L Last %Chg**
  - MG 85.42 0.2%
  - SNC 44.17 0.2%
  - RBC 23.21 0.6%

### Technology
- **Symbol H/L Last %Chg**
  - GTC 76.17 -0.1%
  - DD 26.05 -0.2%
  - CST 11.97 0.0%

### Financials
- **Symbol H/L Last %Chg**
  - XGU 18.35 0.5%
  - ATM 10.28 -0.2%
  - BAC 31.85 1.0%

### Health Care
- **Symbol H/L Last %Chg**
  - UVD U 16.01 -1.2%
  - M 1.75 2.3%
  - DRI 15.93 0.7%
  - AXC 8.95 9.9%
  - LW 10.52 -1.0%

### Consumer Staples
- **Symbol H/L Last %Chg**
  - SC 59.70 0.7%
  - PJC/A 18.12 -2.4%

### Utilities
- **Symbol H/L Last %Chg**
  - XBB 30.00 -0.0%
  - AGUI 6.32 -1.1%

### Utilities
- **Symbol H/L Last %Chg**
  - XRB 21.22 -0.6%

### Market Elements
- **Symbol H/L Last %Chg**
  - LSG 0.38 7.0%

### Market Elements
- **Symbol H/L Last %Chg**
  - MG 85.42 0.2%

### Market Elements
- **Symbol H/L Last %Chg**
  - BDB/B 4.85 1.4%

### Market Elements
- **Symbol H/L Last %Chg**
  - MG 85.42 0.2%

### Market Elements
- **Symbol H/L Last %Chg**
  - MG 85.42 0.2%

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**Note:**
- Bold = ETF, **Bold** = S&P/TSX 60 member,
- Italics = EFT, **Bold** = move of more than 5%
Relative Strength Filter

European Banks Part II – Breaking Out

- Why the media and market is going on about U.S. politics & the potential for debt default (and T-bill yields coast, yet do not retreat this morning), across the pond European banks are breaking out (Figure 1), as the cost to protect their debt against default is breaking down – Figure 2. Two days ago we highlighted the momentum buys and a risky and derisking Portuguese bank, all in Euro terms; today we look at European banks in USD terms for those that do not hedge.

- A link to USD price trends on European Banks is found here.
  - Amongst large caps, Banco Santander is breaking out of a 2-year bottoming pattern, which measures to $12.50 – Figure 3. The CDS trend that defines the “risky and derisking” driver is found here.
  - Amongst small caps, a momentum buy, whose stock has been sleeping for past six weeks while the CDS has been narrowing sharply, is Bank of Ireland – Figure 4.

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
You Know You Are in Trouble When

- You know you are in trouble when stocks become highly correlated – Figure 1, and are being driven off of T-bill yields – Figure 2. That trouble is for quant models and program traders.
- You know you will find opportunities when stocks become highly correlated – Figure 1, and are being driven off of T-Bill yields – Figure 2. That opportunity is for investors that know that T-bill yields are not the long-term determinant of equity performance.
- The signalling at how long we will be in this U.S. default mess is found by looking at how high and how far out US T-Bill yields will be stressed during the “Brinkmanship”. This is the same statement we made Monday; the only difference is that is now “sells” are targeting both the stocks that are not liked (Monday’s list) and the stocks that are liked – Figure 1.

- We figure it is in between what you want to sell (pretty much everything is being sold now) and what you want to buy (the market is doing what markets do best, speak loudly such that politicians get it right in the end), so now is the time to put together shopping lists.
- We know what we like: earnings growth (earnings estimates being revised higher, positive earnings, long-term expected earnings growth exceeding 10%) is working in many segments of the market, our top 3 SubIndustry deciles will narrow this list down, and if you can get yield and dividend growth, why not. This narrow list is shown in Figure 3.

Figure 1: CBOE S&P 500 Implied Correlation (JCJ)

Quantifying “Group Think” When Stocks Become Highly Correlated For a Brief Time

Figure 2: S&P 500 and US 1m T-Bill Yield Yesterday

You Know Fundamentals Don’t Matter When Stocks are Driven by the Humble U.S. 1m T-Bill Yield; But This Sale Has a Limited Timeframe

Figure 3: Stocks in Top 3 SubIndustry Deciles That Meet Both Our Earnings Growth Filter and Dividend Yield/Growth Filter

You know You Are in Trouble When

- You know you are in trouble when stocks become highly correlated – Figure 1, and are being driven off of T-bill yields – Figure 2. That trouble is for quant models and program traders.
- You know you will find opportunities when stocks become highly correlated – Figure 1, and are being driven off of T-Bill yields – Figure 2. That opportunity is for investors that know that T-bill yields are not the long-term determinant of equity performance.
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Debt Woe Waining – Not U.S., but European Banks

- OK, U.S. debt woe is not waning yet, and U.S. political theatre is pushing both the VIX and implied correlation among U.S. stocks higher, but…
- …if you look across the pond at Europe (where indices are outperforming), the cost to protect European banks against default is forming another leg down – Figure 1.
  - And, yes, it’s the same picture for peripheral European Banks.

If we scan European banks within MSCI Europe, we find:
- High credit risk Banco Espirito Santo SA is forming both a major double bottom and a H&L bottom against MSCI Europe – Figure 2.
- We classify one-fifth of European Banks as “momentum buys” due to consistent outperformance, positioning above rising moving averages, and the fact that they are not overbought – Figure 3.
- The one bank that remains a momentum sell is Emerging Market-leveraged Standard Chartered. This makes sense given the credit picture we see in EM (see page 10 of this overview).
- The reason you may not want to play European banks via an ETF is due to the underperformance of heavyweight HSBC.

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
On the possibility of a U.S. debt default on U.S. Government “Brinkmanship,” there is lots of political noise out there and then there is signal. The signal comes from looking at the short end of the U.S. T-bill curve, and watching how elevated yields go, and how far out in time the “hot potato” pricing gets – Figure 1. On Friday, concern moved from late October to mid-November.

Between our four weakest sectors, we expect that the market will treat the threat of U.S. default as a threat on the global economy and take it out on the Materials sector. This sector has recovered from horrid pricing of July, but remains negative, and has lost upside momentum. Otherwise put, there is a bid to sell into.

We highlight USD price trends on the largest material momentum sells in the weakest five sub-industries in Figure 3 below. Charts are found at this link. We know there are many gold stocks in there, and many see a US default as a bonanza for gold, but we still see gold trending down – see link.
Industrial Internals & Transportation Infrastructure

- The weakest sector momentum this week was found in **Industrials** – Figure 1. This sector has undoubtedly received flows that did not want to go into resources, as typically industrial and resource strength is paired, but that was not the case this time around.

- Digging into the internals (Figure 2), the most material casualty has been government spending related **Aerospace** (which we covered yesterday). There has also been strength, however, notably in **Airlines**, which are making a comeback, and **transportation infrastructure**.

- **Airlines** are a great recovery story. They have had a great 2H 2012-13, but stepping back, they are just now breaking out of a bottoming formation, and are still recovering from a three-year decline – Figure 3.

- Transportation Infrastructure is coming up to a key inflection point – Figure 4. It was a former stellar outperformer that has spent the last six years market/underperforming and is close to taking out this key downtrend. In a **portfolio**, benchmarked against a **Global Infrastructure Index**, transportation makes up one-third of the momentum buy list – Figure 5.

**Relative Strength Filter**

**October 4, 2013**
Research Comment
**Quantitative/Technical Research Website**

**Mark Steele**
(416) 359-4641
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Assoc: Tiberiu Stoichita/Jin Li

**Industrial Internals & Transportation Infrastructure**

**TOOLKIT**

**CLICK HERE**

**Figure 1: Industrial Relative Strength Z-Score**

**Figure 2: MSCI World Industrial Industries vs. MSCI World**

**Figure 3: Airlines vs. MSCI World**

**Figure 4: Transportation Infrastructure vs. MSCI World**

**Figure 5: Transportation Infrastructure Momentum Buys vs Macquarie Global Infrastructure Index**

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
Relative Strength Filter

October 3, 2013
Research Comment
Quantitative/Technical Research Website

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Aerospace & Defense – Too Close to the Sun

- It is day 3 of the U.S. government shutdown, and there will be problems for some companies that rely on the government.
- Lockheed Martin, Northrop Grumman and Rockwell Collins have broken below outperforming trends. Raytheon has also broken down against a global benchmark.
- If you missed Aerospace & Defense this year, you missed a great party. After marketperforming for four years, the relative performance spiked like it has not done in over a decade – Figure 1. A pullback after such a fantastic run would be significant in scale.
- This subindustry is typically a heterogeneous mixture of stocks, which shows up in our breadth work as a group that would look more like noise than signal. That was until this year, when the reading coalesced at the first decile position. That coalescence is starting to break down again – Figure 2.
- Lockheed Martin is the largest stock to have broken both its outperformance and steep dividend-adjusted price trend. It is just starting to enter a support zone now, but if it breaks below $120, there is an air pocket until $108 – Figure 3.
- Raytheon (Figure 4) and Northrop Grumman have similar patterns.

Figure 1: Global Aerospace vs. MSCI World

Figure 2: Aerospace & Defense Relative Strength Z-Score

Figure 3: Lockheed Martin Dividend-Adjusted Price Trend

Figure 4: Raytheon Co. Dividend-Adjusted Price Trend

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
Sell Small Cap Value Traps to Buy Earnings Growth

- Why small caps? More upside torque, and while large caps are pulling back, small caps are hitting new highs – [see this link].
- Last week we highlighted the fact that positive earnings growth is working for small caps, while a value focus is actually harnessing negative results. Today we will focus on both, suggesting some value traps to dispose of (or short) while harnessing some earnings growth-focused stocks as replacement alternatives.
- Value traps (sells/shorts) are on the left: Sherritt, CVR Partners, and Erie Indemnity. They are all from weak subindustries, and are not oversold. Earnings growth (buys/overweights) stocks are on the right: Mullen Group, On Assignment and 8x8. They are from strong subindustries, and are not overbought. All of our screens and charts came from [this link].

**Value Traps to Sell**
Figure 1: Sherritt Intl (S CN) Dividend Adjusted Price Trend

- Not Oversold

**Earnings Growth to Buy**
Figure 2: Mullen Group (MTL CN) Dvd Adjusted Price Trend

- Breakout & 2mo Consolidation

- Not Overbought

Figure 3: CVR Partners LP (UAN US) Dvd Adj Price Trend

- Key Trend
- Will Have To Find Another Support
- Not Oversold

Figure 4: On Assignment Inc. (ASGN) Price Trend

- In the Cruising Lane, (H&R Stocks are 1st Decile)
- Not Overbought

Figure 5: Erie Indemnity (ERIE US) Dvd Adjusted Price Trend

- Double Top
- Breaking Support
- Not Oversold

Figure 6: 8x8 Inc. (EGHT US) Price Trend

- In the Cruising Lane, (Alternative Carrier Stocks are 1st Decile)
- Not Overbought

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
October 1, 2013
Research Comment
Quantitative/Technical Research Website

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Relative Strength Filter

Wireless Breaking Out of Decade-Long Base

- **Wireless telecom just hit 1st decile** – Figure 1.
- It is the new staple.
- Looking longer term, the relative performance of the global wireless group is breaking out of a decade-long base – Figure 2.
- **Softbank** is the current very buyable large cap momentum buy, just breaking out of a consolidation pattern – Figure 3.
- **Cellcom Israel** is closer to the bottom, yet has still established itself as a momentum buy, and has also just started to break out of a consolidation pattern on volume yesterday – Figure 4.
- **SBA Communications** has very low volatility, is reversing an underperforming trend against the S&P 500, and is breaking out on an absolute price basis – Figure 5.
- **SK Telecom** is a large, liquid, emerging market stock with moderately low volatility, good upside torque, and shares are also breaking out of a 5mo consolidation pattern – Figure 6.

Figure 1: Wireless Telecom Relative Strength Decile

Figure 2: World Wireless Telecom vs. MSCI World

Figure 3: Softbank Corp DVD Adjusted Price Trend in USD

Trending Higher (at 130%/yr), and Breaking out of a Consolidation Pattern

Breakout Level and Pullback Support at $10

Accumulation At The Bottom

Figure 4: Cellcom Israel Dividend Adjusted Price Trend in USD

Figure 5: SBA Communications Dividend Adjusted Price Trend

Breaking out of a Wedge, to the Upside

Figure 6: SK Telecom Dividend Adjusted Price Trend in USD

Breaking out of a Textbook Consolidation Pattern, All The While Trending Higher at Over 60%/Yr

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
If anything, we expect our clients will treat current equity weakness as a buy, but perhaps not quite yet. The strength we see is in Industrials, Technology and segments of the Consumer Discretionary sector. We will focus on what can be sold to make room for such purchases.

While U.S. indices hit new highs in September, four sectors did not: Financials, Staples, and interest rate sensitive Telecom and Utilities. Given the improvement in bond pricing and volatility, we focused heavily last week on the downside risks in Financials and Staples stocks.

The staples sector has slid rather dramatically in our Group Selection Report – Figure 1.

Below, we highlight three stocks that have broken outperforming trends, show topping patterns where RSI and MACD did not confirm the highs, and are priced quite a far distance from major support: General Mills, Campbell Soup, and Sanderson Farms – Figures 2-4.
Looking for Trouble, Financials Again

- Fourth note in a row from us with a negative tone? Yes.
- Something smelly out there? Well, we have to admit that when see a head and shoulders top on the world’s 3rd largest financial, JPMorgan, we start looking for trouble. Bonds are also too well bid lately.
- On the whole, the credit market is trending in the right direction, yet over the past five days 18 out of 20 of the world’s too interconnected to fail financials have widened more than 5% – Figure 1.

- We will centre on financials – Figure 1. We will use our relative strength work to focus in on the weakest three industries in our group selection report. Then looking at the price trends in these 406 stocks, we are going to look for trouble.
- There are 11 stocks with broken price trends, we covered JPM and Citi a few days ago, but now just breaking down yesterday is CI Financial, which has been trending higher at a very impressive rate of 47%/year. We advocate trimming a position here. Shoot first we suppose – Figure 2.
- There are 34 stocks in our Momentum Sell list. The one Underperform rated by our REIT team is Hudson Pacific Properties – Figure 3.
- Finally, a credit situation where the CDS uptrend matches the equity downtrend – Standard Chartered PLC – Figure 4.
Staples for Sale

- Not liking staples kind of feels like not liking a puppy, but according to our global breadth work, the sector is shifting out of neutral and toward more of a negative reading – Figure 1.
- From a market cap weighed relative strength standpoint, the trend is clearly negative, and consistently so –

**Figure 1:** Consumer Staples Relative Strength Z-Score

- Stocks with weak technicals (breaking down, or momentum sells):
  - Monster Beverage is a momentum stock on the verge of losing momentum, which can be a difficult time – Figure 3.
  - Kellogg broke below support and we don’t see another level of safety for quite a few dollars lower – Figure 4.
  - On our momentum sell list with high torque is Suedzucker AG, and with low torque, is Rogers Sugar – Figures 5, 6.

**Figure 2:** Consumer Staples vs. MSCI World

**Figure 3:** Monster Beverage (MNST) Price Trend

**Figure 4:** Kellogg Dividend Adjusted Price Trend

**Figure 5:** Suedzucker AG Dividend Adjusted Price Trend

**Figure 6:** Rogers Sugar Dividend Adjusted Price Trend

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
Relative Strength Filter

U.S. Financial Weakness Part 2 – JPM, C

- Weakening U.S. Financials are making a notable mark on the U.S. equity market, which is sinking relative to the ACWI – Figure 1.
- The four major Financial sub-industries: Other Diversified Financials (JPM, BAC, C), Diversified Banks (WFC, CMA, USB), Regional Banks, and Asset Managers have all broken below 50d MAs.

Half of the stocks in the 500 that have broken below outperforming trends are financials – Figure 2.
  - JPM sports a “textbook” distribution top and has downside risk to $44 – Figure 3.
  - Citigroup just broke a consolidation pattern to the downside yesterday. Support and downside risk is to the $38-42 zone – Figure 4.
  - And yes, treasuries continue to be very well bid this morning.

Figure 1: S&P 500 vs. MSCI ACWI

Figure 2: Half of 500 Members Breaking Below Outperforming Trends are Financials

Figure 3: JPM Dividend Adjusted Price Trend

Figure 4: Citigroup Dividend Adjusted Price Trend

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
U.S. Rate Relief : Sell Financials to Buy Some UTs

- The shellacking that bonds have taken since ‘taper’ hit the financial lexicon is starting to wane, with US and Canadian bond yields breaking below steep uptrends – Figure 1.
- At the same time, U.S. Financials are breaking below outperforming trends. You see this at the index level – Figure 2. You see it with the large bellwethers: WFC, JPM, BAC, C, PNC, …

- With the rate relief, we suggest shifting some U.S. financials (which are breaking down) into some utilities, but a very specific group: the few that are in outperforming (if but only marginally) trends against the market, and also in outperforming trends against the sector – Figure 3.
  - NextEra (NEE) is at the bottom end of the channel, which is rising at a rate of 27% /year – Figure 4.
  - NiSource (NI) has spent six months consolidating gains. We expect shares to break to the upside – Figure 5.

Figure 1: Trends on Global 10y Bond Yields

Figure 2: U.S. Financials vs. S&P 500

Figure 3: S&P 500 Utilities in Outperforming Trends vs. Market and Sector

Figure 4: NextEra Energy Dividend Adjusted Price Trend

Figure 5: NiSource Inc Dividend Adjusted Price Trend

This report was prepared in part by an analyst(s) employed by BMO Nesbitt Burns Inc., and who is (are) not registered as a research analyst(s) under FINRA rules. For disclosure statements, including the Analyst’s Certification, please refer to pages 2 to 3.
Relative Strength Filter

Media Momentum

- The market cap weighted global media index is steadily and consistently outperforming the MSCI World - Figure 1.
- From a breadth standpoint, 70% of the 133 media stocks we cover are outperforming the S&P 500. We highlight the large cap outperformers in Figure 2.
  - The Advertising group has risen to a 1st decile position.
  - Broadcasting has shown a positive reading for over a year now.
  - Cable and Satellite stocks have shown a similarly positive ranking for most of the past two years.
  - The weaker groups within media, garnering just a neutral reading are Publishing and Movies and Entertainment.
- There is clearly a large list of positive stocks within Media. This link takes you to the 133 stocks covered. Selecting a few members of our momentum buy list (outperforming, above moving averages, and not overbought):
  - MDC Partners is just breaking out of a six-week consolidation pattern – Figure 3.
  - DreamWorks Animation SKG has just recently regained positive momentum after breaking out of a two-year base this year – Figure 4.

Figure 1: Media vs. MSCI World

Figure 2: Large Cap Media Outperformers ($5bn cutoff) vs SPX

Figure 3: MDC Partners in DVD Adjusted USD Price Trend

Figure 4: DreamWorks Animation SKG Price Trend

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
The Inflation Play – Steel (X, MT, LIF)

- In this taper-free week, U.S. and German Inflation expectations broke above downtrends – Figure 1.
- If you are looking for a bottom fishing, but not a garbage picking (AKS looks to open down 10% this morning) inflation vehicle, the markets have found it for you; it is the Steel Subindustry that just made it back to a neutral reading in our Group Selection Report – Figure 2.
- Of course large players in the steel group are notorious for being high credit risks, but here too we see improvement. The credit risk of a global basket of steel stocks displays the pattern of a distribution top. Otherwise put, it is risky and derisking – Figure 3.
- A link to USD price trends on 72 steel & iron ore stocks is found here.
- The North American stock that best fits the risky and derisking pattern is U.S. Steel – Figure 4. Shares have started to bottom against the S&P 500 and ACWI.
- Globally, ArcelorMittal has a similar credit pattern and is basing both on an absolute and relative basis against the ACWI.
- There are three steel stocks ranked momentum buys on a USD adjusted basis, and they are all small caps: Bekaert SA, ArcelorMittal South Africa Ltd and Siderar SAIC.
- In Canada, Labrador Iron Ore Royalty is still in an underperforming trend against the TSX, but is outperforming materials and shares are close to breaking a downtrend.

Figure 1: U.S. 5Y5Y Forward Inflation Expectation

Figure 2: Steel Relative Strength Decile

Figure 3: Credit Risk (CDS Basket) of Steel Group

Figure 4: United States Steel Corp Equity/CDS Overlay

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
Earnings & Technicals: LEA, SKF, TRIP, HCA

- Earnings growth is working for large caps too.
  - **Yesterday, we highlighted** the fact that small cap stocks with top decile earnings estimate revisions, positive earnings and cash flow yield, plus a long-term earnings growth expectation of at least 10% have a higher percentage of outperformance.
  - Large caps follow the same pattern, with over 70% of earnings growth focused stocks outperforming U.S. and Global markets, while in Canada the result is 90% outperformance.
  - See links for the stocks that fit this earnings growth profile.
    - 14 large cap stocks in Canada
    - 102 North American-listed large caps
    - 208 Global large cap stocks

- We highlight three below from our global earnings growth focused filter that are on the momentum buy list (which excludes Bernanke-induced “when have I ever refused an accommodation” overbought stocks), and are also in consolidation patterns, with very tight Bollinger bands relative to history: Lear, SKF, and TripAdvisor – Figures 1-3.

- Our best pick from the earnings growth filter that is breaking above an underperforming trend is HCA Holdings – Figure 4.

---

**Figure 1: Lear Corp Dvd Adjusted Price Trend**

- Trending Higher at 88%/Year, Yet Has Consolidated Gains for 1mo
- Auto Parts Group is 1st Decile
- Earnings Estimate Revisions is 1st Decile

**Figure 2: SKF AB Dividend Adjusted Price Trend**

- Breaking out of a 3-Year Consolidation Pattern, Yet has been Consolidating Gains for 6 weeks; 2nd Decile Earnings Estimate Revisions; Industrial Machinery Group is 1st Decile

**Figure 3: TripAdvisor Price Trend**

- Trending Higher at 135%/year, Pullback Holding Above 50d MA; 3rd Decile Earnings Estimate Revisions
- Internet Retail Group is 1st Decile

**Figure 4: HCA Price Trend**

- Breaking out of an 8Mo Consolidation Pattern; CDS level is high at 300bps, but is below a falling 50d MA

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
Small Caps 3: Earnings Growth Trumps Value, Yield

- For Small Caps it is earnings growth that's working as an overweight strategy, value is not working at all, and yield is working as a good underweight strategy. Looking at “severed trends”, we see a push against value and more bottom fishing in earnings, or yield themes, than in value – Figure 1.

- We ran three small cap universes against three benchmarks – see this link for all profiles.
  - Our earnings-focused filter is: top 3 earnings estimate revision deciles, positive earnings yield, and IBES long-term earnings growth estimate exceeding 10%.
  - Our value-focused filter is: top 3 value deciles (earnings yield, cash flow yield, book value/price), and positive earnings and cash flow yields.
  - Our yield-focused filter was: top 3 dividend deciles (a combination of yield and dividend growth) and dividend yield greater than 2%.

- We highlight the earnings driven Canadian outperformers in Figure 2, and the North American listed momentum buy list (outperforming but not overbought) in Figure 3.
Small Cap Outperformers Part 2 - Global

- Yesterday, we highlighted the trends on small cap indices, with the bottom line being that they are outperforming large caps.
- We cover over 2,600 members of the MSCI ACWI Small Cap index.
  - 952 of them are in outperforming trends against the small cap index and their sector.
  - 946 of these outperformers are in dividend-adjusted price uptrends.
- 52 of this list are Outperform rated by a BMO Fundamental analyst – Figure 1 (click link for the full list).

Figure 1: ACWI Small Cap Index Members Outperforming the Market and the Sector That Are BMO Outperform Rated

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Name</th>
<th>Sub Industry</th>
<th>Grp</th>
<th>RS</th>
<th>LT</th>
<th>RS</th>
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<th>1-Day Equity Chg (%)</th>
<th>MktCap (US$)</th>
<th>Chg Last Day</th>
<th>ACWI Sml</th>
<th>Trend Slope</th>
<th>RS HI (Mo)</th>
<th>RS LO (Mo)</th>
<th>BS Band Width</th>
<th>BMO Rank</th>
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<td>88%</td>
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Source: BMO Capital Markets, Bloomberg, Thomson, Markit
*Note: BMO Capital Markets is restricted on Pandora Media Inc.
Small Caps Are Outperforming Part 1 - Canada

- Small caps are outperforming.
- The Russell 2000 is trending higher at a rate of 30%/year while the S&P 500 trends higher at 23%/year. As a ratio, the Russell is beating the 500 by a 7% margin – Figure 1.
- Outside of the US, the MSCI World ex US Small Cap index is outperforming the MSCI World ex US at a rate of 6%/year.
- It’s not yet a trend, but even the CDN S&P/TSX Smal Cap Index is gaining a footing relative to the Composite – Figure 2.
  - In Canada, small cap managers care more about beating their peers than the resource-heavy small cap index, so we highlight the momentum buy list of 44 stocks in the Small Cap index using dividend-adjusted price trends (as opposed to relative strength trends) – Figure 3.

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
Material Weakness

- When we look at the breadth of the market, we see strength in Industrials, Consumer Discretionary and Technology sectors. This grouping is not surprising. The odd pairing is weakness of rate-sensitive utilities with rate-sensitive materials. Utilities are being punished as rates rise, which is generally when materials are desired, so seeing these two sectors side by side is unique.

- Utilities continue to slide, as long rates rise, and bond prices fall – Figure 2. We do not expect a change until we see more green on the screen in bond land, and until this is the case; the negative trend is your friend (avoid/underweight).

- Materials, however, while negative, are not nearly as negative as they stood mid-year. The last time this group garnered a positive breadth reading, inflation expectations were above 3% - Fig 3, 4. Currently, inflation expectations continue to trend lower, so while materials are off of their lows, the trend which is still your friend is toward underperformance. We highlight the USD trends on developed market momentum sells in the material sector in Figure 5.

Figure 1: Sector Heat Map From Our Group Selection Report

Figure 2: Price Trend on U.S. 7- to 10-Yr Bond ETF (IEF)

Figure 3: Materials Relative Strength Z-Score

Figure 4: US 5y-5y Forward Inflation Expectations

Figure 5: USD Adjusted Price Trends on Developed Market Momentum Sells – CLICK Here for Complete List

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
Client Check-Up

- Collectively, you (Asset Managers) are losing steam, dropping from a first decile ranking at the start of the year to a neutral ranking in August, but yesterday you just slipped to an 8th decile position.
- What you can notice in the decile history is that our ranking of asset managers can swing back and forth four deciles rather quickly. This speaks to the non-homogenous nature of the group.
- Given both the seemingly collective weakness and taking into account the volatility of the reading, we are going to split asset managers into a few groups, first converting all of your price trends into U.S. dollars to make an apples-to-apples comparison, free of currency swings.
  - Starting on a positive note, we highlight the momentum buys. You know what you are doing right – Figure 2.
  - Moving toward the “check up needed” group, there are four of you that are breaking below price uptrends. We always say that our system asks the question here – why the trend, why the breakdown, which is the key going forward?
  - Finally, there are those of you that are in price downtrends. Given that some of you may be compensated in such currencies, we can hear you saying from here “I know, I know.”

**Figure 1: Asset Management & Custody Banks RS Decile**

Swings Can Be Wide Speaking to the Non-Homogenous Nature of the Sub Industry, However...

...Collectively, you are Just Entering a Bottom Tier Decile

**Figure 2: Asset Managers – USD Price Trend Momentum Buys**

Momentum Buys = In Consistent Uptrends, Above Rising Moving Averages and Not Overbought

**Figure 3: Asset Managers Breaking Below USD Dividend-Adjusted Price Uptrends**

**Figure 4: Asset Managers in USD Dividend-Adjusted Price Downtrends – Click Here for Complete List**

Source: BMO Capital Markets, Bloomberg, Thomson, Markit

BMO Capital Markets is restricted on Fiera Capital (FSZ)
Industrials Getting Back Their Mojo

- Industrials started the year in a very illustrious position in our Group Selection Report. They then plunged back to neutral territory as global rates retreated between late March and early May. Rates started to surge again in May, but this has largely been priced as loss of stimulus (tapering) as opposed to positive economic signaling. The last week has been different.
  - Our gauge of industrial breadth is breaking out of the neutral zone – Figure 1.
  - Every global industrial industry sports a positive 1- and 5-day relative strength rate of change – Figure 2.

- The largest positive 5d move has been in Airlines, where our relative strength ranking also started the year at an illustrious position. The group slumped with industrials, but more so, down to a 10th decile. It has just rebounded sharply back to a neutral 6th decile position.
  - USD price trends on 35 Airline stocks are found here.
  - The most consistent uptrend can be found in Delta.
  - In Canada, WestJet is breaking out of a consolidation pattern – Figure 3.

- One industrial subindustry that followed a similar pattern, yet only retreated back to a 5th decile ranking, and now stands as 1st decile is Human Resource & Employment Services.
  - USD price trends on 22 H&R stocks are found here.
  - One momentum buy, which currently offers a nice opportunity to buy on a pullback is TrueBlue – Figure 4.

Figure 1: Industrial Relative Strength z-Score

Figure 2: Global Industrial Industries vs. MSCI World

Figure 3: WestJet Airlines DVD Adjusted Price Trend

Figure 4: TrueBlue Inc DVD Adjusted Price Trend
Moving Earthly Stuff

• There are 28 sizable marine stocks out there and collectively they have moved to a positive decile position. There are profits to be made shipping stuff around – Figure 1.
  - Many marine stocks saw volume spikes yesterday, and they are moving above the top end of their price channels – Figure 3.

• Earlier in the chain, there are companies that provide the equipment to dig and move stuff off of the earth. Collectively, they have moved to the top end of a neutral reading in our Group Selection Report – Figure 2.

• Shorts should be covered, and a market weighted-stance taken. Picking two very different stocks from the construction equipment group:
  - Alamo is a momentum buy, with an outperformance pattern – Fig 4
  - Joy Global just broke above its downtrend. Shorts should cover, and longs should consider the double bottom potential – Figure 5.

Figure 1: Marine Relative Strength Decile

Figure 3: USD Price Trends on Marine Stocks

Figure 4: Alamo Group Dividend-Adjusted Price Trend

Figure 5: Joy Global Dividend-Adjusted Price Trend

Breaking Above Downtrends, or Above The Top of Uptrends
Note all the Volume Spikes Yesterday

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
Energy Transports to Sell

On Friday we mentioned that interest-sensitive energy transports should be sold to make room to buy energy service stocks. The breadth of the group has faded from the top deciles, to the mid deciles (currently ranked 6th), and when we look at the price trends, we note the spectrum is shifting to the right (downtrends) as more stocks break down (shaded red) – Figure 1.

There are two types of shares to sell (short):
- Stocks in uptrends that are breaking down. These are the shares under the green wedges which are shaded red in Figure 1. The steepest uptrend breaking is Martin Midstream Partners – Figure 2.
- Stocks in established downtrends, such as Petronet LNG and Gibson Energy – Figure 3.

As More Stocks Break Down, Spectrum Is Shifting Towards Downtrends
Tighten Up

- In May and June, markets started a new dance called the Tighten Up.
  - 1st tighten up on the long end of the U.S. treasury curve – Figure 1.
  - 2nd tighten up the Chinese interbank lending curve – Figure 2.
  - 3rd tighten up on the short end of the U.S. treasury curve – Figure 3.

Sock it to me now
Tighten it up
Archie Bell & The Drells

- A tipping point has been reached. The central bankers’ bank (BIS) now deems that (1) there has been enough stimulus provided to the global economy, (2) more cannot be done without compounding risks that central banks have already created, and (3) easing has led to the delay of structural reforms (BIS Annual Report June 23, 2013).
- After a period of unprecedented central bank easing, and ultra low interest rate volatility, markets are adjusting to now rather rapid tightening and escalating volatility.
  - The known unknown is that when interest rates move from low and highly certain, to high and highly uncertain, that carry trades blow up. This was Long-Term Capital Management, this was Carlyle Capital Corporation, and this is the known unknown that markets are routing out now.
- Our goal over the next few pages is to detail these stresses, which we believe are still at very early stages. We expect global equity weakness to persist over the near term.

Figure 1: U.S., German, and Japanese 10-Year Bond Yields (Top) and Implied Volatility (Bottom)

Figure 2: Chinese Interbank Lending Rates

Figure 3: Odds of a ’14 Fed Rate Hike From Fed Funds Futures

Source: BMO Capital Markets, Bloomberg, Thomson, Markit
FOMC: Early Withdrawal? Really?

- There has been a change in the calculus of the FED this year. In BIS terms, “Delivering further extraordinary monetary stimulus is becoming increasingly perilous”.
  - U.S. inflation expectations just started to ease leading into the FOMC minutes release in February.
  - On February 20 we learned that the FED was concerned about its open ended QE policy.
    - This was also the start of the market's fascination with the term “tapering” which has been written about 150 times per day, on average, in the month of June (“NT Tapering” on Bloomberg).
  - Inflation expectations really started falling after Cypriot debt resolution uncertainty came to bear on March 18.
    - One month later, inflation expectations were breaking down globally.
  - While inflation expectations were falling, asset price inflation was picking up. This is obviously not the inflation that the fed targets, but it was the destination that the market was targeting for QE related flows.
  - Would outgoing Bernanke go down as the FED who stoked asset price inflation? – Figure 4.
    - On May 22 Bernanke and the FOMC told the market that QE could be stepped down as early as June.
    - On June 19 Bernanke delivered the withdrawal schedule verbally.
    - Asset price inflation is no longer a problem.
  - Asset price deflation in our clients’ portfolios is our key interest now.

---

Figure 4: US Inflation Expectations (10-Year Breakeven Rate) Top; FTSE Global REIT Index (TENHGU) Bottom
PBOC: Money Not in the Right Places

- While it may seem to be a stretch to jump from looking at inflation expectations at the long end of the U.S. curve, to the stresses at the ultra short end of the Chinese credit curve, it is not.
  - The combination of low U.S. interest rates, and interest rate volatility encouraged flows into emerging markets with higher-yielding assets.
  - The FOMC, whose policy underpins the world’s largest and most liquid bond market becomes the central banker to the world via the carry trade.
    - $3.9 trillion had flowed into emerging markets over the past four years.
- It is a mistake to apply market western policy thinking to policy action of the new People's Republic of China government, and the PBOC.
  - Rather than releasing stimulus in response to weak economic figures, which was the point where the Chinese sovereign CDS broke to the upside (Figure 5), China has done the opposite, has withheld stimulus, and has allowed banking stress to build – Figure 2.
  - China is getting it’s plumbing in order by reigning in the shadow banking system, which it needs to get under control such that it can have a handle on its financial system. During this plumbing exercise,
    - Chinese bank CDS levels are soaring – Figure 6.
    - Chinese Real Estate CDS levels are soaring – Figure 7.
- We are sure that the Minsky Moment for many shadowy players in the Chinese financial system is upon them now, but to call this the Lehman moment for China as a whole is premature. Possible, but premature – Figure 8.
  - China has breathing room to tighten up, and so it is.
  - Global growth oriented resource countries such as Canada should continue to be underweighted.

---

**Figure 5: Chinese Sovereign CDS**

![Chart of Chinese Sovereign CDS](image1)

**Figure 6: Chinese Bank 5Yr CDS**

![Chart of Chinese Bank 5Yr CDS](image2)

**Figure 7: Chinese Real Estate CDS**

![Chart of Chinese Real Estate CDS](image3)

**Figure 8: Chinese Sovereign CDS Levels and Curve**

![Chart of Chinese Sovereign CDS Levels and Curve](image4)
BIS: Borrowed Time

The tone of the BIS annual report released Sunday shows central banking thinking turning from carrot to stick:

What central bank accommodation has done during the recovery is to borrow time...But the time has not been well used

The short end of the U.S. curve is tightening up.
- The FED's assessment, disclosed last Wednesday, was to bring the time of a rate hike forward by two months.
- Fed funds futures on Friday signaled a greater than 50% probability of a FED rate hike next year – Figure 3.

Nowhere does time seem to be more borrowed than in the European periphery where bonds received a massive ECB (Draghi) induced grace period. It seems that European policy makers could use the stick to un-jam the process that calm has created.
- The stick is coming:
  - The Spanish sovereign CDS, like many others, has broken to the upside – Figure 9.
  - A peripheral European banks CDS basket is basing and should soon mint a higher high– Figure 10.
  - Italian-German and Spanish-German stress and spreads are just now starting to turn up again – Figure 11.
  - The Italian bank UniCredit remains the SIFI with the most inverted curve – Figures 12, 13.
SIFI: Stresses Rising

- The cost to protect systemically important financial institutions (SIFI) is rising – Figure 13.
  - Where the trends were showing improvement in creditworthiness (green wedges), the trends have broken (red arrows).
  - Our systems’ best fit for most European SIFI CDS trends is towards widening (red wedges).
- Debt protection costs at the short end of the curve (1yr) debt is rising faster than the long end of the curve (5yr).
  - Our SIFI CDS trend list below is sorted by this ratio (CDS Curve 1/5Yr).
  - No curve is even close to being over 100% (LEH-like), but it is interesting (and unflattering) to see Asia-centric HSBC line up close to UniCredit (top two lines in Figure 13).

Figure 13: CDS Trends on Too-Interconnected to Fail Banks

<table>
<thead>
<tr>
<th>Name</th>
<th>1-day Equity Chg (%)</th>
<th>5-day Equity Chg (%)</th>
<th>MktCap (US$)</th>
<th>Chg Last Day</th>
<th>Trend Slope</th>
<th>CDS Hi (Mo)</th>
<th>CDS Low (Mo)</th>
<th>CDS Curve 1/5Yr</th>
<th>CDS % Chg wrt 50 DMA</th>
<th>Chg wrt 50 Day MA Trend</th>
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<tr>
<td>UniCredit SpA</td>
<td>-4.1%</td>
<td>-7.2%</td>
<td>27,666</td>
<td></td>
<td></td>
<td>-13%</td>
<td>2.5</td>
<td>0.58</td>
<td>22%</td>
<td>Above Rising</td>
</tr>
<tr>
<td>HSBC Holdings PLC</td>
<td>-0.1%</td>
<td>-3.6%</td>
<td>191,403</td>
<td></td>
<td></td>
<td>-30%</td>
<td>7.5</td>
<td>0.51</td>
<td>32%</td>
<td>Above Rising</td>
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<tr>
<td>ING Groep NV</td>
<td>-2.1%</td>
<td>-3.1%</td>
<td>33,509</td>
<td>°</td>
<td></td>
<td>-45%</td>
<td>2.0</td>
<td>0.49</td>
<td>9%</td>
<td>Above Falling</td>
</tr>
<tr>
<td>Banco Santander SA</td>
<td>-1.2%</td>
<td>-6.9%</td>
<td>69,239</td>
<td>°</td>
<td></td>
<td>-42%</td>
<td>2.5</td>
<td>0.47</td>
<td>24%</td>
<td>Above Rising</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>-1.0%</td>
<td>-3.6%</td>
<td>48,825</td>
<td>°</td>
<td></td>
<td>-60%</td>
<td>5.5</td>
<td>0.46</td>
<td>35%</td>
<td>Above Rising</td>
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<td>Royal Bank of Scotland Group Plc</td>
<td>-5.1%</td>
<td>-10.3%</td>
<td>27,112</td>
<td></td>
<td></td>
<td>-10%</td>
<td>9.5</td>
<td>0.46</td>
<td>43%</td>
<td>Above Rising</td>
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<tr>
<td>Barclays PLC</td>
<td>-0.8%</td>
<td>-5.3%</td>
<td>56,350</td>
<td>°</td>
<td></td>
<td>3%</td>
<td>7.0</td>
<td>0.44</td>
<td>22%</td>
<td>Above Rising</td>
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<tr>
<td>Goldman Sachs Group Inc</td>
<td>-0.7%</td>
<td>-5.3%</td>
<td>70,724</td>
<td>°</td>
<td></td>
<td>-49%</td>
<td>6.5</td>
<td>0.42</td>
<td>39%</td>
<td>Above Rising</td>
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<tr>
<td>Credit Suisse Group</td>
<td>-1.2%</td>
<td>-5.3%</td>
<td>42,253</td>
<td>°</td>
<td></td>
<td>50%</td>
<td>7.0</td>
<td>0.38</td>
<td>20%</td>
<td>Above Rising</td>
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<td>Bank of America Corp</td>
<td>-1.6%</td>
<td>-2.9%</td>
<td>136,803</td>
<td>°</td>
<td></td>
<td>-47%</td>
<td>6.5</td>
<td>0.36</td>
<td>28%</td>
<td>Above Rising</td>
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<td>Commerzbank AG</td>
<td>-2.3%</td>
<td>-1.8%</td>
<td>10,873</td>
<td>°</td>
<td></td>
<td>35%</td>
<td>3.0</td>
<td>0.36</td>
<td>14%</td>
<td>Above Rising</td>
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<tr>
<td>Credit Agricole SA</td>
<td>-2.3%</td>
<td>-6.0%</td>
<td>21,255</td>
<td>°</td>
<td></td>
<td>5%</td>
<td>2.0</td>
<td>0.35</td>
<td>15%</td>
<td>Above Rising</td>
</tr>
<tr>
<td>UBS AG</td>
<td>-1.5%</td>
<td>-4.7%</td>
<td>64,921</td>
<td>°</td>
<td></td>
<td>11%</td>
<td>6.5</td>
<td>0.35</td>
<td>23%</td>
<td>Above Rising</td>
</tr>
<tr>
<td>Deutsche Bank AG</td>
<td>0.6%</td>
<td>-4.2%</td>
<td>44,674</td>
<td>°</td>
<td></td>
<td>27%</td>
<td>2.5</td>
<td>0.35</td>
<td>19%</td>
<td>Above Rising</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>-2.6%</td>
<td>-5.9%</td>
<td>66,362</td>
<td>°</td>
<td></td>
<td>-26%</td>
<td>2.5</td>
<td>0.35</td>
<td>18%</td>
<td>Above Rising</td>
</tr>
<tr>
<td>JPMorgan Chase &amp; Co</td>
<td>-1.0%</td>
<td>-2.2%</td>
<td>196,392</td>
<td>°</td>
<td></td>
<td>-2%</td>
<td>6.5</td>
<td>0.34</td>
<td>18%</td>
<td>Above Rising</td>
</tr>
<tr>
<td>Citigroup Inc</td>
<td>-2.2%</td>
<td>-4.8%</td>
<td>142,620</td>
<td>°</td>
<td></td>
<td>-55%</td>
<td>5.5</td>
<td>0.33</td>
<td>31%</td>
<td>Above Rising</td>
</tr>
<tr>
<td>Societe Generale</td>
<td>-2.1%</td>
<td>-5.6%</td>
<td>27,619</td>
<td>°</td>
<td></td>
<td>-16%</td>
<td>2.0</td>
<td>0.32</td>
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<td>Above Rising</td>
</tr>
<tr>
<td>Wells Fargo &amp; Co</td>
<td>2.2%</td>
<td>2.8%</td>
<td>216,940</td>
<td>°</td>
<td></td>
<td>-29%</td>
<td>0.29</td>
<td>12%</td>
<td>13%</td>
<td>Above Rising</td>
</tr>
</tbody>
</table>
US Equities: Last Dot Finally Connected, Picture Now Emerging

- The stress in the banking system is just starting to be felt in the U.S. equity market – Figure 14.
  - The breakout in the cost to protect the US Banks against default last Thursday coincided with the breakdown in the S&P 500.
- The U.S. 2-year swap spread, a gauge of counterparty risk, has just started to get in the game – Figure 15.
  - It is still incredibly low – Figure 16, but will move higher with continued stress in the banking system.
  - When stresses are high enough, one can watch this counterparty risk move with S&P futures tick for tick.
  - We have not seen this yet, but are expecting it. When we see it, we will be closer to an equity bottom.
- The known unknown is that when interest rates move from low and highly certain to high and highly uncertain that carry trades blow up.
  - This is the precursor to LTCM, to CCC, and to the known unknown of 2013.
    - When this unknown is known, we believe equities will be lining up for a bottom.
Misplaced FED Optimism & Market Risk

- “Yes, rates have come up some. That’s in part due to more optimism, I think, about the economy. It’s in part due to perceptions of the Federal Reserve” - Fed Chairman Ben Bernanke during yesterday’s Q&A.

- Of the backup in treasury yields, and the associated destruction of “risk on” carry trades, we know that,
  - Very little of the backup in treasury yields increase came from optimism (albeit stronger-than-expected U.S. payroll data on May 3 marked the bottom for treasury yields) – Figure 1
    - Much more comes from perceptions of the FED, which includes the May 22 bomb and yesterday’s “...it would be appropriate to moderate the monthly pace of purchases later this year...ending purchases around mid-year (next year)”
    - And more still came from yen carry trade (PRDC) related unwind pressure.

- Misplaced optimism, by the world’s central banker, on why treasury yields are rising is causing,
  - another leg up in yields and volatility – Figure 1; and
  - continued collapse of “risk on” carry trades of many descriptions – Figures 2, 3.

- Another notable Bernanke line yesterday was “…as we try to land the ship on a...you know, on a ...in a smooth...in a smooth way into the ...on to the aircraft carrier.” Communication gap? There is a scene from Apocalypse Now, when the ship drops in a harsh way into the ocean. It ends with “I love the smell of napalm in the morning”.

Figure 1: US Treasuries Tighten Global Markets via Higher Yields and Higher Volatility

**Source:** BMO Capital Markets, Bloomberg, Thomson, Markit
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<th>Rating Category</th>
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<th>BMOCM US IB Clients**</th>
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<td>Underperform</td>
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