

TSX Earnings: Not a Bad Quarter, Stripping Out the Insurers

Peter Buchanan

Equity investors stateside have been accused of fiddling while Rome burns, as recession worries re-emerge. But the S&P 500's limited reaction to some decidedly unpleasant economic news isn't altogether surprising given Q2's feisty 38% year-on-year rise in earnings. The TSX earnings recovery has been tamer, never having fallen as steeply in the recession. But a closer examination of Q2's flat year-on-year headline still shows hidden strength. Lower yields and stock prices sliced over \$4 billion from insurers' bottom lines. Net of that hit, that could be reversed if volatile markets change course, earnings are on track for a 26% rise in the year, not much different from Q1's decent pace (Chart 1).

View from Boardrooms Turning More Cautious

Economic disappointments clearly haven't, so far, stood in the way of good earnings news. But the gap between boardroom and Main Street sentiment may be starting to narrow. Negative-to-positive earnings guidance for the S&P 500 for Q3 has been running at an above average 2.3-to-1 so far. That's a departure from the earlier overtly positive pattern, and may signal an end to the string of better-than-expected earnings reporting seasons that fueled the market's ascent from its March 2009 lows. Forward earnings expectations for the TSX are still fairly healthy, with the bottom-up analysts' consensus looking for increases of around 15% this year and over 20%

next. But the decline in the number of firms raising dividends so far in Q3 compared with pattern of recent quarters is a potential sign that corporations, like their US counterparts, are becoming more cautious. Q2's dip in revenue growth also suggests a need for prudence on the outlook.

Past is prologue and the latest harvest of TSX reports show the mining and fertilizer/chemicals-dominated materials group continuing to drive the earnings recovery. Although prices for a number of resource products softened on growth jitters and the housing credit's expiry hammered lumber, earnings still managed to record an impressive 89% gain on the year in Q2, only modestly softer than the preceding quarter's triple-digit tempo (Table 1). De-hedging has amplified the gold group's sensitivity to underlying price movements, a key plus given debt-related haven demand. Gains in the group, combined with the positive impact of firmer volumes and prices on the potash/chemical group, accounted for about two-thirds of the year on year dollar rise in the material sector's profitability. While a measurable downshift in global growth could present risks for some industrial commodities next year, hopes for an "inflection point" in the potash market has drawn investment to that sector.

Chart 1

TSX Earnings, Total and Ex Insurance

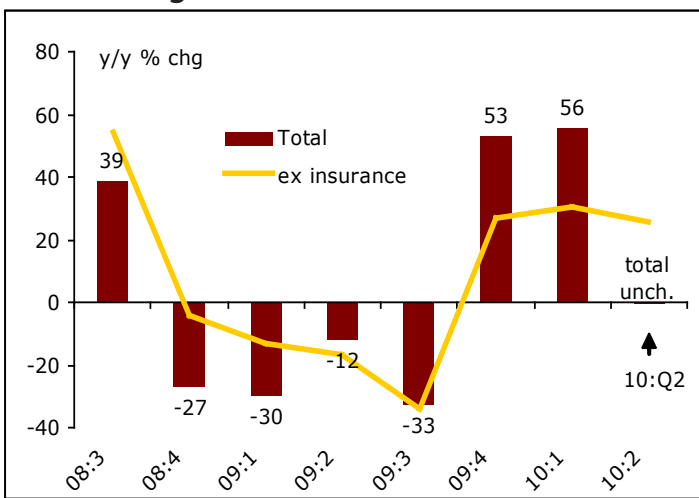


Table 1

Operating Earnings, TSX Composite vs S&P 500			
	TSX Composite		S&P 500
yr/yr % change	2010:Q1	2010:Q2	2010:Q2
Energy	24.0	24.7	93
Materials	139.3	88.6	97
Industrials	10.0	16.2	27
Consumer Discretionary	70.1	53.2	66
Consumer Staples	17.5	15.5	7
Health Care	-8.0	27.6	14
Financials	83.2	-42.7	37
Info Tech	35.0	33.6	66
Telecom Svcs	11.2	21.7	2
Utilities	149.0	30.7	4
All Sectors	55.6	-0.4	28
-less insurance	30.5	25.6	

Note: May, Jun or Jul quarter end

Source: CIBC, Thomson Reuters

Canada's job recovery has shown some light and fire recently, in contrast to the US. Stronger outlays at domestic retailers and gains in both the media and auto parts sectors, reflecting supportive developments at home and abroad, bolstered earnings in the consumer discretionary group. Helped by an easy comparison to a weak prior year, earnings in that sector advanced by 53%, the second best performance of any market group. While the higher C\$ is a negative for a range of industries, it aids others, including many retailers, who benefit from lower input costs. That may also be reinforcing the sector's performance.

Earnings Growth Stronger in TSX Telecoms, Health, Utilities Segments

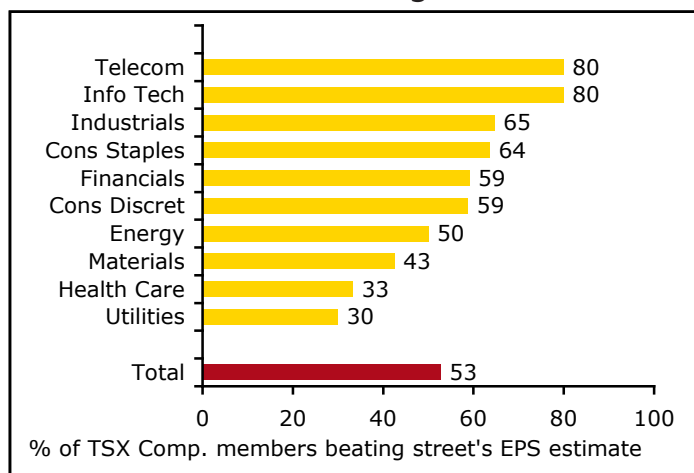
On a north-south basis, TSX showed greater earnings momentum than the S&P in four market groups (Table 1). Canadian telecoms did particularly well in comparative terms. Decent subscriber growth numbers allayed, for now, fears of heightened competition from new market entrants. The over-20% rise in earnings in that sector contrasted with a flat quarter for the major carriers stateside. Cell and other services are increasingly a "must have", making the sector a potential defensive play. A higher dollar also cuts imported equipment costs. The TSX health and utilities sectors, meanwhile, outpointed earnings growth stateside, the latter benefiting from improved power margins. The oil and gas sector, in contrast, lagged momentum stateside. Soft natural gas prices partly offset a solid 87% rise in profitability in the integrated sector, including the major oil sands producers.

Profit Margins Hold Up, Revenue Growth Decelerates

Benchmarked to analysts' consensus, the latest crop of TSX results beat the street's expectations in 53% of all cases. On a comparative basis, the telecom and info tech sectors once again did well, with four-fifths of firms in those sectors surpassing the consensus. Two-thirds of industrial and consumer staples firms also surprised to the upside (Chart 2). While the beat rate was lower than the 75% recorded for the S&P 500, that did not stop the TSX index from registering modestly stronger performance during the reporting period. One reason is that beats or misses on the earnings and revenue side are not punished or rewarded as decisively in Canada as in the US (Chart 3). With less material consequences, firms arguably have less incentive for guiding expectations precisely.

Chart 2

Telecoms, Info Tech Had Highest Beat Rate



Looking at the two key drivers of earnings performance, profit margins for TSX companies continued to hold up well in Q2. The evidence suggests, in fact, that TSX stocks have done a bit better than S&P members in that regard in recent years, despite widespread concerns over Canada's uninspiring productivity track record (Chart 4). Revenue growth, however, slowed sharply to a 3% pace on the year (Chart 5). The higher C\$ and flatter recent trend in resource prices likely contributed to the deceleration. Alongside more difficult year-on-year comparisons as the recovery matures, that's a reason to look for softer earnings growth in coming quarters.

Chart 3

Consequences of Missing or Beating Street Larger Stateside

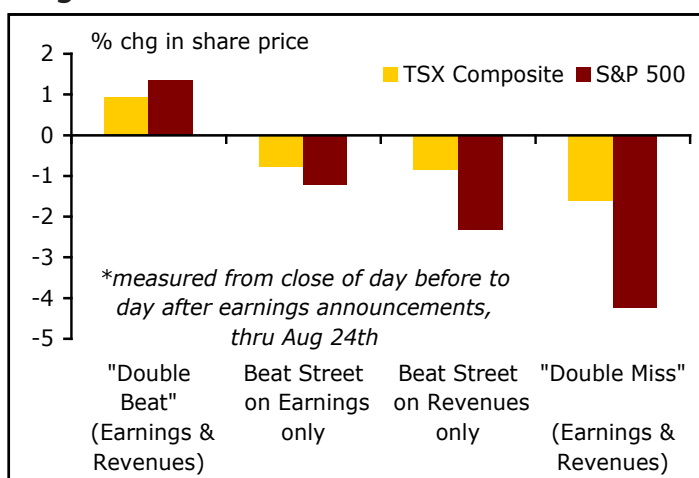


Chart 4
Profit Margins Hold Up

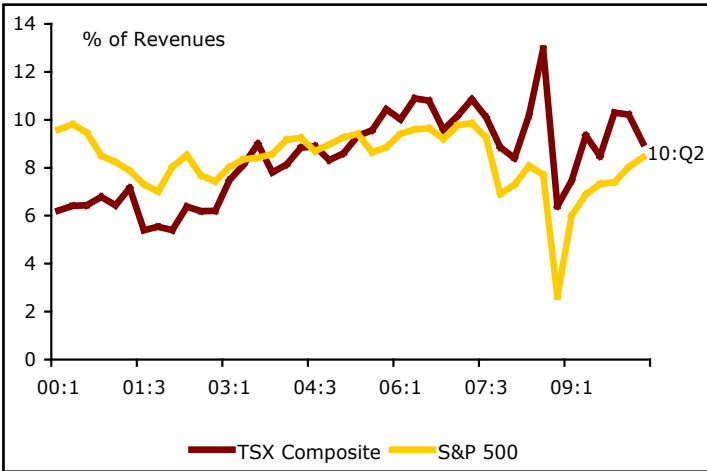
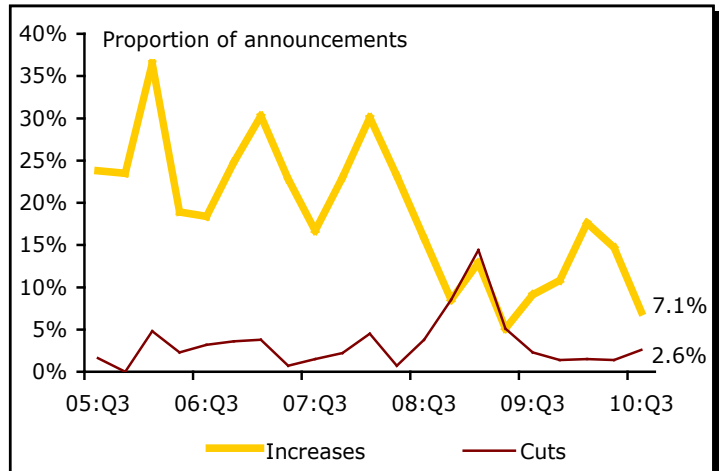


Chart 6
Caution on the TSX Dividend Front



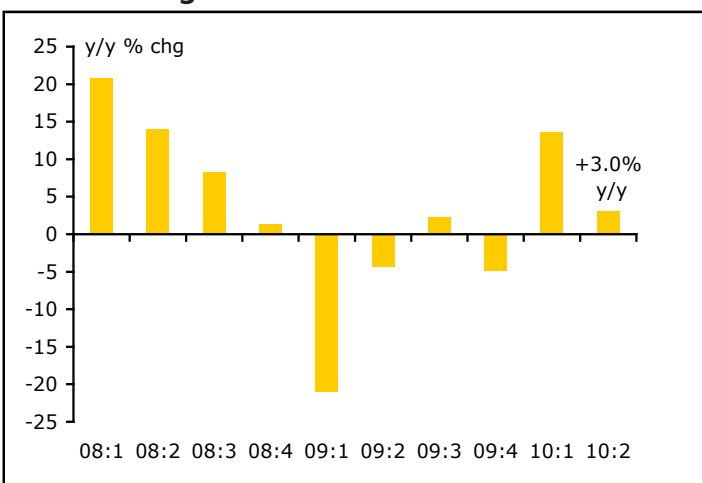
Source: CIBC, Bloomberg

Corporations Somewhat Cautious About Distributing Excess Cash

As in the US, rising cash from operations and still-constrained capital spending levels have combined to put upward pressure on corporate cash holdings. Earlier in the year, we estimated that corporate cash holdings were about 20% heavier than normal relative to sales, a difference equal to \$45 billion. Not surprisingly in view of current uncertainties, corporations appear to be showing some caution these days on how much of that money to give shareholders immediately. The proportion of dividend announcements setting higher rates climbed

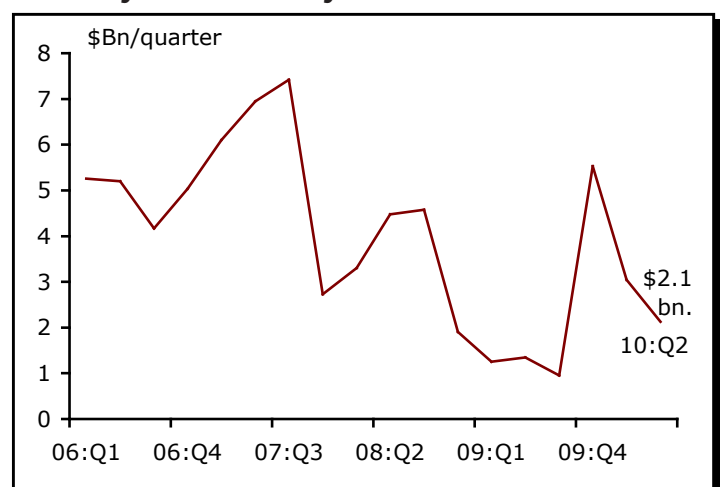
from the recession's end to a high of 18% late last year (Chart 6), but has eased modestly since. That pattern suggests firms for now are inclined to hold onto some of their excess cash as a hedge against uncertainty. Buybacks are sometimes favoured as a method of funnelling excess cash to shareholders, especially in cloudy economic times, since they do not involve the same commitment to maintaining a steady payout. Activity on that front has also eased in recent quarters (Chart 7).

Chart 5
Higher Loonie, Softer Resource Prices
Constraining TSX Revenue Growth



Source: CIBC, Bloomberg

Chart 7
TSX Buy Back Activity Eases



Source: CIBC, Bloomberg