



The TSX Earnings Recession Ends with a Bounce

by Peter Buchanan

Economics

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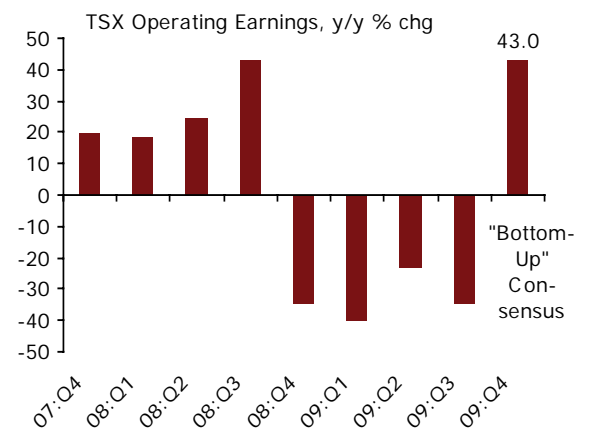
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Last year was the best in nearly three decades for Canadian stocks. How much of that momentum may carry over into 2010 will become clearer this week as the TSX Q4 reporting season shifts into full gear. With forward PEs not much different than the longer term average, any further upside for the TSX from here will depend heavily on prospective earnings growth. As usual, the rails will be near the front of the parade, followed by the oils, consumer staples and telecom firms (Chart 1).

As in the US, the forthcoming reports will mark the end of the earnings recession, after four down quarters. "Bottom-up" expectations are for an increase of 43% in TSX operating earnings on the year (Chart 2). That's the first positive print since 08:Q3 and compares with an expected 189% increase

Chart 2

TSX Earnings Recession Ends



Source; Thomson Reuters, CIBC

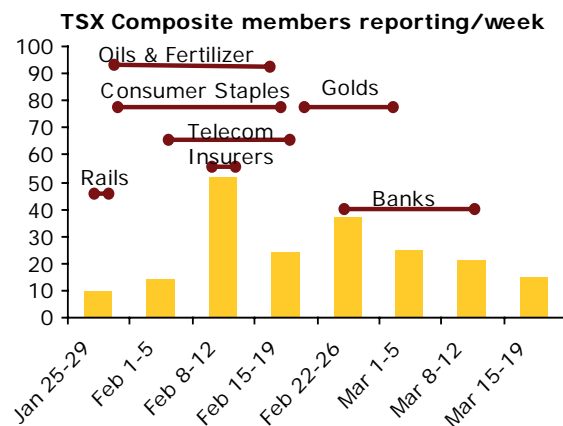
for S&P 500 stocks. The gain for the TSX looks like a tough wall to climb, but will in fact benefit hugely from an easy comparison with a year earlier, when both the Canadian and global economies sank into recession, dragging commodity prices and profits down. In sequential terms, TSX earnings will have to rise by only 5-6% from the previous quarter to meet expectations.

Insurers, Mining Sector Expected to Drive Q4 Earnings Growth

Performance in two TSX segments in particular is expected to show striking year-to-year improvement (Chart 3). Insurers lost over \$1 billion in the year-earlier quarter as a result of adjustments on segregated funds and some of their other assets and liabilities.

Chart 1

Upcoming Q4* TSX Reporting Season

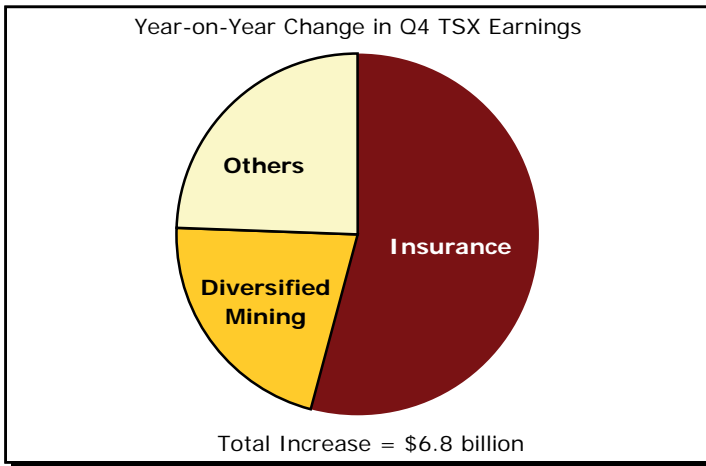


* reporting period ending Nov, Dec or Jan

<http://research.cibcwm.com/res/Eco/EcoResearch.html>

Chart 3

Better Results From Insurers, Metal Miners to Drive Q4 Results



That sector is expected to see a well-over \$3 billion positive swing in profitability. The diversified mining group, meanwhile, is expected to see a \$1.5 billion improvement on a year earlier, aided by the strong metals-led rally in commodity prices. Based on the street’s latest estimates, gains in those two segments will account for about three quarters of the total year-on-year rise in earnings.

Earnings in seven of ten major TSX market sectors are expected to show improvement on the year (Table 1).

Table 1

Expectations for Q4 Earnings

yr/yr % change	TSX Composite			S&P 500
	2009:Q3	2009:Q4	2009	2009:Q4
	<i>Actual</i>	<i>Consensus</i>	<i>Consensus</i>	<i>Consensus</i>
Cons. Discr.	-19.4	-2.7	-18.3	67.4
Cons. Staples	11.9	7.6	12.2	3.6
Energy	-68.3	-3.6	-49.9	-29.1
-E&P Firms	-68.8	-32.5	-57.1	19.8
Financials	-4.4	101.5	2.2	NM
-Banks	13.8	-2.9	2.6	NM
-Insurance	-24.8	NM	-1.3	NM
Health Care	-11.8	105.0	13.8	-7.3
Industrials	-10.0	-18.1	-22.3	-12.7
Info Tech	15.5	23.7	19.7	32.4
Materials	-48.6	4015.4	-27.9	136.9
-Gold	12.8	13.1	7.0	205.0
-Diversified Mining	-21.8	NM	-0.7	NM
-Chemicals	-83.6	-66.4	-72.6	99.8
Telecom	16.4	5.6	7.6	-70.2
Utilities	-154.2	58.6	160.5	-15.4
Total, All Sectors	-34.4	43.0	-26.0	188.5

NA=not available

NM=not meaningful, -ve yr ago

Next to the two areas identified above, health care, info tech and utilities stocks are expected to show the largest increases. Gains by gold and base metals producers should help to lift earnings in the materials sector despite the drag on the chemicals industry from softer fertilizer prices. Overall, TSX earnings are expected to show greater momentum than the S&P 500 in six major sectors, including energy, trailing in four others. A 43% rise in fourth quarter earnings would nevertheless translate into a 26% drop for the year as a whole. That’s a sizeable setback, although still better than the 80% decline in earnings in the early 1990s recession, when commodity prices plumbed even greater depths.

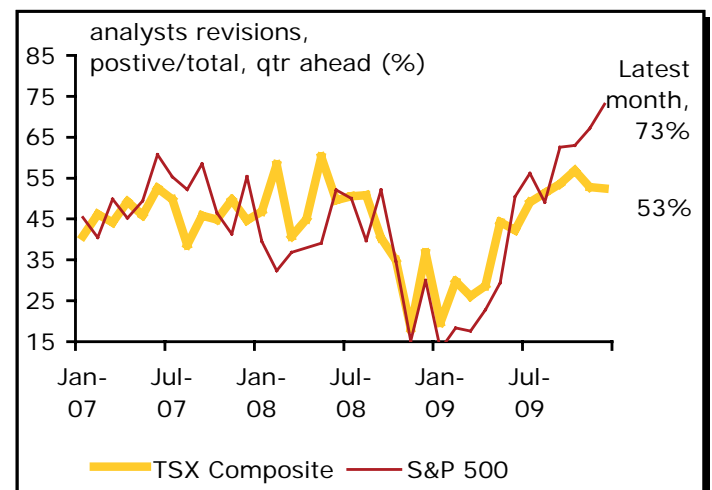
Analysts on both sides of the border have been ratcheting up their near-term expectations for earnings, in response to improvements in the economy and commodity prices. In Canada, positive revisions have accounted for 53% of all revisions for the quarter ahead recently, compared to a normal ratio of 42%. South of the border the ratio is an even loftier 73%. That suggests more of the positive news may already be priced into stock valuations than a few quarters ago, limiting the potential for stocks to rally strongly on the upcoming reports (Chart 4).

Revenues in Some Sectors Should Do Well Despite Difficult Environment

Revenue growth has and continues to be a prime concern on both sides of the border. Canada’s inflation rate cooled to 1.3% in the 12-months through December.

Chart 4

Less Room for Upside Surprises Than in Quarters Past?



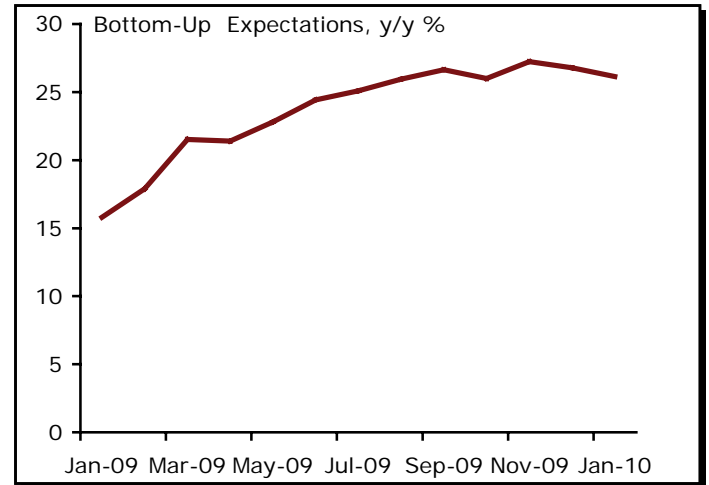
Source: Thomson Reuters, CIBC

That suggests a lack of pricing power, and by extension revenue performance, remains a concern for some firms. Steep job cuts, especially in the US, have led to fears that recent profit growth is being fueled excessively by cost cutting rather than “organic” revenue growth, and that companies are effectively improving today’s performance at the expense of tomorrow’s. While such concerns remain, some sectors should show fairly good top-line momentum. Rising emerging market demand is expected to lift revenues in resource segments like mining. Also likely to see gains are high tech firms and others selling differentiated products, or facing favourable demographics like health equipment and services. Improved market conditions, meanwhile, are a plus for financial sector revenues (Chart 5).

Pressure on Firms to Meet Hearty 2010 Expectations

While a seemingly high 43% rise in earnings this quarter should be attainable, Composite members could face greater pressure validating expectations for a 26% rise in 2010 (Chart 6). Although such increases have occurred after past recessions, that has generally been in the context of stronger economic recoveries than we expect this time, given the drag from a scaling back of fiscal stimulus programs in both Canada and the US. The currency, moreover, has seldom been as large

Chart 6
2010 TSX Earnings Growth, (Ir)rational Expectations



Source: Thomson Reuters, CIBC

a drag as it is at present. While the loonie’s well over 20% appreciation from the spring’s lows may help a few sectors, like retailers selling a largely imported product mix, it will restrain earnings to a varying degree across a range of other sectors (Chart 7). Commodity prices, another recent profit driver, are unlikely to advance quite as much this year as they did in 2009, when prices rose by the most in three decades.

Chart 5
Some Sectors Could See Good Revenue Growth Despite Headwinds

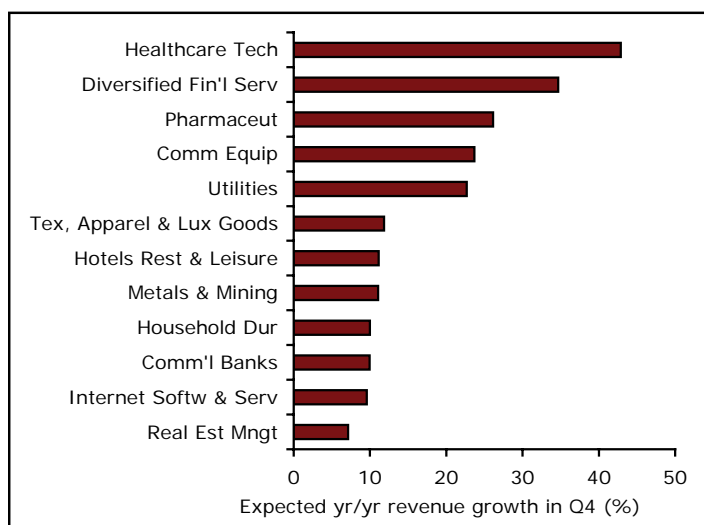
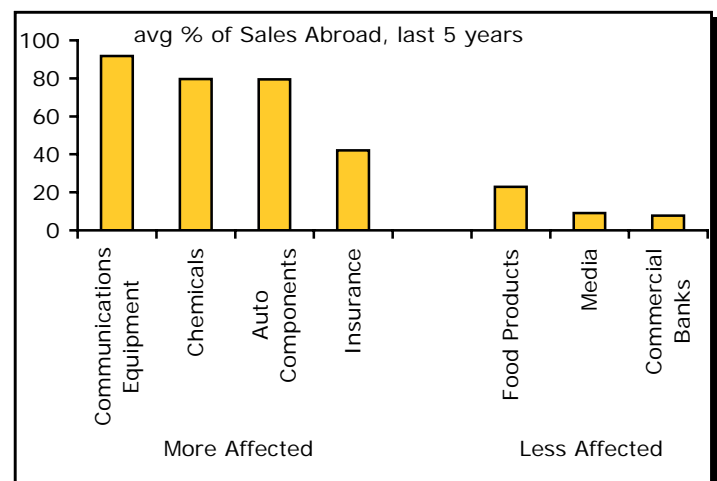


Chart 7
Exposure to Higher-Flying Loonie Varies



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