



As the Earnings Roll, Investors Look Ahead

by Peter Buchanan

Economics

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Peter Buchanan
(416) 594-7354
peter.buchanan@cibc.ca

Warren Lovely
(416) 594-8041
warren.lovely@cibc.ca

Meny Grauman
(416) 956-6527
meny.grauman@cibc.ca

Krishen Rangasamy
(416) 956-3219
krishen.rangasamy@cibc.ca

TSX Earnings Expected to Rise 8% on Year/Year in Q2

The earnings reports south of the border are now flowing freely, and TSX companies will join the parade meaningfully this week (Chart 1). With the recent twists and turns in both market performance and expectations for the economy, investors' financial health has depended on nothing so much as keeping a close eye on the road ahead. While investors will be dissecting the past quarter's hard numbers as they normally would, it's a good bet they'll be looking even more closely than usual at management's view on the future.

Insurers' Weaker Bottom Lines Will Restrain Headline

Based on the latest compendium of analysts' firm-level predictions, Q2 earnings for Composite members should see a rise of about 8% on the year (Table 1). That figure compares with the latest blended consensus of about 28% for the S&P 500, but is expected to be followed by increases of just over 25% for the TSX in the subsequent two quarters. Q2's anticipated increase would leave earnings for members of the main Toronto index running some 60% above the recession's trough, although still a good 25% below the all-time high reached in 2008 when prices for many resources set records.

Chart 1
TSX Composite Members Reporting/Week

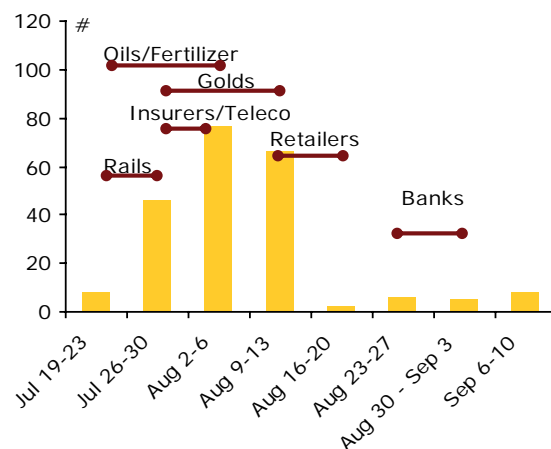


Table 1
Historical & Expected Earnings Growth

yr/yr % change	TSX Composite S&P 500		
	2010:Q1	2010:Q2	2010:Q2
Energy	14.2	14.1	74
Materials	114.2	81.0	90
Industrials	15.7	8.5	19
Consumer Discretionary	311.1	146.3	49
Consumer Staples	19.9	15.4	5
Health Care	-8.0	5.9	5
Financials	86.5	-20.5	19
Info Tech	35.0	31.6	59
Telecom Svcs	11.2	9.3	0
Utilities	152.2	-0.6	-5
All Sectors	56.2	7.8	28

NM=not meaningful, -ve yr ago

Note: May, Jun or Jul quarter end

Source: Thomson Reuters, CIBC

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

On the surface, Q2’s projected earnings growth pace looks like a notable, even disturbing, downshift from Q1’s heady 56% year/year pace—the largest increase in seven years. Largely driving the story, however, are less favourable year/year comps in the insurance sector. Rising yields and stock prices boosted that group’s earnings to record levels a year ago. A reversal of those factors will weigh this time around. The 40% of insurers’ revenues generated abroad also implies some translation drag from a modestly firmer C\$.

Leaving insurers out of the equation improves the bottom-line arithmetic appreciably. TSX earnings are expected to be up an appreciably healthier 25% on the year on that basis, only modestly softer than Q1’s 31% rate (Chart 2). Both numbers compare favourably with an average annual growth rate of about 14% for TSX index earnings for all periods in the last quarter century, in which neither the US or Canadian economy was in outright recession.

Some Other Sectors Should Show Notable Improvement

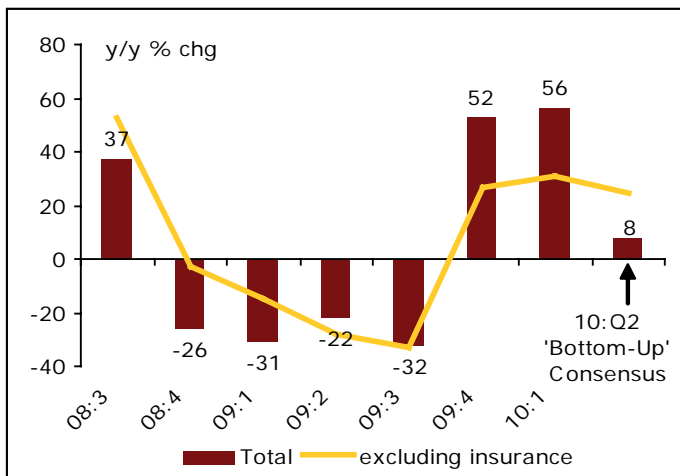
In contrast to insurers, several other sectors should see bottom-line improvements or continuing solid momentum. By metrics like employment growth, Canada’s consumer recovery has looked healthier recently than stateside. Aided by that fact, the consumer discretionary group did quite well in Q1, and some of that strength is expected to carry over into Q2. Earnings

are expected to more than double from a year earlier. Improvements in the automotive, retailing and media sectors will all contribute to that increase. Turning to the mining-dominated materials group, gains in both the gold and potash/agricultural segments should help to lift earnings by a vigorous 81% from weak year-ago levels, although softer base metal prices could well lead to more cautious guidance from some firms, looking ahead. Tech firms have led in positive earnings revisions stateside recently. Some of the same forces, including stronger corporate IT outlays, are expected to see earnings in that sector outpace the market north of the border as well.

Last quarter, the TSX surpassed the S&P 500 in earnings growth in five sectors, trailing in five others. That pattern should hold this time as well. The TSX is expected to outpace the large caps stateside in half of all sectors, with telecom services and the consumer groups doing particularly well relative to their S&P 500 counterparts.

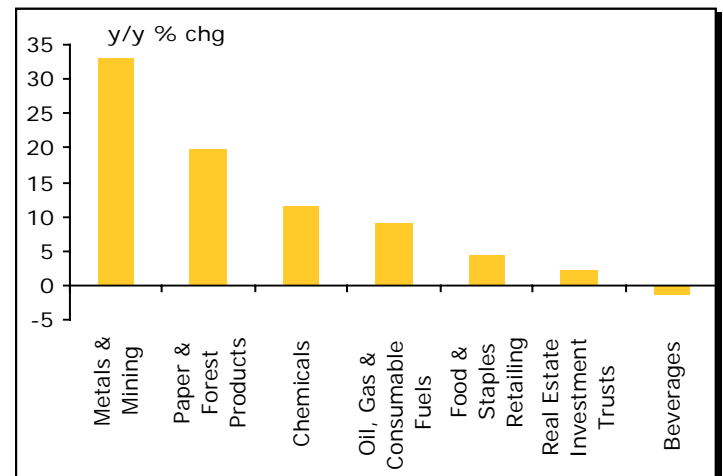
The reaction to the results released thus far south of the border suggests investors are continuing to look closely not just at the EPS numbers, but indicators of “earnings quality”, particularly revenue growth. While low inflation remains an overarching negative for revenue growth stateside, the Canadian numbers are likely to show a somewhat more mixed picture. Although low inflation will weigh on domestically oriented enterprises, resource producers and other firms levered to dynamic emerging markets should benefit from stronger revenues, driven by improvements in both pricing and volumes (Chart 3).

Chart 2
TSX Operating Earnings Earnings



Source: Thomson Reuters, CIBC

Chart 3
Expected Q2 Revenue Growth, Selected TSX Industries



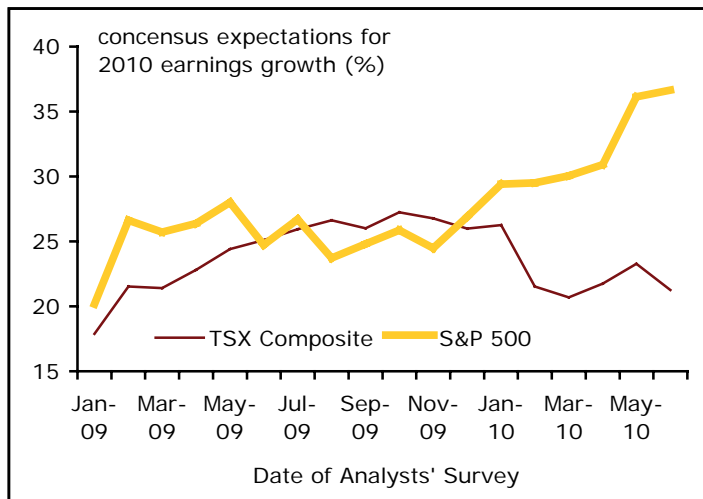
Source: Thomson Reuters, CIBC calculations

Less Aggressive TSX Revision History May Lessen Disappointment Risk

Stocks rallied strongly for the first two weeks of the last earnings season, then fell steadily over the next month. Whether the current reporting season turns out to be simply a replay of Q1 will depend on what the upcoming economic and earnings reports show, and the guidance that firms provide. We expect economic growth in Canada and the US to downshift in the second half of the year.

While that could create a more challenging environment for some firms, TSX earnings estimates have eased slightly in recent months, seemingly bearing a closer relationship to the economic environment than those stateside. Estimates for the large caps there for the current calendar year have risen at the fastest pace in six years (Chart 4). With as many as two upgrades for each cut, Q2 revisions for the S&P 500 in the lead-up to the reporting season have also been a good deal more aggressive than for the TSX. Those differences and the TSX’s greater exposure to Asia suggest the Canadian market is potentially less at risk than the US large caps from disappointments in the boardroom arithmetic or guidance.

Chart 4
US Earnings Estimates Have Been Ratcheted Up More Aggressively



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