Economics & Strategy

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Resource Profit Outlook Says 'Buy Canada'

by Peter Buchanan

TSX Earnings Headed for Over 20% Growth in 2008

The TSX has started out 2008 on a solid note, eclipsing other major industrial country markets en route to May's all-time high of over 15,000 (Chart 1). Upgraded profit expectations suggest that Canadian equities, particularly recent winners like energy and material stocks, are likely to remain prime candidates for portfolio exposure over the next 12-18 months.

Analysts have been lifting their expectations for earnings growth north of the border, almost as aggressively as they have been wielding the knife stateside (Chart 2). We now expect TSX earnings, net of non-recurrent items, to rise by nearly 21% to an index-adjusted 988 in 2008, 5% above previous expectations, with a further advance of around 12% to 1,107 in 2009 (Chart 3). That surpasses 2007's 12% increase and the 10% rise anticipated at last count for the S&P 500—just half of the 17% gain expected for the US market as recently as January. It is also better than the 7% average annual rise in TSX profits over the course of the last 25 years.

Contributing to our relatively sanguine assessment of the earnings picture, profit margins also appear to be holding up quite well despite pressure from sources like the high dollar—better, in fact, than margins south of the border (Chart 4).

Chart 1
Top Performing G-8 Market in 2008

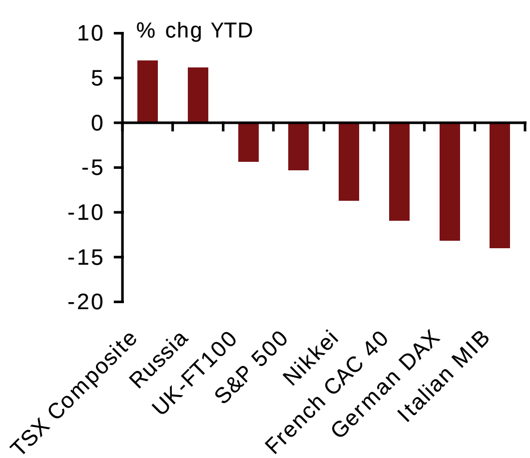


Chart 2
Earnings Growth Expectations: Changing Places

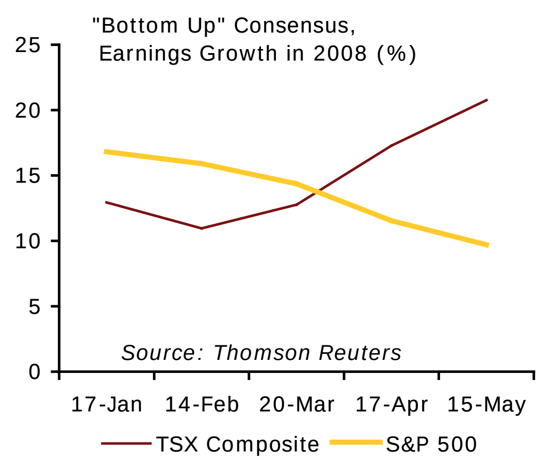
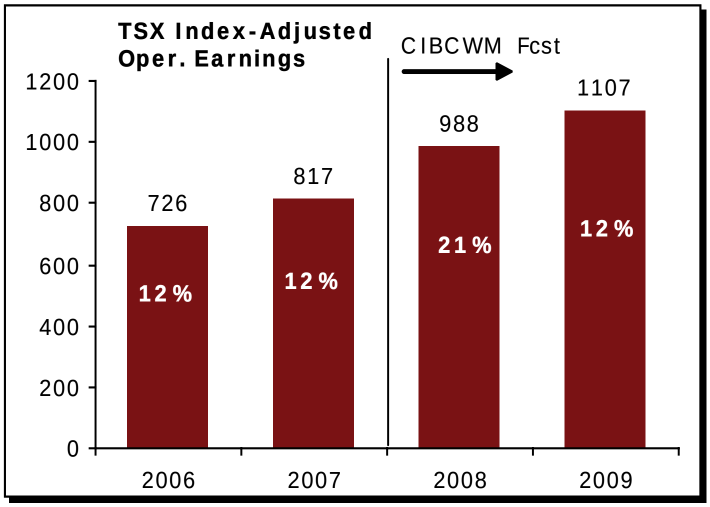


Chart 3

Raising Our 2008 TSX Earnings Forecast to 21% From 16%



Blending actual EPS figures with estimates for firms that have not as yet reported (like the banks), TSX earnings appear to have notched up a gain of around 17% on the year in the latest quarter. This is comparable in absolute magnitude to the decline recorded by S&P 500 members. A weaker US economy and drag from the financial sector should help to limit TSX earnings growth to a 10% pace in Q2. That loss of momentum is likely to prove temporary, however. Traction in the TSX's heavily weighted energy and resources sectors, and gradually improving economy stateside should see earnings growth snap back solidly to a near-30% pace in the second half of the year.

Chart 4

Profit Margins Holding Up Despite C$'s Rise

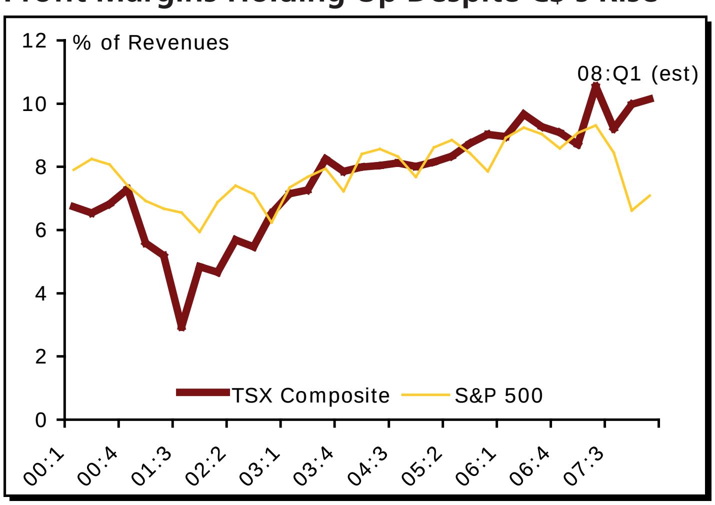
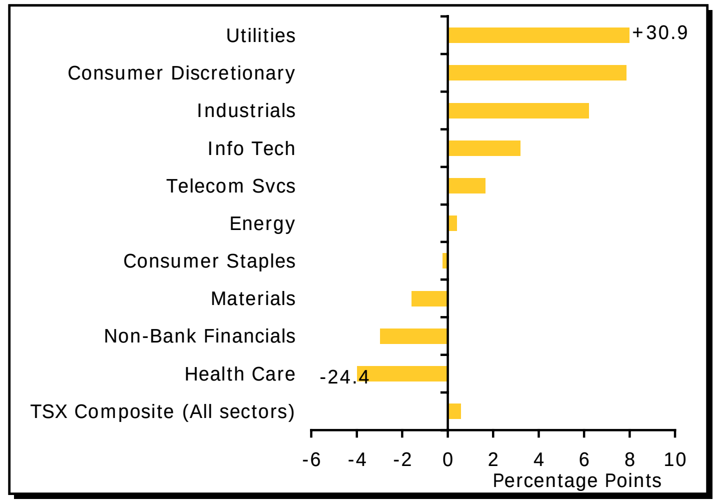


Chart 5

Deviation of Reported Earnings from Analyst Consensus, Current Quarter (as of May 20th)



Earnings released by TSX Composite firms so far for Q1 have surpassed analysts' consensus by about 0.6%. Utility firms have fared the best, topping the consensus by over 30% on average, compared to a nearly 25% undershoot in the health stocks, at the other extreme (Chart 5).

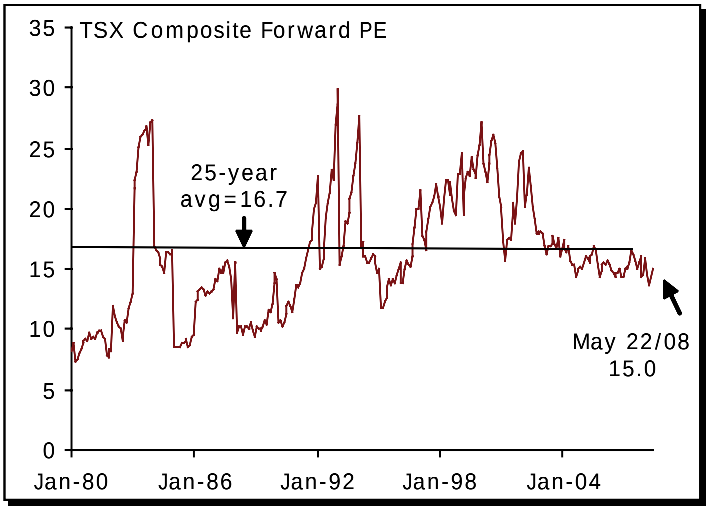
PE Ratio Has Risen But Still Not Expensive

The half-decade long rally invites comparison with the comparably long *dot.com* rally of a decade ago. Such comparisons are misplaced, however. The gains of that era were driven by "concept" companies, whose financial allure far surpassed their ability to deliver. The market's recent run-up has, in contrast, been earnings-driven. While PEs have risen in step with stock prices, they are still not at an over-valued level. At around 15, the TSX present forward multiple is slightly on the cheap side, and nearly a third below its late 1990s' peak (Chart 6). The roughly 300-bp gap between the TSX earnings yield and the yield on 10-year bonds suggests, moreover, that stocks are not particularly expensive relative to bonds.

We remain equally dubious of the mantra that recent resource price gains are largely driven by speculative pressures, and are consequently unsustainable. At nearly US$4 trillion per year, the global oil market's vast size—almost twenty times the value of global commodity index investment—is itself an obstacle to market-moving speculation. Inventories for oil and other commodities are also not ballooning, as might be expected if speculators were truly keeping prices radically above costs.

Chart 6

Valuations Not Expensive Even With Market's Rise



Resource Cyclicals Offset Profit Headwinds From Financials, Telecoms

The costs of the subprime debacle are still being counted, but a reduction in risk aversion, and shift in focus back to fundamentals, is benefiting stocks, particularly north of the border. The CRB index's record highs, a sign that overseas economies are weathering the housing-centric US slowdown better than many observers had expected, bodes well for the TSX's heavily weighted resource segments. Adding to this, China's recent earthquake could lift commodity consumption in coming quarters, as the focus shifts to metal-intensive reconstruction. Petroleum consumption there should also rise, as diesel capacity is pressed into service in place of quake-idled hydro and coal-fired plants.

Each dollar-per-barrel increase in the price of oil lifts earnings in the TSX oil and gas group by US$700-800 million, or around 3%, allowing for the long-standing correlation between oil and natural gas prices. Rising global fertilizer demand, related to the global food crisis has lifted new potash supply prices to the US$1,000 per tonne level. Metallurgical coal prices have also risen sharply, owing to strong steel-making demand and supply problems, exacerbated by strong flooding in Australia's Bowen Basin, the source of 40% of the world's steel-making coal.

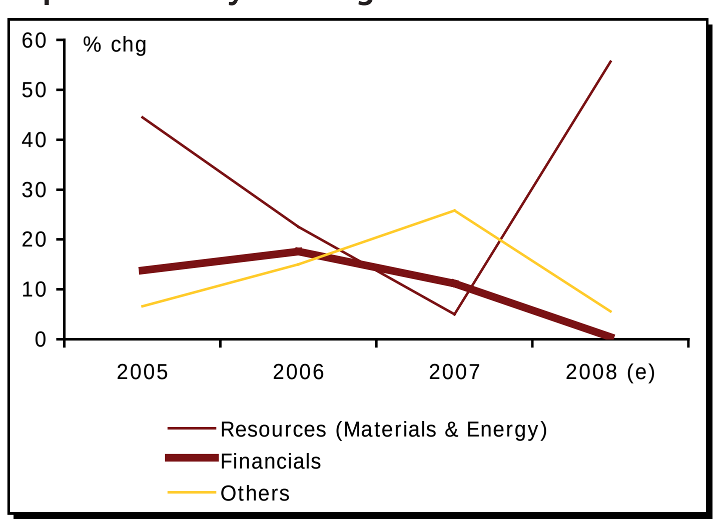
Outpacing present consensus expectations, these forces should help to lift earnings in the energy sector by nearly 60% and those in the materials group by more than 80% in 2008 (Chart 7). Our forecast for oil and gas profits assumes an average wellhead price of US$125 per barrel for WTI this year, rising to US$140 in 2009. Earnings in both the TSX energy and materials groups should top trends stateside in 2008. TSX oil patch earnings are more levered to strong oil and gas prices, less to unfavourable gasoline margins, than the major US integrateds. TSX agricultural chemical firms are also less vulnerable to weaker growth than the S&P 500's heavily weighted stable of industrial chemical producers.

Earnings in the technology sector should also show resilience, rising by nearly 70% in 2008. Share prices for many firms, however, already build in a sizeable premium for continued strong performance. Cutbacks by financial firms, a key customer, could make it difficult for players to meet the market's high expectations for revenue growth. Rising saturation in the cell phone market is likely to detract from hitherto strong momentum in the telecom sector. The growing share of revenue derived from entertainment and other essentially discretionary services, increases the sector's susceptibility to weaker consumer spending.

In both Canada and the US the financial sector has been a key source of profitability growth. Earnings momentum has now slowed from the double-digit pace of the last few years. We expect earnings for the TSX financial group

Chart 7

Historical & Consensus Earnings Growth Expectations by TSX Segment



to fall for the first time since 2002 this year, a bit more bearish than the market consensus. While firms have now made progress towards recognizing the effects of the subprime crisis, there are assorted other reasons for caution on the sector's financial performance including the effect of weakening capital market activity and the adverse credit quality implications of the weaker economy. Insurers earn over half of their revenues abroad and are consequently susceptible to the translation effects from an above-parity C$.

High Dollar Less Serious Hurdle for TSX Than Economy

The loonie's strength has caused earnings growth in traditional manufacturing to lag behind other TSX groups in recent years (Chart 8). However, these segments modest share of capitalization means the currency is less of a hurdle for the market than the general economy. Some TSX sectors, like retailers selling imported goods and heavy users of imported technology like telecom providers, actually benefit from a higher exchange rate.

Table 1

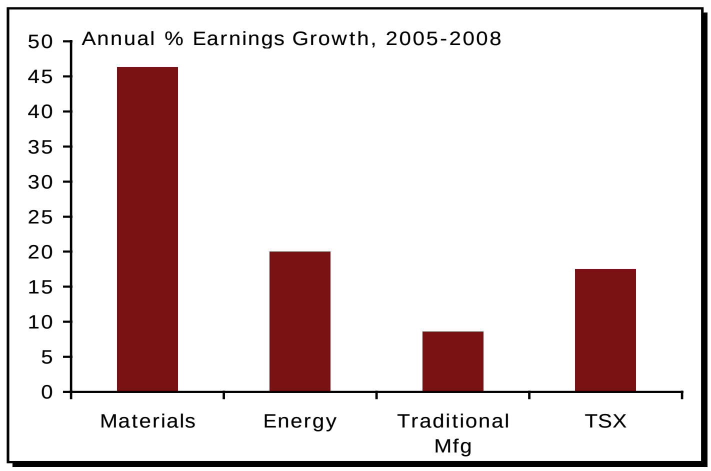
Detailed Earnings Table

Sector	TSX Wt. (%)	Operating Earnings (yr/yr % ch.)			
		TSX Composite		TSX Comp.	S&P 500
		2007	*2008*	2008	2008
		Actual	CIBC WM Forecast	Consensus	Consensus
Energy	*32.6*	8.0	56.0	47	21
Materials	*18.2*	-2.4	81.9	79	16
Industrials	*5.3*	38.5	-22.4	-17	6
Cons. Discr.	*3.9*	12.8	2.7	9	0
Cons. Staples	*2.1*	-1.5	-0.9	5	10
Health Care	*0.4*	-38.8	8.2	15	6
Financials	*26.3*	11.2	-5.3	0	-8
Info Tech	*4.9*	153.8	65.7	78	19
Telecom Svcs	*4.8*	28.4	-10.3	-1	-1
Utilities	*1.5*	56.2	6.9	5	5
All Sectors	*100*	11.8	20.9	21	10

Source: CIBC World Markets, Thomson Reuters, Bloomberg
Note: Earnings are for calendar years & excl. non-recurrent items & taxes.

Chart 8

Higher Dollar Squeezing Traditional Manufacturers



Note: "Traditional" manufacturing is non-resource factory sector, excluding info tech; 2008 earnings are consensus estimates