CIBC

TSX EARNINGS WATCH

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Will Earnings Season Tame the Market Juggernaut?

by Peter Buchanan

Economics

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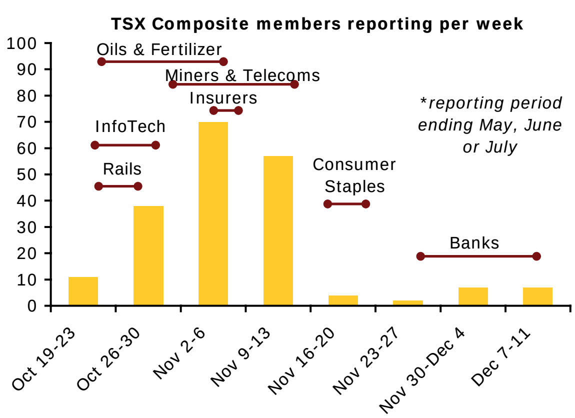
The upcoming Q3 earnings reports will provide a critical test of whether equity markets on both sides of the Canada-US border can continue their winning ways. Despite some pre-curtain jitters, the show stateside has opened well enough, with over three quarters of early S&P 500 reporters beating expectations. No less significant given top-line concerns, 60% of those firms topped revenue estimates.

With Signs of Recovery, the Expectations Bar Rises

The parade for TSX-listed companies starts this week, with the rails occupying their usual spot near the front of the line (Chart 1). Collectively, analysts now expect TSX earnings to fall by 31% on the year, net of one-off items. That figure, based on our aggregation of the Thomson survey data, is better than the 34% drop anticipated 2-3 months ago. While it is steeper than Q2's 24% year-on-year decline, the 'deterioration' is in reality, a reflection of tougher year-on-year comps, due to the potent year-earlier boost from record oil and metals' prices.

Chart 1
Upcoming Q3* TSX Reporting Season



Looking ahead, a 51% expected year-on-year rise in Q4 earnings still seems to defy gravity. But thanks to an easy comparison with a weak year-earlier reporting period, that seemingly high peak may not, in fact, prove to be so unconquerable. Earnings dived by 40% in the final quarter of 2008 as commodity prices and domestic spending tanked in the wake of Lehman's demise.

We've noted in the past that reporting periods have historically been a good time for exposure to Canadian stocks. (See CIBC's TSX Earnings Watch dated July 18, 2008 entitled *"Will Earnings Season Help Stem the Market's Bleeding?"*). That was clearly true in both Q1 and Q2 (Chart 2). The economy is showing signs of turning the corner. While that should benefit profits, firms may not have quite the easy time topping severely beaten-down expectations as they did earlier in the year, as analysts tailor their views to the incoming data. About 57% of all revisions to Q3 EPS estimates for TSX Composite members have been positive in the last month. That's a good 15 percentage points above the long-term average and points to a higher expectation wall to climb (Chart 3).

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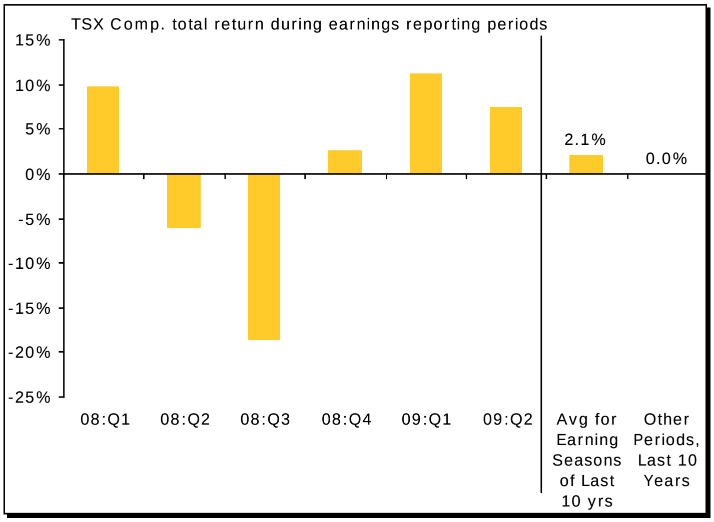
Chart 2

Earnings Period Good Time to Hold Stocks



Looking at the detailed arithmetic (Table 1), health, gold, and info tech stocks are expected to lead in year-on-year growth this quarter. The financial sector, another expected above-average performer, should benefit from firmer year-on-year earnings growth by both the banks and insurers. On the flip side, year-on-year declines in the rail and aerospace segments are likely to weigh on the industrial sector, which should still do better than the matching S&P 500 group. Tech earnings readily surpassed the matching S&P 500 group last quarter and the Canadian sector's greater leverage to high growth areas points to a repeat of that pattern.

Chart 3

TSX Composite Stocks: Analysts' Earnings Revisions

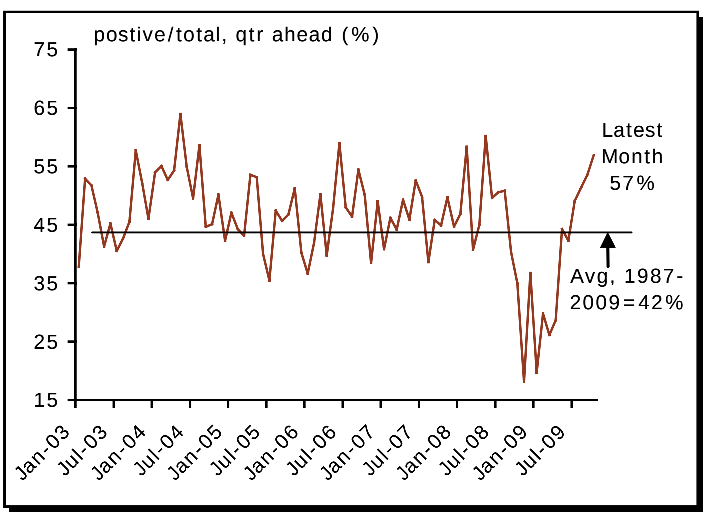


Table 1

Expectations for Q3 Earnings

yr/yr % change	TSX Composite 2009:Q2	2009:Q3	2009	S&P 500 2009:Q3
	Actual	Consensus	Consensus	Consensus
Cons. Discr.	-21.2	**-4.9**	**-10.4**	*2.9*
Cons. Staples	7.3	**-5.9**	**3.9**	*-4.4*
Energy	-60.7	**-67.5**	**-50.2**	*-66.2*
-E&P Firms	-75.8	**-75.5**	**-57.7**	*NA*
Financials	8.4	**14.3**	**7.2**	*614.1*
-Banks	3.4	**9.7**	**1.4**	*-61.5*
-Insurance	19.5	**-0.9**	**6.3**	*176.1*
Health Care	-7.2	**42.8**	**18.3**	*-4.5*
Industrials	-30.1	**-29.0**	**-26.0**	*-45.9*
Info Tech	16.0	**18.1**	**19.9**	*-15.5*
Materials	-51.3	**-42.0**	**-25.7**	*-61.7*
-Gold	12.7	**63.0**	**19.7**	*NA*
-Diversified Mining	-56.6	**-34.2**	**-13.4**	*NA*
-Chemicals	-64.6	**-77.2**	**-65.3**	*NA*
Telecom	4.8	**-4.0**	**5.2**	*-23.4*
Utilities	-15.7	**NM**	**166.3**	*-2.6*
Total, All Sectors	**-24.1**	**-31.0**	**-25.5**	***-22.2***

NA=not available

NM=not meaningful, -ve yr ago

High Dollar Will Hurt A Range of Sectors . . .

The C$ averaged just over 91 cents US during the third quarter, a marked 6% rise on Q2. While the full impact will only come with a lag, the quarter's results should provide early feedback on Corporate Canada's ability to weather the competitive stresses resulting from the loonie's renewed quest for parity. Exposed sectors include not only traditional trade mainstays such as auto parts, but also industries like communications and electronic equipment and pharmaceuticals, which are highly levered to US or overseas demand (Table 2). Note that many of the TSX's largest listed members have operations or sources outside Canada. Lower non-C$-denominated costs for these firms could soften some of the direct blow from the costlier currency.

. . . But More Dovish Rate Expectations Could Offer Some Support

Valuations would ordinarily draw support from strengthening earnings expectations at this stage, offsetting rate hike fears. The recent cycle has, however, been far from typical, and more support this time could come from changing views on rates. With the bottom-up consensus now looking for a 26% rise in TSX earnings

Table 2

Ten Most Export-Dependant TSX Industries

Industry	% of Sales Abroad, last 5 yrs
Health Care Technology	99.5
Communications Equipment	91.7
Electronic Equip., Instruments	89.3
Pharmaceuticals	89.3
Household Durables	89.2
Containers & Packaging	86.9
Life Sciences Tools & Services	82.9
Chemicals	79.6
Auto Components	79.4
Textiles, Apparel & Luxury Goods	78.2

Source: Worldscope, CIBC calculations

next year, an increase typically associated with stronger growth in the economy than most observers expect, markets already appear to be trading on fairly generous assumptions about earnings growth during the recovery's early stages. A comparison of the expected pace of this earnings upswing with some earlier ones bears that view out. TSX earnings took a full three years to regain their previous highs after the 2001 slowdown (Chart 5). The profit slide was larger then, but recovery headwinds also less severe.

If there's one area where investors may not be making due allowance for supportive valuation factors, it's on the interest rate side. The consensus continues to price in at least two Bank of Canada rate hikes by mid-2010. That is very likely too aggressive, given prospects for continued 2% or less core inflation, not to mention the Bank's own concerns about the currency.

Less Cost-Cutting Fervour Than in US, But Domestic Momentum Should Help Revenues

Thanks to the steepest three-quarter plunge in a half century, US unit labour costs are down a stunning 3% or so from year-earlier levels. While recent job gains suggest cost-cutting mania hasn't swept Canadian boardrooms as fervently, we see profit levels north of the border benefiting from some critical offsetting factors.

The first is the potential for stronger top-line momentum, thanks to a more vigorous domestic recovery. Ex-auto US retail sales may have surprised in September, but whether the momentum can be sustained is another question. Canadian consumers and businesses still look healthier, based on a range of indicators, including wealth and income growth and credit availability. Retail sales have also held up better north than south of the border (Chart 6). We expect all of that to translate into better top-line momentum, the lack of which stateside has helped spark fears about the sustainability of the corporate earnings recovery.

Chart 5

Consensus Expects Earnings to Regain Peaks Faster Than After Tech Correction

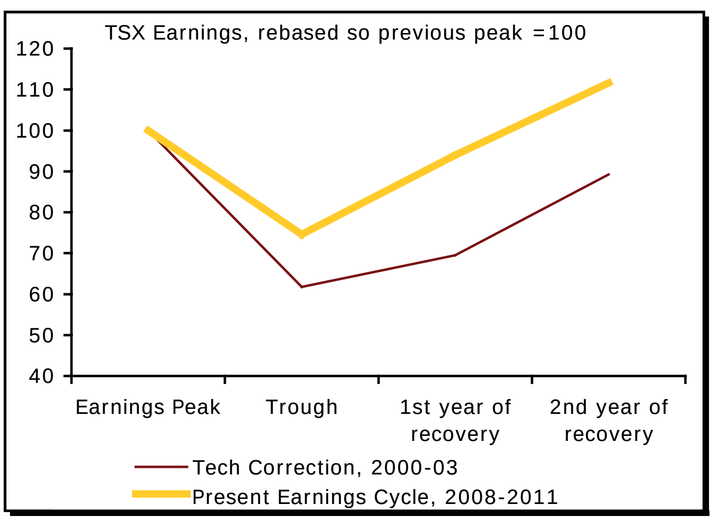
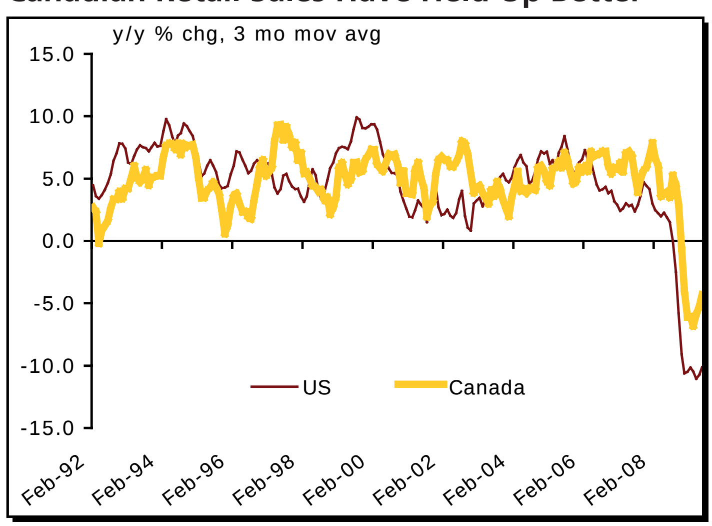


Chart 6

Canadian Retail Sales Have Held Up Better



Resources have three-four times the weighting in the TSX than in the economy as a whole. While recent gains in those prices won't fully offset the influence on the broader economy of a loftier loonie, they should temper the effect on some of the TSX's largest members. Commodity prices were up by 16% in Q3 in US$ terms from their average level in Q1, when oil and most metals hit multi-year lows, and by a more modest, but still positive 2-3% against the C$.