

Markets surge on strong US bank earnings *But risks still abound*

July 17, 2009 – Surprisingly positive earnings reports from some bellwether US companies dominated the markets last week, even as mixed signals about consumer prices clouded the picture on inflationary trends. The net result was a week-long surge in investor optimism, pushing the big market indexes back towards their mid-June highs, pretty much erasing losses sustained during the previous four weeks.

Investors seized first on investment bank Goldman Sachs' remarkable comeback story, which it revealed last Tuesday in the form of a 65% expansion of year-over-year earnings for the second quarter (a 33% quarterly increase). Income from trading and underwriting contributed most to Goldman's stellar results, as the company moved aggressively to grab market share away from rival Citigroup in the vacuum left by the collapse of Lehman Bros. and Bear Stearns. Even after repaying the US\$10 billion loan and associated costs from the government's Troubled Asset Relief Program (TARP), Goldman posted second-quarter net income of US\$3.44 billion.

Not wanting to upstaged, JPMorgan Chase & Co., the second largest bank in the US, announced a profit increase for the first time since 2007. Like Goldman, JPMorgan banked burgeoning fees from trading and underwriting operations, which handily offset grimmer news in its consumer loans, mortgages, and credit card divisions, where rising defaults led to increasing loan loss provisions. JPMorgan's second-quarter earnings jumped to US\$2.7 billion, or 36% from a year earlier. The bank has also paid back its US\$25 billion TARP loan, along with US\$795 billion in "dividends."

B-lister Bank of America reported a 5.5% slide in second-quarter profit, to US\$3.2 billion. Its US\$0.33 per share reported earnings slid dramatically from the US\$0.72 it reported for the same period last year, but remained in the black.

Citigroup booked a second-quarter profit of US\$4.3 billion, mostly a result of a massive one-time gain from its joint venture with Morgan Stanley on brokerage Smith Barney.

Still the champagne remained corked up, owing to serious problems in both companies' consumer loan portfolios. The banks both remain deeply in hock to the US government through the TARP program as credit loss provisions continue to balloon in the face of rising credit card, mortgage, and consumer loan defaults. In addition, management turmoil continues to add to uncertainty to the outlook as political interference will

dominate board decisions for as long as TARP loans remain on the books. (Think General Motors and Chrysler, and you'll get a pretty good idea of the current operational dysfunctionality of these businesses as well, both of which could easily slide down the same slippery slope to full government ownership.)

General Electric Co., which is symbiotically tied to its gigantic finance unit, reported a 47% plunge in second-quarter earnings. GE Capital, which is heavily involved in lending to everything from credit cards to commercial real estate, reported a slim profit in the second quarter, but still down 80% from a year ago.

While it's encouraging to see positive net earnings from the financial sector, it might be a bit premature to break out the party hats. The reason for our caution is the massive structural problems still besetting the consumer credit market. Although the rate of credit defaults and delinquencies might have eased somewhat, we can't say that either the economy or the financial sector will truly be back on the path to growth until unemployment eases and consumer confidence begins to show a sustainable uptrend.

That's why we've insisted in our comments that the financial sector, and banking stocks in particular, will lead any upswing in economic growth. Second-quarter revival in investment banking activity does not necessarily herald a full-blown recovery, keeping in mind that any movement off rock bottom will appear spectacular, particularly if it's fuelled by strong gains in only a portion of the market. It's the sustainability of the trend that's important, and that is likely to be a tougher row to hoe in the US financial sector over coming quarters.

Last week's imminent collapse of CIT Group Inc. served as a reminder of just how tough it will be. The troubles at the commercial lender, one the biggest in the US, reverberated through the asset-backed securities market, raising fears of another credit crisis similar to the one that froze up commercial paper in 2007 (a gut-wrenching event that's still in the process of being sorted out in Canada's asset-back commercial paper market).

Despite these concerns, we continue to watch the banking sector in both Canada and the US for signs of a steady pulse in the broader economy. And we remain optimistic for a return to sustainable growth next year.

Last week's inflation numbers in both Canada and the US seemed to argue against any kind of sustainable growth, as the key all-items consumer price indexes (CPI) in both countries appeared to indicate an alarming deflationary trend in the works.

Canadian consumer prices fell 0.3% year over year in June, the first such deflation in 15 years. In the US, the all items consumer price index dropped at an annual rate of 1.4%. But most of the decline in consumer prices could be attributed to plunging energy costs, especially gasoline, over the past year. Excluding gasoline and other volatile price from the basket of goods and services that make up the CPI (the so-called "core" rate), yields a different result, with Canadian core CPI at +2.1% year-over-year, and US core CPI at +1.7% year-over-year.

While we've often questioned the arbitrary nature of "headline" and "core" CPI as effective metrics on which to base monetary policy, it's hard to argue with the exceptional influence that energy prices alone have had on the indexes, and tends to support the argument for the exclusion of such volatile items from consumer price metrics.

That said, the current inflation picture is not nearly as grim as might be supposed, with the Canadian core rate right in the Bank of Canada's target sweet spot target of 2%, and the US core rate, at 1.7%, now also approaching what is widely believed to be the Federal Reserve Board's unstated, but implicit, target of 2% (unlike the BoC, the Fed does not specifically target inflation).

While headline monthly rates are likely to appear deflationary for some time yet, perhaps for the rest of the year, the core rate tells a story of incipient underlying economic recovery. With a 0.6% increase in US retail sales in June and a smaller-than-expected contraction in industrial activity (-0.4% in June, versus the expected -0.6% decline), there are growing signs that the recession has bottomed. In Canada, a key index of leading indicators compiled by Statistics Canada fell only 0.1% in June, while sales of existing homes rose 8.7%, marking the fifth straight monthly rise for a 17.9% year-over-year advance. A resurgent real estate market is an early indicator of returning consumer confidence.

For the week, then, stock markets regained some of their late spring bounce, and turned sharply higher as initial second-quarter earnings reports turned out to be not as bad as expected. The S&P/TSX Composite Index advanced 6% week over week, while the Dow Jones Industrial Average posted a 7.3% gain, and the S&P 500 Composite Index jumped 7%. Even the Nasdaq Composite Index, famed for its small-cap and high tech issues, surged 7.4%, as robust second-quarter profits at chip-maker Intel overcame more subdued earnings announcements and forecasts from Dell and Google.

We've warned of volatility of this type as markets consolidate along a bottom after a deep bear market. Last week's action didn't disappoint, but be prepared for more downdraft as earnings season progresses. ■

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