

Markets advance into December

Commodity surge overcomes weak financials on TSX

December 3, 2010 – All eyes were, for a time, on the big Canadian banks last week, as they underwent their quarterly trial-by-fire. Yes, the banks all made money, but generally just not as much as analysts had expected. That took the financial sector on a hair-raising ride through the week, but didn't drag down the broader market, which kicked in the afterburners as the price of oil closed in on US\$90/barrel. In Canada, at least, the eurozone debt troubles faded from the screen for awhile, as resources again seized investors' interest.

The thing about Canadian banks is that they're among the most successful (and largest) businesses in the country. Every pension and retirement plan, and most individual portfolios, have exposure to the Canadian banks. Because they are so few, it's relatively easier for financial regulators to watch their comings and goings than it is for U.S. regulators to do the same thing. And Canadian rules governing capital ratios and other matters related to bank risk have, over the years, been more finely tuned as a result. Hence, Canadian banks, while neither immune to nor insulated from competitive and market risks, were better positioned to withstand the 2008 financial meltdown than many other, much larger, global institutions. (Yes, they availed themselves of emergency liquidity facilities when credit markets dried up, but no major Canadian financial institution went bankrupt or became a ward of the government.)

Consequently the six sisters of Canadian banking emerged quickly from the crisis and returned to profitability. Even Canadian Imperial Bank of Commerce, arguably the bank most exposed to risk during that period, recovered. CIBC just announced fourth-quarter earnings of \$1.17 per share, down from \$1.56 a year ago, falling short of consensus estimates of \$1.63.

Except for two notable exceptions in National Bank of Canada and Bank of Nova Scotia, that was the story for the big banks this quarter. Royal Bank of Canada's fourth-quarter earnings fell to \$0.74, down 9% from last year. And The Toronto-Dominion Bank's \$1.07 profit was down 2% from last year's \$1.12 for the same period. Bank of Montreal will announce its results Dec. 7. For CIBC and TD, the big problem lay in something called wholesale banking (banking services provided to large institutions), where revenues plummeted in what has basically been a slash-and-burn environment for this type of business these past couple of years. RBC's capital markets revenue was the big sinker for its earnings, as trading activity evaporated during the eurozone crisis.

Still, National Bank's core earnings rose to \$1.63 per share, outstripping consensus estimates of \$1.56. And National raised its dividend by \$0.04 to boot, a 6% increase, to \$0.66 per share – so far, the only bank to do so. Scotiabank also suffered losses in its trading operations, but still managed to post a 21% increase in net income, to \$1.00 per share, up from \$0.83 a year ago.

Canadian banks are endlessly fascinating because they're the only banking game in town. As noted at the outset, just check your portfolio. Somewhere there's a bank or two lurking, and probably not in just a token amount either.

Canada's third-quarter economic output didn't encourage investors about the outlook for the big banks. Gross domestic product grew only 1% from the previous quarter, thanks largely to the impact of the strong loonie and rising imports. Exports actually declined 5% year-over-year for the first time since 2009. However, the labour market improved in November, as 15,000 more Canadian found work, and the unemployment rate dropped to 7.6% from 7.9% in October. Most of the job gains came in part-time employment, while the number of full-time private sector jobs declined, led by losses in manufacturing. This suggests continued sub-par growth for the next quarter, as the pace of growth in the Canadian economy more closely reflects conditions in the U.S. That's a net negative for Canadian bank stocks, which tend to be economically sensitive.

And all of that raises the likelihood that the Bank of Canada will remain sidelined on interest rates at its scheduled announcement on Dec. 7. The Bank's target overnight lending rate is currently 1%, and even though both headline and core consumer prices are nearing the Bank's 2% mid-point target, it will be loath to add on another 25-basis-point rate hike before, say, the second quarter of 2011, at the earliest.

Global manufacturing growth, measured by various manufacturing indexes, indicates that factories are still humming a lot faster than they were a couple of years ago at this time, when they basically hit rock bottom. The US Institute for Supply Management's benchmark manufacturing index showed a reading of 56.6 in November, down slightly from 56.9 in October, but still far above the 50 reading that the threshold between growth and contraction. Strong growth in manufacturing was also reported in China, India, the UK, Germany and France. But there was some cause for concern, as the US index showed that inventories exceeded new orders, often a sign of a slowdown in the making.

A US payrolls report of only 39,000 new hires in November fell far short of expectations for 150,000 or more. Most of the gains came in the private sector, but any optimism on that count was quickly neutralized by a jump in the number of long-term unemployed, to 6.3 million. Overall, the unemployment rate remained stalled at 9.6%. Meanwhile, productivity – the measure of how much a worker produces in an hour – rose 2.3%, as employers kept squeezing costs rather than sifting through job applications.

No matter. North American markets – indeed, markets around the world – advanced on the week in fairly typical December-rally fashion. Toronto's S&P/TSX Composite Index gained 2.2% week over week, as both gold (US\$1,414) and oil (US\$89.45) surged during

the week, leading the ThomsonReuters Jeffries/CRB commodity index to a 5% weekly advance. Naturally, that helped lift the resource heavy S&P/TSX, outweighing any dampening from the financials. The S&P/TSX Composite gained 4.9% month over month in November and was ahead 10.3% year to date.

In New York, the Dow Jones Industrials advanced 2.6% on the week, ignoring the poor employment report (which, according to some observers may be showing incorrect retail employment readings). The DJIA gained 2.4% month over month in November, and was ahead 5.5% year to date at November's close.

The Standard & Poor's 500 Composite Index beefed up even more, gaining 3.0% week over week as of Friday's close. In November the S&P 500 jumped 3.5% from October's closing level, and had advanced 5.9% year to date at month's-end.

If ever proof were needed that markets forever climb a wall of worry, November's trading, culminating with last week's blast, was it. December rallies aren't unusual, and so we may yet see more upside movement, even as reasons to worry seem to multiply. ■

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