

Is it redundant to say ‘bank profits’? *Winners and sinners among the financials*

August 27, 2010 – Canada’s big banks reported their third-quarter earnings last week. By and large, there was no really awful news, which should give Canadian investors some encouragement that the bad old days of the bank crisis are truly behind us. All the banks made money, some more than others. Some topped estimates, some didn’t. But with a tight focus on fundamentals, investors are quick to punish the big banks for any perceived transgressions at all.

As a consequence of this newfound Jesuitical logic-chopping of the banks’ earnings sins, the S&P/TSX Capped Financials Index has been falling since mid-April, when it soared to a 52-week high of 192.26. Since those heady early-Spring days, investors have been steadily discounting diminished earnings performance, and the index has dropped nearly 14% from its high, falling well below the 10% drop that is generally considered to be a “correction.” Indeed, the Canadian financials benchmark is getting perilously close to its 52-week low of 161.31. If that can be considered a major support level, then it may be possible that the Great Canadian Financials Correction of 2010 is bottoming out.

S&P/TSX Capped Financial Index – 3-Month



Courtesy CTVglobemedia

The question is whether all the disappointment is already priced in. Among the banks, Royal Bank of Canada and Bank of Montreal had the most to answer for, as profits declined on falling revenues from capital markets divisions. Royal Bank felt disappointment most keenly from its European trading operations, although both banks’

US exposure also weighed on results. BMO posted earnings of \$1.13 per share, up 20% from a year ago, while Royal Bank recorded profits of \$0.84 per share, down 13% from the same time last year.

On the other hand, and illustrating that the sector has now recovered from its lemming-like race on the road to perdition in 2008, at least two of Canada's big banks are surprising on the upside. Canadian Imperial Bank of Commerce is steadily regaining investor confidence, with third-quarter earnings of \$1.58 per share, up 48% from a year ago. National Bank of Canada reported net income of \$1.56 per share – down 11% from a year ago, but still ahead of analysts' far gloomier estimates.

With the big six Canadian banks still profitable (perhaps with some being not quite profitable enough), the term "bank profits" may indeed be a redundancy. And this is why they're found on just about every conservative equity index, pension fund, and RRSP in Canada.

Of the big non-bank financials in the sector, Manulife Financial Corp. has received a well-deserved spanking for producing a record quarterly loss of \$1.36 per share in its second quarter, compared with a profit of \$1.09 per share a year earlier. Along with some of Canada's worst-performing bonds, a credit-ratings review warning from Moody's, and a 50% share-price pummeling since March (down 39% year to date, and the worst performer on the financials index), Manulife is in just about everyone's bad books these days.

But by comparison with the state of the financial sector in places like, say, the U.S. and Europe, Canada's seems like an oasis of financial serenity and fiscal probity. Even in China, there's anxiety that the banking sector's profits have gone about as far as they can go, now that the authorities are busily tightening financial conditions in an effort to put the brakes on potentially runaway growth. No wonder that Canada's markets keep attracting inflows of international funds seeking safe haven.

And speaking of the U.S., all eyes were on a place called Jackson Hole, Wyoming on Friday, where an annual symposium hosted by the Federal Reserve Bank of Kansas heard Fed Chairman Ben Bernanke assert that the Fed "will do all that it can" to keep the wheels from falling off the economic recovery. The symposium includes central bankers and economic honchos from 40 countries, so it's considered an important sounding board and barometer for what happens next to monetary policy globally.

What really got investors' attention was Mr. Bernanke's assertion that the Fed would buy more long-term securities as a way to ease financial conditions, should the economy deteriorate. That boosted the markets' animal spirits to the tune of triple-digit gains on the big North American indexes in Friday afternoon's trading. You'd think the global economy had suddenly sprouted wings and taken off!

It's not that simple, of course. Any move by the Fed to forestall further economic weakness with another liberal dose of Keynesian money-printing will lead inevitably to a

weaker U.S. dollar. That implies higher commodity prices, and that's what helped buoy Toronto's benchmark stock index on Friday. In the U.S., stock markets advanced broadly, as 10-year Treasury yields rose after hitting a 17-month low earlier in the week.

The fact is that there's still a lot of bad news about the U.S. economy. And what's bad for the U.S. is bad for Canada. Despite a revised estimate of 1.6% year-over-year GDP growth in the second quarter, U.S. home sales slowed to the lowest rate ever in July as tax incentives drying up, as consumer confidence ebbed away, as durable goods orders faded, and as unemployment stays stuck at a troubling 9.5%. Announcement of softer sales estimates in coming months by technology companies Intel Corp. and Sony Corp. also point to a gloomier outlook for both consumer and business spending.

Meanwhile, the Fed remains divided over whether to set policy in response to what one faction sees as the threat of deflation as current price indexes continue to soften, or inflation, which the other faction argues will be the inevitable result of the Fed's massive money-printing (figuratively speaking, of course) efforts.

At least one publicly-traded company, Fairfax Financial Holdings Ltd. (also a component of the S&P/TSX financials index), has made a \$200 million bet on the deflation scenario through purchases of derivatives based on CPI to hedge \$22 billion of its investment portfolio against declines in the CPI. So far, the bet is up \$100 million, and the company says it has no plans to unwind its position. Now that's putting your money where your mouth is!

Toronto's benchmark S&P/TSX Composite Index got a tremendous lift on Friday's effusions from Jackson Hole, lifting it out of a hole for the week. The index ended the week with a 1.3% week-over-week advance.

Not so with the big U.S. benchmarks, neither of which managed to climb out of the hole for the week, despite those triple-digit advances on Friday. The Dow Jones Industrial Average posted a 0.6% retreat on the week, while the S&P 500 Composite Index dropped 0.7%.

The markets remain "choppy," as the saying goes, gyrating quickly through gains and losses on low summertime volume, which tends to exaggerate swings. It's best not to read too much into this type of activity. Second-half economic weakness had been widely predicted (including in these notes) in the first half of the year. And it's very likely that markets have already discounted that slowdown, with a persistent bearish bias since April. With sentiment lately running on the deeply pessimistic side, we wouldn't be surprised to see some upside surprises in the weeks ahead. ■

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