The greasy pole

Banks, energy stocks cushion Canadian market

February 25, 2011 – Lost in all the huffing and puffing about crude oil, its sources, and its outlook was the unheralded rally in the Canadian financial sector. Canadian banks and insurance companies have been quietly trending higher since last September, as the S&P/TSX Capped Financial index touched a 52-week high in mid-February before slipping back last week. But that all changed Thursday when two of the big-six Canadian banks reported consensus-beating quarterly profits last week. It was the one bright spot in an otherwise dismal week that saw stock markets around the world slump. We warned in these notes of such an eventuality. It just took a little oil to grease the pole.

Canadian Imperial Bank of Commerce was one of the hardest hit of the Canadian banks in the financial crisis. But it seems to have pulled itself up by its bootstraps, with share price doubling from a bargain-basement low near $40 in February 2009 to a recent $82. The bank reported first-quarter earnings of $1.92 per share (vs. estimate of $1.77), up from $1.58 a year earlier. It's also planning to buy back hundreds of millions of dollars worth of hybrid bonds and is considering early redemption of preferred shares and other instruments that no longer count as Tier 1 capital under the Basel banking accords.

Meanwhile, National Bank of Canada, the country's sixth largest after CIBC, reported record quarterly net income of $1.80 per share (vs. estimate of $1.64), up from $1.22 a year ago. The company said it benefitted from stronger performance in its wealth management and lending business. It also reported a drop in loan loss provisions, to $39 million from $43 million.

The other big banks are slated to report earnings results in the next few days, and if the news continues to be good, it might help cushion the broad selloff triggered by what can now only be classified as a civil war in Libya. The stanching of some or all of Libya's roughly two million barrels per day of crude oil production into the global supply chain was enough to spook stock markets out of their complacency last week, as the spot price of West Texas Intermediate crude oil (the price used in North America) hovered at US$96 per barrel, while the Nymex (New York Mercantile Exchange) contract for April delivery rose to as high as US$103 at one point before easing off slightly. The price for the Brent crude oil (the price used mostly in Europe) nearby futures contract rose to US$110 per barrel.

The spike in prices cannot be attributed to a constriction in Libyan supply alone, much of which goes to Europe. Any shortfall there is likely to be made up by slightly more output from other OPEC members, mostly Saudi Arabia, which stepped in last week, upping production from its vast reserves of the same light crude that Libya produces.

What really troubled markets was the possibility that the current North African dictator-replacement cycle might spread to the Middle East. Specifically that means to Saudi Arabia, which has been ruled by the same Arab dynasty (the House of Saud) since 1924. And we don't mean "ruled" in the liberal-democracy sense, either.

An aging and muddled line of "royal" succession is now set against a youthful, restive population with a high unemployment rate, and with dictator-replacement well underway in neighbouring Bahrain, it makes for a potentially explosive mixture in one of the world's top producers of crude oil. That would make for a far bigger threat to global oil supply, pushing prices well beyond the US$120 per barrel level considered by many economists to be the tipping point at which economic growth retreats back into recession. It's a lot of "ifs" to consider, but the market deals mostly in "ifs" and hence the intense anxiety last week.

A collapse of Saudi Arabia may or may not be imminent. There simply is no way to tell. Saudi King Abdullah last week attempted to head off Egyptian-style unrest by raising government wages and spreading around $11 billion in other largesse. But it may be too little too late, because what's driving unrest in these regions is the desire for *political* reform. And that is not forthcoming in Saudi Arabia.

Despite the anxieties besetting the crude oil market, Canada's energy sector, like its banks, appears to be doing just fine, thanks. Over the past month, the S&P/TSX Capped Energy Index is ahead about 7%, joining financials (ahead 6% in the past month) on the upswing, and helping keep the broader Composite buoyed nicely for the month. That's partially because some of Canada's biggest energy players have very little exposure to Libyan production, including Canadian Natural Resources Ltd., which has no operations in Libya at all. But even those with some exposure, like Suncor Energy Inc. (up 5.5% in the past month), with about 2% of its production coming from Libya, remain cushioned owing to rekindled interest in Canadian crude from south of the border.

With increasing volatility affecting Middle Eastern supply, US regulators have rediscovered the undeniable benefits of a large, stable source of crude oil just across the border. And that's nothing but good news for pipeline juggernaut TransCanada Corp. and its proposed 3,200 kilometre Keystone XL pipeline that would carry 500,000 barrels per day of Canadian crude oil from Northern Alberta to US Gulf Coast terminals. TransCanada shares are up 5.5% in the past month as a result.

While events in North Africa and the Middle East have understandably dominated headlines and markets these past few weeks, a couple of other really major financial problems haven't just vanished into thin air. The eurozone is still struggling with the shambles of Greek sovereign debt. It's hard to see how much longer the polite fiction of Greek solvency can be maintained – credit markets have already priced in a "restructuring." Ireland isn't far behind. And the eurozone hasn't cobbled together more than a stopgap bailout agreement, given deep political reluctance in Germany for anything other than swift, deep, and accountable fiscal austerity from basket-case regimes as the price for German taxpayer backing.

The other pot of trouble bubbling away on the back burner is Japan and its sovereign debt. Moody's Investors Services last week warned of a cut in Japan's debt rating if its massive public debt isn't brought under control. Japan's public debt is currently twice the size of its US$5 trillion GDP. A Japanese bond crisis is brewing now and will come to fruition in the next couple of years. Higher yields are inevitable, putting the market for Japanese bonds into a tailspin, unless the government acts quickly to impose some fiscal discipline. But that's for another day.

The big North American stock indexes, already ripe for a price rollback, got the Wal-Mart treatment in a big way last week, courtesy of Libyan "strongman" Muammar Gaddafi, whose strength appears to be ebbing rapidly.

Still the S&P/TSX Composite Index rallied sufficiently on Friday to end the week back over the 14,000 threshold, albeit with a 0.5% week-over-week loss. The Index did, however, seem headed for a solid monthly gain, and remained 4.5% ahead year to date, despite fears and anxieties over the fate of Middle Eastern oil.

Markets rallied on Friday aided and abetted by a three-point jump in the Thomson Reuters/University of Michigan consumer sentiment index for February, to 77.5 from 74.2 – a three-year high. Still, the Dow Jones Industrial Average likewise slipped on the oil-greased pole to post a loss of 2.5% last week, but was on track for a comfortable gain for the month, and posted a 4.8% advance for the year to date.

The S&P 500 Composite ended the week on a downbeat, with a precipitous drop and a Friday bounceback, leading to a net weekly loss of 1.7%. The Index was still on track for a monthly gain, and had posted a 4.9% year-to-date advance as of Friday's close.■

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