Slow and steady?

By Richard Croft

October 9, 2012—Another institution has cut its growth outlook for the Asia Pacific basin. In this case, the World Bank believes that China may be headed for a protracted period of slower growth. However, we should put that into perspective, because 7% per annum GDP growth is considered “slow” for China. The principal concern is that China is feeling the pinch of slowing demand from the eurozone, its largest trading partner. Analysts have been telegraphing this message for some time, which probably explains why the markets’ reaction was muted. But should investors get spooked by further downbeat guidance through the third-quarter earnings season, the mood could change quickly.

But for now, there is too much uncertainty to be a raging bull and too much cash in circulation and on the sidelines to be a diehard bear. Consider the outlook for third-quarter earnings as a case in point. Analysts have been taking down their numbers for the third quarter, yet the market has moved higher. The rationale is that lowered expectations might actually be positive, because it sets the stage for upside surprises.

Earnings season kicks off with the quarterly report from aluminum producer Alcoa Inc. (NYSE: AA). The consensus among analysts is that Alcoa will report a breakeven quarter, down from a profit of US$0.15 cents per share in the same period a year earlier.

There are some who place a lot of emphasis on the numbers, going so far as to suggest that as Alcoa goes, so goes the market. I am not convinced the relationship is that strong. But the numbers, and more importantly, the guidance will provide another data point on the investment strategy aggressiveness index.

What we know in the current environment is that companies have the strongest balance sheets on record, and that will likely continue into the foreseeable future. Without clarity around corporate, dividend, and capital gains tax rates, the cost of healthcare reform and consumption preferences, corporations will maintain margins and hoard cash. That should be positive for stock prices but will do little for the broader economy.

Speaking of the broader economy, central banks are providing ample liquidity and will continue to ease on down the road for a protracted period of time. Never has the old saw “don’t-fight-the-Fed” played such an aggressive role in the investment landscape.
One could argue that central bank policies will lend support to the market by effectively limiting downside risk. Central bankers are trying to encourage risk-taking by forcing investors to seek out “risk-on” strategies by limiting viable lower-risk alternatives. Stocks are simply the best investment in a questionable environment. Still we should be cautious, because global output is definitely slowing, and at some point, that will affect stock prices.

Given this bull/bear tug of war, we are nibbling at the Canadian financial sector, with dividend yields near or above 4% per annum. One could argue that Canadian banks are ripe for a rally, given that so far this year they have paled in comparison to their US counterparts. Note US banks have returned more than 20% in 2012 – almost twice the 10.9% return generated by iShares S&P/TSX Capped Financials Index Fund (TSX: XFN), which tracks the Canadian financial sector. And while it is fair to say that US banks were recovering from a very deep hole, we could posit that Canadian banks have lagged and are set to turn around with some very strong numbers over the next 12 months.

The one thing that impressed me during 2012 was the number of dividend increases announced by Canadian banks. A dividend increase is about the closest a banker gets to showing unbridled enthusiasm. Toronto Dominion Bank (TSX: TD) is particularly noteworthy, because it delivered on two fronts, announcing both a dividend increase and an increase in its dividend payout rate.

The dividend payout rate is the percentage of a company’s earnings that a company’s board has approved to be paid out as a dividend. Typically companies up their dividend payout when the board is comfortable about the upward trend in earnings and the sustainability of that trend.

We expect earnings among Canadian banks to be much better than expected during the third quarter. We also anticipate positive guidance for 2013, which in banker language translates into slow and steady returns. Any positive fallout from the Canadian banks should also be good for the broader market, which is desperately looking for leadership.

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