

Market Pulse

AT THE BELL FORECAST

Fortunes of S&P/TSX rest with performance of big banks

BY ALLAN ROBINSON

The fourth-quarter results next week, led by Bank of Montreal on Tuesday, and the group will need to play a pivotal role if the S&P/TSX composite index is to continue to climb next year.

"I will point out that while the S&P/TSX return will be fairly good, you are looking at a polarized stock market, with most of the return expected from two sectors, energy and financials," said Jeff Rubin, chief strategist for CIBC World Markets Inc.

That could be good news. "The TSX seems made to order for an environment of rising energy prices and falling interest rates," Mr. Rubin said. Two-thirds of the market capitalization of companies comprising the index are in interest-sensitive and energy stocks. CIBC has a 12-month target for the index of S&P/TSX of 13,500, which implies the market could move up another 7 per cent from its close yesterday at 12,644.9. Since Nov. 1, the index has surged 4.9 per cent.

Investors in bonds and stocks



J.P. MOCZULSKI FOR THE GLOBE AND MAIL



The banks have historically been the major beneficiaries of interest rate decline.

JEFF RUBIN, CHIEF STRATEGIST FOR CIBC WORLD MARKETS INC.

are anticipating the U.S. Federal Reserve Board and the Bank of Canada could begin cutting interest rates next year, strategists say.

"The banks have historically been the major beneficiaries of interest rate decline," Mr. Rubin said. Relatively high-yielding utilities and telecom stocks also benefit, he said. The banking sector currently yields about 3.1 per cent.

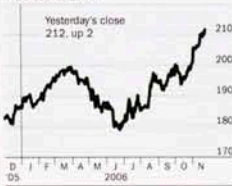
CIBC estimates that for every 100 basis points cut in 10-year yields, the share price of banks increase on average by about 9.5 per cent. The yield on 10-year Canadian government bonds is currently 3.97 per cent and CIBC forecasts the yield could drop 55 basis points to 60 points next year, which implies more than a 5-per-cent gain in the bank shares from that alone. (A basis point is 1/100th of a percentage point.) The bank shares could also get a boost from rising profits, which CIBC estimates will increase 14 per cent in the fourth quarter and 12 per cent during 2007, Mr. Rubin said. Lower interest rates boost profit margins and lower default rates.

James Keating, an analyst with RBC Dominion Securities Inc. is

Strong showing

S&P/TSX capped financials index

INDEX, DAILY CLOSE



SOURCE: THOMSON DATASTREAM THE GLOBE AND MAIL

looking for about a 13-per-cent return, including dividends, from the banks. On a year-to-date basis, the banks have outperformed the S&P/TSX by 3.3 percentage points after rising 14 per cent during the past four months, he said. Robert Wessel, the banking analyst for National Bank Financial Inc., forecasts bank profits will increase 9.8 per cent in 2007 and 10.9 per cent in 2008 and trade at 13 times and 11.7 times, respectively, his profit estimates. He remains bullish.

TIP SHEET

Jennings reduces Cascades to 'hold'

The runup in the share price of forest products company Cascades Inc. (CAS-TSX) has caused John Duncanson, an analyst with Jennings Capital Inc., to reduce his recommendation to a "hold" from a "buy."

The Cascades shares closed yesterday at \$13.97 on the S&P/TSX composite index, down 3 cents. Jennings Capital has a 12-month share price target of \$14 a share.

Cascades has increased 20 per cent since its last recommendation on Aug. 2 and since it was rated as one of Jennings Capital's "top picks" for 2006, the shares are up 40 per cent, he said.

The prices for containerboard and tissue continue to rise, although its boxboard operations in Europe and North America continue to lose money. Boxboard accounts for about 40 per cent of the company's sales. Mr. Duncanson reduced his share price target for 2007 to \$1.10 from \$1.25. Its profit for 2006 is estimated at 80 cents.

RBC Dominion 'tweaks' TD profit forecast

James Keating, an analyst with RBC Dominion Securities Inc., rates the Toronto-Dominion Bank (TD-TSX) as an "outperform" and says the decision to take 40-per-cent-owned TD Banknorth private is a turning point.

Yesterday, he raised his share profit forecasts on a cash basis by 4 cents in 2007 and 5 cents in 2008 to \$5.40 and \$6.05, respectively. Mr. Keating describes his profit increase as a "tweak," but he says RBC's cash estimate is the highest on the Street.

"In our view, investors are too bearish on TD's earnings-per-share outlook, meaning the discounted price-to-earnings multiple is doubly attractive."

The latest deal simplifies the corporate structure, adds to future profit and increases the incremental leverage to any rise in the U.S.-Canadian dollar exchange rate, he said.

The shares of the bank closed yesterday at \$67.96, up 55 cents. RBC's 12-month share price target is \$84.

BEST BETS

U.S. stocks get nod — but slightly

BY ANGELA BARNES
INVESTMENT REPORTER

If forced to choose, fund manager Dan Bain says U.S. equities will outperform Canadian equities next year. But with returns expected to be around 10 per cent in both, he doesn't really have to.

"Our one-year projection for the market return is around 10 per cent," said the president and chief investment officer of Toronto-based Thornmark Asset Management Inc. and lead manager of the Thornmark Enhanced Equity Fund. That projection applies to both the S&P/TSX composite index and the Standard & Poor's 500-stock index, both in local dollars. "If I was going to give a bias to one or the other, I would think that at this point we are giving the nod to the S&P," he said.

His optimism about the two markets stems from a feeling that global economic fundamentals are intact and that co-ordinated global growth will continue.

It therefore comes as little surprise that Mr. Bain says he is finding value in the materials sector. "We find that the tight commodity markets offer potential for further appreciation," he said. His top picks are zinc and uranium. "I would not be surprised if we see uranium at \$70 (U.S.) in short order," he said. It currently stands at about \$63.

He likes energy as well, especially after the pullback seen in the first half of this year. He expects that global demand will keep energy prices firm with West Texas intermediate crude prices staying in a range between \$50 and \$70 a barrel and natural gas between \$6 to \$9 per million British thermal units.

The \$53.9-million (Canadian) Thornmark Enhanced Equity Fund has continued its winning streak, rising 14.87 per cent in the first 10 months of this year. It had a return of 27.4 per cent in the 12 months ended Oct. 10, 24.86 per cent annualized over three years and 16.9 per cent over five years.



DAVID PAUL MORRIS/GETTY IMAGES

Fund manager Dan Bain has limited exposure to consumer staples but still likes Abercrombie & Fitch Co.

Abercrombie & Fitch

Mr. Bain is limiting the fund's exposure to consumer staples but still likes Abercrombie & Fitch Co. (ANF-NYSE), a New Albany, Ohio-based retailer of casual clothing primarily to teens and young adults through the Abercrombie & Fitch, Hollister and Ruehl banners. He said the company is growing through new store openings in an otherwise mature industry. He expects Abercrombie & Fitch's square footage will rise by about 12 per cent in the fiscal year that ends January, 2008, and that sales will increase by 18 per cent. Share price is forecast to increase by 15 per cent to \$5.40 (U.S.) a share. He has a 12-month price target of \$81 on the shares, which closed yesterday at \$71.21 on the New York Stock Exchange.

Suncor Energy

He expects even more attractive returns from Suncor Energy Inc. (SU-TSX), a pure play on the Athabasca oil sands. The 12-month price target is \$100 (Canadian) on shares that are currently changing hands at \$87.50 on the Toronto Stock Exchange. Mr. Bain said the current round of expansion, which is on budget, should bring capacity to 350,000 barrels a day in 2008. "Extensive operating experience and a superior land base position SU [Suncor] for strong future growth and to realize full-cycle returns on current and future capital investment," he said. He also noted that Suncor's third-quarter results beat consensus because of strong downstream operations.

Gabriel Resources

Mr. Bain has a 12-month price target of \$6.25 a share for his third pick, Gabriel Resources Ltd. (GBU-TSX), which operates the massive 80-per-cent-owned Rosia Montana gold project in Romania. "The company is on the verge of becoming a viable producer with a high probability of success," he said. The project, one of the biggest in the world with about 20 million ounces in reserves, has a potential output of 600,000 ounces of gold a year within the first five years, he added. Construction could begin next spring, he said. He suggested Gabriel, which closed yesterday at \$4.89, is a takeover candidate. The Toronto-based firm is 21 per cent owned by Newmont Mining Corp. There would be "significant upside" to the target in case of a takeover, he added.

RESOURCES

Commodity index falls for second month

BY ANGELA BARNES
INVESTMENT REPORTER

Bank of Nova Scotia's commodity price index declined for the second consecutive month in October, as sliding energy and forest product prices outweighed continued gains in base metals and stronger prices for agricultural products.

The index, which measures price trends in 32 of Canada's major exports, fell 4.2 per cent last month from the previous month and that followed on a 3.3-per-cent slide in September. That left the index 5.6 per cent below its level of October, 2005, the first year-over-year decline since August, 2002.

The oil and gas index slid 17.8 per cent in October to its lowest level since September, 2004. West Texas intermediate crude prices slipped from \$63.90 (U.S.) a barrel to \$59.14 in October. They then dropped to \$55 on Nov. 17, under pressure from relatively warm temperatures.

Crude prices have recovered somewhat since then. Patricia Mohr, vice-president of Scotia Economics, expects WTI prices in 2007 to be slightly higher than they are now, averaging \$60 over the course of the year.

More-than-ample U.S. natural gas inventories in late September pushed Canadian natural gas export prices below \$5 for 1,000 cubic feet in October, almost 60 per cent below the hurricane-boosted prices of a year earlier. "However, U.S. natural gas prices on an energy-equivalent basis in September were heavily oversold, relative to residual fuel oil, and have rebounded significantly — pushing up Canadian export prices in November," Ms. Mohr said.

Forest product prices also lost ground in October in the face of the correction in the U.S. housing market and the weak U.S. newspaper advertising lineage.

Base metal prices were a big story

last month, with spot uranium prices, for example, rising from \$54 a pound in late September to \$60 in late October and \$62.50 in mid-November. Uranium prices have increased \$6.50 a pound since the Oct. 23 flood at Cameco Corp's Clarendon Lake mine in Saskatchewan. Cameco is the world's largest uranium producer. A year ago, uranium prices were at \$34.25.

Zinc prices have also been climbing, jumping from \$1.12 a pound in September to \$1.73 in October, reaching a peak of \$2.08 on Nov. 9 on the London Metal Exchange. "This year's large deficit between world consumption and lower refined metal supplies has caused LME inventories to plunge 78 per cent since late 2005," Ms. Mohr said. The LME reported yesterday that the zinc inventory it monitors has slumped to a 15-year low.

Nickel prices have also been advancing. Yesterday, nickel on the LME hit at least a 19-year high on reports that stockpiles of the metal may drop. The previous high was set on Oct. 20.

But not all base metal prices advanced in October. As investment interest has shifted to zinc and nickel from copper, and worries have arisen about gradually slowing growth in China's industrial activity, copper prices dropped, edging down from \$3.45 a pound in September to \$3.40 in October and \$3.03 on Nov. 17. They have since recovered modestly to \$3.11 on the heels of the proposed merger between Freeport-McMoRan Copper & Gold Inc. and Phelps Dodge Corp.

"While most mining companies expect copper prices to ease in 2007-08, prices are expected to remain quite lucrative over the medium term and well above the \$1.01 average of the 1990s," Ms. Mohr said.

Current copper prices yield "exceptional profit margins of 157 per cent over average world total costs."

FIXED INCOME

Credit quality isn't everything — it's the only thing



HARRY KOZA
YIELD SIGNS

I've long been a big fan of credit rating reports. I don't care if they are written by Dominion Bond Rating Service or Moody's or Standard & Poor's or Fitch, if an e-mail crosses my desk with a blurb about the latest up or downgrade, or a newly rated issue, I'll click on the link and read the whole thing.

It doesn't matter if it's a corporate or government rating, an asset securitization or structured finance report, or a general survey of an industry or asset class — they're pretty much all worth a look.

In the bond market, credit is important. You've heard that old saw about how the three most important things in real estate are location, location and location? In the

bond market, the three most important things are credit, credit, and credit. As Vince Lombardi might have put it, had he been a bond trader, credit isn't everything, it's the only thing.

Sure, traders jump on every central bank utterance and often react spasmodically to the economic statistic of the day, and while there are sometimes clues as to the future general trend of interest rates in that data, it's usually just noise. But credit, well, that determines whether you get your principal back at maturity, so it's well worth paying attention to any movements in credit quality.

This week, for instance, DBRS released a comment on how it was going to treat the latest development: mortgages with 40-year amortizations being included in securitization pools. Even Canada Mortgage and Housing Corp. is now insuring no-money-down mortgages (as of Nov. 17) and interest-only mortgages. The latest is that, as of Dec. 15 this year, it will be insuring 40-year amortizing mortgages, too.

If someone is making mortgage loans that amortize over 40 years, they're likely to want to securitize them at some point, so DBRS staff, after putting fresh batteries in their calculators and sharpening their pencils, have figured out what that means in terms of credit risk for investors in those securities.

Mortgage-backed securities (MBS) are just pools of mortgages structured to act like bonds. They usually carve up the pools into slices of varying credit quality and sell them at appropriate spreads. There'll be a triple-A-rated tranche, and a double-A piece, and so forth, sometimes ranging right down to junk grade. The way a particular slice gets a triple-A rating is by over-collateralization, or credit enhancement. That, a \$100-million MBS might get rated triple-A because it is secured by, say, \$120-million worth of (usually insured) mortgages.

DBRS has crunched the numbers for 40-year amortizers and run them through their "stress models," much like auto manufacturers run cars into cement walls to

see how they hold up in crashes. They've decided that they will permit both insured and uninsured Canadian residential mortgages with amortizations of 40 years to be included in rated securitizations, though there are a few wrinkles.

If someone plans a new MBS deal with a pool of mortgages including some uninsured 40-year loans, and requests a triple-A rating, a separate analysis of the 40-year mortgages will be required. All other loan characteristics being the same as for normal 25-year amortizing loans, getting that triple-A rating will require a 21-per-cent increase in the amount of credit enhancement on the extra long loans. DBRS has already done a similar exercise on the inclusion of 30- and 35-year amortizations, and extending from 35 years to 40 years requires a 7-per-cent increase in collateral enhancement.

That's for uninsured mortgages. If the 40-year mortgages are insured, whether by CMHC or by one of the private insurers such as Genworth, the situation is a little differ-

ent. After all, in that case, the insurer is on the hook. For insured 40-year amortizing mortgages, no increase in enhancement is required, provided several conditions are met.

First, the term of the loans in the pool must be less than 10 years. Second, the weighted average coupon of the pool of mortgages must be at least 0.5 per cent greater than the lender's funding costs, to ensure that the mortgage servicing and swap costs are covered. Finally, the transaction documentation must have appropriate provisions for what happens if the mortgage insurer's credit rating ever gets downgraded.

If, because of some exogenous event like, for instance, a major collapse in housing prices, the insurer's credit rating was cut by two notches, the loans would be considered uninsured, and maintaining the rating of that MBS would be subject to the credit enhancement rules above.

So, 40-year amortizers have some extra risk. This seems reasonable, since the only reason

you'd want a 40-year mortgage in the first place was because you couldn't cover the nut on a 25-year amortizer's bigger monthly payments. That means there is a higher chance that you might default on the loan, though the probability is still low. Mind you, that's what they said in Calgary and Houston in the eighties, when people were mailing their house keys to their banks and walking away.

DBRS is proactively quantifying the risks of these new mortgage products, at least for lenders and investors — home buyers are still pretty much on their own.

But I wonder: Just how much credit enhancement would it take to get a triple-A rating on the securitization of a pool composed entirely of uninsured, 100-per-cent loan-to-value, interest-only, 40-year amortizing mortgages? I figure it's only a matter of time before someone issues one.

Harry Koza is senior Canadian markets analyst at Thomson Financial and a columnist for GlobetinvestorGOLD.com.