



## **Global Securities Market Bulletin**

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### **COMMENTARY – Investors in an unforgiving mood**

***Reaction to Alcoa and Google quarterly numbers indicate tough earnings season ahead***

**Elvis Picardo, CFA**

The Q1 earnings season got underway this week with the release of Alcoa's quarterly report. Judging by the market reaction to Alcoa's report earlier this week and Google today, investors seem to be in no mood to forgive any shortcomings.

The primary reason for this adverse reaction may be one that we discussed briefly in our quarterly strategy update last week – earnings expectations have been ratcheted too high. This makes individual companies vulnerable to a sell-off if they disappoint on any front. The fact that few companies warned of shortfalls in the run up to this earnings season may also have lulled many investors into believing that Q1 earnings would be as robust as the Q4 2010 numbers.

But Q1 certainly proved to be a challenging period for investors and companies, in sharp contrast to the previous calendar quarter. Geopolitical risk was back in a big way in Q1, while concern about European sovereign debt resurfaced and surging food and fuel costs took a toll on market sentiment. The Japanese earthquake / tsunami and subsequent nuclear debacle also rattled investors across the world.

So how badly did Alcoa and Google disappoint to warrant a 7% decline in their stock prices after reporting Q1 earnings? Alcoa missed on the top-line, with Q1 revenues of \$5.96 billion (up 22% from a year earlier) missing analysts' average \$6.06 billion estimate. The company said results were affected by a weaker US dollar and higher costs for energy and raw materials. Google missed on the bottom-line, as it reported per-share profit excluding some items of \$8.08, compared with analysts' average estimate of \$8.12. The shortfall was attributed to a 54% increase in Q1 operating costs, which was well ahead of a 29% increase in revenues.

While it may be too early in the season to extrapolate any sort of trend from these numbers, the point is that Alcoa and Google are bellwether stocks in two sectors – commodities and technology respectively – that have been in the vanguard of this two-year rally. Investors can therefore be expected to be on tenterhooks in the weeks ahead, as they look for signs of whether the shortfalls from Alcoa and Google are indicative of a deteriorating environment for corporate earnings, or rather can be attributed to stock-specific factors.

Earnings estimates for the S&P 500 have crept up over the past couple of weeks. Based on analysts' bottom-up estimates compiled by Standard & Poor's, the index EPS forecast for the S&P 500 is currently at \$96.99 for 2011 (up from \$96.66 at March 31) and at \$110.29 for 2012. Those are record EPS numbers, representing year-over-year growth of about 16% and 14% respectively. Index EPS estimates for the TSX (based on Bloomberg data) have also increased over the past couple of weeks, to \$914 for 2011 (up from \$906 at March 31) and \$1056 for 2012, for forecast y/y growth of 35% and 15% respectively.

For the S&P 500, per-share sales growth (based on Bloomberg data) is forecast at 8.9% for 2011 and 5.8% for 2012. For the TSX Composite, per-share sales growth is forecast at 11.7% for 2011 and 7.4% for 2012.

Those aggressive sales-growth forecasts have to be achieved against a backdrop of moderating economic growth. In its Monetary Policy Report released this week, the Bank of Canada forecast Canadian growth of 2.9% in 2011 and 2.6% in 2012 (compared with 3.1% in '10).

The IMF, in its World Economic Outlook report also released this week, forecast global growth of 4.4% in 2011 and 4.5% in 2012, compared with 5.0% in 2010. Growth is largely expected to be driven by the emerging and developing economies, where growth is collectively estimated at 6.5% in 2011 and 2012 (compared with 7.3% in 2010). In contrast, the advanced economies are jointly forecast to grow 2.4% in 2011 and 2.6% in 2012 (2010 – 3.0%). The IMF estimates US growth at 2.8% in 2011 and 2.9% in 2012, little changed from the 2.8% pace achieved last year.

**Bottom-Line:** Investors seem to be in the mood to take a hatchet to the stock of a company that falls short of expectations in any area – revenues or earnings, operating margins, guidance, and so forth. Earnings estimates are already quite high, but with moderating economic growth on the one hand and higher raw material costs on the other, operating margins can be expected to come under pressure going forward, which would adversely impact earnings. In this scenario, it is difficult to see how the current lofty earnings expectations for the S&P 500 and TSX Composite can be attained.

**Market Snapshot at 12:25**

<b>S&amp;P TSX</b>	13822.44	+0.64	<b>Commodities</b>			<b>Yields (%)</b>	<b>Can.</b>	<b>US</b>
<b>TSX Venture</b>	2294.49	-6.55	Canadian \$	1.0407	+0.0001	90 Day T-Bill	0.80	0.06
<b>DJIA</b>	12339.18	+54.03	Gold (Spot)-US\$	1486.15	+11.97	2-Year Bond	1.75	0.69
<b>S&amp;P 500</b>	1319.19	+4.67	Oil (WTI-May)	109.41	+1.30	10-Yr. Bond	3.29	3.41
<b>NASDAQ</b>	2761.40	+1.18	CRB Index	362.78	+2.12	30-Yr. Bond	3.72	4.46

**Thought for the Day**

“Any sufficiently advanced bureaucracy is indistinguishable from molasses.” – Anonymous

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