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Light at the end of the Tunnel?

By Gavin Graham

The rapid rise in world stock markets over the last six weeks has been a welcome relief from the unrelenting barrage of negative news that characterized the first quarter of 2009 and the last quarter of 2008. Not only was there some signs of improvement in economic indicators, but companies were even announcing they were making money! It is a sign of how depressed investors had become that the fact that banks could make profits when able to borrow at virtually zero interest rates was regarded as a pleasant surprise.

For of course, as Warren Buffet noted recently when discussing his big position in Wells Fargo Bank, banking is relatively straightforward business. You borrow at low (or in today's circumstances very low) interest rates and don't lend too much to borrowers who don't pay you back. The ability of the banking industry in the US, western Europe and Japan to ignore the second part of this formula, by buying securities based upon lending to borrowers who were incapable of ever paying back their loans, under the false idea that they would always be able to sell them if necessary, is what has resulted in the present credit crisis.

As I have noted on several previous occasions, the Canadian banks did not forget the second part of the formula and have performed much better than their more complacent or aggressive rivals, but even they saw their share prices driven down to levels which left them yielding 6%, 7% or 8%, which in turn led to speculation that they would have to cut their dividends. When discussing this possibility it is useful to remember why companies have to cut their dividends; they need to preserve capital or cannot raise it readily from outside investors. With the Canadian banks still profitable, including the quarter ended January 31st, and having raised over \$10bn in new common equity and \$6bn in preferred equity, which counts as Tier 1 Capital, over the last 15 months, neither of these applies. BMO Nesbitt Burns has pointed out that one possibility should there be any concerns about sustaining the dividend is to make the Dividend Reinvestment Programmes (DRIPs) which the banks all have more attractive, by increasing the discount to the market price at which the shares are issued and by issuing them rather than by buying them in the secondary market.

Let's look at how the various recommendations I've made in income Investor have performed so far this year, and see if the "green shoots of recovery" are on display yet. It makes sense to start with the financials, as they have been the centre of this credit crisis. As noted, Canadian banks have suffered in the sell-off, although not as much as US or European ones. Scotiabank is actually down for the year-to-date (-1.7% before dividends, all prices to April 20th) and so is Sun Life (-4.9% before divs) while cheque printer Davis + Henderson is down -20.5% before income. This is somewhat surprising as D+H maintained its earnings and distributions in 2008 on flat revenue after removing the non cash effect of interest rate swaps, even though the volume of property transactions and cheques ordered were both down from 2007. Sun Life had the effect of the bear market on its equity linked policies but was less affected than Manulife and Scotiabank is the bank with the lowest US exposure. Interestingly Scotiabank has been the worst performing Canadian bank, as others regarded as more vulnerable have rebounded the most.