Market Bulletin

Issue No. 249
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Summary

Economic Analysis: Key week for U.S. data, with FOMC announcement on Wednesday, jobs numbers on Friday. We don't anticipate it to be smooth sailing, so expect volatility next week.
Screen Shots: Energy producers and telcos dominate ranks of TSX-60 Top 10 dividend yielders.
Recommendation: **Canadian Oil Sands (COS, $23.25) – Revising to Hold (from Buy)** ahead of Q1 earnings report on April 30, target price under review.

Commentary – Are operating margins peaking for S&P 500 companies?

S&P 500 operating margin reached record 9.76% in Q4 of 2013

Elvis Picardo, CFA

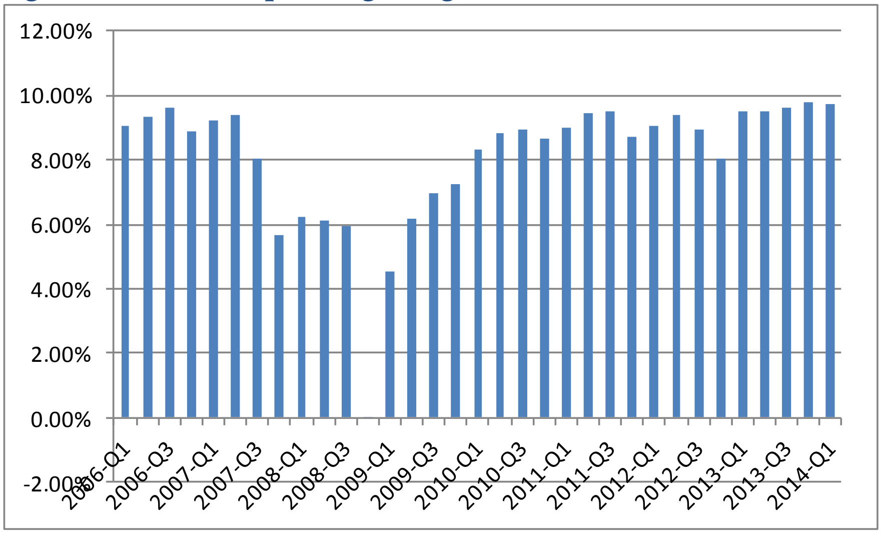
While there is little denying that certain sectors of this market are exhibiting frothy behaviour, the reality is that the broad U.S. market advance of the past five years has been driven by solid earnings growth. That earnings growth, in turn, has been the result of operating margins that are at record highs for U.S. companies.

A company's operating margin is broadly defined as the amount it generates before interest and taxes on each dollar of sales. Operating margin has a strong positive correlation with profitability and EPS – the higher the operating margin, the higher the EPS.

According to Howard Silverblatt, senior index analyst at S&P, operating margin for the S&P 500 companies reached a record 9.76% in Q4 of 2013, and is estimated at 9.75% in Q1 of 2014. Operating margin for the S&P 500 exceeded the previous record of 9.6% set in Q2 of 2006, in Q3 of last year (when it reached 9.63%) and set a new high in Q4.

Figure 1 shows quarterly operating margin for the S&P 500 since 2006, based on Silverblatt's analysis. The S&P 500's operating margin has averaged 8.11% over this period, and given that it is currently well above this number, the question is whether margin is peaking. This is a valid concern, since there is a limit to how much incremental margin companies can squeeze from cost-cutting in an environment of weak sales growth. Current EPS estimates for the S&P 500 are at $120.31 for FY14 (up 12% from $107.31 in FY13), and $137.30 for FY15 (expected EPS growth of 14%). If operating margins are indeed in the process of peaking, those EPS forecasts for next year (and perhaps this year) may be difficult to achieve, in our opinion.

Figure 1: S&P 500 Operating Margin (%) – 2006 to Q1 2014



Source: Howard Silverblatt, S&P Dow Jones Indices Senior Index Analyst

Economic Analysis

Key week for U.S. data, with FOMC on April 30, jobs data May 2

Fed expected to taper by additional $10 billion, U.S expected to add 210,000 jobs this month

Next week could well be one of those pivotal weeks that set the near-term (and perhaps medium-term) direction of the markets, with the Federal Open Market Committee announcement scheduled for Wednesday, and the U.S. jobs numbers for April expected on Friday. Most economists expect the Fed to continue with its tapering efforts, reducing its bond-buying spree by $10 billion to $45 billion. On the jobs front, the economy is forecast to have added 210,000 jobs this month, while the unemployment rate is expected to tick lower to 6.6%.

Don't expect it to be smooth sailing, however. Recall the brouhaha caused by Yellen's "around six months" comment (in response to a reporter's question on how long interest rates would stay low after the Fed stops assets purchases) in her first press conference on March 19. That casual (candid?) comment led market-watchers to speculate that the Fed may raise the federal funds rate sooner than expected. While Yellen subsequently downplayed those concerns with effective damage control, the Fed's announcement and Yellen's comments will be parsed rigorously for new clues on the Fed's rate policy. Renewed concerns about the upward trajectory of short-term rates could cause a repeat of the March sell-off, in our opinion.

As for the jobs data, "just right" numbers of about 200,000 jobs added are unlikely to have the same positive impact they had last year. With investors' focus on stock valuations, we feel that the downside risk if the jobs numbers do not come in as expected (i.e. significantly lower or higher than forecast) outweighs the upside potential if they do meet expectations.

Screen Shots

TSX-60 highest dividend yielders – Energy producers and telcos dominate

Average dividend yield of Top Ten has declined over past year due to dividend cuts, stock gains

Table 1 shows the top ten dividend yielders on the TSX-60, a list that is dominated by energy producers (four) and telecom / cable providers (three). Note the following points with regard to these dividend payers –

- The average dividend yield of the Top Ten has declined to 4.93%, from 6.62% a year ago. The lower yield is on account of dividend cuts by companies like Penn West and TransAlta (the two highest yielders on the TSX-60 a year ago), as well as broad market gains, with the TSX-60 up almost 18% over the past year.
- The composition of the Top Ten has been fairly stable over the past year, with seven of the highest yielders from a year ago making it to this year's list. New entrants this year are Rogers Communications (due to its 15% drop over the past 12 months), Shaw Comm. and CIBC, which ranked No.11 and No.13 for dividend yield last year but made the cut this year because of the lower cut-off. The lowest yield of the Top Ten this year is National Bank's 4.05%, while the lowest last year was Iamgold's 4.53%.
- Four of the Top Ten – and the three highest yielders – are energy producers (CPG, COS, PWT, ERF) while three are telcos / cable companies (BCE, RCI/B, SJR/B). The latter three are the only Canadian "Dividend Aristocrats" – companies that have raised dividends annually for at least five years – on the list.
- There are two banks in the Top Ten yielders, but that number would double if one were to consider the 15 highest yielders on the TSX-60, as this would include BMO and Royal Bank.

Table 1: Highest dividend yielders on TSX-60 index

Ticker	Name	Last Price	Chg Pct YTD	Dvd Ind Yld
CPG	Crescent Point Energy Corp	$44.02	8.0	**6.19**
COS	Canadian Oil Sands Ltd	$23.20	20.8	**5.80**
PWT	Penn West Petroleum Ltd	$9.79	12.4	**5.62**
TA	TransAlta Corp	$13.11	-3.1	**5.51**
BCE	BCE Inc	$48.42	5.5	**5.09**
ERF	Enerplus Corp	$23.94	25.1	**4.47**
RCI/B	Rogers Communications In	$42.22	-11.2	**4.29**
SJR/B	Shaw Communications Inc	$26.28	1.9	**4.18**
CM	Canadian Imperial Bank of	$96.01	5.6	**4.09**
NA	National Bank of Canada	$45.26	2.8	**4.05**

Source: Global Securities Research, Bloomberg

Recommendation

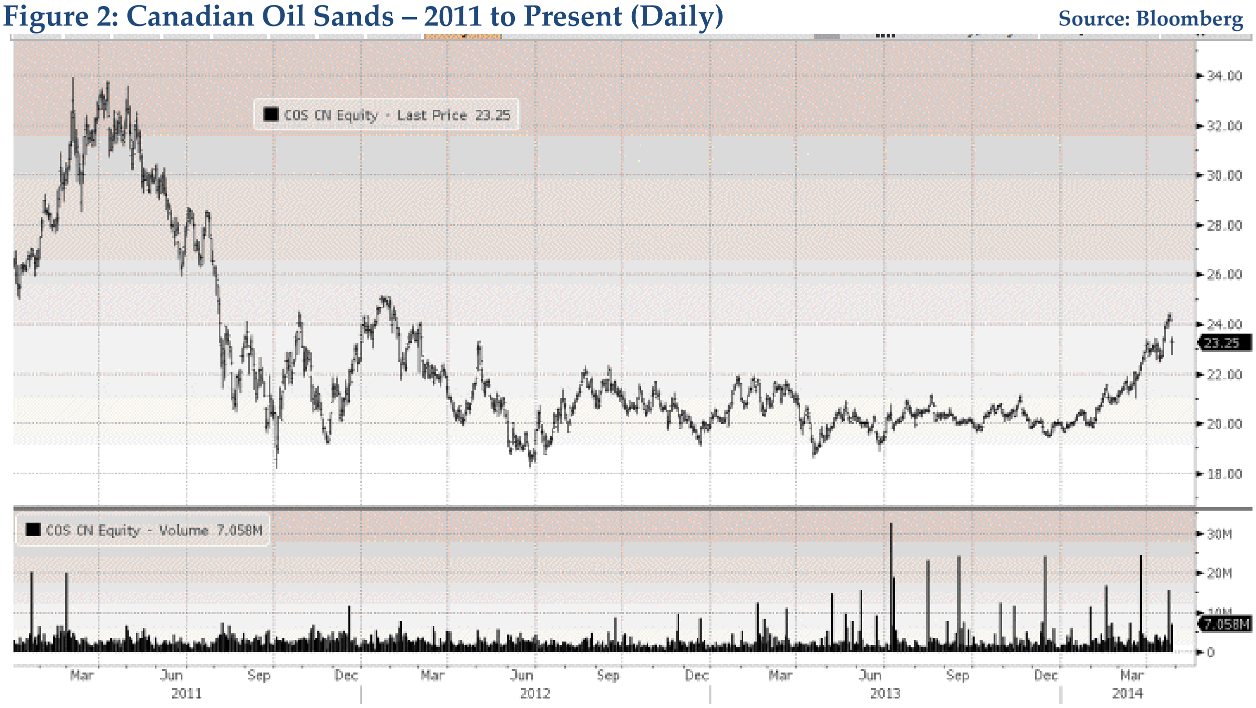
(Update) Canadian Oil Sands – Revising to Hold, target price under review

We are revising our recommendation on **Canadian Oil Sands (TSX: COS, $23.25)** to Hold. We had previously rated it as a Buy for investors with moderate risk tolerance, in our last update on the stock on November 4, 2013. Our target price of $23 is under review.

COS has traded above our previous $23 target in recent weeks, but tumbled 3.7% today on news of unplanned repair work at Syncrude's Coker 8-1. The breakdown comes at a bad time for COS, as it overlaps the turnaround of Coker 8-2, which is scheduled for Q2. As a result, COS revised its annual production estimate for Syncrude to 95-105 million barrels (single-point estimate = 100 million barrels) for 2014, down from 95-110 million barrels (single-point estimate of 105 million). Revised guidance will be provided along with Q1 results on April 30. For Q1, COS is expected to report EPS of $0.55, up 34% from a year ago, on revenues of $1.01 billion.

COS traded at a two-year high of $24.46 yesterday, and its 16.4% advance this year has occurred despite a lack of enthusiasm on the Street, with analysts' average target price currently at $21.98. The stock's advance has coincided with a sharp narrowing in the price differential between Western Canadian Select and WTI, with WCS trading at a discount of $18.50 to WTI today, compared with as much as $42 in November. While we remain positive on COS' long-term prospects on account of its stable cash flow, solid financial position and dividend sustainability, its recent advance leads us to revise our rating to Hold ahead of its Q1 results.

Figure 2: Canadian Oil Sands – 2011 to Present (Daily) **Source: Bloomberg**



Market Snapshot

At close on Friday, April 25, 2014

S&P TSX	14533.57	-20.68	**Commodities**			**Yields (%)**	**Can.**	**US**
TSX Venture	1013.59	-0.86	Canadian $ (US cents)	90.59	-0.14	90 Day T-Bill	0.92	0.01
DJIA	16361.46	-140.19	Gold (Spot)-US$	1303.20	+9.84	2-Year Bond	1.06	0.43
S&P 500	1863.40	-15.21	Oil (WTI-June)	100.60	-1.34	10-Yr.Bond	2.40	2.66
NASDAQ	4075.56	-72.78	CRB Index	310.69	-1.50	30-Yr. Bond	2.92	3.44

Thought for the Day

"I can calculate the motion of heavenly bodies, but not the madness of people."
– Sir Isaac Newton

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IMPORTANT RESEARCH DISCLOSURES

(1) The analyst and/or a member of the analyst's household have a long position in the following stocks discussed in this report – **Canadian Oil Sands**

Research Rating System
Strong Buy: Expected total returns of 20% or more over the next 6 – 12 months.
Buy: Expected total returns of 10% to 20% over the next 6 – 12 months.
Speculative Buy: Significant gains expected over the next 6 – 12 months, but entire investment may be at risk.

Hold: Expected total returns of 0% to 10% over the next 6 – 12 months.
Reduce: Expected total returns of up to -10% over the next 6 – 12 months.
Sell: Expected total returns of over -10% over the next 6 – 12 months.

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