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BANK EXPOSURE: TIME TO DIVERSIFY?

A special report by the Portfolio Advisory Group

There's Wealth in Our Approach.™

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For Required Disclosures see page 6.
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RBC Wealth Management
Dominion Securities

Bank Exposure: Time to Diversify?

Canadian investor equity portfolios have typically had Canadian bank stocks as their foundation. That approach has been rewarded over time as the banks have, on average, outperformed the broader Canadian equity market, making their dividends a reliable source of income growth. Nevertheless, it is important to set aside past performance and assess the outlook for the Canadian banking industry. On this front, we believe there are some headwinds that may hinder the ability of Canadian banks to grow their earnings at the pace at which investors have become accustomed. Meanwhile, in the U.S., the economic backdrop has improved to the point that multiple tailwinds have positioned U.S. banks for strong potential performance. We believe this disparity offers Canadian investors an opportunity to consider fine-tuning their bank exposure.

Canada Backdrop

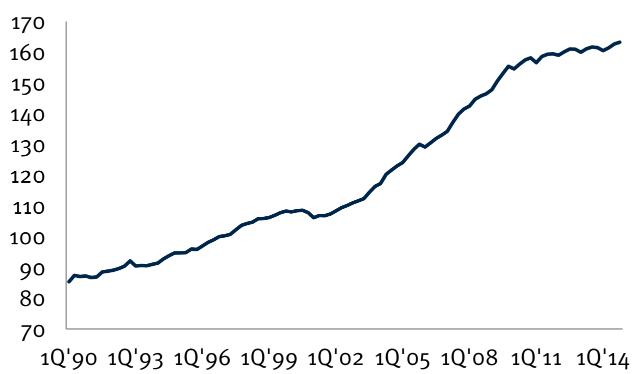
Canadian banks' annual earnings growth has ranged from the high-single digits to well into double-digit territory since 2010. Indeed, in any given year in which the economy is not in recession, the banks have, more often that not, generated greater than 10% earnings growth. However, it is widely expected that industry conditions will constrain growth this year as many headwinds have materialized.

Slower Loan Growth Expected to Weigh on Domestic Personal & Commercial Earnings

Domestic consumers appear set for a slowdown as Canadian household leverage sits at historical highs. While leverage expansion has moderated and low interest rates have kept debt servicing costs low, the ability of many Canadians to take on more debt appears to be waning. Coupled with a richly valued housing market and the potential for a reduction in new mortgage demand, loan growth in domestic retail banking may be challenged.

Household Leverage

Credit Market Debt as a % of Personal Disposable Income



Source - Statistics Canada, RBC Economics; data through 4Q'14

Expectations for Net Interest Margin Expansion Have Been Pushed Out

Net interest margins (NIMs)—the difference between the rates that banks pay on deposits and the rates that banks receive for loans—is one of the biggest sources of revenue and profitability for the banks. Many bank management teams expressed optimism at the start of the year with respect to the potential for stabilization in net interest margins, which have been at low levels for some time. But those hopes may have faded as the Bank of Canada (BoC) surprised markets in late January with an interest rate cut that sent short- and long-term rates lower, thus further "flattening" the yield curve and squeezing NIMs. The BoC recently indicated that financial stability risks are evolving as "expected" since its rate cut, and characterized the degree of monetary stimulus as appropriate. Nevertheless, further rate cuts remain a possibility, particularly in the event of any further deterioration in the economy and/or oil prices. In other words, net interest margins may continue to be vulnerable for the foreseeable future, while a significant widening in NIMs is less likely, in our view.

Bank Exposure: Time to Diversify?

Depressed Energy Prices Create Potential for Significant Economic Dislocation in Western Canada

The overhang of lower energy prices began to weigh on bank stocks toward the back half of 2014 and into 2015. Much of the eventual impact of lower crude prices rests not with the magnitude of the decline, but rather for how long low prices persist. RBC Capital Markets forecasts a Q2 2015 bottoming in crude prices and a marked improvement by the Q4, when it estimates crude will average $70 per barrel as the impact of lower capital spending manifests into lower production volumes. However, there is significant uncertainty around this forecast, and we believe investors should consider the possibility that oil prices will remain depressed for a prolonged period of time.

We believe the energy industry's spending decline and job cuts will weigh on the Alberta economy this year with RBC Economics forecasting GDP growth of 0.6%, a marked drop from its prior 2.7% estimate. A "lower for longer" energy markets depression may imply further downside for earnings growth estimates as wholesale revenues, loan growth, and loan losses are likely to be adversely impacted. While parts of the Canadian economy will likely benefit from lower oil prices, thus offsetting some of this weakness, these benefits, as the BoC stressed in its statement that accompanied its January rate cut, are likely to come with a lag, making the Canadian economy susceptible to near-term growth risks.

Normalization in Credit Could Prompt Higher Provisions

Credit losses have been declining since the 2009 recession, and this has served as a tailwind for industry earnings growth. Should credit begin to normalize (losses rise), perhaps sparked by a "lower for longer" energy price scenario, bank earnings may be adversely impacted. A reversal to long-term credit provision levels may result in a double-digit cut to 2015 EPS estimates, according to RBC Capital Markets.

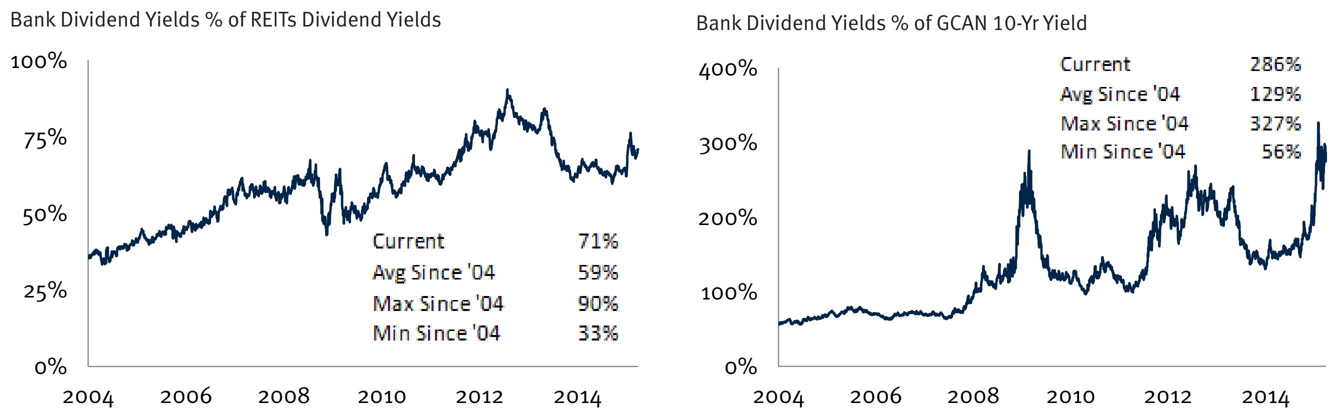
Current Valuations Suggest Limited Scope for Multiple Expansion

At a median value of 11.3x estimated FY2015 EPS, shares of the Canadian banks are trading slightly below their 11.4x long-term average. While we acknowledge the market has likely priced in some impact, we believe the numerous headwinds outlined earlier pose potentially more downside risk to earnings estimates and, thus, the banks may not be as inexpensive as they might appear. Moreover, with current expectations calling for below-trend earnings growth, a multiple in-line to below the long-term average seems justified, in our view.

But, Dividend Yields Could Provide Support

While valuations on a price-to-earnings basis appear full, on a comparative-yield basis, the banks look more attractive. Relative to other traditional yield sectors such as Real Estate Investment Trusts (REITs) and utilities,

Bank Dividend Yields Relative to the Dividend Yield of REITs and Government of Canada (GCAN) 10-Year Bond Yields



Source - RBC Capital Markets; data through 3/27/15 the dividend yields on the Canadian banks look attractive, a supporting factor not to be ignored in today's low interest rate environment. Likewise, the yield spread relative to 10-year Government of Canada bonds is approaching its highest level since the financial crisis.

U.S. Backdrop

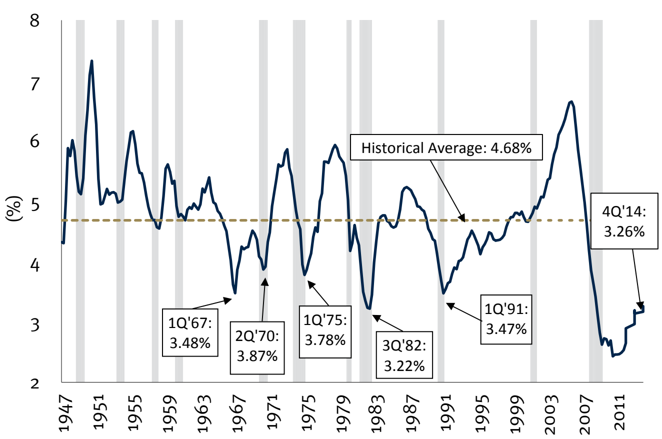
The U.S. banks' backdrop looks increasingly compelling, in contrast to Canada, driven predominantly by a U.S. economy that continues to show signs of strengthening. More specifically, we believe the tailwinds propelling the U.S. banks include:

- Loan growth that looks set to reaccelerate;
- Net-interest margins that may expand as the Federal Reserve prepares to raise interest rates, a marked contrast to Canada and most of the rest of the world; and
- Return of capital that may become a significant contributor to investor returns.

Improving U.S. Consumer May Drive Loan Demand

The labour market has been staging a very robust recovery. To put the current pace of job growth into perspective, in the last three months (ending February 28, 2015), the economy added over one million jobs, a run-rate that has not been witnessed for nearly 20 years. Employment is the lifeblood of personal consumption expenditures. As Americans continue to find work and trade up from their current jobs, their ability to take on credit increases.

Private Residential Investment as a % of GDP



Source - U.S. Bureau of Economic Analysis, RBC CM; data through 4Q'14

The very slow housing market recovery, from 2010's bottom, is another important aspect of the narrative. As the chart shows, private residential investment as a percentage of GDP has yet to fully recover from the financial crisis. While there has been some progress in the recovery, current levels remain consistent with prior cycle troughs. A further recovery in U.S. housing remains a source of potential upside for the economy and the U.S. banks.

Rate Hikes Could Drive Net Interest Margin Expansion

As the U.S. economy continues to gather momentum, so too does the probability the Federal Reserve will finally move away from the zero-bound and raise rates for the first time in nearly a decade. The potential for rising short-term interest rates is supportive of improving net interest margins, currently at 30-year lows. We believe margin expansion can be thought of as the missing piece of the puzzle with respect to the outlook for the U.S. banks, as they tend to be the largest source of profitability. RBC Capital Markets expects margins to stabilize and eventually increase as the Fed begins to tighten policy as early as mid-2015.

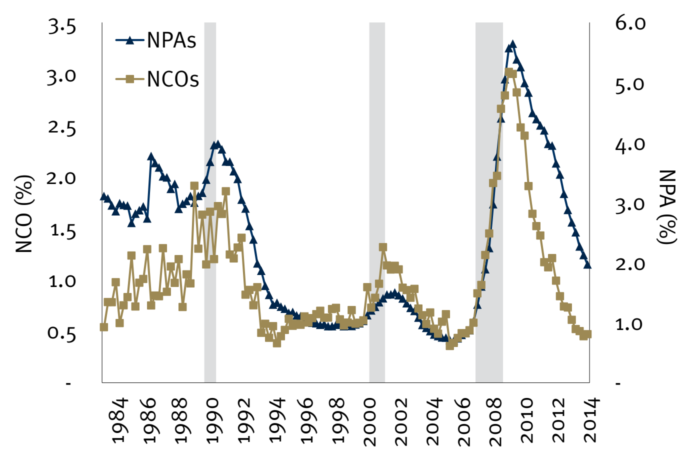
Strong Credit Quality & Capital Levels

While the U.S. banks have come through a very difficult period, many of the issues of the past decade have been addressed. The top chart on the following page shows non-performing assets that have steadily trended lower, to just over 2% today from over 5.5% of total loans in 2009. Net charge-offs (the gold line) are near historic lows.

Bank Exposure: Time to Diversify?

One of the most profound implications of the financial crisis was the drastic change in industry regulations. In the face of more-stringent regulation including Dodd-Frank, Basel III, and the so-called Volcker Rule, U.S. banks have been shoring up capital on their balance sheets for the better part of six years. As a result, U.S. banks are over capitalized. In fact, the last time U.S. financial institutions carried capital levels that mirror those of today was in the 1930s.

Nonperforming Assets & Net Charge-Offs



Note: Data as of 3Q 2014; shaded areas indicate U.S. recessions
Source - FDIC, RBC Capital Markets; data through 4Q'14

Potential for Record Capital Returns

The dividend yields on the Canadian banks are about 150–200 basis points higher than those of the U.S. banks. However, Canadian bank payout ratios (the percentage of earnings they pay out in dividends) are also substantially higher (about 45% vs. 25%–30% for U.S. banks). While the U.S. banks need to have their capital return policies approved by the Federal Reserve, we believe these lower payout ratios leave significant room for dividend increases and share buybacks in the intermediate term. The dividend payout ratio gap of U.S. banks relative to their Canadian peers may narrow due to excess capital reserves and future earnings growth, in our view.

2015 Capital Return Estimates as % of Earnings

CCAR 2015 Capital Return Estimates - U.S.		% of Earnings		
Company	Ticker	Dividends	Buybacks	Combined
JPMorgan Chase & Co.	JPM	30%	20%	49%
Bank of America Corporation	BAC	31%	38%	69%
Citigroup Inc.	C	4%	46%	50%
Wells Fargo & Co.	WFC	38%	26%	64%
U.S. Bancorp	USB	31%	39%	70%
The Bank of New York Mellon Corp.	BK	27%	62%	89%
The PNC Financial Services Group, Inc.	PNC	29%	49%	78%
Capital One Financial Corporation	COF	18%	57%	75%
State Street Corporation	STT	24%	76%	100%
BB&T Corporation	BBT	31%	29%	60%
Average: 10 Largest US Banks		26%	44%	70%

Source - RBC Capital Markets estimates, RBC Dominion Securities

In the bottom table on the right, the expected combined payout ratios—dividends and share repurchases—are highlighted for the U.S. large cap banks. RBC Capital Markets' 2015 estimates the top 10 largest banks in the U.S., based on market capitalization, will return nearly 70% of earnings in the form dividends and buybacks, a record high for the U.S. banking industry.

Final Thoughts

Canadian banks' earnings power has proven resilient over time. Absent a recessionary backdrop, shareholders have been rewarded more often than not. However, we believe the current environment presents many headwinds to earnings growth, while valuations are about in-line with historical levels. We believe that the Canadian banks remain core holdings in client portfolios; however, we also believe reducing this exposure in favour of U.S. banks is prudent in light of these "made in Canada" headwinds. Conversely, we believe the U.S. banks stand to benefit from the continued recovery in the U.S. economy, a steepening of the yield curve, a gradual rise in wage growth resulting from a tightening labour market, a housing market that is still well below normalized levels, and ample room to gradually enhance their capital return policies.

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As of December 31, 2014

			Investment Banking Services Provided During Past 12 Months	
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Hold [Sector Perform]	686	40.47	137	19.97
Sell [Underperform]	112	6.61	6	5.36

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