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Canadian Banks: Recession Headwinds

A special report by the Portfolio Advisory Group

There's Wealth in Our Approach.™

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For Required Disclosures see page 5.
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Amid entrenched trends of low interest rates, slowing growth in consumer lending, and elevated home prices, the shock of plunging oil prices has hammered business investment in Western Canada. These tough regional economic conditions have chastened expectations for business loan growth and given rise to the specter of credit losses.

Such challenges have brought the bears out as short interest on Canadian bank stocks has risen materially with the S&P/TSX Bank Index down 12% from its 52-week high. Canadian banks are trading at modest valuations from a historical perspective, but the next few quarters remain difficult to gauge, which leaves us somewhat cautious on the group in the near term. We recommend investors underweight the Canadian banks as they position portfolios heading into 2016.

Earnings Expectations and the Historical Experience

Canadian banks have delivered a strong track record of core earnings growth, which has averaged 11% over the last 20 years. The primary drivers of this growth are the state of the economy and capital markets. Earnings can be volatile with prior periods of economic malaise often delivering a contraction in earnings for the bank group as a whole.

With two quarters of negative GDP growth in H1 2015, Canada entered into what is commonly dubbed a "technical" recession. While the current slowdown is regional and not a nationwide recession, a precipitous decline in business investment has been at the heart of the slowdown. Low commodity prices have pressured balance sheets amongst oil & gas producers and energy services providers, not to mention base and precious metals producers. Finally, the broader effects at the consumer and commercial levels may have yet to be fully felt as the impact of lower employment extends its reach through the economy.

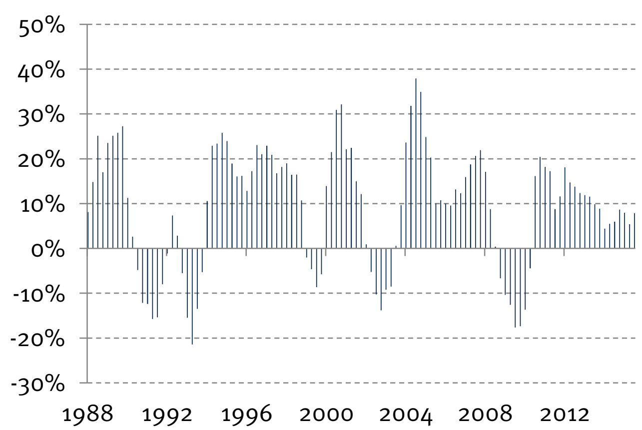
Consensus earnings growth expectations for the "Big 6" Canadian bank group currently reside at 4% for 2016. These estimates appear low when compared to the high single-digit and low double-digit growth figures experienced over the prior four years.

Credit Risks Flashing Yellow

Exposure to oil & gas loans generally runs around 1%–3% of the total loan books of the large Canadian banks, and about 4%–9% of the non-consumer loan books. To put these figures in the context of each banks' size and capital position, the upper chart on the next page shows oil & gas loans as a percentage of Tier 1 capital.

Credit quality remains benign as of the latest financial reporting with broad measures of commercial lending and consumer credit card debt showing flat or improving numbers. Home prices in Calgary are down 6% y/y and up modestly in Edmonton as of October data. Signs of credit

Canadian Bank Index Recurring Earnings Growth (y/y)



Source - RBC Capital Markets

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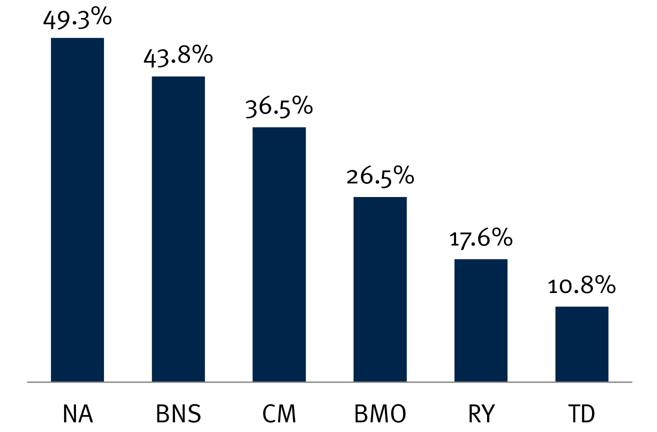
quality erosion specifically within the oil & gas sector ticked higher with gross impaired loan formations and/or loan-loss provisions increasing modestly across all "Big 6" Canadian banks. We would characterize credit conditions as flashing yellow at this stage, but remain mindful that credit deterioration tends to happen with a lagged effect.

Stress tests have been characterized by bank leadership teams across the board as "manageable," with two of the "Big 6" banks describing lower-for-longer oil price scenarios in 2016–17 yielding provisions for credit losses (PCLs) in the 30–40 basis point (bps) range. Looking at historical patterns, PCLs in this range would indeed be manageable as compared to prior peaks over the last four decades (see lower chart).

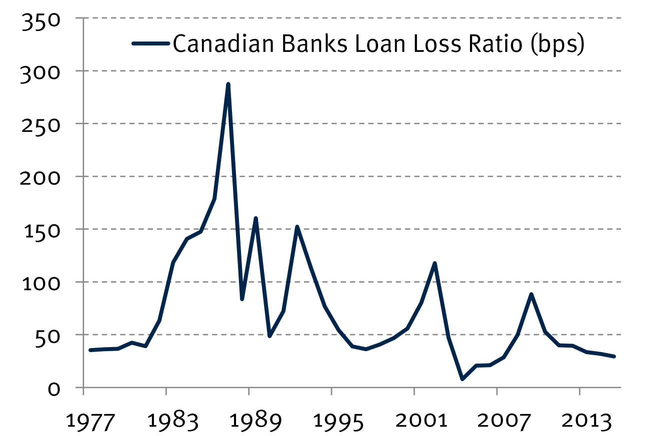
Expectations of more moderate credit deterioration in the current downturn are reasonable, in our view, given that recessionary conditions are regional. Also, having learned the hard lessons of prior cycles, banks have improved risk management measures with stricter single name limits and industry concentration limits. Finally, as compared to the 1980s and 1990s, banks now have substantially more diversified businesses that include capital markets and wealth management arms.

Oil & Gas Loan Exposure As a % of Tier 1 Capital



Source - RBC Capital Markets; as of Q3 2015

Canadian Banks - Historical Provisions for Credit Losses



Source - RBC Capital Markets

Longer-term Challenges

Low interest rates, slower mortgage growth, historically high household debt, and elevated home prices remain challenges. Low interest rates have compressed the spread between retail lending and deposits (plus other funding sources) to approximately 2.5% today from 3%–3.5% in the early 2000s. Current trends show net interest margins as relatively flat with analysts cautiously optimistic of improvement in the medium term.

Residential mortgage growth has eased to mid-single-digit levels over the last three years, well below the 6%–9% range post the financial crisis and double-digit levels prior to that. Household debt remains high, driven by larger mortgages as house prices have soared nearly 75% over the last decade, according to the 11-city Teranet-National Bank National Composite House Price Index. Current conditions remain robust in the nation's largest markets—Toronto and Vancouver—with sideways trends in Winnipeg, Halifax, Victoria, Ottawa, Montreal, and Quebec City in recent years. Calgary has shown recent weakness in the latest data.

Subdued Dividend Hikes

While the banks have room to raise dividends based on their targeted payout ratios, slower growth and a focus on capital preservation may temper dividend increases. We have seen one bank recently issue common equity in relation to capital levels which were low relative to its comfort level. Over the medium term, the potential for higher regulatory capital hurdles may also play a role. The risk of dividend cuts seems remote to us as none of the "Big 6" Canadian banks cut dividends during the global financial crisis, which presented much greater capital and credit challenges than those that are likely to emerge in the current downturn.

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Short Interest and Valuation

Short interest levels on the Canadian banks have risen substantially. Over the last 12 months, short interest is up more than 50% for most Canadian bank stocks as investors have expected that share prices would decline as the credit cycle turns down. These short positions are especially large amongst U.S.-based investors, who appear to be simultaneously anticipating that Canadian banks will be negatively impacted by the above headwinds and that the loonie will underperform relative to the greenback.

On a price-to-book value basis, the group trades at 1.7x, which is between the financial crisis trough of 1.1x and the 10-year average of 2x. On a price-to-earnings basis, the Canadian banks trade at an average of 10.4x 2016E (consensus) EPS, about 1–2 multiples above the levels observed during the financial crisis, but below the 10-year average of 11.4x.

Conclusion

The historical experience, longer-term, shows that Canadian banks have been resilient with an impressive track record of earnings and dividend growth. We believe that valuation multiples for the banks are fair, trading at multiples that are below long-term averages. The outlook for 2016 earnings remains fragile given the uncertainty related to credit losses, and the historical precedent of economic malaise delivering volatility in bank earnings. Given the uncertainties in loan growth and credit losses, we remain somewhat cautious on the Canadian banks in the near term, and recommend an underweight stance as we approach 2016.

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