SEPTEMBER 2013

Canadian Banks and Housing

A special report by the Portfolio Advisory Group

There's Wealth in Our Approach.™

Priced as of September 11th, 2013, unless otherwise stated.
For important disclosures see Page 6 and 7.
All values in CAD unless otherwise stated.
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RBC Wealth Management

Summary

- Canadian banks continue to trade at modest valuations, which reflect slower earnings growth and investor concerns over Canada's housing market. Earnings growth has declined to mid-single digit levels from the low-double digit levels of only a few years ago.
- This pattern has been underpinned by slower mortgage growth, which has in turn stemmed from relatively high levels of Canadian consumer debt and significant home price appreciation since the early 2000's. Investor concern can be observed in the elevated short interest positions on Canadian bank stocks.
- However, at present, most Canadian housing markets continue to show price increases, which means that the banks do not appear to face an imminent risk to their mortgage portfolios.
- Price-to-earnings ratios for banks are modest in the historical context, offering attractive valuations despite the recent run in share prices.

In This Report

HOUSING & MORTGAGE RATES

Since 2005, Canadian house prices are up about 58% based on the 11-city composite of the Teranet-National Bank House Price Index. Price increases since 2005 across the 11-city composite have ranged from +37% in Victoria to +95% in Winnipeg.

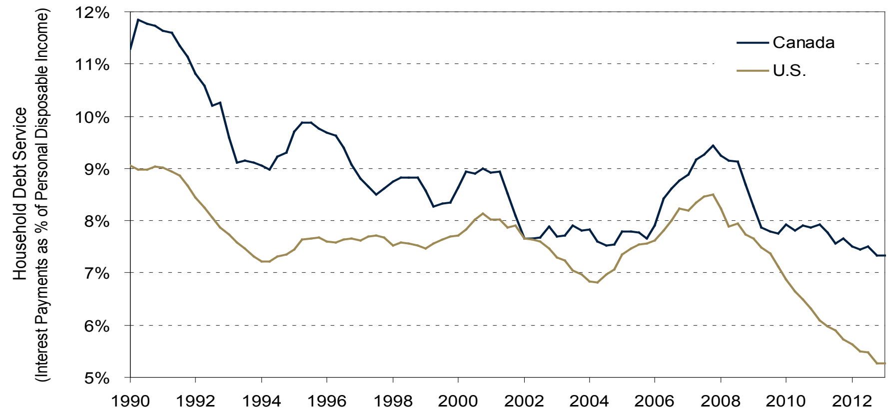
As a consequence of climbing house prices and hence larger mortgages, consumer credit has roughly doubled in the last 10 years with residential mortgage debt outstanding now at approximately $1.2 trillion. Consumer leverage has risen to greater than 150% of disposable income from closer to 110% through the 1990's, and compares to the U.S. peak of 164% during its housing boom in the mid 2000's. Despite increased debt loads, the cost of servicing debt for the average household has declined during the past two decades as interest rates have fallen.

Roughly 28% of Canadian mortgages are on floating rates, and another 7% are combination fixed/floating. Of the fixed rate mortgages, approximately 5-10% are up for renewal in the next year. Thus, over the course of a year, just over a third of outstanding mortgages will reset to the prevailing level of interest rates.

Historically, a large majority of Canadian mortgages have had fixed 5-year terms. Fixed mortgage rates have been on a steady rise since bond yields began moving higher in May of this year. From its bottom on May 16, the 5-year Canada bond yield has increased from 1.4% to 2.1% as of September11. Mortgage rates for 5-year fixed terms have gone from headline grabbing offers of 2.99% this past spring to current levels near 3.9%. Historically, fixed mortgages rates have been somewhat higher averaging 4.7% from 2003 – 2012, and 5.5% from 1993 – 2012.

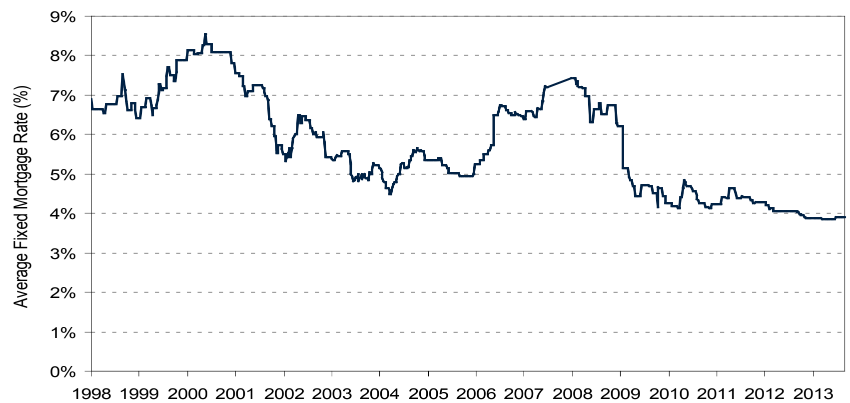
EXHIBIT 1: HOUSEHOLD DEBT SERVICE

(INTEREST PAYMENTS AS A % OF PERSONAL DISPOSABLE INCOME)



Source - Federal Reserve Board, Board of Economic Analysis, Statistics Canada and RBC Capital Markets

EXHIBIT 2: HISTORICAL FIXED MORTGAGE RATES



Source - Bloomberg

In the short term, the rise in rates appears to have boosted sales activity as buyers enter into the market sooner than they might have planned in anticipation of still higher rates to come. After a slow period for sales activity over much of the last year, July data showed Vancouver sales activity up 40% year over year. Other major centers with notable increases included Toronto at +16% and Calgary at +17%.

Price conditions remain robust across most major centers. As of the July data, the national composite price index rose +1.9% year over year, and +0.7% month over month. While prices decreased in Victoria and Vancouver, prices in all other major centers were up.

Mortgages Rules

Mortgage rules have been tightened in various ways over the last several years. The Federal Department of Finance has reduced the limits on mortgage insurance four times since 2008. Mortgage insurance is mandatory in Canada when the borrower has a down payment of less than 20%. These changes have lowered the maximum amortization period for insured mortgages from 40 years to 25 years, increased the minimum equity required for new mortgages and re-financings, and put caps on certain debt service ratios. The last wave of these changes was announced in June 2012 and contributed to slower sales activity in the ensuing months. Also in mid 2012, the Office of the Superintendent of Financial Institutions put forward a set of regulations on residential mortgage practices referred to as the B.20 guidelines. These principles cover due diligence matters regarding income and identity verification, debt service coverage, risk limits, etc. They also place specific limits on the size of home equity lines of credit (65% maximum loan to value). All of these measures have been put in place to keep the housing market from becoming further extended and to encourage a soft landing.

Impact on the Banks

While investors remain concerned about Canada's housing market, there are several factors which would argue against significant loan losses for the banks, including: mortgage insurance, equity buffers, and the historical experience. The "Big 5" Canadian banks have nearly two-thirds of their residential mortgages covered by insurance (primarily from the government-backed Canada Mortgage and Housing Corporation). On their uninsured mortgage portfolios, average loan to value levels range from 47-59% suggesting large equity buffers before the banks would suffer any losses. Finally, the historical experience would show provisions for credit losses on residential mortgages at modest levels, peaking at 6 bps during the early 1990's period of house price declines and again at a similar level during the 2009-10 period.

Rising interest rates could negatively impact banks in other ways such as a weaker economy given constrained consumer spending and lower asset growth (mortgages and personal loans). A mitigating factor to weaker asset growth would be the likely positive impact from rising interest rates on net interest margins. At their core, banks take in deposits and lend out money. Banks tend to borrow on the shorter end of the yield curve (e.g. deposits) and lend further out (e.g. 5-year mortgages). Should the Bank of Canada overnight rate remain low, while medium- and longer-term government bond yields rise, as in the current environment, net interest margins should improve.

Exhibit 3: Canadian Residential Mortgage Metrics

	$ billions	Insured	Uninsured	Uninsured Loan-to-Value
BMO	86	59%	41%	59%
BNS	189	56%	44%	56%
CM	144	72%	28%	54%
NA	36	67%	33%	55%
RY	180	43%	57%	47%
TD	158	65%	35%	47%
Median		**62%**	**38%**	**55%**
Total	***793***	***464***	***329***	

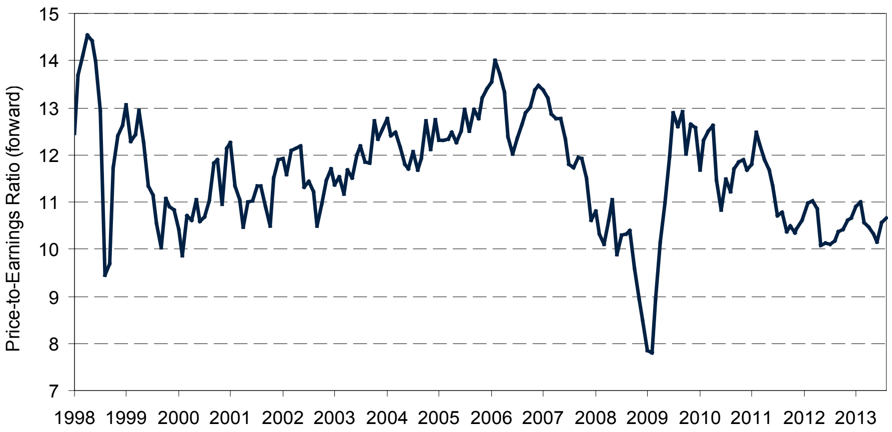
As at Q3 2013

Source - RBC Capital Markets

Short Interest & Valuation

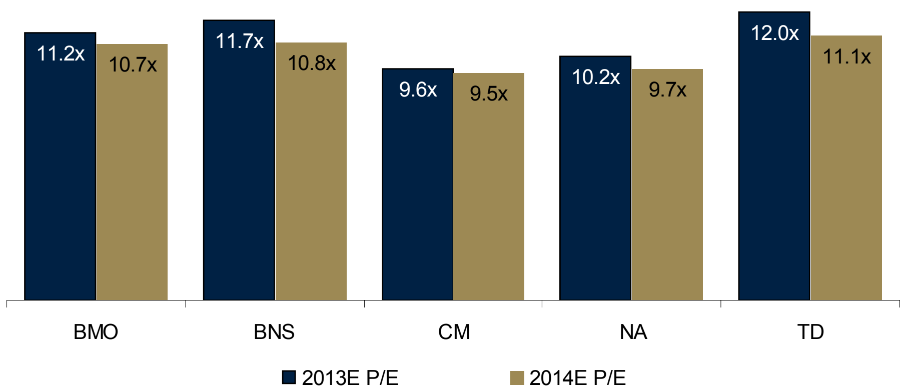
Short interest levels (market transactions made by investors in anticipation of share price declines) on the Canadian banks have increased in the last year, as a large contingent mainly made up of foreign investors has speculated that a weaker housing market and domestic economy could lead to challenging conditions for Canadian banks. National Bank and CIBC have seen the highest levels of short interest on their shares. National Bank has a Canada-only

Exhibit 4: Historical Price-to-Earnings Ratio (Canadian Bank Index)



Source - RBC Capital Markets

Exhibit 5: Bank Price-to-Earnings Ratios



Source - Bloomberg consensus EPS, ThomsonONE, RBC Wealth Management

footprint, lacking any significant international diversification, and has capital ratios at the low end of the peer group. Similar to National Bank, CIBC has a more concentrated exposure to Canada, lagging performance in its Canadian retail division, and higher relative exposure to credit card debt.

The current 10.5x price-to-earnings multiple average for the group is at the low end of the 10x-13x range that has prevailed over the last fifteen years. With earnings growth for the group at an expected 5% for 2014/13, dividends near 4%, and low multiples as compared to historical levels, the Canadian banks continue to look like a worthwhile investment over an intermediate-term investment horizon.

Conclusion

Despite investor concern over house prices and significant short interest activity on the bank stocks, the economic and interest rate backdrops support robust pricing conditions for housing across most major centers in Canada. Even if a period of softening were to occur, there are several mitigating factors which would argue against significant loan losses for the banks including: mortgage insurance, equity buffers, and the historical experience. With earnings growth for the group at an expected 5% for 2014/13, dividends near 4%, and historically low valuation multiples, the Canadian banks continue to look like a worthwhile investment over an intermediate-term investment horizon.

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