How A Recession Could Impact Stock Prices of Canadian Banks

March 10, 2023

QV Investors

How prepared are they to weather a storm?

At approximately 30%, Canadian banks make up a large part of the S&P/TSX Composite Index. This tells us that the performance of banks has a large impact on the returns of the Canadian stock market.

The question that keeps coming up is whether we are going into a recession and if so, what impact might that have on our bank holdings? Although we're not calling for a recession, we currently have an inverted yield curve (one where the short-term bond rates are higher than long-term bond rates). The Bank of Canada created it by increasing its overnight interest rate. Historically this inversion leads to weaker economic conditions.

Let's assume we find ourselves in a recession. What could happen to Canadian bank stocks? Let's explore the potential impacts.

What Reduces Bank Stock Prices?

There are two factors that could lead to stock price declines.

The first is a shift to a more negative outlook, resulting in a decline in the valuation level an investor will pay. This can be as simple as an increasing fear that the economy may be entering a recession and the market may become weak.

The second is an earnings decline. Since investors are paying for earnings, lower earnings typically result in lower share prices.

What can Reduce Bank Earnings?

Provision for Credit Losses (PCLs)

Recently, Canadian banks reported their quarterly earnings. One of the key numbers reviewed by investors is the provision for credit losses or PCLs. PCLs are amounts banks set aside as they try to anticipate what will be required to cover losses on their portfolio of loans and mortgages.

As banks become more concerned about increasing losses in their credit portfolio, these PCLs rise. This rise reduces period earnings.

Funding Cost Pressures

Simple banking refers to taking in funds on deposit and then lending these same dollars out to several individuals or businesses. The difference between the interest rate paid on the loan by the borrower versus the interest rate paid to the consumer or business that deposited money is referred to as 'the spread'. This number is reported by Canadian banks and is called the net interest margin (NIM).

Typically, prior to a recession, interest rates are raised by central banks to reduce inflation while the economy continues to run full steam ahead. As interest rates rise, it increases the NIM that banks earn. The rise in NIM is primarily due to the rapid rise in interest rates. New loans and variable-rate loans automatically adjust upwards with the rise in central bank rates, improving bank earnings.

When a recession does hit, the Bank of Canada reduces interest rates. This is done to help businesses and consumers deal with debt payments as unemployment rates climb and the economy slows with a decreased demand for products. Often this results in the NIM declining as interest rates on term deposits may be fixed and the variable rate loans reset at the lower rate. To summarize, during a recession the NIMs typically decline, reducing bank profitability.

What can help stem bank stock price declines?

Bank Valuations

The valuation level of a stock prior to a recession is important in determining how far down a stock can go in a recession. If a stock is trading at below-average levels, then the share price decline may be muted if we enter a recession. This is relevant to all companies, not just banks.

In scenarios like the 2007-2008 Great Financial Crisis or even the COVID pandemic, price declines were quite significant. In our opinion, this was largely due to valuation levels that were not pricing the negative environment that was experienced.

Capital Levels

Bank regulators demand that banks carry a certain amount of capital to protect the bank from a financial shock such as a large number of loans going delinquent.

One measure is the Common Equity Tier 1 (CET1) ratio, which is a standard set by an international banking regulator. The CET1 ratio outlines the required capital (common shares and retained earnings) that a bank must have as a percentage of its risk-weighted assets. The current standard is to have a CET1 ratio of at least 8%.

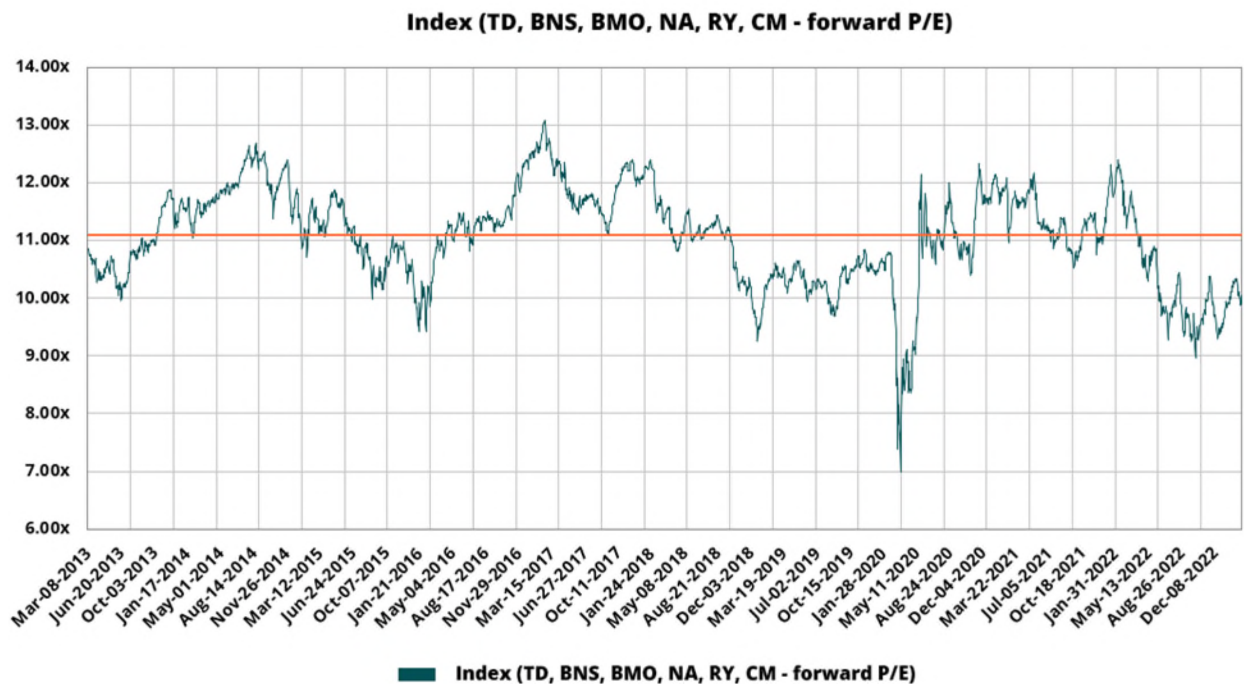
As a result of the Great Financial Crisis, the Office of Superintendent of Financial Institutions (OSFI), the Canadian bank regulator, increased the amount of capital required to provide even more stability to the Canadian banking system. OSFI introduced the domestic stability buffer (DSB) that would be added to the international level of 8%. The current DSB is 3.0%, so Canadian banks must have capital levels above 11%.

The result, Canadian banks can absorb higher levels of shock. The regulator has also said that in times of stress, such as a recession, it could reduce the DSB required to help Canadian banks cover losses. This new higher level of capital should help mitigate share price declines in recessions as the banks are better prepared to maintain the required capital without having to issue new shares (which has been the pattern observed in previous recessionary environments).

How are Canadian Banks Faring Now?

In the most recent bank reporting period, we saw five out of the six large Canadian banks see an increase in impaired loans (those not being paid on time). As impaired loans rise and concerns of a recession have increased, the banks have begun increasing their provision for credit losses, negatively impacting earnings.

The net interest margins at banks have been increasing. As an example, in the recent quarter all are seeing an increase in their Canadian net interest margins, which should also help earnings. Bank valuations have moved to levels that are below their ten year average (based on price to earnings ratios). See the chart below of the average P/E of the big six Canadian banks.



Source: S&P Capital IQ

This level of valuation looks to be contemplating some of the risks that we have outlined above.

The capital levels of Canadian banks are at all time highs. Although the required minimum is 11%, the lowest bank is currently at 11.5%. There are two banks substantially above this level, Bank of Montreal and TD. These banks are incidentally in the middle of acquisitions which requires additional capital.

[Investment Blog, Portfolio Mgmt Blog - QVI Weekly Update (qvinvestors.com)](qvinvestors.com)