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Moody's Downgrades Six Canadian Banks

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On Wednesday night, Moody's, one of the major credit rating agencies, downgraded the six main Canadian banks by one notch. The downgrade was a reflection of concerns that the banks were "more vulnerable to downside risks in the Canadian economy," as a result of expanding consumer debt levels and elevating housing prices.

The initial market reaction was mildly negative, with bond yields for the Canadian banks rising a few basis points, bank stocks falling between 0.5-2.5%, and the Canadian dollar weakening modestly. In light of these developments we've put together some thoughts on portfolio positioning and the Canadian market as we look forward.

Currency and Fixed Income

The loonie weakened modestly on the news, largely as a reflection of the view that the Bank of Canada will be on hold for a more prolonged period than the market initially suspected. Our view is that the loonie will weaken over the next year versus the U.S. dollar, partly as a function of expectations that the Bank of Canada (BoC) will likely keep interest rates unchanged due to lacklustre economic growth while the Fed continues to gradually increase interest rates. As a result, our currency view was biased towards a weakening Canadian dollar and we were well positioned to benefit from this week's move downward.

From a fixed income perspective, in the current environment where interest rates are low and employment remains stable, there is no evidence of credit deterioration from the big six banks. These companies are very well-capitalized with strong access to broad-based funding and are operating under a prudent regulator in Canada. As a result, we do not have concerns about the downgrade being a canary in the coal mine for Canadian banks and their bonds, nor do we have concerns around their credit-worthiness.

Equities

In terms of equity market moves, the banks with more domestic retail exposure were more impacted than those with higher exposure to international operations. Moody's statements around growth in Canadian consumer debt levels and elevated housing prices are concerns that we share. We monitor these risks on an ongoing basis to understand what the resulting impact of stress – like a rise in unemployment rates or increased interest rates – could be on Canadian consumer balance sheets and thus on the banks and their provisions for credit losses.

For a number of years we have tilted our bank exposure within funds like RBC Canadian Dividend Fund towards banks that generate a higher percentage of their revenue from international sources. While these positions can fluctuate based on underlying valuations and the level of concern that exists in the market, holding banks with diversified operations has generally served us well over time as there are a number of revenue levers that can be pulled when other areas of the market slow down. While a downgrade like this doesn't change how we think about investing in these securities, it does highlight the importance of ensuring that the portfolio is not overly concentrated in one area of the market – something we spend a lot of time thinking about.

Conclusion

There's a wide swath of newsflow floating around right now, whether it's around an elevated Canadian housing market, the credit downgrade of Canadian banks, or even the recent news around Home Capital and its liquidity issues and ongoing regulatory investigations. To that end, we would note the following points around these developments:

- While the banks are a large part of our economy and market, for the most part their earnings come from a variety of sources, including international operations, investments, and capital market activity. These non-domestic businesses can help with revenue growth through a period of Canadian economic weakness and a slowdown in domestic loan growth.

- The newsflow around Home Capital Group, while disconcerting, is being monitored carefully. The company represents less than 1% of the total mortgage market in Canada, and while the company has experienced some difficulty accessing funding at normalized rates, it did secure funding in order to cover the deposit outflows it was experiencing. The company is exploring its options around selling off portions of its loan book and while there are a wide range of possible outcomes, we do not think a significant decline in the housing market is imminent as a result of these company-specific issues.
- Home prices in Canada are elevated and affordability has deteriorated. However, much of this deterioration has occurred in major city centres like Toronto and Vancouver, where measures to slow the pace of price increases have been undertaken. While we continue to monitor the housing market closely, our base case is still an outcome where housing prices could consolidate over a number of years rather than decline significantly.

More broadly speaking, the downgrades speak to the importance of maintaining a globally diversified portfolio that has good exposure to other countries, global multi-asset credit, and levers that can be pulled to increase or decrease exposures as opportunities and risks present themselves.

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