FINANCIAL POST

August 29, 2019

Canadian banks decouple from one another as economic cycle wanes

Disparity is showing up in the Big Six stock lockstep

Struggling with steeper credit loss provisions has been a trend this earnings season.*Peter J. Thompson/National Post files*

Three Canadian banks are retesting the floors they reached in December, decoupling from the rest of the Big Six in what analysts say is a sign of uncertain times.

After releasing mixed third-quarter earnings over the past week, Bank of Montreal and the Canadian Imperial Bank of Commerce both briefly fell below the lows they reached on Dec. 24, when markets plunged as trade tensions and an aggressive interest rate environment stoked fears of recession.

The Bank of Nova Scotia narrowly avoided doing so — floating one per cent above its low in August — before better-than-expected third-quarter results led to a bounce.

Meanwhile, the Royal Bank of Canada, Toronto-Dominion Bank and National Bank of Canada are each trading in lockstep with the Solactive Equal Weight Canada Banks Index, ranging between eight and 10 per cent above their December lows.

The disparity, a significant one given how closely the trading patterns of the Big Six banks often mirror each other, is a result of the current economic environment, said ***Veritas Investment Research*** analyst ***Nigel D'Souza***.

"It's only when we're in conditions of elevated credit risk or concerns of economic growth where the banks start trading less as a group and more independent of each other so you see more divergence in performances," he said.

The decoupling could be a result of the market's perception of which stocks will be hit the hardest by issues such as credit risk during the latter stages of the economic cycle, he said.

Struggling with steeper credit loss provisions has been a trend this earnings season.

In particular, BMO this week reported that its loss provisions increased by a staggering 65 per cent from the past year to $306 million. With the exception of Scotiabank, which lowered its credit loss provisions by 24 per cent from last year to $713 million, and TD, which hasn't yet reported earnings, each of the other banks reported between 13 and 23 per cent increases in the third quarter.

D'Souza had sell ratings on each of the big six Canadian banks when he first spoke to the Financial Post on Tuesday, but on Wednesday he issued a buy rating for BMO that came with a price target of $91 after the stock opened at $89.05.

Before the switch, the analyst had argued the banks would only be worth buying when their credit losses peaked, something he suggested might not occur until 2020. Until then — due to interest rate cuts in the U.S. and the possibility of the Bank of Canada following suit — there would be more pain for investors.

Now, ***D'Souza*** expects BMO to outperform the sector by five to 10 per cent in the next 12 months, ranking the bank higher in terms of credit risk while arguing it can more easily reduce non-interest expenses going forward.

"Even though we model out 75 per cent increases for credit losses year-over-year for BMO in 2020, there's still enough earnings growth in terms of the next 12 months to justify a valuation that's a little above what the market is currently pricing shares," ***D'Souza*** said.

Cormark Securities analyst Meny Grauman doesn't think investors should view the trading separation through the lens of credit risk. Instead, he said, the real issue that they should be studying is flexibility, or which banks will have the ability, during a downturn, to continue to invest in things such as technology and deliver positive operating leverage without making sacrifices elsewhere.

National Bank is a unique case, he said, because of its strong regional ties to Quebec, which is proving to be economically stronger than other provinces.

Investors would be more interested in RBC and TD, said Grauman, who has a buy rating on both, simply because they are the country's two largest banks and trade at a premium because of it.

"When it comes to RBC and TD, part of it is a function of an uncertain environment," he said. "Part of what's going on here is you tend to see people look for safety or a calm harbour. When it comes to the banks, the two biggest tend to benefit from that."

Even in the event that Canada enters into a recession, something Grauman doesn't think will happen, and bank stocks continue to fall, RBC and TD will still be better off than the others, he said. That doesn't mean that he expects them to trade in the green, though.

"If we have a recession in Canada and the U.S., the banks will take it in on the chin and go down from here, but I do think in that scenario, RBC and TD will continue to perform better than their peers," he said.