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Why this top analyst has a sell rating on each of the Big Six banks

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Most of the time, betting against the big Canadian banks is a big mistake. Last year was an exception.

In 2018, the Big Six group of stocks put up its worst calendar year since the global financial crisis, as it succumbed to a downdraft in the energy sector, a housing market slowdown, concerns over household debt, trade tensions between the United States and Canada and a global stock market correction.

"Only once or twice a decade do you want to be underweight Canadian bank stocks," said ***Nigel D'Souza***, an analyst at ***Veritas Investment Research.***

Those rare occasions tend to coincide with a slowing economy and rising credit losses – precisely the conditions that materialized last year and continue to loom over the banking sector today, ***Mr. D'Souza*** said.

With "sell" ratings on all six of the big banks, ***Mr. D'Souza*** is a clear outlier among Canadian bank analysts.

That bearishness, however, earned him the distinction of last year's top bank stock analyst, as conferred by the annual Thomson Reuters StarMine Analyst Awards.

The awards rank sell-side equity analysts based on their investment calls for the companies they cover.

Each analyst's ratings through the year are compiled to create a hypothetical portfolio, and a return is calculated based on what an investor would have earned by following all the "buy" and "sell" recommendations.

Mr. D'Souza's stock picking would have generated an excess return of 11.1 per cent over the industry benchmark in the 2018 calendar year.

Going into last year, a slowdown in consumer credit growth, particularly mortgages, was an emerging risk for the banks. Interest rates were on the rise, while a new stress test taking effect Jan. 1 would require mortgage borrowers to prove they could manage higher payments.

With "sell" recommendations already in place on Toronto-Dominion Bank, Bank of Nova Scotia and National Bank of Canada, to start the year, ***Mr. D'Souza*** downgraded Royal Bank of Canada in May, in part because of the bank's heavy exposure to unsecured consumer credit, including credit cards, lines of credit and auto loans.

The only bank with a higher weighting in consumer lending is Canadian Imperial Bank of Commerce, which ***Mr. D'Souza*** downgraded in November.

The most recent precedent for a credit downturn occurred after the collapse of oil prices in 2015-16, when bad loans to the energy sector squeezed Canadian bank profits.

Back then, the end of the sell-off in bank stocks coincided with the peak of credit risk, ***Mr. D'Souza*** said.

“You would have made a great return if you backed up the truck and bought as many bank stocks as you could, when credit losses reached their highest part of that mini cycle.” Since February of 2016, the average diversified Canadian bank stock has risen by about 50 per cent.

In the current cycle, it is not yet the right time to pull the trigger, ***Mr. D’Souza*** said. Bank loan losses are still on the rise, having increased by more than 15 per cent year over year in each of the first two quarters.

And with household finances increasingly squeezed by record levels of debt, banks will likely have to set aside more and more money for bad loans through the end of the year, ***Mr. D’Souza*** said.

The household debt service ratio, or the proportion of disposable income committed to principal and interest payments, rose to a record high 14.9 per cent in the first quarter, according to Statistics Canada.

Meanwhile, the effects of a slowing economy and inflated debt on big bank loan books is making for an unpredictable earnings backdrop. In each of the past two quarters, four of the six big banks fell short of their profit forecasts.

“You don't typically see that many banks miss earnings expectations,” ***Mr. D’Souza*** said. “We expect that to continue.”

In March, ***Mr. D’Souza*** removed the last of his Big Six “buy” ratings, and downgraded Bank of Montreal on valuation concerns, putting him firmly against the sell-side consensus.

“When the data changes, our calls will change. We’re not perma-bears.”