What Bank Earnings Reveal About the Canadian Economy

Description

In the Canadian Business 2013 “Investor 500” report published earlier this year, Canadian banks outdid their commodity counterparts to claim top status in the category of profitability. The “Big Five” Canadian banks — **Royal Bank of Canada** (TSX: RY), **Toronto-Dominion Bank** (TSX: TD), **Bank of Nova Scotia** (TSX: BNS), **Bank of Montreal** (TSX: BMO), and **Canadian Imperial Bank of Commerce** (TSX: CM) — took spots one, two, three, five, and ten, respectively, in profitably rankings, easily swamping all other industries. Bank earnings have been improving over the past several quarters. What inferences can we draw about the Canadian economy as a whole from recent bank profits?

Interest income is up

Over the last four quarters, the Big Five have seen a steady uptick in net interest income — the difference between what banks earn on the money in depositors’ accounts and the interest paid to those depositors. This is also known as net interest margin[AS1] . With the Bank of Canada sticking to a low-interest-rate, stimulus-based policy[AS2] , banks aren’t growing their profits through huge interest rates spreads. Rather, they are adding to their deposit base as the economy improves, and making higher net interest income through an increase in volume.

Below is a table that shows how net interest income has improved during the past four business quarters[AS3] :

Big Five Banks: Net Interest Income, April 2013 Versus April 2012

Company	**April 2013**	**April 2012**	**% Change**
Royal Bank of Canada	$3,223	$3,031	6.33%
Toronto Dominion Bank	$3,902	$3,680	6.03%
Bank of Montreal	$2,098	$2,120	-1.04%
Bank of Nova Scotia	$2,784	$2,481	12.21%
Canadian Imperial Bank of Commerce	$1,823	$1,753	3.99%
Totals:	$13,830	$13,065	5.86%

Source: Toronto Stock Exchange Financials Data. All dollar figures in CAD millions.

As businesses gear up and personal finances see a little sunlight, deposits are growing, and banks’ interest revenue is increasing modestly.

Credit quality is on the mend

Earnings are particularly vulnerable to the quality of the loans the banks dole out. When banks report their earnings each quarter, we can get a global sense of the credit quality of their loans by monitoring the “Loan Loss Provision” on their income statements. A loan loss provision is an expense a bank takes when it is writing off current bad loans or preparing to take hits on its loan portfolio in the future. The line item appears as a negative in the income statement, reducing net interest income. The smaller the number, the better the relative recent credit quality of a bank’s portfolio. As you can see, loan loss provisions have mostly decreased over the last four quarters on the Big Five’s profit and loss statements:

Big Five Banks: Loan Loss Provisions, April 2013 Versus April 2012

Company	**April 2013**	**April 2012**	**% Change**
Royal Bank of Canada	($288)	($348)	-17.24%
Toronto Dominion Bank	($417)	($388)	7.47%
Bank of Montreal	($145)	($195)	-25.64%
Bank of Nova Scotia	($343)	($264)	29.92%
Canadian Imperial Bank of Commerce	($265)	($308)	-13.96%
Totals:	($1,458)	($1,503)	-2.99%

Source: Toronto Stock Exchange Financials Data. All dollar figures in CAD millions.

This trend also opens up some insight into the economy: businesses and consumers are stabilizing their financial position, and defaulting at a lower rate on loans, resulting in less bad debt in the banking system. This is a net positive for Canadian business and the economy in general, as stronger credit quality is indicative of greater economic productivity.

Now let’s combine the two tables above, to view an extremely important number to banks: Net Interest Income after Loan Loss Provisions:

Big Five Banks: Net Interest Income After Loan Loss Provisions: April 2013 Versus April 2

Company Results Total:	**April 2013**	**April 2012**	**% Cha**
Total Net Interest Income	$13,830	$13,065	5.86%
Total Loan Loss Provision	($1,458)	($1,503)	-2.99%
Total Net Interest Income after Loan Loss Provision	$12,372	$11,562	7.01%

Source: Toronto Stock Exchange Financials Data. All dollar figures in CAD millions.

Higher net interest income and diminished loan write-offs are combining to add spark to banks’ earnings. They also give us some reassurance outside the daily news cycle that the Canadian economy is indeed laying a fledgling foundation for growth. The recovery so far feels tenuous; Canadian GDP is growing at less than 2% per year. But on the flip side of the coin, bank earnings indicate that given a solid catalyst, say an uptick in exports to our neighbors to the south (where economic activity is starting to gel), the Canadian economy might just start to pick up some steam in the next twelve to eighteen months.

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Fool contributor Asit Sharma doesn't own shares in any company mentioned at this time. The Motley Fool doesn't own shares in any of the companies mentioned.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:BMO (Bank Of Montreal)
2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:RY (Royal Bank of Canada)
5. TSX:TD (The Toronto-Dominion Bank)

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Date
2025/08/24
Date Created
2013/07/29
Author
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