Exercise Caution When Banking on this Sector

Description

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Dear Fellow Fools,

Examining a broad swath of Canadian economic statistics might lead you to believe that the good times will continue to roll. Unfortunately, minute cracks may be forming in the foundation for at least one sector. Though it is most certainly possible that these cracks are being addressed early enough, we have all seen how quickly a chip in your car's windshield can erupt into a spider web of fissures at even the slightest hint of unbalanced pressure.

Is a confirmation bias building?
Wages are up , Canada's unemployment is steady, and as the chart below indicates, the value of many of our houses has reached Mount Logan-esque heights… what could go wrong?

Canada New Housing Price Index

Image not found or type unknown
Canada housing index

Source: Bloomberg

Simply taking these data points and running with them only opens our eyes to part of the story however. It's during times like these, when things appear to be clipping along nicely, when a lot of investors can become complacent, happy to let the market climb higher with their portfolio in tow.

What the overarching numbers don't show, however, is that a shockingly high number of Canadians are dependent on two things: the continued success of the construction market and household debt.

In fact, not in the last 38 years has a higher percentage of Canadians been employed by the construction industry when compared to the overall labour force. The figure loomed over 7.5% at the end of 2013. Combine this with the fact that construction accounts for over 7% of GDP – a level that has traditionally been a ceiling – and you are staring at a vulnerable cornerstone of the Canadian economy’s foundation.

Further, when comparing household debt-to-disposable income in Canada to that of American households, the period beyond 2007 has shown some pretty dramatic divergence. While the two have treaded similar paths since 1990, the U.S. actually began trimming its household debt load after the financial crisis, while we maintained our trending ascent.

Peering over the edge
As construction and housing statistics reach dizzying heights – in tandem with our debt levels – it leaves me with a sense of hesitation when addressing one sector in particular: **Canadian banks**.

With the top three spots in the S&P/TSX Composite Index occupied by banks, and 18% of the entire Index dedicated to the Big 5, our communal propensity to spend, coupled with the potential for rising rates, could place tremendous strain on our market if defaults start to creep up or a dramatic reduction in loan activity takes place.

What are these banks on the hook for exactly? Given that the housing sector has been on such a tear, it’s easy to guess that mortgage loans have been accumulating, but the total value of these loans might catch you off guard. According to recent data, and illustrated in the chart below, Canadian mortgage debt outstanding has eclipsed $1 t.r.i.l.l.i.o.n.

Mortgages Outstanding

Canada mortgages outstanding

Image not found or type unknown

Source: Bloomberg

Breaching the trillion dollar mark has occurred while the household debt-to-income ratio has recently eclipsed 160% in its relentless, though dubious, pursuit of reaching 200% of the amount we earn. At what level were our southern neighbours teetering on just prior to their great recession? Try 30 percentage points… lower than where we currently sit.

Palms sweaty yet? If they aren't, try not fogging up your computer monitor with heavy breathing while digesting recent comments from Bill Gross' Pimco and Ray Dalio's Bridgewater Associates. Together, the two venerable firms suggest the Canadian housing market is "overvalued and due for a correction" and that the overall Canadian economy is "just beginning a needed de-leveraging in order to rebalance." Thankfully, some solace can be found in comments from Pimco's Canadian investment head, Ed Devlin, which state that the "correction will likely happen over several years," which hints that it won't necessarily be sudden or painful.

On the front lines

If you read the comments from **Toronto-Dominion Bank's** (TSX: TD)(NYSE: TD) CFO, Colleen Johnson, last month, then you'll know the correction might have already started. She mentions that there has been some tapering off in the level of mortgages and home equity loans of late. While a slowdown might sound worrisome, fuse these comments with her idea that growth rates are now "at more healthy and sustainable levels," and your vitals might regress towards the mean, a bit.

Echoing these same sentiments, Royal Bank of Canada's (TSX: RY)(NYSE: RY) CEO, Gord Nixon, acknowledged that a more prudent Canadian consumer has already begun the deleveraging process to some degree, thus reducing demand for mortgages and other loans. Despite such self-policing on the part of Canadian consumers, both banks believe that mid-single digit growth in consumer lending is a reasonable glide path to consider.

Reap what you sow

Listening to the latest conference calls of these two Canadian bank heavyweights makes it seem like belts are tightening, but in my opinion not quickly enough to spark a brush fire in the banking sector. As an investor, I certainly hope the sentiments of Johnson and Nixon *regarding the changes in consumer borrowing habits* are true. As 2014 progresses, I will maintain a watchful eye on these statistics to ensure the continued practicality of Canadian consumers and lenders while reporting back to you periodically. Right now though, we should all be crossing our fingers that a plateau in consumer borrowing is indeed being reached, followed by a gentle downward slope on the backside. Hopefully, this isn't too ~~Foolish~~ foolish on my part.

Ask a Fool

Thoughts? Comments? Criticisms? Endorsements? We'd love to hear them! Drop us a line at CanadaEditorial@fool.com with whatever might be on your mind!

Sincerely,

Taylor Muckerman

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Motley Fool Canada

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