



3 Reasons Canada's Banks May Plunge

Description

For the last 20 years, investors in Canada's banks have enjoyed almost uninterrupted growth. Sure, there have been a few memorable price declines — the recessions in 2002 and 2009 immediately come to mind, along with a few company-specific blowups — but for the most part, investors have to be pleased with the performance of Canada's largest banks.

On the one hand, **Royal Bank** ([TSX: RY](#)) ([NYSE: RY](#)), **TD Bank** ([TSX: TD](#)) ([NYSE: TD](#)), **Bank of Nova Scotia** ([TSX: BNS](#)) ([NYSE: BNS](#)), **Bank of Montreal** ([TSX: BMO](#)) ([NYSE: BMO](#)), and **Canadian Imperial Bank of Commerce** ([TSX: CM](#)) ([NYSE: CM](#)) are perhaps the finest group of financial institutions on the planet. Collectively, they weathered the financial crisis with only a minimal amount of government intervention, performing much better than their U.S. and European counterparts. Each of Canada's major banks enjoys certain protections from foreign competitors, yet have expanded into other countries that don't offer the same benefits to their own domestic banks. This is a good position to be in.

Twenty years ago, Canadian banks were much simpler businesses than they are now. Investment banking was still largely done by small, specialized shops. Banks didn't offer insurance products, and credit card usage was only a fraction of today's levels. Even online banking didn't exist back then. Canada's banks have done a nice job diversifying themselves into new growth areas of financial services.

And yet, despite all those positive things I just said about Canada's largest banks, investors should seriously look at selling some of their bank shares. Here are three reasons why.

1. Housing bubble

Many words have already been spoken about Canada's ever-inflating housing bubble. It's only a matter of time until the party's over. The only question is how bad the aftermath will look.

Even if the housing market does have that soft landing that everyone hopes, it's still not good for the banks. When prices stagnate, suddenly borrowers don't have the equity in their home to do renovations, go on vacations, or even trade up to a larger place. Not only does this hurt the economy,

but it also hurts the mortgage businesses of the banks. As much as Canadian banks have diversified into other financial services, they still make a majority of their profits from lending money on homes.

If the housing market really suffers, Canada's banks will suffer right along with it. Even though the majority of mortgages are insured by CMHC, there are still a bunch of uninsured mortgages that will suffer. This will lead to higher default rates, and, ultimately, lower bank profits.

2. Mortgage competition

It started at the end of March, with Bank of Montreal coming out with a 2.99% five-year fixed mortgage.

Then **Investor's Group** got in on the action, offering borrowers a three-year variable rate of 1.99%.

And just this week, Bank of Nova Scotia upped the ante, offering a five-year fixed mortgage at 2.97%.

Canada's mortgage market is more competitive than ever. Mortgage brokers and other discount lenders have made borrowers extremely rate-sensitive. Banks used to be able to charge certain uninformed borrowers higher rates, but that just doesn't happen anymore.

This will be especially evident when the housing market starts to correct. More lenders competing for a smaller pie is not good news for mortgage margins. The big five Canadian banks have the resources to outlast competition in that type of environment, but nobody can argue a rate war is good for the bottom line.

3. Expensive valuations

It's not that Canada's banks are *that* expensive, but they're certainly not cheap.

Currently, the average of the group is about 12 times earnings, and a price-to-book ratio of a little more than two times. On the surface, this doesn't look particularly expensive, but what happens when earnings start to decline in any sort of meaningful way? This could easily happen if mortgage originations stop growing, and would be accelerated if loan losses started to pile up.

Investors are only willing to pay 12 times earnings for a group that has solid earnings that are still growing. It's not out of the question that the banks' P/E ratios would drop to under 10 if earnings growth was no longer there. That's a haircut for investors right there, not even factoring in how much earnings could fall.

Additionally, earnings declines could lead to the kiss of death for many investors: a lack of a dividend increase. A few quarters of lackluster results could turn investor sentiment against the banks quickly, which could lead to further sell-offs.

Nobody is arguing that Canada's banks are about to go out of business. They continue to be great brands, and have terrific foreign businesses and strong balance sheets. But we all know that current good times can't last forever. If the housing market even starts to sputter, it's not good news for Canada's banks, and certainly not for bank investors.

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Author

nelsonpsmith

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