Are Canada’s Banks a Safe Haven From the Oil Crash?

Description

Canada’s banks have performed extremely well in recent years. They avoided the worst of the global financial crisis that brought the U.S. banking system close to collapse. This, coupled with recent record profits and regular dividend hikes, has made them extremely popular among investors that believe they are safe-haven stocks.

However, this couldn’t be further from the truth. Contrary to popular belief, banks are cyclical businesses that are dependent upon economic growth in order to grow earnings.

Now what?

The primary growth driver in recent years has been a rapid expansion in the consumption of credit. This was fueled by Canada’s rapidly growing economy, which was reaping the benefits of higher oil prices.

When oil was trading at about $100 per barrel the demand for credit, particularly in western Canada, grew ever stronger. This, coupled with low interest rates and strong wage growth, created a feeding frenzy in the housing market, propelling housing prices and demand for mortgages to all-time highs.

This created ever higher earnings for the banks, but with the oil crash causing Canada’s economy to slow, the party appears to be over. Sharply lower crude prices are having a significant impact on economic growth. Canada’s GDP for 2015 is expected to expand by 1.9%, well below the 2.4% reported for 2014. This, along with higher unemployment and lower wage growth, combined with dwindling business and consumer confidence, will drive demand for credit lower.

If we take a closer look at Canada’s banks we can see how dependent they are upon loan revenue.

Bank	Market-cap	Gross Revenue	Loan Revenue	Loan Re
Royal Bank of Canada	$117B	$42B	$17B	
Toronto-Dominion Bank	$103B	$36B	$20B	
The Bank of Nova Scotia	$79B	$28B	$18B	
The Bank of Montreal	$52B	$21B	$11B	
Canadian Imperial Bank of Commerce	$38B	$17B	$10B	
National Bank of Canada	$16B	$8B	$3B	
Canadian Western Bank	$2.5B	$1B	$0.8B	
Laurentian Bank of Canada	$1.4B	$1.5B	$1B	

Source: Company filings.

The most dependent are regional banks **Canadian Western Bank** (TSX:CWB) and **Laurentian Bank of Canada** (TSX:LB). This makes their earnings extremely sensitive to slowing credit demand. The potential impact will also be quite severe for Canadian Western because almost half of its loan book is located in Alberta, the heart of the energy patch.

The **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) is also highly dependent on loan revenue, but the risks this poses are mitigated by its substantial international operations. These are located in emerging economies that are growing at a faster rate than Canada's economy and generate over a quarter of its revenue.

The least vulnerable are the **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **National Bank of Canada** (TSX:NA). Both obtain significant proportions of their revenue from wealth management, brokerage, custodial, underwriting, and advisory fees.

So what?

Despite the gloom surrounding Canada's economy and the impact this will have on the banks, I believe they should not be ignored by investors. The **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) remains a solid choice because unlike other Canadian banks, it has a solid U.S. presence with this business generating over quarter of its revenue. This leaves it well positioned to benefit from a resurgent U.S. economy and a stronger U.S. dollar.

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