The 2 Biggest Risks the Bank of Canada Wants Canadian Investors to Know About

Description

Since 2001 the Bank of Canada has released a bi-annual report known as the “Financial System Review.” It outlines key risks and vulnerabilities in the Canadian economy. This report outlined four vulnerabilities, and Canadian investors would be very wise to pay particular attention to two of them.

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The four major risks were household financial stress made worse by a correction in house prices, an increase in interest rates (driven by higher global risk), stress coming from China, and further weakness in commodities. The Bank is particularly concerned about two of these risks: a housing correction & Canadian household finances as well as China.

Out of all of the scenarios, the Bank sees housing & household finances as the most severe in terms of effect, but this scenario has a fairly low probability of happening. However, the Bank not only sees stress coming from Chin as being severe, but also more probable than housing-related risk.

If you are a Canadian bank shareholder (particularly if you own names like **Royal Bank of Canada** (TSX:RY)(NYSE:RY) or **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS)), it is important to understand these risks.

Canadian household finances and a correction in home prices

Household debt growth has outpaced income growth. The household debt-to-disposable income ratio hit a record high recently (at 165%). This is an unsustainable situation and is even more concerning when it is noted that much of this growing debt is fairly high risk.

More and more new uninsured loans have high loan-to-income ratios. In 2014, 12% of newly originated, uninsured mortgages had a loan-to-income ratio of over 450%; in 2015, it went from 12% to 15%. In addition, 24% of outstanding uninsured mortgages in 2015 had a loan-to-income ratio of over 450% compared to only 19% in 2014.

More importantly, these high loan-to-income mortgages are increasingly ending up in the hands of both younger, lower-income individuals. These individuals typically have less income and fewer financial assets to use in the event of a loss of income or increase in debt-service costs.

Should Canadian home prices fall (they inevitably will since home prices increasing at 2015’s national growth rate of 17% would yield an average home price of $21 million in 24 years), a portion of Canadian mortgages could end up underwater. This poses a risk to lenders and the Canadian economy as a whole, especially if debt-servicing costs increase, which could cause Canadians to have less disposable income and increase their risk of default.

Royal Bank and Bank of Nova Scotia are most exposed to these risks of the Canadian banks; 20.4% and 16.5%, respectively, of total loans are uninsured mortgages and HELOCs in Ontario and B.C.

Stress coming from China

China is facing a situation where its GDP growth rate has been declining steadily since 2010, when it peaked above 12%. It is now 6.7%.

At the same time, China’s credit growth as a percentage of GDP has been steadily rising and is currently over 240% of GDP and growing at twice the rate. As a result, China’s interest payments as a percentage of GDP have nearly doubled since 2009. If this trend continues, this will be a major headwind for Chinese growth.

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The main risk is that much of China’s debt (it is estimated by analysts at **Goldman Sachs** to be as much as $11 trillion or more) is unproductive debt, and this could lead to loss rates for banks skyrocketing to over 20%. This would result in a devaluation of China’s currency and a decline in the country’s growth rate, which would spill over to Canada via weaker commodity prices, slower exports, as well as through general risk aversion, which would pressure stock prices.

Canadian investors should be mindful of these risks. It’s important that your portfolio have proper diversification across sectors, asset classes, and geographies. Investors could also follow the footsteps of George Soros and increase allocation to gold and gold producers.

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2. NYSE:RY (Royal Bank of Canada)
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4. TSX:RY (Royal Bank of Canada)

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amancini

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