These 3 Factors Will Limit Upside in Canadian Banks for 2017

Description

Year-to-date, Canadian bank stocks are up nearly 25%, and the TSX Bank Index is sitting at all-time highs—a remarkable performance for some of Canada's largest and lowest-risk businesses. The sector grew earnings by 4.2% in 2016. That's weaker than the 10% or 11% that banks typically see, but it's still quite strong when investors consider that most of 2016 saw record-low interest rates and oil prices that weighed on bank earnings.

At the same time, the recent string of bank earnings releases saw many analysts actually boosting earnings-growth forecasts for 2017 and 2018. This may convince investors that there is still considerable upside in bank stocks, when the reality is that upside may be much harder to come by than many think.

This year's strong bank performance was not due to stellar earnings growth or a major boost in long-term growth expectations for banks; it was because forward earnings multiples for the banks exploded during the year. Investors were undervaluing the sector due to worries over low prices. Bank stocks went from trading at 8.2 times 2017 earnings estimates in early 2016 to well over 11 now.

This leads to the first major reason Canadian banks have limited upside in 2016.

The entire sector seems overvalued

Currently, Canadian bank stocks are trading at about 11.7 times their estimated 2018 earnings. **Royal Bank of Canada** (TSX:RY)(NYSE:RY) leads the way, trading at 12.1 times its 2018 earnings, while **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) follows close behind at 12 times its 2018 earnings. **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) remains the best value, trading at only 11.1 times its 2018 earnings, which makes it an attractive buy.

Is 11.7 times earnings an expensive average multiple for Canadian banks? It is certainly getting there. Looking all the way back to the year 2000, there were only a few occasions where multiples grew above 12, and when multiples did grow above these levels, they did not stay there for long.

Multiples briefly touched the 12 level in 2014 before crashing, and before that, they had not touched this level since 2009-2010 after the recession recovery. The only time banks had been able to hold these levels for any period of time was in the mid-2000s, which were an excellent time for Canadian banks; earnings were being constantly revised upwards.

With slowing economic growth, an overvalued housing market in Canada that will lead to weak mortgage growth, and growing competition, it is difficult to see how Canada's banks can maintain these valuations going into 2017.

A slowing housing market and indebted consumers

While Canada's banks have recently diversified internationally, most earnings still come from Canadian retail (about half). Growth in Canadian retail segments, however, is weak. Canadian retail segments are expected to grow by a modest 2-3% in 2017 after only growing about 4% in 2016.

Part of this weakness comes from the fact that loan growth in Canada is expected to be extremely weak—potentially even flat in a bad scenario.

Canadian consumers are currently sitting on record levels of debt—approximately 170% of disposable income. At the same time, the government just implemented a series of new standards that make it more difficult for Canadians to borrow to buy homes. In fact, the Bank of Canada recently stated that one-third of people who took on high-ratio mortgages (less than a 20% down payment) would not qualify for mortgages under the new rules.

This will be a headwind for bank stocks.

U.S. and Canada will see different rate0-hike schedules

Canadian bank stocks have been soaring because Donald Trump's victory lead to interest rates moving upwards quickly (Trump's pro-growth policies means more inflation and higher rates).

The Federal Reserve just hiked interest rates, but Canada is not expected to do so in 2017. This means that while Canadian banks are rallying because U.S. rates are rising, it will not lead to a massive earnings boost for Canadian banks and will largely just be felt in U.S. segments and through some fixed-rate mortgage rate increases.

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Author
amancini