# Is it Finally Time to Sell Canadian Bank Stocks?

## Description

It's been a fantastic ride for Canadian bank investors, and it's little wonder that investors get skeptical when told to sell Canadian banks. This strategy would have almost never worked historically. Since January 2013, the Canadian Equal Weight Bank Index is up 80% — an impressive return for names that have had fairly modest earnings growth.



Last year was a particularly good year with Canadian bank shares rallying by 25%, followed by an additional 7% in the first seven weeks of 2017. The bulk of this performance has come not from fantastic earning strength, but rather from the multiples on bank earnings expanding. In other words, investors have been willing to pay much more for a dollar of Canadian bank earnings over the past year.

In fact, Canadian banks as a whole were trading at 9.9 times earnings at the end of 2015, according to **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS), and this grew to 12.2 times at the end of 2016 using Bank of Nova Scotia's analyst estimates for earnings. This is 23% growth in the price-to-earnings ratio, and with bank shares growing by 25% in 2016, this means that over 90% of the strong bank share performance came from growing price-to-earnings ratios rather than earnings growth.

Can the growth continue?

**The bullish case for banks**

Obviously, investors are bullish on banks. Banks are still expected to post fairly strong earnings and dividend growth in both 2016 and 2017; earnings and dividend growth are both expected to be about 7%. While these are fairly solid earnings numbers, they are still a few percentage points lower than they have been historically, and with banks trading at the highest valuations in Q1 2017 since 2007, this is surprising.

While earnings forecasts have improved slightly due to improving energy prices (which means banks need to charge less against their earnings as provisions to deal with bad energy loans), much of the recent strength is due to Donald Trump's recent election.

Trump’s election means several things for Canadian banks. Trump is promising tax reform (dropping corporate tax rates from 35% to 20%), looser bank regulations, and a $1 trillion infrastructure spending program. This means stronger U.S. economic growth, which benefits Canadian banks both directly and indirectly.

Canadian banks have fairly strong U.S. exposure; **Toronto-Dominion Bank** and **Bank of Montreal** have close to 30% of earnings from the U.S., and **Royal Bank of Canada** has around 15% of exposure in the U.S. These names will benefit from increased economic growth, but also from a rise in U.S. interest rates, which has already happened.

Since Trump has been elected, U.S. five-year bond yields have grown from about 1.3% to 2%, and the Federal Reserve hiked U.S. short-term rates by 0.25%. This means better net interest margins for banks and higher earnings for U.S. segments. A stronger U.S. dollar will also benefit these Canadian banks.

The Canadian segments of banks benefit too, since Canadian bond yields have risen about the same as U.S. bond yields, and, overall, this is a tailwind for Canadian banks.

**Banks are still overvalued**



This growth, however, is already baked in to earnings estimates for 2017 and 2018, and Canada’s banks are still expensive. Currently, for example, Canadian banks as a whole are trading at 12.6 times consensus 2017 earnings. This would be the most expensive level since 2009, and banks typically do not trade at these levels for very long.

Banks are trading at 11.8 times 2018 earnings, and while this may mean that banks have some upside as investors start focusing on 2018 earnings, it is important to realize that banks usually trade at about 11.2 times earnings on average, so even 11.8 times is expensive.

This makes Canadian banks look risky, and investors looking for a low-risk bank should consider Bank of Nova Scotia, which is trading at cheaper levels than the other big banks, while benefiting from faster domestic growth and a strong international segment.

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