Are Canadian Bank Stocks Under Threat From Mounting Consumer Debt?

Description

It's an another day and another warning from an international agency about the mounting consumer debt in Canada and its devastating implications for the nation's top five lenders.

Moody's Investors Service, in its latest report, warned that Canada's banking system is facing a growing threat from souring consumer loans, as the Bank of Canada raises the borrowing cost. The country's ratio of household debt to disposable income reached a record 171% in the third quarter of last year.

Moody's joined the Bank for International Settlements and S&P Global Ratings, which also raised alarm bells during the past 30 days on the threat faced by banks from highly indebted consumers.

According to Moody's rating agency, the past decade of housing boom has fueled the proportion of uninsured mortgages to 60% from 50% five years ago.

Almost half of outstanding mortgages, many of them on fixed-rate terms, will have an interest rate reset within the year, increasing the strain on households' debt-servicing capacity, Moody's said in a statement. Further fueling the debt boom are auto loans that are getting offered at terms as long as 68 months.

Should investors be worried?

There is no doubt that Canada's consumer debt is a big danger faced by the Canadian economy. But I think these international agencies are behind the curve this time. After some regulatory actions of the past one year, three interest rate hikes, and tightening of the mortgages, Canadian credit expansion has reversed its course.

The latest housing data also showed that sales are down drastically in February when compared to the same month a year ago. Sales in the Greater Toronto Area plunged 35% from a year earlier, according to data by the Toronto Real Estate Board early this month. It was the weakest month of sales for February since 2009.

From the Bank of Canada perspective, it's probably the time to go slow on raising interest rates. The Bank of Canada said it will adopt a cautious approach in raising rates going forward, as consumers put the brakes on their debt consumption.

"More broadly, the bank continues to monitor the economy's sensitivity to higher interest rates. Notably, household credit growth has decelerated for three consecutive months," the Bank of Canada said in its rate-setting statement.

The bottom line

I don't think Canada's consumer debt situation has gotten worst than what it was last year. In fact, the credit consumption is going to fall going forward due to cooling of the housing market and tighter mortgage regulations. I'm still bullish on **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) and **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) stocks, which are underperforming other players and offering a better value.

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