Caution: Economic Headwinds Make Canada's Banks Risky Investments

Description

With lingering NAFTA concerns removed and inflation starting to pick up here in and in the United States, all eyes are on Bank of Canada to hike rates one more time this year. For many investors, rate hikes are bullish signals for shares of bank stocks, since in theory they stand to benefit from higher interest margins.

Unfortunately, the reality is a bit more complex than the theory. Following their third quarter numbers, shares of the major banks are down an average of 10 percent in the past two weeks. So what gives? Two macroeconomic factors might be behind the under performance: Canada's inverted yield curve and a downturn in the Canadian credit cycle.

Economic headwinds ahead

In a healthy growing economy, yield curves are upward sloping as market participants require higher yields to compensate them for holding longer term bonds against expectations of future inflation. However, when investor confidence in the economy wanes, yields on further dated securities fall below shorter maturities, leading to an inversion in the yield curve.

History has shown that inverted yield curves are generally an ominous precursor to a recession, and while equities are naturally affected across the board if recessionary concerns rise, banks are especially hard hit as they pay short-term rates on deposits and lend at longer-term rates. As spreads between the long and short ends of the curve narrow, or in this case, go negative, bank profit margins will be subsequently squeezed.

The second cause of concern for bank investors would be a slowing economy and rate of loan generation in Canada. For example, residential mortgage growth in Canada grew at 3.6% in August 2018, which was about 50% less than August of last year. Further, the banks also reported flat or declines in personal loan growth, with names like **Canadian Imperial Bank of Commerce** (TSX:CM)(NY:CM) reporting a year over year decline of 5.7% in personal and commercial loan generation. Additionally, shakiness in the Toronto and Vancouver housing sectors, and tightening of mortgage qualifications also imply continued downward pressure on credit growth in Canada.

With Canadian GDP expected to slow down below the trajectory seen in 2017, and a shift in growth drivers from consumption spending to exports, Canadian banks are currently facing too many economic headwinds to justify premium valuations.

Given where we are in the economic cycle, are there any banks that are worth buying?

Although we're seeing declines in the credit and consumption cycles here in Canada, and an inverted yield curve, I favour **Bank of Montreal** (TSX:BMO)(NYSE:BMO) over its peers due to its exposure to the fast moving U.S. economy, and the benefits of U.S. tax reform. On the domestic side, BMO's commercial lending unit delivered double-digit earnings growth year over year, which should help insulate the bank against a slowdown in personal loan growth. Finally, for those looking for income, BMO offers a safe and steady 3.7% yield to wait out any potential economic headwinds.

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