Warning: Growing Credit Risks Could Send Canadian Bank Stocks Lower

Description

For years, bank stocks have been among the safest bets on the TSX. Owing to their slow but steady growth and excellent creditworthiness, Canadian financials have been bastions of safety in a sea of risk. Recently, however, that perception has been changing. With a sluggish housing market and slowing economic growth, some are wondering if the country's financial engines are starting to stall … and with them, the banks.

Recently, an alarming development has emerged, adding to the precarious situation at Canada's banks. In the first quarter, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) and **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) both reported results that included higher provisions for loan losses. Factors blamed include rising bankruptcies and credit card delinquencies — both of which can adversely impact banks' bottom lines.

To understand why that is, let's take a close up look at deteriorating credit quality.

Credit quality deteriorating

In recent years, household debt has been growing rapidly in Canada, reaching 178% of income in Q4 2018. That's a historically high percentage, so it's no surprise that credit quality is deteriorating along with it. Although aggregate credit score data is hard to come by, the fact that banks are reporting more loan losses would indicate that scores are starting to suffer. This is a major issue for banks, as they earn most of their money from loans.

Bank earnings growth already slowing

Recent quarterly reports are showing that earnings growth is beginning to slow at Canadian banks. In Q1 of 2019, TD grew EPS from $1.24 to $1.27. That's a growth rate of just 2.4%, down from around 9% in past quarters. In the same period, CIBC fared even worse, posting a 10% year-over-year earnings decline. There are many reasons why these earnings are starting to fall. Slowing Canadian mortgage growth is a definite culprit; in a past article, I talked about how TD's mortgage revenue was nearly unchanged year over year in its most recent quarter. The aforementioned credit issues can also be a contributor, since every delinquent loan results in forecasted revenue that does not materialize.

Analyst says banks at “inflection point”

Recently, Veritas Investment Research analyst Nigel D’Souza wrote that an “inflection point” had been reached in the credit cycle, and that investors should “reduce exposure” to Canadian banks. This advice appears sound given that banks are expecting higher loan losses and reporting lower earnings. When you add the housing slump into the equation, the situation becomes even more dire.

Foolish takeaway

Canadian bank stocks are some of the most reliable in the world, having not experienced a major crisis in more than 150 years. This basic fact isn’t going to change any time soon. However, at present, a slowing economy and rising personal debt are creating issues for the Big Six. For now, I’d be comfortable holding Canadian bank stocks, but I wouldn’t initiate any new positions this year.

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