Is it Time to Sell Canadian Banks?

Description

There has been a fair bit of buzz in the media lately regarding the health of the Canadian banks. U.S. hedge funds are back on the "short Canadian Banks" bandwagon — a play which has proven to be quite frustrating for the naysayers. For the better part of the last decade, Canadian banks have defied the odds and come out ahead — until the last earnings report, that is.

The first-quarter results were almost universally dismal for the Canadian banks. Although most of these institutions pointed to the generally poor Q4 capital market results, the truth is that there was some weakness in other areas as well.

In this article, I will use **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) to examine three fundamental reasons why the short-sellers are not wrong, and why there may be some pain coming to the Canadian bank stocks in the near future.

Slowing Canadian financial results

The first-quarter results of 2019 did not paint a rosy picture for the Canadian banks. CIBC saw its Canadian net income from personal and small business lending drop 29% year over year. Loan impairments were also up 6% over Q1 2018. Keep in mind, these issues are happening when times are still good. If the economic worm were to turn, what would happen then?

The banks' customers have gotten themselves in a pickle

Probably the biggest risk to the Canadian banks comes from the banks' customers. Over the past decade, consumers have proven that they are unable to resist candy given to them in the form of low interest rates.

The debt binge has been on, with consumers packing on massive amounts of debt from consumer loans, residential mortgages, and home equity lines of credit (HELOCs). This is especially true for the larger regions of Canada, namely the Greater Toronto (GTA) and Greater Vancouver (GVA) areas of the country. For CIBC, much of its Canadian loan portfolios come from these regions, so a meaningful slowdown in either area could significantly impact profits.

Unfortunately, for health reasons, consumers are already feeling the inevitable pinch of their debt loads. Currently, debt as a percentage of disposable income has reached around 176%. Compare this to debt levels 30 years ago, where the ratio was around 66%. The bank’s customers have been on a feeding frenzy, and they just can’t take on any more leverage.

The state of the general economy

Unfortunately, our glorious leaders have contributed significantly to potential risks. Ontario, the province that almost universally contributes to the banks’ domestic loan portfolio, is the most indebted non-national government in the world. That is not a great title to hold. As long as the economy is roaring ahead, everything is roses. But what if there is, heaven forbid, a slowdown in economic activity? That might be a bit of a situation.

Canada’s federal government has its own debt problems. Instead of trying to balance the budget, the government has decided to make a whopper of an election budget, offering Canadians more expensive goodies once again.

Since the banks are dependent on the strength of the economy for their ability to lend and make money, any problems with the economy could result in negative pressure on bank stocks. Excessive government debt levels could exacerbate any troubles the banks may face. CIBC, with its heavy exposure to the Canadian economy, could feel economic pain quite acutely.

Don’t worry, it’s not all bad

Many of the Canadian banks, CIBC included, have been feverishly expanding abroad to diversify their revenue and earnings base. For CIBC, its U.S. expansion has already been quite successful. In Q1 2019, the bank reported a 20% increase in its U.S. Specialty Finance and International division. Many of the other Canadian banks have reported similar success with their international expansion exploits.

Furthermore, this is not a tale of doom and gloom for the banks. The banks, CIBC included, are all excellent organizations that should be a core part of a Canadian portfolio. Rather, I am merely stating that there will likely be a significant amount of pain in the near future if a downturn affects Canadian economic performance. Don’t sell the banks, but investors should be prepared to add to their holdings if stock prices fall.

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