Are Canada's Banking Stocks Ready to Crash?

Description

As the saying goes, "a broken clock is right twice a day." Why is this relevant to the topic at hand? Bears south of the border have been calling for Canada's housing and subsequent banking demise since the start of the decade. Recently, several of the pundits, such as *The Big Short's* Steve Eisman, have once again been calling on investors to short Canada's banks.

The problem is, these short-sellers have been saying the same thing for the better part of 10 years — Esiman included. As bears wait, Canada's Big Five have performed quite well with **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) leading the way. Over the past 10 years, TD Bank has returned 168.2% for a compound annual growth rate of 16.82%, not including dividends.

In fact, not a single one of Canada's big banks have underperformed the TSX over the same period. On average, they have returned almost double the 4.25% annual returns posted by the TSX Composite Index.

Will this time be any different? Is this the year that bears finally get it right?

Increasing consumer debt

The reasons for Canada's banking system demise change on a regular basis. One factor, however, has remained consistent. Rising consumer debt loads continues to be an issue. In this environment of low interest rates, Canadians have been borrowing at an unprecedented pace.

Statistics Canada announced that the amount Canadians owe relative to their income trended upwards in the fourth quarter. For every dollar of disposable income, households held $1.79 in debt. This was the fifth consecutive quarter in which the debt service ratio increased. Oh, and it matched a record high.

On the bright side, household credit market borrowing fell 19.5% in 2018 — the lowest level of borrowing since 2014. Perhaps consumers are beginning to get the message.

Why is this a problem for Canada's banks? As debt outpaces income, consumers will have a harder time keeping up with the required debt payments. This leads to a higher percentage of delinquency rates and a direct hit to banking profits.

Last week, **Equifax** announced that the 90-day delinquency rate climbed to 1.12% — the highest rate in two years. These rates are still relatively low and manageable, but they are the current crux of the problem facing the Big Five banks. Although it's not time to panic, there is a reason to keep an eye on current delinquency rates.

Diversification

Despite the high consumer debt and increasing delinquency rates, Canada's Big Five are in no immediate danger. If you are worried, the best way to protect against a Canadian economic downturn and to alleviate fears of a credit crash is to invest in those banks that are less reliant on their home country.

TD Bank is the second-largest bank in Canada but has also established itself as a the sixth-largest bank in North America. Its strong presence south of the border has it targeting 7-10% earnings growth over the next few years. This is the highest growth rates among its peers.

Royal Bank of Canada and **Bank of Montreal** are two other banks that are highly diversified. Approximately 23% of RBC's revenue comes from the U.S. and an additional 15% originate from various international markets. Likewise, Bank of Montreal generates 31% of revenue south of the boarder and 9% from international markets.

As three of Canada's largest banks, they are better able to navigate any potential credit crash. Their diversification outside Canada will also lead to continued and sustainable growth.

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mlitalien