A Recession Is Bad News for Canada and the Big Banks

Description

There are growing fears that a recession is looming. Earlier this week, the yield curve between two-year and 10-year U.S. treasuries inverted, and this event, since 1950, has occurred before all major U.S. recessions. If a major U.S. recession emerges, it will sharply impact other developed nations, such as Canada, because of the close correlation between their economies and financial markets.

This has triggered considerable concern over the outlook for Canada's major banks. Heavily indebted households, stagnant wage growth, an overheated housing market, and the banks' considerable reliance on mortgage lending to drive earnings growth will all magnify the impact. Among the banks perceived to be the most exposed is **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) because of its extensive U.S. presence, where it is rated as a top-10 bank.

Looming recession

Economic slumps typically hit banks hard, because they are heavily reliant on demand for credit and the ability of borrowers to meet their repayments to generate earnings. As a recession worsens, it can do real damage to banks because it eats into earnings, sharply impacts the quality of their credit portfolios, and causes the value of investments to decline. Decreasing loan quality and rising volumes of impaired loans can have a particularly negative effect on bank balance sheets, because mortgages and commercial loans typically form the core assets of traditional non-trading banks.

As earnings and balance sheets decline, banks are forced to tighten lending standards and reduce the availability of credit. Declining credit volumes only cause recessions to deepen, further impacting banks and creating a vicious cycle, forcing them cut back further. This is known among economists as the financial accelerator. It was responsible for causing credit markets to grind to a halt during the financial crisis, which emerged in the wake of the U.S. housing bubble bursting in 2007, causing the slump to worsen so that it triggered the greatest financial crisis since the Great Depression.

A major fear is that central banks lack the policy tools needed to stimulate economic growth and head off a deep recession. This because central banks such as the U.S. Federal Reserve and Bank of

Canada have been unable to normalize monetary policy since the Great Recession ended in 2009. Official interest rates remain at near historical lows, while many central banks have bloated balance sheets after buying large amounts of distressed assets during the Great Recession to bolster the money supply and stimulate economic growth.

Canada’s banks are vulnerable

While Canadian banks, unlike those in the U.S., emerged from what was the worst global financial crisis since the Great Depression in good shape, there are fears that the next recession could have a far sharper impact. A mountain of household debt, which is near historical highs, combined with stagnant wage growth and an overheated housing market have left Canadian households especially exposed to external economic shocks. That means the big banks, which generate a large portion of their earnings from domestic mortgages, are vulnerable to a downturn.

Nonetheless, the impact could be even worse for Toronto-Dominion because of its considerable U.S. exposure, which is responsible for earnings almost 40% of its net income. There is a view that a U.S. recession could be far deeper than normal, not only due to the Fed’s lack of policy tools but because of Trump’s erratic policy making and adversarial approach to trade.

That will significantly crimp Toronto-Dominion’s earnings and have a marked impact on its credit portfolio. This is because a third of all the bank’s loans were originated in the U.S., and most of them are commercial loans, and its businesses are among the most vulnerable to a recession.

Foolish takeaway

The emerging consensus is that a recession is due, but no one really knows when it will occur or how severe it will be. Those sentiments are weighing on bank stocks, causing Toronto-Dominion to lose 10% since the start of 2019. While a recession will push its value lower, it shouldn’t cause shareholders to panic. Toronto-Dominion has unlocked considerable value over the last 10 years, generating a return of 167% for investors when dividends are included. That highlights why you should ignore short-term market noise and invest for the long term.

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Author
mattdsmith