The Stock Market Is Showing Eerie Parallels to the Last Market Crash

Description

Will the Bank of Canada cut interest rates to counter an economic downturn? The reason for this likely move is the inverted yield curve. The phenomenon happens when long-term yields drop lower than short-term yields.

Canada is experiencing its deepest inversion since May 2000. The 10-year yield is 20 basis points below the two-year yield, and therefore it's highly inverted. With the inverted yield curve flashing, a recession is a strong possibility.

Past recessions

In the last 50 years, Canada has had five recessions with at least two consecutive quarters of contraction. While an inverted yield curve usually precedes recessions, the collapse of oil prices was the cause of the recession of 2015.

However, it was the inverted yield curve that prompted a recession during the 2008-2009 global financial crisis. Fortunately, Canada doesn't always fall into recession because of the inverted yield curve.

But if the curve further inverts, the Bank of Canada could act and tighten financial conditions. Banks would not have the incentive to lend, and a global slowdown could hurt commodity exports, including oil.

Safe anchors

Historically, a recession has followed a shift in the yield curve. Typically, however, yields invert an average of 18 months before a recession commences. Hence, you have time to look for safe harbours for your money.

Ironically, banks affected by low-interest scenarios such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY

) and **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) are your docks. The two largest banks in Canada can take it in on the chin and still perform better than industry peers.

RBC, for instance, is showing rising profits amid warnings of inverted yields, stock market volatility, and a low interest rate environment. In the third quarter, the bank posted a record $3.3 billion in profits. Its residential mortgage business even grew by nearly 6%.

TD is doing slightly better than expected. The second-largest lender in Canada posted an 11% growth from its U.S. retail business segment and a 9% growth in its wholesale banking segment, which includes investment banking and capital markets. Its retail income in the home country also rose by 3.4%.

So far, the earnings of both banks remain unaffected by the inverted yield curve. RBC and TD are also increasing credit loss provisions in case there's a need for write-offs. As a collective group, Canada's six top banks have raised the total amount of provision for bad loans by 27% as of the quarter ended July 2019.

Investments for tougher times

It's not unusual for RBC and TD to significantly raise credit provisions when a recession is looming within the next couple of years. Both banks are a step ahead in preparing for a worsening economic outlook if the household debt in Canada reaches record high level.

With RBC and TD having a track record of paying dividends for more than 100 years, the identical 3.9% dividend each bank pays is safe no matter how long the period of instability takes. To survive a recession, all you need is a pair of high-quality investments that provide wealth and stability to the investing public.

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