Are Canadian Banks Too “Toxic” to Hold Through 2020?

Description

Don’t bank on a massive rebound in the Canadian bank stocks in 2020.

While growth could begin to pick up after a forgettable 2019 that was full of rising provision for credit losses (PCLs), higher expenses, and thinning net interest margins (NIMs), I’d expect a recovery to be very modest given the existing high risks and still uncompelling valuations. Of course, every bank has a different multiple and risk profile, so your mileage will vary based on which one you bet on.

This piece will have a glimpse at the extreme end of the spectrum, with **CIBC** (TSX:CM)(NYSE:CM), a domestically overexposed and arguably ill-prepared Canadian bank that got clobbered since the fourth quarter of 2018.

CIBC stock took on a considerable amount of damage over the last two years relative to its peers, and with that, one would think that CIBC would have the most room to run once industry headwinds finally subside.

While shares of CIBC have always traded at a slight discount to the Big Six peer group, the recent valuation gap widening, I believe, is more than warranted as we head into the part of 2020 — a year that could see the Canadian banks continuing to drag their feet.

Will CIBC make up for lost time?

CIBC doesn’t exactly boast a reputation for delivering steady, low-risk growth through both the ups and downs.

The bank got hammered during the Financial Crisis, and I don’t think it’s cleaned up its act since recovering ground over a decade later. It appears that CIBC’s attempt to catch up with its bigger brothers had ironically caused it to lose more ground to some of its “higher quality” peers that showed more discipline when credit was easier.

“It’s been a long time coming to transition into the next credit cycle, and those banks that were overly aggressive (with easier loans) during the upswing are now paying the price with amplified adverse effects that come with a credit downturn," I said in a prior piece. "That means soaring provisions, among other difficult-to-control issues that could devastate top- and bottom-line numbers."

One could argue that even at today's valuation gap isn't wide enough given CIBC's relative ill-preparedness for credit's move toward normalization and how challenging it's going to be for the bank to tame provisions and potential restructuring expenditures over the year ahead.

CIBC stock has been losing ground to many of its peers amid the overdue Canadian credit downturn — deservedly so.

With the headwinds unlikely to subside entirely in 2020, the Canadian banks face a slate of new challenges as they look to restructure to better deal with the growth-stunting effects that will likely linger on for another year or two.

Yes, CIBC stock is the cheapest it's been in recent memory, with shares trading at 8.9 times next year's expected earnings and 1.3 times book, both of which are substantially lower than five-year historical average multiples of 10.3, and 1.75, respectively.

But the "cheapness" of shares doesn't necessarily mean that CIBC can't become even cheaper as the harsh industry headwinds continue to take their toll.

If you're one to believe that the troubles for the banks are only in the early innings, you'd be well-advised to steer clear of CIBC. Of the Big Six banks, CIBC appears to have the most downside risk.

Analysts at Canaccord Genuity recently downgraded the Canadian banks, citing "a toxic mix" of risks and that banks would be "lending less at lower margins."

Add off-the-charts provisioning into the equation and Canadians should demand a wider margin of safety with the banks, especially CIBC, which is nowhere close to being out of the woods.

While I wouldn't refer to all Canadian banks as toxic, I would advise cautious optimism on the part of investors and a strong preference for higher performers, which excludes CIBC.

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