Further Downside Is in Store for Canada’s Banks

Description

Canada’s banks are supposed to the be pillars of our economy, revered by investors for their inherent stability and safety. But given that we could very well be in the beginning stages of a protracted economic downturn, Canada’s banks have been systematically sold off alongside the rest of the TSX. While we’re two weeks into the sell-off, and prices have come 20% (or more) off their highs, I believe the bottom for this sector is still too early to call.

Last quarter might have been the last hurrah

In their latest earnings reports, the major banks reported strong earnings thanks mostly to revenues from their capital markets divisions. For example, **CIBC** (TSX:CM)(NYSE:CM) reported a gain of 63% year over year in capital markets net income, while the personal and commercial banking segment earnings came 2% below last year’s due to higher spending on strategic initiatives.

While strong numbers should be applauded, not all “beats” are equal, and I would have liked to see healthy earnings that reflected more on core businesses rather than capital markets, as the latter segment’s revenues have proven to be extremely cyclical (during the 2008 financial crisis, CIBC’s capital markets division saw its revenues fall 40% year over year).

Further, the weakness in core business lines might get worse in the coming quarters thanks to increasing credit losses. In its January report, the Office of the Superintendent of Bankruptcy in Canada reported that Canada wide consumer insolvencies (both bankruptcies and consumer proposals) grew by 9.7% compared to the previous month, and 10.4% over the previous year, while business insolvencies also gained by 2.5% during the same period. Just how bad can insolvencies truly get once unemployment picks up during a recession?

The second headwind that the Canadian banks are facing is deterioration of their net interest margins (NIMs). This is because the banks tend to borrow on the short end of the yield curve while lending at the long end and netting the spread. After the recent 50-basis-point cut by the Bank of Canada, yields on 10-year bonds have nose dived to .97% as of writing.

While this is already a dismal picture for forward NIMs, it's most likely going to get even worse, as oil prices have also cratered thanks to a price war between Saudi Arabia and Russia. Currently, West Texas Intermediate crude is trading below $30 per barrel, signaling an oil bear market, which will increase pressure on the Bank of Canada to further cut Canada's benchmark interest rate.

The bottom line

Canada's banks have fallen 20% of their highs, but the pain is far from over. Thanks to shocks to the Canadian economy and further central bank emergency monetary policies, we might well see increases in loan losses and compression of NIMs for Canada's Big Six banks, leading to further shedding of their stock prices.

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Date
2025/07/17
Date Created
2020/03/15
Author
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