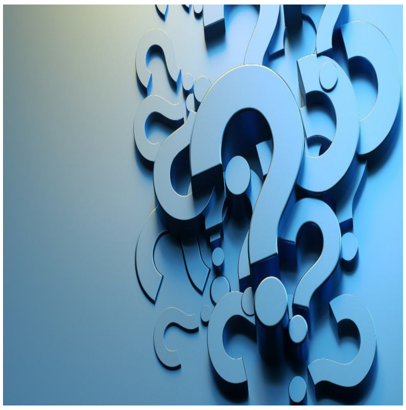

Will Canada’s Bank Stocks Cut Their Dividends?

Description

Millions of local investors own Canada’s bank stocks in their portfolios primarily for one simple reason: these companies have historically been great investments.

Even after the so-called Big Five have suffered +30% draw downs, they’ve still delivered excellent results. We’re talking total returns of at least 10% annually over the last 20 years. No wonder many investors want to buy this dip.

It certainly seems like a great time to buy Canada’s bank stocks. These companies are all trading at five-year lows, and there’s a chance they could breach levels not seen since the Great Recession back in 2009. Sure, it’s pretty scary putting cash to work right now, but investors who buy good companies when they’re depressed tend to do pretty well over the long term.

Canada’s bank stocks also have some major advantages compared to other investments. Remember, the riskiest mortgages these banks issue are insured against default. They also collectively own the banking market in Canada — a comfortable oligarchy that ensures plenty of profits for everyone. And you know the Canadian government won’t let our banks fail.

I’m convinced Canada’s bank stocks will weather this storm and eventually come through. The question is whether these companies will do so without cutting their dividends. Let’s take a closer look at the sector from that perspective.

The problem with dividend security

On the surface, the dividend question seems to have a pretty simple answer. All of Canada’s top bank stocks target a 40-50% payout ratio, choosing to put the other half of earnings back to work either through share repurchases, shoring up the balance sheet, or acquiring new assets. As earnings go up, dividends slowly increase with them to maintain the payout ratio.

It doesn’t take a genius to see what’s wrong with that analysis. It’s backwards looking — something that isn’t really applicable any longer. That’s the whole reason why Canada’s bank stocks are down so much. Nobody really knows what their earnings will look like in 2020. Heck, there's even the argument to be made earnings will collapse for a couple of years as they write off bad loans.

Over the last few years, a tepid Canadian economy has limited bank earnings growth. These companies have been saved by their foreign operations, especially in the United States, which has experienced solid growth. But this isn't a localized problem. The entire world is suffering from COVID-19 issues. This means every aspect of their business is about to be hurt. Stimulus packages will certainly help, but there's no guarantee these will get passed or they'll be enough.

Which is most likely to cut?

I don't think any of Canada's bank stocks will end up cutting their dividends. I predict the economy will rebound after a few months and stimulus packages will ensure a quick recovery.

However, I'm the first to admit there's a definite chance it will happen. Banks always get more conservative during times of economic duress, and suspending a dividend is a great way to free up a few billion dollars.

If I was going to wager on which of Canada's bank stocks is most likely to cut its dividend, I'd guess **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM). CIBC has always had the highest dividend yield among its large bank peers, and the market crash has boosted that payout to an eye-popping 8%.

That's a very enticing yield, and the company should be able to afford it for a year or two, even if earnings fall off a cliff. But there comes a point where it's in the best interest of shareholders to slash the payout. Besides, CIBC did take on quite a bit of debt when it acquired Private Bancorp in 2017. The company has a solid balance sheet, but investors usually argue its competitors are just a little more secure.

The bottom line on Canada's bank stocks

Like I mentioned earlier, I don't think any of Canada's bank stocks will cut their dividends. I believe a combination of prudent management, stimulus plans, and a quick recovery keeps their payouts secure. I continue to hold my bank stocks, because I think these great businesses recover nicely when all this is over.

But if I were to guess which company is weakest, it would be CIBC.

CATEGORY

1. Bank Stocks
2. Dividend Stocks
3. Investing

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