U.S. Bank Earnings Show Pain Ahead for Canada's Banks

Description

U.S. bank earnings season has just ended. The results of the four largest banks were worse than expected, reflecting the economic impact of the coronavirus pandemic. They are a harbinger of what's to come for Canada's banks, particularly those like **Toronto-Dominion** (TSX:TD)(NYSE:TD), which have considerable U.S. exposure.

Poor bank earnings

Major U.S. banks have reported significant earnings declines for the first quarter 2020, seeing many failing to meet analyst estimates. The largest U.S. bank, **JPMorgan Chase's** earnings per share (EPS) cratered by a whopping 71% year over year to US$0.78.

That was also 58% lower than the consensus analyst estimate. **Bank of America**, the second-largest lender, saw its EPS tumble 46% to US$0.40.

The third-largest **Citigroup** announced a 44% decrease to US$1.05 per share. **Wells Fargo** performed the worst of the four largest banks, announcing EPS of US$0.01 per share compared to US$1.20 for the equivalent period in 2019.

Other banks announced similar declines. The seventh-largest lender by assets, **U.S. Bancorp,** posted a 28% year-over- year drop, while eighth-ranked **PNC Financial** saw its earnings per share shed 25%.

A significant spike in credit losses, loan defaults and lending loss provisions was responsible for the poor results.

This round of poor results saw investors dump U.S. bank stocks. The largest industry ETF, the **Financial Select Sector SPDR Fund**, which has the three largest U.S. banks among its top four holdings, lost 4% yesterday.

Weak economic outlook

There are signs of worse to come. The impact of coronavirus during the first quarter 2020 was only for a relatively short period. It wasn't until the end of the first quarter when governments were forced to take extreme measures to prevent the virus from spreading.

Those actions included essentially suspending the economy by shuttering non-essential businesses, closing borders and significantly restricting movement.

For those reasons, the economic fallout during the second quarter 2020 will be far more severe. Investors should expect bank earnings to deteriorate further, with many institutions expected to post losses, which doesn't bode well for Canada's banks, indicating that a coronavirus ravaged rough patch is ahead for the Big Six.

Canada's banks

Toronto-Dominion is the most exposed of the Big Six because it is the ninth-largest U.S. bank by assets. For its fiscal first quarter 2020, 38% of Toronto-Dominion's net income was generated by its U.S. retail bank.

Toronto-Dominion's second quarter 2020 earnings could decline by more than the average 20% decrease some analysts have forecast for Canada's Big Six banks.

Toronto-Dominion is vulnerable because earnings from its U.S. banking business were already under pressure during the first quarter. Net income declined by almost 8% year over year because of a 2% drop in net interest income and 4% increase in lending loss provisions.

In fact, the lowest analyst forecast for Toronto-Dominion's second quarter predicts that earnings per share will fall by 28% compared to the previous quarter.

It isn't only Toronto-Dominion's U.S. earnings that will be hit hard, however. The outlook for the bank's Canadian operations is also poor. The IMF predicts that Canada's 2020 gross domestic product (GDP) will contract by 6.2%, boding poorly for bank earnings.

There are also fears of a housing meltdown, which will not only impact earnings, but also cause credit losses to mount. Canadian households, because of high levels of debt, seeing them ranked as the fifth most indebted globally, are particularly vulnerable to external economic shocks.

As unemployment rises and households are unable to meet their financial obligations the volume of defaults and impaired loans will rise, weighing on Toronto-Dominion's earnings. Toronto-Dominion's vulnerability is highlighted by 62% of its total Canadian loans being composed of residential mortgages and HELOCs.

Foolish takeaway

The latest U.S. banks earnings indicate that there is worse ahead for Canada’s Big Six banks. Toronto-Dominion will be particularly vulnerable to a sharp decline in its bottom line because of its considerable U.S. exposure.

A deteriorating Canadian economy and housing market will further impact Toronto-Dominion’s performance.

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