Will Canada’s Big Banks Cut Their Dividends?

Description

Canadian dividend stocks are under considerable pressure to cut their dividends. In a shock announcement, Dividend Aristocrat **Suncor** slashed its dividend by a whopping 55% after reporting a devastating $3.5 billion loss. Many banks, retailers, REITs and oil stocks were under considerable financial pressure before the pandemic.

Poor 2020 earnings and weak economic data indicates that the worst is far from over. To shield themselves from the pandemic and ensuing economic fallout, companies are cutting costs in a desperate attempt to preserve their financial position. This indicates that the dividend carnage isn’t over.

Weaker economy

Dividends paid by many Canadian companies are unsustainable if the economy worsens. April 2020 job numbers, which were the poorest of modern times, caused unemployment to spike to a worrying 13%.

Canada’s first quarter 2020 gross domestic product (GDP) shrank 2.6%. Canada’s economy is expected to contract by 6.2% for 2020.

Ottawa’s economic stimulus has done little invigorate growth. The shuttering of non-essential businesses, closure of entertainment venues, social distancing, travel bans and restrictions are weighing on the economy, applying significant pressure to corporate earnings.

Declining corporate earnings

While oil stocks will be responsible for a large portion of the dividend cuts, Canada’s banks could be next. U.S. first-quarter bank earnings were poor. Profits fell by half or more compared to a year earlier and this occurred before the full economic impact from the coronavirus was felt.

Because of their crucial role in providing credit and other financial services, banks are an economic barometer, rendering them particularly vulnerable to economic downturns, which means that any economic slumps hit their earnings hard.

The worsening economic outlook for Canada indicates considerable pain ahead for the big banks. A sharp deterioration in earnings may force them to cut or even suspend dividends, despite claims that bank dividends are rock-solid.

The problem isn't limited to declining earnings, but also the growing likelihood a Canadian housing bust.

Deteriorating credit quality

Canada's heavily levered households, which are among some of the world's most indebted, are especially exposed to external economic shocks. This will be responsible for a marked uptick in loan defaults, delinquencies and credit losses, further impacting earnings and bank balance sheets.

A forecast sharp decline in credit quality was responsible for U.S. and Australian banks boosting the cash held on their balance sheets. No one wants a repeat of the 2007 financial crisis, when many commercial banks nearly collapsed because of an unprecedented spike in loan losses and a lack of provisions as well as cash.

Major banks, especially those deemed too big to fail, started hoarding cash to build a coronavirus buffer. In response to the anticipated economic fallout two of Australia's big four banks, **ANZ** and **Westpac** suspended dividends and **NAB** cut its payment by 64%.

While Australia's banks historically had high dividend payout ratios compared to Canada's banks, it doesn't make the big six immune. They currently have payout ratios of around 50%, the lowest being **National Bank of Canada's** 42% and **Bank of Nova Scotia's** 52% the highest compared to over 80% for Australia's big banks pre-coronavirus.

It would take a greater than 50% decline in bank earnings to force a dividend cut. While such a large fall is unthinkable, it could happen. A perfect storm of sharply weaker housing prices, growing loan defaults and a marked drop in earnings is feasible.

The banking regulator and policy makers will exert pressure on banks to retain sufficient capital to absorb growing loan losses so as to ensure the stability of the financial system.

The most vulnerable bank

Dividend cuts by the big banks appear unlikely but they could happen as Canada's economy worsens and credit quality heads south. The most vulnerable are Scotiabank and **Canadian Imperial Bank of Commerce** because they have the highest payout ratios of 52% and 51%, respectively.

Scotiabank faces a sharp deterioration of earnings on two fronts, Canada and Latin America. Its rapid expansion into Mexico, Colombia, Peru and Chile sees international banking responsible for over 42% of Scotiabank's net income. Latin American will be one regional economy most sharply impacted by the pandemic.

For these reasons, Canadian bank investors should brace for the possibility of dividend cuts.

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