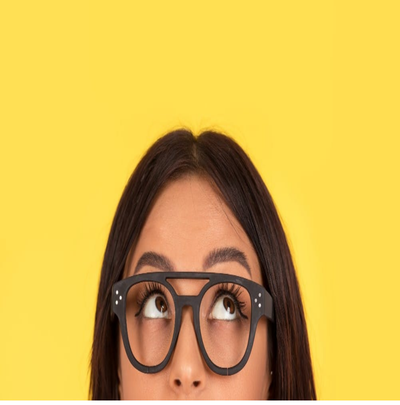

Warning: Canadian Bank Stocks Could Become Zombies!

Description

There's a dark cloud hovering over Canadian bank stocks. Household and corporate debt across the country may reach a tipping point this year. That could eviscerate the country's Big Five bank stocks and threaten their lucrative dividends in the next few years.

Here's what you need to know.

Balance sheet recession

It shouldn't come as a surprise that Canadians have overborrowed over the past two decades. What *should* surprise you is the level and pervasiveness of this debt. At the moment, Canadian households have $230 in debt for every $100 in disposable income.

Meanwhile, corporate debt is 118% of gross domestic product (GDP) and government debt is likely to reach 97% of GDP by the end of the year. In other words, households, businesses and the government have borrowed more than they earn.

This could trigger a phenomenon that Richard Koo, chief economist at Japan's Nomura Research Institute, called "balance sheet recession." Put simply, it's an environment where a nation spends more money on paying off debt than investing for the future or growing.

Bank stocks are risky

Balance sheet recessions have already played out in Japan and the European Union. As economic growth stagnated, bank stocks in these countries plummeted. The **Stoxx 600 Bank Index**, a basket of the top 600 European banks, dropped 43% this year and is now trading at the lowest level since 1988. A similar story has played out in Japan.

Now, it looks like this crisis could hit Canada. That would make our bank stocks, particularly the five largest ones, risky.

Bank stocks are value traps

Canada's five largest bank stocks have been remarkably stable this year despite the crisis. **RBC Bank**, for example, is down just 6% year-to-date. The bank, along with its major rivals, have avoided dividend cuts as well. That means Canada's banks now offer the highest dividend rates in the global banking sector.

However, growing debt and near-zero interest rates could threaten this sector. Canadian bank stocks could follow the same trajectory as eurozone ones if the government can't figure out a way to boost growth or cut debt substantially. Keep a close eye on this sector.

How to avoid zombie bank stocks

Since the debt problems are domestic, investors can avoid them by focusing on banks with a vast international presence. **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) was probably the most international bank in the country until last year. In 2013, the bank had operations in over 54 countries, including Turkey, Russia and Taiwan. Since then, it has reduced its presence to just 33 overseas locations.

That puts it behind RBC, which is operating in over 36 countries. In fact, 38% of RBC's revenue is generated outside Canada. Most of its revenue is generated in the largest and most robust economy in the world: the United States.

This exposure to overseas markets makes RBC and Scotiabank relatively safer for investors who want to mitigate the risks I described above. Investors exposed to the other, mostly domestic banks, face much greater risks. **Laurentian Bank**, for example, generates 100% of its revenue within Canada.

Bottom line

Canada's economy is over-leveraged, which could make some of its largest banks in danger. Investors should focus on banks with a larger international presence, such as RBC.

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