Weekly Trends

PRIVATE CLIENT SOLUTIONS

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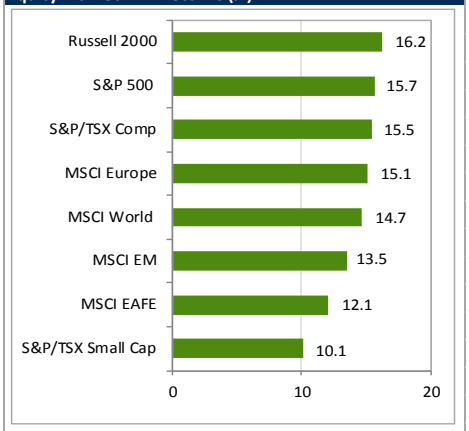
April 18, 2019

Give Credit to the Banks

Canadian banks are in the headlines again thanks to Steve Eisman of Neuberger Berman his short thesis on the banks. The basis behind the short is that the banks are not provisioning enough for loan losses in the event of normalization in credit conditions. In addition, capital ratios will be slip given risk-weighted assets are calculated assuming too rosy a picture on the Canadian economy (capital ratios range from 11-12%; the regulatory requirement is 9%). While Eisman is negative on the banks, he notes his call is not for a collapse similar to what happened in the US in 2008 (housing driven), but simply that credit conditions normalize within the context of an economic slowdown. Under this scenario, delinquency rates will rise, putting pressure on bank earnings. Of course, the timing of this normalization is difficult to pinpoint and reminds us of John Maynard Keynes' famous quote, "the market can stay irrational longer than you can stay solvent."

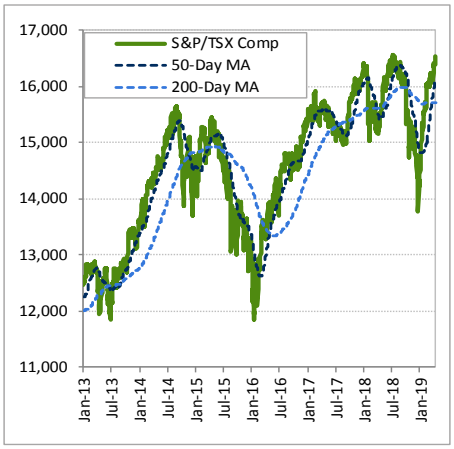
- On aggregate, the Canadian banks are trading at a discount to their 10-year P/E and P/B averages with the cheapest banks being CIBC (CM-T) followed by Scotiabank (BNS-T). Given current valuation levels, we think a lot of the bad news surrounding the housing market and Canadian consumer have been built into the price.
- We view the banks as core building blocks for a portfolio given their attractive income characteristics. Further, over the long term, buying the Canadian banks at abnormally cheap valuations has tended to be a good idea. Looking at the 12-month return for the S&P/TSX Banking Index after the index traded at an abnormally discounted valuation level has resulted in an average return of 18.0% (12.6% excluding the financial crisis).

Equity Market YTD Returns (%)



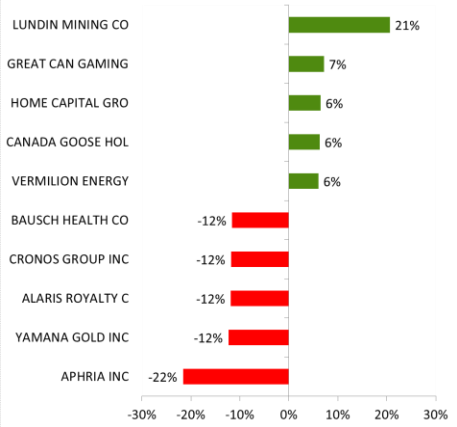
Canadian Sectors	Weight	Recommendation
Consumer Discretionary	4.3	Underweight
Consumer Staples	3.8	Overweight
Energy	18.5	Underweight
Financials	32.4	Market weight
Health Care	2.1	Underweight
Industrials	11.0	Market weight
Technology	4.5	Market weight
Materials	10.4	Market weight
Communications	5.7	Overweight
Utilities	4.1	Market weight
Real Estate	3.3	Overweight

Technical Considerations	Level	Target
S&P/TSX Composite	16,544	15,600



Source: Bloomberg, Raymond James Ltd.
Sectors are based on Bloomberg classifications

S&P/TSX Top 5 Gainers/Laggards*



S&P/TSX Market Internals

Weekly Advance	115	46%
Weekly Decline	127	51%
Advance-Decline	-12	
New 52 wk high	1	0%
New 52 wk low	2	1%
No. Stocks Above 50-d	134	53%
No. Stocks Above 200-d	145	58%
Arms Weekly Index	0.64	Neutral
RSI (14-day)	71.5	Overbought
50-DMA	16,103	Uptrend
200-DMA	15,714	Uptrend

*Source: Bloomberg, Raymond James Ltd; * 5-day price return*

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Canadian banks are in the headlines again thanks to Steve Eisman of Neuberger Berman his short thesis on the banks. The basis behind the short is that the banks are not provisioning enough for loan losses in the event of normalization in credit conditions. In addition, capital ratios will be slip given risk-weighted assets are calculated assuming too rosy a picture on the Canadian economy (capital ratios range from 11-12%; the regulatory requirement is 9%). While Eisman is negative on the banks, he notes his call is not for a collapse similar to what happened in the US in 2008 (housing driven), but simply that credit conditions normalize within the context of an economic slowdown. Under this scenario, delinquency rates will rise, putting pressure on bank earnings. Of course, the timing of this normalization is difficult to pinpoint and reminds us of John Maynard Keynes' famous quote, "the market can stay irrational longer than you can stay solvent."

The short Canadian bank thesis pops up every so often, the last time around the Home Capital Group (HCG) liquidity crisis in 2017 where the Ontario Securities Commission alleged the company falsified documentation for a segment of mortgages. At the time, the US shorts pointed to HCG as the 'canary in the coalmine' for the impending Canadian housing collapse. However, as we all know the Canadian housing market continued to chug along reaching new heights and punching the shorts. The continued advance in housing prices, however, did push governments to enact policies to help avoid a future hard landing. Ontario and British Columbia enacted a 15% non-resident speculation tax to deter foreigners from bidding up house prices and tougher mortgage qualification rules were implemented. The changes have had their intended effect as housing has softened over the past year, but the banks have a solid buffer against any potential credit losses especially when looking at their loan-to-value (LTV) ratios – they sit around 61%, which means there is a healthy level of collateral backing the loans. Those with higher LTVs have CMHC insurance, insuring banks against mortgage default risk. However, as mentioned, Eisman made it clear that his short was not a call on the housing market, but on a "normalization of credit" that the Big 5 are not ready for. In our view, so long as the Bank of Canada (BoC) keeps a lid on future rate hikes, then we see the downside risk to Canadian housing as limited given past home-grown housing crises have been driven by higher interest rates.

Big 5 Loan-to-Value Ratios

Ticker	Name	Residential mortgages LTVs	Homeline Products LTVs	Nonperf Loans % Tot Loans	5Y Avg	Loan Loss Provision % Tot Loans	5Y Avg
RY-CA	Royal Bank of Canada	55%	49%	.35%	.53%	.21%	.23%
TD-CA	Toronto-Dominion Bank	68%	66%	.46%	.51%	.36%	.33%
BNS-CA	Bank of Nova Scotia	64%	63%	.90%	.98%	.43%	.40%
CM-CA	Canadian Imperial Bank of Commerce	64%	67%	.41%	.53%	.23%	.28%
BMO-CA	Bank of Montreal	54%	45%	.53%	.67%	.17%	.19%
	Average	61%	58%	.53%	.64%	.28%	.29%

Source: Bloomberg, Raymond James Ltd.

On aggregate, the Canadian banks are trading at a discount to their 10-year P/E and P/B averages with the cheapest banks being CIBC (CM-T) followed by Scotiabank (BNS-T). Given current valuation levels, we think a lot of the bad news surrounding the housing market and Canadian consumer have been built into the price. That said,

we do remain underweight the banks at this point given financials tend to lag other sectors late in the economic cycle, a flattening and/or inverted yield curve makes for a difficult operating environment pressuring net interest margins and we continue to evaluate the impact the BoC's decision to remain on hold will have on credit and future consumption.

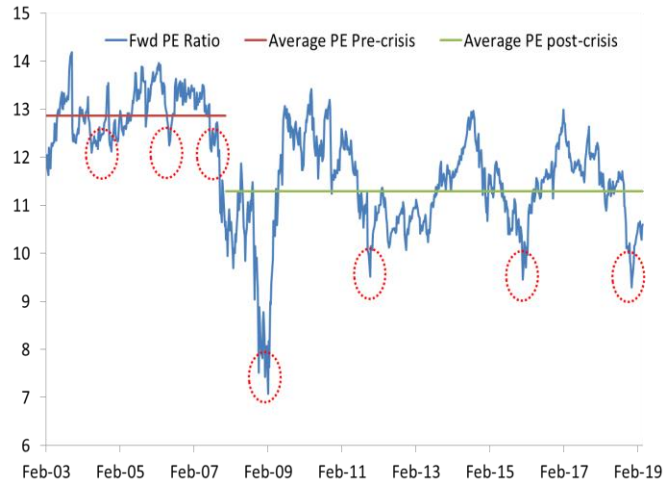
Big 5 Current Valuation & Potential Mean Revert Values

	Current				10 yr Aver		Mean Revert Projected Value			
Company Name	Last	P/E	P/B	BV per sh	P/E	P/B	P/E	P/B	Average	Delta
Toronto-Dominion Bank	$ 75.65	11.2x	1.7x	$ 40.50	11.7x	1.8x	$ 75.70	$ 72.90	$ 74.30	-1.8%
Royal Bank of Canada	$106.92	11.8x	2.0x	$ 51.12	11.9x	2.3x	$ 99.48	$117.58	$108.53	1.5%
Bank of Nova Scotia	$ 72.98	10.1x	1.4x	$ 49.75	11.8x	2.1x	$ 83.90	$104.47	$ 94.19	29.1%
CIBC	$110.74	9.0x	1.4x	$ 73.83	10.3x	2.2x	$125.76	$162.42	$144.09	30.1%
Bank of Montreal	$105.40	10.9x	1.5x	$ 64.73	11.2x	1.6x	$100.69	$103.58	$102.13	-3.1%
Average		*10.6x*	*1.6x*		*11.4x*	*2.0x*				

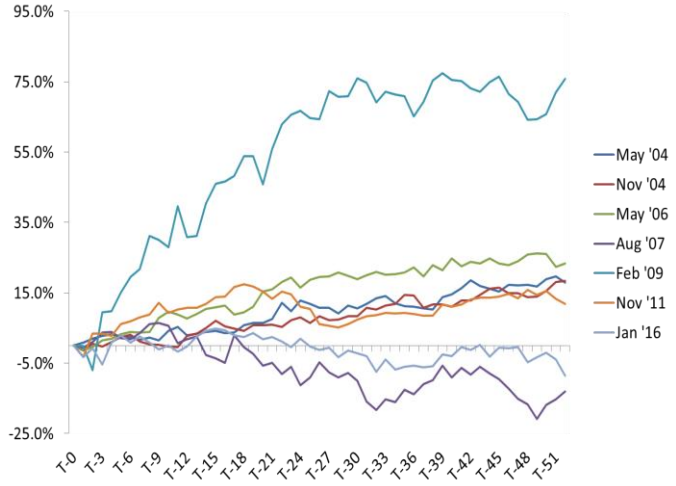
Source: Factset, Raymond James Ltd.

Nonetheless, we view the banks as core building blocks for a portfolio given their attractive income characteristics. Further, over the long term, buying the Canadian banks at abnormally cheap valuations has tended to be a good idea. Looking at the 12-month return for the S&P/TSX Banking Index after the index traded at an abnormally discounted valuation level has resulted in an average return of 18.0% (12.6% excluding the financial crisis). As a point of interest, during our analysis we noticed bank valuations pre- and post-crisis differed, in that the average valuation is lower today compare to pre-crisis which may potentially be explained by the higher capital ratios regulators have required banks to hold to offset future credit cycles.

S&P/TSX Banking Index Historical Valuation…



…12-Mth Returns After Buying At Discounted Valuation

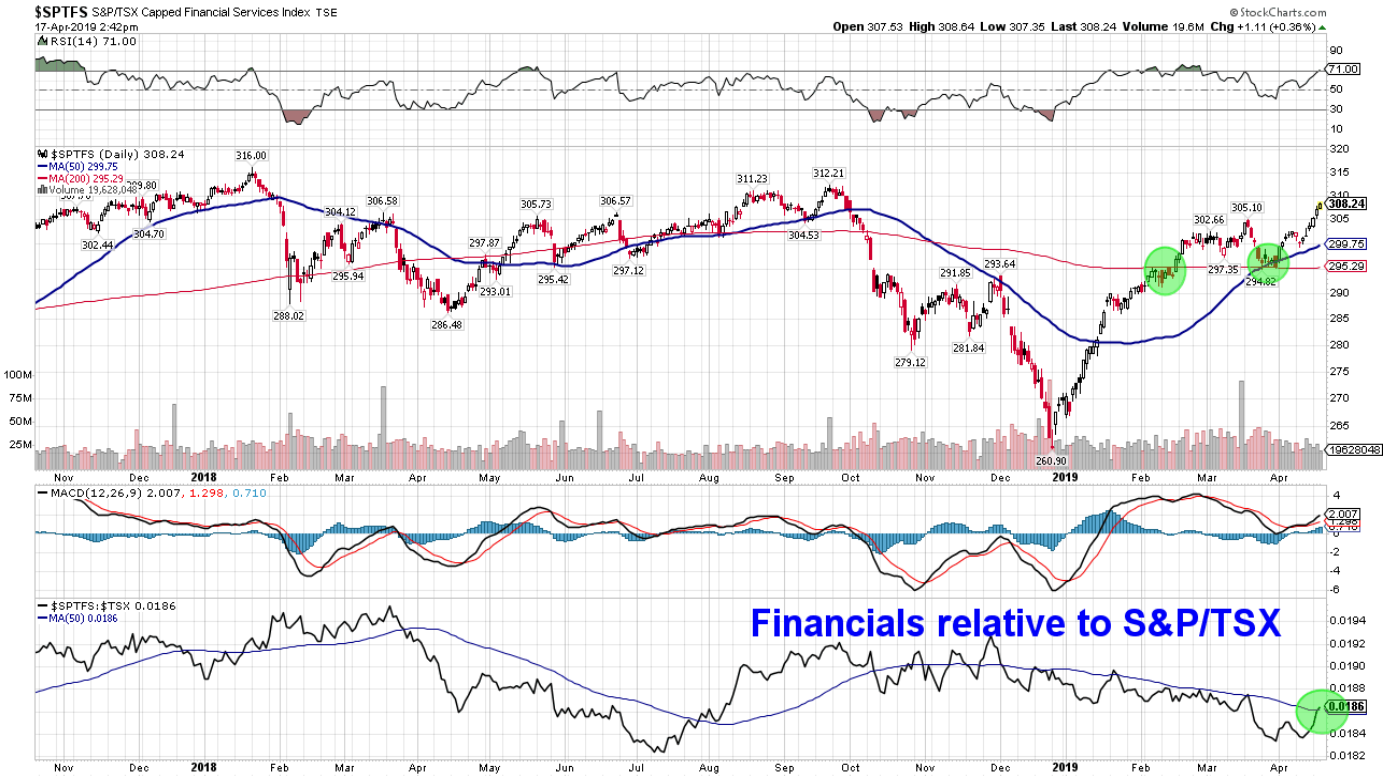


Source: Bloomberg, Raymond James Ltd.

As with the broader market, the technical picture is improving for financials as the sector has broken above its 200-day moving average in February and successfully retested the level in March. The 50-day moving average crossing above the 200-day

moving average (golden cross) is also an indication to take a more constructive view on the sector. On a relative basis, the sector has underperformed the S&P/TSX since September but it is attempting to push above its 50-day moving average, another sign that the market believes underlying fundamentals for the sector are improving.

S&P/TSX Financials Pushing Higher; Relative Trend Also on the Mend



Source: stockcharts.com

While the banks face a challenging operating environment, time and time again they have shown an ability to manage. If you're an investor with a long time horizon, adding to the banks at a discounted valuation has proven to be a good trade, but we would not suggest overweighting the banking sub-industry at this time given other sectors offer what we believe to be a better risk/reward profile.

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