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MAKING SENSE OF INVESTING

Weakening Outlook for the Canadian Household Sector

FINANCIAL SERVICES SECTOR REPORT

July 21, 2020

ANALYST(S)

James Shanahan, CFA

Companies mentioned in this report:

- **Bank of Montreal** (BMO.TO - Buy; $75.56)[1-6]
- **Bank of Nova Scotia** (BNS.TO - Buy; $56.57)[4,5]
- **CIBC** (CM.TO - Hold; $93.68)[4,5]
- **Royal Bank of Canada** (RY.TO - Hold; $95.78)[4,5,6]
- **TD Bank Group** (TD.TO - Buy; $61.80)[5]

Prices and opinion ratings are as of market close on 7/20/20 and subject to change. Source: Reuters, Edward Jones

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Growth in business and government loans accelerated in recent years, but loan portfolios are still dominated by consumer or retail loans. As of the end of the fiscal first quarter, almost two-thirds of total loans were retail loans. Among Canadian households, outstanding residential mortgage and consumer debt reached $2.29 trillion at the end of April, almost 60% higher than 10 years ago. Like U.S. households, mortgages comprise more than 70% of household debt.

The vast majority of consumer debt on the balance sheets of the Canadian banks is secured by real estate, and to a lesser extent, auto loans. This is a clear positive, as the collateral should reduce net loan losses. The banks do have exposure to unsecured consumer debt, mostly credit cards and personal lines of credit, which are likely to exhibit deterioration sooner than other loan categories. We would also anticipate higher loss rates for these loans.

North American bank regulators are looking to the banks to support borrowers impacted by illness and/or financial hardship. Many programs have been rolled out, and borrowers are taking advantage of opportunities to defer payments. *Deferral of mortgage, home equity and credit card payments will free up hundreds of millions of dollars per month for Canadian households, which will certainly help to offset the impact of the sharp economic slowdown.*

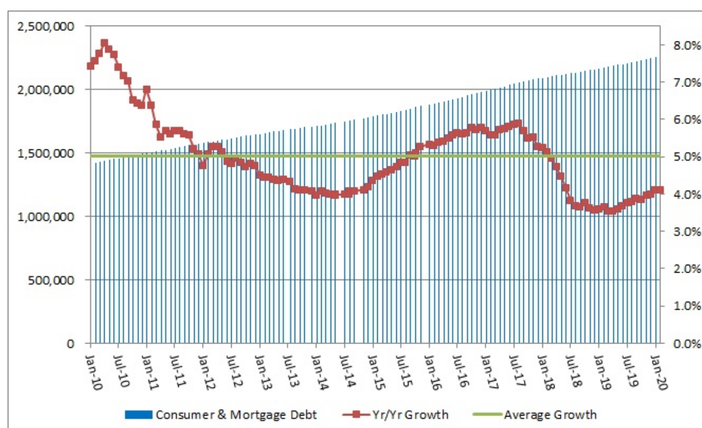
As a result of the spike in unemployment, we expect residential real estate demand to fall sharply, contributing to a decline in home prices. We do not expect that the magnitude of this decline will be so severe as to jeopardize the homeowner equity supporting the large portfolios of uninsured loans backed by residential real estate.

Rebalancing Could Be Appropriate at This Time. We recommend that clients allocate no more than 20% of equity portfolios to financial services stocks. We suggest working with your Edward Jones advisor to reduce your portfolio's equity exposure to bank stocks if you are currently overweighted.

Within this report, we discuss recent economic trends and provide an update on our thoughts related to the Canadian household sector. **For additional detail regarding the individual bank stocks mentioned in this report, please see our bank-specific opinions.**

Growth in business and government loans accelerated in recent years, but loan portfolios are still dominated by consumer or retail loans. As of the end of the fiscal second quarter (the three-month period ended April 30, 2020), loans outstanding to retail borrowers represented almost 60% of total loans held on Canadian-bank balance sheets. Among Canadian households, outstanding residential mortgage and consumer debt reached $2.29 trillion at the end of April, almost 60% higher than 10 years ago. Like U.S. households, mortgages comprise more than 70% of household debt.

Figure 1. Growth in Aggregate Canadian Consumer and Mortgage Debt



Source: Bank of Canada and Statistics Canada

Consumer debt generally includes loans not secured by residential real estate. Consumer debt can be secured, including loans for automobiles, mobile homes or boats, or unsecured, including credit cards, personal lines of credit, and loans for education or vacations. Credit costs have historically been lower for secured loans, given the ability to liquidate collateral to mitigate loss of principal. Unsecured personal loans, especially credit cards, typically exhibit signs of deterioration in quality very early in a recession and generate the highest loss rates.

It is a clear positive that the bulk of consumer lending in Canada is secured, as it will reduce loan losses and credit costs for the banks, everything else held constant. Among the largest banks, Canadian retail loans total approximately $1.75 trillion, and we estimate that five-sixths is secured by residential real estate. If the recent economic disruption were to lead to a large increase in homeowner delinquencies, these loans would benefit from either significant home equity or mortgage insurance.

We estimate that the big five banks hold over $85 billion in auto loans, accounting for a relatively large portion of the remaining consumer exposure. Captive auto-finance companies (those that are associated with a major auto manufacturer) dominate in Canada, which limits the market opportunity for the banks, as does buyer preference for leases versus loans. Scotiabank has a relatively large share of the auto-lending market in Canada, followed by TD Bank. For the others, we believe that auto loans represent a small percentage of their respective Canadian retail loan portfolios (approximately 4% or less of the total).

If an auto-loan borrower defaults, the bank can acquire the collateral and sell it at auction to reduce the potential loan loss. As a lender's loan book migrates away from prime loans, it is more likely that the lender is exposed to borrowers with poor credit histories and/or auto loans with very long amortization periods and, potentially, negative equity. Another consideration is the strength of the used-vehicle market. If used-vehicle prices are declining, which can happen in a recessionary environment when demand for used cars softens, recovery values also decline, resulting in higher net loan losses.

According to a recent report by TransUnion Canada, the average balance for outstanding auto loans in Canada was over $21,000 at the end of 2019. For Canadian households that have credit cards, the average outstanding balance was over $4,000. Of course, each of the five-largest Canadian banks have exposure to credit cards and other unsecured personal loans. If credit quality were to deteriorate meaningfully, we would expect to observe it first among unsecured consumer loans.

Unlike previous economic downturns, however, many borrowers are taking advantage of opportunities to defer payments, which leads to more of a soft landing for consumer credit. Regulators are, in fact, looking to North American banks to support borrowers impacted by illness and/or financial hardship. Generally, credit card payments can be deferred for three months, while borrowers can request up to six months relief from home-equity and mortgage-loan payments. There is no fee charged to skip a payment, but the interest is added to the outstanding balance on the loan. *Deferral of these payments frees up hundreds of millions of dollars per month for Canadian households, which will certainly help to offset the impact of the sharp economic slowdown.*

Figure 2. Long-term Credit Performance

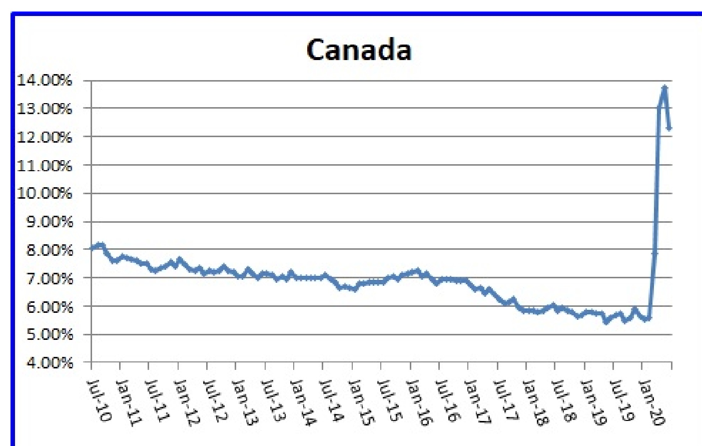
$CAD (millions)		2015	2016	2017	2018	2019
Big	Gross Loans	2,153,777	2,319,778	2,468,430	2,626,089	2,807,731
Five	Gross Impaired Loans	16,264	19,858	16,701	17,077	18,144
CA	**% of Total**	**76 bps**	**86 bps**	**68 bps**	**65 bps**	**65 bps**
Banks	Allowance for Loan Losses	13,347	14,539	13,974	15,211	16,952
	ALL % Gross Loans	62 bps	63 bps	57 bps	58 bps	60 bps
	ALL / Impaired Loans	0.8 x	0.7 x	0.8 x	0.9 x	0.9 x
	Net Charge-Offs	4,997	6,962	7,783	6,693	8,337
	Net Charge-Off Ratio	24 bps	31 bps	33 bps	26 bps	31 bps
Net Charge-Off Ratio for U.S Banks		41 bps	44 bps	46 bps	45 bps	48 bps

Source: Company reports and Federal Financial Institutions Examination Council (U.S.)
("bps" stands for basis points. 1 basis point = 0.01%)

In recent years, the largest Canadian banks have performed well from a credit standpoint. The percentage of loans classified as impaired has been generally declining but has also been consistently better than impairment rates reported by U.S. banks. Among the large Canadian banks that we follow, if there has been much year-to-year change in impaired loans, it has been primarily with the business- and government-loan portfolios. For example, there was an increase in impaired loans outstanding to borrowers in the oil and gas sector throughout 2016, but these loans were resolved. This is evident in the data above, reflected by the increase in impaired loans in fiscal 2016, followed by the decline in fiscal 2017. Comparatively, retail-loan portfolios have been relatively stable.

Labour market conditions had been solid in Canada, as illustrated by a national unemployment rate of 5.6% as of the end of February. At that time, the unemployment rate in Canada was only modestly higher than the lowest rate in the 40+ year history of the data series (5.42% in May 2019).

Figure 3. National Unemployment Rate (Trailing 10 Years Ended June 2020)



Source: Statistics Canada

Earlier this calendar year, oil prices plummeted, driven by conflict among major global producers and a continuing supply glut. The oil market decline has pressured jobs in the oil patch. During the last downturn, in late 2015 through early 2016, the unemployment rate in the prairie provinces increased by approximately two percentage points over a 12-month period. By May 2020, the unemployment rate in the prairie provinces had spiked by over seven percentage points to over 14%, well-above the recent peak of 8.2% in November 2016.

Meanwhile, the coronavirus has spread from China, west towards Europe and North America. The global economy has been significantly impacted, and it is has become clear that this will be a historic disruption for Canada, too. The Canadian banks are facing a tough test, no doubt. Since mid-March, millions of Canadians have filed for jobless benefits. Based on recent Labour Force Survey data, the nationwide unemployment rate spiked to 13.7% in May, and remained above 12% in June.

Outside of the oil sector, job losses have disproportionately impacted the transportation, travel, and hotel & hospitality sectors. Should the economic slowdown persist and/or worsen, jobs in other sectors could be impacted, too, including the real estate & construction and manufacturing sectors, among others.

There is some evidence that the Canadian consumer was beginning to feel some pressure prior to recent events. The Office of the Superintendent of Bankruptcy (OSB) tracks consumer insolvencies. Insolvencies include both bankruptcies and proposals.

Bankruptcy. The state of a consumer that has made an assignment in bankruptcy or against whom a bankruptcy order has been made.

Proposal. An offer to creditors to settle debts under conditions other than the existing terms. Proposals are more common. In the last couple of years, proposals have accounted for 55%-60% of total consumer insolvencies.

Consumer insolvencies declined steadily for several years following the financial crisis but have been rising recently. In the fourth quarter of 2019, over 35,000 insolvencies were filed by consumers, the highest level since the second quarter of 2016. The increase in consumer insolvencies is remarkable given the strength in labour-market conditions.

The recent increase can be observed in the charts below. In the first chart, we present the long-term

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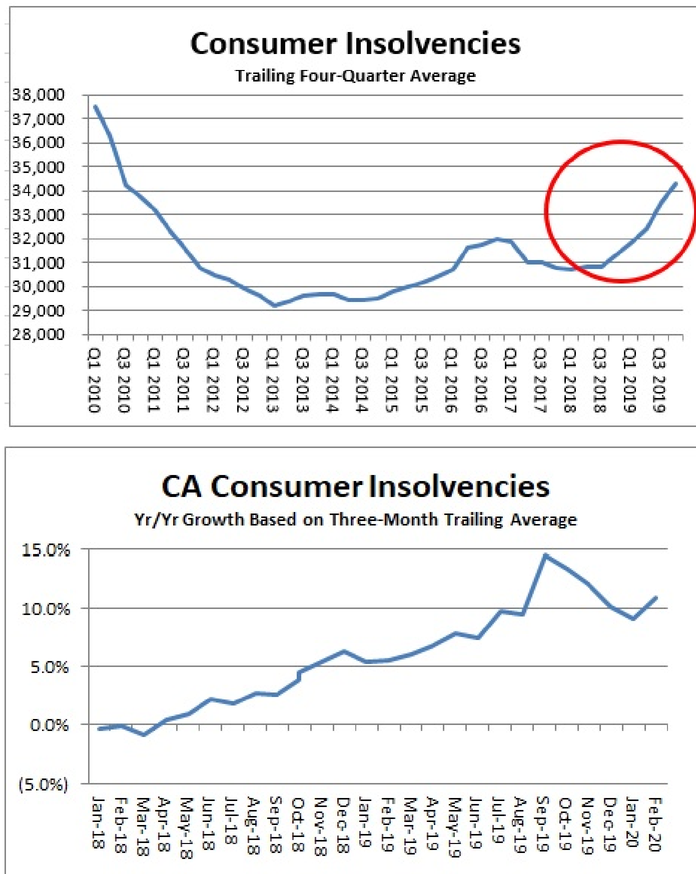
trend, using smoothed quarterly results. The graph illustrates the decline in filings coming out of the Great Recession, as well as the more recent increase. In the second chart, we have blown up the circled area from the top chart. Using two years of smoothed monthly data, we can illustrate the steady year-over-year growth in filings. We expect recent events to trigger additional filings.

Figure 4a & 4b. Consumer Insolvency Trends

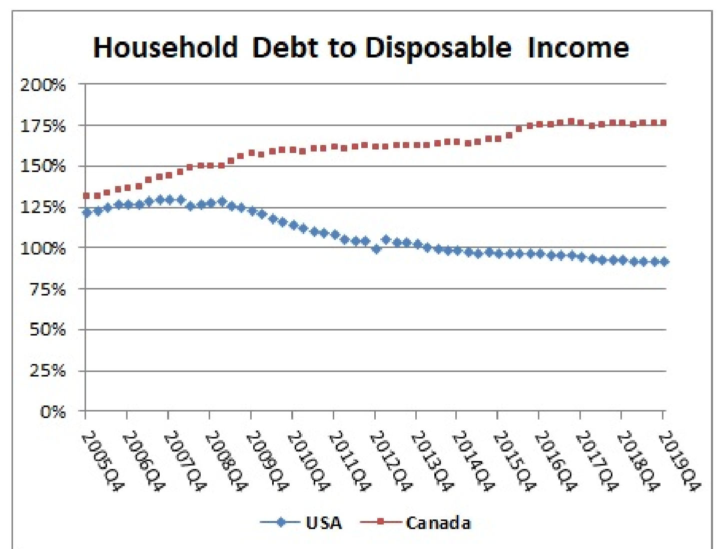


Source for both charts: Office of the Superintendent of Bankruptcy

Relative to disposable household income, average Canadian households are carrying record levels of mortgage and consumer debt. As of the end of the fourth quarter of 2019, the average Canadian household held $175,850 of debt for every $100,000 of disposable income. Expressed as a ratio, household debt approximates 176% of disposable income as of year-end 2019. We believe that the increase in insolvency filings can be at least partially attributed to relatively high levels of household debt.

In the U.S., the ratio of household debt to disposable personal income rose to 130% in the third quarter of 2007, driven by a combination of low interest rates, rising home prices, weak underwriting standards, and strong mortgage market liquidity. Household borrowing growth slowed entering the financial crisis, and U.S. households have continued to deleverage. Currently, the ratio of household debt to disposable income is 92% in the U.S. The ratio in the U.S. has also benefited from stronger growth in disposable income. For example, disposable income has grown by almost 45% over the last 10 years in Canada, less than the 50% growth rate in the U.S. Still, debt levels among Canadian households are very high, and a higher percentage of Canadian families carry debt today than ever before.

Figure 5. Household Debt as a Percentage of Disposable Personal Income, Canada & United States



Source: Statistics Canada, Federal Reserve Bureau of Economic Analysis and Edward Jones Estimates

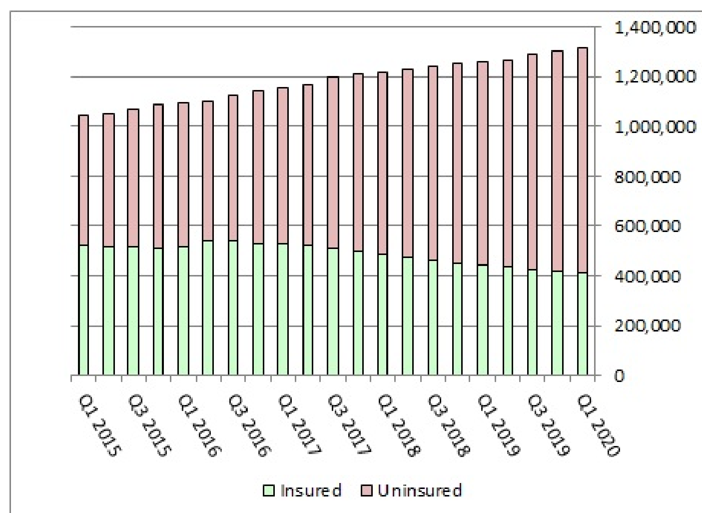
Earlier, we suggested that the high level of secured debt, particularly real estate secured debt, was a clear positive for the Canadian banks. This is true, so long as home values remain strong. For some time now we have felt that home prices were due for a pullback. Given the spike in unemployment, we would expect residential real estate demand to fall sharply, contributing to a decline in home prices.

Most mortgages are recourse loans in Canada, meaning that borrowers must repay the loan even in the event of a foreclosure and sale of the property for less than the amount owed. The Canadian banks are also protected by mortgage insurance and/or homeowner equity. Of note is that the percentage of insured loans held on bank balance sheets has declined, meaning that home values are somewhat more important than in years past.

Five years ago, half of the value of outstanding mortgage and home equity loans held on the balance sheets of the large banks were insured, provided

mostly by the Canadian Mortgage and Housing Corporation (CMHC). The CMHC has retrenched, however, reducing the size of its in-force mortgage insurance portfolio, from $540 billion to approximately $430 billion. Meanwhile, the Canadian banks have continued to deliver growth in loans backed by Canadian residential real estate. As a result, the proportion of total loans that are backed by insurance has declined to only about 30%. The CMHC has effectively transferred significant housing-market risk from taxpayers to investors in the largest Canadian banks.

Figure 6. Growth in Loans Backed by Canadian Residential Real Estate



Source: Company Reports and Edward Jones estimates

Valuation Considerations for Bank Stocks. When valuing financial services companies, we use various methodologies. First, we often consider the current stock price relative to expected earnings per share, or the price-to-earnings ratio. A key consideration is that investors typically place a higher value on stocks with higher anticipated earnings growth. Another methodology is to compare the current stock price with the book value of equity (value of assets less the value of liabilities). With the price-to-book-value ratio, we often consider the company's return on equity in addition to the growth outlook. Everything else equal, a company with a higher return on equity and a higher growth rate is generally rewarded a higher price-to-book-value multiple.

Our current earnings estimates for the Canadian banks reflect our outlook for both lower earnings and profitability in 2020, which supports price-to-earnings and price-to-book-value ratios below recent historical levels. On average, valuations for the big five banks have declined to 1.6 times tangible book value (assets - liabilities - goodwill), below the five-year average of 2.2 times. Meanwhile, the large U.S. banks that we follow, which include JP Morgan and Bank of America, are currently valued at an average of 1.2 times tangible book value.

We expect some quite significant challenges in the near term, and valuations could weaken further, especially if earnings are pressured to a greater degree than we currently expect. That said, we believe that this virus-driven pullback presents an opportunity for long-term investors to buy shares of high-quality companies. We currently have Buy ratings on TD Bank, Scotiabank and Bank of Montreal. Aside from other company-specific factors, these banks are generally more diversified geographically.

Figure 7. Price to Book Value Per Share (BVPS) and Return on Equity (ROE)

Bank	Symbol	Current Rating	21-Jul Price	Yield	Current Price to BVPS	5-Year Avg Price to BVPS	Average ROE 2017-19	Estimated 2020 ROE
RBC	RY	Hold	95.70	4.5%	1.7 x	2.0 x	17.4%	12.6%
TD Bank	TD	Buy	61.92	5.1%	1.3 x	1.7 x	15.8%	11.2%
Scotiabank	BNS	Buy	56.39	6.4%	1.1 x	1.6 x	14.5%	12.2%
BMO	BMO	Buy	75.08	5.6%	1.0 x	1.5 x	14.0%	9.2%
CIBC	CM	Hold	94.15	6.2%	1.1 x	1.8 x	17.0%	9.8%

Source: Bloomberg, FactSet and Edward Jones Estimates

Memo: *Valuation as of July 21*, 2020. BVPS: Book value per share as of April 30, 2020.

Risks. Some of the risks associated with investing in financial services companies include

- Sensitivity to the health of the economy. In the event of a weaker Canadian economy or a prolonged recession, share prices could be negatively affected as credit risks become elevated and asset values decline;
- Sensitivity to the pace and magnitude of changes in interest rates; and
- Regulatory and legal risks.

Please see our opinion on each of the companies mentioned in this report for more information on the benefits, valuation, and risks of investing in these stocks.

Required Research Disclosures

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Buy (B) - We believe the valuation is attractive and total return potential is above average over the next 3-5 years compared with industry peers. Hold (H) - We believe the stock is fairly valued and total return potential is about average over the next 3-5 years compared with industry peers or a special situation exists, such as a merger, that warrants no action. Sell (S) - We believe the stock is overvalued and total return potential is below average over the next 3-5 years compared with industry peers. In some cases we expect fundamentals to deteriorate considerably and/ or a recovery is highly uncertain. FYI - For informational purposes only; factual, no opinion.

The table below lists the percent of stocks we follow globally in each of our rating categories. Investment banking services indicate the percentage of those companies that have been investment banking clients within the past 12 months. As of: July 21, 2020

	BUY	HOLD	SELL
Stocks	**50%**	**46%**	**4%**
Investment Banking Services	**4%**	**0%**	**0%**

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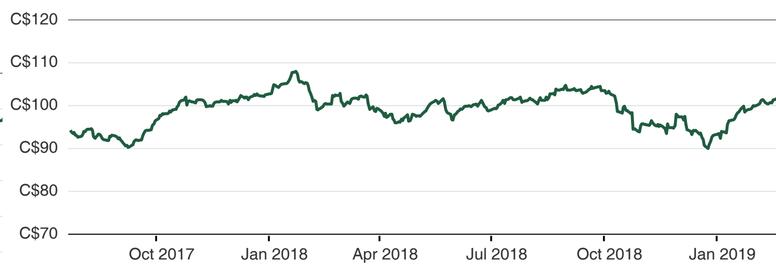
3-Year Rating and Price History for: Bank

Source: Re

3-Year Rating and Price History for: RBC Fina



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3-Year Rating and Price History for: Bank of

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Source: Reute

Source: Reuters

3-Year Rating and Price History for: Canadian Imperial Bank (CM.TO) as of 07/15/2020

Source: Reuters