

# AN UPDATE ON CANADIAN BANKS

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Through various economic/credit cycles and over longer periods of time the Canadian banks have consistently outperformed the S&P/TSX Composite Index.<sup>1</sup> This outperformance is a product of their strong competitive positioning in Canada which over economic cycles has allowed them to generate returns well above their cost of capital as well as robust earnings and dividend growth. We believe the attractive fundamentals of the Canadian banks have not changed and therefore continue to view them as quality businesses with short-term earnings volatility influenced by economic factors. As a result, the approach we take with the Canadian banks is to hold them as core positions and trade around them depending on a) where we are in the economic/credit cycle and b) where valuations are.

## Reasons for buying Canadian banks

During the COVID-19 related market selloff in March 2020, the valuations of Canadian banks came under material pressure declining close to book value (source: Bloomberg). We took this as an opportunity to add to our Canadian bank positions for the following reasons:

1. we had a margin of safety in valuation
2. longer-term fundamentals remained attractive and
3. COVID-19 was a health crisis so governments around the world - including Canada - had the political capital to act quickly and decisively with monetary and fiscal support.

## Reasons for selling Canadian banks

Since the depths of the COVID-19 related market sell-off in March of 2020 Canadian banks have rallied sharply outperforming the S&P/TSX Composite Index on a total return basis.<sup>2</sup> The magnitude of the bank stocks' outperformance was even greater up until January of 2022<sup>3</sup> which we saw as an opportunity to selectively trim our Canadian bank exposure. This was entirely a valuation call which for the big six banks had climbed to ~1.7 times book value. At these valuation levels we believed the bank stocks fully reflected a number of positives including a rising rate environment and at the time a much stronger global economic outlook.

## Where are we today?

Over the past four months Canadian banks have underperformed the broader Canadian equity markets due to a deterioration in the global economic outlook caused by central bank tightening, still no clear resolution to Russia's war in Ukraine, and more recently a slowdown in China's economy from COVID-19 lockdowns. Today, the big six banks trade at ~1.5 times book value. The risks, and the knock-on effect of rising rates on Canada's housing market, have introduced considerable risk countered to a certain extent by:

1. the banks' historically high capital levels
2. attractive dividend yields (~4.5% on average for the big six banks) and compelling short and medium-term dividend growth prospects
3. Canada's relatively strong economic outlook because of the commodity supply shock caused by the Russia-Ukraine conflict and
4. key indicators like Canada's household debt service ratio remain below historical highs.

## What are we doing in our portfolios?

We are holding onto our Canadian banks for now. While we expect upcoming quarterly results for the banks due at the end of May to be strong and anticipate no material change in the outlooks from the bank's management teams, we believe caution is warranted until we gain better visibility on the stabilization of the economy and/or more attractive valuations.

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<sup>1</sup> Source: Bloomberg, From May 5, 2003 to May 4, 2022 The S&P/TSX Composite generated a total return of 436% versus 744% for the S&P/TSX Composite Banks GICS index (an index that focuses on financial securities classified as a bank)

<sup>2</sup> Source: Bloomberg, from March 23, 2020 to May 4, 2022 the S&P/TSX Composite's total return was 101% versus 117% for the S&P/TSX Composite Banks GICS index

<sup>3</sup> Source: Bloomberg, from March 23, 2020 to January 14, 2022 on a total return basis the S&P/TSX Composite Index was up 101% versus 136% for the S&P/TSX Composite Banks GICS index

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