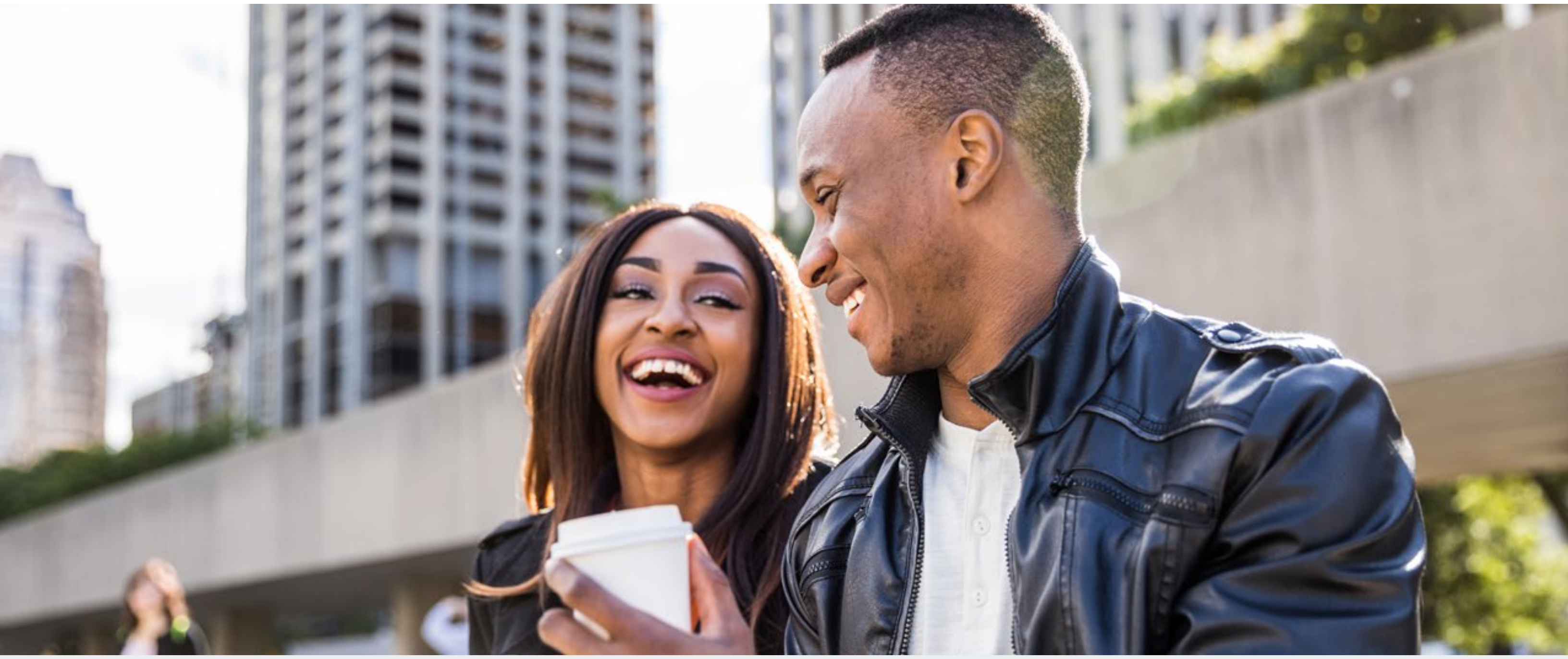
CONTINUED CONFIDENCE IN CANADIAN BANKS DESPITE RECENT GLOBAL MARKET VOLATILITY

April 2023

David Andrich, CFA – *Senior Equity Research Analyst, Portfolio Management & Research*
Ryan Diamant, CFA – *Associate Client Portfolio Manager – Equities*



While equities, specifically bank stocks, may be volatile over the short term, we continue to have confidence in the Canadian banking sector over the medium to long term. Here's an overview of what caused recent volatility in the financial sector and why we maintain ownership of several banks within our portfolios.

What caused financial sector volatility?

- On Friday, March 10, 2023 Silicon Valley Bank (SVB) was taken over by the Federal Deposit Insurance Corporation (FDIC).
- On Sunday, March 12, 2023 the FDIC also took control of Signature Bank, a regional US commercial bank with a focus on cryptocurrencies. Market volatility that started with US regional banks expanded into Europe. Creditors, investors and depositors of Swiss bank Credit Suisse lost confidence in the bank's ability to operate.
- In an effort to restore stability and confidence in the European banking sector, Swiss regulators structured a bailout and Credit Suisse was acquired by UBS.
- Canadian banks subsequently declined 8.6% from March 1, 2023, to March 22, 2023 amidst the financial sector developments originating in the US and Europe. Throughout the same period, the broader S&P/TSX Composite Index declined by 3.2%.
- The market volatility and index declines were caused by a general sell-off in the financial sector due to negative investor sentiment. During this time, Canadian banks and their US subsidiaries weren't at risk or in need of funding or bailouts.

What's the outlook for Canadian banks and the global financial sector?

- While equities—specifically bank stocks—may be volatile over the short-term, we continue to have confidence in the Canadian banking sector over the long-term.
- We believe the issues affecting SVB were largely idiosyncratic. SVB's management team made a series of errors that ultimately resulted in a loss of confidence by the market and deposit holders. With US regulators taking measures to boost confidence in the US banking system, we don't believe this will have broader implications to the global financial sector.
- Today, the global financial sector is a lot more secure in comparison to the period during the global financial crisis (GFC) in 2008 and 2009.
- Larger US banks are subject to Dodd-Frank requirements which enhance financial stability and involve frequent stress testing to ensure adequate capitalization.
- There have been a total of 563 bank failures in the US since 2001, 73 of which have occurred after the financial crisis from 2013 onwards. Canada has not had a major bank failure in nearly 100 years.
- Most of these US bank failures occurred with smaller regional banks. This illustrates how common bank failures are within the US, how small an impact bank failures typically have had on the broader US economy since the financial crisis, and how resilient the Canadian banking system is in comparison.

Why are bank failures unlikely to happen in Canada?

- Canadian banks have been selective in their US acquisitions, are well capitalized and are more active in managing interest rate and liquidity risk than US regional banks.
- Canadian banks face greater scrutiny by regulators on their liquidity requirements versus US regional banks and have a more diversified deposit and funding base.
- Banks in Canada tend to have solid Returns on Equity, very strong capital positions and operate within one of the strongest regulatory frameworks in the world.
- In Canada, the Office of the Superintendent of Financial Institutions (OSFI) regularly monitors capital ratios, liquidity and ongoing risks to ensure a safe banking environment. For example, to help protect the financial system throughout the recent pandemic-related economic downturn, OSFI imposed a ban on dividend increases, share buybacks and raising executive compensation.
- We continue to own Canadian banks and carefully monitor their trajectory along with central bank developments and regulatory requirements.

What is our rationale when considering bank stocks?

We breakdown the key components used to analyze bank stocks which are a part of our independent in-depth research and due diligence process.

Net Interest Margin (NIMs)

NIMs are watched closely by financial institutions and analysts alike because they measure the income earned through loans and mortgages, and the amount they pay out on deposits (i.e. interest earned versus interest paid). NIMs are a key indicator for assessing profitability and growth.

- Typically, NIMs will widen when interest rates are on the rise and narrow when interest rates are falling.
- Interest rates on deposits typically don't rise as quickly as interest rates on loans. This is due to the stickiness of the rates of interest paid on near-cash assets such as deposit accounts and GICs etc.
- Given that we are in a higher rate environment, we see the big six banks' NIMs continue to expand over 2023 albeit at a much slower pace compared to 2022.
- We believe interest rates will remain elevated throughout 2023 acting as a tailwind for banks.
- If a recession occurs, we could see Provisions for Credit Losses (PCLs) increase which will act as a headwind on earnings.
- We continue to see medium- to long-term strength in the Canadian banking sector and very often, the best time to invest in Canadian banks is during a recession.
- In every recession and timeframe analyzed, Canadian bank stocks outperformed the broader S&P/TSX Composite given that markets are forward looking and typically anticipate an economic recovery even while a recession is underway.

The below charts show the returns of Canadian banks during and after recessions along with the start date of every recession over the last 40 years in Canada.

Returns of Canadian banks during and after recessions

1990s recession as of March 1990

Timeframe	1 year	2 years	3 years
S&P/TSX Composite Banks TR Index	9.34	13.72	7.76
S&P/TSX Composite TR Index	-2.12	2.38	1.22

Financial Crisis (Start date: October 2008)

Timeframe	1 year	2 years	3 years
S&P/TSX Composite Banks TR Index	13.39	12.39	8.31
S&P/TSX Composite TR Index	-2.30	5.92	2.65

Covid-19 (Start date: March 2020)

Timeframe	1 year	2 years	3 years
S&P/TSX Composite Banks TR Index	17.75	24.53	13.24
S&P/TSX Composite TR Index	16.27	17.04	10.89

Source: [†]Morningstar Direct as at March 23, 2023

Capital requirements for banks

- Capital requirements ensure financial institutions have enough capital available to sustain operations, maintain adequate liquidity and financial health, and aim to mitigate the risk of default promoting public and depositor confidence.
- In December 2022, OSFI announced they were expanding the Domestic Stability Buffer (DSB) upper limit from 2.5% to 4.0%—a requirement designed to ensure adequate capital to protect against risks.
- OFSI then increased the DSB from 2.5% to 3.0% effective February 1, 2023. This resulted in the minimum Common Equity Tier 1 (CET1) ratio increasing from 10.5% to 11.0%.
- OSFI is expected to increase the DSB by 0.50% in June 2023, increasing the CET1 ratio to 11.5%. This may increase further in 2024 to 12.0%.
- All big six Canadian banks target a 0.50% buffer above the minimum and are aiming to achieve a 12% capital ratio by the end of 2023.
- These developments will enhance the stability and resiliency of the Canadian banking sector.

Credit and mortgage conditions

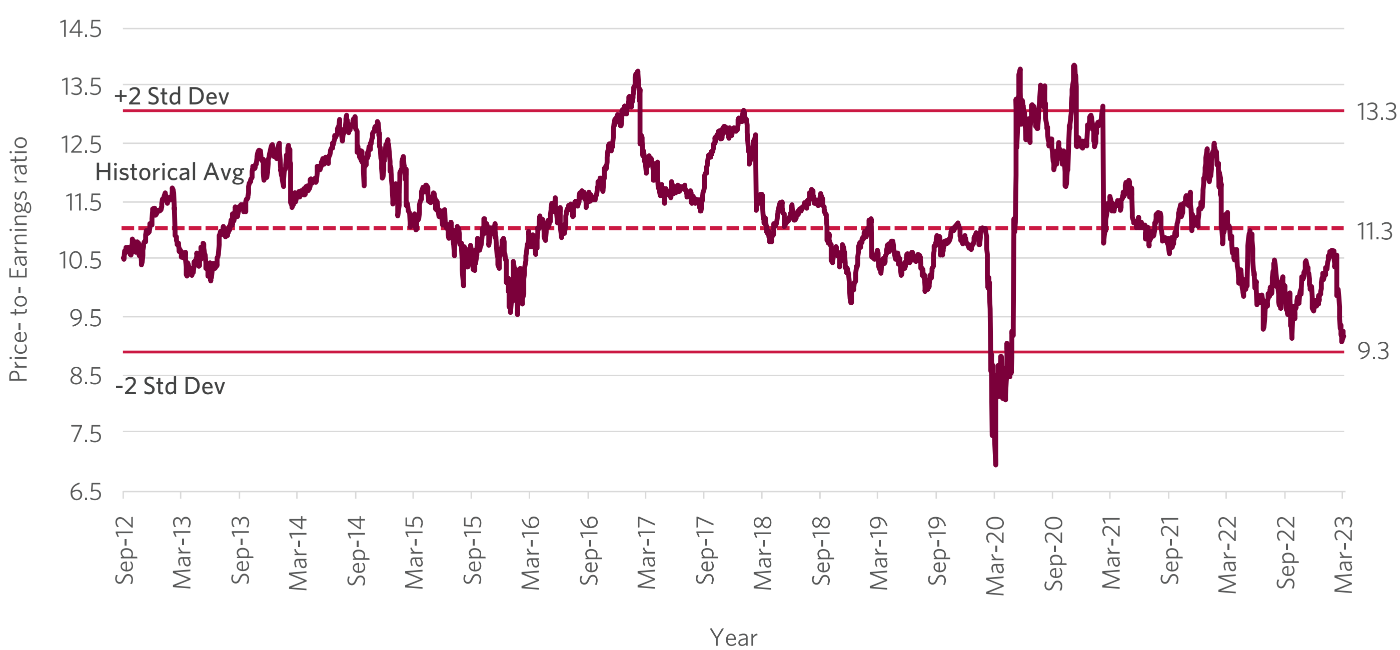
- Credit and mortgage conditions are important indicators to monitor for the banking sector as they can signal potential future growth or losses which may ultimately affect profitability. Strong credit conditions illustrate the ability of debtors to pay back their outstanding loans. Poor credit conditions may suggest the inability of debtors to pay back their debt, and could lead to greater non-performing assets.
- Credit conditions remain healthy and better than they were pre-pandemic in 2019, despite interest rates currently being at their highest levels since the GFC. The amount of consumers who were delinquent past 90 days in 2019 was approximately 1.12%. This figure decreased to around 0.90% in 2021 and was 1.01% at the end of 2022.
- Canadian banks experienced strong loan growth in 2021 and 2022. However, we expect loan growth, particularly mortgage growth, to moderate over the next six to 12 months. We do see a return to long-term historical averages over the medium term.
- Provisions for Credit Losses (PCLs) could build in the event of a recession, but currently remain below their long-term averages.
- The Canadian mortgage market has grown significantly over the past decade, aided by historically low interest rates. It has been a large source of revenue for Canadian banks.
- Mortgage growth is expected to be around 3% to 4% year-over-year (Y/Y) throughout 2023 due to lower renewal demand, lower home prices and modest sales levels.

Valuations and investment opportunity

- We believe banks are attractively priced. Valuations for the banking sector are two standard deviations below their historical average which suggests there could be a future reversion to the mean. This is represented by the Price-to-Earnings ratio of the S&P/TSX Composite Bank Index, shown below.
- In many of our Canadian equity portfolios, we have significant exposure to Canadian banks, although we're selective on which banks we choose to invest in.
- Some of the big six banks have performed quite well and remain excellent long-term opportunities, but have less upside over the short term.
- For other Canadian banks, we expect further NIM expansion or we have identified catalysts from recent acquisitions. As a result, we feel there are several banks that remain great investment opportunities within our Canadian Equity, Equity Income and Balanced portfolios.
- The big six banks also offer very compelling dividend yields which are exceptionally stable. They have had a successful track record of consistently raising dividends over the last several decades, and there hasn't been a dividend cut in the last 100 years. This shows the resilience in their capital structure and their ability to generate sustainable cash flows.

Overall, we're confident in the Canadian banking sector going forward and maintain ownership of several banks within our CIBC Asset Management portfolios.

10-year valuations of Canadian banks



Source: Bloomberg LP, as at March 23, 2023.

About the authors

David Andrich, CFA
Senior Equity Research Analyst, Portfolio Management & Research

Ryan Diamant, CFA
Associate Client Portfolio Manager – Equities

About CIBC Asset Management

At CIBC Asset Management, we believe every customized investment solution begins with research and rigour. We specialize in a variety of investment solutions such as equities, fixed income, currency management, liability-driven investments, asset allocation and responsible investments.

Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset class teams. Across a spectrum of investment solutions, we commit to best-in-class research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation.

We provide our clients with our research insights and expertise on industry issues and themes that matter most to them. By sharing insights across asset class teams, we maximize opportunities to add value to our client portfolios.

Contact us any time

To learn more about CIBC Asset Management and our investment solutions, please contact your advisor.

For more investment insights, connect with us on LinkedIn and Twitter.

592 | 04/2023