TD Wealth

Canadian Banks

Market Insights

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Wealth Investment Office

Revenue Buoyed by Capital Markets Growth

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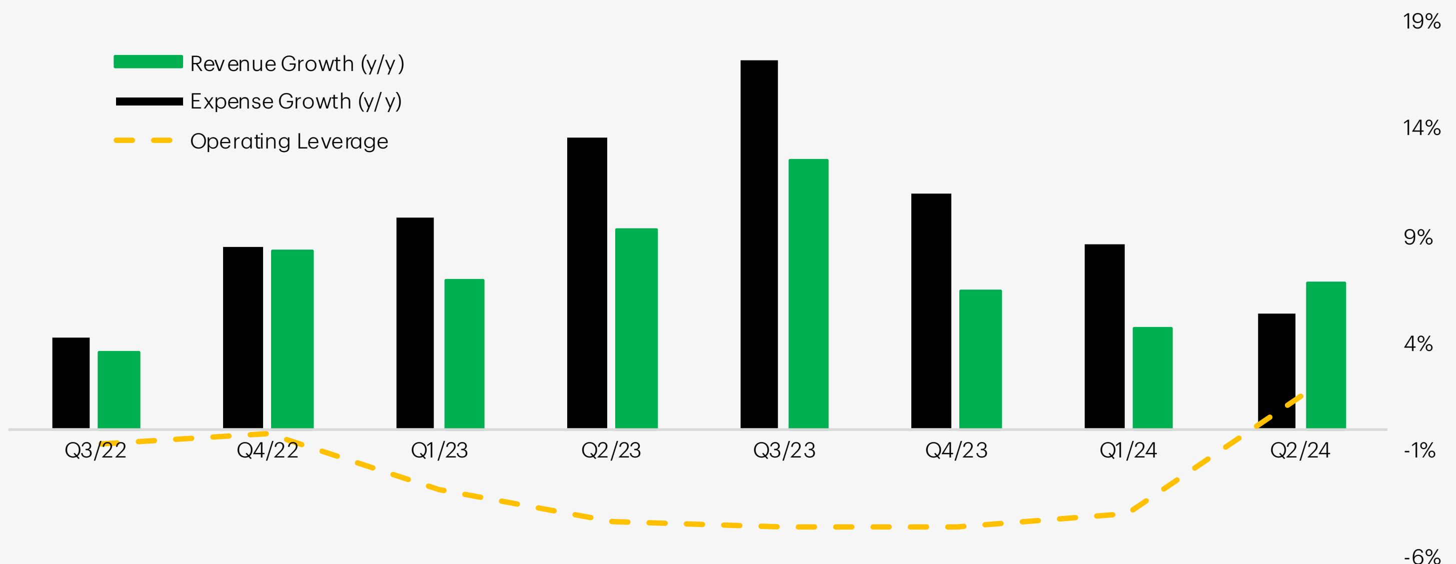
Key Points

- **Q2 marks the first quarter** of positive operating leverage largely driven by capital markets revenue growth.
- **Growing investment banking revenue** bodes well for Canadian banks with U.S. capital markets businesses. Domestic and U.S. margins diverge.
- **Continuing credit deterioration** in domestic personal loans.
- **The industry could migrate to a lower CET 1 ratio** as the credit environment improves and this could lead to better long-term return on equity.

Canadian banks have been plagued by weak underlying fundamentals for the last two years: high expense growth and lower capital markets related revenue (CMRR) offset the benefit of rising rates. This resulted in several quarters of negative operating leverage that, combined with the normalization in credit losses, has weighed on the stock performance of Canadian banks. However, Q2 marked the first quarter of positive operating leverage, which was driven by improving revenue growth and slowing expense growth (from last year's cost initiatives and moderating inflation).

Figure 1: Q2 marks turnaround in operating leverage

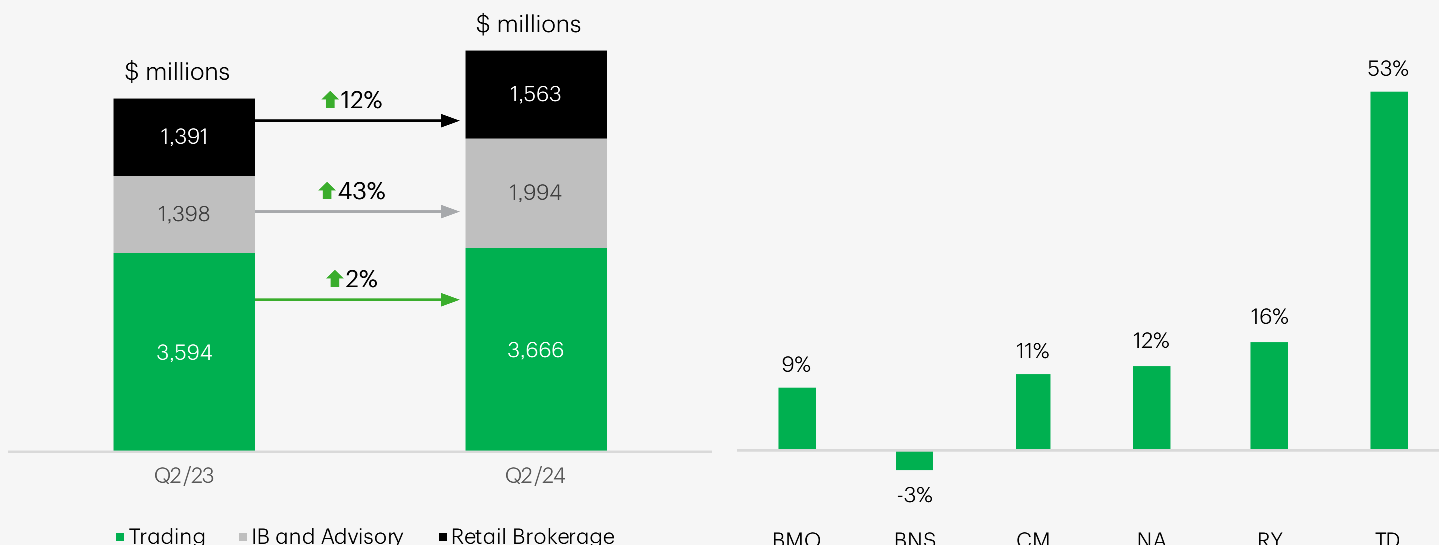


Source: Company Reports, Wealth Investment Office as of April 30, 2024.

Bank results buoyed by capital markets

Capital markets were the bright spot for banks in the quarter and accelerated revenue growth in the segment boosted overall topline growth. This is in line with Q1/24 earnings results for large U.S. banks. The rebound was supported by 43% year-over-year (y/y) growth in investment banking revenue and 12% y/y growth in retail brokerage revenue. Bank of Nova Scotia (BNS) was the only bank to report lower CMRR y/y growth, hurt by a 20% decline in trading revenue (reflecting reduced foreign exchange trading and strong trading numbers in 2023). Capital markets conditions are expected to remain healthy in 2024, with industry players in the U.S. forecasting a sizeable recovery driven by increased participation from private equity companies looking to exit investments and pent-up demand (following decades-low activity in 2022 and 2023). JPMorgan Chase & Co. raised its forecast for second-quarter markets and investment banking, only a few weeks after it had increased its guidance at investor day. This bodes well for Canadian banks with U.S. capital markets businesses such as Bank of Montreal (BMO) and Royal Bank of Canada (RY).

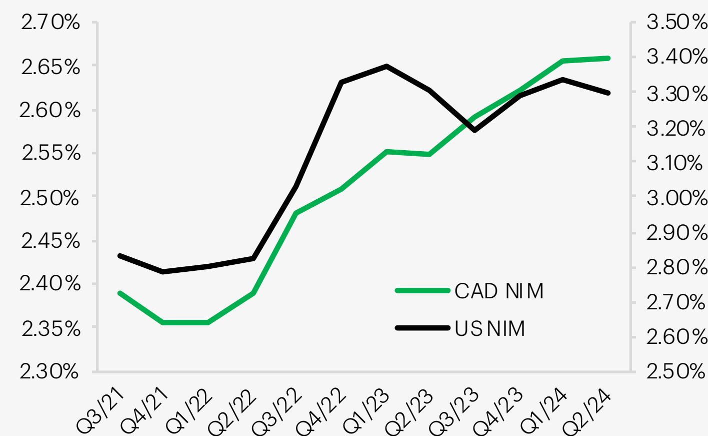
Figure 2: Recovery in investment banking drives CMRR growth



Source: Company Reports, Wealth Investment Office as of April 30, 2024.

Another noteworthy observation for banks with operations south of the border was the divergence between domestic and U.S. margins (Figure 3). U.S. margins have come under increasing pressure as delayed rate cuts and deposit competition offset any benefit from the higher repricing of assets (loans and securities). Margins were stable quarter-over-quarter (q/q) in the domestic market where deposit competition is less intense than in the U.S. BMO's U.S. margin weakened more than its Canadian peers, declining 10 basis points (bps) q/q, which was consistent with, but better than, its U.S. peers. The bank attributed this weakness to the continued shift to higher cost term deposits. BMO management suggested this shift has slowed.

Figure 3: CAD and U.S. margins diverge

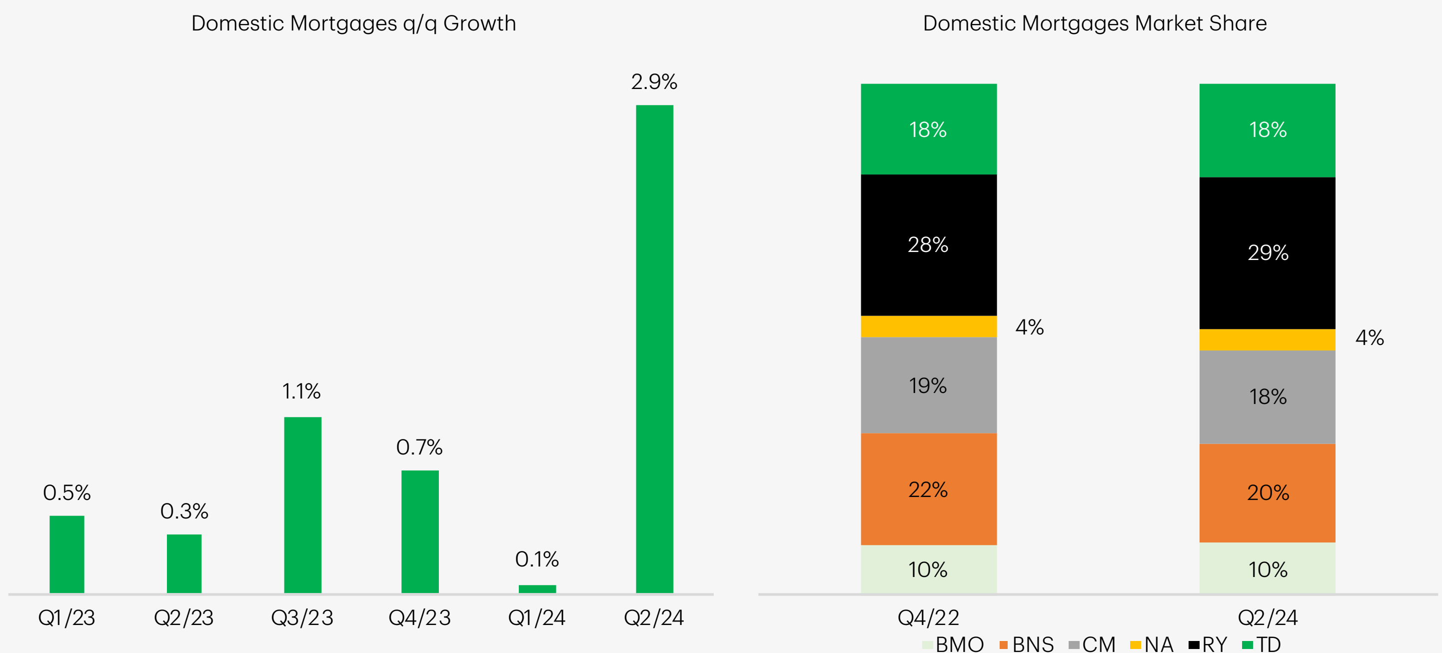


Source: Company Reports, Wealth Investment Office, as of April 30, 2024.

Strategic changes for BNS

High interest rates continue to weigh on demand for domestic residential mortgage loans, which constitute 36% of total loans (Figure 4). Mortgage loans grew 2.9% q/q in Q2/24, reflecting the acquisition of HSBC Bank Canada by RY. Adjusting for the acquisition impact, we estimate that sequential growth was below 1%. Although mortgage loans market share tends to be stable over time—due to the high concentration of the Canadian banking sector and its competitive dynamics—BNS's market share has declined by 2 percentage points since Q4/22. In fact, BNS's total assets increased only 0.5% q/q in Q2/24, compared to average growth of 3% for its peers. The reason behind this is that BNS is going through a strategic change in its business model and is looking to: 1) strengthen its deposit franchise while reducing reliance on wholesale funding, and 2) focus on client primacy as a means for growth, or deepening relationships with customers through cross-selling rather than aiming for customer growth. As a result, BNS didn't raise the dividend during the quarter, which signaled to investors that it doesn't expect to grow in the near term.

Figure 4: High interest rates continue to dampen domestic residential mortgage growth

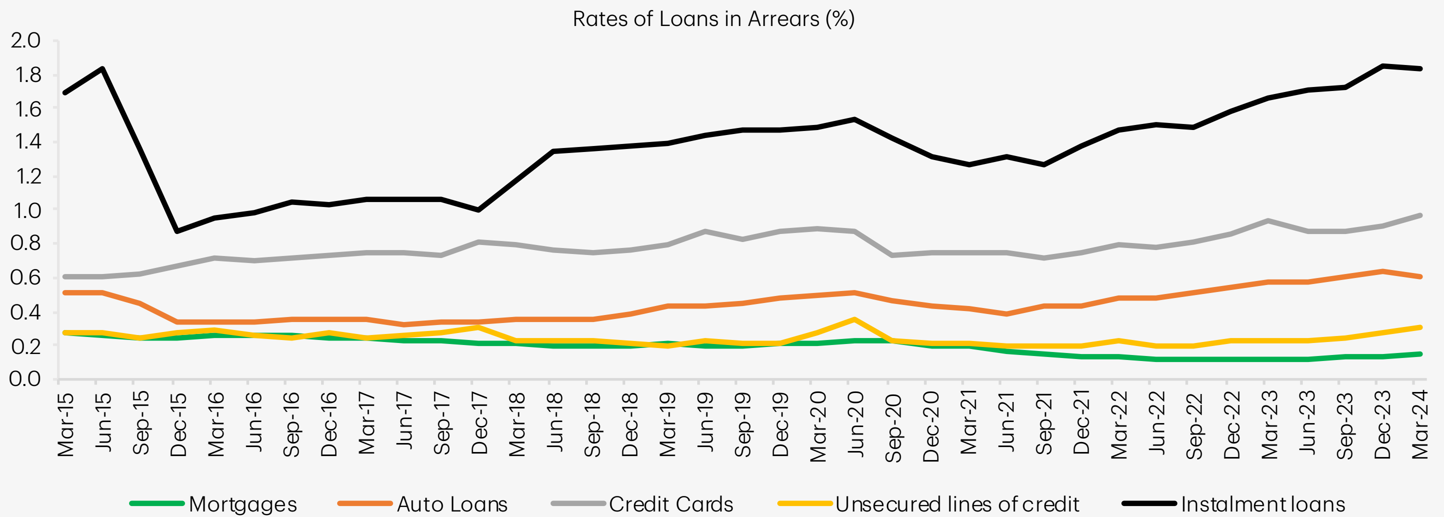


Source: Company Reports, Wealth Investment Office as of April 30, 2024.

Credit deterioration in domestic personal loans

Another noteworthy trend is the continuing credit deterioration in domestic personal loans. Delinquency rates on mortgages are rising but remain very low. Provided loan-to-value ratios remain in the 50%-55% range, it's still very unlikely that we will see significant losses in the mortgage book. However, the risk from mortgage renewal is still important, not because of potential losses in the mortgage book, but rather because of the impact on other parts of the consumer lending business such as, credit cards, personal loans and auto loans (Figure 5). It's in these segments where the stress on Canadian borrowers is showing up. Domestic commercial credit losses, on the other hand, have moderated and remain low on an absolute basis, suggesting that commercial credit conditions, at least for now, are solid.

Figure 5: Rising delinquency rates on domestic personal loans



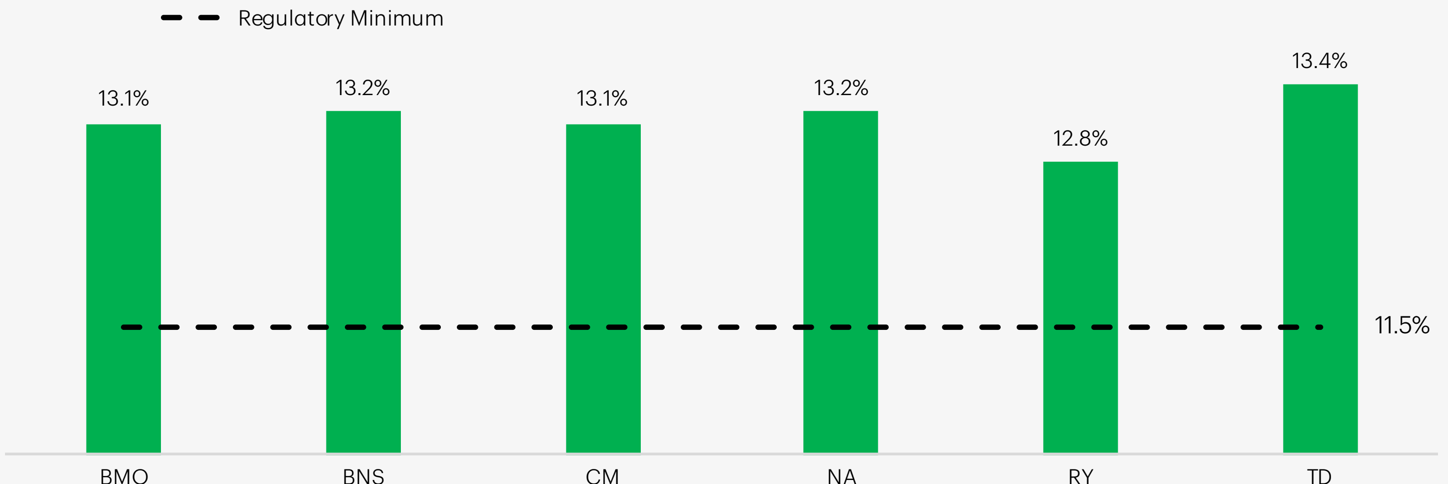
Source: Bank of Canada, Wealth Investment Office as of June 14, 2024.

Healthy capital position for banks

Canadian Banks, as a group, maintain a healthy capital position. The Common Equity Tier 1 (CET 1) ratio—which compares a bank's capital against its risk-weighted assets—came in at 13.1%, down 30 bps q/q but well above the regulatory minimum of 11.5% (Figure 6). Following its semi-annual review, Canada's banking regulator, OSFI, decided to maintain the Domestic Stability Buffer (DSB) at 3.5% of total risk-weighted assets. (The DSB is the amount of capital the country's biggest lenders must hold.) OSFI noted that its decision reflects elevated but stable systemic vulnerabilities and low but rising near-term risks.

RY was the only bank to announce a stock buyback program—a positive surprise for investors especially since RY had just completed an acquisition, and its CET 1 ratio, at 12.8%, was the lowest in the group. RY's management sees the appropriate CET 1 level at 12.5%. RY's view on capital suggests the industry could migrate to a lower CET 1 ratio as the credit environment improves and this could ultimately lead to a better long-term return on equity (ROE) across the industry.

Figure 6: Canadian banks maintain healthy capital position

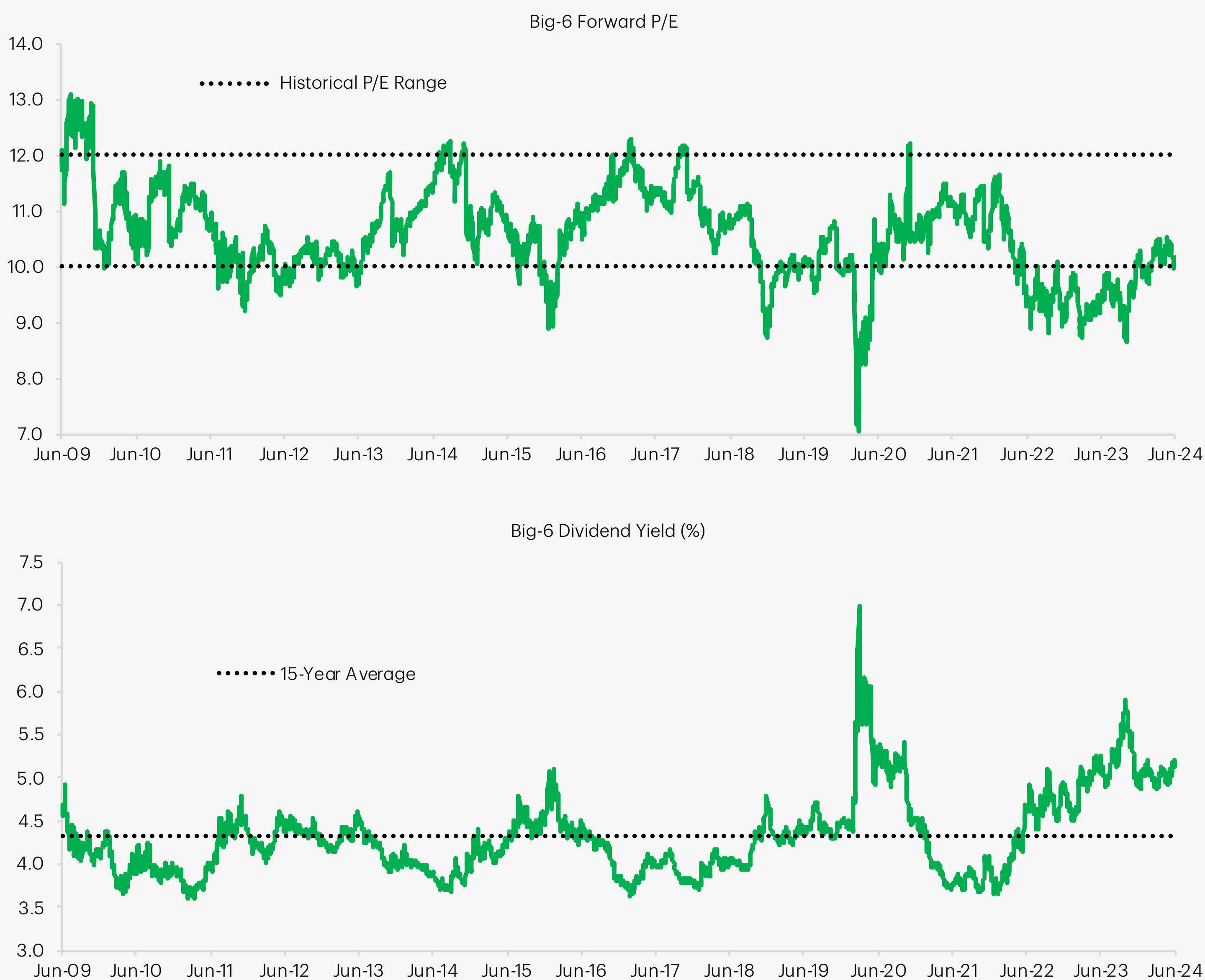


Source: Company Reports, Wealth Investment Office as of April 30, 2024.

Valuation and dividend yield

Historically, Canadian banks have traded between 10x and 12x forward earnings 70% of the time. Currently, the group is trading at the bottom of the range, at around 10x forward earnings (Figure 7). This valuation is fair considering it's within the normal range and credit losses are rising, which increases the downside risk for earnings estimates. However, the dividend yield, at 5.2%, is well above the historical average of 4.3%. While some would argue that a dividend yield of 5.2% doesn't seem very attractive in an environment where short-term interest rates are yielding 5%, we would suggest that dividends grow with earnings, which is the closest thing to a certainty for Canadian banks. The same cannot be said for interest income earned on a savings account or GIC, which carry reinvestment risk, especially when the Bank of Canada has just delivered its first rate cut.

Figure 7: Current valuation at bottom of historical range



Source: FactSet, Wealth Investment Office as of June 26, 2024.

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