TD Wealth

Canadian Banks Diverge in Q3

Market Insights

September 2024

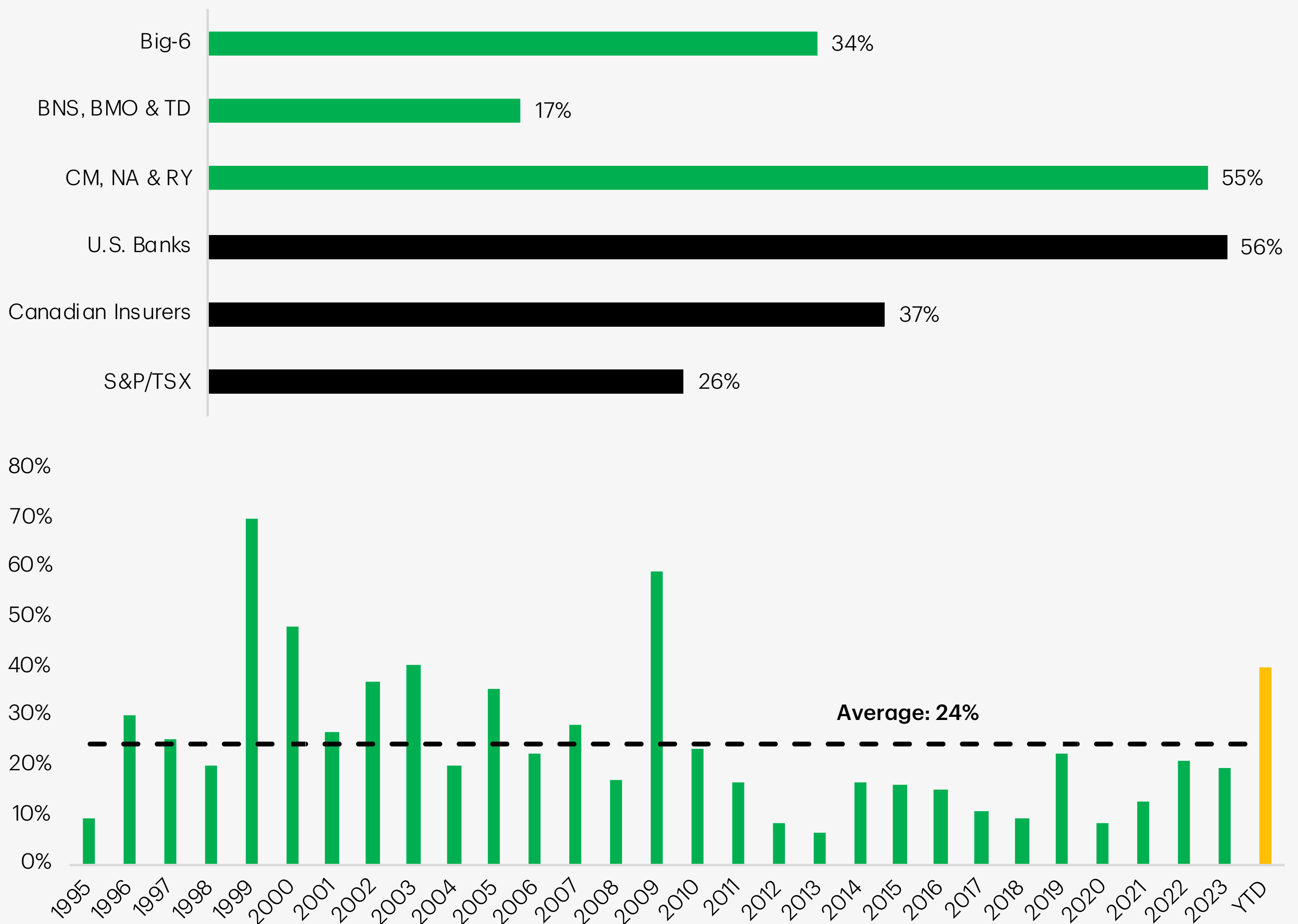
Wealth Investment Office

Canadian Banks Diverge in Q3

Chadi Richa, Senior Equities Analyst | TD Wealth

Taken in isolation, the performance of the six largest Canadian banks (the Big 6) has been solid this year, with their stocks up 34% since the October 2023 bottom. However, there are a couple of observations that should be brought forward. First, as a group, the Big 6 have underperformed other financials, such as Canadian insurers (+37%) and U.S. large banks (+56%), over the same period. Still, half of the banks — namely Canadian Imperial Bank of Commerce (CM), National Bank of Canada (NA) and Royal Bank of Canada (RY) — have done significantly better than the rest of the group and are on par with their U.S. peers. The second point is that the group has been less homogeneous this year than over the past 14 years. Indeed, the dispersion in returns, calculated as the spread between the best- and worst-performing banks, is at its highest level since the global financial crisis.

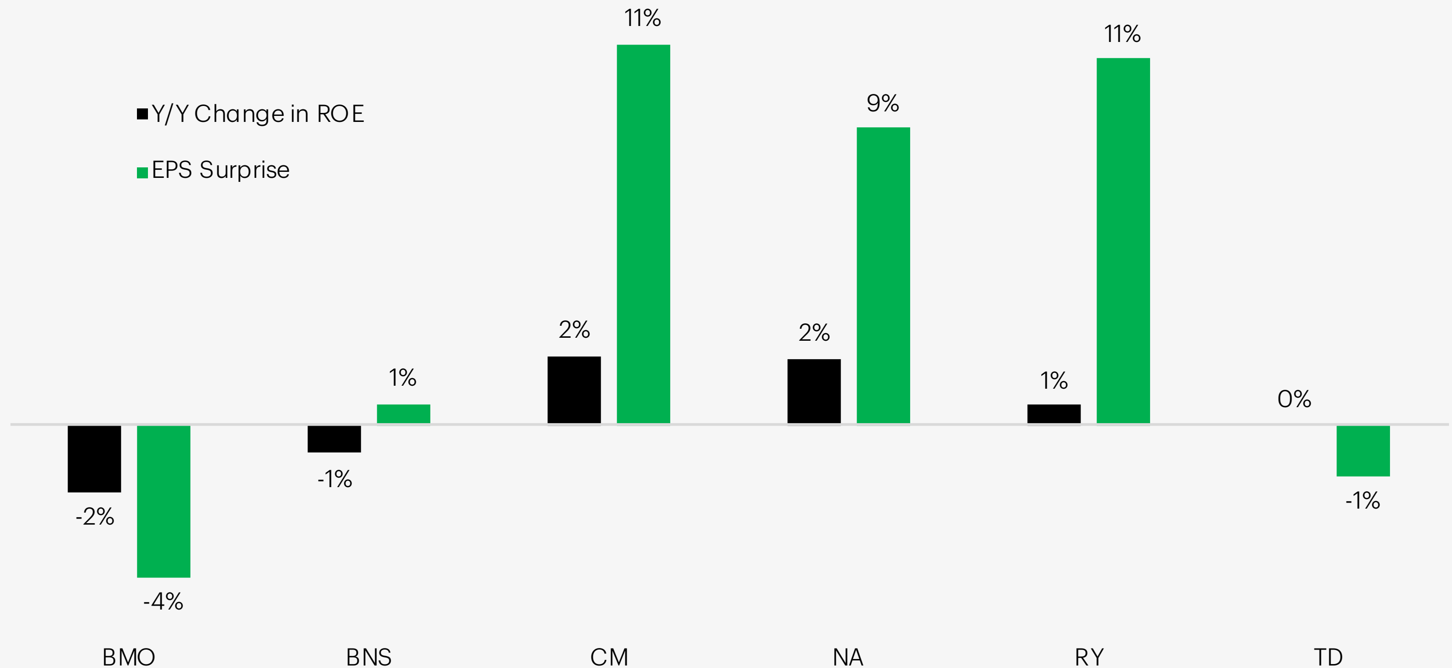
Figure 1: Dispersion among Canadian banks at its highest since 2009



Source: FactSet, Wealth Investment Office as of September 18, 2024

This dispersion in stock performance reflects the divergence in profitability trends among the banks, which was further highlighted by fiscal Q3/24 earnings disclosures. CM, NA and RY saw their return on equity expand by 100 to 200 bps y/y and exceeded consensus EPS expectations by 10% on average. BMO, BNS and TD experienced a 100-bp y/y contraction in ROE and missed the Street estimates.

Figure 2: Q3/24 earnings were mixed

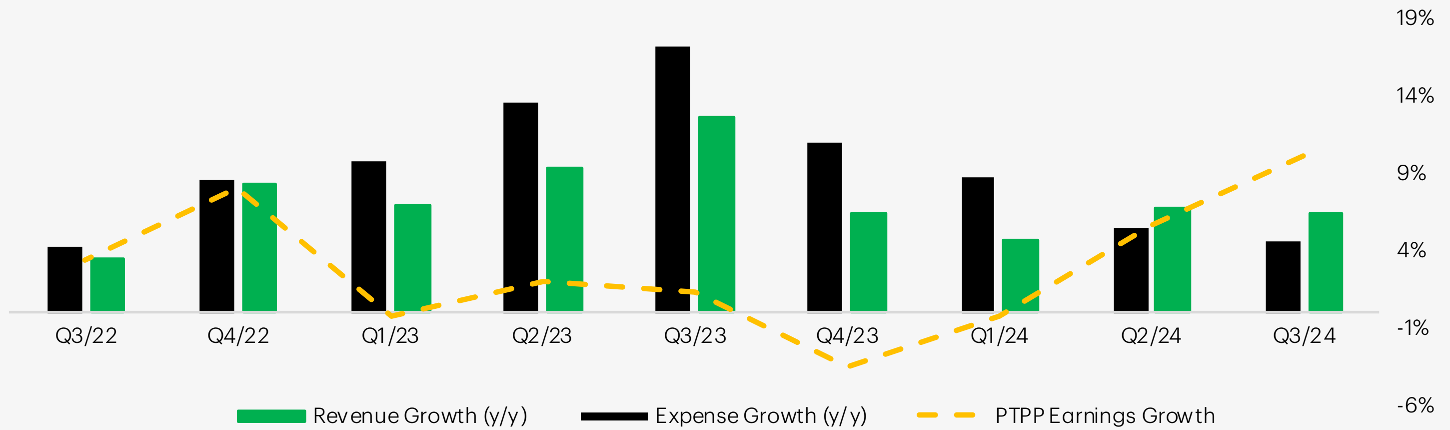


Source: FactSet, company Reports, Wealth Investment Office as of August 29, 2024

On a consolidated basis, the sector continued to show resilience in the face of a challenging macroeconomic backdrop. Q3/24 marked the second consecutive quarter of positive pre-tax pre-provision (PTPP) earnings growth (+10% y/y), reflecting 6% revenue growth and positive operating leverage, as the group benefited from the expense-control initiatives they implemented in 2023. NA, RY and CM led the group, growing PTPP earnings by 17%, 14% and 11%, respectively. NA's strong results were driven by a 52% increase in revenue from capital markets. RY benefited from the acquisition of the assets of HSBC Canada. And CM's results were supported by industry-leading net-interest-margin expansion. BNS's PTPP earnings growth of 2% was the lowest, as the bank continues to grow its balance sheet at a significantly slower pace than peers. The bank has shifted its focus from market share to customer primacy (cross-selling), which was highlighted on its December 2023 investor day.

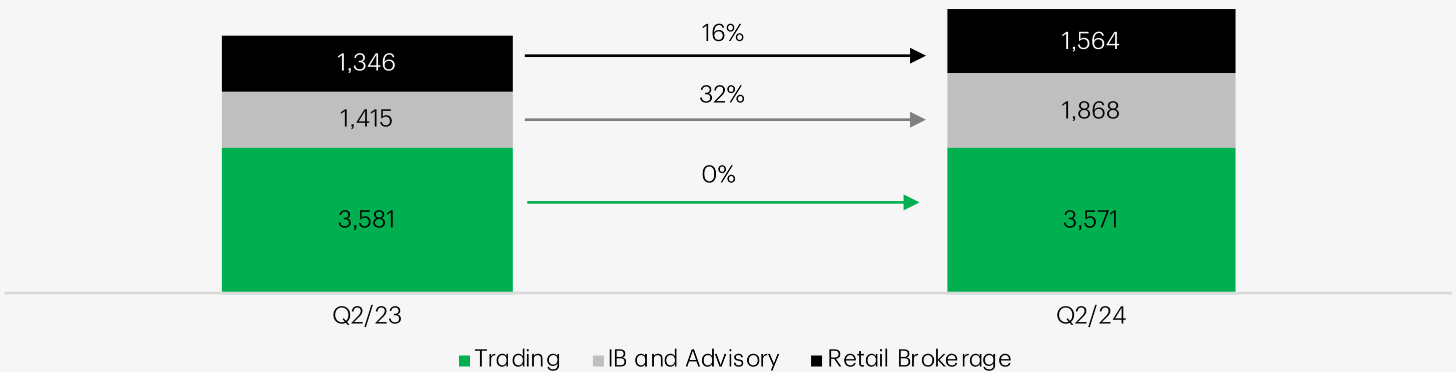
Capital markets continue to be the bright spot for the sector, driven by solid investment banking (+32%) and retail brokerage (+16%) revenue growth, while trading was unchanged y/y due to strong activity in the previous year. BMO and RY are expected to be the biggest beneficiaries from the rebound in investment banking and M&A activity, due to their scale and presence in the U.S. There could be a slowdown in the third quarter due to seasonality, but the capital markets rebound is most likely far from over., given that announced M&A volumes are trending higher, capital-markets activity is coming off of three-decade lows relative to nominal GDP, and the Federal Reserve has just embarked on its rate-cutting cycle.

Figure 3: Q3/24 marked the second consecutive quarter of PTPP earnings growth



Source: Company reports, Wealth Investment Office as of July 31, 2024

Figure 4: Capital-markets rebound drove revenue growth

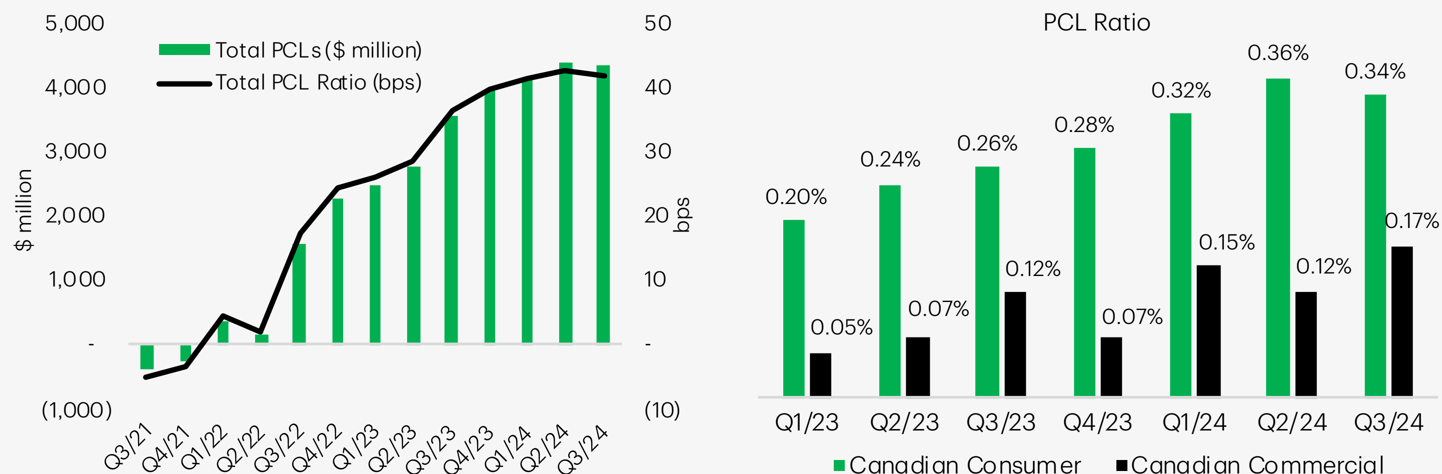


Source: Company Reports, Wealth Investment Office as of July 31, 2024

Provision for credit losses (PCL) increased 22% y/y but were stable sequentially, with the PCL ratio of 42 bps relatively unchanged from Q2/24. The biggest concern going into the quarter was the deterioration in unsecured consumer loans from higher interest rates and mortgage payments. However, while PCLs are expected to keep rising, there were indications of the resilience of the Canadian consumer. In addition, there was a positive shift in tone from some banks, which indicated that peak losses will be lower than previously expected. To address concerns around the mortgages-maturity wall, CM noted that, if upcoming mortgage renewals reprice at a 6% interest rate, the monthly payment increase would not exceed 3.7% of total income at origination. According to data from the Bank of Canada, the most recent (June 2024) average interest rate charged on new insured residential mortgages was 5.39%, down from the November 2023 peak of 6.31%. It's worth noting that the Bank of Canada delivered two interest-rate cuts since June 2024, which should provide further relief to Canadian borrowers.

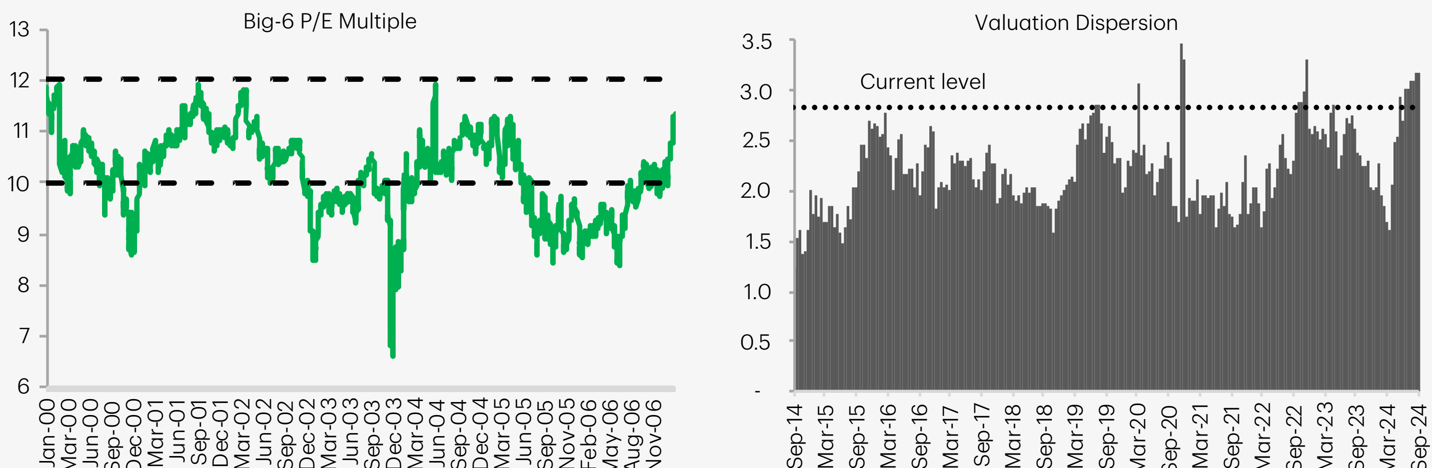
BMO was the outlier this quarter. In fact, if we exclude BMO, total PCLs for the remaining five banks would have declined 6% q/q. BMO booked credit losses materially higher than peers, causing the bank to miss earnings for the third consecutive quarter. The increase in impaired PCLs was broad-based but primarily in U.S. corporate and commercial loans, while impaired loan formation was elevated across many sectors. BMO warned of further elevated credit losses of 50 to 60 bps over the next one to three quarters.

Figure 5: PCLs have stabilized, and the Canadian consumer has proven resilient



Source: Company reports, Wealth Investment Office as of July 31, 2024

Figure 6: Valuations within the historical range, but dispersion is elevated



Source: FactSet, Wealth Investment Office as of September 20, 2024

Overall, Q3/24 results confirmed our view that Canadian banks have reached an inflection point with regards to earnings growth. We see more reasons to be optimistic about the outlook due to improving revenue growth, easing funding pressure, stability in credit losses and a rebound in capital markets. Capital levels remain healthy and above the level required by regulation, which may lead to dividend increases and share repurchases. Furthermore, easing monetary policy will over time provide relief to borrowers, boost loan growth and positively impact margins if the yield curve steepens. While all banks should benefit, we believe that some will perform better than others. The Big 6 currently trade at a reasonable price-to-earnings multiple of 11.4, between the historical range of 10 to 12. However, the dispersion in valuations is also at a high level, similar to the dispersion in returns we discussed at the beginning. The reason we believe this observation is relevant is because the current dispersion creates an opportunity for patient investors. Eventually, the lagging banks will recover from the issues that drove their underperformance. BMO, BNS and TD have already outperformed CM, NA and RY by 4.5% since the end of August.

Wealth Investment Office, TD Wealth

Head of Wealth Investment Office

Brad Simpson | Chief Wealth Strategist

North American Equities:
Christopher Blake | Senior Portfolio Manager
Chadi Richa | Senior Equity Analyst
David Beasley | Senior Quantitative Portfolio Manager, Equities
Andrej Krneta | Senior Equity Analyst
Neelarjo Rakshit | Senior Equity Analyst

Managed Investments:
Christopher Lo | Senior Portfolio Manager, Head of Investment Team
Fred Wang | Senior Portfolio Manager
Aurav Ghai | Senior Fixed Income Analyst
Mansi Desai | Senior Equity Analyst
Kevin Yulianto | Portfolio Manager, Equities
Shezhan Shariff | Senior Alternative Investments Analyst

Investment Consulting:
Brian Galley | Head of Investment Consulting
Shanu Kapoor | Senior Portfolio Consultant
Richard Nguyen | Senior Portfolio Consultant
Shaun Arnold | Senior Portfolio Consultant
Greg McQueen | Senior Portfolio Consultant
Remek Debski | Senior Portfolio Consultant
Jesse Kaufman | Senior Portfolio Consultant
Ivy Leung | Senior Portfolio Consultant
Anita Linyu Li | Senior Portfolio Consultant
Shaiara Hossain | Senior Portfolio Consultant
Joseph Abinaked | Senior Portfolio Consultant
Dan Iosipchuk | Portfolio Consultant
Kerron Blandin | Senior Portfolio Consultant
Jack Zhang | Investment Management Analyst
Leroy Li | Investment Management Analyst
Daria Yip | Investment Management Analyst

The information contained herein has been provided by TD Wealth and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

Certain statements in this document may contain forward-looking statements ("FLS") that are predictive in nature and may include words such as "expects", "anticipates", "intends", "believes", "estimates" and similar forward- looking expressions or negative versions thereof. FLS are based on current expectations and projections about future general economic, political and relevant market factors, such as interest and foreign exchange rates, equity and capital markets, the general business environment, assuming no changes to tax or other laws or government tregulation or catastrophic events. Expectations and projections about future events are inherently subject to risks and uncertainties, which may be unforeseeable. Such expectations and projections may be incorrect in the future. FLS are not guarantees of future performance. Actual events could differ materially from those expressed or implied in any FLS. A number of important factors including those factors set out above can contribute to these digressions. You should avoid placing any reliance on FLS.

TD Wealth represents the products and services offered by TD Waterhouse Canada Inc., TD Waterhouse Private Investment Counsel Inc., TD Wealth Private Banking (offered by The Toronto-Dominion Bank) and TD Wealth Private Trust (offered by The Canada Trust Company).

Source: London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). © LSE Group 2024. FTSE Russell is a trading name of certain of the LSE Group companies. "FTSE®", "Russell®", and "FTSE Russell®" are trademarks of the relevant LSE Group companies and are used by any other LSE Group company under license. "TMX®" is a trade mark of TSX, Inc. and used by the LSE Group under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication.

Bloomberg and Bloomberg.com are trademarks and service marks of Bloomberg Finance L.P., a Delaware limited partnership, or its subsidiaries. All rights reserved.

All trademarks are the property of their respective owners.

® The TD logo and other trade-marks are the property of The Toronto-Dominion Bank