TD Wealth

# Extra Time

## Canadian banks with little margin for error

Market Insights

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## Canadian banks with little margin for error

Canadian banks are firing on all cylinders, but lofty valuations leave little room for disappointment.

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### Executive Summary

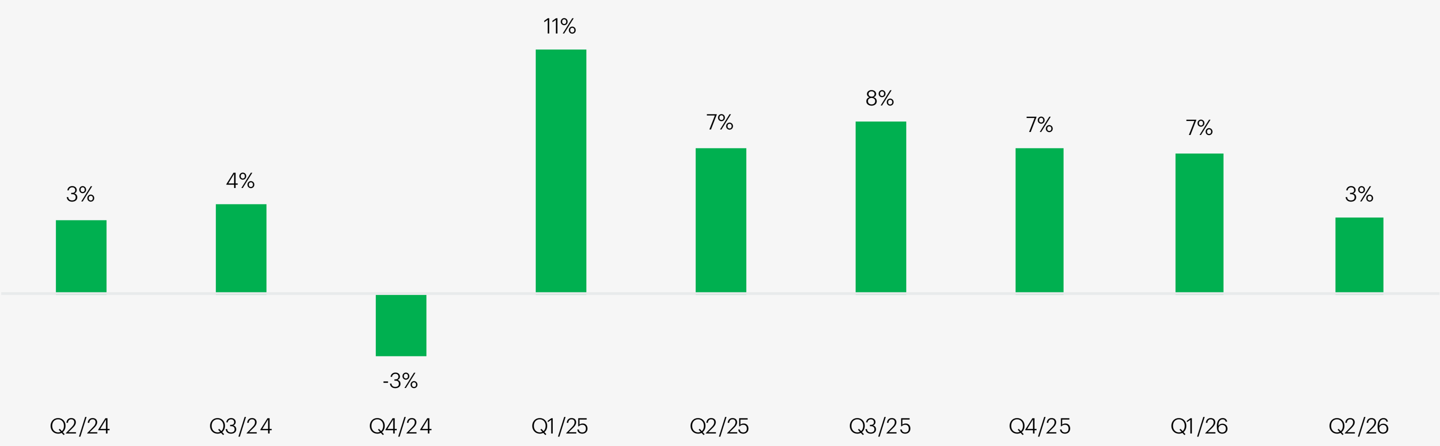
- **Fundamentals remain strong:** earnings, revenue and capital-markets activity are solid, with stable credit and an improving commercial loan outlook.
- **Risks from USMCA negotiations are manageable** and mitigated by elevated allowances and capital levels.
- **Valuation is elevated** and leaves little cushion against macro risks (e.g., USMCA, weaker growth).

Canadian banks are benefiting from one of the strongest fundamental backdrops in years, with elevated interest rates, solid capital-markets activity, stable credit conditions and the potential for renewed loan growth all working in their favour. At the same time, high valuations leave little margin for error, particularly if macroeconomic risks tied to trade uncertainty or credit quality begin to rise.

### Q2/26 Recap: A narrow beat, but a beat nonetheless

Canadian banks reported solid results supported by positive, broad-based momentum. Earnings per share increased 28%, coming in 4% above market estimates. On the other hand, this was the narrowest beat in six quarters and compares to an average of 8% over the previous five quarters (Figure 1). It's likely that the "beat and raise" trend has either ended or at least taken a pause. Pre-tax, pre-provision earnings increased 15% year-over-year. While this slowed from the 20% growth rate of 2025, it's much higher than the long-term average of 7%. So, bottom line, excluding the impact of credit and taxes, the core business is still firing on all cylinders.

**Figure 1: Earnings beats have shrunk**




Source: Company reports, Wealth Investment Office as of June 23, 2026

Revenue growth was driven by higher interest rates and strong capital markets. Canadian banks continue to benefit from elevated interest rates, given that maturing assets are being reinvested at higher yields, driving margin expansion and 7% growth in net interest income. However, the tailwind from expanding margins is expected to moderate because interest rates are stable and close to what the banks currently earn on their assets. Loans grew 3% and, on the earnings calls, the banks were optimistic about commercial loan growth and noted that it could improve in the near term.

Capital markets revenue grew 14% against a strong Q2/25, supported by underwriting and advisory income. Recent comments from a U.S. broker indicated that the deal pipeline remains robust due to an AI-driven capital-expenditure supercycle that is creating a broad-based wave of financing and strategic activity across M&A, equity issuance, debt financing, commodities and prime brokerage.

Credit continues to stabilize, with impaired credit losses declining one basis point sequentially. Commercial losses were down but impairments on consumer loans continue to increase, especially on unsecured loans. In mortgages, the banks noted that they anticipate minimal impact on borrowers from renewals, with monthly payments expected to increase by a manageable $69 on average in 2027, while loan-to-value remains healthy.

**OSFI lowers capital buffer**

On June 19, the Office of the Superintendent of Financial Institutions announced that it had lowered the domestic stability buffer to 3.0% (from 3.5%), and reset the buffer range to 0% to 3% (from 0% to 4%). The move effectively lowers the minimum common equity tier 1 ratio to 11.0% from 11.5% for all the banks, which are already running well above the minimum and have ample buyback capacity.

While positive, this announcement came as a surprise because the domestic stability buffer is a countercyclical measure that is lowered during times of economic stress to release borrowing capacity and support the economy. The language in OSFI's decision note doesn't signal that the regulator is concerned about a macroeconomic shock or a rise in delinquencies. The regulator emphasized that this is the first change since June 2023 and framed the move as "prudent and proactive" rather than reactive to stress, highlighting that these actions together provide greater flexibility for banks to deploy capital into the economy.

OSFI repeatedly framed this as supporting economic adjustment and long-term growth, not as a defensive measure, and signalled that the Canadian economy should have ample credit availability to support an investment cycle at a time when Canada is adapting to changes in technology, trade and geopolitics.

The main question going forward is whether the pro-business tone championed by Prime Minister Mark Carney can translate into a pickup in investment activity and commercial loan growth, especially given persistent uncertainty tied to U.S. trade negotiations, which continues to weigh on business sentiment.

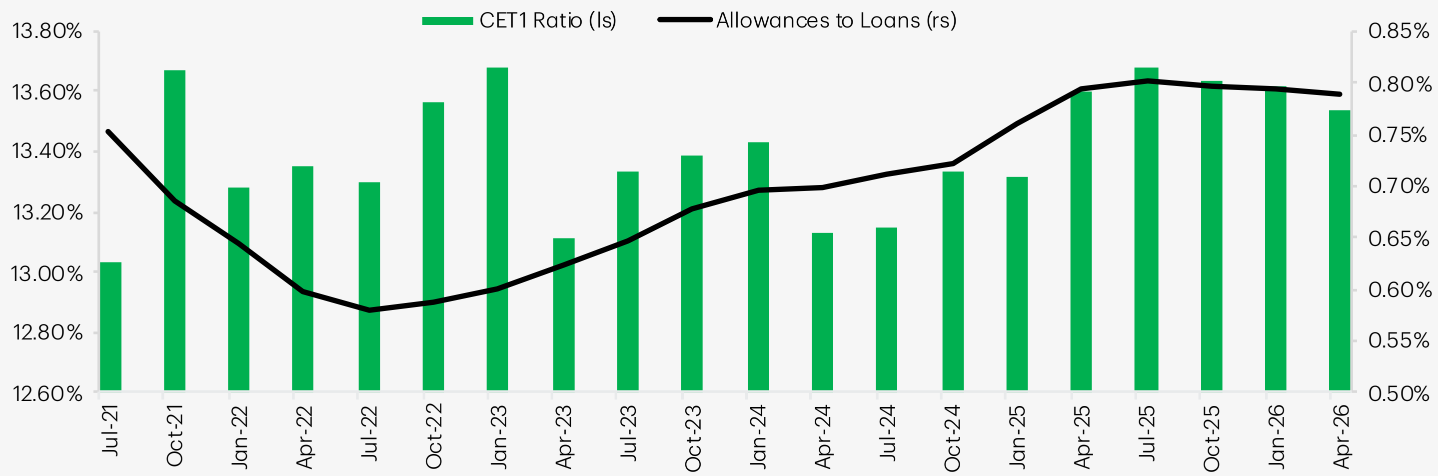
**Trade: North American risks linger**

The biggest risk facing Canadian banks and the economy is a negative scenario from an unfavourable trade deal with the U.S. On his way back from the G7 Summit, U.S. President Donald Trump briefly suggested the possible termination of the North American trade agreement, which is probably nothing more than a negotiation tactic, considering that it contradicts the signalling of incremental progress by U.S. Trade Representative Jamieson Greer and Minister of Internal Trade of Canada Dominic LeBlanc. For the time being, an extension seems like the base-case scenario rather than a full breakdown.

What gives us comfort is that a negative scenario is baked into the Canadian banks' allowances, which currently stand at 0.80% of gross loans, significantly higher than the normal 0.55% (Figure 2). Furthermore, Canadian banks are currently sitting on $75 billion in excess capital, which is more than sufficient to absorb losses.

That said, the biggest risk is that current valuations don't reflect even the slightest probability of a negative outcome, leaving investors sensitive to any sign of higher credit losses and weaker loan growth.

**Figure 2: Banks are ready for any headwinds**



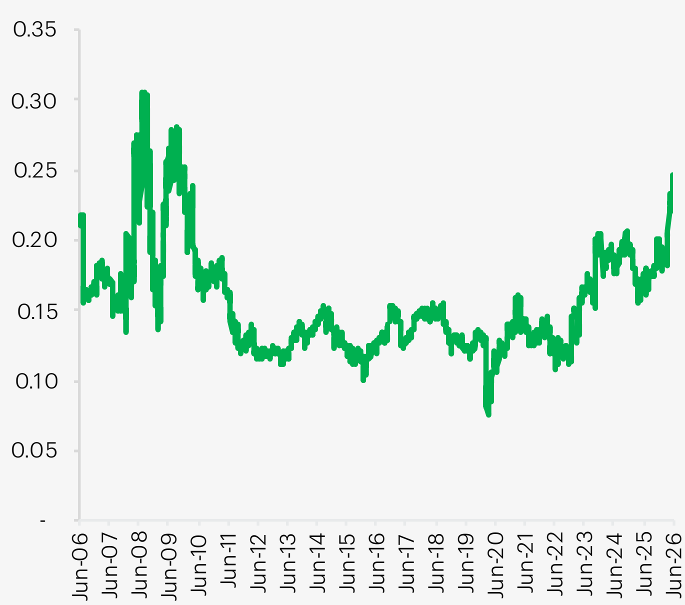

Source: Company reports, Wealth Investment Office as of June 23, 2026

## Valuation: Risks elevated?

Valuation, which is elevated on all metrics, is currently the biggest risk, even when taking into consideration improvements in profitability over the past two years and expectations of solid earnings growth. When fundamentals and profitability improve, a stock typically re-rates higher, but the relationship between valuation and profitability should remain stable over time.

A metric we look at is the ratio of price to book over excess return, defined as return on equity minus the five-year government of Canada bond yield. As the accompanying chart shows (Figure 3), this metric has been range-bound for a good part of the period after the financial crisis until 2022, with the exception of some aberrations, such as the 2020 market crash. This ratio currently stands at an 18-year high, if not more when we exclude the financial-crisis period, when profitability — the denominator in this ratio — was depressed due to elevated credit losses.

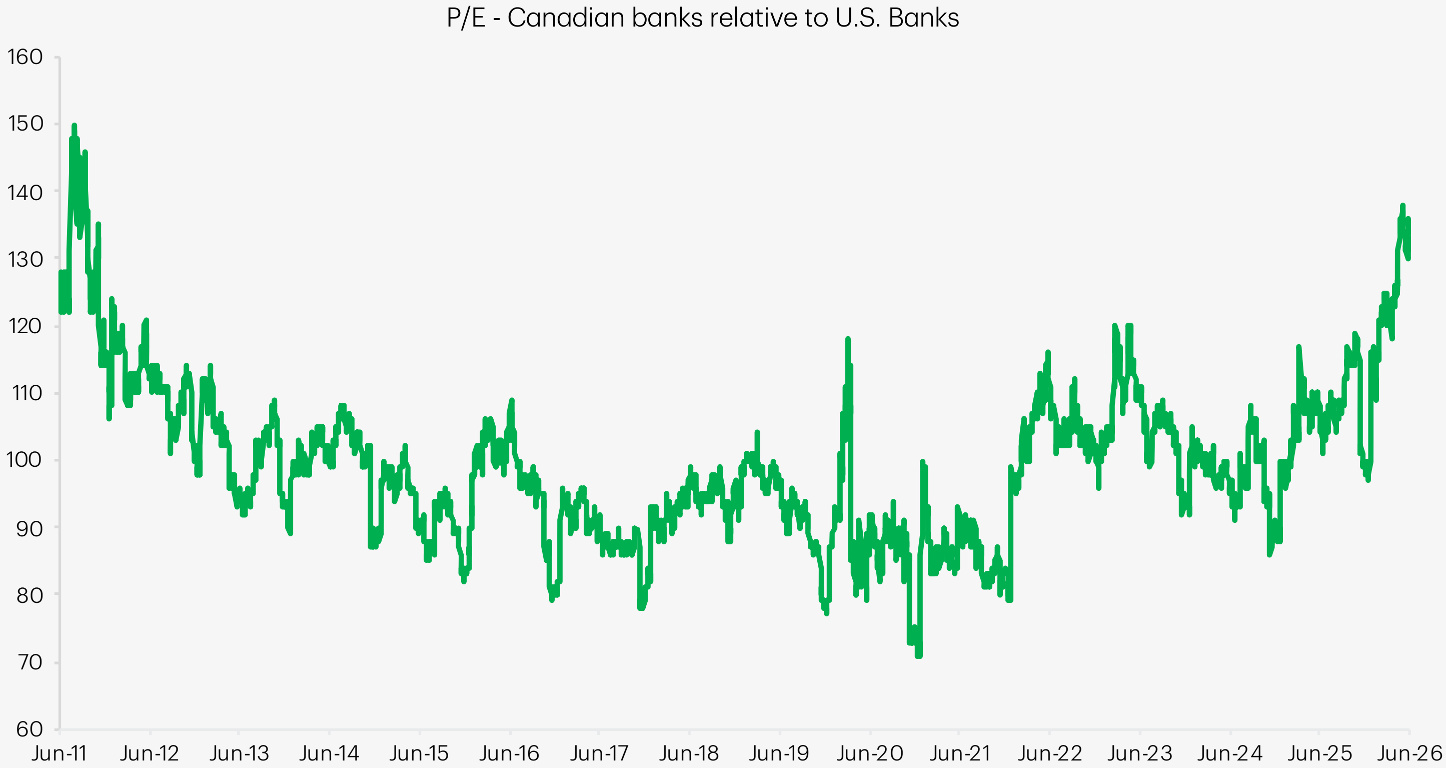
**Figure 3: Lofty Valuations (price-to-book over excess return)**




Source: FactSet, Wealth Investment Office as of June 23, 2026

Even when we look at price-to-earnings relative to U.S. banks, valuation is at a historic high (Figure 4). Is it possible that Canadian banks are expected to grow earnings at a higher rate, which justifies the premium valuation? Based on consensus estimates, U.S. banks are expected to grow earnings per share by 12.3% compared to 10.6% for the Canadian banks.

**Figure 4: Canadian banks pricey relative to U.S.**




Source: FactSet, Wealth Investment Office as of June 23, 2026

### Conclusion: Strong fundamentals, stretched valuations

It's important to emphasize and reiterate that fundamentals for the Canadian banks are very strong. It's been a while since we've seen most earnings drivers working to the benefit of this group at the same time: elevated interest rates, strong capital-markets activity, stable credit conditions and a potential rebound in loan growth, in addition to ample excess capital. We believe that risks from an unfavourable trade agreement are manageable and could be mitigated by elevated capital levels and allowances and, more importantly, a pro-business agenda by the Canadian government, which could drive balance-sheet growth. That said, high valuations don't leave much of a buffer against macroeconomic risks.

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