BMO Global Asset Management

3 Reasons Why Canadian Banks Could Rebound in 2024

What does 2024 have in store for Canadian banks? Sohrab Movahedi reveals why he thinks the "Big Six" may be primed for a bounce-back.

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The Case for Canadian Banks in 2024 (and Beyond)

For investors, banks are a levered play on the economy, which is to say that their performance often reflects the underlying economic environment. 2023 reminded us of this, as Canadian banks were dragged down by many of the same headwinds that affected the economy at large: higher interest rates, investor concerns about inflation and a possible recession, a softening Canadian housing market, and highly indebted consumers. The result? The "Big Six" posted cash operating earnings of approximately $56 billion, down 6% from the year prior, as well as declining return-on-equity (ROE)—13.8% in 2023 vs. 15.8% in 2022. Ultimately, this weighed on valuations, as the Big Six underperformed the S&P/TSX composite index for the second consecutive year.[1]

The new year offers the chance for a fresh start. Though the economic forecast remains uncertain, here are three reasons why Canadian banks may be primed for a bounce-back in 2024 and beyond.

#1: Strong Fundamentals

Investors can take great comfort in the fact that Canadian banks entered 2024 with very strong balance sheets. In examining balance sheets, the first two key considerations are the banks' capital levels, which remain healthy, and loan loss provisions. Well-run banks should be expected to build reserves in anticipation of future losses (rather than strictly being reactive), and that's largely what we've seen—in our view, the Big Six have reserved appropriately for the economic outlook we expect, which is a soft-landing (or no recession) scenario.

In addition to capital and reserves, the other important measure of a balance sheet's strength is available liquidity. This can be measured in several ways—for instance, Liquidity Coverage Ratio (LCR), which reflects the proportion of a bank's high-quality liquid assets. By any such measure, the Canadian banks are well off. Overall, we believe that the strength of the Big Six's balance sheets should enable them to navigate an uncertain market environment with limited downside risk.

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#2 An Improving Macroeconomic Landscape

Over the past six-to-twelve months, many of the concerns around Canadian banks—and banks in general—have been macroeconomic in nature. Three particular macro issues are particularly relevant to the banks' outlook for 2024: the economy, interest rates, and regulation. From an economic standpoint, banks are operating in an environment in which central banks, including the Bank of Canada (BoC), have made an effort to intentionally slow down the economy in order to bring down inflation. This, of course, has led to higher interest rates, which has made it more difficult for homeowners and other consumers to service their debt. In terms of regulation, we have a saying: no regulator has ever let a crisis go to waste. The Silicon Valley Bank (SVB) crisis, which saw it and at least one other U.S. lender go out of business in 2023, was arguably specific to a particular subset of the U.S. regional banking space. But it nonetheless had the effect of prompting a more muscular regulatory presence, including here in Canada with the Office of the Superintendent of Financial Institutions (OSFI), which has increased regulatory minimum capital requirements for Canadian banks by about 100 basis points over the last year. Banking is a thin-margin business, and there's no doubt higher capital requirements, all else equal, represent an ROE headwind for any bank.

The good news for Canadian banks is that while these macroeconomic concerns persist, they're generally improving. We appear to be on track for the type of gentle economic slowdown that is not likely to result in a spike in the unemployment rate, which is an important driver of Canadian bank credit quality given the level of consumer leverage. The U.S. Federal Reserve (Fed) and BoC appear to be done raising interest rates. And just a few weeks ago, Canadian regulators conducted their semi-annual review and chose not to make regulatory requirements for banks even more stringent. It would be an overstatement to say that the macroeconomic headwinds of 2023 have turned into tailwinds, but the headwinds do appear to be lessening, which bodes well for Canadian banks going forward.

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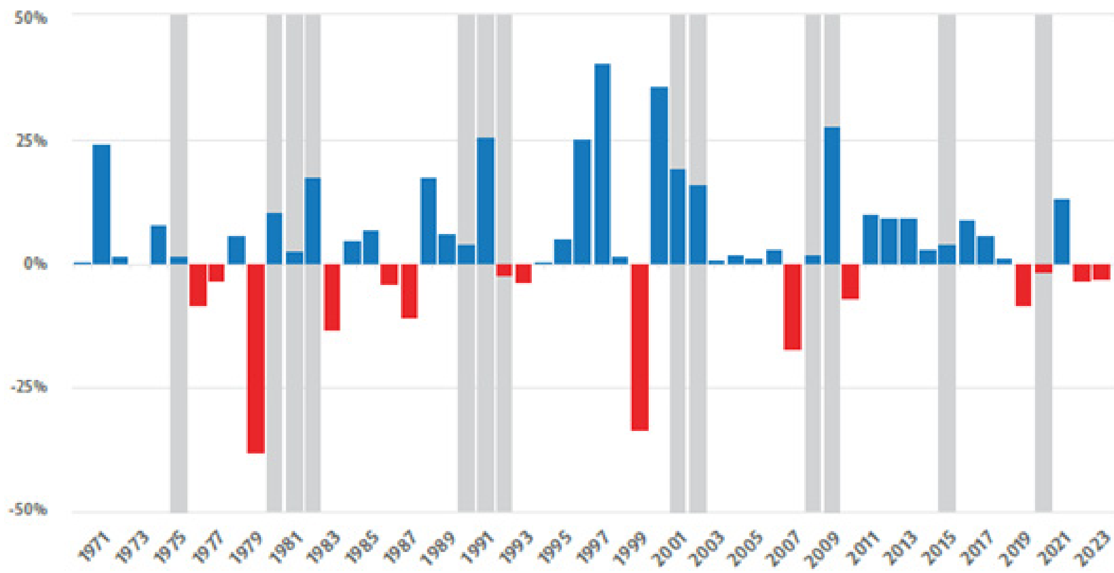
#3 Global Context and Historical Precedent

When it comes to institutions like the Big Six banks, some of which have existed for over 150 years, taking a step back and considering the broader context can be illuminating. First, it is worth remembering that the top Canadian banks are considered to be pillars of the global financial community. Both RBC and TD are included in the Financial Stability Board's list of Globally Systemically Important Banks, while OSFI considers all of the Big Six to be systemically important domestically; this means that, for all intents and purposes, all six big Canadian banks are globally systemically important. The Canadian banking system is renowned for its stability, with only two small regional banks having failed in the last century,[2] and most of the Big Six have a history of paying dividends that stretches back more than 100 years.[3]

Investors may also be interested in the following compelling statistic. Earlier, I noted that in 2023, the Big Six underperformed the S&P/TSX composite index for the second year in a row. As the chart below demonstrates, the Canadian bank index *has not underperformed three years in a row since 1970.*

Canadian Bank Index Annual Total Return vs. S&P/TSX 1970 to 2023



Shaded grey areas represent recessions (1975, 1980-82, 1990-92, 2008-09, 2020) or slowdowns (2001-02 and 2015). Last datapoint for total return is Dec 29, 2023. Total return on a calendar year basis. Source: Bloomberg, BMO Capital Markets. Index returns do not reflect transactions costs or the deduction of other fees and expenses and it is not possible to invest directly in an Index. Past performance is not indicative of future results.

This, of course, is no guarantee that Canadian banks will outperform in 2024. But it does mean that historical trends are on investors' side.

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Shifting to Offense

The conundrum for the Big Six is that they operate in a constrained, concentrated market structure—it's hard to see major shifts in market share. That market structure allows them to generate a degree of excess capital. But there are also obvious limitations on growth. The investment case, then, is dependent on the banks' ability to find ways to deploy capital being generated at home in a shareholder friendly way. This is why many of the Big Six are opportunistically pursuing mergers, acquisitions, and other opportunities in the United States and abroad. It's a bit of a trade-off, as every dollar deployed away from Canadian banking is likely to be ROE-dilutive. But it does offer the potential for growth.

Think of 2023 as something of a pit stop: due to the headwinds outlined earlier, the Big Six had to slow down a bit. The first half of 2024 is likely to see a continuation of the economic fundamentals of 2023. But as we get into the second half of 2024 and 2025, we see cause for greater optimism, including continuing balance sheet strength, greater clarity on the economy and interest rates (including potential rate cuts), and earnings growth prospects. It is always difficult to time it perfectly, but patient investors may find it an opportune time to start playing a little more offense with Canadian bank stocks.

For exposure to Canadian banks, consider the **BMO Canadian Banks ETF Fund** and the **BMO Covered Call Canadian Banks ETF Fund**.

[1] Company reports, BMO Capital Markets.

[2] James F. Dingle, "The Bank Failures of September 1985," *Planning an Evolution: The Story of the Canadian Payments Association: 1980-2002*, the Bank of Canada and the Canadian Payments Association, May 2003.

[3] Source: Nasdaq Dividend History Database.

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