Fidelity Connects

The Road Ahead for Canadian Financials

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Announcer: Hello and welcome to Fidelity Connects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

The Canadian Financial sector has seen its share of ups and downs this year. Equity Research Analyst Nicolas Bellemare puts things into perspective and provides his insights on financials, Canadian banks, interest rates and inflation. He also gives an overview on the road ahead in 2023 for Canadian financials.

Nic discusses the possibility of another interest rate hike from the Bank of Canada and what we could expect from the release of earnings from major Canadian banks. Thinking through to next year, Nic says there could be a few challenges for banks including funding, credit, and capital. For example, he says we need to look at the deep inverted yield curves and leading indicators rolling over into sectors like housing, retail, and trucking.

In addition, Nic also talks about opportunities he's seeing in Canadian financial markets, other financial sub sectors, mergers, and acquisitions.

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Bryan Borzykowski: Nic, next week and the week after there's a lot going on. The Bank of Canada has an interest rate announcement on December 7th, as I mentioned. Bank earnings are coming out next week. We'll get to all of that. Maybe we'll start with kind of the macro environment. Where do you think the Bank of Canada could take interest rates in that next announcement? What have you seen from them so far that you're looking at?

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Nic Bellemare: Rates have been a dominant theme, I think, for every investor out there but especially for financials investors because rates directly impact the P&L of those companies. We've come a long way, right? We started the year near zero rates. This tightening cycle has been pretty unique from both the magnitude and the speed at which it is unfolding. Right now, both the Fed, Bank of Canada are sort of in the high threes with the market looking at a terminal rate in the U.S. probably with a 5 handle on short-term rates and probably a little bit lower in Canada with a 4 handle, so more to go, obviously. What central banks are trying to tackle is inflation. There has been some good progress in terms of the good side of the inflation equation.

Let's remember, services is about three-quarters of CPI and it's very tied to the employment situation. The question from here is how fast and how low will service inflation drop? It's possible that without a higher unemployment there is some stickiness there. That means we will have to live with higher rates for longer and also the resulting inversion of the yield curve.

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Bryan Borzykowski: It's impossible to predict where the rate hikes will stop but there was sort of an expectation at some point that it might slow down at about 4%. We're pretty close to that. From what you've seen from the Bank of Canada, what they're saying and even the Federal Reserve in the U.S., do you think it could go higher than that 4%? Do you expect a big increase or will it start moderating from there?

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Nic Bellemare: I think that's reasonable. Again, what we're closely watching is just that service piece and can it really drop meaningfully without a change in employment? We know that monetary policy acts with a lag, so we'll also have to think increasingly into next year about what are the consequences of those higher rates and how they filter through in the economy.

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Bryan Borzykowski: Bank earnings coming out next week. What are you anticipating from the major Canadian banks?

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Nic Bellemare: Let's think about the picture for Canadian banks right now. As you mentioned, they've done fairly well, and that's because the earnings estimates have been resilient for banks. They have seen a little bit of normalization of credit and pressure on some fee businesses but that's been overwhelmed by very strong performance of their net interest income. That's both on the NIM side, the Net Interest Margin, the difference between the rate at which they lend and which they pay their depositors, that's been expanding with higher rates. Until very recently, you've also seen a very strong loan growth. I say very recently because you've definitely seen a downtick in mortgage lending, and we can get back to the housing situation soon, but that's been the picture, resilient earnings estimates.

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Obviously, the stocks are off from their peak and that's been mostly on the multiple as investors start to think about the potential for recession next year. I think, thinking through next year, there are a couple of challenges for the space.

Number one would be on the funding situation. As much as in the early part of an interest rate hike cycle, every bank benefits from this increasing NIM. At some point, there's a bit of a catch-up on the liability side. That really varies from bank to bank but you're seeing sort of the funding costs go up and banks are less poised to benefit at some point in the hiking cycle. You're also going to see, probably, a slowing loan growth.

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The other thing we'll have to think more about next year is, obviously, the credit picture. We talked about how monetary policy acts with a lag and so I think we'll see the full impact of that into next year. That's probably going to be another headwind they're going to deal with. I think investors will be keenly focused on that funding and that differentiation between banks. They'll be focused on expenses as well and the outlook that banks may provide on that for next year. I think the expenses is, obviously, like every business under some pressure from inflation but that is probably the one lever that is most within the control of the banks.

Lastly, we're watching how the capital situation evolves. The banks are well capitalized, but they have used a lot of their surplus capital that they were sitting on 12 to 18 months ago, either to fund acquisition or fund their organic growth, so that sort of surplus capital story has also faded.

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Bryan Borzykowski: Can we talk a little bit more about some of those challenges that you were talking about, the credit issue. Explain what are you looking for there, what are the concerns on that topic?

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Nic Bellemare: Usually when you see a recession you see a credit cycle. We've seen some extremes in the past 15 years. So, people tend to incur ... One extreme of bad was the financial crisis. That was a crisis where the banking sector was at the centre of it. That was maybe one extreme on the bad side, especially in the U.S. or Europe.

On the other side, COVID was a bit unique because there was such a strong monetary and fiscal response. It was almost a recession without a credit cycle. Perhaps there's something that can sit in between but some of the recession indicators we're looking at, obviously, deeply inverted yield curves and leading indicators rolling over some of the early cycle sectors like housing, retail, or trucking are seeing some weakness. Some of the red flags appear. That is sort of a normal part of an economic cycle. It's a healthy part of an economic cycle. You see increasing losses tied to that.

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The thing we don't know yet is just the depth and exact timing and nature of the recession, where the bodies are buried. All we can do for now is really prepare. Map each company, each maybe bank to their exposure, so once that becomes more clear, we can act.

Also, I think that's across all of Fidelity, all sectors. The analysts, for more than six months now, we've been thinking about this potential for recession and mapping, looking at historical precedents and thinking what's different this cycle, mapping what it means for revenue, margins and profits, and just have a road map so we're ready.

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The most important thing is coming up with a price as well. If there are headwinds, what price do we feel we're compensated to navigate through that? The best buying opportunities, they do happen in the fog of war when there's a lot of uncertainty. You can't be paralyzed by fear. What you have to do is be ready. What price are we paid to wait three years, we can double our money. There's a price where bad news stops to impact the stock price meaningfully. This is all the work that comes into the preparation for a situation like that.

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Bryan Borzykowski: Just on housing, everybody knows that housing is very much tied to our economy and to the banks. We are starting to see all sorts of housing, real estate indicators slowing down. How big is the concern or the impact that a slowing real estate sector could have on our financial industry?

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Nic Bellemare: Let's look at where we are now. Obviously, housing is a rate-sensitive sector. That's where we started the discussion, the discussion with rate. The first impact you're seeing higher rates is a slowing of demand for housing. That's just because the buyers, they cannot afford the same amount as they did with 0% interest rates. If you look to the median mortgage payment on a house that you would buy at today's price relative to median income has hit pretty much 60% in Canada. That's the highest ever. It's surpassed the prior peak in, I think it was, April of 1990. It's just an affordability issue pressures demand. Now, sellers also kind of pulled out of the market initially because they don't want to sell in a perceived weak market. You're not seeing a huge surge of inventory and really you're seeing depressed transaction levels. That's where we sit today.

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What's the next thing to happen is it buyers coming back from the sidelines? It's possible. We have a lot of immigration that drives demand tailwinds over time but barring a cut in rates, the affordability issue is not going away. What about the supply side? Obviously, I think no one wants to sell in a weak market but we're looking at certain pockets, maybe you could see more sort of forced seller situations. Some of those would be recent buyers or those who have refinanced maybe a little upside on payments or investors have maybe carried too many properties. The cost of carrying those has increased significantly that some of them look to deleverage.

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Lastly, the bucket of kind of the mortgage market we're paying more attention to is probably outside the banks. It's more in that private lending where a lot of it is less sticky financing. A lot of it is from retail investors investing in sort of those mix. If they decide to redeem, some of those lenders may turn to the borrowers and request the payment in which case often the only way to solve that is by putting the property on the market. Those could be sources of more supply that we're watching and that could drive more weakness in the market.

If I just try to tie that back to the banks, I think the quality of the mortgage portfolio of the banks is, obviously, pretty good because of all the regulations around it, just starting with the fact that you need at least 20% equity on an uninsured mortgage. That certainly offers a buffer. Canadian homeowners tend to ... That's kind of the last thing, they will stop paying the mortgage. They'll cut a lot of stuff before that. The mortgage itself may not be the biggest issue but as you have households maybe cutting in other parts of their budget, it can hurt the economy and then, obviously, banks are kind of elaborate play on the economy, so they may still have a more indirect impact.

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Bryan Borzykowski: Mortgages, housing, recessions, I can't help but think about 2008. In 2008, Canadian banks were the gold standard. The financial sector, everybody was raving about how well the Canadian banks did. Now, there was a recession in 2020 but let's leave that aside. It was quick and things rebounded, at least in markets. When you compare 2008 to what's happening now, how do the Canadian banks stand up against their global peers?

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Nic Bellemare: First of all, a couple reasons why it may not be as bad as 2008 from a banking kind of perspective globally. I think one reason is definitely that the system has been shored up in the aftermath of the financial crisis from a transparency, liquidity, capital standpoint. If you take in Canada, for instance, we have this countercyclical buffer. That's basically the regulator telling banks, keep this rainy-day fund aside and if things are bad, basically, you can use that capital. Those are the kind of things that didn't exist before.

I think the overall global financial system is in much better shape. When we think about Canada relative to other areas, obviously, Canadian banks have always been seen as some of the highest quality banks in the world. They have a high ROE, we know it's an oligopoly with a favourable regulatory treatment of mortgages and diversified revenue streams and strong fee businesses.

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All that helps but we've also seen a higher than average kind of private sector debt growth in Canada. Part of it was this very kind of elevated housing market. In a rate induced recession, that may put a little more pressure on Canadian banks relative to other systems.

The benefit we have is we really have a global research. Every two weeks, I sit with all my financials colleagues from around the world, Asia, Europe, North America, and we kind of compare notes. We are seeing, potentially, in our global mandates there is possibility to invest in other areas where they may not be as high-quality banks but, perhaps, they can go from kind of bad to a little better businesses and priced as such, those may be better stocks. In some countries in Europe, you have to be selective but if they have the fiscal kind of firepower to support their citizens through the energy crisis, you have some European markets where you can see a path for these banks to go from, obviously, very low ROE, maybe mid-single digit to low teens, and the starting point on valuation may be a lot lower. Those can be examples where we may see more compelling opportunities globally when we just kind of compare our opportunity set.

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Bryan Borzykowski: Is what we're seeing now with the Canadian banks similar to what we saw in '80 to '82?

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Nic Bellemare: In terms of the housing downturn and so on? I think some of those...

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Bryan Borzykowski: Sorry, and in terms of high inflation as well.

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Nic Bellemare: Inflation, it's not necessarily the worst for banks because, again, even if you have a higher level, structurally higher level of interest rates, that does provide a higher level of profitability for the system and that may come with higher losses.

Remember, the first line of defense for banks against credit losses is their own profitability. That's one thing Canadian banks have is a very high ratio of their profits before credit losses to credit losses, meaning they can withstand a multifold increase in their loss ratios before they would even record a loss. That's a huge protection.

If this kind of inflationary backdrop persists, perhaps a drag on the economy but there's some parts of the banks, such as their net interest income, that could remain more resilient and provide some buffer. It's not necessarily all bad but you just have to be cautious in terms of what that means for the valuations and think about where we may be in that credit cycle.

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Bryan Borzykowski: It sounds like from what you're saying, maybe some global banks – as where in 2008 Canada was kind of the cream of the crop here – some other banks might be better opportunities but Canada still is in relatively ... we're not going to fall apart here. There's a question here, are the banks ready for a recession risk? If we kind of directly ask that, what do you think?

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Nic Bellemare: I think from being able to navigate through it, as I said, I think the same points apply, the starting point of their profitability and the ability to absorb higher losses. Again, on that point of just generally the banking systems across the world, including Canada, having more buffers. Lastly, let's remember here, what may induce this downturn is higher rates in response to inflation. If we do enter a period where there's higher unemployment and slower economic activity, that does leave room for central banks to eventually reverse course.

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Now, some people want to have maybe their cake and eat it, too, see the benefit of lower rates without what needs to come first. By increasing rates, central banks have given themselves room here for in bad times be able to stimulate again. That's not really relevant as of today but it's something to keep in the back of your mind. You want to think a couple steps ahead and not be too gloomy. It all comes down for us as investors: do the work, stress test, and have your prices in mind and be ready to act. In the meantime, there may be other places in financials that can be interesting. We can talk about that as well.

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Bryan Borzykowski: I have another question on the Canadian banks. Yeah, let's talk about some of the other things you cover. The banks all have sort of different properties to them. I'm just wondering sort of from an opportunity perspective, where do you see opportunities in the Canadian financial markets? Some of the banks have more global expansion. Maybe just talk about some of the differences and what you're kind of liking these days?

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Nic Bellemare: This has been a great year to actually be a bank analyst because there has been a lot of divergence. Even within Canadian banks there's been a lot of divergence between the performance of the stocks. Then we talk about Canada versus the rest of world and we may talk about even other subsectors of financials.

If we think within Canadian banks, some of the things that have driven some divergence, we talked about this funding equation. Perhaps in the U.S., for instance, it's a market that is more deposit rich and so there's less reliance on what we call wholesale funding. Wholesale funding has gotten a lot more expensive now for banks. If you have this better coverage of your loans with deposits, some of those banks have had a more resilient kind of net interest income trajectory and that may continue for some time.

Even within deposits, the nature of those is different from bank to bank. If you have a very transactional kind of deposit base, sort of you and I, our main bank account where we just keep kind of the basics there. We're okay, the bank doesn't pay any interest on that. That's the highest quality of deposits you can get. When you think about savings and excess savings, in a higher rate environment that's where depositors may kind of seek, can I go in a high yield or a fixed income fund or term it out in a GIC, that's where you're seeing that repricing.

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There are differences from bank to bank. I think the other one is capital allocation. During the pandemic some banks had been more proactive managing their risk-weighted assets, have created a lot of room in their capital and then turned around and made some significant acquisitions. A lot of those have not closed yet but as they come in into next year and 2024, these earning streams that they will bring on, as well as kind of the synergies that can be extracted if they already have a footprint, for instance, in the US, those will add up and create a different earnings profile. Those are just some examples of things we look at in terms of even analyzing the different earnings trajectories between the banks.

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Bryan Borzykowski: Great. Do you see an improvement in bank P/Es coming at all? What might that look like to see that improvement?

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Nic Bellemare: The P/E has the price and also the earnings. I talked about maybe some of the challenges for the earnings. Banks, again, you should think of them as kind of elaborate plays on the economy. If we do see signs of economic reacceleration that would boost the multiples. On the flip side, if we see more a deteriorating outlook you would probably see more pressure on valuation.

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Bryan Borzykowski: Now, you do cover other things than just Canadian banks. Within sort of the Canadian market, what other financial sector, subsectors do you cover and are there opportunities there for investors and advisors to look at?

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Nic Bellemare: I would say I look even beyond just the confines of Canada. We have global research across all subsectors of financials. Financials we, rightly, think of banks and lifecos because they're the giants but there's a lot more going on. Just to give you some examples, for instance, exchanges. Exchanges, they sit between buyers and sellers of risk, especially if you think about options or futures. In a volatile backdrop, the demand to either offload risk kind of just goes up and you're seeing these companies actually benefit from a tougher backdrop with taking very little credit risk. A lot of them have sort of transformed into being more like software or recurring service revenue. There are some interesting idiosyncratic stories there.

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Think about brokers, online brokers. You and I, probably if we do a trade, we'll sell a stock and we'll have some cash in the account while we debate what to buy next. Those brokers, they can take those cumulative cash balance to their clients, reinvest in short-term treasuries, which now yield a lot more than they did in the past, and sort of benefit out of that on top of the commission income. That's just kind of a business model that, again, in an environment we have higher rates but may be higher credit risk emerging is perhaps differentiated. Insurance has multiple segments. Auto or home insurance, those are not very discretionary purchases. We're often required by the lender or by law to hold those. That's just another area where, as long as there's good pricing dynamics in the industry, you can benefit and ride out a credit cycle.

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Bryan Borzykowski: On the global bank side, which you kind of talked about a bit before, what countries or what areas do you find attractive today outside of Canada?

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Nic Bellemare: As I said, I won't get too specific, if you look … even some countries in Europe, if they have the fiscal firepower to support their citizens and limit the credit impact, and you're going from negative rates there to somewhere like earlier, probably earlier days in the *[audio cuts out]* cycle, some of those banking markets are consolidating as well.

You're seeing maybe more favourable competitive dynamics emerge. They've seen less asset growth and loan growth, we can see that's a negative but if you're going into a tougher period, maybe that also can be seen as a positive.

Again, some banks have kind of a pathway to maybe almost double their return on equity. If you start with a low enough price-to-book, those can be just interesting rate of change stories. I don't think any of those will get to be the same kind of absolute quality of Canadian banks but again, sometimes it's just the difference between good business and good stock. We always kind of think about that and look globally, where are the best stocks we can position.

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Bryan Borzykowski: There's another question about whether the current environment is a good time for mergers and acquisitions. Maybe not just sort of in the banking sector but all the things you cover. Are you seeing any activity there or where could that go?

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Nic Bellemare: In theory, it should be a good time for buyers. I like some of these companies that have very strong balance sheets because that may be a good time for them to deploy. The issue is, again, it's like the housing market where the sellers, it takes some time to adjust. You're actually seeing a big dip in M&A activity because it's just a wide bid ask spread. Now, if conditions remain tight for longer, some of the companies even started to tell me, we're seeing more enquiries, some of these leveraged businesses from private equity, they're kind of coming around maybe more willing to sell. I think it's a good time for well-capitalized buyers. We've seen some of that play out. I talked about it and the banks, those that have freed up a lot of capital, some have already made those moves. Those transactions are pending. Some banks still sit on a lot of excess capital. They would also have an above average flexibility and optionality. I think that that may well be something that we'll have to watch in 2023 in terms of do the bid ask for these transactions kind of close and we're going to see real big strategic moves being deployed.

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Bryan Borzykowski: I'm going to move to a little bit of a different financial sector. Crypto has been in the news for a while now. I'm just wondering, a lot of people are nervous that some of the issues happening in the crypto space could find themselves affecting kind of the broader financial industry. Is that a concern of yours?

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Nic Bellemare: No, it's not just because the banks don't lend or hold any meaningful crypto exposure. It's very different from the subprime crisis that was really banking at the centre. The banks have one issue to deal with, they may curtail lending to other parts of the economy. That's how you really get this contagion that we call.

Crypto has been contained very much into some of those platforms involved in lending that don't have the proper risk controls and you're seeing that deleveraging. What I find interesting is when you dig one layer down, the crypto networks themselves are holding up. They're doing what they're supposed to do. They're holding up well. That's interesting in terms of thinking about the longer-term promise there in terms of potential applications.

I think global trade settlement, cross-border payments, I'm going to continue to pay a lot of attention to developments in blockchain and how they may or may not be disruptive to centralized entities. I think that will continue but certainly right now there's sort of a clean-up and deleveraging kind of event happening. That's not very relevant for the traditional financial system.

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Bryan Borzykowski: I'm just wondering how investors and advisors might be able to take advantage of opportunities in the financial space today. I think by nature of being invested in Canada you're going to own some financials. A lot of people are probably just owning them in Fidelity Funds, whatever they are, Canadian funds. Is now the time to tweak the allocation, diversify more? What would be your advice for investors and advisors to approach the financial sector today?

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Nic Bellemare: I can't really provide for *[indecipherable]*. Internally, it's a really exciting time because there's a lot of change, there's a lot of macro. Our process of understanding how our companies work and react in different environments and especially price levels where at some point you take some of those more defensive and resilient companies and you can invest when people panic in some other areas. We're just really on top of it and doing the homework. It's kind of a play-by-play. Can't really provide a blanket advice, but hopefully you got a good sense of what we're doing, some of the areas we're looking at, where we're more excited, where we're more kind of in wait and see and we're just deploying this process across the funds.

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Bryan Borzykowski: I will leave it there. We're at time. It's always fun talking about financials. It's such a big part of our economy and everyone has interactions with banks here. I think it's a great sector that everyone can relate to. Hopefully, we will chat again soon. Thank you so much for being here today.

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Nic Bellemare: Thanks, Bryan. Thanks, everyone.

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Thanks again, see you next time.