

Views from the Desk

Decoding Q2 Canadian Bank Earnings

Sohrab Movahedi, Chris Heakes and Daniel Stanley dig deeper into the positive earnings surprises amid the broader economic context, including inflation concerns, potential rate hikes and the continued reopening. Daniel Stanley is an ETF Specialist at BMO Global Asset Management. He is joined on the podcast by Chris Heakes, Portfolio Manager and ETF Specialist, BMO Global Asset Management and Sohrab Movahedi, Managing Director, Financials Research, BMO Capital Markets. To listen to the full podcase please visit bmoetfs.ca

Bank Results

Great results in this last quarter on the back of lower credit provisions and revenue diversification. In a low rate environment, having revenue outside of loans such as capital markets and wealth management have been a great additive.

Credit reserves look to be conservative and we expect to have a gentle tailwind of reserve releases going forward. The next 2 quarters should have similar results. We may not have the same strong above expectations results but, but certainly good results going forward.

Performance of BMOs Bank ETFs

Performance of our bank ETFs have been strong. ZEB – BMO Equal Weight Banks is up 27% YTD, our ZWB – BMO Covered Call Canadian Banks is up 21%. To compare, the TSX is up 16% YTD. Overall, cyclical companies have been doing well and we are seeing outperformance from Canadian Banks.

We are optimistic on the trend of outperformance lasting a while. One catalyst we are looking forward to is the potential dividend hikes from the banks. If we see a 10% increase in dividends, we would see the avg dividend yield back at approx. 4% again. We expect banks to rally further. A downside catalyst would be the impact of tapering however, we would most likely see that coming closer to Q4 2021. Double digit returns before the end of the year is very possible with Canadian banks.

Banks vs Bonds

Banks are usually always owned for their dividend yields. Sustained payment of dividends and commitments to these dividends have been strong with the banks. Because of the regulatory restraints, the banks have not been able to increase their dividends. We expect dividend yields are going to be an important part of the return story for banks investors. Furthermore, there is potential to improve the yields of the banks. The yields on bonds have not been as attractive.

We are looking for the banks which typically operate in a 40 to 50% dividend payout ratio range. Investors should get some catch-up potential from these dividends. We may even see some banks go as far as increasing their dividends as much as 25%. We'd also expect the dividends to provide some downside risk when reinvested. We expect dividend yields to look more favourable than long term Bonds.

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Steeper Yield Curves

Covered calls can give you some downside protection and provide you a much larger yield. Our ZDV – BMO Canadian Dividend is yielding approx. 4% and the covered call version ZWC – BMO Canadian High Dividend Covered Call is paying approx. 7.2%. 25 % of these funds are in the banks complimented by other sectors.

We are seeing a lot of interest for high dividend yield solutions. Strong fundamentals will help drive strong returns. Historically, inflation and steeper yield curves tends to favour value investing. With dividend and value there is a natural connection. Dividend based companies tend to have a value bias. These strategies have been outperforming this year.

Commercial Loans and Mortgage Loans

Commercial lending tends to be very pro cyclical. Its not surprising that we've seen a decline in commercial lending. We have experienced lockdowns and its been harder for business owners to make commitments to capital expenditures. Economists at BMO are looking for 6% GDP growth and believe this will be good for commercial loans.

We have had aggressive stimulus spending. There is quite a bit of liquidity right now and we are seeing these excess deposits at the banks. We will need these deposits/liquidity to be drawn on from borrowers before we will get a rebound in loan growth. From a bank perspective commercial loan vs mortgage loan, commercial loan volumes are much bigger. The return on the commercial loan is higher than the mortgage loan.

US Banks and Canadian Banks Performance

Global financials have been a phenomenon. ZUB – BMO Equal Weight US Banks is up 34% vs the ZEB – BMO Equal Weight Banks 27% YTD. ZBK BMO Equal Weight US Banks is unhedged is up 28% with a strong Canadian dollar. Furthermore, ZWK – BMO Covered Call US Banks is up 25% (which has a 7% yield).

Out 2 years on a price to earnings basis financials, energy and utilities are relatively cheap. Fundamentals are looking strong. What we see here in Canada very much applies to the US as well. Canadians can be diversified across US and Canadian banks to get that global financial exposure.

Buy Backs and Acquisitions

Canadian banks are very well capitalized by historical standards (regulatory minimums, reserve levels, quality of book). Canadian Banks are well positioned to deploy capital and typically look for organic growth opportunities.

MNA banks are sold not bought, we need willing sellers. The promise of higher rates, steeper yield curves presumably changed the psyche of willing sellers usually out of the US. With and economic recovery on the horizon, we'd assume sellers are thinking "should I wait it out and get full value?" or "sell now".

We think its important to look at the executive team and the tenure of CEO. Is there a willingness from the CEO to pull the trigger, or is that up to the successor? In the meantime, Canadian banks will be a lot more focused on organic opportunities as well as buy backs and dividend increases as apposed to MNA.

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To get exposure to Canadian banks;

- ZEB – BMO Equal Weight Banks
- ZWB – BMO Covered Call Canadian Banks
- ZDV – BMO Canadian Dividend
- ZWC – BMO Canadian High Dividend Covered Call

To get exposure to the US Banks:

- ZBK/ZUB – BMO Equal Weight US Banks
- ZWK – BMO Covered Call US Banks

These ETFs all actively trade on the TSX.

To listen to the full podcase please visit bmoetfs.ca

This podcase is available on;



Source: Bloomberg, All returns and data points June, 2021.

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