June 2, 2020– Market Overview & Canadian Banks Q2 earnings Update

BMO Nesbitt Burns

Week in **Review**

BMO Wealth Management
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Market & Portfolio Overview:

Markets have been recovering based on optimism that economies are coming back online as Covid 19 cases peak and healthcare systems appear better prepared. Another factor is speculation of a vaccine within the next 12 months, although health experts warn this timeline could be overly optimistic. Since the high volatility in March with the US and Canadian markets falling 37% and 39% from February highs, Canadian and US markets have stabilized and are now down 11% and 5% in 2020 respectively. Looking ahead, with the TSX trading at 15.6x's and the US S&P at 18.9x's 2021 earnings, we would remain cautiously underweight equity exposure with a higher than average C$ and US$ cash position in our portfolios. We note that offsetting the equity declines, bonds have rallied this year and the weakness in the C$ (although recently recovering somewhat) along with a rally in gold has mitigated the declines in our model portfolio as can be seen in the schedule below.

Returns YTD of our 60/40 model portfolio using benchmark returns (to June 1st) are -1.65% as shown below:

2020 year to date 1-Jun-20	**Benchmark Symbol**	**Total Return in C$ 2020***	**Model Allocation**	**Allocated Return - C$**
C$ Cash			0.0%	0.00%
US$ Cash			0.0%	0.00%
Agg. Bond C$	VAB	5.5%	15.0%	0.83%
Agg. Bond US$	BND	10.5%	10.0%	1.05%
Prefs	CPD	-16.0%	10.0%	-1.60%
Cash & Bonds			**35.0%**	
TSX	XIU	-8.5%	30.0%	-2.55%
S&P 500 in C$	SPY	0.5%	25.0%	0.13%
International	VGK	-10.0%	5.0%	-0.50%
Equity			**60.0%**	
Gold	**GLD**	**20.0%**	**5.0%**	1.00%
Total			**100.0%**	**-1.65%**
***including dividends and interest**				

Canadian Banks Update:

The Canadian Banks make up 25% of the TSX index and are the most heavily weighted sector in Canada. Traditionally they have provided stability to the markets in Canada compared to the volatile energy sector which is the next most heavily weighted sector, although much diminished since the decline in oil prices starting in 2015. Over the past 5 years (to May-31-2020) the equal weight bank index ETF "ZEB" (comprised of equal weights of the 6 main banks) had an annualized total return of 4.3%, slightly better than the TSX at 4.0%. Having said that the impact of Covid 19 has affected the banks significantly this year, such that the ZEB is down 20% YTD vs. the TSX, which is down 11%. As can be seen in the schedule below, bank earnings across the board will be significantly reduced in 2020 and according to consensus estimates are expected to only catch up to 2019 earnings, by 2022. The main reason for the earnings declines is the large provisions for bad debts that were announced in their Q2 earnings last week. Provisions were as much as 4 – 5x's normal levels, and are immediately deducted from earnings. These provisions may be adequate going forward (or may be increased or decreased) as the impact from Covid is more fully understood. A second headwind for the banks is the ultra-low interest rates, whereby the net interest margin (a main source of banks earnings) gets compressed. On the positive side dividends of the major banks have been maintained and are at levels still below the reduced 2020 earnings estimates. Looking ahead at 2021 we see the banks trading at only a slightly lower p/e than historical levels which is also reflected in the current trading price at only a modest discount to consensus target prices.

Looking at banks as a major portfolio component, we would maintain the current weighting of 23.5% of our Canadian equity allocation with TD at 14% and Royal at 9.5%. While earnings growth will be modest over the next 2 years, we believe the 5% dividend yield is safe and that Bank's management have been conservative in provisioning, such that further earning shocks will be moderate. On the upside, if the economy (US and Canada) can recover more quickly with lower than forecast bad debts and somewhat higher interest rates, we could also expect some upside for the share price.

We note that TD and Royal have outperformed the bank index over the past 5 years with total returns of 6.0% and 6.8% annualized vs. 4.3% for the equal weight banks index ETF "ZEB". We continue to prefer TD for its stable retail focus and strong US presence; while Royal has a much larger capital markets and wealth management component to its business, offering higher growth potential. Both TD and Royal with AA- credit S&P ratings are the highest rated major banks in North America and also rated higher than almost all of their global peers.

Key Investment Metrics:

2-Jun-20	Bloomberg/Thomson Consensus							%	2017	2018	2019	2020	2021	2022	2020	2021	2019	2017- '22
Symbol	Price Tg.	5 Year Total Return*	Current Price	Ann. High	Ann. Low	Mcap	Div.	Yield	eps	eps	eps	eps	eps	eps	p/e	p/e	P/B	EPS Growth Ann.
BMO	76.00	1.9%	70.70	104.75	55.76	45	4.24	6.00	8.07	8.85	9.43	6.56	8.06	8.97	10.8	8.8	0.89	2.1%
CM	93.64	4.1%	93.25	115.96	67.52	42	5.84	6.26	11.04	12.06	11.92	8.29	10.17	11.25	10.4	9.2	1.08	0.4%
RY	98.77	6.8%	94.31	109.68	72.00	134	4.32	4.58	7.43	8.38	8.92	7.20	8.53	9.24	13.1	11.1	1.66	4.5%
TD	63.54	6.0%	61.50	77.96	49.01	111	3.16	5.14	5.43	6.33	6.69	4.72	5.70	6.61	13.0	10.8	1.24	4.0%
BNS	61.50	1.6%	57.49	76.75	46.38	70	3.60	6.26	6.45	7.16	7.14	5.07	6.15	6.99	11.3	9.3	1.06	1.6%
Average								**5.65**							**11.7**	**9.8**		**2.52%**
* To May 29th																		

Net Income by Business Segment:

Estimate of Earnings by Business Segment					
Symbol	Cdn. Personal+ Comm.	US & Internat ional	Wealth + Ins.	Inv. Bking + Cap mkts	Total
BMO	41%	25%	17%	17%	100%
CM	55%	11%	12%	22%	100%
RY	42%	2%	27%	29%	100%
TD	40%	30%	20%	10%	100%
BNS*	37%	21%	16%	26%	100%

**BNS International Banking is focused on Latin America, Central America. Also it includes International Portion of Wealth Management as they do not break earnings down by business segment within the International Category*

TD Bank: TD has the highest percentage of its cash flow from the US with a strong US retail platform, although now has reduced its majority ownership in TD Ameritrade. TD reported Q2 results on consensus and down 54% over last year, mainly due to a 4.5x's increase in provisions for bad debts, while revenues (pre provisions and pre-tax) increased 9.5%. TD remains our largest Canadian equity holding given its stable and high quality core earnings while we acknowledge the earnings growth going forward will be modest until we see a full recovery in US and Canadian economies. **We continue to hold TD as our top bank holding.**

Royal Bank: Royal Bank is Canada's largest bank by market cap, slightly ahead of TD. Its business mix is also diversified but with a much larger component of capital markets and investment banking than TD. Royal missed estimates of Q2 earnings, mainly due to a 7x's increase in provisions for credit losses, over the same period last year. While Q2 was a challenging quarter for Canadian banks and in particular Royal, we believe that the high provisions taken in Q2 will allow for solid results going forward absent a second Covid wave. **We continue to hold Royal Bank as a second position.**

Scotiabank: Scotiabank is unique among the Canadian banks with significant investments in Mexico and South America, comprising most of its international earnings. Scotia reported better than consensus estimates for Q2 with loan loss provisions up only 2.5x's vs. double this increase for other banks. While good on a comparative basis for Q2, it raises the question as to whether further increases in provisions will be needed in the next two quarters. On the revenue side both global banking and wealth management reported strong numbers while Canadian banking revenue fell. We have held BNS as a third position in some cases due mainly to its international diversification. We consider it higher risk, but potentially better returns in the short term.

CIBC: CIBC is the smallest of the "Big 5" and historically the most reliant on its Canada retail franchise and in particular its Canadian mortgage portfolio. It recently expanded into the US with the purchase of Private BanCorp but remains the most concentrated bank to the Canadian marketplace. CIBC reported a Q2 numbers that missed expectations as loan provisions were 5x's last year's levels. We have not invested in CIBC as it remains largely a Canada only franchise with less diversification than TD and Royal.

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Sources: Bloomberg, JP Morgan, Thomson & BMO Nesbitt Burns research

We deliver a full complement of thoughtful, customized wealth solutions for private clients and institutions, drawing upon global resources, top ranked research and the collective wisdom of BMO Nesbitt Burns and our internal and external partners. For more information on our team we invite you to contact us.

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