Oh Canada's…banks.

With Labor Day, the end of summer around the corner and back to school sales in full swing, the Canadian banks reported quarterly earnings. We are providing links to NBF's recent updates on Bank of Montreal, Bank of Nova Scotia and TD Bank. We hold all three in our Canadian Dividend Growth portfolio. They've been long-term winners and short-term losers. What should we do?

Bank of Montreal 'Credibility on credit waning' NBF Research Aug 27, 2024

NBF Bank of Montreal Aug 27 research link

TD Bank: 'Despite muddied long-term U.S. outlook, upgrading to Sector Perform' NBF Research Aug 27, 2024

NBF TD Bank Aug 22 research link

Bank of Nova Scotia: 'Steady as she goes' NBF Research Aug 27, 2024

NBF Bank of Nova Scotia Aug 27 research link

We've featured Scotiabank earlier this year a few times. We're going to drill down into why we keep pointing it out.

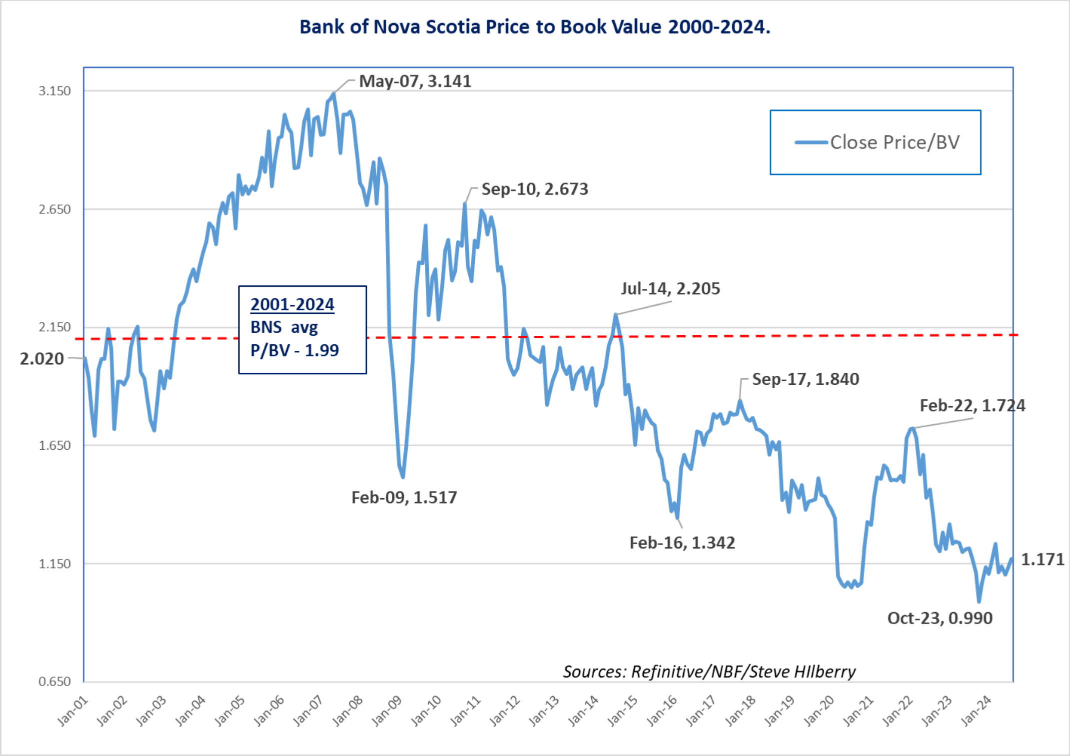
One metric we pay attention to is **Price to Book Value (P/BV).** Book value is roughly defined as assets less Liabilities. (see 'Book value vs Market Value. What's the Difference'-Investopedia). Book Value Shorthand: the theoretical break up value for cash. **Price to Book Value** expresses the market price as a ratio to book value. Example $100 share price vs. $50 book value = Price to book 2.00. $50 share price vs $50 book value 1. (I failed high school math thus the pedantic explanation).

US banks, falling under a looser regulatory regime, tend to be more profitable than their Canadian peers. They also tend to implode far more often explaining why US bank investors accord a deeper discount to Book Value, rarely paying over book value for US banks.

Canadian banks enjoy/suffer much tighter regulations. They are generally less profitable and a LOT less risky. Canadian banks extreme low price to book ratio is 1 X book value. The typical highs are near 3 X BV. 1 is cheap. 2.7 is expensive.

Paying around 1 X book value has historically proved a great entry point. Selling around 2.7+ has been reasonable exit point. **Sellers take note:** One would have had to re-enter the position. Longer term selling banks Canadian banks at any price has meant missing out…eventually.

The next chart compares Scotiabank's **Price to Book Value ratio 2000-2024.** Note the steady decline in the ratio since the summer of 2007. Summer 2007 preceded the Great Credit Crunch of 2008-09 bringing the downfall of Bear-Sterns, Lehman Bros. Merril-Lynch and numerous US regional banks. The following [Basel III accord] imposed higher cash reserve requirements on banks, lowering their profit margins. In turn, investors have lowered the premium they're willing to pay. We think the pendulum has swung well into 'risk-off'.

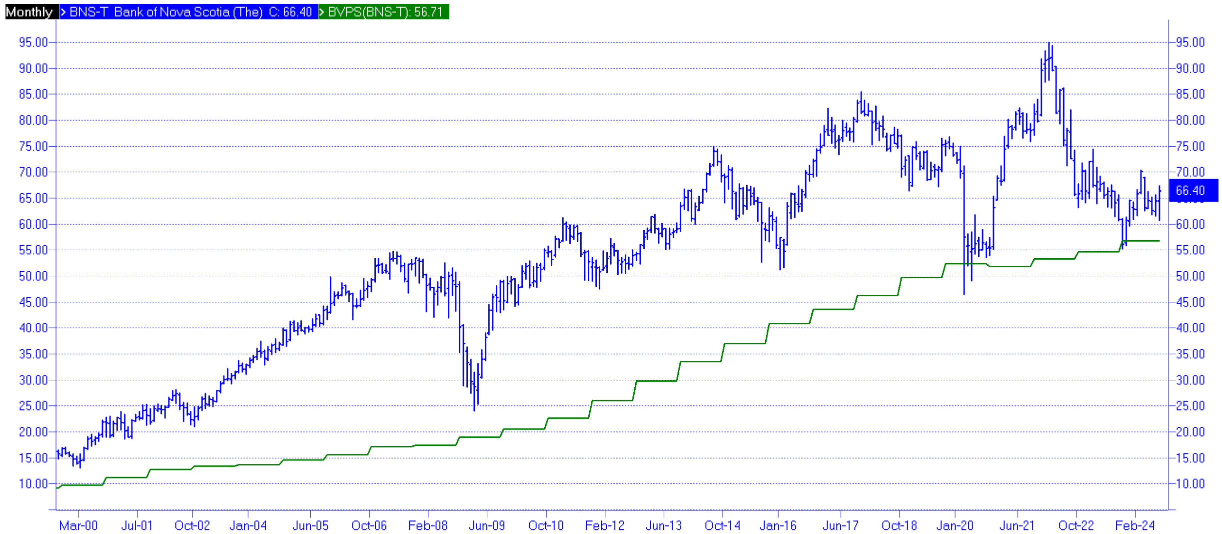


Source: Refinitiv, NBF, Hilberry

The above chart tells us Scotia Bank is at low valuations vs the past 25 years. While 2004-2007 period was excessive, we see the current ratio has historically low. Note the extreme bottom during Mar/April 2020 COVID-19 panic. Recent ratios are about the same.

We should clarify the above chart provides the ratio. Book Value tends to grow each year in a profit generating company. The following chart shows Scotiabank's monthly price ranges (blue) vs posted book value per share (green). Both tilt upwards.

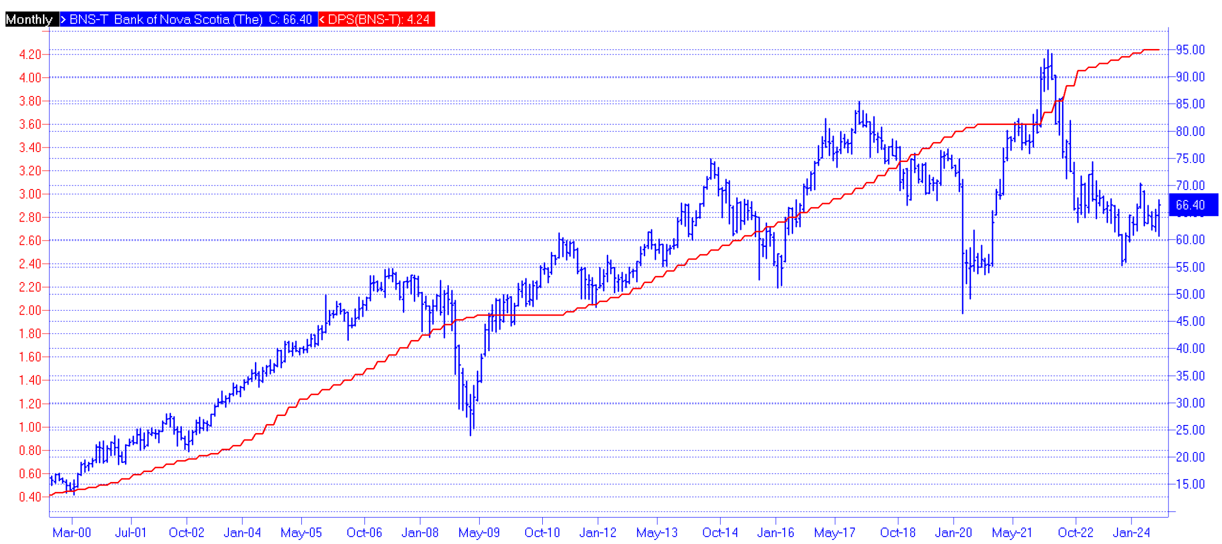
Scotiabank (BNS-TSX-$66.40 – BV $59.36) Price & Book Value 2019 -2024.



Source: Refinitiv, NBF, Hilberry

Note the single quarterly decline in Book Value occurring in late 2021, reflecting write downs from COVID-19 results. There is no guarantee Scotiabank will continue to grow its business, profits and book value. Scotiabank pays a quarterly dividend. The next chart compares price (blue) to dividends (red)

Scotiabank (BNS-TSX-$66.40 – Div $4.24 - yield 6.4%



Source: Refinitiv, NBF, Hilberry

Other than death and taxes, nothing else is guaranteed, including Scotia Bank's continuing to generate growing profits and increased dividends.

Our belief is Scotia Bank is likely to grow its business, profits, book value and dividends into the future. If so, investors are likely to pay up. If history is a guide, and it may not be, investors probably will…eventually…even get giddy on the Canadian banks again and pay over 2.5 to even 3 X book value…eventually. We don't know if or when, but we won't be surprised if it happens.

As an exercise we'll assign some math. Get out your pencils please.

Scotiabank's' current book value is $59.36. Ten years ago, Aug/2014 book value was $33.57. Total growth was 77%. Through some rough times including a flop in the Loonie, hostile government tax and regulatory policy, COVID-19, spike inflation, difficulties in Scotia Bank's Latin American division, geopolitical drama in SE Asia and the US, etc. the average annual compound growth rate was 5.9%. Assuming the same future growth rate implies something like $105 book value per share in 10 years. Let's also assume the prices investors are willing to pay moves up the 10-year average just under 2 X book value per share.

Under this scenario, which is entirely fictitious, if the price ratio rises to 2 X
$105 we'd have $210 dollars per share. Close to a triple. If ratios remain at the current low end 1 X, 1 X $105 future book value vs today's $66 per share isn't a disaster. Add in a compounding 6.8% yield and in that low end scenario it's still a double. There are many issues with this exercise. The point is Scotia Bank might end up being a solid investment…eventually.

What if it takes awhile?

Scotia Bank's current dividend per share is $4.24 At recent prices around $66.40 the stock is priced to pay a 6.4% yield. The second chart demonstrates Scotia Banks past ability to raise its dividend payments. There is no guarantee this will. We're happy to get paid to find out.

After that happy thought….

This week, a client passed along YouTube presentations featuring one of our favorite perma-bear punching-bags, Jeremy Grantham. (a Google search will kick up a number of them). Mr. Grantham has been permanently bearish on stocks, for the past decade…and spectacularly wrong. He regularly insists stocks must decline by (fill-in-the-blank) spectacular XX percentage. His recent predictions see a 65% decline by this fall. Those who followed his fear-based advisories would have missed retirement making total returns. If not for the damage done to investors following his 'free' advice, his musings would be a-musing. His postings are guaranteed to attract eyeballs and thus sell advertising. I had to look, so it worked. Wrong again? No shame. He got paid for his 'click bait'.

On Mr. Grantham's laundry list of woes, is inflation going parabolic. While we don't think inflation will return to sub-2% anytime soon, we also don't think inflation will see high single, let alone double, digit rates either. We're on record anticipating lower lending rates over the next few months. If correct, this down-trend in rates would at be, at worst, not bad for stocks. We think lower yields will help support valuations. It already has.

Client portfolios are at all-time highs. Dividend income is up nicely from last year. We continue to avoid the nose-bleed prices in some sectors. The above banks are a long, long way from expensive and pay nice dividends. We're sticking with 'em. Scott Grannis provides more detail on the near-term direction of US short-term rates. Canada is likely to follow.

'Excess M2 continues to fade away' Scott Grannis blog – Aug 27, 2024

https://scottgrannis.blogspot.com/2024/08/excess-m2-continues-to-fade-away.html

Have a Great Labor Day Weekend

Steve & Anna Hilberry

FOR THE RECORD August 29, 2024 close

DOW INDUSTRIALS:	41,335
S&P 500:	5,591
S&P/TSX COMP:	23,227
WTI:	$75.87
LOONIE IN $USD:	$0.7413 $US

Sent by
Montreal Office
National Bank Financial
Wealth Management
800 Saint-Jacques Street
Office 79721
Montreal, QC H3C 1A3
Ph: 514-879-2222

Toronto Office
National Bank Financial
Wealth Management
130 King Street West
Suite 3200
Toronto, ON M5X 1J9
Ph: 416-869-3707

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