

January 2009

Banking on Success

Canadian bank stock prices underwent an incredible period of growth from 2000 until 2006, as the S&P/TSX Bank Index surged a cumulative 237 percent or 19 percent annualized over seven years, as at December 31, 2006. (Source: Bloomberg L.P., TD Asset Management Inc.)

But late in 2007, a wave of writedowns around the world caused a widespread sell-off of financial assets and sent stock prices tumbling. To date, there have been tremendous writedowns reported by financial institutions around the world to the tune of almost US\$600 billion¹. Canadian banks have not been immune and many have also taken losses due to a combination of direct exposure to U.S. sub-prime related debt and/or tough market conditions. Consequently, Canadian bank stock prices dropped 10 percent in 2007 and have declined even further in 2008, falling 26 percent to the end of November. Canadian banks recently reported their fourth-quarter results, which included some more writedowns.

Doug Warwick, Managing Director and Portfolio Manager of the TD Dividend Income, TD Dividend Growth and TD Monthly Income Funds, remains committed to his position in Canadian banks stocks despite the writedowns and challenges from a slowing economy. Regardless of these short-term risks, Warwick believes there are reasons to be optimistic about Canadian banks as they present great value and he believes that this is a sector that should continue to deliver strong results over the long term.

Canada Has the Soundest Banking System in the World

Unlike some banks in Europe and the United States, which needed to be bailed out by the government, Canada's banks have remained standing independently on their own two feet. Warwick believes that the Canadian banking system remains safe. The 2008 World Economic Forum, where politicians such as China's Vice Premier, Germany's Chancellor, and business elites such as Bill Gates and Michael Dell meet to evaluate the world outlook, echoed Warwick's view by ranking Canada's banking system as one of the soundest in the world.

Some Canadian banks have not been completely invulnerable as they have also reported writedowns that were largely related to U.S. sub-prime related investments. However, Canadian banks have largely managed to avoid some of the crippling writedowns taken by other banks around the world. Since December 2007, the Big six Canadian banks² have written down a total of approximately C\$14.5 billion, but these losses are relatively small compared to some writedowns taken by other banks. Warwick believes the writedowns taken by Canadian banks are manageable in the context of their businesses, yet investors stripped more than \$70 billion off the market cap of banks from their peaks. Warwick believes that this reaction is extreme given that the amount of the write-offs on an after-tax basis only represented less than two-quarters of earnings for the big six banks.

¹ Source: Bloomberg Finance LLP

² Bank of Montreal, CIBC, Royal Bank of Canada, Scotiabank, TD Bank, National Bank of Canada

Even with the writedowns, Canadian banks are expected to continue to pay dividends. Bank of Nova Scotia and TD Bank have actually been raising dividends; suggesting that Canadian banks are in better shape than many of their global peers, many of whom have cut dividends to save money.

The Canadian banking system is markedly different from the U.S. banking system, and this has become glaringly evident as a result of this crisis. The Canadian banking system has a handful of highly regulated banks, compared to the U.S., which has more than 7,000 banks. The Canadian banking system also has more conservative lending standards compared to many other countries, which could mean that Canada does not have a sub-prime market like our neighbours to the south. Consequently, the Canadian economy is expected to experience less stress than the U.S.

Outlook

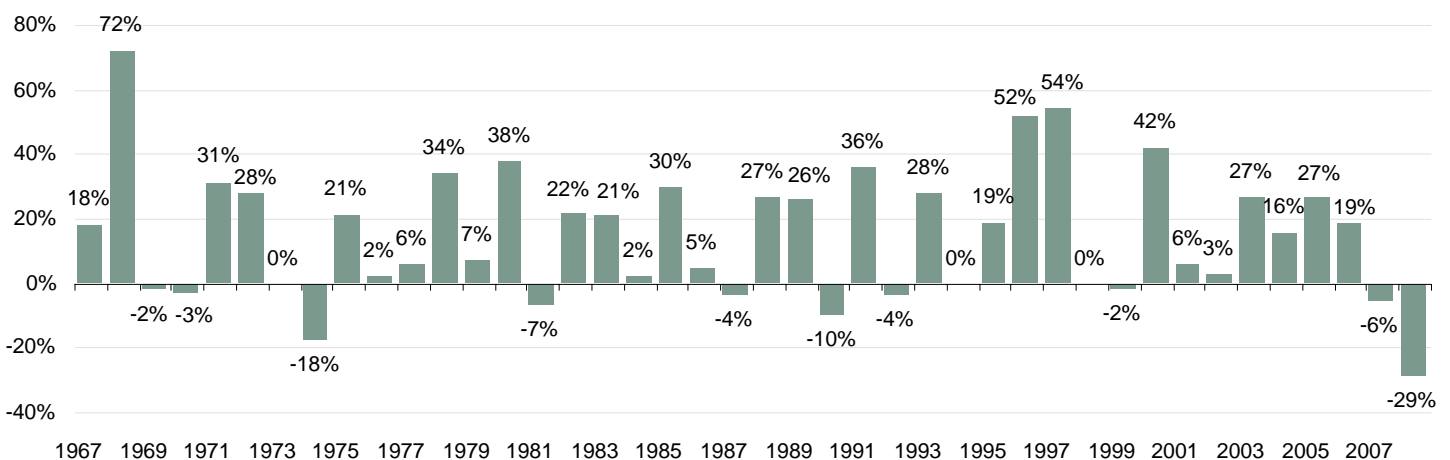
The bad news is that the headline risk and credit environment may get worse before it gets better as the world's largest economy, the United States, goes through a painful recession where many of the excesses that caused this crisis are bled out of the system.

That means headlines may report more delinquencies, foreclosures and rising unemployment in the U.S. This should undoubtedly put strain on U.S. bank stock prices and Canadian bank stocks may also be impacted. However, Warwick believes that we are less likely to see the steep declines in stock prices seen the second half of 2008. Warwick is also encouraged, because historically, Canadian bank stocks have generally demonstrated consistent performance, never having declined more than 2 years in a row. (Source: TD Asset Management Inc.)

However, we do expect short-term market volatility to continue. Warwick expects that the U.S. Federal Reserve Board (Fed) should continue to take actions to mitigate further damage to the U.S. economy. Such Fed action would hopefully restore investor confidence later this year.

For more information, contact your Financial Advisor.

Figure 1: Canadian Banks Stock performance



Source: Scotia Capital, Bloomberg LLP, TD Asset Management Inc.

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