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The most Canadian of the banks versus the most international

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What’s the matter with Canada? Maybe not so much at all, if the most Canadian of banks is also the best-performing bank stock of 2014 – and the most international bank is the worst.

Canadian Imperial Bank of Commerce, regarded as the one major bank with the most exposure to the Canadian consumer, is up more than 7 per cent year-to-date, leading its peers. The shares of the Bank of Nova Scotia, long feted for its global footprint and exposure to fast-growing emerging markets, are essentially flat, ranking last among the big banks.

To some extent, the results seem to mirror investor sentiment. Even as consumer lending is slowing, the long-forecast collapse of the Canadian housing market still has not occurred, and the stocks most sensitive to it, like CIBC, have overcome significant pessimism. At the same time, emerging markets have generally performed poorly in 2014, taking down any number of names closely linked to the global growth thesis.

It’s not just blind investor sentiment driving the performance of CIBC and Scotiabank’s shares, however. Each has, in its own recent results, earned its place at the top and the bottom of the pack in 2014 returns. CIBC reported an impressive first quarter, convincing many investors the bank is moving solidly away from its missteps in the financial crisis. Scotiabank, by contrast, continued to show little earnings growth in its vaunted international segment, denting its best-in-class growth thesis.

The result is that CIBC isn’t as cheap as it used to be, and Scotiabank isn’t nearly as expensive. But there’s a good chance the trends will continue for the remainder of the year, making CIBC worthy of a closer look, with Scotiabank relegated to more of a long-term play.

There were many reasons CIBC trailed peers as recently as last year. The bank had mostly recovered from its U.S. misadventures from a decade before when it got damaged by the 2008-09 financial crisis more badly than any other Canadian bank. Then, in 2013, it revealed its partnership with the Aeroplan credit card was unravelling. It was also revamping its mortgage business.

The bank’s first-quarter results, released in late February, easily beat analyst estimates and suggested CIBC is moving past any number of operational issues. The shares, trading around $90 before the report, have climbed steadily, closing at $96.84 Friday. The recent news that CEO Gerry McCaughey will retire, with no clear successor in place, has not stopped the rise.

“Pretty much everything went right for CIBC,” analyst Meny Grauman at Cormark Securities wrote after the earnings report. He raised his target price to $107, saying he expects CIBC’s price-to-earnings multiple to rise as the market buys into the CIBC story. “Execution appears to be strong and progress is being made.”

The analysts at ***Veritas Investment Research*** have been more bearish on the Canadian housing market than most, and that led to a “sell” rating on CIBC – until last year, when the firm began to believe analysts were being too pessimistic about the possible damage to CIBC of giving up a portion of the Aeroplan business and launching its own travel-rewards credit card.

“We viewed estimates as too low relative to the underlying earnings capabilities of the bank,” says ***Veritas*** analyst ***Kyle MacDonald***, who says that many analysts continue to overestimate the negative Aeroplan effects. The full impact will be seen in the second quarter, he says. “[Our recommendation] has worked out well so far, but the caveat is that it’s a short-term thesis.” His target price is $100.

Typical of the skepticism is RBC Dominion Securities Inc.’s Darko Mihelic, who sees CIBC missing out on $381-million in earnings in 2014 and 2015 from the loss of Aeroplan. He also believes CIBC’s retail banking revenue growth will lag peers. His post-earnings report was titled, *It Will Take More Than One Strong Quarter to Change our Thesis (But It’s a Start)*.

In arriving at his $98 target price, Mr. Mihelic assigns CIBC a price-to-earnings multiple of 10.5 on its 2015 earnings, the lowest of any of the major Canadian banks. His “upside scenario” multiple of 13.2, based on greater-than-expected economic growth in North America and a host of other positives, yields a price of $123.

Scotiabank, by contrast, can’t quite claim everything is going right. Its international segment reported loan and deposit growth, but it also reported higher expenses, including more money set aside for potential loan losses.

“International credit quality isn’t quite the same as it is back home, and with the expansion in some of these emerging markets, you’re going to get higher and bumpier provisions and credit losses,” says analyst Dan Werner of Morningstar, who has a $61 “fair value” estimate on the company shares, which closed Friday at $66.78.

Mr. MacDonald of ***Veritas***, who has a “sell” rating and $66.90 target price, said investors are finally souring on the international growth story that kept Scotiabank shares at a premium to the peer average. “Over the past year and half to two years, there actually has been no growth in the international segment. You’re seeing credit losses and expenses rising and revenue not rising fast enough to meet the headwinds they’re facing. Until it turns around – and it may – the overhang will continue on the stock.”

Mr. Grauman of Cormark, who has a “market perform” rating and $70 target price, argues that while some emerging markets are expected to grow at a faster rate than the major developed nations over the coming years, “that gap is getting smaller while the risk is getting larger.”

He says that while Scotiabank likes to emphasize that its international business is built around the more stable Latin American economies of Chile, Peru, Mexico and Colombia, Scotiabank Economics’s own forecasters believe real GDP growth in those countries will come in mostly at or below their long-term rates in 2013 and 2014 while Canada and the U.S., by contrast, will come close to meeting or exceeding their long-term growth rates in the next couple of years.

That may suggest that a close-to-home focus might finally work in CIBC's favour for at least the remainder of 2014 – and defer the Scotiabank success story for the longer term.