

RBC Dominion Securities

Canadian Banks - Risks, Longer Term Outlook and Dividend Sustainability

PORTFOLIO ADVISORY GROUP

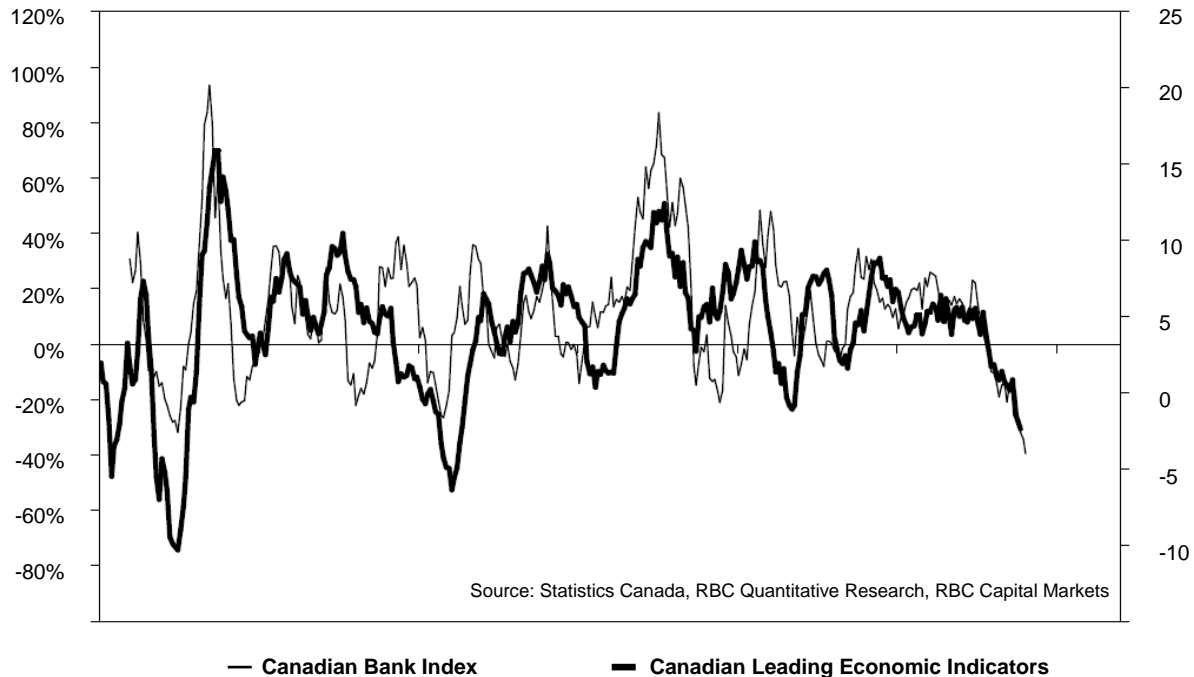
Tuesday, March 10, 2009

Canadian bank stocks remain under pressure in the face of a rapidly deteriorating economic environment and the relentless flow of negative headlines surrounding the global financial system. While our banks remain well positioned to navigate through stormy waters given their strong capital positions and the more conservative nature of their businesses, the worsening credit environment and volatile capital markets represents significant headwinds for the group and the timing of an earnings recovery is difficult to predict. We provide below a quick summary of our short and longer-term outlook for the sector and discuss the possibility of dividend cuts, a key concern for many shareholders.

Short-Term View: Expect Continued Volatility

While bank stocks have already experienced a significant correction, near-term visibility remains murky due to the high level of economic and capital markets uncertainty. In the coming months, the health of the global financial system and the success of government interventions are likely to dictate the direction of Canadian bank stocks. The key concern for banks during recessionary periods is an increase in loan losses. The length and the severity of the current economic downturn will dictate the extent of the losses the banks will incur this time around. In previous credit cycles, leading economic indicators have proven to be the best advance indicator of loan losses and bank share performance. The prudent approach for investors would be to wait for a stabilization of these indicators before buying bank stocks.

Bank Stocks vs. Leading Economic Indicators



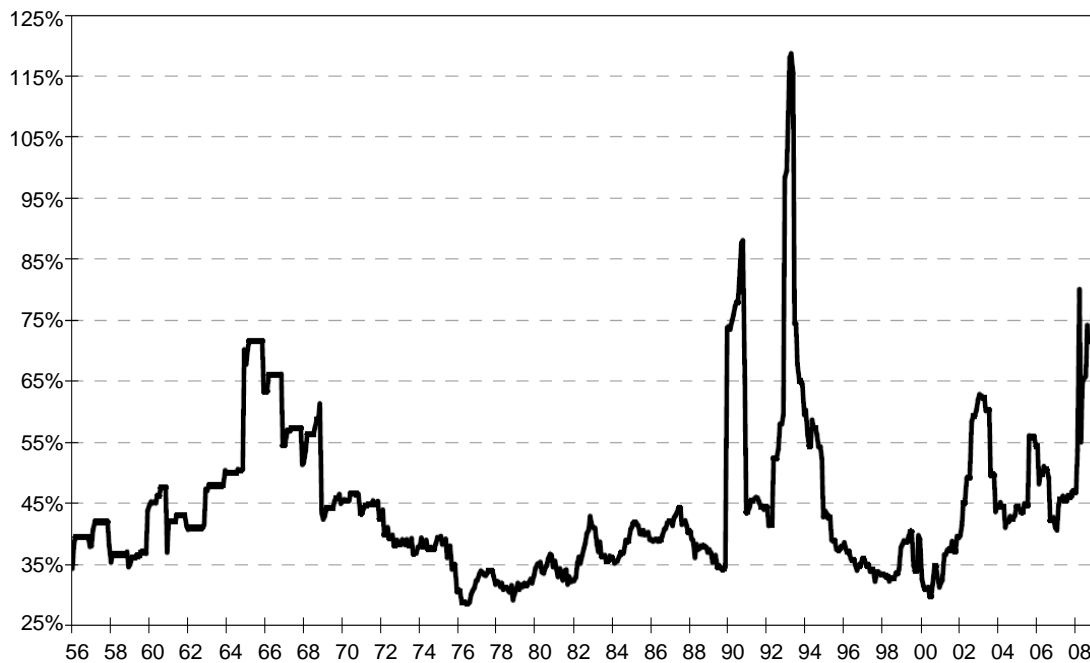
Longer Term View: Bank Stocks Could Double Over the Next Two Years

Patient, long-term investors who can tolerate short-term volatility will want to focus on the upside potential for bank stocks once we emerge from the current economic crisis. Assuming the core earnings power of the banks is not significantly impaired by dilutive capital raises, long-term normalized valuations and profitability levels suggest potential upside of 50% to 150% from current levels (based on RBC CM estimates). The timing of an economic recovery will determine when bank stocks return to these normalized valuation levels. The key risk would be a prolonged downturn (no recovery in 2010) that could force the banks to issue additional equity, diluting the earnings base for existing shareholders.

Dividends Sustainable and Likely to be Maintained in the Near-Term

The Canadian banks have an impressive long-term track record of delivering above average returns and consistent dividend growth. In fact, none of the big five Canadian banks have cut their dividends since the Second World War (National Bank cut its dividend twice, in 1982 and 1992). In the near term, banks appear unlikely to announce cuts in order to maintain their long standing record of paying dividends. Based on current capital ratios, the banks should be able to sustain loan losses consistent with the levels experienced in the downturn of the early 1990s while maintaining current payouts. Evidence of a prolonged recession (no signs that a recovery will take place in 2010 and beyond) may however lead to expectations of higher losses, which could in turn bring the banks to review their dividend policies.

Historical Payout Ratios



What Should Investors do if Banks cut their Dividends?

While dividends appear to be sustainable for now, bank boards could decide to be conservative and announce a temporary reduction or suspension of dividends. Markets are likely to react negatively to such an announcement, at least initially, since the decision may be perceived as a sign that the banks expect further weakness, and income-focused investors may sell their shares. In our view, investors should prepare for the possibility of a dividend suspension and consider the longer-term benefits that such a decision could have for shareholders. A temporary dividend suspension would materially increase internal capital generation and thereby reduce the need for banks to raise capital if loan losses and writedowns prove greater than in the early 1990s. Suspending dividends would also reduce the banks' risk profile, which could in turn lower its cost of funds. That being said, investors who rely heavily on bank dividends for their income needs should know that there is a possibility that dividends could be cut, and may want to consider switching some of their bank holdings into a more diversified income-oriented portfolio.

Are Preferred Dividends at Risk?

The likelihood of a Canadian bank cutting its preferred dividend appears remote at this point. However, the consequences of a potential suspension of common stock dividends on the preferred market may be a concern to some investors. A common dividend cut should, at least in theory, be good news for preferred shareholders. The decision would lower the risk profile of the bank and leave more cash to service the preferreds. In reality, the announcement of a common dividend reduction would likely cause sentiment to deteriorate and could trigger a sell-off in preferreds on concern that the shares are next in line should the banks need to further shore up their capital position. A temporary reduction of common dividends rather than a complete suspension would likely be a more favourable outcome for preferred shares, leaving investors with a sense of confidence that their dividends will be maintained.

Bottom Line:

Canadian bank stocks would offer significant upside potential in the event of an economic recovery. However, a prolonged downturn (no economic recovery in 2010) would likely lead to significant loan losses and could force banks to raise additional equity, which would be dilutive to existing shareholders and would compromise the recovery potential. The prudent approach for investors would be to wait for signs of an economic recovery before adding to positions. Existing shareholders who rely heavily on bank dividends for income should be aware that dividend cuts, though unlikely at the moment, remain a possibility in the future and may actually hold longer-term benefits for shareholders. These investors should consider alternate strategies for income-generation, including a switch to a more diversified portfolio of dividend paying stocks.

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	Count	Percent	Count	Percent
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