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Sector:
Portfolio Strategy

August 30, 2024 **Industry Update**

The "When" For Canadian High Dividend Stocks Is Now

Unwinding Of Excess Term Deposits Is Beginning

Our Conclusion

The rapid rise in interest rates in 2022 and 2023 significantly improved the appeal of term deposits (and various short-term fixed income products) vis-à-vis high yielding Canadian equities.

With rates now heading lower, we expect to see continued rotation from these fixed income products into high yielding Canadian equities, resulting in outperformance for REITs, Utilities, Telecoms and Financials.

Key Points

We have previously shown there has been "excess" funds flow into term deposits on bank balance sheets over the past two years. We estimate the excess funds in fixed income products in Canada (inclusive of money market and HISA products) at over $200 billion currently. With falling rates, it makes intuitive sense that some of this will reverse – but also reasonable to ask "when" will this occur?

We reviewed funds flow of Canadian bank term deposits over the past 35 years to gain insight into the likely timing of outflow as interest rates fall. Specifically, there have been four periods of meaningful term deposit outflows – on average, they occurred 350-400 days after the peak in 3-month bill and 2-year bond rates in Canada. Interestingly, these two rates actually peaked in October 2023 and have been falling since.

We believe high dividend paying Canadian stocks have been a more "natural" traditional home for these funds. Dividends have tax advantages over interest income, and stocks have the benefit of dividend growth over time. Sectors such as REITs, Utilities, Telecoms and Financials have added appeal of better-than-average business and earnings stability.

The relative yield of these stocks (when compared with 2-year government rates) is becoming increasingly attractive. We are now largely back above the zone which accelerated flow into term deposits, and if rates fall further as we expect, fund flows should reverse.

All figures in Canadian dollars unless otherwise stated.

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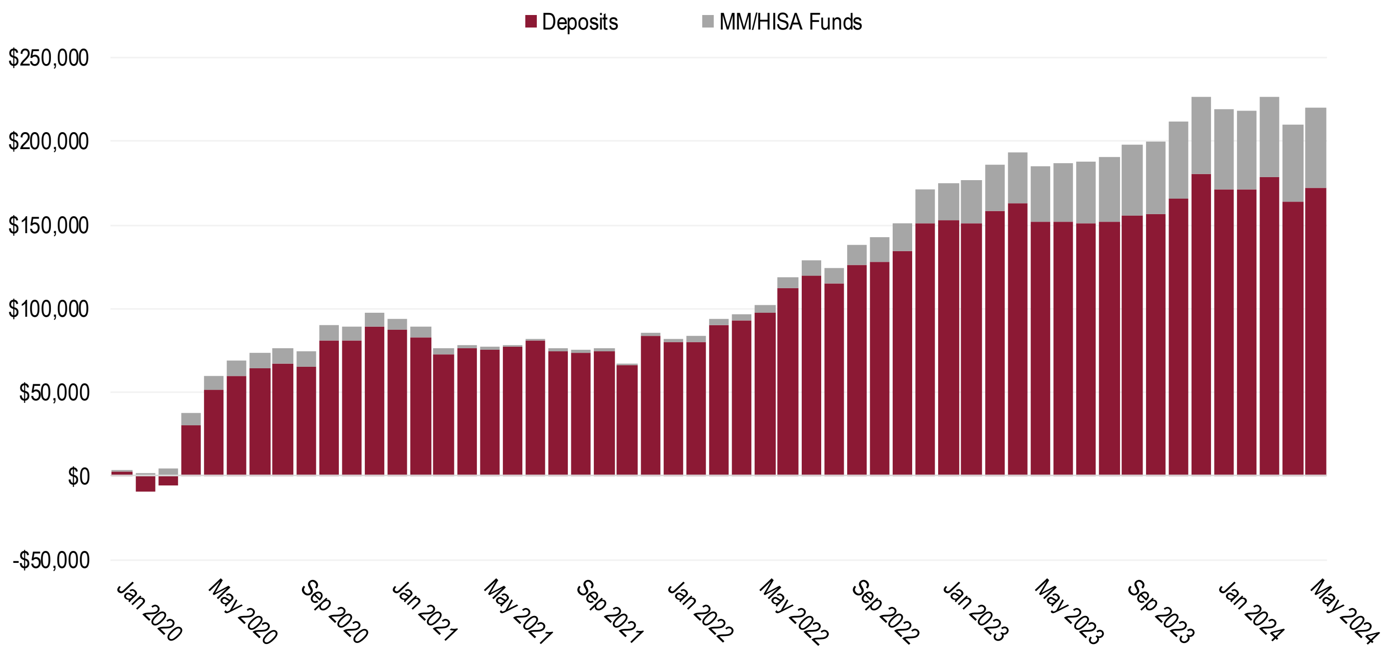
Excess Funds In Fixed Income Products In Canada

Over $200 billion in excess fixed income in Canada.

In a report last month, we highlighted there is almost a quarter of a trillion dollars of “excess” funds sitting in short-term fixed income instruments in Canada. This includes both money market and High Interest Savings Account (HISA) ETFs and mutual funds, as well as in term deposits sitting on bank balance sheets. This is shown in the bar chart in Exhibit 1. For more details on how we quantified these amounts, please see **link**.

Exhibit 1: Excess Yield Liquidity In Term Deposits And Money Market Funds, December 2019 To May 2024



Note: MM/HISA Funds include Money Market and High Interest Savings Account mutual funds and ETFs.

Source: Bank of Canada, Lipper and CIBC World Markets Inc.

To state the obvious, it is the spike in interest rates which has stoked disproportionately strong funds flow into these products. As we have detailed, a more traditional home for these funds would be high dividend yield, low volatility stocks listed on the S&P/TSX. Remember, equity yields on several (relatively) stable businesses are quite high, and upper income Canadians (who are disproportionately large holders of term deposits) incur lower tax rates on dividend income than on interest income. A simplified rule of thumb is a 4% dividend yield is currently equivalent to a 5% interest coupon, when taxes are considered at the highest tax bracket.

Falling interest rates will improve the appeal of big dividend payers.

In our opinion, a decline in rates at the pace we are suggesting (see Appendix 1 for CIBC Economics Forecasts) should drive investors back into Canadian dividend paying stocks – particularly since many of these equities have performed poorly vis-à-vis the broader market, over the past couple of years.

In this analysis, we focus **only** on the bigger component of the excess funds, i.e., term deposits (really Guaranteed Investment Certificates (GICs)) on bank balance sheets, which make up $170 billion of the $220 billion of excess fixed income holdings.

However, there are two crucial questions investors will reasonably ask even if meaningful interest rate declines over the next 18 months are viewed as inevitable. Namely, 1) When will the funds meaningfully move out of term deposits? and 2) What rate (in absolute or relative terms) is needed for the flowback to occur in earnest? Neither of these questions can be answered definitively, but in our view it is highly likely that what was a headwind for REITs, Utilities, Communications and Financials in Canada will become a tailwind in the coming quarters.

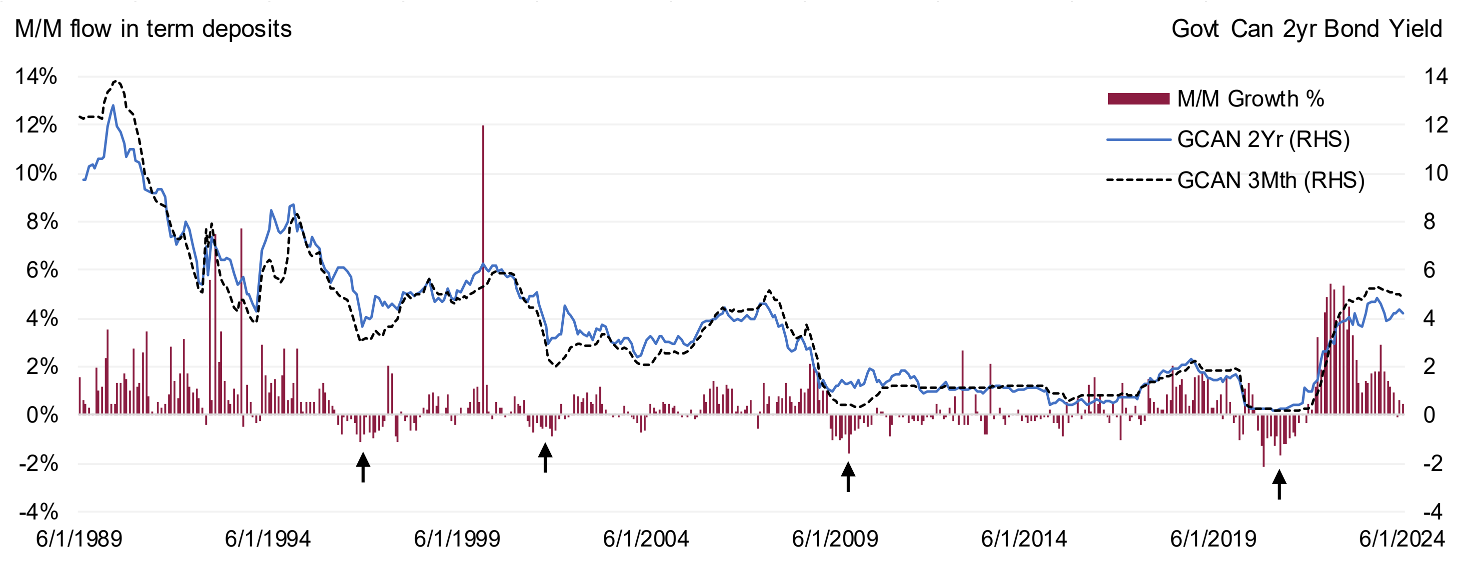
It Takes Time For Money To Flow

Even in today’s world of sharp price moves, money flow takes time. In Exhibit 2, we show the monthly percentage growth rate of Canadian Bank term deposits over the past three plus decades. On average, term deposits on bank balance sheets grow at 0.6% a month – this modest “typical” growth simply reflects growth in the Canadian economy and the wealth of Canadians. Note, however, the month to month changes are quite volatile, and there is some seasonality with a modest surge in February and March coinciding with Registered Retirement Saving Plan (RRSP) deadlines.

High rates boost term deposits, and vice versa.

In Exhibit 2, we also show the level of interest rates on Canadian government three-month bills and two-year bonds. As is clear, inflows and outflows are affected by changes in interest rates, though the impact is not instantaneous. Note the significant spike recently, as well as four periods (highlighted by arrows) of meaningful term deposit outflows over the past 35 years. The outflows invariably followed declines in shorter term rates.

Exhibit 2: Canadian Term Deposits – Month-over-month Flows And Govt. Of Canada Interest Rates, 1989-2024



Note: Bars show the monthly percent change in term deposits at Canadian banks, and the arrows highlight periods of meaningful outflow.

Source: Bloomberg, FRED, Bank of Canada and CIBC World Markets Inc.

Unquestionably, interest rates are the overwhelming factor affecting term deposit flows (based on statistical regressions, interest rates actually only explain 50%-60% of the monthly percent changes in term deposits), but the change in rates does not instantly drive flows, one way or the other.

Things take time.

The most obvious timing issue is that term deposits are just that, “term” products. Many have penalties for early redemption (assuming they are even cashable) so are often held to maturity, even if interest rates move meaningfully in short time periods. To say nothing of the lethargy of some individual investors.

Context is always important when it comes to investment decisions. The four periods of outflows we highlighted in Exhibit 2 all followed material declines in interest rates. As well, all occurred around periods of stock market turmoil. The year 1994 was a difficult one for equity investors, and took over a year before term deposit flows went negative (Period 1). Despite the Nasdaq collapse (and the specific impact of the failure of Nortel) in the early part of the century, it still took 300 days from the start of rate declines to see deposit outflows (Period 2).

The Financial Crisis (Period 3) had a material impact on investor psyche and it took almost two years before investors migrated out of term deposits. Most recently, the COVID movement was relative quick but that was because there was no discernable benefit to duration given the shape of the curve, i.e., the money that went into term deposits during COVID likely skewed to shorter periods, which would have made them more liquid. Each environment was different, but it is clear a sharp decline in interest rates will typically result in an unwinding of excess in bank term deposit books, albeit with some time lag.

In Exhibit 3, we simply tabulate the four periods highlighted in Exhibit 2, and also show the current timeline of changes in interest rates on 3-month bills and 2-year bonds. There is no homogenous GIC rate and there is no single interest rate that determines term deposit pricing, but we believe these two interest rates are extremely important.

2-yr and 3-mth rates actually peaked about a year ago.

What is interesting is that, on average over those four periods, banks experienced term deposit outflows between 350-400 days after the peak in these two interest rates. It is now over 300 days since these rates peaked (see Appendix 2). Of course, we are assuming that the current downward trajectory of rates continues.

Exhibit 3: Net Outflow Periods – Length And Interest Rate Declines, 1995-2024

Period	Peak 2yr Date	Outflow* Date	Length Date	Peak 2yr Rate	Outflow* 2yr Rate	2yr Rate Decline	Peak 3mth Date	Outflow* Date	Length Date	Peak 3m Rate	Outflow* 3m Rate	3m Rate Decline
1	2/1/1995	4/1/1996	425 days	8.69	6.11	-2.58	3/1/1995	4/1/1996	397 days	8.31	5.01	-3.31
2	6/1/2000	4/1/2001	304 days	6.20	4.71	-1.49	6/1/2000	4/1/2001	304 days	5.92	4.60	-1.31
3	8/1/2007	4/1/2009	609 days	4.62	1.08	-3.55	9/1/2007	4/1/2009	578 days	5.12	0.90	-4.22
4	1/1/2020	8/1/2020	213 days	1.70	0.27	-1.43	1/1/2020	8/1/2020	213 days	1.91	0.26	-1.66
		Average	**388 days**			**-2.26**		**Average**	**373 days**			**-2.62**
Current	9/20/2023	8/29/2024	344 days	4.973	3.295	-1.68	10/16/2023	8/29/2024	318 days	5.169	4.205	-0.96

Note: *Outflows have not yet turned negative for the current period. As such, the current period “outflow date” is simply today’s current date.

Source: Bloomberg, FRED, Bank of Canada and CIBC World Markets Inc.

To be clear, we are not suggesting Canadian investors are limited to two investment products – term deposits and dividend paying equities. There are a variety of alternatives within the fixed income and equity markets, to say nothing of global alternatives (Nasdaq stocks, for example, have been tremendous recent winners) and Real Estate, and even good-old-fashioned consumption!

We don’t actually need outflows. Just no more term deposit inflows, please!

However, it is reasonable to assume that the spike in interest rates and the proliferation of new investment products has had a negative impact on the relative appeal of Canadian dividend payers. Even if term deposits were simply flat, i.e., no inflow, the incremental wealth of Canadians will drive the general demand for investment products.

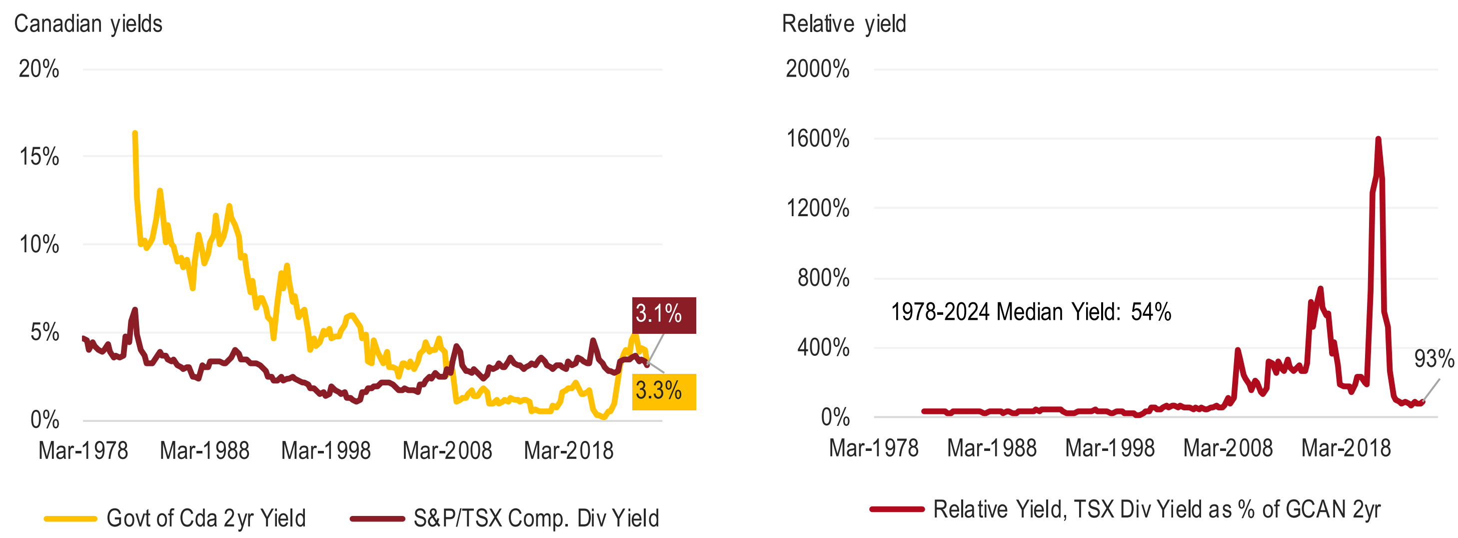
We believe some income is already searching out high yielding Canadian stocks (witness recent strength in some “left behind” GICS sectors), even though term deposits are yet not declining. It is our expectation this trend will accelerate, at least for those conservative investors who were attracted to term deposits, in the first place.

The Level Of Interest Rates Also Requires Context

From the previous section, if history repeats itself and if rates continue to fall in Canada, it is reasonable to assume term deposits will decline. The question is where does that money go? For dividend paying stocks to be relative winners, they can’t simply offer yield – they must offer attractive “relative yields”.

As always, context matters. Dividend yield on the S&P/TSX has varied substantially over time. As we show in Exhibit 4 line charts, there have been occasions when the Canadian equity yields has approached 5% – more often that not during significant market corrections. For most of time before the Financial Crisis, the dividend yield on the S&P/TSX was about half of the yield on 2-year Canadian Government Bonds, e.g., when 2-year rates were 6%, equity yield tended to about 3%!

Exhibit 4: Relative Yields – S&P/TSX Composite Dividend Yield And Govt. Of Canada 2-yr Bond Yield, 1978-2024



Source: Bloomberg, TSE and CIBC World Markets Inc.

Typically, dividend yields are less than government rates.

As is obvious from the chart on the right of Exhibit 4, the uber high “relative” yield only became commonplace when interest rates dropped below 4%. It is almost as if equity investors said, “whatever the level of interest rates, we need some base dividend yield to entice equity ownership”. Our point is that the S&P/TSX dividend yield today looks cheap relative to the yield on bonds over the past 50 years, but no where as cheap as when rates were unusually low.

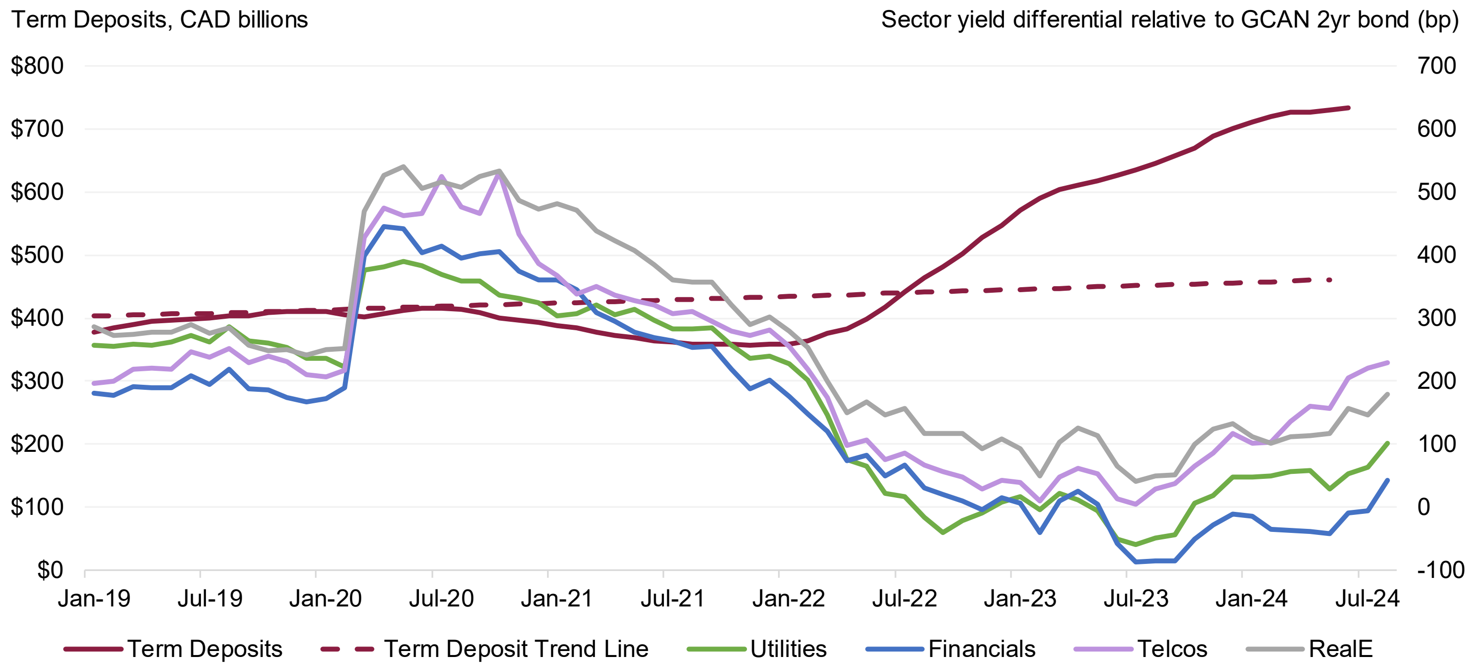
From our perspective, the issue with comparing the S&P/TSX yield with that of the government fixed income market is there is obviously much more risk in equities. A 2-year government bond will mature at par and investors will get all their money back. Equities have “no maturity date” nor a money-back guarantee. The trade-off is that dividends can (and typically do) grow, while the coupon and principal repayment is the maximum an investor can hope for, on a government bond. To say nothing of the fact that buybacks have somewhat displaced dividends in Canada, further tilting the playing field in favor of dividend paying equities.

As the saying goes, over the long term, we are all dead anyway. So, while we argue for the relative appeal of equity yield over the past half century, the reality (as highlighted by the dramatic inflow into term deposits and the underperformance of yield stocks over the past two years) is high dividend S&P/TSX sectors lost some of their appeal given the spike in rates.

A crude way to consider the relative appeal of dividend paying stocks (REITs, Utilities, Telecoms and Financials) is to look at the differential between their yield less the yield on 2-year government bonds. This is shown in Exhibit 5 and we also overlay the level of Canadian bank term deposits, as well as a line showing the historical growth rate.

Note that when the yield differential between these sectors was somewhere between 100 bps-200 bps, term deposit growth turned meaningfully higher – and inflows continued as yield differentials essentially disappeared, i.e., the yield on GICS stocks offered no premium to the 2-year rate. In our opinion, we are currently at an inflection point of dividend yield for these sectors and interest rates.

Exhibit 5: Term Deposit Growth And Yields Differential Across Select Sectors Vs. Gov't Of Canada 2-yr Bond Yield, 2019-2024



Source: Bank of Canada, Bloomberg and CIBC World Markets Inc.

Conclusion

Investors are not homogeneous. Some are extremely risk adverse, and won't ever shift GICs into dividend paying stocks. Some GICs are index linked, so investors do get some equity upside. Furthermore, GICs can be held in RRSPs so the tax advantage of dividends is irrelevant. Of course, rates could move higher – contrary to our expectations.

We believe money flow into dividend paying stocks is just beginning.

Our argument is as follows:

1. Term deposit levels in Canada (we have ignored money market levels, which also appear high) are significantly elevated.
2. Yield sectors have lagged for some period.
3. The "excess" level of term deposits is large vis-à-vis the market capitalization of high yielding sectors.

If interest rates fall as we expect, what was a material headwind should turn by 180 degrees and provide support for REITs, Utilities, Telecoms and Financials. We expect these sectors to outperform in the coming quarters.

Money flow is only one component of relative equity performance. Poor underlying business performance can swamp money flow, if results are bad enough. Telecoms are certainly experiencing elevated levels of competition, and a changing regulatory environment. Some REITs are facing a less positive outlook given the long-term effects of COVID on work and consumption. Utilities are dealing with a shift in the types of power generation.

Financials are likely to be the biggest winners.

From our perspective, the Financials offer the clearest outlook. Recent bank results highlight the strength of the domestic P&C business, and life insurers seem able to manage through the changing rate environment. As such, we expect most flow into these traditional outperformers.

Appendix 1: Canadian Interest Rate Forecast

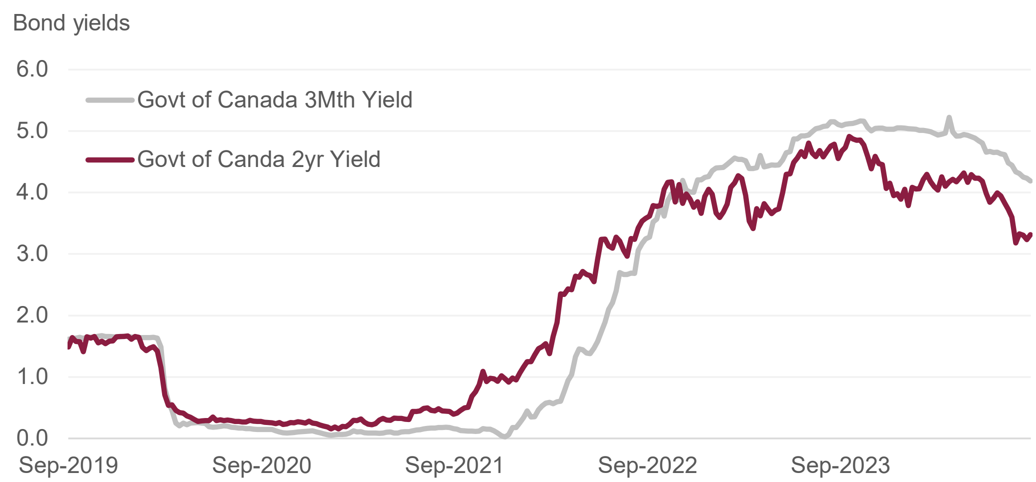
Exhibit 6: Canadian Government Bond Forecasts, September 2024 – December 2025

Interest Rate Forecast	9/30/2024	12/31/2024	3/31/2025	6/30/2025	9/30/2025	12/31/2025
3 Month Treasury Bills	4.15	3.60	3.00	2.90	2.70	2.50
2 Year Govt Bonds	3.35	3.10	2.90	2.80	2.70	2.80

Source: CIBC Economics

Appendix 2: Canadian Interest Rates

Exhibit 7: Interest Rates – Canadian Government Yields, Last Four Years



Source: Bloomberg and CIBC World Markets Inc.

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