This Is a Golden Opportunity to Buy Canadian Banks

Description

These days there are plenty of reasons to hate Canadian banks. Our economy is likely in recession, housing prices remain elevated, consumer debt levels are at record levels, and interest rate cuts will eat into margins. Come to think of it, why would anyone want to buy the banks at all?

Well, as we all know, sometimes the best time to buy a stock is when it's most unpopular. And this time is no exception. We take a closer look at **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) in particular.

Proven stability

There's no denying that the Canadian economy is in bad shape mainly due to low oil prices. The country's GDP contracted by an annualized 0.6% in the first quarter, and negative growth is expected for this quarter, too. And that's created plenty of concerns for the banks—chief among them, will a bad economy lead to a wave of loan defaults?

To answer that question, let's look at what happened during Canada's recession in 2008 and 2009. At the time, loan losses did increase meaningfully for both RBC and TD in their Canadian banking operations. RBC's provisions rose by over 60% from FY2007 to FY2009, and TD's rose by 90% over the same time period. Yet each of the banks reported *increasing* income in their Canadian banking operations during those same years. Clearly the increased loan losses didn't have too much of an impact on the bottom line.

The same could be said today. Both RBC and TD have very strong risk-management practices, especially in the domestic market. So, while a recession in Canada would certainly slow them down, you shouldn't expect big losses to pile up.

A note on lower interest rates

The Bank of Canada has just lowered its benchmark interest rate from 0.75% to 0.5%, which will certainly compress the banks' margins. But this interest rate decrease isn't all bad news for a couple of reasons.

First of all, if Canadians are paying less interest, then loan defaults won't be that high. Secondly, lower interest rates will make investors more desperate for yield. So, the Canadian banks' dividends should look a lot more attractive, giving a boost to their stock prices.

A decreasing share price results in a bigger yield

Without a doubt, the two banks are experiencing some headwinds. But the fall in their share prices is an overreaction. To illustrate, RBC and TD shares have fallen by 5.5% and 6.7% respectively since late November. During that period, both companies have been growing their earnings steadily.

As a result, RBC and TD now trade at a very reasonable 12 and 13 times earnings, respectively. A year ago these numbers were much higher. Better yet, RBC and TD have been steadily increasing their dividends, both of which now yield close to 4%.

So, even if neither RBC nor TD increase their earnings, which is what happened during the last recession, you can collect some juicy dividends while waiting for these stocks' multiples to expand.

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1. Bank Stocks
2. Investing

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1. Editor's Choice

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