Has the Rally Ended for Canada's Banks?

Description

For the following discussion, I'll use **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) and **Bank of Montreal** (TSX:BMO)(NYSE:BMO) as examples.

The banks aren't overpriced

Bank of Nova Scotia's normal long-term multiple implies the bank is fairly valued above $70, indicating that under $63, the bank has a 10% margin of safety. Bank of Montreal's normal long-term multiple implies the bank is fairly valued above $80, indicating that at $78, the bank is essentially at fair value.

Technically, though, the banks had a sharp rally in a relatively short time. In the short span of three weeks from early March, Bank of Nova Scotia rallied 14% from the $56 level to the $64 level before starting to head down after being overbought.

Likewise, in the same period, Bank of Montreal rallied 5% from the $75 level to the $79 level before heading down. Bank of Montreal had a higher price-to-earnings ratio than Bank of Nova Scotia at the start of the rally, so naturally Bank of Montreal's rally was weaker than Bank of Nova Scotia's.

What will affect the banks' prices?

The energy and basic material sectors are a big part of the Canadian economy. With low commodity prices resulting in slow-growth (or worse, negative-growth) economy, it doesn't bode well for the Canadian banks, which generate a big portion of their profits in Canada.

For example, Canadian real estate investment trusts (REITs) with office properties in Alberta have seen falling rent and higher vacancies. At least two of these REITs are looking to sell all or part of their office portfolios in Alberta.

If they thought oil prices were going to improve in the next year (resulting in higher occupancies again), they wouldn't be looking to sell their assets at today's low prices.

Conclusion: What you can do

If you hold shares in any of these banks, you've got to ask yourself why you bought them in the first place. Did you buy them for the long term to maintain your purchasing power against inflation? Did you buy them for the yield? Or did you buy them for a trade?

If you're a long-term investor who got in at a good yield of say 5-5.5%, you're already maintaining your purchasing power because the long-term inflation rate is 3-4%. This means that you can essentially ignore the short-term price volatility and just collect your juicy dividends.

If you don't own any shares but are looking to buy the banks, they will likely go further down in the short term. For example, you can start buying Bank of Nova Scotia at or below $57 and Bank of Montreal at or below $67 for a 5% yield or higher.

CATEGORY

1. Bank Stocks
2. Dividend Stocks
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TICKERS GLOBAL

1. NYSE:BMO (Bank of Montreal)
2. NYSE:BNS (The Bank of Nova Scotia)
3. TSX:BMO (Bank Of Montreal)
4. TSX:BNS (Bank Of Nova Scotia)

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Date
2025/08/24
Date Created
2016/03/25
Author
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