Royal Bank of Canada: Time to Buy the Pullback?

Description

Royal Bank of Canada (TSX:RY)(NYSE:RY) is starting to catch a new tailwind after the recent drop.

Let's take a look at the current situation to see if the stock deserves to be in your portfolio.

Housing market

Canadian banks and mortgage companies have been under pressure in recent weeks amid fears the troubles faced by **Home Capital Group Inc.** (TSX:HCG) might signal the start of further pain across the industry.

The housing market has been in focus for some time, and pundits from all sides claim the upward price trend is simply unsustainable. The longer it runs, the greater the likelihood of a painful correction.

Vancouver and Toronto have already implemented hefty taxes on foreign buyers, and the Canadian government has put tighter restrictions in place to help minimize the number of high-risk buyers.

Home Capital's problems have simply stoked the existing fear.

Should bank investors be worried?

The Home Capital crisis appears to be more of a confidence issue, rather than a concern over the performance of the loan portfolio.

What's the scoop?

The Ontario Securities commission claims Home Capital misled investors when handling problems with falsified loan applications. The announcement triggered a run on the lender's deposits, and that has forced the company to secure an expensive credit line and consider options, including a sale of the business.

Residential mortgages are a large part of the loan book for all of the Canadian banks, so it is easy to see why there has been a knee-jerk reaction.

However, there is reason to believe the Home Capital issue is company specific, and fears about a potential for a spillover effect on the big banks, including Royal, might be overdone.

Why?

Royal Bank finished fiscal Q1 2017 with $244 billion in Canadian residential mortgages. Insured loans represent 46% of the portfolio, and the loan-to-value (LTV) ratio ranges from 47% in B.C. and the territories to 63% in Quebec. The LTV in Ontario is 50%.

As a result, house prices would have to fall significantly, and over a short period of time, before Royal Bank takes a material hit. Most pundits expect a gradual reduction in home prices.

A run on the bank's deposits would be very unlikely, and in the event of a shock, Royal Bank is well capitalized with a CET 1 ratio of 11%.

Diversified revenue

Royal Bank has a balanced revenue stream that includes wealth management, capital markets, personal and commercial banking, and insurance operations.

The company is also expanding its operations in the United States.

Broad-based economic weakness would certainly hit the bank, but it is not at the same risk as the alternative mortgage lenders.

Dividend

Royal Bank has a strong track record of dividend growth. The payout should be very safe and provides a yield of 3.7%.

Should you buy?

The stock is still up more than 20% in the past 12 months, so the pullback in the recent weeks is relatively small when we look at the big picture.

As a buy-and-hold pick to stick in an RRSP for a decade or two, the bank should be fine, but I wouldn't back up the truck right now.

Fears about the Home Capital crisis might be overblown, but the broader market is probably overdue for a healthy correction, and a better entry point might be on the way.

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Date
2025/08/26
Date Created
2017/05/10
Author
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