



Is Now the Time to Buy Canada's Biggest Banks?

Description

A stark difference in monetary policy in recent years from the Bank of Canada has been a marked divergence from the U.S. Fed in terms of the direction of interest rate moves. The Bank of Canada cut rates in recent years to help soften the blow to the Canadian oil and gas industry following a relatively catastrophic drop in oil prices in the face of the United States beginning a rate-hiking schedule. The specific policy has led the Canadian dollar to depreciate significantly against the U.S. greenback in a relatively short amount of time.

This drop in the value of the Canadian dollar has not had as significant an impact on Canadian banks that one would think; while domestic banks tend to perform better when the domestic currency appreciates in value relative to the world, Canada's biggest banks are unique in that most banks have significant exposure outside Canada, effectively hedging the difference.

With banks such as **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)) having the majority of its locations outside Canada, and most banks making a shift to the U.S. market in search of higher returns and increased growth prospects, some laggards such as **Canadian Imperial Bank of Commerce** ([TSX:CM](#))([NYSE:CM](#)) seem to have been more affected in this regard.

For Canada's banks, what can't be disputed is the potential impact of rising interest rates.

While interest rates are linked very closely to the Central Bank's posted overnight rate, the reality is that government bond rates and other factors play into the effective borrowing rate that banks see, rates which are then passed on to consumers via the rates banks charge borrowers for mortgages, loans, and other products.

The spread a bank is able to make between what it is able to borrow at (linked to the overnight rate, government bond rates) and what it is able to lend at (market rates for mortgages, loans) tends to increase as interest rates increase. A bank can simply charge a higher spread at 10% than it can at 3%, and thus bank profits stand to increase during a period of rising interest rates.

Similarly, other industries, such as utilities and high-yielding securities, which are viewed by financial markets as bond proxies, tend to underperform the market in times of rising interest rates.

Investors in financial-related securities will keep a close eye on such interest rate movements, as increases in interest rates have broad direct and positive benefits for financial institutions. Positive news such as rising rates may, however, be offset by worries that rising rates could pop Canada's inflated housing bubbles (or at least pop specific bubbles related to metropolitan areas such as Toronto and Vancouver).

Due to these concerns, Canada's largest five banks have each seen market capitalizations decline of late as worries related to the country's overheated housing market and a continued oil slump have provided headwinds.

In particular, CIBC has dropped substantially over the past three months, dropping more than 12% from a peak of \$120 per share in March. By most traditional fundamental metrics, CIBC is vastly undervalued compared to its peers, and value investors have continued to salivate over the recent price depreciation of CIBC stock during this time.

Though the recent PrivateBancorp deal has been approved, adding a much-needed U.S. presence to CIBC's portfolio, the bank is still heavily reliant on strong performance from the Canadian economy — a fact which has dragged down many of the banks of late.

Bottom line

For investors considering adding to a position or initiating a new position in Canadian banks, I would focus the time and energy on digging into the asset portfolio of each respective bank, with specific focus on how assets are geographically spread out. I have been wary of CIBC for some time, and continue to be given the current economic situation in Canada related to housing and oil. As such, I believe Toronto-Dominion Bank is much better suited to handle an environment in which interest rates may rise, and the Canadian economy may underperform its global counterparts for some time.

Stay Foolish, my friends.

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