



What Is the Impact of Rising Interest Rates on Bank Stocks?

Description

Last month, the Bank of Canada raised its overnight interest rate to 0.75%, the first hike since 2010. There is a high probability that this rate will be hiked again before the end of the year. What does this mean for bank stocks?

When interest rates rise, so will net interest margins

Rising interest rates signal a strengthening economy, which usually means that borrowers have less difficulty making loan payments and banks have fewer non-performing assets. It also means that banks can get higher net interest margins — the spread between what they pay to deposit holders and what they can earn in interest from highly rated debt like treasuries.

When the Bank of Canada raises its rate, banks raise their prime lending rate — the rate that banks charge their most creditworthy customers — by the same percentage. But they lift less than the rate that they pay on deposits, so they earn a larger spread between the rates at which they lend and the rates they pay depositors. Higher interest rates are thus going to increase banks' earnings, which should boost their share prices.

Despite the effects of low oil prices and a cooling housing market, Canadian banks are on solid ground due to strategic allocation of capital to higher-return businesses and cost reductions through technological upgrades and improved operational efficiency.

Two big banks that will profit from the rise in interest rates

Royal Bank of Canada ([TSX:RY](#))([NYSE:RY](#)) and **Canadian Imperial Bank of Commerce** ([TSX:CM](#))([NYSE:CM](#)) are among the big banks that are going to benefit from a rise in interest rates, and their stocks prices should go up.

RBC is Canada's biggest lender with more than \$1.20 trillion in assets.

Last week, RBC reported an increase in third-quarter earnings, helped by gains in its core Canadian banking unit and double-digit earnings growth at its wealth management business, which offset weaker

earnings in capital markets.

The bank reported net income, excluding one-off items, of \$2.8 billion for the quarter ended June 30, up 5% over last year. Earnings per share, excluding one-off items, were \$1.89. Analysts had, on average, anticipated earnings of \$1.87 per share. Earnings per share are expected to grow at a rate of 9.5% this year, 5.4% next year, and 7.35% during the next five years (per annum).

RBC pays a quarterly dividend of \$0.91 by share for a yield of 3.9%. Its share price has a forward P/E of 12.4.

CIBC also reported its third-quarter results last week. Canada's fifth-biggest lender reported better-than-expected earnings.

Earnings per share, excluding one-off items, increased to \$2.77 in the third quarter from \$2.67 a year ago. Analysts had, on average, anticipated earnings of \$2.66 per share. Earnings per share are expected to grow at a rate of 6% this year, 1.3% next year, and 2.32% during the next five years (per annum).

CIBC is focused on boosting profitability through personal and commercial banking, its largest and most important operating segment, by improving its client service. The bank is also developing its wealth management segment and has had success recently, increasing assets under management by selling more long-term mutual funds.

CIBC pays a quarterly dividend of \$1.3 by share for a yield of 4.9%. Its share price has a forward P/E of 9.72.

I have no doubt that, like other Canadian banks, RBC and CIBC will continue to post stronger quarters in the years to come, helped by rising interest rates. Nevertheless, I think RBC's stock is a better buy right now, since it has less exposure to the Canadian housing market than CIBC. In addition, RBC has more diversified sources of income and better growth prospects.

CATEGORY

1. Bank Stocks
2. Dividend Stocks
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