Why it Might Be Wise to Steer Clear of Bank Stocks and Other Lending Companies

Description

As interest rates continue to rise, borrowers are faced with rising costs, which could increase the risk of default. Although interest rates are still very low, many homeowners that locked in mortgages before the rate hikes occurred could see their costs rise when it comes time to renew.

Other consumers that are on variable rates have already seen their costs increase, although buyers on variable rates are subject to more difficult stress tests, making that segment less of a risk for financial institutions.

On Monday, MNP Ltd. released a survey which found that some Canadians claim to have already been impacted by the rate hikes, and 42% of those surveyed expressed concerns about having to go further in debt just to cover basic expenses.

The president of MNP, Grant Bazian, stated in a new release, “It’s clear that people are nowhere near prepared for a higher rate environment.”

What this means for lenders

With many Canadians already stretching their incomes to meet day-to-day needs, consumers with heavy debt loads could pose a significant default risk to banks and other lending companies. **First National Financial Corp.** (TSX:FN) is a non-bank lender with both corporate and residential customers and is one stock that could be adversely impacted from rising rates.

Commercial borrowers present a significant risk as well, and companies like **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) that carry lots of debt could see borrowing costs put further pressure on their financials. Valeant is also close to breaching its debt covenants, and further rate increases could put the company’s ability to meet those obligations in jeopardy.

Tighter mortgage rules will make financial stocks less appealing

Not only will lenders face a higher risk of default from borrowers, but the pool for new loans and mortgages will also be lower. Rising interest rates coupled with harsher stress tests for residential mortgages will likely result in banks and other lenders issuing fewer mortgages to consumers.

Although bank stocks have seen strong growth over the years and in recent quarters, that tide may be turning. In its most recent quarter, **Royal Bank of Canada** (TSX:RY)(NYSE:RY) saw its revenue from loans and leases rise 4% from the previous year, while **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) saw that segment grow by 12%.

In the trailing 12 months, over 80% of CIBC's total interest income has come from loans and leases, while it has made up 70% of Royal Bank's total. Banks certainly have a lot to lose if mortgages and loans start to decline, which, at this point, seems to be an inevitability.

Why investors should avoid financial stocks today

Although banks are generally safe investments and, over the long term, are able to see strong and stable growth, many are at or near all-time highs. A financial crisis could send the stocks for a big correction, and it may be a good time to sell any gains from financial investments before that time comes.

Not only are we facing a time when interest rates are rising, but consumer debt levels are going in the same direction as well. Oil and gas companies in Alberta are still fragile, and we could see even more corporate bankruptcies come as a result of more rate hikes.

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