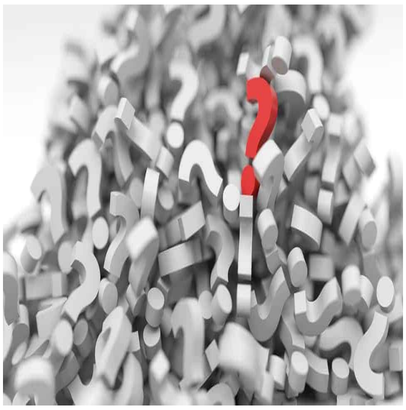

Should You Buy Canadian or U.S. Bank Stocks?

Description

Higher interest rates are good for banks because net interest margins widen as interest rates increase. Banks will be able to make more money from loans by getting higher interest than the interests the bank pays to, for example, our savings accounts.

The Bank of Canada and Federal Reserve affect short-term interest rates by hiking or reducing the overnight rate target or the federal funds rate target. In turn, large banks borrow and lend overnight funds to one another at the overnight rate.

The higher the rate the borrowing and lending rates, the higher the rate of other loans such as commercial loans, consumer loans, and mortgages will be.

Both Canada and the United States have been increasing interest rates. According to Trading Economics, the Bank of Canada has increased the overnight rate from 0.5% to 1.25% from late 2017 to May, and the Federal Reserve has increased the federal funds rate from 0.5% to 1.75-2% since 2016. The long-term average interest rate is almost 6% in both countries.

With a stable economy and interest rates still low, more interest rate hikes are expected.

Should you buy Canadian or U.S. banks?

The big Canadian banks offer eligible dividends with nice yields, which are favourably taxed in a non-registered account. However, U.S. banks are generally cheaper than Canadian banks for their growth potential. In general, U.S. banks offer smaller dividend yields than do Canadian banks, but they have more upside and more room to grow their dividends.

For example, **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) offers a 4.3% yield, has a payout ratio of about 47% this year, is estimated to grow its earnings per share by 7-9% per year for the next three to five years, and can grow its dividend per share by 5-8% per year. At about $75.20 per share, Scotiabank trades at a price-to-earnings multiple of about 10.9 at the time of writing.

Bank of America Corp. (NYSE:BAC) only offers a forward yield of 2%, as the bank will be raising its upcoming quarterly dividend per share by 25%. Yet, the new quarterly dividend will imply a payout ratio of less than 33% of 2017's earnings. In comparison, before the financial crisis, the bank had payout ratios of closer to 45%.

Moreover, Bank of America is estimated to grow its earnings per share at a rate of +20% for the next three to five years. At about US$28.80 per share, Bank of America trades at a price-to-earnings multiple of about 13.3 at the time of writing.

Investor takeaway

The U.S. has been increasing interest rates faster than Canada, which indicates that the U.S. economy is in better shape than the Canadian economy. Thus, it can benefit investors by also considering U.S. banks as well as Canadian banks as part of their diversified portfolios. In particular, it's a good time to pick up some Bank of America stock at the US$28-29 per share level for long-term gains and outsized dividend growth.

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3. Investing

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