Should You Still Buy Bank Stocks After 4 Months of Falling Home Prices?

Description

It's official: Canadian home prices are in free fall. Just days after reports surfaced showing that Canadian mortgage growth had slowed to 3%, **Reuters** reported that home prices have been falling for four months straight. The report stated that weakness in Vancouver, Edmonton, and Calgary led the slide, although other markets have seen prices falling as well.

For shareholders in Canada's Big Six banks, this could be a concern. Mortgage lending is the single biggest part of most banks' businesses, making up as much as 35% of their assets. Should the trend of falling home prices continue, it could lead to less revenue and slimmer profits at the Big Six. To understand why that is, let's take a look at how banks make their money.

Why home prices are so important to banks

Banks earn the vast majority of their money from interest on loans, and mortgages make up the majority of the loans in their retail operations. For example, of **TD Bank's** (TSX:TD)(NYSE:TD) $649 billion in loans, $225 billion are mortgages — approximately 35% of the total.

Banks depend heavily on mortgages to boost interest revenue. But when house prices fall, each loan is worth less, so the total interest paid (assuming rates stay the same) is lower. This can have a severely negative effect on banks' bottom lines. One strategy to counter this is to change the interest rates: raise them to collect more interest on each mortgage, or lower them to stimulate borrowing. As we're about to see, the latter strategy seems to be what the banks are going with.

What falling mortgage rates mean

Royal Bank (TSX:RY)(NYSE:RY) recently announced that it would be cutting its mortgage rate from 3.89% to 3.74%. The cited reason for the rate cut was falling bond yields. Because RBC is the biggest mortgage lender in the country, other banks are expected to follow its move.

If mortgage rate cutting becomes an industry-wide trend, it could help the banks by stimulating more borrowing. The cost of borrowing is a major concern for prospective homeowners, especially in larger markets like Toronto and Vancouver, where house prices often push seven figures. Assuming this disincentive is a major reason people aren't buying, then lower interest rates could stimulate more home purchases. But if it's not, and house prices continue falling, then banks will issue fewer and smaller mortgages than in the past — and collecting less interest on them to boot.

Are banks still buys?

It's clear that falling home prices in an environment of falling interest rates and slowing home sales is bad for banks. In my opinion, banks that are highly concentrated in domestic mortgage lending, like RBC, are probably bad buys right now. However, many Canadian banks are highly geographically diversified, with operations in the U.S. and elsewhere. TD, for example, earns about 30% of its money from U.S. retail — and that percentage grows every quarter. Banks like this that have substantial amounts of revenue coming from sources other than Canadian mortgage lending are probably still solid buys.

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andrewbutton