Warning: 2 Canadian Bank Stocks At High Risk of Correcting 10-15%

Description

The Canadian banks have proven to be stellar investments time and time again. Short sellers have opportunistically touted their bearish theses on the big banks over the last few years, but they've been wrong almost every time.

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Shorting the big banks is a gutsy move, but get the timing wrong, and you'll look end up looking like an idiot. The big banks aren't as shaky as many bears believe, so don't blindly buy into the "doomsday stories" that are featured as headline news in various other mainstream media outlets. They'll only serve to feed your worry. And right now, with the Canadian banks, there's a lot to worry about.

With the less favourable macro environment (slower economic growth, potential rate cuts on the horizon), it may seem like the best days of the banks are in the rear-view mirror. And although we've witnessed the Canadian banks fall under a considerable amount of pressure over the last several months, I'd urge investors to consider the longer-term picture and the expectations placed on the banks today.

In the end, the banks will pull through as they have so many times in the past. Dividends will still be hiked as per usual, and the banks will find a way to improve themselves despite less favourable industry trends.

Over the near- to medium-term, however, volatility could continue to prevail as the banks continue to take a backward step due to a less-than-favourable macro environment that'll dampen both top- and bottom-line growth numbers.

Today, many of the banks are continuing to bounce off their December lows. Some banks have bounced higher than others, so at this critical juncture, let's have a look at the two banks that I believe have bounced too quickly and could be at risk of a nasty 10-15% correction over the next few months.

While some of the big banks should be on your buy list at this juncture, **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Bank of Montreal** (TSX:BMO)(NYSE:BMO) shouldn't make the cut.

Both stocks have soared off their late-December bottoms, thanks in part to solid quarters that amplified the relief rally. Sure, RBC and BMO have been winners in the latest round of bank earnings, but I think the valuations relative to peers make no sense. I believe investors have given too much merit to near-term results and may be forgetting about the environment, which continues to look bleak.

While it was encouraging to see RBC and BMO do well in spite of the challenging environment, the price of admission to both stocks has been raised so much such that a reversion to the mean may be in the cards should the future results of either bank fall flat.

Where's the value to be had?

At the time of writing, RBC trades at a 12.6 trailing P/E, a 2.1 P/B, and a 3.6 P/S, all of which are at par with the bank's five-year historical average multiples of 12.6, 2.1, and 3.4, respectively.

RBC's P/CF of 11.1 is also considerably higher than the three-year historical average of 4.6. With a dividend yield (currently at 3.8%) that's also on par with historical averages, it's clear that there's really not discount to be had with RBC shares, even given the tougher environment that'll be a drag on growth over the medium term.

The U.S. and Canadian banking scene looks less than stellar right now, so investors should insist on a discount because Main Street will not be as forgiving to a more expensive bank stock like RBC in the event of a big earnings miss.

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As for BMO, the stock appears even more expensive as it continues to flirt with all-time highs. Not to take away from BMO's earnings beat streak, but the bar is set quite high here, and with valuations that are among the highest in the industry, I think the risk-reward is the least favourable of the Big Six.

BMO stock trades at a 11.7 trailing P/E, a 1.6 P/B, and a 3.0 P/S, all of which are in line with the bank's five-year historical average multiples of 12.5, 1.6, and 2.9, respectively.

Foolish takeaway

Banks deserve to trade at a discount here. Neither RBC nor BMO are discounted, so unless both names can continue defying the odds, expect a correction.

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