Buy Royal Bank of Canada (TSX:RY) Today

Description

The substantial short interest in Canada's banks is weighing on their value. This has seen the third most-shorted stock by value on the Toronto Stock Exchange, **Royal Bank** (TSX:RY)(NYSE:RY), gain a meagre 6% over the last year, creating an opportunity for investors.

Shorting the Big Five, which has been a popular trade for almost a decade, hasn't become known as a " widow-maker" trade without reason. Hedge funds have been betting against the banks and losing tremendous sums of money over that period, despite clear signs that the underlying fundamentals supporting their stellar performance have not changed. This makes now the time for investors to boost their exposure to Royal Bank.

Credible first-quarter 2019 results

Canada's largest mortgage lender announced some robust first-quarter 2019 results, highlighting the strength of its operations. Those included a 5% year-over-year increase in net income to $3.2 billion on the back of strong revenue growth in personal and commercial banking as well as insurance.

Royal Bank's expansion into the U.S., through wealth management and capital markets, was also a key driver of growth with those combined businesses responsible for 16% of total bank earnings over the last 12 months. For the first quarter, net interest income from Royal Bank's U.S. wealth management business shot up by 19% compared to the equivalent period a year earlier, while its net interest margin (NIM) of 3.56% was higher than the 2.84% reported for its Canadian banking business.

Those operations will become an important driver of growth, because the U.S. is ranked as one of the largest financial services markets globally.

Demand for credit as well as insurance, advisory, and other wealth management services south of the border will expand at a solid clip as gross domestic product grows. The International Monetary Fund has forecast that the U.S. economy will expand by 2.3% during 2019 compared to 1.5% for Canada.

Royal Bank's focus on expanding its U.S. operations along with growing earnings from wealth management, capital markets, and insurance for the remainder of 2019 will further boosting earnings.

Importantly, Royal Bank remains well capitalized, ending the first quarter with a common equity tier one capital ratio of 11.4%, which is considerably higher than the regulatory minimum. Credit quality is also strong, with the bank ending the period with a gross impaired loan ratio of 0.46%, which was one basis point (bps) greater than the same period in 2018.

The impact of any sharp uptick in Canadian mortgage defaults, as anticipated by the traders shorting Royal Bank, will have a minimal impact, because 38% of Royal Bank's Canadian residential mortgage portfolio is insured. That forms an important backstop for the bank should a weaker-than-expected Canadian economy, along with stagnant wage growth, higher unemployment, and heavily indebted households cause impaired loans to rise.

It is also worth noting that Royal Bank's uninsured domestic mortgages have an average loan-to-valuation ratio of 51%, meaning there is significant room for the bank and its borrowers to restructure loans should economic conditions decline.

Such strong credit metrics mean that an economic downturn and subsequent uptick in loan defaults will have little to no material impact on Royal Bank.

Putting it together for investors

For the reasons discussed, Royal Bank will continue to experience solid growth, which will give its earnings a healthy lift. Growing net income will not only support the sustainability of Royal Bank's dividend, which has a conservative payout ratio of around 45% and is yielding almost 4%, but also bankroll additional dividend hikes. Royal Bank has rewarded investors through a series of regular dividend hikes, which has seen the dividend increased annually for the last eight years straight.

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Author
mattdsmith