Is it Time to Load Up on the Big Banks?

Description

Canada's big banks are attracting considerable negative attention with the Big Five making up the five most shorted stocks on the **TSX**. The largest Canadian lender, **Royal Bank of Canada** (TSX:RY)(NYSE:RY) is the most heavily shorted, followed by **Toronto-Dominion Bank**, **Bank of Montreal**, **Canadian Imperial Bank of Commerce** and finally **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS).

Why are the banks being shorted?

Most of that negative interest is coming from U.S. hedge funds, which have for some time been looking for the next big short as they grapple with their own issues relating to profitability and generating attractive returns.

Famed short-seller Steve Eisman, who predicted and profited from shorting the U.S. housing collapse, believes that Canadian banks are particularly vulnerable.

The short thesis centres on the belief that a combination of a downturn in the credit cycle, high levels of household debt, a softer housing market and external economic shocks will disrupt the banks earnings and impact the quality of their balance sheets.

That in turn will cause their stock to plummet as they struggle to manage rapidly growing portfolios of impaired loans and mortgage defaults.

Those concerns have infected the broader market perception of the banks, causing their value to decline sharply over the last year, with Canadian Imperial losing the most to see its stock down by 17%.

Solid results

While there are certainly headwinds ahead for the banks, particularly if the U.S. economy slips into recession, the outlook may not be as bad as Eisman and other naysayers believe. Part of the reason for this is that the Big Five have repeatedly demonstrated their resilience to economic slumps, even emerging from the Great Recession in good shape.

Furthermore, it’s difficult to understand why Royal Bank is the heavily targeted by short sellers. It reported some robust third quarter 2019 numbers, including a 5% year over year increase in revenue to $1.5 billion and a 6% increase in diluted earnings to $2.22 per share.

Royal Bank also reported a solid return-on-equity (ROE) of 16.7%, which, while being 0.6% lower than a year earlier, is still an impressive number, especially in comparison to its peers.

Scotiabank reported an adjusted ROE of 11.5% for that period, while Canadian Imperial’s was 15.5%. This is a key measure of how successfully a bank is unlocking value for shareholders**,** and Royal Bank’s ROE demonstrates that it is delivering considerable value despite the difficult operating environment.

Royal Bank has been steadily diversifying its earnings by growing its U.S. presence as well as wealth management and insurance businesses, which will help to bolster earnings and mitigate the impact of headwinds in Canada.

By the end of the third quarter, the U.S. was responsible for 23% of all bank revenue over the preceding 12 months and 17% of its net income. For that period, U.S. earnings grew by 4% year over year, further helping to reduce Royal Bank’s dependence on Canada.

Meanwhile, Scotiabank reported a notable improvement in its third quarter performance despite the prevailing headwinds. That included a 7% year over year increase in adjusted diluted earnings per share and a 6% dividend hike, seeing Scotiabank yield a very juicy 5%, which is the second highest yield of the big-five.

The key driver of that improvement was the bank’s international business, which experienced solid growth in the Pacific Alliance countries of Mexico, Colombia, Chile and Peru. There is every likelihood that those nations will deliver further solid results particularly as the latest acquisitions are further integrated.

Foolish takeaway

The claims that the Big Banks will be hit hard by an oncoming economic storm appear overbaked. Even amid the current difficult operating environment, they all delivered reasonable third quarter numbers.

The considerable volume of insured mortgages, low loan to valuation ratios for uninsured mortgages and low gross impaired loans ratios will ensure that they can weather any downturn.

The latest decline in their market value has created an opportunity for investors seeking quality buy and hold stocks paying sustainable dividends. Royal Bank and Scotiabank appear to be the best positioned and most attractive of the big five, making now the time to invest.

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