Royal Bank of Canada (TSX:RY): A Top Buy Regardless of a Looming Recession

Description

Canadian banks are attracting considerable negative attention, primarily from U.S. hedge funds, which sees the Big Five making up the five largest short positions on the TSX by value. Despite the headwinds ahead for the banks, their outlook is not as poor as the short-sellers believe, and there are plenty of signs that now is the time to buy. The second most shorted stock on the TSX is **Royal Bank of Canada** (TSX:RY)(NYSE:RY), which has gained a mere 9% over the last year, leaving it attractively valued, with it trading at 11 times projected earnings and two times book value.

Solid results

Royal Bank — aside from being the largest mortgage lender in Canada's oligopolistic financial services market, which allows it to an extent to act as a price maker — is actively expanding its business. The bank is focused on growing its wealth management and U.S. operations, which will further diversify its earnings and reduce its dependence on Canada's mortgage market. That will help to mitigate the fallout from any economic downturn, softer housing prices, and financially stretched households.

Royal Bank's assets under management by the end of the third quarter 2019 had grown by 7% year over year to $244 billion, while net income for its wealth management division expanded by 11% to $639 million. Net income from wealth management now makes up 20% of the bank's total net earnings compared to 19% a year earlier.

Royal Bank's U.S. business's third-quarter earnings grew by 4% year over year and was responsible for 23% of total bank revenue and 17% of total net earnings over the previous 12 months. This steady growth allows Royal Bank to benefit from stronger U.S. growth, where gross domestic product (GDP) expanded by 2% on an annualized basis for the second quarter 2019 compared to 1.6% for Canada.

Royal Bank's ongoing push to digitize its operations, which saw the number of Canadian digital uses expand by 8% year over year for the third quarter, will drive greater efficiency in the bank, thereby boosting margins. That strategy is already generating considerable benefits for Royal Bank. Its third-quarter efficiency ratio of 51.9% was 1.2% lower than a year earlier.

This is an important measure of how effectively a bank can use its assets to earn revenue. The lower the ratio, the better, with analysts generally stating that the optimal efficiency ratio is around 50%.

For these reasons, Royal Bank's earnings will continue to grow, even if a recession occurs, which many pundits are predicting.

Importantly, the bank has a high-quality loan portfolio, finishing the third quarter with a very low gross impaired loans ratio of 0.47%. This indicates that it would take an economic catastrophe of epic proportions to cause Royal Bank's balance sheet to deteriorate to the point where it would have a marked impact on its value.

Furthermore, 36% of the bank's Canadian mortgages are insured, and uninsured mortgages have an average loan-to-value ratio of 52%, thereby mitigating the impact of a decline in the quality of credit that would be triggered by an economic downturn. Royal Bank is also well capitalized, finishing the third quarter 2019 with a common equity tier one capital ratio of 11.9%, which is above the regulatory minimum, highlighting that the bank is capable of weathering any economic storm.

Foolish takeaway

Royal Bank remains a top play on the Canadian economy and is one of the best positioned of the Big Five to continue growing earnings, even if an economic slump emerges. The bank's solid balance sheet, focus on growing profitability through implementing internal efficiencies, and expanding U.S. operations make it a highly attractive investment. While investors wait for that to translate into a higher stock price, they will be rewarded by Royal Bank's sustainable and steadily growing dividend yielding a juicy 4%.

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