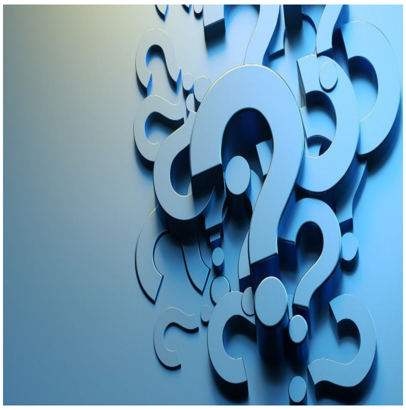

Canadian Banks in Turmoil: Will the Bank of Canada Spark a Banking Meltdown?

Description

As expected, the Bank of Canada (BoC) followed in the footsteps of the U.S. Fed by slashing interest rates to 1.25%. Despite greater inflationary pressures on this side of the border and a larger weighting in financials (which are no fans of higher rates), the BoC has still been reluctant to divorce the Fed with regard to the key lending rate trajectory.

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The TSX Index could go from lousy to downright toxic!

As you're probably aware, the **TSX Index** alone is a pretty horrible investment. It lacks the degree of sector diversification relative to the **S&P 500 —** not to mention that it's been a dog relative to most other global indices over the past decade.

In a nutshell, you're getting a heavy weighting in energy, materials, and financials with an investment in the TSX. The former two sectors have been sluggish for a ridiculously long time now thanks to unfavourable commodity prices, which may be sticking around longer.

With oil firms taking yet another massive hit to the chin following the aftermath of the coronavirus (COVID-19), the TSX just became even less attractive through the eyes of foreign investors. Now, domestic investors are starting to see why. To make matters even worse, the BoC rubbed salt in the wounds of some of Canada's top financial institutions that are already in a tight spot due to the Canadian credit downturn.

Please spare the banks!

Amid the transition to the next credit cycle, the Canadian banks are going to continue to navigate rough waters.

The common theme of less loan growth at lower margins continues to be a concern in 2020. Rising provisions for credit losses (PCLs), upped expenses, pricy restructuring costs, and thinning net interest margins (NIMs) have taken a toll on the Canadian bank stocks and they aren't going to disappear overnight. NIMs will stand to thin even more drastically with recent rate cuts that'll probably keep on coming.

The Fed and BoC hinted at another 50 basis points cut sometime soon. And while the act of combating a biological crisis with monetary policy is up for debate, I find that Canada and its top sector, the financials, have a heck of a lot more to lose from such fast and furious rate cuts relative to most other countries whose central banks have been cutting aggressively.

Banks can't catch a break

The broader basket of Canadian bank stocks sold off viciously following the BoC's cut, with **National Bank of Canada** leading the downward charge (shares nosedived 6% on Friday).

Many Canadian bank stocks have surrendered the modest gains posted last year. Some of them are at multi-year lows with the highest dividend yields they've had in recent memory.

But are they too toxic to own given that the BoC could cut into their margins even further?

Of course, the risk of recession is high, and Canadian banks could continue to spill in a way that short-sellers predicted last year. If you consider yourself a long-term investor, though, you're now able to get a larger yield for a lower price with all your favourite Canadian bank stocks.

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Heck, **TD Bank**, Canada's premium bank, trades at 9.9 times trailing earnings, with a yield that's just shy of 5%. You're only going to get such a deal in times of turmoil, and given that shares have already baked in the new set of headwinds, I'd have to say now may be a time to start nibbling on the way down.

The BoC appears to be a foe to the Canadian banks right now. But over the long-term, I do see the banks bouncing back as, like most negative things, credit downturns don't last forever.

The next thing you know, we'll be in the next phase of the credit cycle, and the BoC will be hiking rates again, but by then, the enormous discount on your favourite bank stocks will likely be gone.

Stay hungry. Stay Foolish.

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