Canada's Bank Stocks Present an Interesting Dilemma

Description

This most recent earnings season for Canada's largest five banks went pretty much as expected at the end of February. All banks reported earnings that beat estimates.

Most banks announced either dividend increases, additional share buybacks, or both. This sector is difficult to assess right now, in my opinion. This difficulty is now being reflected in the stock prices of the Big Five currently.

The bull case

Investors bullish on the Canadian financials sector can easily point to the earnings picture of these banks and call it a day, it seems. These large banks have been extremely consistent in meeting ever-increasing revenue and earnings estimates.

They have also been very predictable in terms of dividend increase expectations, both from a schedule standpoint as well as an average percentage increase each year.

These top and bottom line beats have fueled dividend buybacks as well, increasing earnings per share (EPS) metrics further.

They have led to continued buying, which has further supported these lenders' stock prices. From a fundamentals standpoint, Canadian banks continue to remain cheap when compared to large U.S. banks, with higher average dividend yields.

This makes Canadian banks seem like no-brainers for Canadian income investors, especially as foreign banks don't qualify for the dividend tax credit.

The bear case

Those who are not as bullish on Canadian banks will point to the country's overheated housing market and sky-high debt levels as unsustainable, posing serious systematic risks.

Some Canadian lenders like C**anadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) have more exposure than others.

This housing/mortgage exposure is largely baked into the respective valuation multiples of these peers. Additionally, Canadian banks have increasingly begun to aggressively trim costs.

They are focusing on streamlining operations (reducing headcount). They are also investing in technology/fintech to increase productivity and meet ever higher earnings targets. CIBC, for example, announced during its quarterly earnings report a 5% workforce reduction and a $250 million after-tax charge.

These were in addition to a profit beat, posing questions about how sustainable these profit increases are moving forward.

Bottom line

The Canadian banking sector is an interesting one in the sense that it looks like the market has priced these stocks correctly. These banks are indeed cheap, and there's a reason for that. They offer a relatively attractive risk/reward scenario for investors seeking a decent income.

Canadian banks have proven to be an excellent long-term investment. However, I do see turmoil on the horizon. I would recommend investors who are extremely bullish on these stocks to layer in over time.

I do believe that serious headwinds could be on the horizon if a significant recession does materialize (at which point I'd recommend buying as much as possible, as all five banks are likely too big to fail and the Canadian government will step in to save the day).

Stay Foolish, my friends.

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