Canadian Banks: Once-in-a-Decade Opportunity or Value Trap?

Description

The Canadian banks can't seem to catch a break. The Canadian credit downturn knocked them down, and you could argue that the coronavirus has knocked them out.

Sluggish loan growth at abysmal margins was expected in the pre-pandemic era. And now that the coronavirus threatens the future of various small- and medium-sized businesses, the big banks could be facing a rapid rise in impaired loans.

Deep value in the Canadian banks

To make matters worse, the lights have been dimmed in the oil and gas (O&G) industry following oil's unprecedented collapse, and that does not bode well for Canadian banks like **Bank of Montreal** (TSX:BMO)(NYSE:BMO) that have their fair share of O&G loans that looked downright toxic when oil prices went into negative territory.

Despite the pressures, Canadian banks remain robust. They've been through rough waters before, only to come roaring back in the next phase of the market cycle. During the Financial Crisis, the Canadian banks weren't as well capitalized as they are today, and they were arguably at ground zero of the crisis, as the housing market imploded.

While the coronavirus pandemic may have acted as salt in the wounds of the already ailing banks in the midst of a credit cycle transition, I view the 2018-19 slowdown in Canadian credit as more of a double-edged sword than most. On the bright side, the ominous environment allowed banks like BMO a chance to restructure and better adapt to the gloomy environment that caused rising provisions for credit losses (PCLs), among other negative effects that accompanied mounting macro headwinds.

A rough quarter looms for Canada's banks

With second-quarter earnings coming due later this month, it seems as though investors are already preparing for the worst when it comes to the banks. BMO has taken a brunt of the damage amid the coronavirus sell-off due to its above-average exposure to the O&G industry and its heavy exposure to the province of Quebec, which has suffered the highest number of coronavirus (COVID-19) infections in the country.

As the economy gradually re-opens for the summer, I view BMO as the Canadian bank that has the most upside. At the time of writing, BMO stock trades at just 0.95 times book, making the Dividend Aristocrat the cheapest it's been since the depths of the Financial Crisis. Patient investors can collect the 6.2%-yielding dividend, as they brace themselves for what's going to be a roller-coaster ride through year-end.

Foolish takeaway

While things could certainly get worse for BMO and its peers over the near term, depending on how bad much longer this pandemic drags on, I think that the risk/reward trade-off looks favourable for those with an extremely long time horizon.

For now, the banks look more like a once-in-a-decade opportunity to lock-in a colossal dividend yield rather than a value trap. That said, the Canadian banks are going to continue to be in the grips of the insidious coronavirus for the next several months, and there could be much more downside ahead, so I'd urge investors to dollar-cost average their way into a position, rather than try to get into a full position right before what could be one of the worst quarters in over a decade.

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