Why Is Royal Bank of Canada (TSX:RY) Stock Rising?

Description

Shares of Canada's largest lender, **Royal Bank of Canada** (TSX:RY)(NYSE:RY), has risen more than 11% in the last two trading days. The up-move in the stock continued despite the bank reporting a 54% decline in its net income during the second quarter.

I believe the positive reaction was because market participants anticipated a big drop in the bank's earnings. Similar to its peers, Royal Bank of Canada's provisions for credit losses was bound to increase significantly amid the economic slowdown and low-interest rate environment. Higher provisions remained a drag on the bank's earnings.

Besides, the markets cheer the bank's higher net interest income, continued growth in the loans and deposits, and a 3% increase in the pre-provision, pre-tax earnings.

There are reasons why Royal Bank of Canada's profits could remain low in 2020. Record low-interest rates, higher chances of default, and lower credit growth are likely to hurt the bank's profitability. However, the markets have already priced in the negatives, and Royal Bank of Canada is still an excellent long-term investment.

Strong fundamentals

Despite a tough operating environment, Royal Bank of Canada's fundamentals remain strong. Royal Bank of Canada's loan portfolio is fairly diversified, reducing its exposure to the vulnerable sectors.

As of April 30, the bank's credit exposure to the most vulnerable sectors represented only about 7% of its total loans. Moreover, its credit exposure to the oil and gas sector is pretty low, representing 1.3% of its total loans.

Investors should note that Royal Bank of Canada' loans and deposits continued to grow in the second quarter, which is encouraging. During the second quarter, Royal Bank of Canada's loans and deposits increased by 10% and 17%, respectively.

Royal Bank of Canada remains well capitalized, thanks to the internal capital generation. At the end of the second quarter, Royal Bank of Canada's CET1 ratio stood at 11.7%, which is well above the regulatory requirement of 9%.

Moreover, its loan-to-deposit ratio stood strong, at 67%. Meanwhile, the bank's liquidity coverage ratio was 130%, implying a surplus of $66 billion over the regulatory requirement.

Dividends are safe

Royal Bank of Canada is a great stock for investors seeking passive income in the long run, thanks to its strong track record of consistently paying higher dividends. Investors should note that the bank's dividends have increased at a compound average annual growth rate of 7% since 2009.

Moreover, in the first quarter of the current fiscal year, Royal Bank of Canada raised its quarterly dividends by 3%. While the current economic situation pose challenges for the banks, I don't expect Royal Bank of Canada to announce a cut in its payout. The bank's current payout target of 40%-50% is sustainable in the long run.

Bottom line

Royal Bank of Canada is well capitalized with strong fundamentals, which provides the underpinning for long-term growth. While 2020 is likely to be a rough year for the banks, Royal Bank of Canada is poised to gain from the economic recovery.

The bank's diversified loan portfolio, prudent risk management, strong capital position and a healthy dividend yield of 4.7% makes it an attractive long-term bet.

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Date

2025/08/26
Date Created
2020/05/28
Author
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