Are Canadian Banks Must-Buys Right Now?

Description

The Canadian banks have been under a tremendous amount of pressure in recent months. Last year, the banks were rolling with the punches brought forth by the rare but less-than-ideal Canadian credit cycle downturn. And this year, they found themselves in a crisis that rivals the one they found themselves in just over a dozen years ago.

Short-sellers noted that many of the banks were "ill-prepared" to deal with the headwinds that lied ahead. Although the shorts probably didn't foresee the coronavirus pandemic coming, they were dead right about the banks being terrible investments at the time and are probably laughing their way to the bank right now, as banks struggle to pick themselves back up after the coronavirus crisis knocked them down.

Are Canadian bank stocks a smart catch-up investment in July?

Canadian bank valuations (and their swollen yields) look compelling at this juncture.

To many who missed out on the buying opportunity that was the February-March market crash, Canadian banks may seem like a great catch-up trade at these depths. Before you back up the truck on any one of all of the Big Six bank stocks, though, you should know that not all banks are created equal. Just because a stock's valuation metrics are the lowest does not necessarily mean that it represents the best value.

The best bank for your buck can change at any given time. Still, amid profound macro pressures that have compressed multiples, it'd be wise to resist the urge to chase yield with an excessively discounted bank like **CIBC** (TSX:CM)(NYSE:CM) and consider a more premium one like **Royal Bank of Canada** (TSX:RY)(NYSE:RY), which appears in better shape to deal with more pain that'll likely be in the cards through year-end.

Canadian bank capital ratios and dividends could fall under

even more pressure

If the coronavirus recession lasts longer than most expect, the banks could find themselves between a rock and a hard place, given their exposure to parts of the economy that could weaken substantially over the coming months. Moving forward, investors should expect more of the same for the banks: high provisioning, low loan growth, and lower margins.

While the banks are stress-tested, Capital Equity Tier 1 (CET1) ratios are likely to continue on the downtrend, possibly to the single digits for some of the less-prepared banks if this recession proves to be more severe. And although a dividend cut would be viewed as unprecedented for any one of the Big Six Canadian banks, a bear-case scenario could realistically send a handful of bank dividends to the chopping block in a move to preserve cash.

Now, a Big Six dividend cut is unlikely, especially for Royal Bank of Canada, which has demonstrated its resilience amid this crisis, but if a bear-case scenario or a prolonged recession (or depression) ends up happening, anything is possible. Unprecedented times call for unprecedented actions.

Heck, with share repurchases and dividend hikes off the table for through 2021, one can't help but wonder if a dividend cut is coming up next. A lack of annual dividend raises in itself is already unprecedented for the big banks, after all.

A V-shaped recovery may not be in the cards for the Canadian banks

CIBC's CET1 ratio has been pretty average thus far at around 11%, but with headwinds likely to mount in coming quarters, I wouldn't at all be surprised to see it slip into the high single digits, as it flirts with the regulatory minimum of 9%. Royal Bank, however, is fortunate enough to have limited exposure to the troubled oil and gas sector and has demonstrated its resilience during the modest credit downturn before the coronavirus crisis. Moreover, management noted that even under "severe" scenarios that Royal Bank's CET1 ratio will still be above the 9% mark.

Foolish takeaway

The Canadian banks are buyable. Just pick your spots carefully and assume that the worst is coming, so you minimize your chances of being on the receiving end of an unprecedented dividend cut amid deteriorating CET1 ratios.

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