



I Always Bought Bank Stocks: Sell Them Now!

Description

If you look back to practically every article I have written on the large Canadian banks, I have largely been bullish. The big Six have always been on my buy list. As recently as the March crash, I believed that the big Canadian banks were trading very cheaply compared to their historical valuations.

Now, after an unprecedented 2020, I finally changed my mind. I still think the banks are quite well run and are excellent companies with long histories of dividends and profit growth. I am not selling all my shares. Rather than being a net buyer of Canadian banks, though, I am now a net *seller*. There are several reasons for this about-face in my thinking that I will outline in this article.

Bubbles, bubbles everywhere

For the better part of the past decade, the financial system was delicate. It never recovered from the 2008-09 financial crisis. There was a Bull Run in stocks, to be sure, but much of this was debt-fuelled and inflationary. Now the massive amounts of money-printing and artificially low-interest rates are fuelling a lot of exuberance.

As real estate is very sensitive to interest rates, it is easy to see that it would be massively affected by a low-rate policy. This is clearly visible in the recent reports that real estate is shooting up globally despite the fact that most countries are in the midst of historical economic contractions. Real estate is frequently a highly leveraged investment. Banks lend out these funds. If real estate collapses, the banks will get hammered.

Even a bank like **Royal Bank of Canada** ([TSX:RY](#))([NYSE:RY](#)) is not immune to a real estate contraction. In Q1 2020 Royal Bank hiked its loan loss provisions by 500%, effectively cutting its profit in half for the quarter. This may prove to be a temporary measure should housing remain strong. Nevertheless, it does indicate that the bank is worried about its outstanding loans and is exercising caution.

Fragility is innate in banking

Banks run on faith. This faith helps the banks generate huge profits through fractional reserve banking, but it is also the source of their greatest weakness.

If people withdraw money *en masse*, banks can be in a large amount of trouble. Depositor's money isn't in the bank, after all. It is lent out. In fact, more money is lent out than the banks actually have. While this is expansionary for the economy, it's also a very risky business model if things go badly. There are countless examples of banks collapsing. If you think large banks are not at risk, just go back 10 years and read about a little thing called the financial crisis.

Cryptocurrency banking alternatives

There is another technological advancement that is picking up steam which is beginning to encroach on the banking sector. This advancement is a cryptocurrency alternative called decentralized finance (DeFi). Decentralized finance essentially allows cryptocurrency holders to borrow against their crypto holdings. The loans are overcollateralized, meaning there is often no excessive leverage on many of these lending sites. You can only borrow a percentage of what you have as collateral. The loans are also very easy to take out, which is much easier than doing so at a bank branch.

While this may be in a nascent stage and I have personally never used it, it still demonstrates how the ancient art of banking may be ripe for technological disruption. If DeFi becomes a true alternative to traditional banking, then a bank like Royal may begin to feel some of their lending being siphoned off by the decentralized system.

The bottom line

Never before have I recommended for any investor to *sell* a Canadian bank stock. But right now seems like it is an unusual time in our history. The risks to our financial system are very high, so it is a good idea to lock in some profits in the banks in case things start to get worse.

[Don't sell all](#) of your bank stocks — I'm not. I still have a fair amount of Royal Bank that I will continue to hold. However, the large banks have started to bounce back, so if you made some profits, you might be wise to sell some shares and keep that cash on the side.

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