Don’t Fear a Housing Correction: Canadian Banks Are Strong

Description

Royal Bank of Canada (TSX:RY)(NYSE:RY) serves as a great long-term pick for investors. This diversified global financial services company has been one of my top picks for some time. Indeed, over the past three months, Royal Bank of Canada has been less volatile than at least 75% of Canadian stocks. While many Canadian banks struggled with the pandemic, Royal Bank showed its strength as a great defensive option for investors.

Accordingly, I think investors should not lose faith in this stock, even when there is rampant fear of a market crash or housing market correction. There are reasons to believe that the Royal Bank will continue to perform well over the long term, irrespective of these risks.

Impact of the domestic Canadian housing market on Canadian banks

Soaring housing demand and spiking real estate prices resulting from unsustainable expectations can be quick to reverse. We saw this in the U.S. a little more than a decade ago. These risks are real, and some economists believe Canada’s housing market, on an objective basis, looks more overvalued than the U.S.’ during the 2007 peak.

Indeed, experts believe 2021 could be a record-breaking year for the Canadian housing market. However, many experts suggest that the housing market could cool down markedly in 2022. They believe that rising five-year mortgage rates could have a real negative effect on this sector. In fact, the entire Canadian economy could take a hit in such a scenario. Approximately 50% of the new economic activity generated this past year was a result of housing. That’s a big number, and investors have taken note.

This outsized impact of housing on the Canadian economy could impact banks. Weakening consumer credit quality would directly impact banks’ domestic loan portfolios. Consequently, investors could expect slower growth in the form of revenue and dividends.

There's the doom and gloom for the day.

However, investors can sleep well at night owning a robust lender like Royal Bank. Here's why.

Historical performance of Canadian banks: A race against crisis

Though Canadian banks are still battling the pandemic blues, most analysts agree that they were better-equipped this time than they were in 2008. For example, big banks like Royal Bank of Canada have improved their capital ratios, amid what appears to be a robust expected recovery trajectory.

If we look at the market crash of 12 years ago, we will find that Canadian banks have historically performed well through the crisis. While the U.S. housing market prices plunged by one-third, decimating the sector, the Canadian market overcame the situation quickly.

I think Royal Bank's diversification plays a key role in limiting investor's downside risk. The company has a strong wealth management division and other businesses that cushion the blow. Furthermore, the bank is one of the most diversified internationally among its peers. These factors limit downside risk for investors substantially.

Accordingly, I think Royal Bank stock is a great pick for long-term investors.

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