New Canadian Bank Tax: Should You Buy or Sell Bank Stocks Now?

Description

Canadian bank stocks are trading at or near their lowest levels of 2022, and some are down more than 10% from their 12-month highs. The pullback in the sector and the arrival of a new bank tax has investors wondering if Canada's banks should still have a place in their buy-and-hold TFSA and RRSP portfolios.

New bank tax

The Canadian government just released the details of its anticipated new corporate tax on bank profits. Banks will pay a 15% one-time extra tax on fiscal 2021 profits they earned above $1 billion. They are also going to see their corporate tax rate increase permanently from 15% to 16.5%. The largest Canadian banks reported bumper profits last year and are on track to generate strong earnings again in fiscal 2022. Based on its estimates, the government could pull in an extra $6 billion from the banks as a result of the new taxes.

Bank shares slipped ahead of the news, but the net impact on investors should be negligible over the long run. It might slightly reduce dividend growth or cause the banks to trim their share buybacks, but it is also possible the banks will simply raise fees or increase borrowing costs to offset the hit.

Recession fears

Bond yields recently inverted in the United States with the yield on the five-year treasuries moving higher than the 30-year yield. In the past, a yield inversion in the bond market has often indicated a recession is on the way. The timing and severity of the economic slump can vary considerably, and there is no guarantee a recession is imminent, but investors appear to believe the warnings are justified and might be shifting funds out of bank stocks to segments such as utilities and telecoms that tend to be recession resistant.

A slowdown in the economy could hit the banks, as companies and retail customers borrow less money. For the moment, there is no shortage of job opportunities, and the tight labour market is expected to remain in place for some time. Until that situation reverses and consumers stop spending, it is unlikely we will see an economic downturn.

Aside from the recession risk, the yield inversion can also make it harder for banks to boost their net interest margins. Earlier this year, bank stocks soared on the hopes that rising interest rates will help the banks expand their net interest margins, so there are two forces in play at the moment.

Housing market

A strong housing market helped drive profits for the banks through the pandemic, and the trend has continued in the first part of 2022. Looking ahead, there is a risk that a steep increase in interest rates and bond yields will push mortgage costs up so far that new buyers can't get loans and existing homeowners who need to renew their mortgages won't be able to cover the increase in the payments. As long as people still have jobs, the rise in defaults should be contained. Even if bankruptcies spike, the banks all have strong capital positions to ride out some tough times.

That being said, a combination of much higher borrowing costs with a steep recession that triggers job losses could trigger a meaningful correction in the housing market. This is unlikely, but not impossible. If things go that direction, the result would be reduced bank profits and a downward move in share prices.

Upside?

At the time of writing, **Royal Bank** is down 9.5% from the 2022 high, **TD** is 11.5% lower, **Bank of Nova Scotia** is off 8%, **Bank of Montreal** is down 7%, and **CIBC** has dropped 13%.

The Canadian banks remain very profitable, and dividend growth should continue at a healthy pace. The pullback in the shares of the largest banks now has them trading at 10-12 times trailing earnings. This is getting to a point where the share prices look attractive.

Buying dips in Canadian bank stocks has historically proven to be a savvy move for buy-and-hold investors. I wouldn't back up the truck today, but it might be worthwhile to start adding the banks to your portfolio on any further weakness.

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