Are Canadian Bank Stocks Oversold?

Description

The steep pullback in the share prices of the Canadian banks in recent months has investors who missed the big rally off the 2020 lows wondering if this is a good time to buy bank stocks for TFSA or RRSP portfolios.

Profitability

Canadian banks dodged a bullet during the pandemic. The feared wave of loan defaults that forced the banks to build up massive capital positions never materialized. This is largely due to the billions of dollars in financial assistance the government provided to businesses and households to help them pay their loans and bills during the lockdown periods. Deferrals on mortgages, credit cards, and other loans also helped. At the same time, banks saw mortgage sales soar, as cheap borrowing rates brought new buyers into the market and drove up house and condo prices.

Canadian banks ultimately reported solid profits during the pandemic, particularly in fiscal 2021, and are on track for another solid year in fiscal 2022.

In an effort to recover some of the cash handouts that ultimately protected the banks from booking massive losses, the government announced a special tax on bank profits. The Canada Recovery Dividend, as it is known, is a one-time 15% tax on 2021 bank profits over $1 billion. In addition, the government raised the corporate tax rate on banks and insurance companies to 16.5% from 15% on profits above $100 million.

The net impact on bank investors should be minimal. Share buybacks will likely be reduced, and the size of dividend increases could be trimmed slightly, but this isn’t a large enough issue to justify the 20% drop in share prices since early February.

Recession risks

Investors are more concerned that aggressive interest rate increases by the U.S. Federal Reserve and the Bank of Canada will cause a recession as they try to bring down soaring inflation. The high prices alone could potentially force households to slash discretionary spending to the point where the economy would slow down on its own. A steep jump in borrowing costs will likely speed up this process, as companies reduce investments and excess cash flow gets allocated to paying higher interest charges on debt.

This could ultimately hit bank revenues and profits due to lower loan growth, a decline in deposits, and reduced inflows of cash for wealth management.

Housing risks

The steep rise in mortgage costs is already having an impact on the hot housing market. Sales are down, and prices are beginning to give back some of the pandemic gains.

While pundits fear a major meltdown in the market is finally on the way, the most likely outcome is a gradual decline in prices that could result in a drop of 20-25% from the highs.

That's scary for the person who bought at the peak, but banks are unlikely to take big hits, even if house prices plunge more than expected.

Why?

The government will likely allow amortizations to be extended to help high-risk households manage rising mortgage rates if it looks like too many people are at risk of losing their homes. Lenders will also work with struggling homeowners to keep loans in place. The banks don't like to foreclose on residential properties. The process is lengthy, expensive, and bad for their public images.

Are Canadian bank stocks a buy?

The 20-25% selloff in the shares of the big Canadian banks appears overdone. Dividends are growing and yields are now above 4%. Near-term volatility should be expected, but investors with a buy-and-hold strategy might want to start adding bank stock to their portfolios at these levels.

ETFs provide exposure to the sector if you don't want to buy individual stocks. One option is **BMO Equal Weight Banks Index ETF**.

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Date
2025/09/10
Date Created
2022/06/28
Author
aswalker