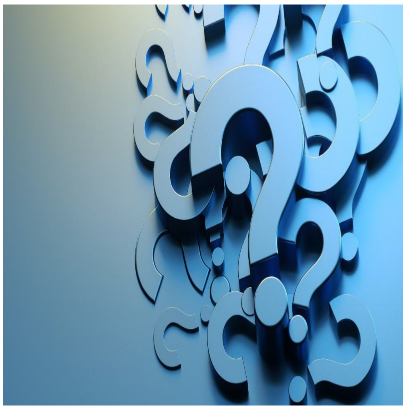

Banks vs. Oil: Which Cheap Sector Is Better?

Description

Banking and oil/energy are two of the cheapest sectors out there. Bank stocks in Canada usually trade at about 10 times earnings, meaning that the company earns back its entire value in 10 years with zero growth.

Oil stocks are, in many cases, even cheaper than that — **Suncor Energy** (TSX:SU)(NYSE:SU) trades at just 6.4 times earnings, for example — but their earnings are more volatile. Energy companies' revenue rises and falls with the price of oil, and their earnings vary even more, so "cheap" valuations in the energy sector can sometimes be deceiving.

In this article, I will explore which of today's two cheapest sectors is better in 2022.

The case for banks

One advantage that banks have over energy companies is that their earnings are somewhat more predictable than those of oil producers. Lending is a business that reliably grows with the economy and contracts when the economy shrinks — you can predict the banking sector's revenue growth if you know what the economy did last quarter. Some individual banks may shrink while the economy grows, but the sector as a whole should grow as long as the economy does.

This is part of why **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is one of my favourite stocks. It's a heavily consumer-oriented bank, which means that its loan portfolio grows reliably with the economy. Beyond that, it's a highly geographically diversified bank, with about 36% of its net income coming from the United States.

Countries have different risk characteristics, so it pays for a bank to operate in a few different countries. The U.S. financial sector is riskier than that of Canada, owing to it being less regulated, but it also offers more growth. So, it's a good thing that TD has a big presence in the U.S. market.

The case for oil

The main advantage that oil has over banks is the fact that it can sometimes deliver truly explosive growth. This year, energy companies like Suncor grew their earnings by hundreds of percentage points . You don't really see that kind of thing from banks.

In 2021, banks had pretty strong earnings growth, but that was mostly on paper. In 2020, banks had to set aside some of their money as provisions for credit losses (PCLs), because the COVID-19 pandemic made their loans appear riskier. PCLs are basically money banks need to have to absorb the shock of borrowers not paying their loans. When banks increase their PCLs, it causes earnings to go down; when they decrease their PCLs, it causes earnings to go up. Banks lowered their PCLs in 2021, which caused a large earnings spike, but keep in mind that this was 90% due to PCL levels changing.

In the most recent quarter, Suncor grew its revenue by 76% and its earnings by 360%. You don't really see that kind of growth from banks — apart from the "on-paper" growth I just talked about — so they usually don't do as well as companies like Suncor in periods of oil scarcity.

Foolish takeaway

Taking all the relevant factors into account, I prefer bank stocks to energy stocks. Banks don't have the same potential for explosive capital gains that oil companies do in the best of times, but they're generally more stable businesses. For that reason, I have banks at a higher weighting in my portfolio than oil stocks.

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