Should You Buy Royal Bank Stock at Current Levels?

Description

This has not only been a terrible year for the tech and consumer sectors. Banks and other defensives have also burnt investors' wealth in 2022. Canada's biggest stock **Royal Bank** (TSX:RY)(NYSE:RY) has declined nearly 20% since January this year. The fall was not limited to Royal Bank, and almost all Canadian bank stocks dropped in the same period.

Notably, when interest rates rise, the bank's interest margins improve, and they outperform. However, this has not been the case this year. So, let's see if you should buy Royal Bank stock in the current rout.

Inflation, interest rates and Canadian bank stocks

Many global central banks started their rate hike cycle quite late in the game after inflation went to multi-decadal highs. This has caused a double whammy for consumers. Inflation had already dented their spending, and higher interest rates raised their borrowing costs. Many borrowers do not have the capacity to repay incremental costs on their existing credits.

Higher rates do increase profit margins for banks. But it cuts both ways. These rates also hamper demand for new borrowing and lead to credit losses on existing loans, resulting in a loss for the banks. As a result, Canadian banks increased their provision for credit losses in the recent quarter.

Royal Bank of Canada: A leader in the oligopolistic market

Royal Bank of Canada has a market cap of $171 billion and is the biggest bank in Canada. It has diversified revenue streams where personal and commercial banking operations contribute 53%, while wealth management derives 18%. The insurance and capital market segments contribute the rest.

It dons the first or second-highest market share in almost all product categories in Canada. RY domestically generates 60% of total revenues, the U.S. contributes 24%, and the rest comes from international operations.

Financial growth in 2022

Royal Bank reported a total net income of $11.9 billion for the nine months ended July 31, 2022. This was a decline from $12.2 billion in the same period last year. Apart from the earnings drop, a decline in interest margins could concern RY shareholders. In the same period, RY reported a net interest margin of 1.46%, a drop from 1.50% in the same period of 2021. Net interest margin is a differential between the interest a bank pays on its deposits and what it earns on loans and mortgages.

On a brighter note, RY has a strong balance sheet and a high-quality credit portfolio. It has a common equity tier 1 ratio of 13.1%, well above regulatory requirements, indicating its financial strength to withstand external shocks.

As the macro picture still looks shaky, there is little probability of Canadian banks changing course anytime soon. The pressure on margins and higher provisions could continue to dent their bottom lines, at least for the next few quarters. Inflation trending lower will be a crucial signal to change policymakers' stance on rate hikes. That will alleviate serious recession fears and will likely revive bank names like RY.

Bottom-line

Even if bank stocks keep trading weak, the current levels look attractive for long-term investors. RY stock is currently trading at a price-to-book value of 1.8x, compared to its five-year historical average of 2x.

So, the undervaluation indicates that the stock will likely rally higher as macro tensions wane. Besides valuation, RY pays a stable dividend yield of 4.2%, in line with its peers. So, given its superior long-term earnings growth prospects, stable dividend profile, and current valuation, RY stock looks like a decent bet for conservative long-term investors.

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Author
vinitkularni20