Why I'm Buying Bank Stocks on Weakness

Description

This year, I am buying bank stocks at a faster rate than I did in past years. When I heard that central banks would be raising interest rates this year, I decided to limit my exposure to tech stocks and move into value sectors like oil and banking. My oil investments paid off pretty quickly; the banking plays are down, but I think they stand a good chance of doing well in 2023. The following are my two main reasons for thinking that.

Reason #1: Bank stocks are very cheap

Bank stocks are very cheap right now. Across Canada and the U.S., they generally trade at less than 10 times earnings. For the most part, their earnings are trending downward but not to a ridiculous degree. Banks that lack investment banking segments are in many cases posting positive earnings growth.

Take **Toronto-Dominion Bank** (TSX:TD) for example. This is one of the bank stocks I bought this year, along with **Bank of America.** At today's prices it trades at the following:

- Nine times adjusted earnings ("adjusted" means "not calculated with the normal accounting rules")
- 9.5 times reported earnings ("reported" means "by the normal accounting rules")
- 1.4 times book value ("book value" means "assets minus liabilities")

These are all pretty low ratios, suggesting that TD is undervalued. And TD's earnings are actually *not* declining. In its most recent quarter, TD's adjusted earnings increased, while its revenue declined a mere 1.6%. There are some challenges here, sure, but TD is not 20% less profitable than it was at the start of the year, as markets seem to think.

Reason #2: Interest rates are rising

A second reason I like bank stocks this year is because interest rates are rising. Both the Federal Reserve and the Bank of Canada are raising interest rates, and higher interest rates *can* be lucrative for banks (can be but aren't guaranteed to be).

Basically, banks make higher interest income when rates rise *if* the rise in rates is parallel across the yield curve. The "yield curve" is a chart of bond yields arranged by maturity ("term to maturity" means "time before principal is paid back"). If yields rise on short-term and long-term bonds alike, banks profit off it, because the spread between their financing costs and lending rates increases.

However, if yields rise on short-term bonds but not long-term ones, then banks don't profit off it, because it makes their operations more expensive. So far this year, the yield curve *is* inverted, but as we climb out of the economic downturn, that will change. Once that happens, banks will be able to profit off higher interest rates.

One big risk with this strategy

As I've shown, there are many macroeconomic factors right now that point to decent returns on bank stocks next year. However, there's one risk you have to keep in mind: the possibility and a steep and prolonged recession. Many people think we'll enter a recession this year — a very mild and short-lived one. That would not be critically dangerous for banks, but a steep and long-lasting recession would be. So, bear in mind the possibility of a severe recession. It would challenge my bullish take on banks.

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Date
2025/06/29
Date Created
2022/10/13
Author
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