Better Buy: Bank of Nova Scotia Stock or CIBC Stock?

Description

Canadian bank stocks are down significantly from their 2022 highs. The big drop has investors who missed the rebound after the pandemic crash wondering which bank stocks might be undervalued today and good to buy for a Tax-Free Savings Account (TFSA) focused on passive income or a self-directed Registered Retirement Savings Plan (RRSP) targeting total returns.

Bank of Nova Scotia

Bank of Nova Scotia (TSX:BNS) stock is down from $95 earlier this year to $65. The steep plunge is the result of growing investor fears about the impact of a potential recession on both the Canadian and international operations.

Bank of Nova Scotia is unique among its peers with a big international business located in Latin America. The bank has spent billions of dollars over the past decade to buy assets in Mexico, Peru, Chile, and Columbia. The four countries form the core of the Pacific Alliance trade bloc that allows the free movement of labour, capital, and goods among the member countries. Combined, they are home to more than 230 million people. Bank penetration is low compared to more developed economies, so there are large growth opportunities for Bank of Nova Scotia as the middle class expands.

In addition, the presence in all four markets gives it an advantage for helping commercial clients who need a variety of cash-management services.

Investors are concerned about that a severe global recession will hit the Pacific Alliance economies hard and hammer the bank's foreign earnings.

Bank of Nova Scotia raised its dividend by 11% late last year and increased the payout by another 3% when the bank delivered the fiscal second-quarter (Q2) 2022 results. The current payout provides a 6.3% dividend yield.

Bank of Nova Scotia trades for 7.8 times trailing 12-month earnings right now. This appears undervalued, considering the strong earnings so far this year and solid capital position. Bank of Nova

Scotia generated $8.01 billion in net income for the first nine months of fiscal 2022 compared to $7.4 billion in the same period last year. The bank finished fiscal Q3 2022 with a common equity tier-one (CET1) ratio of 11.4%.

CIBC

CIBC (TSX:CM) stock is down about 19% in 2022. In this case, the market is more concerned about the risks to the Canadian housing market.

CIBC has a large portfolio of Canadian residential mortgages relative to its peers. Lending to house and condo buyers over the past decade has been a very profitable business, but soaring interest rates are driving up variable-rate mortgage costs. Falling bond prices are pushing up bond yields, causing fixed-rate mortgage costs to surge as well. The longer mortgage rates stay high, the bigger the risk that property owners won't be able to cover the costs when they have to renew the loans.

Even with a strong jobs market, there will be some defaults. If the economy goes into a deep recession, and businesses start cutting employees, a housing crash becomes a risk. Banks can ride it out as long as house prices remain above the value of the mortgages.

However, if the values of thousands of properties fall below the amount owed by the borrowers, things could get ugly, and CIBC would likely take a larger hit than the other banks.

CIBC trades for 8.7 times trailing 12-month earnings. The company's CET1 ratio was 11.8% at the end of fiscal Q3 2022, so it has a strong capital position. Adjusted Q3 net income was $1.72 billion compared to $1.8 billion in the same period last year. Earnings for the first nine months of fiscal 2022 are up slightly from the same period in 2021.

At the time of writing, the stock provides a 5.5% dividend yield.

Is one a better buy?

Bank of Nova Scotia and CIBC both look oversold today, even with the economic headwinds taken into consideration. Near-term volatility is expected, but the dividends appear safe, and investors should see decent total returns over the long run.

If you only buy one, I would probably make Bank of Nova Scotia the first choice today. The yield is higher for investors focused on passive income, and there is likely better upside potential for the share price when the market recovers.

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Date
2025/07/30
Date Created
2022/10/26
Author
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