Is Now the Right Time to Buy Canadian Bank Stocks?

Description

Canadian bank stocks are down significantly in 2022. Investors who missed the rally off the 2020 crash are now wondering if this is a good time to add banks to their Tax-Free Savings Account (TFSA) or Registered Retirement Savings Plan (RRSP) portfolios.

Recession risk

Rising recession fears are the main reason the banks have taken a big hit this year. The U.S. Federal Reserve and the Bank of Canada are aggressively increasing interest rates in an effort to slow down the economy and bring high inflation back down to 2%. Inflation, which is a measure of the year-over-year price increase of a basket of goods and services, came in at 8.2% in the United States in September and at 6.9% in Canada for the same month. These are lower levels than earlier in the year but still way too high.

Markets are concerned that a hard landing is on the way for the economy in both countries. Households are already using up discretionary income or savings to cover the higher cost of food and other essentials. The sharp jump in borrowing costs caused by rising interest rates could drive up mortgage expenses to the point where large numbers of people will be forced to sell their properties.

In Canada, many buyers in the past couple of years chose variable-rate mortgages. These people will be hit immediately by the rising rates. Owners with fixed-rate mortgages are okay until they have to renew. The longer mortgage rates stay elevated, the higher the number of property owners who face large potential increases in payments.

As long as the jobs market remains strong, most households will likely find a way to get through a period of higher expenses. However, if businesses start letting large numbers of employees go as a result of a decline in revenue and soaring expenses, the housing market could get ugly.

In this scenario, the Canadian banks could be in for a rough ride due to their large residential mortgage holdings. A plunge in property prices would potentially put recent buyers in a situation where the amount owed on the mortgage is higher than the value of the property. That’s bad for the bank if it has to foreclose and then try to unload the home or condo.

Expected outcome

For the moment, economists broadly expect the Canadian and U.S. economies to enter a short and mild recession next year or in 2024. The jobs market should remain resilient, and households are sitting on high levels of savings that were built up during the pandemic.

Assuming the economists are correct, the drop in the prices of bank stocks appears overdone, and investors might want to consider adding the banks to their portfolios at current levels.

Bank stocks to buy now

All of the Canadian banks should be solid buy-and-hold picks.

If you only choose one, TFSA investors seeking passive income might want to consider **Bank of Nova Scotia** (TSX:BNS) right now due to its cheap price-to-earnings multiple and attractive 6.25% dividend yield.

The stock likely carries added risk due to the large international business in Latin America, but the share price still looks oversold.

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