Are Canadian Bank Stocks Still Undervalued?

Description

Canadian bank stocks rebounded sharply in recent weeks but still trade below their 2022 highs. Investors who missed the bounce are wondering if the banks remain undervalued and are good to buy for a Tax-Free Savings Account (TFSA) or Registered Retirement Savings Account (RRSP) portfolio today.

Recession risks

Bank stocks started 2022 on a positive note, but sentiment among investors quickly soured once it became evident that the Bank of Canada and the U.S. Federal Reserve planned to raise interest rates sharply to try to get soaring inflation under control.

Generally, rising interest rates are positive for the banks, as they can generate better net interest margins. However, the speed and size of the rate hikes could trigger a wave of loan losses if households and businesses are unable to make the higher payments on variable rate loans or cover the increase in mortgage costs when fixed-rate loans have to be renewed.

The central banks are trying to reduce spending to cool off an overheated economy that is causing high inflation. A reduction in hiring and even a jump in unemployment are expected to be part of the process. As long as the jobs market remains strong, the economy should see a soft landing.

The risk to the banks, however, is a sharp decline in the economy that lasts longer than expected. Households are already using discretionary spending or even savings to cover the higher costs of food, fuel, and other essentials. The added hit from higher borrowing costs could force consumers to hit the brakes hard on spending, and that would potentially lead to a surge in job losses. This, in turn, would likely send the economy into a steeper decline.

Canadian households have high debt levels by historical standards. A good chunk of the debt is linked to property. House prices have already started to fall. In the event that a significant number of property owners are unable to cover increased costs the banks could get stuck with a basket of properties that are worth less than the amount owed on the mortgages.

This would lead to larger loan losses than are currently expected and could send bank stocks lower.

Upside

Economists widely expect the central banks to navigate a soft landing for the Canadian and U.S. economies. Household savings are, on average, still high and it will take time for the jobs market to rebalance. These factors should help offset the negative impact of higher interest rates until inflation falls back to 2%, and the central banks are able to reduce interest rates to lower levels.

In this scenario, the banks appear undervalued, and earnings in the coming quarters could surprise to the upside.

Which bank stocks are cheap today?

Bank of Nova Scotia (TSX:BNS) trades for just 8.5 times trailing 12-month earnings at the time of writing. The share price is around $71 compared to $95 at the 2022 high, so there is decent upside potential in the event that economist predictions for a short and mild recession in Canada and the United States are correct.

Bank of Nova Scotia has raised the dividend twice in the past year, and fiscal 2022 earnings should come in higher than 2021. The current dividend yield is 5.8%, and investors could see another generous dividend increase for fiscal 2023.

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