
Is Now the Right Time to Buy Canadian Bank Stocks?

## Description

Canadian bank stocks have been rising in recent weeks. On a year-to-date basis, TSX bank stocks are down just 9%, compared to 15.1% for the S&P 500. On the whole, Canadian banks have been outperforming the North American markets. They haven't done as well as energy stocks, but they've outperformed most stocks listed in the western hemisphere.



The question is, is now a good time to buy Canadian bank stocks? With interest rates rising, mortgage rates (and other interest rates) are going up. That would tend to suggest that banks will do well. However, there is less overall housing market activity and more stress to borrowers, so the overall effect of the macro environment on banks could be mixed.

In this article, I will explore whether Canadian bank stocks are good buys today, ultimately concluding that at least some of them are.

# Earnings vary widely

Canadian banks reported their earnings just last week, and the results varied widely.

**Toronto-Dominion Bank** (TSX:TD) put out a great release, showing 35% growth in revenue, 76% growth in earnings, and 5% growth in adjusted earnings (adjusted earnings means earnings calculated with slight changes to normal accounting rules). At a glance, TD's earnings looked like a flawless victory, but some of that was due to hedges the bank had in place. After smoothing out the effects of those derivative positions, the bank posted a more modest increase in profit. Regardless, the stock rallied nearly 2% the day the results came out.

The picture wasn't as good for other banks. **Royal Bank of Canada** (TSX:RY) released its earnings a day before TD, reporting 1.6% growth in revenue and a 2% decline in net income. RY is heavily involved in investment banking through RBC Capital Markets. Investment banking is not doing well this year; a weak stock market has led to fewer companies wanting to go public. Taking companies public ("equity underwriting") is a big business activity for investment banks, but it's shrinking this year. So, banks heavily involved in investment banking like RY are doing less well than more traditional banks like TD.

## Interest rates rising while yield curve inverts

As we've seen, some banks are doing well this year; others are doing poorly. It all comes down to individual banks' business mix. The real question is where things are heading in the future. If we know that, we can know whether banks, as a whole, are good buys.

Unfortunately, the signals we're getting are a little mixed. On the one hand, interest rates are going up, which is theoretically good for banks. Banks' profits come from the interest they charge to customers: the higher the interest, the greater the revenue. That should translate to higher profits if the cost side of the equation doesn't change.

However, the cost side *has* changed: the Canada bond yield curve, which normally slopes upward, now slopes downward. That means that short-term bonds have higher interest rates than long term ones. So, the cost of servicing deposits (especially term deposits like Guaranteed Investment Certificates, or GICs) has gone up. That puts pressure on banks' margins.

This year, we're seeing banks offering GIC yields as high as 5%. That's a pretty expensive interest rate to pay out. It's still lower than the interest rates homeowners pay on their mortgages, but the spread between cost and revenue is not that high. So, it's really hard to say where bank earnings will go in the next few months.



For me personally, this just means you need to pick bank stocks carefully. I've been holding TD Bank stock all year, with no plans to sell. It's a very stable bank with strong growth, that doesn't need to offer outrageously high interest rates to gain depositors. It's been doing well over the last month; other banks, less so.

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2. TSX:RY (Royal Bank of Canada)
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