The Big Banks Predict Just a “Mild” Recession: Is it Safe to Buy Bank Stocks?

Description

Recession is the R-word that everybody is worried about this year. Polls show that most bank economists predict a mild recession early next year. The consensus is for a mere 0.4% gross domestic product (GDP) growth for the full year, with growth picking up in the second half.

This year, many people are selling stocks. The TSX index, the S&P 500, and the NASDAQ are all down for the year — the latter being down a truly staggering 31.25%. Some people are selling because of the expected recession; others are selling due to the growth-impeding interest rate hikes that have occurred. The two factors (interest rates and recessions) are interrelated, because high interest rates tend to slow economic growth down.

Here is an interesting question in this environment: what about the banks that are making these forecasts? The big U.S. banks got a big jump after they beat expectations in their third-quarter earnings releases. Canadian banks participated to a lesser extent. The most recent quarter’s results suggest that banks are doing well. But will they be able to survive the “mild” recession they’re forecasting?

What a “mild” recession could look like

In order to know how banks would fare in a mild recession, we need to know what a mild recession is. The word *mild* is ambiguous; if you talk to a big tech shareholder, they’ll tell you that the 2020 recession was mild. An oil worker would probably call it severe.

In objective terms, a mild recession would probably feature the GDP figure declining less than 1% for two quarters and a small increase in unemployment. In this situation, banks would likely face more defaults on credit cards and mortgages and issue fewer loans. That would cause earnings to go down but, because these business activities are cyclical, their earnings would rise again at some point in the future.

How banks could benefit

There are even some scenarios in which banks could rise in a recession — or, more accurately, rise due to the factors *causing* the recession. This year, central banks are raising interest rates. The rapid increase in rates is slowing down the economy, but it's also causing bank interest income to rise.

In its most recent quarter, **Toronto-Dominion Bank** (TSX:TD) delivered the following:

- $14.95 billion in revenue, up 35%
- $6.67 billion in net income, up 76%
- $3.62 in earnings per share (EPS), up 78%
- $7.82 billion in operating income, up 68%
- An 8% dividend increase

It was a pretty solid showing all around. Revenue increased, and earnings increased even more. Of course, part of this strong showing was non-recurring items related to TD's buyout of **First Horizon.** If you exclude those one-time factors, then earnings only grew 5%. Still, the results were solid, even if you back out the deal-related things, so there is cause for optimism here.

One type of bank to avoid

Before concluding this article, I want to give one word of caution:

If you're going to invest in bank stocks, I'd suggest that you think twice about investment banks like **Goldman Sachs** and **Morgan Stanley.** Investment banking has been the weakest banking sub-sector this year, and forecasts have it getting worse in the fourth quarter. What happened was tech stocks crashed, causing founders to not want to take their companies public. This, in turn, led to lower investment banking fees. It is what it is. Nevertheless, the overall banking sector looks strong heading into 2023.

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