Americans Are Betting Against the Canadian Banks. Should You?

Description

On Tuesday afternoon, a report by *Bloomberg* said that American investors (or should we call them speculators?) have increased their bets against Canadian banks. The two banks most affected are **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM).

To be more specific, RBC saw its so-called "short interest" (i.e., the percentage of its shares borrowed and sold short) jump about eight-fold from the end of December to the beginning of February. CIBC's short interest jumped by about 350% over the same time period. Not coincidentally, the bank shares were hammered in the month of January. RBC and CIBC shares each declined by more than 10%, and the other big banks didn't fare any better.

So what are we to make of this? Should we side with the Americans, and bet against the Canadian banks? Or should we take advantage of cheaper prices? Below we take a look.

A bet against Canada

First, we must make one thing very clear: the Americans are betting against the banks in order to bet against Canada itself. As the thinking goes, declining oil prices will wreak havoc on our economy and housing market. In response, the Bank of Canada will continue to cut interest rates, further depressing bank margins.

A look back

Before we look at the logic of this trade, let's look back at a similar bet by Steve Eisman in 2013. Mr. Eisman had gained fame after betting against the U.S. subprime market before the financial crisis — he was even featured in *The Big Short* by Michael Lewis.

And Mr. Eisman saw a similar scenario playing out in Canada, where house prices were very expensive. He responded by shorting **Home Capital Group Inc.** (TSX:HCG), Canada's largest subprime mortgage lender. The move cost his investors dearly — Home Cap shares increased by a whopping 79% over the next year. Mr. Eisman then had to close his fund, due to substandard returns.

So what can we learn from Mr. Eisman's mistake? Well, he ignored the the fact that Home Cap is an outstanding company, one with high returns, strong risk controls, and plenty of growth. He was really just looking to bet against Canadian housing. And this is a very dangerous game to play.

The banks are too cheap now

I brought up that example because this scenario looks so similar. The American shorts don't really care about how strong our banks are; like Mr. Eisman, they only want to bet against Canada.

And at this point, the banks are starting to look pretty cheap. Let's go back to RBC and CIBC as examples. The two banks trade at 12.7 and 11.9 times earnings respectively. These are fairly low ratios for strong companies that have consistently been growing earnings.

Better yet, RBC and CIBC have dividend yields of 3.9% and 4.4%. In today's low-yield environment, these are among the best dividends you can get in Canada. But the American short sellers don't really seem to care about that. I doubt their fate will be as bad as Mr. Eisman's, but they don't seem to have learned the lesson that he taught us. Now could be a great time to take advantage.

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1. NYSE:CM (Canadian Imperial Bank of Commerce)
2. NYSE:RY (Royal Bank of Canada)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:HCG (Home Capital Group)
5. TSX:RY (Royal Bank of Canada)

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