Why Is Toronto-Dominion Bank Canada’s Most Shorted Stock?

Description

It has been widely reported that U.S. short-sellers are betting against Canada, and it appears that **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) is the epicenter. Short-sellers make money when a stock declines in value, and since most short positions are held by large institutional investors like hedge funds, plenty of shorting activity means that professionals see major downside potential for TD.

The numbers speak for themselves. As of July 15, 2015 TD was the most shorted stock on the TSX with 49 million shares being sold short. This represents 2.7% of the total shares outstanding, and more than any other Canadian bank—including over double the 1.3% of shares outstanding **Royal Bank** is being shorted.

What does this mean for TD shareholders? It could represent either a risk, or an opportunity. To determine which is true, let’s look at the factors behind the shorting activity and the degree to which TD is exposed to these factors.

Why TD Bank is being shorted

While it is always difficult to determine the exact reason a particular company has plenty of short interest, it is possible to speculate with some accuracy. Recently, there has been a major increase in negative sentiment against the Canadian economy as a whole, and more specifically, against the Canadian housing market.

Major U.S. hedge funds are actively betting against the Canadian housing market, a continuation of a trend that began in 2013, and these investors are often using Canadian banks as a proxy for the housing market. Canadian bank shares being sold short on American exchanges have doubled since 2013, and over the past several months, short-selling activity has seen a rapid acceleration.

This speculation is premised on the fact that Canada's housing market is in a dangerous bubble, one that could easily burst when interest rates increase, putting pressure on home prices and on banks' balance sheets. Currently, the home price-to-income ratio in Canada is about 5.78, with the average being about 3.5, which also represents the point home prices have reverted to after previous bubbles burst.

Rising housing prices have put the Canadian economy is a precarious position, since the increase has largely been fueled by low interest rates, which have also resulted in Canadians' debt-to-household income ratio hitting a record high of 163%, meaning Canadians are more in debt than ever. When interest rates rise—as they are expected to—indebted Canadians may have trouble servicing their large debt burdens, which could result in increases to loan impairments for banks at a time where a drop in housing prices may mean that home values do not sufficiently cover the value of some mortgages that are outstanding.

To make matters worse, the Canadian economy has become overly dependent on construction jobs to support new home development. TD may be seen as a way to play this potential weakness. Currently, TD has the largest exposure to domestic retail of its peers, with about 66% of earnings coming their Canadian retail segment.

What should TD shareholders do?

Fortunately, despite the negative sentiment towards TD, the numbers reveal that TD is more than able to withstand a decline to Canadian housing. Firstly, when looking at domestic mortgages specifically as a percentage of total loans, TD actually ranks below its peers, with only 34% of its total loans being domestic mortgages. An additional 5% of its total loans are attributable to U.S. mortgages, which would largely be immune from any Canadian weakness.

More importantly, however, is the very low-risk nature of available mortgages. Of TD's domestic mortgages, 68% are insured by the CHMC—the highest of its peers. This means that for 68% of mortgages, the entire principle is guaranteed back to the lender in the event of a default where the mortgage value exceeds the home value.

In Canada, mortgages with a loan-to-value ratio (the home price divided by the mortgage value) greater than 80% must be insured. Uninsured mortgages have a low loan-to-value ratio of 68%, giving home prices plenty of room to drop. Even if prices were to drop, borrowers would likely be able to continue paying—regulations require that mortgage payments occupy 32% or less of income when originated.

The end result is that TD shareholders should ignore short-sellers and use the recent weakness to buy.

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