Why Short Sellers Are Wrong About Toronto-Dominion Bank

Description

Earlier in the year **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) had the honour of becoming Canada's most-shorted stock, which means that a significant amount of investors were betting that TD shares would fall dramatically. Now it appears that these investors are once again ramping up their bets.

From October 1 to October 15, TD saw the largest increase in short positions in Canada; 5.7 million shares were sold short. This brings the total amount of TD shares sold short to 56.7 million, which makes TD Canada's second most-shorted stock.

Why is this concerning? The rapid increase in short positions means that large institutional investors are likely betting against TD. The good news is that major bets against TD and other Canadian banks have been made since 2013, and there appears to be no clear reason why they would be successful this time.

The bet against TD is likely a bet against the Canadian housing market

While the Canadian banks face several major headwinds—low oil prices, an economy briefly in recession, and an over-indebted consumer, the biggest risk is by far the Canadian housing market.

The major concern is that Canadian housing prices are double U.S. housing prices, and that average home prices are nearly six times average income—well above the 3.5 times income that marked the point where previous Canadian housing bubbles burst.

As Canadians are some of the most indebted people in the developed world, the big fear is that rising interest rates, high debt levels, unaffordable homes, and a huge inventory of unsold homes will lead to a crash.

The Economist recently stated that Canadian homes are 34% overvalued, and if prices were to fall, TD could be affected since it has the largest percent of earnings coming from Canadian retail operations of the big banks.

The worst-case scenario is unlikely to come to fruition

The worst-case scenario would be a housing crash similar to what happened in the United States. A double-digit decline in housing prices combined with heavy mortgage defaults could mean that TD would need to write down a portion of its loans. This would be damaging to TD's earnings and balance sheet.

Fortunately, the worst-case scenario (a rapid 20-25% decline in prices) is unlikely. Many experts are expecting a “soft landing” to the housing bubble due to the fact that interest rates are likely to rise gradually, and Canadians have very low debt-servicing costs as a percentage of disposable income (only about 7%).

The Canadian economy is also expected to grow going forward, employment is expected to be stable, and strong immigration and foreign demand for Canadian real estate should prop up demand.

While the housing market is expected to slow next year when prices, sales, and housing starts to come down, the effect should be gradual, and the recent Liberal government plan to spend $4 billion on infrastructure should support construction jobs.

TD is very well prepared to deal with any effects

Firstly, only about 34% of TD’s loans outstanding are Canadian mortgages. While this may be a decent portion, 68% of these loans are insured by CMHC, which means that TD is protected in the event a borrower defaults.

Canadian regulations also require that uninsured mortgages have a loan-to-value ratio of less than 80%, which means the loan must be less than 80% of the home value. This protects banks in the case of default. TD’s LTV is a low 65%.

While there is a risk of a slowdown in mortgage volume growth as the housing market slows down, TD is a highly diversified business and should be able to offset weakness with growth elsewhere.

The bank obtains about 30% of revenues from the U.S. where the housing market is surging, and in Canada TD has indicated plenty of opportunity to grow by expanding market share in areas like unsecured lending, where it has only a 14% market share despite the fact that 40% of Canadians bank with TD.

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