



## Why Are So Many Investors Shorting Canada's Banks?

### Description

Based on the history of Canada's five largest banks, you'd think investors would be positive on the sector.

These financial institutions have delivered consistent profits for decades and, in certain instances, even centuries. They've also paid investors dividends though thick and thin, keeping it up during two world wars, the Great Depression, hyperinflation, the tech bubble, and the financial crisis of 2008-09.

Collectively, Canada's banks have helped countless investors get rich. Sure, they've had down years—what company doesn't?—but overall they've been great stewards of shareholder wealth for generations. Often, investment advice is simple: buy one or two Canadian bank stocks, tuck them away for a few decades, and you'll end up rich.

But over the last little while, it's become exceedingly popular for investors to bet against Canadian banks. **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)), **Bank of Nova Scotia** ([TSX:BNS](#))([NYSE:BNS](#)), and **Royal Bank of Canada** ([TSX:RY](#))([NYSE:RY](#)) are all among the top 10 TSX short positions with 84 million, 53 million, and 34 million shares sold short, respectively. Collectively, that represents nearly \$10 billion worth of assets investors are actively betting against.

If you look at a long-term view, betting against the banks looks to be a foolish decision. Their stock charts all show terrific gains. So what exactly is the thought process for betting against these proven compounders? Let's take a closer look.

### A perfect storm?

Investors are starting to get concerned about the assets Canadian banks hold.

Over the last few years a big chunk of bank profits have come from mortgages. Canada's housing market has been on fire, especially in Vancouver and Toronto. When the economy was doing well, mortgage defaults were virtually nonexistent. And remember, lenders can transfer the risk from mortgages with low down payments to mortgage default insurers.

Investors are starting to see cracks in the housing market. Various reports say foreign money is dominating certain markets, which is making the market more and more unaffordable for the average citizen. Plus, Canada's economy is starting to weaken, especially in areas hit hard by commodities.

Although the banks have collectively protected themselves with mortgage default insurance, they're still exposed. And if mortgages start to default in a meaningful way, unsecured credit will be hit much worse.

Bearish investors are convinced banks aren't fully prepared for the wave of write-offs that are all but certain to be coming. And perhaps they have a point. Loan loss provisions at Royal Bank were just 0.47% at the end of 2015, 0.48% at TD Bank, and Bank of Nova Scotia also coming in at 0.47%. Shorts are convinced these numbers will go much higher in the near future. They're also convinced these provisions are being underreported.

Then there's the exposure to the energy sector. American banks are writing off loans made to oil and gas producers at a pretty aggressive pace, while Canada's banks haven't really adjusted the carrying value on their portfolios. Shorts think it's only a matter of time until Canada's banks are forced to take big losses on these loans, further compounding the consumer debt problem.

Finally, many of Canada's banks have been raising capital in the preferred share market pretty aggressively. In December Bank of Nova Scotia issued \$300 million worth of preferred shares. Royal Bank issued \$675 million on virtually the same day. Preferred share issues are important to note, say the shorts, because they don't affect capital ratios. Issuing preferred shares gets a bank fresh capital but doesn't add onto their debt—at least technically. It's an important distinction.

It's easy to see why investors are betting against Canada's banks, at least from a short-term perspective. Canada's economy is struggling, and the banks will eventually reflect that in their results. Shorts are hoping big headline losses come, which will undoubtedly send shares reeling.

But at the same time, such an event could be very good news for investors who are looking to pick up cheap shares of companies that have proven over decades to be terrific investments. Such an opportunity worked out pretty well in 2009. Perhaps 2016 will be the year it works again.

## **CATEGORY**

1. Bank Stocks
2. Investing

## **POST TAG**

1. Editor's Choice

## **TICKERS GLOBAL**

1. NYSE:BNS (The Bank of Nova Scotia)
2. NYSE:RY (Royal Bank of Canada)
3. NYSE:TD (The Toronto-Dominion Bank)
4. TSX:BNS (Bank Of Nova Scotia)
5. TSX:RY (Royal Bank of Canada)

6. TSX:TD (The Toronto-Dominion Bank)

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