

3 Reasons Why Canada's Banks Aren't as Risky as Hedge Funds Believe

Description

Canada's major banks are attracting unfavourable attention from a range of sources. **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)) is the most shorted and **Bank of Nova Scotia** ([TSX:BNS](#))([NYSE:BNS](#)) is the third most shorted stock on the TSX. This is being driven by U.S. hedge funds, which believe that a perfect storm of lacklustre economic growth, a massive housing bubble, and heavily indebted households will trigger an epic housing bust that will significantly impact Canada's banks.

After all, many of those hedge funds missed out on the *Big Short* of book and movie fame, where savvy investors shorted U.S. mortgage-backed securities in anticipation of a catastrophic housing meltdown. These hedge funds believe they will profit from a similar housing bust and banking collapse occurring in Canada.

But there are signs that the hedge funds have got it wrong, and with the major banks now being so heavily shorted that they're attractively valued, now is the time for investors to increase their exposure.

Now what?

Firstly, the majority of the banks are well positioned to continue growing their earnings over the long term.

There may be signs that Canada's economic outlook will remain subdued for some time because of the prolonged slump in crude, but this hasn't prevented the major banks from reporting solid results. Toronto-Dominion's second-quarter net income shot up by almost 5% compared with the same period in 2015. This can be attributed to the bank continuing to benefit from its considerable U.S. exposure and the U.S. economic recovery.

In fact, of the major banks, only Bank of Nova Scotia reported disappointing results. Its bottom line shrank by almost 12% for that period. This can be attributed to its considerable exposure to the oil industry with its total loans to the energy patch having the highest value of any Canadian bank, resulting in a sharp uptick in credit loss provisions and impairment charges, hurting its bottom line.

Secondly, the risk of a massive Canadian housing meltdown has been significantly overcooked.

You see, while house prices are marching ever upward (the national average house price is up by 11% over the last year), much of this is being driven by Toronto and Vancouver markets, which can be attributed to local dynamics, including high levels of internal and external immigration, low inventories, and higher incomes.

Furthermore, there is a distinct lack of subprime mortgages in Canada, which were one of the key triggers of the housing crisis and near collapse of the U.S. banking system.

In fact, analysts estimate that in the run up to the U.S. housing meltdown, subprime mortgages made

up roughly 21% of all loans originated compared to around 5% in Canada at this time.

Finally, the banks have employed a range of strategies to manage the risk of a housing correction.

Not only have the major banks significantly tightened their underwriting standards for loans in recent years, but a significant portion of mortgages are insured, and those that aren't have, on average, conservative loan-to-valuation ratios of 70% or less. This gives both the banks and borrowers considerable wiggle room to renegotiate those loans in the event of a severe economic shock.

So what?

Canada's banks are performing well despite the headwinds they are experiencing, and with signs that the risks posed by an overheated housing market are significantly overblown, they are attractively priced. With a modest price of 1.7 times its book value, Toronto-Dominion is the most attractively valued of the major banks, and along with its solid U.S. exposure, this makes it an appealing investment.

CATEGORY

1. Bank Stocks
2. Investing

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1. Editor's Choice

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