
# Shorting Canada’s Banks: A Widow-Maker Trade Almost Guaranteed to Lose

## Description

One trade that has gained considerable attention in recent months is shorting Canada’s banks. It is being led by U.S. hedge funds that believe they have found the next big short since the 2007 U.S. housing market implosion. The trade is being driven by concerns of an overheated housing market, near-record household debt, weak economic growth, and the banks’ over exposure to mortgage lending.



Recent data from the TSX shows that the most shorted Canadian stock is **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD). Then there’s **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) at fourth place, and **Royal Bank of Canada** (TSX:RY)(NYSE:RY) at eighth.

Nonetheless, there are signs that despite the growing popularity of this trade, it is fast becoming what is known as a widow-maker trade.

**Now what?**

In the world of hedge funds, a widow-maker trade is a short-sell trade of an overvalued asset that makes sense fundamentally and intellectually, yet the asset continues to rise in value, exposing the short-seller to the potential of ever-larger losses. A classic, well-known widow-maker trade has been shorting Japanese government debt, which has seen hedge funds betting on higher interest rates and falling government bond prices.

Canadian banks are now fast shaping up as the next widow-maker trade.

Short trades on Canada’s banks have been estimated to be worth in excess of US$13 billion. The bet is predicated on the belief that Canada’s housing market is in a bubble, and when it bursts the banks will tumble.

While there are signs that some regional housing markets are hot, the overall view is that the market has cooled. Between January 2016 and January 2017, the national average house price only gained 0.2% with a number of regional markets only modestly gaining in value. Ottawa saw a 6% gain, whereas Montreal posted a 3% gain.

Meanwhile, Vancouver's one-time turbocharged average housing price plunged by almost 19% over that period. The only market that remains in a frenzy is Toronto, where the average price spiked by 22%.

If this is not enough to allay concerns, it is also worth considering that there are significant differences between Canada's housing market and that which existed in the U.S. in the run-up to the 2007 housing bust.

Key among these is the lack of subprime mortgages and non-recourse loans. It was the combination of these two-factors that sparked the alarming cascade of low housing prices as more and more properties were repossessed by financial institutions and put on the market at fire-sale prices. Combined with the considerable exposure of a range of financial institutions to toxic debt instruments, which were predominantly subprime mortgages**,** this triggered a major financial crisis and the near collapse of many major U.S. banks.



While subprime mortgages exist in Canada, it is estimated that they only make up somewhere between 2.5% and 5% of all mortgages underwritten. This is compared to 25% in the U.S. in the lead-up to the 2007 housing meltdown.

More importantly, the volume being underwritten is falling because of tighter lending regulations instituted by the regulator.

Even if there is a housing crash, which appears less and less likely, the impact on the banks would be minimal. This is because a large portion of mortgages are insured, and the mortgage portfolios of Canada's banks have relatively low loan-to-valuation ratios (LTVs). Toronto-Dominion has 48% of its mortgages insured with a portfolio-wide average LTV of 51%. For Royal Bank, those figures come to 46% and 51%, respectively, and in the case of Bank of Nova Scotia, they are 56% and 51%, respectively.

This gives Canada's banks considerable wiggle room should housing prices collapse by removing the need to quickly sell foreclosed properties, thereby preventing the market from becoming rapidly depressed.

**So what?**

The distinct differences between Canada's housing market and that which existed in the U.S. in the lead-up to the 2007 housing bust are striking. For these reasons, a housing bust is unlikely. When coupled with prudent risk management, shorting Canada's banks appears to be a bad bet and a losing proposition.

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