Are the Short-Sellers Right About Toronto-Dominion Bank?

Description

Despite signs that the housing bubble is deflating, Canada's banks continue to garner considerable negative attention from investors. The latest data available from TMX Money shows that Canada's second-largest bank by assets, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), is the third most-shorted stock on the Toronto Stock Exchange.

This is because there is a persistent view, especially south of the border, that Canada will experience a massive housing bust that will significantly impact the banks. There are signs, however, that this belief is unfounded, and that Toronto-Dominion is not as vulnerable as short-sellers believe.

Now what?

There are signs that Canada's one-time red-hot housing market is cooling.

According to data from the Canadian Real Estate Association, the average house price at the end of June 2017 had only grown by 0.4% compared to a year earlier. Even in what were the super-hot markets of Vancouver and Toronto, where the average price had been growing at a double-digit clip, growth declined to 2.7% and 6.3% year over year, respectively.

That cooling will continue because of the recent rate hike, tighter prudential standards introduced by the OSFI, and government moves to curb foreign investment in properties.

A cooler housing market will certainly curb the domestic growth opportunities for Canada's banks. This is because the frenzy surrounding Canada's almost decade-long housing boom was a key driver of ever higher earnings and record profits for the banks.

Nonetheless, even if it becomes increasingly difficult to generate solid earnings growth in Canada's saturated financial services market, the impact on Toronto-Dominion will be minimal. The bank has established a solid franchise south of the border; it now earns almost a third of its net income from its U.S. retail banking operations. That gives is considerable scope for growth given that it is ranked as the 10th largest bank in what is one of the single largest financial services markets globally.

There are also fears that higher interest rates will have a sharp impact on Canada's already financially stretched households. You see, household debt is at near-record levels, and any financial shock, such as higher interest rates causing loan repayments to rise, could trigger a spike in loan defaults.

However, the impact on the major banks, including Toronto-Dominion, would be minimal. This is because all mortgages with a loan-to-valuation (LTV) ratio of greater than 80% are insured, transferring the risk of default from the banks to mortgage insurers, the largest of which is the government-owned CMHC.

That provides an important backstop for Toronto-Dominion, which has 47% of its Canadian residential mortgages insured.

Importantly, the average LTV of its portfolio of uninsured mortgages comes to a very conservative 49%, providing considerable wiggle room for the bank and households alike should financial difficulties arise.

Toronto-Dominion also has an especially low gross impaired loan ratio of 0.47% as of the end of the fiscal second quarter 2017. Such a low ratio means there would need to be epic landslide of impaired loans to do any significant damage to its balance sheet. That is highly unlikely to occur because of the tight underwriting standards applied to mortgages originated by Canada's banks.

So what?

It is difficult to understand why short-sellers are targeting Toronto-Dominion. Credit quality remains high, and the impact of a cooling domestic housing market will be minimal, especially because of the significant growth opportunities created by its solid U.S. banking business.

If anything, the recent decline in its stock of almost 0.5% over the last month has provided a handy entry point for investors.

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