The Short Sellers Targeting Canada's Big Banks Should Not Be Ignored

Description

As is always the case when short sellers repeatedly cry wolf, it can be very tempting to ignore the potential existence of said wolf hounding the neighborhood. After all, the distinction between a short seller and a broken record can sometimes be very hard to see, and it can be tiring listening to all the doomsday talk, which seems to permeate most bull market discussions in recent years.

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While many investors in Canada's largest banks prefer to move past warnings that Canada's largest banks may be set for a correction, should risks to the Canadian economy (the housing and energy sectors, specifically) manifest themselves, the oft-attacked short sellers could be on the right side of the trade — an alternative reality investors should consider and respect, rather than unequivocally dismiss.

To illustrate why such a trade may make sense, here are a few reasons why shorting Canada's big banks has been an attractive trade in the past:

The short is cheap

Generally, the cost for a short seller to borrow another shareholder's shares, sell them, and wait for the market to plummet depends on the availability of said stock. Shorting Canadian companies, many of which have expensive shares to borrow, can be a difficult and less-than-profitable exercise — even if shares in said company eventually plummet, the profit a short seller makes from any trade with high borrowing costs can be significantly reduced or potentially eliminated by "expensive-to-borrow" fees.

Canada's big banks have a very liquid float, making shorting shares in these companies some of the easiest and cheapest targets for short sellers.

At some point, the housing bubble will at least correct

While some believe an outright crash is coming or at least plausible, it remains a fact that Canada's housing market has not meaningfully corrected for a very long time by economic standards. Fueled by low interest rates, foreign investment, and a banking system that has allowed for a hefty amount of levering up (don't forget about those home equity lines of credit and other consumer credit options, which have allowed Canadians to treat their homes as ATMs in recent years).

If and when the housing market corrects and banks begin to pull back on the ATM-like function that the housing market has played in the consumption portion of Canadian economy in recent years, the potential negative effect could result in a significant correction in Canada's big banks, making this trade even more attractive to short sellers.

Bottom line

The Canadian banking system is perhaps one of the most well-regulated systems in the world, and the Canadian economy is poised for a higher growth rate than its G7 peers for the first time in a while. As such, the argument that betting against big Canadian banks such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY) is a play for investors who want to lose their shirts remains a proliferated one in the media today.

That said, in terms of value, it is easy to see the attractiveness of the short side of the trade, as highlighted by a number of prominent investors in recent years. Given the levered state the Canadian economy finds itself in, one slip or macro-economic shock is all the nay sayers and wolf-criers need to be right.

Stay Foolish, my friends.

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