Ignore the Absurd Thesis for Shorting Canada’s Banks

Description

The U.S. hedge funds and Wall Street money managers are at it again, making large bets against Canada’s big banks. Canada’s Big Five, **Royal Bank of Canada** (TSX:RY)(NYSE:RY), **Bank of Nova Scotia**, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), **Bank of Montreal** and **Canadian Imperial Bank of Commerce**, are the five most shorted stocks on the TSX in that order, respectively.

Why short the big banks?

Ever since the global financial crisis, U.S. investors, hedge funds, and traders have been hunting for the next Big Short, which was the massively profitable bet renowned hedge fund manager Steve Eisman made against the U.S. housing boom. The short-sellers believe that a combination of weak growth, overheated housing prices, low-quality mortgages, and record household debt will trigger a collapse in credit quality, causing the banks to suffer considerable losses.

Interestingly, the short-sellers are now claiming the trigger will be a “normalization of credit” rather than a housing collapse that will precipitate a sharp decline in credit quality and earnings. While that implies the decline won’t be as deep or brutal as witnessed when the U.S. housing bubble imploded, it still rests upon the same fundamental triggers.

While there are signs that growth will slow and the worst in the credit cycle has yet to be seen, those shorting Canadian banks are bound to lose money, as they have ever since the global financial crisis ended in 2010.

The new widow-maker trade

Short-selling Canadian banks is fast becoming known as a widow-maker trade, and for good reason. Such a trade is one targeting what appears to be an overvalued asset and makes sense from a fundamental and intellectual perspective but incurs massive losses. One of the most famous widow-maker trades ever undertaken was the colossal push to short Japanese bonds over the last two decades. Market fundamentals indicated that an immense and imminent bond market crash was due, but such an event never occurred, triggering massive losses for short-sellers.

Since the mammoth interest in shorting Canada's banks commenced in 2010, they have all more than doubled in value with Toronto-Dominion and Bank of Montreal recording the highest gains of 244% and 213%, respectively. The second most-shorted stock on the TSX, Scotiabank, performed the worst, gaining 132%. That highlights the considerable losses short-sellers have already incurred by blindly pursuing this trade, and there is every sign they will continue to lose money.

Top-rated banking industry

International credit rating agency S&P Global recently stated that Canada's banks will remain among the top-rated financial institutions globally, despite the vast array of emerging headwinds.

The reasons for this are quite simple.

Strict prudential regulation in Canada, including the tightening of mortgage underwriting standards, have given the industry a high degree of stability that is unimaginable in many other jurisdictions. This ensures that the quality of mortgages issued are consistently high and that the banks are well capitalized.

The latest results from Royal Bank and Toronto-Dominion support those claims. For the first quarter 2019, Royal Bank reported a gross impaired loan ratio (GIL) of 0.46% which**,** while up by 0.9% compared to the previous quarter**,** is well below the level that indicates there are issues with credit quality. Toronto-Dominion ended the first quarter with a GIL of 0.53%, which was 0.06% higher quarter over quarter but well below the 0.83% reached when the fallout from the global financial crisis peaked in 2009.

The uptick in GILs can be attributed to the failure of a U.S. utility, which has impacted many of the Big Five, rather than a marked deterioration in the quality of their Canadian mortgage portfolios.

Royal Bank reported a common equity tier one capital ratio of over 11%. For Toronto-Dominion it was 12%, highlighting that both banks are well capitalized.

What does it mean?

The massive run-up in housing prices since 2010 supported the impressive earnings growth reported by the banks. Any slowdown in the housing market will significantly reduce the growth opportunities for Canada's banks because domestic mortgages are the single largest growth driver.

Domestic mortgages and HELOCs make up 49% of Royal Bank's total loans under management, whereas for Toronto-Dominion that figure comes to 40%. That lower percentage is because Toronto-Dominion has focused on expanding its U.S. retail banking business; it is ranked as a top-10 bank south of the border.

U.S. hedge funds and traders have yet to understand the dynamics of Canada's banking system, ignoring its resilience and strengths at their peril. Shorting Canada's banks is fast becoming a widow-maker trade that will lead to further significant losses.

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