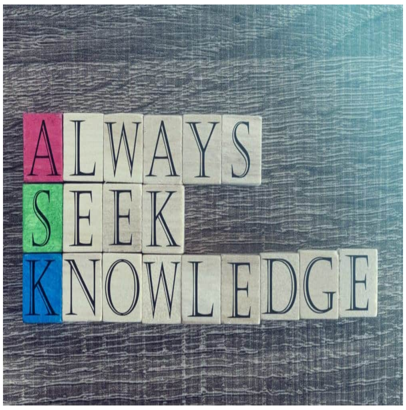

Will Hedge Funds Send Royal Bank of Canada (TSX:RY) Stock Lower?

Description

It's official:

Personal debt is getting out of control in Canada.

After months of talk about deteriorating credit quality, the facts are starting to roll in–and it's not looking pretty. According to a recent Ipsos-Reid poll, 48% of Canadians consider themselves to be within $200 of insolvency, up from 46% a quarter before. Although these figures are self-reported, they highlight the growing number of Canadians who feel incapable of managing their debt.

It's in this context that **Royal Bank of Canada** (TSX:RY)(NYSE:RY) finds itself. As Canada's largest bank and arguably the one with the greatest domestic focus, Royal Bank has a lot to lose if Canadians start to default in massive numbers. And in fact, many hedge funds believe this will happen, with Steve Eisman of "Big Short" fame being just one mogul betting on it.

In general, the consensus among the shorters seems to be that RBC is due for a 20% correction. Whether they're right or not remains to be seen. In the meantime, however, the shorts themselves may send RBC shares lower.

To understand just how bad this will get for RBC, we need to look at the reason hedge funds are shorting.

Why hedge funds are betting against banks

The general thesis for shorting the Big Six is that because credit quality is deteriorating, banks are set to lose money from defaults.

As the most domestic-focused of the Big Six, RBC stands to lose the most, unlike **TD**, which has a vast U.S. Retail business, RBC's foreign operations are limited to providing cross-border banking solutions to Canadian expats. This means that RBC has more exposure to Canada's debt bubble than competitors like TD (which is also being heavily shorted).

Are they right?

There are two concerns investors might have about hedge funds shorting RBC: the direct effects of shorting and whether the hedge funds are correct in their assessment of the bank's risk factors.

The first of these two factors is relatively minor. Although RBC has quite a few shares short, there are far more long positions, so the effect is probably noticeable, though not crippling.

The bigger question is whether the hedge funds are correct in their thesis. If credit quality is deteriorating as badly as they believe, then RBC, as the bank with the largest domestic focus, will indeed be hit hard. The million-dollar question is just how poor that credit quality is becoming and how many defaults will result from it.

The aforementioned Ipsos poll shows that Canadians believe they're getting closer to insolvency; however, its results are self-reported. Another indicator we can use is provisions for loan losses at banks. This is another indicator of deteriorating credit quality, and it's also on the rise. Either of these factors on their own wouldn't mean much. Together, they could be cause for alarm.

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