Are the Short-Sellers Right About Royal Bank of Canada (TSX:RY)?

Description

Canada's major banks continue to attract considerable negative attention from hedge funds and traders. The largest domestic lender, **Royal Bank of Canada** (TSX:RY)(NYSE:RY), ranked as the most shorted stock on the TSX. The short-sellers clambering to profit from a sharp decline in the value of Canada's banks include Steve Eisman, who is famous for shorting the 2006 U.S. housing bubble and profiting from the massive financial meltdown that followed.

Why short Canada's banks?

Eisman's thesis is relatively simple. It centres on claims of a looming cycle of credit normalization. He asserts that a combination of a weaker-than-anticipated economy, financially fragile Canadian households, rising unemployment, and stagnant wage growth will trigger a significant uptick in the volume of mortgage defaults.

That will cause an unhealthy lift in the volume of credit defaults and impaired loans for major domestically focused institutions like Royal Bank, leading to higher provisions and lending losses, causing earnings and balance sheets to deteriorate sharply. This will ultimately cause the market value of Canada's major banks to decline, seeing short-sellers reap tremendous profits.

While there are certainly headwinds ahead for Canada's banks, the situation is not as grave as Eisman and other short-sellers south of the border believe.

Overall, the big banks reported some solid first-quarter 2019 results. Royal Bank's net income popped by almost 6% compared to a year earlier to $3.1 billion, which came after a solid lift in non-interest income and increased profitability.

However, what is becoming apparent is that the decade of strong gains experienced by the Big Five could very well have come to an end. A combination of a cooling housing market, heavily indebted households, and a saturated highly competitive mortgage market will weigh on the earnings of the more domestically focused banks such as Royal Bank.

Nevertheless, the catastrophic decline in credit quality expounded by Eisman and other short-sellers is unlikely to occur.

Shorting Canadian banks is not known as a widow-maker trade without reason. U.S. hedge funds and other traders have been insisting for almost a decade that a housing meltdown and banking collapse is due. This has not occurred and has cost many short-sellers considerable money.

The reasons are quite simple.

System-wide credit quality remains high because of stricter prudential regulation while compulsory mortgage insurance and conservative loan valuation ratios act as an important backstop should the economy head south.

Royal Bank's credit quality remains robust. It reported a gross impaired loans ratio of 0.46%, which is well below the level indicating there are issues with credit quality. That ratio was a mere 0.01% greater than for the same period a year earlier. While the value of impaired loans grew by 10% year over year, that can be attributed to a single account in the utilities sector, which added $432 million to the balance of gross impaired loans.

It is also worth noting that 38% of Royal Bank's Canadian mortgages are insured and the average loan-to-valuation (LTV) ratio is 57%, indicating that there is plenty of room to absorb the fallout from an economic slowdown.

Royal Bank's earnings are also well diversified, more so than many of the other domestically focused banks, further reducing risk. Personal and commercial banking is responsible for 48% of its earnings, another 22% is generated by capital markets operations, 18% from wealth management, and the remainder through insurance and treasury services.

What many investors don't realize is that Royal Bank has invested in expanding its U.S. presence. It earns 16% of its total bank earnings from south of the border, where it is focused on becoming a top-tier wealth manager. That further mitigates the impact of a weak Canadian economy on Royal Bank's earnings.

The latest surge in confidence regarding the outlook for the U.S. and global economy that propelled the TSX, S&P 500, and the Dow Jones Industrial to record highs, as well as a surge of merger and acquisition activity in the global energy patch, bodes well for higher earnings from Royal Bank's capital markets operations.

What does it mean for investors?

For the reasons discussed, those hedge funds and traders shorting Royal Bank will ultimately lose money. The bank should also be a core holding in every portfolio, and while patient investors wait for its stock to appreciate, they will be rewarded by its regular dividend payment yielding almost 4%.

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Date
2025/08/24
Date Created
2019/05/06
Author
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