Warning: Are the Canadian Banks on the Verge of Crashing 50%?

Description

The banks have been clobbered a good one over the past few months as the Canadian economy suffered a slowdown, bringing forth some mild headwinds that have dampened the performance of many Canadian financial institutions.

With less activity in the capital markets, slower mortgage growth, and a nice tailwind (rising interest rates) that may soon turn into a slight headwind (rate cuts, anyone?), it's not a mystery as to why the banks have been treading water of late. The poor past-year performance has caused some U.S.-based short-sellers to come out of hiding in recent months to rub salt into the wounds of the Canadian banks with alarmist statements like the Canadian banks could fall by "at least 50%".

Kevin Smith, one of the biggest Canadian bank bears and CEO of Crescat Capital, sat down with *BNN Bloomberg* back in January, highlighting the Canadian housing bubble and the ridiculously high debt-to-GDP ratio as primary reasons why the banks could be in for a big plunge. Mr. Smith thought that the outflow of Chinese money from Canadian banks could be a potential catalyst that could send the Canadian banks down the hill and thinks that a 50%-plus drop isn't out of the question.

With President Trump ready and willing to bring the tit-for-tat trade war with China to the next level, the Canadian banks could be in for some major pain if Mr. Smith's short thesis is indeed correct. Yikes!

As a bank investor, short-sellers coming out during times of turmoil should be nothing new. The Canadian bank shorts have been wrong in the past, and I think they're going to be wrong again, especially when it comes to the Big Five.

In a prior piece, I highlighted two overvalued banks that were at risk of correcting 10-15%. A 20% drop for **Royal Bank of Canada** (TSX:RY)(NYSE:RY) is completely plausible, especially when you consider that the stock is flirting with all-time highs in an environment that's anything but ideal.

As for the 50-plus percent drop for the Big Six, I think such a scenario is highly exaggerated and "over the top," as many of the short points have been common knowledge to most Canadian bank investors who tune into mainstream financial television programs.

High consumer debt and a frothy housing market? That's old news! And I find it highly unlikely that America's trade war with China will spark an implosion in Canada's top banks.

Such a violent 50% drop, I believe, will only end up happening if we're sent into a severe recession that's comparable to the 2007-08 Financial Crisis. In such a scenario, stocks in aggregate will lose around the same, so you'd probably be better off shorting a stock that doesn't have such a fat dividend yield if you're predicting a recession and are looking to profit off it.

Could Royal Bank fall by 20%?

Royal Bank is one of Canada's finest banks, and it's done a remarkable job of holding its own over the last few quarters as its peers exhibited signs of weakness.

While Royal Bank may have been seen as the winner over the last four quarters, the positive moves were overhyped and exaggerated. If I were to guess, I'd say that bank investors in Royal Bank's peers jumped ship after Royal Bank pulled the curtains on its results.

In a prior piece, I stated that banks "deserved to trade at a discount" and Royal Bank's fairly high multiple led me to believe that the stock was at high risk of a mild 10-15% correction.

Foolish takeaway

Don't buy into the "over the top" short theses. A +50% drop probably isn't going to happen unless the sky ends up falling.

While the banks will be moving through a more challenging macro environment, I wouldn't dare short any of them. Royal Bank of Canada looks to be the most overvalued bank at this juncture, but even though I expect a mild pullback, I still wouldn't short the stock because shorting Canada's big banks is an extremely risky proposition!

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