Ignore Wall Street and Buy Royal Bank of Canada (TSX:RY)

Description

Rising fears of a trade war, heavily indebted households and stagnant economic growth are creating a gloomy outlook for Canada's banks, which has seen U.S. hedge funds, including Steve Eisman of *Big Short* fame bet against the big five. Eisman recently announced he was doubling down on his bet against the banks and that recent earnings pointed to growing weakness. Each of the big five is among the 10 most shorted stocks on the TSX, with **Royal Bank of Canada** (TSX:RY)(NYSE:RY) and **Toronto-Dominion Bank** attracting the most negative attention.

Understanding the short thesis

Eisman's controversial investment thesis is predicated on the belief that an economic downturn, coupled with heavily indebted households and a normalization of credit, will trigger a sharp increase in the volume of impaired loans, which, it's believed, will weaken the banks' balance sheets and crimp earnings growth, causing their market value to plunge.

As a result, the Big Five have failed to perform over the last year, with Royal Bank gaining a modest 3% and Toronto-Dominion losing 2% amid fears that the major banks will decline further. While there are headwinds ahead, particularly as the economy slows, it is difficult to see any major catastrophe emerging. RBC Chief Financial Officer Rod Bolger warned against shorting Canadian financial institutions, stating in a BNN Bloomberg article: "*We don't see those dark storm clouds on the horizon yet.*"

While Eisman has an impressive record, it's difficult to understand the basis for his investment thesis.

Royal Bank reported a 6% year over year increase in net income of the second quarter 2019, while diluted earnings per share shot-up by 7% to $2.20. Credit quality remained strong, with the value of gross impaired loans (GILs) representing only 0.49% of total loans under management. This was only 30 basis points (bps) greater than the previous quarter and two bps higher than a year earlier.

Royal Bank's credit portfolio remains sound even after a 15% year over year hike in the value its GILs to just over $3 billion. It is worth noting that the sharp increase in the value of GILs can be blamed on a deterioration in Royal Bank's U.S. wholesale lending portfolio rather than its Canadian mortgages.

Much of the uptick in GILs can be attributed to the oil and gas sector, where weak balance sheets, an ongoing price slump and deteriorating fundamentals weigh heavily on many smaller upstream explorers and producers.

This is contrary to Eisman's thesis and can be attributed to Canada's stricter prudential regulation, stress testing conducted by the banks, tighter underwriting mortgage underwriting standards and a lack of subprime loans.

In fact, insurance for all Canadian mortgages with less than 20% down forms an important backstop for the big banks, which will help prevent any material decline in the quality of their mortgage books should the credit cycle deteriorate. Around 37% of Royal Bank's Canadian mortgages are insured, and those that aren't, including HELOCs, have a conservative loan to value ratio (LTV) of 52%, thereby indicating there is plenty of room to renegotiate the loans should the need arise.

While Canada's once red-hot housing market has cooled, there are no signs of a market rout, meaning that any economic downturn will have little material impact on Royal Bank. I also expect the bank's earnings to continue growing.

Royal Bank's wealth management and capital markets businesses reported solid earnings growth — a trend that should continue despite fears of a trade war between China and U.S. If a range of macro factors shift in favour of the bank**,** such as an improved global economic outlook, then Royal Bank's earnings will continue to improve at a decent clip over the remainder of 2019.

Putting it together

It appears that Eisman's concerns are overblown. Shorting the banks isn't known as a widow-maker trade without reason. Hedge funds and trades have been doing it for nearly a decade, losing considerable sums of money.

Royal Bank remains my favourite out of the Big Banks, offering a healthy mix of income and growth. Once the hype created by Eisman dies down, Royal Bank's stock will experience a meaningful bump in value. Until that occurs, investors will be rewarded by a sustainable steadily growing dividend yielding 4%.

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