



Should You Short These 3 Banking Stocks?

Description

Steve Eisman, the portfolio manager who shot to fame when he bet against collateralized debt obligations (CDOs) during the collapse of the U.S. housing bubble in 2007-2008, has been targeting Canada's seemingly robust banking sector for his next big short. His concern seems to be that Canada's debt cycle hasn't normalized in over 20 years, and some of the country's largest banks appear ill-prepared.

His firm is now betting against the likes of **Royal Bank** ([TSX:RY](#))([NYSE:RY](#)), **Laurentian Bank** ([TSX:LB](#)), and **Canadian Imperial Bank** ([TSX:CM](#))([NYSE:CM](#)).

Eisman isn't alone. Institutional investors have been pouring billions into their bet against the Canadian banking sector. According to data published by the *Financial Times*, short bets against the banks are up 19% this year and are collectively now worth \$12.3 billion.

It seems institutions are convinced of the banking sector's weakness, but should retail investors follow them on ditching some of Canada's most lucrative dividend stocks? Here's a closer look at the underlying fundamentals for each of the banks Eisman picked.

Royal Bank

RBC is by far one of the largest private lenders in the country. The stock currently offers a 4% dividend yield and trades at a price-to-book ratio of 1.95. At first glance, the bank seems fairly valued.

Laurentian Bank

Comparatively smaller than the other two banks on this list, Laurentian offers investors a better valuation and better dividend yield. At the current market price, the stock trades at 83% of net book value and offers a 6.2% dividend yield — both substantially better than the industry average.

Canadian Imperial Bank

Comparatively larger and more well known, CIBC is mostly in line with the other banks on this list. The dividend yield is 5.5%, while the stock trades at a 34% premium to net book value.

The short thesis

Despite the seemingly attractive metrics, institutional investors are concerned that Canadian citizens and corporations have taken on too much debt, and the delinquency rate is likely to go much higher in the near future as interest rates rise.

Meanwhile, [the banking sector](#) has kept either low reserves or negative reserves for such an uptick in delinquency rates. This means banks will have to pay out of pocket if (when?) the credit cycle returns to normal, eroding the profitability and growth of the major banks.

Early indicators seem to be validating these concerns. Last week, **Equifax** Canada revealed that non-mortgage delinquency rates were steadily rising in 2019, and the rate at which seniors were defaulting on their debt was up 9.4% year on year.

Although it is too early to say if this trend will continue, the market seems unconvinced. All three of the stocks mentioned in this list are up so far this year. That's despite other concerns for the Canadian economy such as a potential recession and the ongoing trade war.

Bottom line

Despite the mounting risks and early red flags about Canada's economy and debt cycle, the banks seem to be priced as if business conditions will remain stable forever. For investors who understand the cyclical nature of the economy, these banks are best avoided. However, I wouldn't go as far as saying the average investor should short the stocks and bet against them.

CATEGORY

1. Bank Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. NYSE:CM (Canadian Imperial Bank of Commerce)
2. NYSE:RY (Royal Bank of Canada)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:LB (Laurentian Bank of Canada)
5. TSX:RY (Royal Bank of Canada)

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Date

2025/09/11

Date Created

2019/06/17

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vraisinghani

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