Shorting Canada’s Banks: A Trade Guaranteed to Lose

Description

Canada’s banks continue to attract considerable negative attention, with the big five ranked among the 10 most-shorted stocks on the TSX.

Bank of Montreal is now the most-shorted stock, while **Royal Bank of Canada** (TSX:RY)(NYSE:RY) is ranked second. This is being led by U.S. hedge funds that believe that Canadian banks will experience sharp losses because of a downturn in the credit cycle.

While the latest results for the banks were mixed, there are signs that the short sellers misunderstand Canada’s banks and will incur considerable losses.

Growing short volume

Short trades against the big five banks are estimated to be worth in excess of US$11 billion. The bet is based on the belief that a rapidly cooling Canadian housing market coupled with a softer economy and heavily indebted households will trigger a sharp decline in loan quality.

That in turn will lead to greater volumes of impaired loans and credit write-offs, which will significantly impact earnings and balance sheets causing stock prices to tumble. While there are signs of weakness, the outlook is not as poor as the hedge funds believe.

Domestic economic growth has been better than anticipated, unemployment remains low, and the U.S. Federal Reserve’s latest interest rate cut, coupled with signs that the trade war between the U.S. and China could end, bodes well for a stronger economy.

On top of that, it is anticipated that the housing market will recover over the next year, with prices expected to exceed the 2017 peak by 2021.

Key differences

There are also significant differences between Canada's housing market and that which existed in the U.S. in the run-up to the 2007 housing meltdown.

The key difference is the lack of subprime mortgages and non-recourse loans. Those two factors triggered rapidly cascading housing prices, as more and more properties were repossessed and put on the market at fire-sale prices, which caused the meltdown to gain uncontrollable momentum.

Coupled with many financial institutions being exposed to a range of toxic debt instruments comprised of subprime mortgages, those factors were responsible for triggering the financial crisis and near-collapse of major U.S. banks.

Tighter prudential regulation and a more conservative approach to managing risk among Canada's banks means that only around 3% of all mortgages underwritten are classified as subprime. This is compared to a peak of 14% in the U.S. in 2007 when the housing bubble finally burst.

The volume of subprime mortgages being underwritten in Canada has fallen significantly because of even tighter lending standards instituted by the prudential regulator.

Even if the housing market experiences a sharp correction, which appears unlikely, the impact on Canada's banks would be minimal. This is because a large portion of mortgages are insured, while those that are uninsured have low loan-to-valuation ratios (LTVs), thereby significantly mitigating the impact of any notable decline in credit quality.

Over 36% of Royal Bank's Canadian mortgages are insured, while those that aren't have a low LTV of 52%, indicating that there is considerable room to absorb lower housing prices. The bank's low gross impaired loan ratio of 0.47%, which despite being 0.07% higher year over year, highlights the quality of its loan portfolio and that it can absorb any significant decline in credit quality.

Even the weaker economic conditions that existed during the third quarter and tighter underwriting requirements had little impact on Royal Bank's ability to grow its portfolio. Residential mortgages expanded by a healthy 6% year over year, while business loans shot up by a notable 10%.

This indicates that Royal Bank's loan portfolio will continue growing, particularly once the more optimistic economic outlook is considered.

Royal Bank's push to expand margins by unlocking operational efficiencies and digitizing its platform will lead to lower costs and greater profitability, further offsetting any impact on earnings caused by declining credit quality.

Final thoughts

The differences between Canada's mortgage market and that which existed in the U.S. during the lead-up to the 2007 housing bust means that a sharp decline in credit quality is highly unlikely to occur. When that is considered along with a more upbeat economic outlook and tighter prudential regulation, shorting Canada's banks appears to be a losing proposition.

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