Struthers Report V28 # 10.3 Sell/short Canadian Banks, Real estate woes, CIBC CM, BNS, ZEB July 4 2022

Know when to hold-em!
Know when to fold-em!
Know where to set stops!
Know when to run!
Never count your portfolio
Until the sells are done..

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I am expecting a 30% or more average decline in Canadian real estate. That would basically unwind the 50% bubble increase in the last 2 years during the pandemic. Canadian Banks have dangerously high leverage to the housing market and have been too loose and careless. I have been warning of a real estate bubble since mid last year and that prices would come way down as increased interest rates would pop the bubble. I will give some tidbits from other experts that are now echoing my concerns.

From a Desjardins report - Home prices increased by about 50 per cent, on average, during the pandemic, as low rates allowed buyers to qualify for larger loans while still keeping the ongoing payments relatively affordable.

Much of those inflated house prices have been built on a foundation of debt. Almost one in five Canadian households are now considered "highly indebted," which means their debt to income ratio is 350 per cent or more, the bank says.

Prior to the pandemic, only one in every six were that much in debt. Barely 20 years ago, in 1999, only one out of every 14 households had that much debt.

"*Those numbers mean that each rate hike will inflict more pain on the economy than it would have in the past*," said Desjardins economist Royce Mendes.

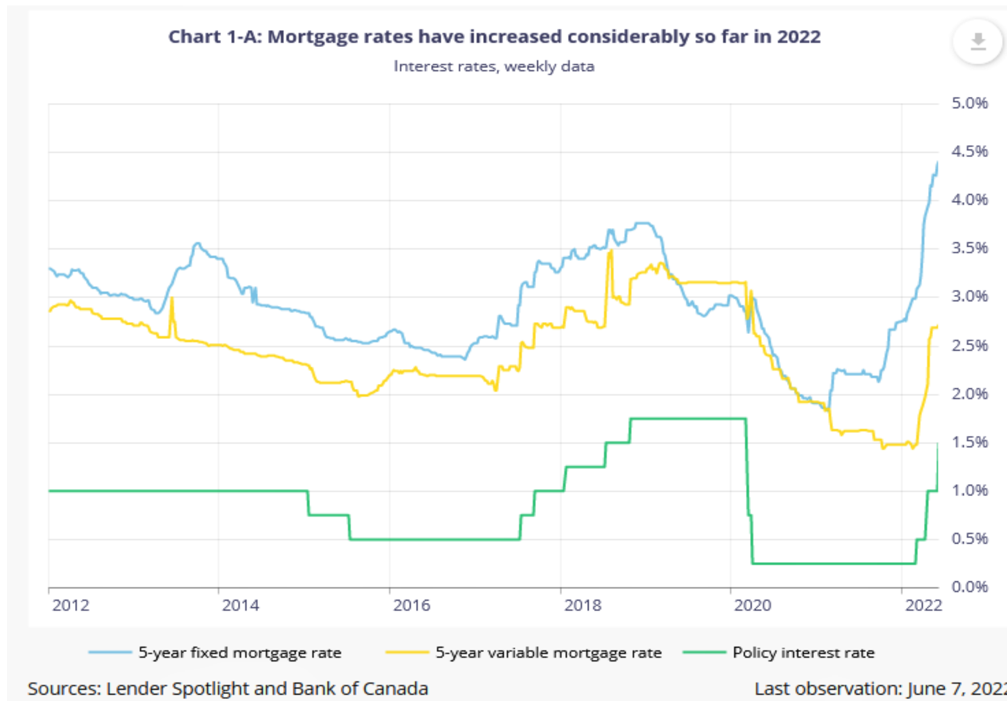
Canaccord Genuity Wealth Management. *"We are avoiding all exposure to Canadian credit. We have no Canadian bank stocks in our portfolios, because we believe loan losses will go up."*

June 7 " -The area we're most concerned about is Canadian housing, especially given the high percentage of floating-rate mortgages in the market today," said David LePoidevin, Senior Portfolio Manager and Senior Investment Advisor at LePoidevin Group,

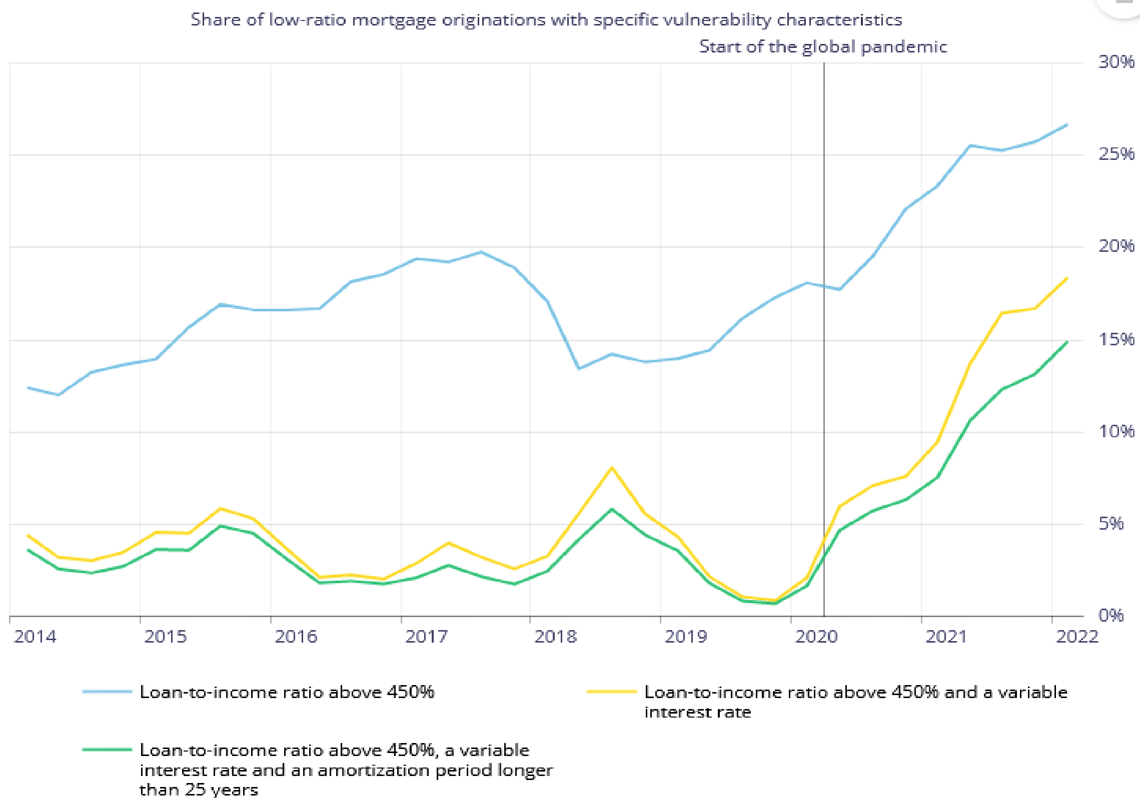
"*If you're old enough, you can remember when mortgage rates went up in 1981. That created a problem in lending, which brought the housing market down and banks ran into trouble,*" LePoidevin says. *"Remember, during the pandemic, mortgage rates went from 3% to 1.5%, so people were able to borrow more. Now the tide is turning: a mortgage that was 2.19% on January 1 is now 4.59%."* Some may argue that the 1981 surge in mortgage rates was more eye-watering, as rates increased from the 10% to the 20% range. But LePoidevin points out that mortgages were also more modest back then, when a $200,000 mortgage was considered extremely high. That means in plain dollar terms, a homeowner with a mortgage today is likely to feel the same squeeze as one who went through that challenging period four decades ago.

Canada's current vulnerability also marks a reversal of its situation relative to the U.S. during the 2008 financial crisis. At that time, LePoidevin notes, the U.S. was rocked by troubles in the housing market, while Canada fared very well as it had virtually no exposure to subprime mortgages.

"Back then, the Canadian banks were very careful in their lending. And now we have a situation where our subprime market is as big or bigger than what the U.S. had in 2007," he says. "*Canada's credit market has gotten very loose, while the U.S. is much tighter than it used to be. So they're much more able to withstand a housing slowdown than Canada."*



Above shows the quick rise in interest rates that will go much higher. The next chart from a recent [Bank of Canada assessment of real estate]. They did a simulation assuming mortgages would be renewed in the years ahead at a median of 4.4% for variable and 4.5% for fixed. The average variable rate mortgage payment would increase by over $700 and fixed around $300.



According to Manulife's Bank Debt Survey, which looks at Canadians aged 20 to 69 who make over $40,000 a year, many are worried about their ability to buy or keep their home. Per the research, **one in four Canadian homeowners feel that if interest rates continue to rise, they will be forced to sell their homes.** Currently, around 18% say they can no longer afford the house they own,

Canadian's are swamped with home equity lines of credit (HELOC) on top of their mortgages and interest rates move up lock step on these with short term rates. The HELOC is always a variable rate. Released by BNN Bloomberg and RATESDOTCA, the survey found that 27 per cent of homeowners who participated have accessed a (HELOC). Almost 80 per cent of those participants have used it, and half of them said they have done so in the last two years.

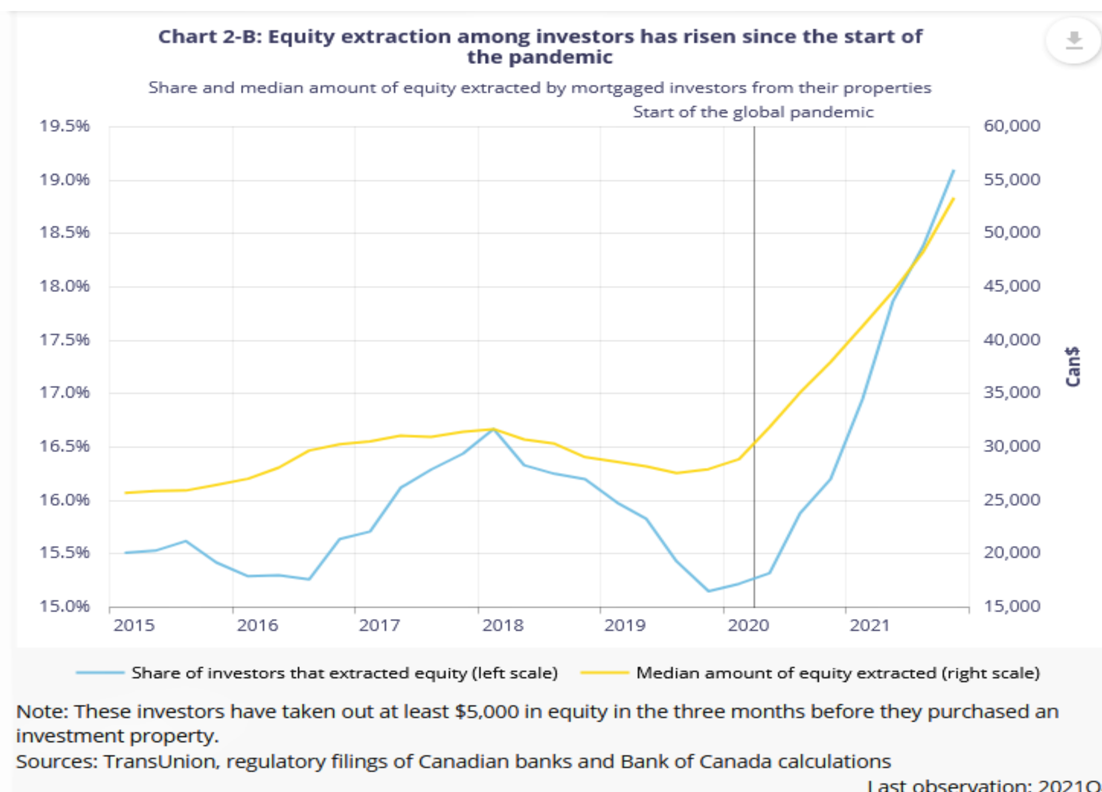
Aside from the pressure of increased interest rates, HELOCs are complicated by new real estate loan guidelines announced by the Office of the Superintendent of Financial Institutions on Tuesday. In late 2023, borrowers will be required to pay principal and interest on combined loans above 65 per cent of the property value. And when home values come down, many more will go above the 65% threshold. **And lenders can demand full payment of these at any time.**

And with falling prices, those that took a HELOC to renovate and flip the property could end up under water very quickly. Especially now as prices for renovation are through the roof.

Key findings

- **27% of Canadian homeowners have a home equity line of credit (HELOC).**
- **Those who requested a HELOC from their lender are significantly more likely to have used it (85%), and to have used it in the last two years (81%).**
- **Nearly six-in-ten (58%) HELOC holders have an outstanding balance.**
- **43% of HELOC holders say they used their HELOC for home renovations.**

According to Statistics Canada, debt owed on home equity lines of credit (HELOC) increased by 0.3% in March, reaching $167.3 billion. That's on top of February's $2 billion increase, the highest month-over-month growth since 2012. This next Bank of Canada chart is investors only. They consider someone an investor if they have more than one mortgage. It is a good illustration how much home equity loans were piled on since the pandemic.



Note: These investors have taken out at least $5,000 in equity in the three months before they purchased an investment property.
Sources: TransUnion, regulatory filings of Canadian banks and Bank of Canada calculations
Last observation: 2021Q4

You should get the picture here quite clearly. Never before has housing in Canada been so leveraged with so much debt at a time of rapidly increasing interest rates and recklessly piled on in a bubble of the last 2 years.

Now lets look at the Canadian Banks and how they took on so much leverage to this housing bubble. First lets put to rest **mortgage insurance, it will not help. About 75% o**f the big bank mortgages are not insured. Canada has got into the Mortgage Back Securities (MBS), just like the US did before the 2008 crash. However, Canada's MBS are highest quality all insured by the CMHC (mortgage insurance). This is great for the buyers, but the banks are selling their best backed or safest mortgages therefore holding more riskier ones.

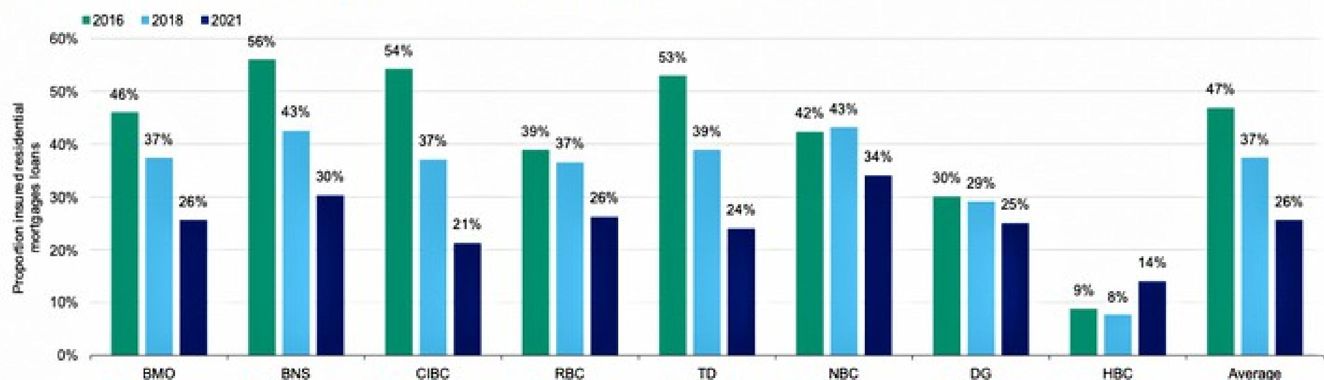
I poured over the Canadian Banks latest quarter financial statements to come up with their amount of mortgages and HELOC. I than did a ratio to their market cap as of June 27th and a ratio to their total 2021 revenue and net revenue. My purpose was to see what banks had higher leverage to the mortgage market and would be more vulnerable. This in the table below. The lower the ratio, is more leverage and risk.

Bank	$B Market Cap	$B Mortg & HELOC	share	Market Cap to Mortg/heloc	2021 Rev $B	Total Rev to Mortg	2021 Net Rev $B	Net Rev to Mortg	$B Mortg last Qtr	$B heloc last Qtr
Royal Bank	$175	$404	25%	0.433	$46.693	0.1155	$16.100	0.03984	$368	$36
TD	$153	$348	22%	0.440	$42.693	0.1227	$14.298	0.04109	$240	$108
Scotiabank	$92	$316	20%	0.292	$31.252	0.0991	$9.955	0.03155	$294	$21
CIBC	$57	$273	17%	0.208	$20.015	0.0733	$6.446	0.02361	$254	$19
BOMontreal	$84	$150	9%	0.562	$27.186	0.1816	$7.754	0.05180	$140	$10
Nat. Bank	$28	$102	6%	0.280	$8.927	0.0880	$3.177	0.03130	$102	$0
total		$1,592								

CIBC wins hands down with a 0.208 ratio to market cap and the lowest ratio to 2021 revenue and net revenue. Scotiabanks is next with more leverage and risk.

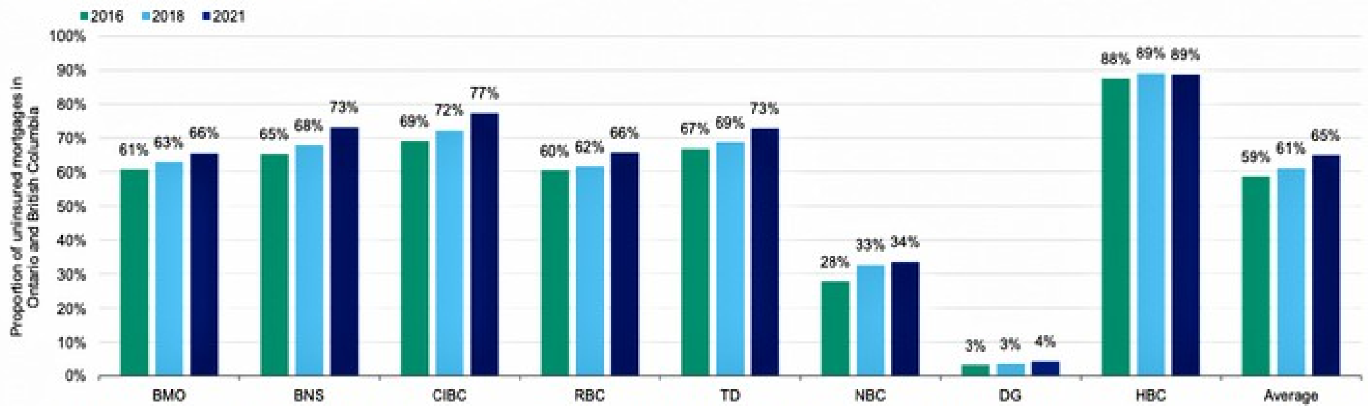
This next chart is insured mortgages and you can see the dramatic decline since 2018. Again CIBC is most at risk with just 21% in this regard. Scotiabank BNS is not so bad here but TD shows a big decline too at just 24%

Fewer insured residential mortgages increase the potential loss during a stress



Data as at 30 April 2016, 30 April 2018 and 31 July 2021 for BMO, BNS, CIBC, NBC and TD. 31 March 2016, 31 March 2018, and 30 June 2021 for Desjardins and HBC. Residential mortgag exposures include home equity lines of credit.

The housing markets with the biggest increases and bubble like price action was Ontario and BC. All the banks took on more exposure here and once again CIBC has the most risk with highest exposure at 77%. BNS and TD tie for next spot at 73%. Basically 3/4 of the big banks mortgages are in the bubble provinces.



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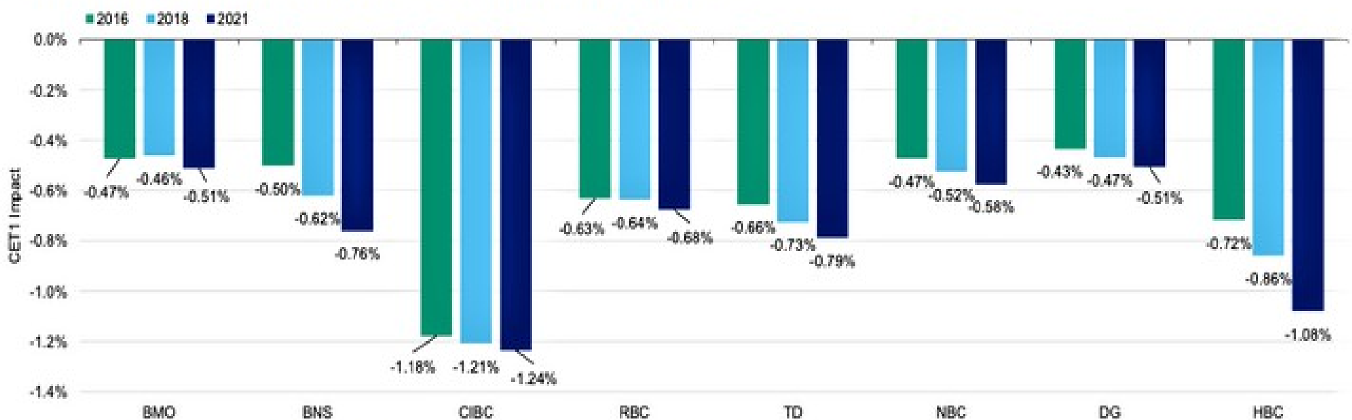
On the stress test, once again CIBC comes out as the worse, but they always have been in this metric. Scotiabank BNS shows the largest deterioration since 2018



Data as at 30 April 2016, 30 April 2018 and 31 July 2021 for BMO, BNS, CIBC, NBC and TD. 31 March 2016, 31 March 2018, and 30 June 2021 for Desjardins and HBC. Based on Moody's assumptions including default and loss rates and a standard residential mortgage loan to value distribution that may differ from actual lenders' distribution.

The top 6 Banks hold about 95% of Home mortgages. HSBC specializes more in home equity loans here but has big exposure to China that has a mortgage/housing problem as well. The Central Bank and all other major Canadian banks have to maintain minimum capital ratios established by OSFI: a CET1 capital ratio of at least 10.5%, a Tier 1 capital ratio of at least 12.0%, and a Total capital ratio of at least 14.0%. If 5% of mortgages crap out it is not going to fold the banks, but if it climbs over 10% it would be a huge problem. Never the less, the Canadian Banks are going to see profits plunge as their bad loans and mortgages rise.

There was some interesting news out of TD and Royal Bank this morning. Statistics Canada reported that

retail sales volumes rose 0.9 per cent in April from the month before, a measure that accounts for higher prices. Statscan estimates retail sales climbed another 1.6 per cent in May, again outpacing the month-to-month rate of inflation. After adjusting for inflation, spending by Toronto-Dominion Bank clients using debit and credit cards **was up 15 per cent in May from a year earlier. RBC has found that consumer spending on its credit and debit cards is roughly 30 per cent higher than prepandemic levels.**

Not only do the Canadian Banks **short sale against their clients stock accounts** but also according to The Globe and Mail in todays edition some of the largest **banks are blocking on-line investors from buying high-interest-savings exchange traded funds, which compete with the banks' own deposit accounts.** The Globe's Clare O'Hara writes that discount brokerage arms at RBC, BMO and TD Bank do not allow do-it-yourself investors to purchase high-interest-savings ETFs, also known as cash ETFs, or HISA ETFs.

I have mentioned numerous times to spend cash on consumables with shelf like because prices will only be higher down the road. **Are Canadians spending more because they know prices will rise or is it just for the sake of not being locked down anymore?** If they fear higher prices, than high inflation is becoming entrenched into the economy.

I believe it is time to short the Canadian Banks. From the numbers above, I am starting with CIBC. The stock broke major support around $69. I was waiting for a decent rally in the bank stocks but it is not looking like we will get much of one. US hedge funds have been increasing their short positions significantly on Canadian Banks and will probably just short more into any rallies. CIBC has only mild support around $62. I expect it is heading to $55 short term and then down the pandemic lows around $36.

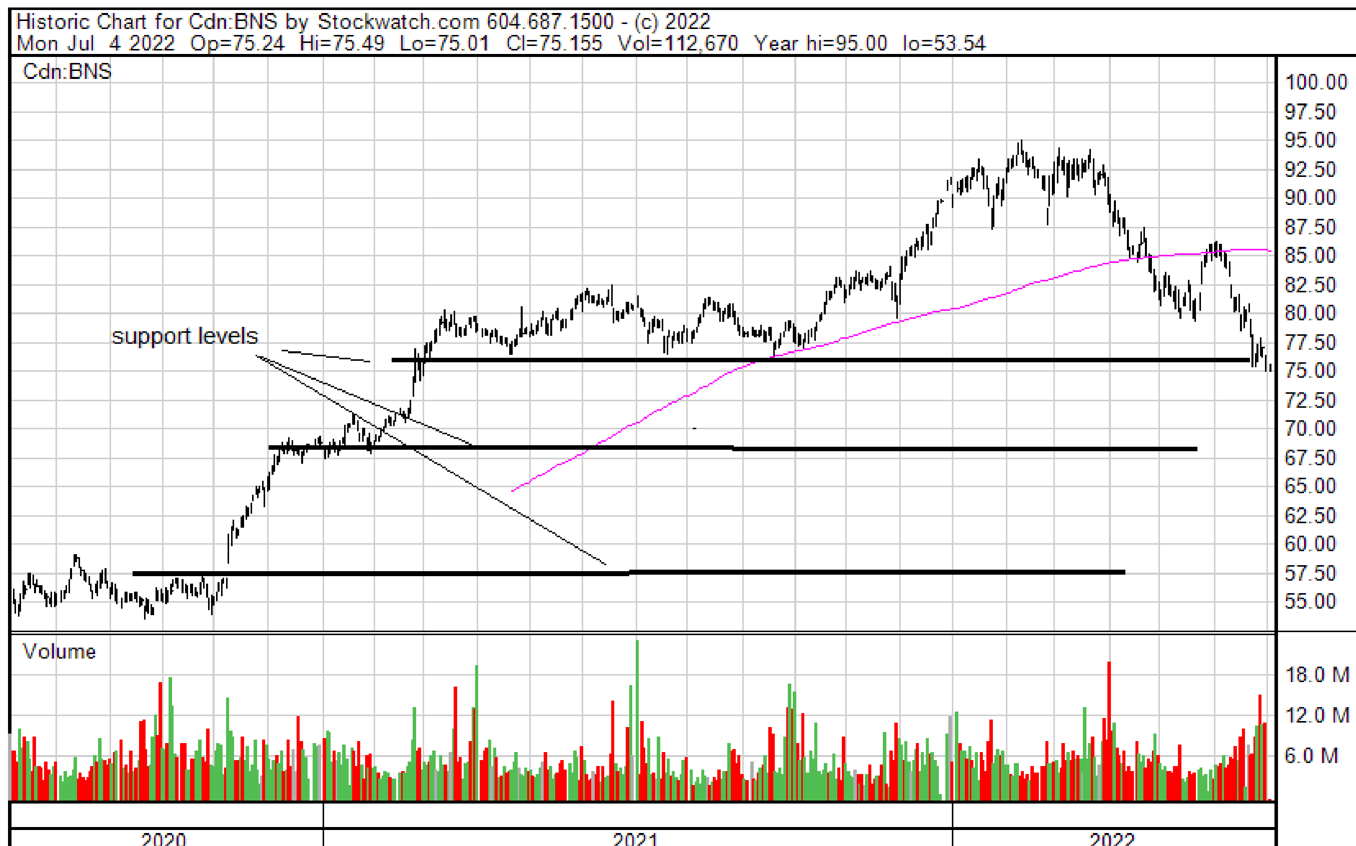
CIBC has the weakest looking chart and the other bank stocks are still holding around their first support level except Bank of Nova Scotia.

To short CIBC, I like the **March 2023 $65 Put Options around $6.00 (they are about $3 in the money). A cheaper alternative is the December 2022 $62 Put for about $2.80**

Bank of Nova Scotia TSX:BNS and TD Bank TSX:TD were about next in line after CIBC for mortgage exposure. BNS has broken down on the chart so I am suggesting some Put options here as well.

BNS is just breaking below it's first support around $76, has mild support around $67.50 and is probably heading for the $57 area.

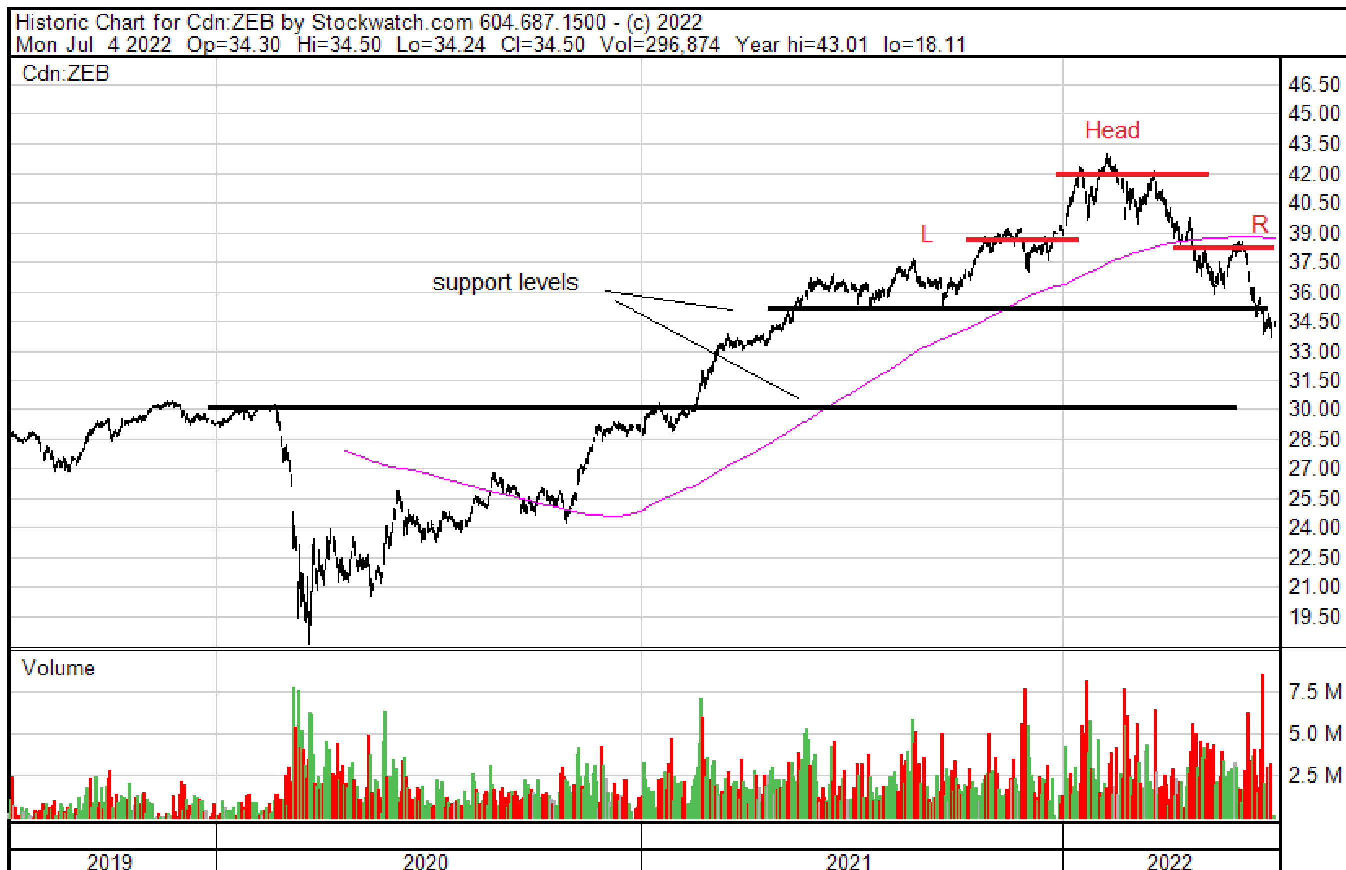
I like the **March 2023 $80 Put for around $8.00.** A cheaper alternative is the **December 2022 $72 Put for about $3.00.** The March Put is about $5 in the money so both are priced about the same.



There are some Canadian Bank stock ETFs, but I don't think there are any short ETFs just long. These have lower prices than the individual stocks but the Put options have low premiums and are attractive. I like the BMO equal Banks Index TSX: ZEB. Here is the allocation from last year, but it does not change much.

ZEB Bank Holdings	**Allocation**
Canadian Imperial Bank of Commerce (CM)	17.94%
Bank of Montreal (BMO)	17.26%
National Bank of Canada (NA)	16.88%
Royal Bank of Canada (RY)	16.68%
Toronto-Dominion Bank (TD)	15.64%
Bank of Nova Scotia (BNS)	15.12%
Cash	0.47%

On the chart, ZEB has fallen through first support around $35 and next is around $30. Most of the banks stocks have also put in head and shoulders topping patterns. It shows up well in this equal weighted bank ETF.



With the ZEB ETF we are not picking on what we see as the weakest bank, but the price of the options is attractive so makes up some. I like the **March 2023 $34 Put for about $2.00.**

Some of the other bank ETFs used covered call strategies so that will help limit their downside, so we don't want to short these. The other decent one is the **RBC Canadian Bank Yield Index, TSX: RBNK. T**hese are recent holdings and interesting it is more weighted in what I see as the weakest two Banks, CIBC and BNS, probably because they have a higher dividend yield and this is what this ETF is trying to achieve

RBNK Holdings	Allocation
Canadian Imperial Bank of Commerce	26.7%
Bank of Nova Scotia	23.7%
Royal Bank of Canada	17.0%
Toronto-Dominion Bank	15.7%
National Bank of Canada	8.5%
Bank of Montreal	8.5%

The problem is there are no options available on RBNK. There is also the iShares S&P/TSX Capped Financials Index ETF TSX:XFN, but is it more diversified with insurance companies. I am not bullish on them either but the other issue is that open interest in the Put options is low so not as much liquidity.

I am adding the CIBC, BNS and ZEB Put options on the Selection List. **You can also view these as a good hedge for your portfolio in a bear market.**

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