Stocks to Avoid in a Slowing Canadian Real Estate Market

Description

Last week, we saw reports from RealNet that were quite troubling. A severe drop in residential land investment was reported in several major Canadian cities. Realnet reported that purchases of land for new housing saw dramatic declines in Calgary, Toronto, and Vancouver. In the first half of the year, Toronto saw a 51% decline in residential land investment, Vancouver saw a 30% drop, and Calgary saw a 52% drop. Is this the builders' way of saying that their expected returns on these projects are not high enough anymore, and we have shifted into an oversupplied real estate market?

Further to this, building permits fell 12.9% in June for single dwelling homes, and 18.8% for condos.

And the negative news continues: The government has put a limit on the issuing of mortgage-backed securities, which makes it harder for banks to secure the cash for issuing mortgages and clearly signifies that the government continues to be worried. This also will make it more expensive for banks to secure the money and will drive the mortgage cost up for the buyer.

Have we finally hit the point where the low interest rate environment that we have enjoyed for years has driven up prices to unsustainable levels? Housing affordability is low, and household debt levels are still high. According to Statistics Canada, the average household debt to income ratio fell to 161.8% in the second quarter of 2013. That is still uncomfortably high. In 1980, it was 66%. Low interest rates and rising home prices have resulted in households taking on an unprecedented burden of debt. This is not sustainable.

Even the IMF has predicted that the Canadian Economy will continue to be held back by high household debt levels and a cooling housing market. As BMO's chief economist said, "Canadians are already drunk on housing". That, to me, sums it up perfectly and captures the mood exquisitely.

With this backdrop, let's look at some names in the financial industry and the home improvement retail industry that will be impacted by a decline in the housing market.

Stocks to Avoid

In the financial sector, the **Laurentian Bank** (TSX: LB) is particularly vulnerable because it is not as strong financially as its peers in the banking industry, and because of its big exposure to the Quebec market. Its Tier 1 capital efficiency ratio of 9.1% compares unfavourably to its peers, and the bank's heavy exposure to the Quebec real estate market makes it especially vulnerable.

Home Capital (TSX: HCG) is also one that is extremely vulnerable because it focuses on the "higher risk" homeowners, or those who typically do not meet all the lending criteria of traditional financial institutions. While results recently have been strong, in the event of an acceleration of a housing slowdown, this company will not fare well. Furthermore, it trades at a lofty P/B ratio of 2.3, which is on the expensive side when the big 5 Canadian banks average P/B multiple of 1.7 is considered.

In the retail sector, **Rona** (TSX: RON) is extremely vulnerable because the driver for home improvement retailers such as Rona is the housing market. When people are buying houses, they are also renovating and investing in their houses more. Rona has already begun to feel the sting and sales have been flat to down in recent quarters.

Less Vulnerable Stocks

Given its US exposure, **TD Bank's** (TSX: TD) financial results will be less impacted by a slowdown in the real estate market. Although its Tier 1 capital ratio has weakened in the most recent quarter, its geographic diversification will provide a buffer to TD relative to these other names. In fact, because of their more diverse business models, though growth will be impacted for all 5 of Canada's big banks, they do not face the same risk of a direct hit like the company's mentioned above.

Home Depot (NYSE: HD) has been increasing its presence in Canada, and so it will also feel the sting if the real estate market weakens further. However, sales in the US have been very strong in the last few quarters, so Home Depot will have that to lessen the impact of a Canadian slowdown.

Foolish Final Thoughts

The risk of a "hard landing" in the real estate market cannot be ignored. The signs are strong enough to at least position our portfolios with this in mind and guard against this risk. Remember, investing is all about risk versus reward. Consider, with the possibility of an imminent housing correction staring us in the face, is the reward for venturing into this sector really worth it?

Three more names that will feel absolutely no impact from a slowdown in Canadian housing are profiled in our special **FREE** report "**3 U.S. Companies That Every Canadian Should Own**". **Click here now** to download this report at no charge.

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Fool contributor Karen Thomas does not own shares in any of the companies mentioned. The Motley Fool does not own shares in any companies mentioned at this time.

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TICKERS GLOBAL

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2. TSX:LB (Laurentian Bank of Canada)

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