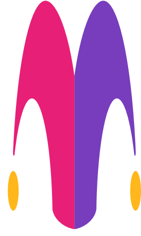

3 Reasons Canada's Real Estate Market Is in Trouble

Description

Over the last decade, you'd be hard pressed to find a better performing sector than real estate in Canada.

House prices have essentially doubled in that time, and yet the average household income hasn't risen much more than inflation. Canada's market has survived a U.S. housing crash, a world economic slowdown and former Finance Minister Jim Flaherty's best efforts to suppress the market with mortgage qualification restrictions, like eliminating 0% down mortgages and shortening the maximum amortization period to 25 years, from a previous maximum of 40.

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Mostly thanks to low interest rates and the perception that real estate is safe, the market has shrugged off any bad news and continues to hit a new record high almost every month. But like all good things, this ride will also come to an end. Here are three reasons why it'll happen.

1. Increasing interest rates

The only reason why Canadian housing is reachable for the average family is low interest rates. Historical norms for mortgage rates are in the 6% range, at least double what you'd pay today.

While I'm not predicting interest rates to suddenly double overnight, I am predicting a slow return to more normalized rates. The United States is chugging along nicely. Unemployment keeps going down, so the Fed will continue to taper. This will cause interest rates to slowly rise, and this will eventually make its way to Canada.

A 1% rise in interest rates doesn't seem like much, but it can have a huge effect on a homeowner. If you owe $400,000 on your house, an extra 1% is $4,000 per year, or more than $300 per month. Canadians have record low savings rates and record high debt. There are a lot of people who can't afford an extra $300 per month.

2. Record high debt

As a country, Canada is maxed out.

The average household owes $164 in debt for every $100 in disposable income. This is slightly down from record levels, which peaked at 164.2% of disposable income. This is right around the level the U.S. peaked at in 2007. Growth in borrowing against houses is staggering, and many Canadians use home equity lines of credit (HELOCs) as a way to consolidate higher interest credit card debt. We're borrowing against our houses to consume. Canada's largest bank, **RBC** (TSX:RY)(NYSE:RY), grew HELOC lending by eight times from 2004 to today. That's a massive increase.

This creates a situation where the average Canadian is in deep trouble after just a couple of weeks without a pay cheque. If I had no wiggle room, I'd probably stop paying my credit card or student loan before I stopped paying my mortgage, since keeping the house would be a priority. But what if I'd consolidated all that debt into a line of credit, secured against my house? I'd need to find another solution, and fast.

3. Nobody left to buy

Increasingly, young Canadians feel as if it's impossible to enter the housing market. Activity from first-time buyers is starting to dry up. The slack is currently being picked up by people who are using low interest rates and some of their newfound equity to upgrade to a better place. Any healthy real estate market needs first-time buyers. There are hundreds of thousands of condos being built in Canada, especially in Toronto and Montreal. If first-time buyers don't gobble those up, it could start a cascade of decreasing real estate prices.

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If condo prices start to fall, look for the thousands of "investors" who've speculated in big city condos to get nervous and exit the market in droves, further depressing the market.

These are the main reasons I'm reluctant to buy shares in **Home Capital Group** (TSX:HCG), even though it's reasonably attractive on the surface. Yes, it has solid underwriting standards, but it's still lending to people regular lenders won't touch. The super low default rate of 0.09% is partly because a rising market will help a distressed homeowner get out of a property with a portion of their equity intact.

I'm not predicting bankruptcy for Home Capital or anything close, but there's a reason why it's the cheapest mortgage lending stock in the country. Sentiment will send the share price lower if the national real estate market suffers.

Foolish bottom line

It's simple. At some point, the Canadian real estate market will start to stumble. While there's still the hope of a soft landing, it's hard to make the argument that the sector is primed for another decade of growth. Even though Canadian lenders are well capitalized and have solid balance sheets, the vast majority of their earnings growth has come from increased mortgage lending. Look for lenders like Home Capital to underperform going forward.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:RY (Royal Bank of Canada)
2. TSX:HCG (Home Capital Group)
3. TSX:RY (Royal Bank of Canada)

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