Are Investors Wise to Short Canada?

Description

As we all know now with the benefit of hindsight, 2007 was a poor time to be in the mortgage origination business in the United States. Crummy mortgages and overzealous bankers combined to create a market that ended up failing spectacularly, bringing the entire world's economy to its knees in the process. We recovered, but not without massive bailouts and huge government stimulus programs.

For a small pocket of investors, Canada represents a very similar situation. Since the Great Recession, Canada's growth has been primarily driven by two factors — real estate construction and exporting commodities. These investors believe that both of those growth areas are poised to experience major corrections, leaving the Canadian economy in pretty poor shape.

Let's take a closer look at their thesis and whether investors should avoid stocks most exposed to this potential weakness.

Real estate

The more I look at the Canadian real estate market, the more nervous I get.

The price of the average Canadian house has essentially doubled over the last decade. Canadian household income certainly hasn't gone up enough to cover that gap. Luckily for Canadian homeowners, interest rates have gone down, making owning a home possible. But to do so, Canadians have amassed record debt levels, more than $1 trillion in mortgages, and overall we have an alarming amount of wealth stuck in home equity.

Observers understate the effect that a weak housing market will have on the average Canadian consumer. People borrow money against their house to buy stuff or to consolidate debt all the time. If real estate prices start to go down, so does the confidence of the average Canadian. People aren't likely to spend on big ticket items if the price of their largest asset starts going down. We saw that first-hand in the United States in 2008.

The obvious stock to avoid if an investor is concerned about Canada's real estate market is **Home Capital Group** (TSX: HCG). Home Capital specializes in lending to consumers traditional banks won't touch, and has done a terrific job, limiting loan losses to just 0.09%.

But that's during a good market. What happens during a bad market? During the aftermath of real estate booms in western Canada in the early 1980s and southern Ontario in the early 1990s, default rates rose to just a hair over 1%. Considering Home Capital caters to customers more risky than a traditional lender and has moved away from mortgages that are CMHC insured, there's potential that 0.09% default rate could rise by a factor or 10 or 20 during a sustained real estate downturn.

Rona (TSX: RON) is another stock to avoid during a rocky real estate market. Renovations will grind to a halt, and house flippers will simply stop. Even the average homeowner will slow down maintenance. All these factors are bad news for the company.

Commodity slowdown

The other source of Canadian strength over the past few years has been our commodity business, exporting raw materials to markets around the world.

A big customer of Canada's raw materials has been China, as the nation continues to build infrastructure and real estate. But as billionaire investor Prem Watsa has discussed, China's growth has some serious issues. The home ownership rate in the country is more than 100%. The Chinese have built the equivalent of 50 Manhattans over just the past five years.

If China slows down, there are several Canadian resource companies that will feel the pinch. The most obvious is **Teck Resources** (TSX: TCK.B)(NYSE: TCK), which exports more than 27 million metric tons of coal to Asia, most of which goes to China to aid in steel production.

Two other stocks to avoid if China starts to slow down are lumber producers **West Fraser Timber** (TSX: WFT) and **Canfor** (TSX: CFP). Both companies are increasingly exposed to China's building boom, and we can't expect U.S. housing to make up the slack if China cuts the orders.

Foolish bottom line

It's relatively easy to make an argument that weakness in the real estate market and soft Chinese demand for natural resources would be bad for the Canadian economy. That's obvious. The question investors must answer is how likely these events are to occur. I can see both scenarios happening, but I can also see soft landing scenarios where both are weaker going forward, but don't lead to huge damage. Either way, the Canadian economy will be an interesting place to invest.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:TECK (Teck Resources Limited)
2. TSX:CFP (Canfor Corporation)
3. TSX:HCG (Home Capital Group)
4. TSX:TECK.B (Teck Resources Limited)
5. TSX:WFG (West Fraser Timber Co. Ltd.)

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