Bearish on Canadian Real Estate? Then Run Away From These 3 Stocks

Description

The voices used to be soft and easily drowned out by the crowd.

Then, as fundamentals continued to look more and more out of whack, the voices got louder, joined by many of the previous naysayers. Soon, the vocal minority got bigger, and started making enough of a fuss that folks couldn't help but notice.

The mainstream started embracing the group's ideas. Important people, like chief economists of large banks and even the governor of the Bank of Canada, expressed some sort of support for the group's thesis. Major publications have featured stories on the issue, and even common investors have taken steps to ensure there's a plan in place to protect themselves from the event happening.

I'm talking about the Canadian real estate bubble, an idea that has slowly gained traction over the last few years. Simply put, the market is being held up by low interest rates and loose lending policies. Low rates are allowing consumers to buy higher-value homes, while keeping carrying costs the same. This is great — until these people are forced to renew at a higher rate.

Banks have been lending like crazy as well. Over the past decade, home equity line of credit growth has grown exponentially. Growth in mortgage lending has been the largest driver in profit increases for the banks as well. Canada's banks have become extremely dependent on mortgages, to the point where they regularly get into rate wars to temporarily gain market share.

For the average Canadian, housing in major cities has become almost unaffordable, and that's even with record low mortgage rates. Plus, 70% of Canadians already own property, which is a record high. Where are all the new buyers going to come from?

Canada's market is on such fragile footing that simply a change in sentiment could send the entire country tumbling. The market's strength is largely regional as well, with Calgary and Toronto propping up the country, while the rest of the nation sees tepid growth at best.

Canada's real estate has been on an almost uninterrupted 20-year bull cycle. At some point, this will end very badly.

This is why investors should stay away from companies like **Home Capital Group** (TSX: HCG), Canada's largest alternative mortgage lender. On the surface, the company looks like a terrific buy. The stock is trading at just 12 times next year's expected earnings, and has reported next to nothing for loan losses.

However, investors need to ask themselves one question — during a falling real estate market, is it really wise to hold shares in the lender that specializes in the so-called "subprime" market? Unlike its traditional competitors, Home Capital has been actively moving away from loans backed by mandatory insurance. That doesn't look like such a bad move now, but could look terrible if defaults start to ramp up.

Another company to avoid is **First National** (TSX: FN), one of Canada's largest lenders. The company works exclusively with mortgage brokers, allowing it to really cut down on overhead. It usually has some of the most competitive mortgage rates in the country, yet still earns enough to comfortably cover its 6.5% dividend.

The reason to avoid First National is simple. While the vast majority of its loans are CMHC-insured, any slowdown in the housing market will hit First National harder than the average bank that offers diversified financial services. Being only a mortgage lender is good when mortgage growth is outpacing everything else, but during bad times it's nice to have backup sources of income.

Genworth MI (TSX: MIC) is Canada's largest private mortgage insurer, playing second fiddle to the CMHC, the federally backed alternative. Genworth has carved out a nice niche market by insuring certain types of loans that the CMHC doesn't tend to like.

The company's financials look pretty solid as well. It trades at less than 10 times earnings, and at only slightly above book value. According to management, reserves are in place to ensure the company will barely feel the effects of a real estate slowdown.

Management should be applauded, but again, sentiment plays an issue. It doesn't matter if the company has taken precautions, the stock will still fall. The market is a short-term thinker. As investors we can exploit this, but the time to look at these financials isn't now, at the top of the market. Just avoid these stocks for now, and reconsider once sentiment for overall housing prices turns bearish.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:FN (First National Financial Corporation)
2. TSX:HCG (Home Capital Group)

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