Is Canada Really Headed for a Housing Market Crash?

Description

For some time now, analysts, economists, and real estate market pundits have been arguing about the direction of Canadian housing prices and whether a crash is imminent.

The view that the Canadian housing market is overheated and may even be approaching bubble territory is broadly supported. The International Monetary Fund recently stated in a report that global housing prices are trending above historical averages, with some markets overheating. The report then went on to single out the housing markets of Canada, Australia, Norway, and Sweden for particular attention.

This supports the view of many naysayers who claim a crash is imminent and could wipe up to 30% or more off housing prices overnight. However, despite more naysayers emerging, housing prices continue to defy gravity, spiking 7% in June 2014 compared to the equivalent period in 2013.

What is driving this surge in housing prices?

The key driver of these higher prices is rock-bottom mortgage rates, which are spurring consumers to take on more mortgage debt than they otherwise would. These low rates are also fueling the desire among consumers to upgrade their homes and purchase investment properties, as they are now able to borrow significantly higher amounts.

These factors continue to drive prices higher, particularly in major cities like Toronto, Vancouver, and Montreal.

What are the signs that the housing market is overvalued?

However, before concluding whether a crash is imminent, let’s take a closer look at a range of key indicators to see just how overvalued the market is. A key measure of whether a housing market is overvalued is the price-to-rent index. The index currently indicates that Canada’s housing market is overvalued by 76%.

Another key indicator is the price-to-income ratio, which compares the average house price to the average income. It currently suggests that Canadian housing prices are overvalued by 31%.

Thus, it appears that housing affordability is becoming a crucial issue and prices are continuing to move well above historical averages.

What could trigger a correction?

Canada's household debt is now approaching record levels with a debt-to-income ratio of 163%. This means that households are now extremely vulnerable to range of external economic shocks. Another global economic crisis or worldwide economic slowdown could easily derail Canadian economic growth, seeing it fall from the 2% of GDP growth projected for 2014 and 2015, and thus leading to higher unemployment and stalled wages.

This would see a number of households unable to afford debt repayments, including mortgages, and increase the volume of housing stock for sale.

An interest rate hike would have a similar impact, making it difficult for a number of heavily indebted houses to afford their financial obligations and leaving them underwater on their mortgages.

How likely is this to happen?

A range of regional and global factors could trigger such an event. Europe is still reeling from its financial crisis, and this, in addition to escalating geopolitical risk emerging from the conflict in the Ukraine, could create some disruption in the global economy.

However, with much of this focused on sanctions against Russia and Western European nations seeking alternative markets to purchase crude and natural gas, the Canadian economy could actually benefit. Any disruption caused by ongoing macroeconomic and geopolitical issues in Europe would also be minimal, with the U.S. and China being the key global drivers of economic growth.

The U.S. economy continues to go from strength to strength, with better-than-expected employment figures and industrial activity. It is also expected to grow by around 3% over this year and the next, boding well for Canadian economic growth since the U.S. is Canada's largest trade partner and export market for its top export, crude oil. China's industrial activity also continues to grow, with the purchasing managers' index hitting a six-month high at the end of June 2014.

These things will continue to drive global economic growth and offset any fallout from the problems in Europe.

Furthermore, there would need to be a massive spike in unemployment, well above the current rate of 7%, to create a crash, with some analysts stating it would need to move as high as 9% or 10%.

A huge interest rate hike would be required to trigger a crash and this is just not in the cards at this time, with the Bank of Canada set to keep rates low until 2016. This is particularly true as Canada's economy is expected to grow at a relatively modest 2% annually over this year and the next.

Therefore, the consensus view among analysts is that the market is overpriced but generally stable.

Bank of Montreal (TSX: BMO)(NYSE: BMO) recently called the housing market stable and boring, while both **Toronto Dominion Bank** (TSX: TD)(NYSE: TD) and the IMF see it as overvalued by a modest 10%. Even the majority of those analysts predicting a correction of up to 30% see it having a soft landing, with prices declining gradually rather than crashing off a cliff and the hardest-hit properties being in less desirable areas.

Furthermore, Ottawa continues to monitor the situation, implementing measures to remove the excesses that could trigger a hard landing. This has included tightening the regulations around mortgage insurance to prevent irresponsible lending.

Based on the factors discussed, I believe the probability of a hard landing is particularly low and even a major global macroeconomic event is unlikely to trigger it.

What does this mean for investors?

The primary impact will be felt by Canada's banks, but it won't be a system-wide collapse or even trigger a significant decline in balance sheet strength and thus significantly destroy earnings. It will more than likely manifest as a loss of growth or even a modest decline in earnings, as domestic mortgage lending has been a growth staple for Canadian banks over the last decade.

The banks that will be hardest hit are those predominantly focused on the domestic market, and include **Canadian Imperial Bank of Commerce** (TSX: CM)(NYSE: CM), **Royal Bank of Canada** (TSX: RY)(NYSE: RY), and **National Bank of Canada** (TSX: NA). In contrast, those banks with offshore growth strategies, such as Bank of Montreal, Toronto Dominion, and **Bank of Nova Scotia** (TSX: BNS)(NYSE: BNS) are best positioned to weather any fallout.

A leading reason for this moderate impact is that Canada's major banks are adequately capitalized. The six largest banks control the majority of the mortgage market and have Common Equity Tier 1 Capital ratios of between 8.7% and 9.8%, which is well above the regulatory minimum. More impressive is their low ratio of impaired loans to total loans of between 0.2% and 0.79%, which can be attributed to conservative credit policies and the tight regulation of banking in Canada.

They also continue to maintain robust balance sheets and risk management policies, which, in conjunction with high capital adequacy and a low proportion of impaired loans, leave them well positioned to weather any moderate to severe housing correction.

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1. Investing

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2. TSX:BNS (Bank Of Nova Scotia)
3. TSX:CM (Canadian Imperial Bank of Commerce)
4. TSX:NA (National Bank of Canada)
5. TSX:RY (Royal Bank of Canada)
6. TSX:TD (The Toronto-Dominion Bank)

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