How Safe Is Your Retirement From Canada's Housing Bubble?

Description

If you're buying real estate now, you'll hate yourself later. At least, that's the advice of famed industry critic Garth Turner.

Most Canadians know Garth best as a rebellious Member of Parliament. He was kicked out of Stephen Harper's caucus in 2006 for blogging about party business. In addition to his time in government, Garth has had an impressive number of titles—including journalist, broadcasting entrepreneur, and PC leadership candidate.

Today, he is a bestselling author and financial speaker. From his popular blog GreaterFool.ca, Garth warns that soaring debt levels have created an epic housing bubble, especially in Toronto and Vancouver. Even a small correction in real estate prices, he argues, could wipe out the retirement dreams for millions of homeowners.

In part two of my interview with Garth, we discuss Canada's housing boom and the future of the real estate market. The following is a transcript of our conversation. It has been lightly edited for clarity.

Robert Baillieul: A lot of people have argued that this economic recovery since 2009 is only the result of easy monetary policies. If central banks turn off the money taps, how does that play out in Canadian real estate?

Garth Turner: Read the comments on my blog. Every time I warn people about the dangers of higher interest rates, they come back and tell me I'm an idiot. There's a general denial that monetary policy can ever return to normal. Their argument is, "Well, interest rates can never go up because nobody could afford the debt. Therefore, the government would never do it."

I'm going to come back again to my financial illiteracy argument. People have no idea how the bond market works. They really don't know how capital flows around the world. Obviously, central bankers are going to have to normalize the cost of money or we're all going to sink. When that happens, there's going to be some serious implications.

There's an inverse relationship between real estate prices and the cost of money. Real estate is at a historic high right now in Canada because interest rates are at a historic low. There’s no doubt about it.

We have a credit union here in Toronto bringing in a 1.49% mortgage for 18 months fixed rate. We’ve never been in this territory before. When that reverses, it’s going to be a big shock.

The Bank of Canada will obviously try to mitigate the damage, but damage there will be.

Baillieul: You look at Toronto landlords buying condos with 2% capitalization rates. That’s not much of a risk premium if anything goes wrong to begin with. But if cap rates go to 4%, the impact on equity is troubling.

Turner: Absolutely. The impacts are far reaching.

Once bond yields start to rise, you have the competition. Why would you put money into a condo, where you basically get inflation or less, when you could put it into a risk-free asset that’s earning as much or far better?

The implications are considerable. We’ve created an historic anomaly here. Most people are blind to it.

Baillieul: What will be the impact on banks? If I’m buying and holding the Royal Bank of Canada (TSX:RY)(NYSE:RY) or the Toronto-Dominion Bank (TSX:TD)(NYSE:TD) for the dividends, is this something I should be worried about?

Turner: It’s hard to say. There could definitely be a negative implication for the financial sector. That said, the bankers know this quite well. They’re certainly trying to mitigate the risks.

You saw a lot of bulk insurance taken off mortgages by the big lenders. The government has been trying to cut back. There’s the potential for a big hit to bank earnings, but we can’t foretell the absolute course of interest rates.

I don’t know how robust the U.S. economy will look two years from now. I don’t know where the Fed will have gone with precision. I don’t know how much the Bank of Canada will be able to resist it.

Everyone wants the move back up to be easy. They’ll try to make it as smooth as possible. But if you bought a million dollar Toronto property and you can’t get CMHC [Canadian Mortgage and Housing Corporation] insurance, you’re going to be in serious difficulty with even a modest interest rate hike.

That is going to cause a lot of distress in the market with overall values coming down.

Baillieul: I’m in Halifax right now and I don’t see any evidence of a bubbly real estate market. Are you worried about the rest of the country?

Turner: Actually, yeah. It’s a weird situation. Eight out of 10 major markets in Canada have stagnant or declining sales.

Nova Scotia is a good example of that. Montreal is the second-biggest market in Canada and it's absolutely flat. Markets that were bustling, like Regina and Saskatoon, are now in negative sales. Even Edmonton and Winnipeg were doing quite well. Now, they're basically stagnant situations. It's a dichotomy. Toronto, Calgary, and Vancouver get all the headlines.

But let's not forget, Calgary, too. A year ago Calgary was the poster boy of real estate excess. You had a vibrant market with prices soaring at a double-digit annual clip. Now, we have an explosion in listings and sales are down by about a third. Prices really haven't started to move down yet. That takes a bit of time because real estate prices are sticky. However, I would expect to see a drop soon.

When, if, interest rates start to normalize, you'll see listings in Vancouver and Toronto go up. Sales will go down. Prices will stay sticky for a long time, but eventually they will decline.

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