How Worried Should Canadians Be About a Housing Meltdown?

Description

While the sharp collapse in oil prices is set to have a marked short-term impact on Canada's economy, it is the looming threat of a housing crash that worries policy makers the most. Not only would it wipe out the wealth of many Canadians, but the ripple effects would be felt across the economy and threaten the stability of Canada's financial system.

While a spectacular housing market collapse followed by the meltdown of Canada's financial system is unlikely, it does raise a number of questions for investors, including how they can hedge against this risk.

Now what?

The key concern is that with household debt hovering at near-record levels, many households are extremely vulnerable to external economic shocks that could make them incapable of meeting their financial commitments.

These external shocks, including the spillover effects of a hard economic landing in China, ongoing financial stress in the Eurozone, and an increase in interest rates could impact the Canadian economy far more severely than the oil rout. Sharply low crude prices have already had a marked impact on the economy as whole, with Canada's 2015 forecast GDP growth slashed to 1.4%.

If a financial shock of sufficient magnitude occurred, a number of already stretched households would default on their financial commitments, like mortgages, which would spread the contagion into Canada's banks.

You see, Canada's banks, particularly the Big Six, have aggressively built their lending portfolios in recent years with a focus on residential mortgages as a key source of growth. In fact, mortgages makes up between 35-60% of their total loans. **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) is the most exposed.

However, at this point, we need to ask ourselves the question of whether or not Canada's housing market will collapse. The oil rout has given us some idea as to what could occur. Already, personal solvencies in Alberta have risen for the first time since the Global Financial Crisis, and rental vacancies in Calgary and Edmonton have roughly doubled over the last year.

Surprisingly, housing prices have yet to truly falter; Alberta's average house price in May 2015 remained unchanged year over year. More tellingly is that the Canada Mortgage and Housing Corporation, while highlighting some concerns about overheated regional housing markets, stated in a recent report that the overall national risk remains low to moderate.

Furthermore, while household debt has risen significantly in recent years, so too has household wealth, and this creates a buffer that would slow any rapid deceleration of Canada's housing market.

But what does all that mean for investors?

So what?

Well, there is certainly a risk of some regional housing markets coming off the boil, particularly those in the energy patch, but the risk of a major correction is low.

Of the big banks, the most vulnerable are Canadian Imperial Bank of Commerce and the **National Bank of Canada** (TSX:NA) because they have focused on the domestic mortgage market as their primary growth lever. Smaller regional banks like **Laurentian Bank** (TSX:LB) that have focused on mortgage lending as a driver of growth are also particularly vulnerable. This is because National bank of Canada and Laurentian Bank lack the deep pockets and diversified asset bases of the Big Six Banks.

CATEGORY

1. Bank Stocks
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1. NYSE:CM (Canadian Imperial Bank of Commerce)
2. TSX:CM (Canadian Imperial Bank of Commerce)
3. TSX:LB (Laurentian Bank of Canada)
4. TSX:NA (National Bank of Canada)

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Date

2025/08/27

Date Created

2015/06/17

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