Why 2016 Could Be the Year Canada’s Housing Bubble Bursts

Description

It seems like one of the most popular calls for pundits in 2014 and 2015 was the imminent collapse of the Canadian housing market.

The thesis is simple. When using traditional metrics of value, Canada’s housing market is perhaps the most overvalued in the world. One recent report listed Toronto’s market as more expensive than New York’s and said the valuation of Vancouver’s houses compared to median incomes was more expensive than San Francisco.

Canadian personal debt remains at record levels as well. The average Canadian household owes $1.64 for every dollar in disposable income. This is higher than the peak in the same ratio from the United States back before its housing market collapsed.

It isn’t just Canadians who are noticing this. Shorting Canada was a popular trade for U.S. hedge funds in 2015, as scores of foreign investors bet on everything and anything related to Canada’s real estate market. The trade is working as the TSX Composite continues to be weak mostly due to slumping commodities.

One of the other things propping up Canada’s houses looks poised to end as well. Foreign buyers–mainly Chinese nationals–were desperate to get capital out of China. Many of them bought Canadian real estate not as an investment, but as a store of value. With China’s main stock index plunging daily, much of this wealth is now disappearing. This combined with oil’s weakness now really being felt around the country could bode very poorly for Canadian real estate in 2016.

Cracks are already starting to appear in Alberta. Prices in Fort McMurray, the city closest to the oil sands, have already fallen by more than $100,000. Houses in Calgary have also fallen after the number of transactions slowed significantly throughout 2015. Real estate in dozens of small towns in Alberta and Saskatchewan has become a hated asset after being so sought after for the last decade.

Put all these together, and I see how 2016 could be very painful for Canadian homeowners.

How should you prepare your portfolio for such a disastrous event? Here are a couple of ideas.

Avoid Home Capital

One of the favourite shorts for many of these U.S.-based hedge funds has been **Home Capital Group Inc.** (TSX:HCG), Canada's largest non-prime mortgage lender.

Home Capital shares plunged in the summer when the company disclosed that it cut ties with 45 mortgage brokers who were suspected of submitting fraudulent deals. In total, some $2 billion in loans could have some sort of misrepresentation, which is quite a bit for a company with $20 billion in assets.

The bear case is easy to make if you assume Home Capital has been the victim of a wide-scale fraud. Management claims these loans are actually performing quite well, but a rising market erases a lot of sins. If the average homeowner runs into trouble, they can just sell, pocket a nice profit, and move on.

Nearly all of Home Capital's loans are in the Toronto area, which is of comfort to bulls. At least Toronto seems fairly insulated from Alberta's troubles. But a large-scale slowdown in Canadian housing will likely affect Toronto, too. After all, it's one of the most expensive markets.

How about the banks?

There's a reason why **National Bank of Canada** (TSX:NA) trades at just 8.6 times earnings and yields an impressive 5.55%. The market is concerned about its exposure to the Canadian economy.

Unlike its larger competitors, National Bank has virtually no assets outside of Canada. At least the company has minimized its exposure to Alberta and Saskatchewan, but investors are still concerned about Quebec, National's home province. National also is a prominent player in Atlantic Canada, another region not really growing much.

The bear case for National Bank isn't quite as strong as with Home Capital, but the same risks exist. A company overly exposed to Canada's real estate isn't going to do well, even if many of its loans are covered by mortgage default insurance.

If Canada's economy continues to be rough in 2016, there's the very real possibility that housing could fall hard. It's better to prepare now than be caught in the middle of that storm.

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