Why 2016 Won't Be the Year Canada's Housing Bubble Bursts

Description

Last week I argued that 2016 could be the year where we finally see Canada's massive housing bubble pop.

All the ingredients to the recipe are there. When looking at metrics such as price-to-median household income and price to rent, it's obvious that most of Canada's major cities are overvalued. Pundits have been calling for a correction for years.

Because of this theory, shorting Canada was a popular trade among hedge fund managers in 2015. And for the most part, these guys got that trade right. From its peak in mid-April, the TSX Composite Index fell more than 15%. Add in the decline in the Canadian dollar during that same time, and a U.S. investor betting against Canada did pretty well.

But at the same time, it wasn't a decline in real estate that caused Canadian companies to fall. Outside of pockets in Alberta, Canadian real estate either went up or at least stayed flat in 2015. Toronto and Vancouver, the two biggest markets, saw continued strength.

I firmly believe that Canada's real estate market is in a bubble. But I've certainly been wrong before. Here's why I might continue to be wrong in 2016.

Flight to safety

Among a big part of the population, real estate is viewed as a "safe" investment.

I think that's preposterous, but there is some logic behind it. In most places in Canada, real estate has been on an uninterrupted march upwards for 20 years. Sure, cap rates might only be 3-4% from a rental, but add in just 2-3% in price appreciation and you get a pretty nice return, especially if an investor used a lot of debt to buy the property in the first place.

Compare that to stocks. In 2000 the TSX Composite was dominated by Nortel Networks. Two years later, the index was down 50%. After the markets recovered, the 2008-09 Great Recession hitinvestors hard. Within a matter of a few months the TSX Composite fell another 50%.

With that kind of volatility in stocks, it's easy to see why investors would move into what they perceive as safe real estate. And 2016 looks to be one of the most unpredictable years for stocks in recent memory.

Flight from China

One of the factors that led to Canada's real estate bubble in the first place has been capital coming from China. Real estate has become a convenient store of value for thousands of wealthy Chinese.

The Shanghai Composite Index is down almost 15%. Most investors don't believe the growth numbers issued by the Chinese government either. And with China experiencing a property bubble of its own, it's easy to see the logic in getting capital out of the country sooner rather than later.

And remember, China's currency is pegged to the U.S. dollar. That means in yuan terms, prices of Canadian houses are much cheaper than they were a year ago.

Bargain stocks?

Canada's banks have gotten hammered because investors are worried about the bubble bursting. If it doesn't, look for them to rally, especially the more Canadian-centric names.

National Bank of Canada (TSX:NA) is one such stock. It trades at a very low 8.6 times trailing earnings and sports a dividend yield of 5.6%. Shares of the bank haven't been this cheap since 2012. This is because it's a truly Canadian bank. Just about all of its assets are here in Canada.

If housing continues to be at least relatively strong, National Bank could easily outperform its peers over the next year or two. Its valuation will return to the sector mean, which signifies upside potential of 20-30%. Add in the dividend, and it's a good result.

Another stock that's been hammered on housing worries is **Genworth MI Canada Inc.** (TSX:MIC). Like National Bank, it has an attractive valuation, trading at just six times trailing earnings. Its dividend yield is 7% and it trades at a big discount to book value.

Genworth's management has been preparing for a housing meltdown for years now and has made progress paying down debt. And remember, Canadian taxpayers indirectly guarantee 90% of Genworth's insurance. That's a nice safety net.

It's hard to say whether we'll see Canada's real estate rise or fall in 2016. Just remember, many things could happen to avoid the crash that so many people think is inevitable.

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