Will Canada's Housing Bubble Affect Your Retirement?

Description

It seems obvious that Canada is in a housing bubble.

It isn't just me sounding the alarm. Numerous pundits have voiced concerns about our real estate market, especially in Toronto and Vancouver. They're convinced that issues such as foreign money flooding into the country, low interest rates, and elevated price-to-income ratios will eventually cause a big tumble.

The thesis goes like this: houses cost too much, especially in certain markets. The inevitable decline will be felt hard by just about everyone as values plunge across the nation. Not only will this decline wipe out precious equity from millions of Canadians, but it'll also hurt shareholders in Canada's banks and other alternative lenders.

Just how serious is this threat? Let's take a closer look.

Safe as houses?

Over the last decade the price of the average Canadian house has more than doubled. Certain places in the country have performed much better, but you'd be hard pressed to find a market that hasn't done well.

This has led many Canadians to aggressively invest in real estate, convinced its a safer investment than the stock market. But underneath price increases lie some troubling truths about affordability, debt levels, and money from China propping up the market. Critics say it's a giant house of cards that could all come tumbling down if just one or two small things go wrong.

But at the same time, I'm not so sure I buy the explanation. Not so much the part about the housing bubble, because that seems obvious. I doubt the outcome will be as dire as everyone predicts.

Firstly, there's a very easy argument to make that interest rates could stay low for a long time. Japan and Europe's banks both have negative rates, and the yield for Canada's five-year bond is just 0.6%. According to analysts that cover the industry, it looks as though mortgage rates will go down this year, not up. This is good news for Canadian debt holders.

Secondly, Canada's banks have made a major effort to move mortgages off their balance sheets and shift the risk to CMHC, which is backstopped by the Canadian government. When Ottawa is taking on the majority of the risk involved with the high-ratio mortgage market, it's easy to see how lenders can be confident.

The risks

On the other hand, there's plenty of evidence that Canada's banks will experience a correction. Many have aggressively been issuing preferred shares over the last few months with **National Bank of Canada** leading the way by raising $400 million. It's important to note that preferred shares do not count towards a bank's capital ratios since they are not officially debt.

There's also the movement in certain non-bank lender shares. Take **Home Capital Group Inc.** (TSX:HCG) as an example. Shares of Canada's largest subprime lender are down nearly 35% over the last year as investors bolted to the exits on worries of a weakening market in Toronto and because of fraud allegations from a select group of mortgage broker partners. When it's all said and done, the company thinks up to $2 billion in loans might be fraudulent.

But at the same time, if you're convinced the real estate bubble isn't as bad as advertised, Home Capital looks to be a screaming buy. It trades at just 6.3 times earnings and pays a 3.1% dividend. And it really hasn't expanded seriously beyond the Greater Toronto Area. There's some serious growth potential if it can morph into a true nationwide lender.

Ultimately, the point is this: any number of things that could happen. Canada's real estate market could crash. It could just as easily keep on ticking. Or we could see big declines in certain areas, while other places stay relatively unchanged.

The question investors have to ask themselves is whether or not the banks are prepared to weather the upcoming storm. Personally, I'm convinced they'll survive, but a sustained housing crunch would not be good news for their share prices. Thus, I'm avoiding the whole sector.

Perhaps the most important rule in investing is this: don't lose money. I see a scenario where bank shares could head much lower, so I'm avoiding them on a just-in-case basis. Perhaps other investors should position their retirement savings accordingly.

CATEGORY

1. Bank Stocks
2. Investing

POST TAG

1. Editor's Choice

TICKERS GLOBAL

1. TSX:HCG (Home Capital Group)

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Date
2025/07/08
Date Created
2016/02/05
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