Don’t Let Canada’s Housing Bubble Ruin Your Retirement

Description

It’s obvious Canada is in a housing bubble.

The Toronto and Vancouver markets are particularly nuts. According to recent data, it costs nearly 10 times the average family’s income in Toronto to buy a pretty normal house. In Vancouver, it costs even more. The average family in B.C.’s largest city will have to shell out 11.2 times their income to be able to afford an average place to live.

It gets worse. In Vancouver the price-to-rent ratio downtown is a whopping 22.5 times. That works out to a cap rate of 4.4%, a number that doesn’t even include expenses like taxes or basic maintenance, never mind mortgage interest. Once a landlord pays those things, I doubt there’s much profit at all. Toronto’s price-to-rent ratio is similar.

The question is how bad the carnage will be when it inevitably pops. Many investors think the results won’t be pretty with predictions as dire as a repeat of the 2008-09 financial crisis, a once-in-a-century event that shook the world’s financial markets to their very core. These investors are convinced Canada’s largest banks will have to, at a minimum, cut their dividends. Some think a few of the weaker banks could actually go to zero.

I am not one of those investors. I certainly agree that some markets are expensive. But at the same time, Canada’s banks have used CMHC mortgage default insurance to move the risk from high-ratio mortgages onto the balance sheet of the federal government. Add in factors like money from China continuing to flow into Canada and an improvement in commodity prices, and I see a scenario where the banks can escape from this without much damage.

I’m just not sure that’s enough for investors to touch the sector, especially names like **Home Capital Group Inc.** (TSX:HCG) and **Genworth MI Canada Inc.** (TSX:MIC). Here’s why.

The big risk

On the surface, both Home Capital and Genworth Canada look insanely cheap.

Genworth trades at $27.05, even though it has a book value of $37.25 per share. That's a 27% discount. Over the last 12 months it has earned $4.19 per share, putting it at just 6.5 times earnings. It pays a 6.2% dividend, which is easily covered by earnings. There's an argument to be made that it's the cheapest stock in Canada.

Home Capital is almost as cheap. After reaching a low of $23 each in January, shares of Canada's largest subprime lender have rallied some 40% to today's price of $32.25. Even after that huge rally, shares still trade hands for less than eight times trailing earnings.

There's a reason for both of these companies' valuations though. Home Capital Group has disclosed some $2 billion worth of mortgages on its balance sheet may have been obtained fraudulently. The company no longer does business with the group of mortgage brokers who sent in these loans, and, as a group, the borrowers aren't defaulting. Still, bearish investors think that much fraud getting through is an indication Home Capital's underwriting standards are too lax.

Home Capital is also very exposed to Toronto real estate, and much of its loan portfolio is not protected by default insurance. If things get very bad in Toronto, Home Capital is in a world of trouble.

Genworth has similar issues. I've heard rumblings from folks in the industry that Genworth often will insure mortgages CMHC will not touch. If Genworth's balance sheet is filled with riskier mortgages, then it's easy to argue that it'll get hit hard if a wave of defaults sweeps Canada.

Genworth has $184 billion worth of mortgages it has insured compared to $3.4 billion in equity. A 1% default rate would do some serious damage, even if the average loan-to-value ratio is approximately 50% on these loans.

The bottom line is this: there is a chance Genworth and Home Capital blow up spectacularly. There's also a chance that today is a terrific buying opportunity for two massively undervalued stocks. When it comes to retirement savings, I'm not sure investors should be taking a chance on stocks where there are very real dangers, even if those dangers are remote.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:HCG (Home Capital Group)

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