Is Canada’s Warren Buffett Right About Canada’s Housing Bubble?

Description

Prem Watsa, the man that many call Canada’s Warren Buffett, had some harsh words to say about Canada’s housing market in his most recent letter to **Fairfax Financial Holdings Ltd.** (TSX:FFH) shareholders:

> “As we have said a few times before, the collapsing commodity prices will not spare Canada. Canadian housing prices, particularly in Toronto and Vancouver, have gone up significantly, driven by lax policies at CMHC (Canada’s equivalent to Fannie Mae and Freddie Mac). Canadians have accessed their increasing real estate wealth through lines of credit easily available from the banks. Sounds familiar? This is exactly what happened in the United States before the financial crisis in 2008/2009. If history is any guide, this will reverse and we continue to be shocked at the massive debt levels incurred by young people (below 45 years old), with no financial buffer against hard times as the C.D. Howe report, Mortgaged to the Hilt, shows.”

Watsa is only the latest pundit to come out with a bearish prediction on Canadian real estate. It seems like countless others think the country is in a massive bubble that is fueled by low interest rates and easy credit.

But at the same time, we’ve been hearing these predictions for years. Even as far back as the Great Recession, many Canadian market commentators were saying the market was overvalued–a call that doesn’t look great in hindsight.

Is Prem Watsa right? Let’s take a closer look.

The case for Watsa

Looking back over the last few years, Watsa has been pretty accurate on his macroeconomic predictions.

In 2010 he started warning investors about a massive real estate bubble in China. In 2011 he began to talk about a commodity bubble that would eventually collapse, taking Canada down with it. In 2012 Watsa warned about the low yields in so-called junk debt. And in 2014 Watsa announced that Fairfax had taken a massive bet on deflation, buying Consumer Price Index-linked derivatives that would pay billions if deflation hit the western world in a big way.

Thus far, the predictions from 2010-12 are looking pretty accurate. The demand for commodities from China has collapsed as that nation has really cut back its spending on infrastructure and building out real estate. And yields on riskier securities are much higher than they used to be, especially in commodities.

Besides, the fundamentals scream "overvalued" in certain markets. In Toronto it costs approximately 10 times the average family's income to buy a median house. That's cheap compared to Vancouver, where it costs more than 11 times the average family income to buy a regular house.

Or, to put it another way, the price-to-rent ratio in downtown Vancouver is 22.5 times, with Toronto's not far behind. That's a return on investment of just over 4%, and that doesn't even include any expenses. Once an investor pays the interest on the mortgage, the taxes, and a little for maintenance, there's not much left in profits.

The case against Watsa

There's really only one thing we can say against Watsa and all the other pundits who called for the bubble to pop long ago.

The market has been elevated for years, and isn't slowing down–at least in Toronto or Vancouver. With these two cities remaining quite popular with immigrants, there's the argument that like New York, London, or Hong Kong, the value of real estate in these cities will remain sky high simply because there's so much pent-up demand.

Why Fairfax is a good choice

For investors worried about the Canadian housing market, Fairfax Financial is a solid choice.

Firstly, the company has no exposure to Canadian real estate whatsoever. Many of Canada's other top insurers have exposure to the market, whether it's through lending or owning physical real estate.

A marked decline in Canada's housing market would likely be accompanied by bearish stock markets as skittish investors move to the safety of cash and near-cash instruments. Fairfax is protected against such a move, since it has hedges to cover much of its equity portfolio.

If you're a believer that Canada's housing market is ripe for a fall, there are worse places to be in the financial sector than Fairfax shares.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:FFH (Fairfax Financial Holdings Limited)

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Date
2025/07/08
Date Created
2016/03/14
Author
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