Will Canada’s Real Estate Bubble Finally Pop in 2017?

Description

A number of things happened in 2016 that were designed to send house prices reeling. In B.C., the government passed a law saying all foreign buyers of Vancouver real estate had to pay a 15% tax. The federal government also changed the rules for all insured mortgages, making it harder for buyers to qualify.

Changes in Vancouver appear to be having the intended impact. Prices in Canada’s third-largest metro have fallen since the foreign buyers’ tax was implemented, especially in more expensive parts of the city.

Other cities have also started to see house prices decline. Regina’s real estate is struggling, and Edmonton is barely treading water. Halifax and Quebec City are also faltering a bit. And Winnipeg’s average price is up a paltry 0.5% over the last year. Surprisingly, Calgary houses are up an average of 5% versus the same period last year.

In fact, gains are largely coming from one place: Toronto. House prices in Canada’s largest city are up a shocking 22.8% over the last year.

Will 2017 be the year the year Canadian real estate crashes? Let’s take a closer look.

Yes, it will

The big reason why the market could crash in 2017 is demand drying up from buyers.

The new mortgage rules will have a big impact on already stretched first-time buyers. According to **Genworth MI Canada Inc.** (TSX:MIC), approximately one-third of first-time homebuyers would no longer qualify for their current homes if they were forced to re-qualify under the new mortgage rules.

Genworth also said in October that approximately half of its total portfolio of insured loans wouldn’t have qualified under the new rules. That is a lot of demand exiting the market.

There’s also the possibility mortgage rates go up. Although the Bank of Canada seems content to keep its bank rate at 0.75%, fixed-rate mortgages are increasing along with bond yields. All of Canada's largest banks have increased mortgage rates in the last couple of months.

Such a trend could easily continue in 2017, which will eventually hit heavily indebted homeowners right where it hurts most.

Finally, there's the Toronto factor. If the average price there starts to fall, it could have a real psychological impact on the market. **Home Capital Group Inc.** (TSX:HCG), the subprime lender with a focus on Toronto, would get hit especially hard if Toronto started crashing.

The counterargument

One of the most interesting things about bubbles is, they can last longer than we expect.

Toronto real estate was in a bubble in mid-2013, back when the average price was $531,000. These days, the average is closer to $780,000.

If prices truly have separated from what a reasonably astute buyer would pay, then what's the limit? And remember, money is pouring into the Toronto market from wealthy foreigners who have been shut out of Vancouver.

Speaking of Vancouver, plenty of foreigners are using relatives who already live in Canada as proxy buyers. So I'm not sure that market will really correct.

Even Calgary didn't suffer that much as oil declined. Many economists are predicting the worst is now behind the city.

In fact, when you strip out Toronto and Vancouver from Canadian real estate, the average place is worth $361,000 versus median household income of approximately $79,000. That puts houses at 4.6 times family incomes — a little higher than the average over the last 40 years, which is close to 3.5 times income. But those homeowners didn't have the benefit of 2-3% mortgage rates, either.

The bottom line

I firmly believe both Toronto and Vancouver real estate prices are insane and would never consider buying a house in both of those metros. But at the same time, it's hard to predict prices that don't follow fundamentals. Both markets could easily surge or crash.

As for the rest of the country, I'm not entirely sure houses are that overvalued. Some markets are quite reasonable.

It's hard to say what's going to happen. Thus, I think the actionable advice for investors is to just stay away from Genworth or Home Capital shares. If real estate does crash, both those stocks will take it on the chin.

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Date
2025/07/07
Date Created
2016/12/30
Author
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