Can Your Portfolio Survive a Toronto Real Estate Crash?

Description

Bank of Montreal chief economist Doug Porter did not mince words when he wrote about the Toronto real estate market on February 15.

“Let’s drop the pretence. The Toronto housing market — and the many cities surrounding it — are in a housing bubble … Prices in Toronto are now up a fiery 22.6% from a year ago, the fastest increase since the late 1980s — a period pretty much everyone can agree was a true bubble — and a cool 21 percentage points faster than inflation and/or wage growth.”

Porter is just confirming what dozens of different pundits, analysts, and even real estate agents have been saying for years now. We’ve come to the point where proclaiming the largest real estate market in the country to be massively overvalued is met with a collective yawn.

Opinions on this issue have been cemented for a long time. Folks who already own a house in Toronto love it. They’re watching the value of their largest asset explode higher. Who wouldn’t like to make 22% a year?

Naysayers claim Toronto homeowners are playing a dangerous game. Some people have 100% of their assets invested in real estate with additional debt on top of that. If values fall 20%, some of these folks will be insolvent.

No matter where they live, investors should ensure they’re not going to get hurt when the Toronto bubble pops. Here’s how you can protect yourself.

Sell and rent

I realize most people don’t want to sell an asset going up more than 20% a year. I also know moving is a pain. But I still think folks sitting on houses worth $1 million, $2 million, or even more should look at selling.

Let's say the Toronto market falls 25% and a homeowner is sitting on a mortgage free property worth $1.5 million. They could lose $375,000.

Now moving doesn't sound like that much of a pain, does it?

This is doubly true for homeowners nearing retirement age. If these folks sell and unlock their equity, they'll have enough to afford a retirement in their choice of tropical paradises. Toronto is a fine city, but it can't compete with a beach in Mexico, Costa Rica, or Thailand.

Avoid Toronto lenders

Investors who live a long way from Toronto could still be impacted by a housing crash.

The company with the largest exposure to Toronto's real estate market is subprime lender **Home Capital Group Inc.** (TSX:HCG), which also made the news recently because it received an enforcement notice from the Ontario Securities Commission. The notice was regarding the company's disclosure of potentially fraudulent mortgages issued in 2014 and 2015.

Ultimately, it comes down to this. Much of Home Capital's portfolio is lent out against Toronto real estate. If values in the city fall, it will feel the impact. Investors will likely further exacerbate the problem when sentiment truly goes south.

How about mortgage default insurers?

Many investors are short Home Capital shares in preparation for a real estate crash. Some of these investors are also short **Genworth MI Canada Inc.** (TSX:MIC), Canada's largest privately held mortgage insurer.

I'm not so convinced this is a smart idea, however. Genworth is diversified across the country. Home Capital isn't. Genworth also benefits from much of its insurance being issued years ago when prices were much lower. Its balance sheet is also much stronger than Home Capital's.

Still, it's probably a good idea for investors worried about Toronto housing to avoid it. It could also get hit if sentiment turns profoundly negative.

The bottom line

Every Canadian investor has to worry about Toronto's real estate market — at least a little bit.

Many are too exposed to the area and would be smart to diversify more. That could be as simple as selling an overpriced house and choosing to rent. Or it could mean selling shares of a company with exposure to the area.

The time to do so is now when the market is red hot. Even if you don't hit the top, it'll be much better to sell today than to feel the pain afterwards.

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Date
2025/08/26
Date Created
2017/02/27
Author
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