What Could Take Down the Canadian Real Estate Market?

Description

A bank’s business used to be much simpler than it is today. Each bank operated in a local community and knew its customers. These traditional banks had two main sources to generate revenues: charging a monthly fee for customers to maintain a chequing account, and taking deposits from local customers and, in turn, making loans to local customers.

While the simplicity of this business is well known, the main risk most investors take for granted today is the risk of contagion. By having bigger financial institutions, which now serve an entire country, the risks of a local collapse have declined significantly. Instead, when things go very bad in any one area of the country, many of these institutions may be less prone to lend money to new lender in other areas of the country.

Take the events of **Home Capital Group Inc.** (TSX:HCG) as an example. The company is currently experiencing liquidity issues given the large amount of lending done in the very desirable Ontario housing market, and it may not be able to survive. Home Capital previously had a market capitalization in excess of $2 billion and is now worth no more than $350 million.

Although contagion between Canada’s lenders may be very difficult given the structure of the financial system, the truth is, each lender is responsible for keeping the funding and lending in balance. In Canada, many of the risks are very well known with (in many cases) safeguards in place to contain the risk.

What if the risk is not already known?

As investors are aware, the price of oil declined significantly approximately two years ago, and the Albertan housing market went along with it. Given the oil production in the country is localized to only a few places, with the majority of it coming from Alberta, the financial system again was able to isolate the localized downturn.

Now, two years later, the country faces the risk of another oil downturn. Companies outside the oil industry (but who still support the oil industry) are no longer going to be content to simply “treadwater.” The oil industry may be the catalyst for job cuts in other industries.

Considering the price of oil is again on a downtrend at less than US$47 per barrel, the lower prices are already taking their toll. Shares of **Baytex Energy Corp.** (TSX:BTE)(NYSE:BTE) hit a 52-week low this past Thursday at a price of less than $3.84 per share. The stock market, which leads the economic cycle, is clearly pricing in bad news.

Getting back to the housing market, investors are aware that each transaction has a buyer and a seller (supply/demand), which is how the market arrives at an equilibrium price. The challenge for the housing market may present itself when any one factor, which is not necessarily directly related to the housing market, becomes a more generalized problem.

Over the past 10 years, investors have wanted to invest money in the housing market as the supply/demand factors were the most attractive in relation to other markets. As oil declines in price (again), not only does the oil industry begin to look more attractive, but real estate investors may begin to worry about tenants paying the rent and, in turn, the landlords paying the mortgages.

As the Canadian housing market has been on a clear path upwards for the past 10 years, a small pullback could rock the boat a great deal — especially for investors who have never had the boat rocked!

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