Income Investors: Should You Be Worried About Canada's Housing Bubble?

Description

A spectre of Canada's housing bubble burst has been haunting investors for many years now. The latest data show this fear isn't without reason.

After all, home prices in the country's two largest cities — Toronto and Vancouver — swelled to the point where the most forecasters agreed that these markets were overvalued and the price gains were unsustainable.

The latest real estate numbers show home sales in June posted their largest monthly drop since 2010 with the Greater Toronto Area market leading the decline.

It was the third consecutive monthly of declines. Sales for June were down 6.7% compared with May on a national basis, according to the Canadian Real Estate Association.

While 70% of local markets registered month-over-month declines, the ratio of sales compared to new home listings fell below 40% in Toronto, moving the Canada's largest city to buyers' territory.

What can income investors do to protect their portfolios if this correction turns into a crash with home prices falling steeply, taking their cue from this latest plunge in sales?

I believe the Canadian real estate market won't experience this worst-case scenario, which we saw in the U.S. almost a decade ago. In Canada, demand dynamics still remain healthy due to housing shortages and strong immigrant inflows.

But if you want to cut your exposure to investments exposed to the country's real estate market, then here are a few ideas.

Avoid alternative lenders

If this correction turns into a housing crash, you should definitely avoid the sub-prime lending market. This segment of the mortgage lending caters to riskier borrowers who, in times of distress, may not be able to service their debt.

The recent crisis at **Home Capital Group Inc.** (TSX:HCG), Canada's largest alternative mortgage provider, is a reminder to prudent investors how quickly things can turn sour in this market.

Shares of Home Capital Group lost half of their value after the Ontario Securities Commission concluded that company-linked brokers provided mortgages based on false documentation.

The revelation of these wrong practices led a run on the company's deposits, forcing it to seek a costly bailout from the world's most renowned investor, Warren Buffett.

Genworth MI Canada Inc. (TSX:MIC) is another stock I recommend you avoid. Genworth is a private mortgage insurer in Canada, operating alongside Federal Crown corporation Canada Mortgage and Housing Corp., which is Canada's largest residential mortgage insurer. If things really turn bad for the Canadian housing market, Genworth will be among the first companies facing a tough patch.

Be picky about REITs

If we see the housing bubble bursting, there is a good chance that short-sellers will start betting against the Canadian Real Estate Investment Trusts (REITs) to play the potential slump. This is evident from the performance of the **iShares S&P/TSX Capped REIT Index ETF**, which has dropped about 5% since Home Capital Group's crisis began to unfold in April.

Canadian REITs are generally strong, and they don't face an immediate threat, but in a situation where home prices collapse and a slump in oil prices continues, you should stick to quality names. **RioCan Real Estate Investment Trust** (TSX:REI.UN) and **Chartwell Retirement Residences** (TSX:CSH.UN) are my two favourite picks in this area due to their strong portfolios of clients and healthy cash flows.

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1. Investing

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1. TSX:CSH.UN (Chartwell Retirement Residences)
2. TSX:HCG (Home Capital Group)
3. TSX:REI.UN (RioCan Real Estate Investment Trust)

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