Housing Bubble: Should Investors Be Worried About Canadian Banks?

Description

Canadian banks have been a great source of steady income for investors. In fact, they survived the biggest financial turbulence of our time in 2008, when many banks down south failed or needed a bailout.

For the past four months, however, this crucial sector for income investors is under pressure on speculations that a Canadian housing bubble is about to burst. In that catastrophic outcome, the leading banks will suffer because they have a huge exposure to the real estate market.

The price action in their shares suggests that investors are taking these calls seriously by avoiding Canadian banks. The **iShares S&P/TSX Capped Financials** ETF is down ~3% since March, underperforming the Toronto benchmark share index.

If you look at individual stocks, the declines are even more steep. **Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM) is down 9%, while **Bank of Montreal** (TSX: BMO)(NYSE:BMO) and **Toronto-Dominion Bank (TSX:TD)(NYSE:TD)** have fallen between 6-8% during this period.

Are these concerns overblown, or should income investors should be worried about this situation which is lingering on for about five months?

I'm in the camp of those forecasters who believe that Canadian housing market is in the phase of a mild correction after massive gains of the past decade. What we're experiencing here is a knee-jerk reaction to some regulatory changes introduced in this spring in the nation's largest city — Toronto.

The 15% foreign buyer tax and tightening of the mortgage rules have pushed buyers on the sidelines and forced home owners to cash in. This standoff has resulted in a massive increase in listings, creating a situation where buyers have more choices, unlike bidding wars we saw in early spring.

What's next?

I see Canadian banks riding through this slowdown without too much trouble. By the next spring, we should be able to see the housing market back to its normal course. But before we discuss whether there is a need for income investors to re-balance their portfolios to reduce risk, I want to discuss another potential threat to the banking sector's mortgage lending that I think is more pronounced than what we're experiencing now.

Canada's banking regulator, the **Office of the Superintendent of Financial Institutions** (OSFI), in July has unveiled a proposed new rule change that would impact a large number of home buyers in Canada.

OSFI plans to require home buyers who have down payments more than 20% of the purchase price to prove they could still afford their uninsured mortgages if interest rates were two percentage points higher than the rate they are offered by their bank.

This stress testing is likely to have a more severe impact on the real estate sector because uninsured buyers make up a large proportion of home buying in Canada.

A report in The Globe and Mail, citing Canadian Imperial Bank of Commerce economist Benjamin Tal, says if OSFI goes ahead with its proposed change, and that coupled with the Bank of Canada's interest rate hikes, the "mortgage growth in Canada could be half of what it is now."

Bottom line

Those Canadian lenders which rely more on home mortgages for their income growth might see more pressure building up as we near this OSFI rule change in this fall.

I don't think there is an immediate need to exit your positions if you have Canadian banks in your portfolio. Canada's largest banks have been curtailing their mortgage lending to avoid big losses if the housing market crashes.

However, I'll recommend avoiding CIBC until we have more clarity on this proposed rule change. CIBC has a larger share of uninsured mortgages and home equity lines of credit in Ontario and B.C., leaving the lender more exposed to a housing downturn compared with other big banks.

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Date
2025/09/13
Date Created
2017/08/07
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