Why Raising Rates Are Far More Detrimental to Housing Than We Realize

Description

Over the past few months, the Bank of Canada has increased interest rates on two separate occasions, making home ownership more expensive to many Canadians. The result of higher interest rates has not only affected the cost to purchase a home, but they will also lead to a material change in the supply/demand equation.

For most buyers, the most important cost to owning a home is the mortgage payment, which is made up of principal and interest. For almost all Canadians, this is the largest monthly expense in their budgets. As rates increase, buyers will have to make a decision to either spend less on a home or save more before making the purchase. For too many buyers, a home with the same purchase price and higher interest rates translates to monthly mortgage payments, which are just too high.

As interest rates increase, the total mortgage amount extended to new buyers will have to decline as the interest expense will make up a larger dollar amount every month. The consumer, however, will still be making the same total monthly mortgage payment, resulting in lower house prices. Effectively higher rates make housing less affordable to the average person.

Another effect that higher interest rates will have on the housing sector is a higher Canadian dollar. As interest rates have increased, many foreign buyers who'd previously bought and held property in the past several years may now be in a position to sell and reap the rewards of both the capital appreciation and the appreciation of the Canadian dollar. Although this is believed to be minimal by many people, it is important to realize that this will increase the supply of houses available for sale and reduce the current demand from foreign buyers.

The increase in interest rates has impacted both the supply and demand sides of the equation.

How investors can profit

Although a decline in housing is typically not very good for consumers, the best opportunity may be to purchase shares in alternative lenders such as **Equitable Group Inc.** (TSX:EQB), which, at a current price of $55 per share, is priced at a discount to tangible book value by $9.37 per share. As the company continues to experience increasing revenues as variable mortgage rates increase, there is a significant amount of potential for investors to experience profit through both dividends and capital appreciation.

With shareholders’ equity, which has been steadily building over time, the company may experience a slowdown in lending mixed with real estate investors locking in profits and discharging mortgages, leading to the availability of more capital, which would lead to a share buyback at some point in the future. Until that time, investors will receive a dividend of approximately 1.75% to remain patient.

Although many will argue that the company is better off retaining the capital to grow the balance sheet, it is important to realize that when housing activity and borrowing slows down, the company’s total capital will continue to come at a cost — a cost which could be avoided. For investors willing to take the risk, shares of this alternative lender may lead to the biggest gains of any company over the next year.

CATEGORY

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TICKERS GLOBAL

1. TSX:EQB (EQB)

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