2 Reasons the Recent OECD Report Doesn't Inspire Confidence in Canadian Housing

Description

Recent housing data has been mixed, showing a bounce back in home sales month over month but still-lagging home prices in comparison to earlier in the year. The real estate industry is reeling over new OSFI rules set to trigger in January 2018, and now more data has emerged that could increase anxiety.

Canada boasts the most indebted citizens in the developed world

On November 23 the Organization for Economic Cooperation and Development (OECD) released portions of a report showing that Canadian households were worldwide leaders in debt. Canadian consumer debt made up over 100% of GDP in the fourth quarter of 2016, surpassing South Korea and the United Kingdom — both are at over 80%.

The report appears to vindicate the dovish position taken by the Bank of Canada in October. It elected to hold rates late in the month, even as the Canadian economy showed continuing strength. In late September, I'd discussed whether or not this indicated that investors should buy alternative lenders.

Since then, shares of both **Home Capital Group Inc.** (TSX:HCG) and **Equitable Group Inc.** (TSX:EQB) have climbed 15%. Stocks have moved in step with a broader rally in the S&P/TSX Index, but can it last? Recent data shows that Canadians are adjusting their spending habits in response to rising interest rates, but the tightening environment is also bringing greater proportions of the population closer to financial trouble.

Suffice it to say, the Bank of Canada will be walking a tight rope in 2018, as it attempts to ameliorate the Canadian debt problem without plunging citizens into major financial trouble.

OECD predicts trouble for the Canadian housing market

The OECD also calculated that Canadian homes are nearly 50% overvalued compared to the rental market. Israel, New Zealand, and Sweden were over 40% overvalued going by this metric. The OECD warned that these conditions have been present before major recessions in the 1970s, 80s, 90s, and early 2000s.

All the while, many experts and analysts are projecting a correction in housing prices, at least in the opening months of 2018. New OSFI rules, which will include a stress test for uninsured borrowers, are expected to dramatically decrease the purchasing power of prospective buyers. This will put a cap on loan growth for Canadian banks and alternative lenders.

Home Capital Group released its third-quarter results on November 14. It reported mortgage originations of $385 million compared to $2.54 billion in the third quarter of 2016. Though the company returned to profitability, the steep drop in originations is a cause for concern. Equitable Group saw a 14% increase in mortgages under management to $22.8 billion compared to $19.9 billion in Q3 2016.

Both lenders are a significant risk heading into 2018. The steep dip in Home Capital Group mortgage originations, even with its solid liquidity, may be a sign of things to come, as loan growth will likely be harder to come by in 2018. Equitable Group will face similar challenges, but its stock offers a 1.5% dividend yield to entice investors.

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