Here's Why Real Estate Stocks Are a Bad Investment in 2018

Description

Canada's once highly frothy real-estate market seems to have entered a slow patch, burdened by the heavy government regulations.

Steps taken by federal and provincial governments and the Office of the Superintendent of Financial Institutions, Canada's banking regulator, are curbing new demand and forcing sellers to remove their listings. The end result of these interventions may be more significant than what the government had originally intended, but these moves have slowed down the pace of price growth and the rampant speculation considerably.

The number of homes sold in Canada dropped by 14% in April compared with the same period in 2017, touching a seven-year low for the month, the Canadian Real Estate Association said this month. The national average sale price tumbled by 11.3% year-over-year to just over $495,000.

In a separate report by an industry group, sales of new homes in the Greater Toronto Area in April were the lowest in 20 years as more stringent mortgage rules and climbing interest rates contributed to the market slowdown.

The new rules implemented by the Office of the Superintendent of Financial Institutions mean that even borrowers with a down payment of 20% or more face a stress test, as has been the case since January 2017 for applicants with smaller down payments who require mortgage insurance.

Implications for real estate stocks

This dismal picture of Canada's housing market is certainly not good for financial stocks such as Home Capital Group Inc. (TSX:HCG), which are dependent on the mortgage business. With strict mortgage rules and taxes on foreign buyers, the demand for housing is likely to remain weak in the next two to three years unless we see interest rates falling.

Home Capital, which last June got a lifeline from Warren Buffett's **Berkshire Hathaway Inc.**, is pinning its hopes on mortgage renewals as borrowers facing stringent rules prefer to stick with the existing lenders.

"We will have better renewals than any time. Not just last year, but any time in the 30 year history of this company," Home Capital President and CEO Yousry Bissada told analysts on a call about the lender's latest quarterly results.

However, that optimism isn't reflected in the company's share price, which is down 16% this year, underperforming other non-bank lenders, such as **First National Financial Corp.** (TSX:FN). Home Capital lost a significant market share to other lenders after it faced a liquidity crisis last spring amid accusations that it misreported the extent of mortgage fraud within its network of brokers.

The bottom line

I don't see 2018 as the year to invest in stocks whose fate is closely tied to Canada's real estate market. While there is little doubt that the dynamics in the Canadian housing market remain strong, and they won't let the market collapse, the falling mortgage demand will keep real estate stock prices depressed. Thus, it's better to stay on the sidelines.

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