Should You Bet the Farm on This 8% Yield?

Description

Ever since the new mortgage rules came into effect on January 1, the housing market has seen a dampening in the level of interest by Canadians.

If you own a home and were thinking about upgrading, the new stress test imposed by the Office of the Superintendent of Financial Institution requires home buyers to qualify for the Bank of Canada's five-year benchmark rate, which was 4.99% at the beginning of the year, but is now 5.34% after four interest rate hikes since last July.

Home buyers who might have qualified for a bigger mortgage under the old rules aren't necessarily being rubber-stamped by banks under the new rules, and that's put a lot of downward pressure on home prices.

"Rising interest rates and this year's stress test on mortgage applicants will likely prove to be difficult hurdles to overcome for many would-be first-time and move-up homebuyers, heading into the second half of the year and beyond," the Canadian Real Estate Association's chief economist, Gregory Klump, recently stated in a report.

Rising interest rates don't help

For income investors interested in generating stable cash flow from mortgage investments, rising interest rates have thrown a wrench into the mix. That's because even though rising interest rates are generally good news for mortgage lenders, the pace of the rate increases and the change in the mortgage rules have put a crimp in mortgage origination, as fewer people are looking for mortgages, and those that are are having a tougher time qualifying.

As a result, the annual rate of mortgage growth in Canada has fallen to 4.1%, its lowest level since May 2001. Things have gotten so slow that **Canadian Imperial Bank of Commerce** expects it will originate 50% fewer mortgages in the second half of 2018 than it did in the same six months a year earlier.

In fact, the decline is so pronounced that the bank's revenues from mortgages have gone from two-thirds of its overall revenue a year ago to just 25%, suggesting the bank is positioning itself for a period of low mortgage growth.

This doesn't mean you shouldn't invest in mortgage-related businesses

At the end of May, Fool contributor Brian Paradza made a case for buying the stocks of either **MCAN Mortgage** (TSX:MKP) or **Firm Capital Mortgage Investment** (TSX:FC), ultimately favouring MCAN because of its attractive yield of 8.1% combined with a more consistent growth trajectory.

While I wouldn't bet the farm on MCAN given the mortgage origination market isn't very strong at the moment, I would take a reasonable position for several reasons.

The first is that the company has benefited from the new rules.

"While creating uncertainty in terms of the number of borrowers that qualify for new mortgages, these new stress tests provide for an improvement in the quality of newly originated mortgages," the company stated in its second-quarter press release. "We estimate that the uninsured stress test has impacted approximately 10-15% of mortgages that we underwrite…"

So, while it will have less mortgage volume in the coming quarters, those who do qualify will have healthy credit profiles, resulting in fewer delinquencies.

Secondly, the credit quality of its uninsured single-family mortgage portfolio remains extremely healthy with the impaired total mortgage ratio decreasing by eight basis points in the second quarter to 0.02% from 0.10% in the first. Also, the loan-to-value ratio on those uninsured mortgages sat at 56.9%, which means the average homeowner has more than 40% equity in their houses.

Thirdly, given the current state of the economy and a slowdown in the housing markets, the company is taking additional steps to strengthen its balance sheet further to withstand whatever these uncertain times throw at it.

You should buy this 8% yield

While MCAN stock has experienced far better capital appreciation in previous years, the $1.48 annual dividend pays you to wait until the business conditions improve enough to warrant its next leg up.

I wouldn't bet the farm on MCAN — maybe just the barn.

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