



3 Stocks from the Financial Sector I'd Buy Ahead of Home Capital Group (TSX:HCG) Right Now

Description

Last week a report surfaced out of **Goldman Sachs** ([NYSE:GS](#)) indicating that the current state of many Canadian households is eerily resemblant of the same state of affairs that preceded the housing meltdown that took place in the United States exactly 10 years ago.

Not only that, but the picture provided by Goldman was also similar to the environment present in the U.K. shortly before that country experienced a housing crisis that many say it has yet to recover from.

Now, if you one of those who are saying to themselves right now “we’ve been hearing this narrative for years already” I will be the first to agree.

In fact, when I purchased my first home in the Toronto market nearly eight years ago, I can still vividly recall cynics warning me that the market was back then flirting with “bubble territory.”

To be perfectly honest, even today I remain bullish on the long-term health of Canada’s real estate market.

That’s largely because of the conservative lending guidelines that banks are required to adhere to as well as fairly liberal regulations around immigration that should in theory at least continue to support a consistent level of population growth for the country.

But the report from Goldman [has my alarm bells ringing](#), if only because the picture that it paints – and the threat it points to – is not only pretty straightforward but logical, and rather easy to wrap your head around.

Over the past decade, many critics have pointed to the rising level of household debt in relation to household incomes.

Yet that has for the most part not been enough to deter me from not only from continuing to invest in the Canadian housing market, but even buying a stake in **Home Capital Group** ([TSX:HCG](#)) last year.

That worked out to be a profitable trade for me, and one I have since sold.

But the problem with the oft-reported debt-income ratio is that it simply isn't representative of how credit markets work.

Rarely, if ever are borrowers required to repay their entire outstanding principal balance out of current earnings in a given year.

Think for a minute about how many publicly traded companies you know that have debt on their balance sheets equal to or less than one year of their current earnings?

So while I've largely been a critic of the supposedly important ratio of household debt to incomes the report from Goldman highlighted a second metric that I do think could prove very critical – and potentially disastrous for the Canadian market.

In that report, Goldman revealed that Canadian households are now spending more money on average, than they are bringing in.

And they are making up the difference through borrowing on products like home-equity loans, which have surged in popularity over the past decade amidst the latest housing boom.

The problem is, that strategy only works as long as long housing values remain stable or continue to appreciate.

Should the housing market experience a sudden or even sharp correction – regardless of how short-lived it may be – there will undoubtedly be those Canadians out there who will suffer some very unfortunate consequences.

Sound familiar?

And the Canadians who will be most likely to suffer the worst fate are exactly those with the least credit to begin with.

And those who already have a decent understanding of the type of book of business that Home Capital has been built up over the past decade will see exactly why the HCG stock – despite what could be a solid long-term holding – may not be exactly where you'll want to be parking your money for the time being.

Bottom line

Granted this is a situation that could still take years to play out – not in any way unlike how there were those who were warning about the state of the sub-prime market in the U.S. back in 2005, two years before the eventual default of Lehman Brothers.

But for this author, an investment in Home Capital right now just doesn't seem to be worth the risk.

Instead, if I were going to look toward an investment in the financial sector I'd be looking to [pay up for quality](#), favouring stocks in names like **CI Financial Corp**, **Bank of Nova Scotia** or **Canadian Imperial Bank of Commerce**

, the last of which is currently paying investors a solid – and relatively secure – 4.40% annual dividend yield.

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