Warning: 2019 Could Get Ugly if Canada’s Housing Bubble Pops

Description

Housing bears, nervous investors, and other pundits have been calling for a Canadian housing collapse for almost a decade now.

I’m the first to admit these folks have a valid point, at least when it comes to both Vancouver and Toronto real estate. Both those markets are among the most expensive in the world when valued on traditional valuation metrics like price-to-rent and price-to-median income ratios.

Many thought Canada’s bubble would pop shortly after the United States’s real estate market imploded in 2008, but the average price nationwide kept chugging upwards. It kept going up even when the federal government took steps on multiple occasions to curb prices. Real estate survived multiple interest rate hikes, a collapse of the energy sector, and the attempts of multiple short sellers to bring the asset class down.

Finally, nearly a decade after alarm bells were first rung, it appears cracks are beginning to form. Both Toronto and Vancouver have recently posted tepid sales numbers, and the average sale price in each market is beginning to weaken.

Investors must be cautious if such an event occurs. Here are some ways you can protect your wealth.

Continue renting

The easiest way to avoid a real estate meltdown is to not have any exposure to real estate in your portfolio. Thus, investors nervous about the market should either avoid buying a house in the first place or sell, book gains, and then look for property to rent.

Note that this might be the nuclear option for some. Uprooting a family is no small task, and many folks own a home for reasons other than financial benefits. Besides, if you don’t plan to sell for a while, weathering a downturn is as easy as continuing to make your mortgage payments.

Switch to defensive investments

An alternative lender like **Equitable Group** (TSX:EQB) will likely take a downturn right on the chin, despite having a significantly lower valuation than its peers.

The irony is there's a lot to like about the stock. It operates in an expanding niche in the credit market, and it's doing a nice job spreading loans across the country. The company's balance sheet is sound, and it has successfully attracted retail deposits — something many alternative lenders struggle with.

Unfortunately, none of that will matter if housing declines in a big way. Investors would get spooked in such a scenario, which could lead to a run on the bank. Remember, the same thing happened to **Home Capital Group** (TSX:HCG) in 2017.

An Equitable Bank GIC may prove to be a far better investment than the stock in 2019.

Avoid Home Capital too

Although Home Capital has done an admirable job shoring up its balance sheet and regaining the market's confidence — thanks in large part to a capital injection by Warren Buffett — it's still at risk if Toronto's real estate market sees a major downturn.

Some 80% of Home Capital's loans are secured by Ontario real estate, with the majority of those loans in the Greater Toronto Area. Just 7% of the portfolio is invested in British Columbia. Thus, Home Capital is strictly a Toronto story.

In addition, only 23% of Home Capital's portfolio is insured against default, although the average loan-to-value ratio of the uninsured portion is under 60%. This shows management is well aware of the risks surrounding the property market, but this restraint will likely fall on deaf ears if we see a sustained downturn. Investors will sell first and ask questions later.

The bottom line

Some analysts — myself included — think the likelihood of a major housing correction in 2019 is unlikely. There are simply too many long-term factors helping to push prices higher in our major markets.

But at the same time, it is an easily identifiable risk. We could see a downturn in 2019 if underlying economic numbers get worse and interest rates keep going up. Perhaps it's prudent investors avoid stocks like Home Capital and Equitable Group until the future gets a little less murky.

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