Is Canada Headed Towards a Housing Market Crash?

Description

The Canadian housing market has climbed back into the good graces of investors in 2019. Back in 2017, the near collapse of **Home Capital Group** (TSX:HCG) sparked a sell-off for housing-linked lenders. Policymakers acted quickly to introduce new regulations, including a foreign buyer's tax in the province of Ontario. The OSFI introduced new mortgage rules, including a stress test for uninsured buyers, in 2018. This had its desired effect, as the market cooled significantly, but sales volumes have shot back up.

Industry experts are projecting good things for the sector in the coming months. The Canada Mortgage and Housing Corporation (CMHC) forecasts that home sales will increase over the next two years. Volumes are projected to be high enough to offset declines we have seen since 2016. It also cites the growth in household disposable income as a bullish indicator. The CMHC predicts that home prices will also increase in 2020 and 2021, eclipsing the peak we saw in 2017.

Are we in a bubble?

This has been a lingering question since the middle of the decade. Real estate in Canada, particularly in major metropolitan areas surrounding Vancouver and Toronto, has enjoyed a tremendous boom. This has occurred during a period of historically low lending rates. There was an expectation that rates would normalize as the recovery matured, but recent developments have shown that central banks in the developed world may extend this policy for much longer than original anticipated.

Lenders may be happy about this, but Canadians are still burdened by record levels of debt. The debt-to-income ratio improved in the second quarter, but Canadians still owned $1.77 on average for every $1 they make. Canadians are also carrying high levels of credit card debt and high balances on their lines of credit. These are dangerous indicators that could lead to catastrophe in the event of a recession.

There are also troubling indicators when it pertains to the market's overall valuation. The Swiss bank UBS recently ranked 24 major cities on four continents for their "bubble risk." This takes factors like historical valuations and affordability into account. Toronto came in second of the 24, right behind Munich. Vancouver came in sixth on the list.

How should investors prepare?

The calls for a sharp correction in housing have been constant for years. Many of these cities have generated new wealth due to the growing tech economy. Housing starts have not sufficiently increased to keep up with this growing demand. High immigration levels into these metropolitan areas, combined with low supply, is likely to underpin prices and sales into the next decade.

What about lending stocks? Shares of Home Capital have surged 130% in 2019 as of late-morning trading on November 14. The stock shot up in November after the release of its third-quarter 2019 results. Total mortgage originations rose 7.6% year over year to $1.55 billion as single-family mortgage originations posted 16.8% growth. Its total loan portfolio grew 6.4% to $16.99 billion. Home Capital reported net income of $39 million, or $0.67 per share, compared to $32.6 million, or $0.41 per share, in the prior year.

Home Capital stock now possesses a price-to-earnings ratio of 18 and a price-to-book value of 1.1. The company has rebounded with the broader market and looks poised to benefit from this return to form for the market as we look ahead to the new year. Canada housing passed through a tough test in the back half of this decade. The sector is worth trusting in the coming years, as it is still supported by strong fundamentals.

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