



Will Canada's Housing Bubble Burst in 2020?

Description

Despite claims the Canadian housing market has cooled over the last year, there are signs that it is still caught in a bubble. Between November 2018 and November 2019, the national average house price gained 8.4% despite Greater Vancouver's red-hot market seeing its average price fall by 4.6%.

The significant gain was driven primarily by Greater Toronto where the average price edged upward by 6.8% and strong gains in Nova Scotia where it rose by a stunning 19%. There are claims that 2020 will be the year when Canada's housing bubble will finally burst.

High debt

Growing uncertainty over the outlook for the global economy and rising fears of a recession fuel those assertions, as does data showing Canadian households are among the most heavily indebted in the developed world.

The fear is that an economic slump will cause rising unemployment and already stagnant wage growth to worsen, placing ever greater pressure on heavily indebted households. This, combined with high housing prices – the average price in Greater Toronto being \$579,000 at the end of November 2019 – will cause sales to fall.

Such an event would spark a marked increase in mortgage defaults as financially stretched households find it increasingly difficult to meet their obligations. Higher mortgage defaults would lead to an increase in housing supply in an environment where sales are softening, placing greater pressure on prices. It would also cause the credit quality of Canada's banks to deteriorate, weighing on their balance sheets and earnings.

An anticipated decline in the credit cycle was why Steve Eisman, of Big Short fame, announced in June 2019 that he was [shorting Canada's banks](#). Canada's big six banks are among the 10 most shorted stocks on the TSX, with **Toronto-Dominion Bank** ([TSX:TD](#))([NYSE:TD](#)) the most shorted, followed by **Canadian Imperial Bank of Commerce** ([TSX:CM](#))([NYSE:CM](#)) and Royal Bank of Canada.

It is easy to see why those three banks are attracting the most negative attention from hedge funds and other traders; they have considerable exposure to the domestic housing market and are highly dependent on residential mortgages to drive earnings growth.

For 2019, 58% of TD's revenue was net interest income from mortgages and other loans, while Canadian mortgages made up 29% of its total loans under management. That highlights its exposure to a housing correction and decline in credit quality.

CIBC is even more vulnerable because its U.S. operations are far smaller than TD's and it has a far greater reliance on the domestic market to drive earnings.

Over half of the bank's 2019 revenue was from net interest income and 51% of its loans from Canadian residential mortgages, underscoring the bank's vulnerability to a domestic housing meltdown.

Nevertheless, the risks posed to the bank's balance sheets by a housing meltdown are mitigated by low average loan-to-valuation (LTV) ratios and compulsory mortgage insurance for all loans underwritten with a down payment of less than 20%.

TD's Canadian real estate lending portfolio had an average LTV of a conservative 53%, with 31% of all loans being insured at the end of 2019, while CIBC's LTV was 64% and 30% of its loans were insured.

Those numbers indicate that neither bank is particularly vulnerable to a housing correction. While CIBC's higher average LTV and lower proportion of insured loans indicates that it is more vulnerable to a housing correction, it is TD's exposure to the U.S., where it is a top-10 ranked bank, that explains why it is a more popular target among short sellers.

Foolish takeaway

Regardless of an increasingly upbeat outlook for Canada's housing market heading into 2020, there are still signs that it could be overheated. If a global recession [were to strike](#) it would have a sharp impact on the housing market which in turn would negatively affect the performance of Canada's banks, but would be mitigated by conservative LTVs and mortgage insurance.

There is also an emerging consensus that Canada's housing market is not in a bubble and, while overheated in some areas, will perform well during 2020.

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