Will Canada’s Housing Market Collapse in 2021?

Description

The Canada Mortgage and Housing Corporation (CMHC) recently issued a letter that urged lenders to stop offering so many “high-risk” mortgages, reinvigorating fears that many investors had that Canada’s frothy housing market could be on the cusp of a vicious correction.

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There’s no question that the big banks could get clobbered if the Canadian housing market were to crumble like a paper bag. Many lenders are likely to dismiss the CMHC’s warning as alarmist. But for investors, I think the CHMC’s words are not to be taken with a grain of salt, as a housing meltdown could wreak havoc on a portfolio that’s overexposed to Canadian mortgages.

In a pandemic, even those not-so-risky mortgages could have the potential to sour, as government relief is unlikely to be a sustainable long-term solution for longer-term unemployed people who will have a massive mortgage on their shoulders.

In a prior piece, I’d highlighted the possibility that the COVID-19 pandemic could act as a pin that pops the Canadian housing bubble.

Is the pandemic the pin that pops Canada’s housing bubble?

“You can only defer mortgages for so long. I see mortgage deferrals as akin to the teaser rate period in the lead-up to the Financial Crisis. Although there’s no foul play this time around, the mortgage deferral period, like the teaser rate periods before 2008, do not make for a sustainable payment plan over the long haul.” I said in a prior piece. “They both assume that the income of the mortgagor will be at a level to meet payment after the expiry of each respective period — an assumption that may not be safe to make. If deferrals continue dragging and employment never recovers to pre-pandemic levels, I wouldn’t at all be surprised to hear default as the “d” word that follows deferrals.”

While employment has seen some relief in recent months, I certainly wouldn't rule out the risk of a housing crash in 2021 if this pandemic worsens drastically and causes another round of shutdownsand business disruptions. The pandemic is an unpredictable beast, and in a bear-case scenario, itcould certainly burst the Canadian housing market bubble.

Risk ahead

Even if the Canadian housing market makes it through this crisis without a severe correction, I still find few reasons to overweight one's portfolio to the potential sore spot. Mortgage-heavy Canadian bank **CIBC** (TSX:CM)(NYSE:CM) and alternative mortgage lender **Home Capital Group** (TSX:HCG) are two firms that could take a beating if the housing market takes a hit over the next year.

Back in 2017, Home Capital Group ran into liquidity trouble before Warren Buffett swooped in to the rescue, marking the bottom in the stock.

Shares of HCG were on the cusp of recovering over the last two years, but then came the coronavirus crisis, which tanked shares by around 60% from peak to trough. Whether or not Buffett comes to rescue again is anyone's guess. Regardless, I can't say I'm a huge fan of the stock's risk/reward equation at this juncture, even with today's hefty discount, which partially bakes in the potential for trouble to brew in Canada's housing market amid this pandemic. The stock trades at a whopping 20% discount to book value and just 3.6 times cash flow, making HCG one of the cheaper stocks on the **TSX Index**. Despite the discount, there's a chance that the name could prove to be a value trap.

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CIBC may seem like a safer choice, but with the most exposure to the Canadian housing market, the Big Six bank could lead the downward charge if housing were to implode. Moreover, CIBC stock isn't even that cheap given the mortgage exposure, and mounting banking headwinds.

With shares trading at 1.2 times book, shares are cheap, but compared to the other banking bargains, I'd say the stock is expensive given the risks you'll bear with the name. Banks are already heavily exposed to mortgages, so why seek to increase your exposure for a higher price?

If the housing market does crash, count me as unsurprised to see CIBC slash its 6%-yielding dividend.

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