When Will the Housing Market Correct?

Description

When will the housing market correct? A year ago, the answer to that question could have been “imminently.” After all, the pandemic and lockdown had erased decades of employment gains and economic growth. Surely, Canada’s overvalued housing market would be a victim? It turns out, it’s not.

In 2021, the housing market has turned absolutely parabolic. 67% of the 64 markets surveyed by Royal LePage posted double-digit, year-over-year aggregate home price gains this past month. Even obvious teardowns are selling far above asking price. If you’re looking to get in, the doors to the property market are being slammed shut.

However, this pace of price growth cannot go on forever. Real estate booms on this scale have ended badly in nearly every other country. Canada is no different. If you’re an investor, it may be time to wonder when will the housing market correct. Here’s a closer look.

Valuations

Financial experts and real estate analysts often use a simple rule of thumb to decide if real estate is overvalued: the price-to-income ratio. Put simply, the average price of a house in your city should not exceed four times the average income. If it does, the property market is overvalued. Ordinary families may struggle to pay their mortgage if the ratio is too high.

In Canada, the price-to-income ratio is at a 40-year high. The average house price is seven times greater than the average household income. In cities like Toronto and Vancouver, the ratios are much higher. It would take 12 times the average income to afford Vancouver’s average home, while in Greater Toronto the ratio is 10.

Valuations clearly suggest a bubble. Even homeowners agree. Will the bubble ever burst?

Housing market correction triggers

Timing the market is nearly impossible. However, investors can look for triggers that could pop the bubble. The most obvious trigger is a sudden rise in interest rates. If the cost of a mortgage becomes too expensive, fewer people can afford their homes. Those on variable rates may be forced to sell. This compresses the value of housing.

Another trigger is government intervention. The government is currently considering measures ranging from a foreign buyers' tax to a capital gains tax on primary residences to curb the market. Some of these measures could be hinted at in Canada's federal budget scheduled for April 19.

What should investors do?

If you're a homeowner, perhaps this is a good time to cash in and take some profits off the table. If you're a potential buyer, it may be wise to stay on the sidelines till the mania settles.

For stock investors, a potential housing market correction could be detrimental to banks and real estate investment trusts (REITs). If you rely on **RBC's** 3.6% dividend yield, you may want to consider that the bank's balance sheet is overexposed to residential mortgages. A spike in default rates could chew into the bank's profits and dent its budget for dividends.

REITs like **Canadian Apartment Properties REIT** have already faced a decline in rental income. Rents have been declining for months. If the housing market corrects, CAPREIT's book value could decline, too. A spike in interest rates could make the trust's debt load more expensive to maintain.

Bottom line

If you're wondering when the housing market will correct, it may be time to cut your exposure to residential real estate.

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