3 Ways the Housing Market Could Correct

Description

The Canadian housing market is on a tear! House sales are up 70% this year. The price of an average Canadian house has jumped a whopping 30% over the past 12 months. You now need roughly $716,828 to afford an ordinary house across the country.

Speculators and homeowners believe the boom could continue. After all, it's been sustained for roughly two decades. Now there's pent-up demand and record-low interest rates. The momentum in housing looks somewhat unstoppable. However, double-digit annual gains are simply unsustainable. Here are three ways the housing market could crash and how you can prepare for it.

Housing market triggers

Supply and demand factors are lining up to deflate the housing market relatively soon. For one, the Bank of Canada pulled back its expected interest rate hike from 2023 to 2022. They now believe interest rates could rise sooner, because the economy is recovering quicker. That also means that if the economy heats up further, the rate hike could be pulled even closer.

Meanwhile, Canada's AAA credit rating is under siege. The recently released federal budget laid out broader spending measures and an expanded safety net for nearly everyone. Credit rating agencies could be compelled to take another look at Canada's credit rating.

Finally, immigration has slowed to a crawl. And new units are being listed at a record level. Any of these factors could reduce the irrational exuberance in the housing market or cause a correction.

What should investors do?

If a housing market correction is just around the corner, you may want to reduce your exposure to lenders and property stocks. A real estate investment trust like **Minto Apartment REIT** is overexposed to residential real estate, particularly in overheated Ontario.

Minto stock has jumped 36% since October last year. While its underlying book value should have benefited from the recent boom, the decline in rents has reduced its free cash flow. If interest rates spike and property prices drop, stocks like this could plunge.

A correction in housing could also lead to a spike in delinquency. That has a direct impact on Canada's largest banks. **Royal Bank of Canada**, for instance, is overexposed to the mortgage sector. That ties its fate with the housing market.

No one can predict the housing market accurately. Few would have expected prices to jump double digits when a pandemic erupted this time last year. Yet here we are. The path ahead is equally foggy. However, there's plenty of upside in other sectors of the Canadian economy (healthcare or FinTech) and considerable downside risk in the housing market. Reducing risk is probably the best course of action.

Bottom line

The Canadian housing market is overheating. Prices are up double-digit percentages while interest rates remain at record lows. This could change as we face inflation, rising rates, and growing supply. Investors might want to consider lowering their exposure to real estate trusts and banks as the cycle turns.

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