Is Canada’s Real Estate Bubble About to Burst?

Description

Canadian real estate has been one of the best-performing asset classes over the past two decades. The average price of a home has more than doubled since 2015. Over the past year, it’s up a jaw-dropping 31.6%, the largest annual gain on record. For most first-time homebuyers, the market has been red-hot throughout their adult life.

Based on fundamentals this market is clearly in a bubble. Now, there are signs that the bubble could be about to finally burst. Here’s a closer look at what lies ahead for Canada’s real estate sector and how investors should position themselves.

Valuation

Local household income is the basis for residential real estate valuation. If families can barely afford their mortgage or rent, the housing market is overvalued. In Canada, the price-to-income is seven. Meanwhile, most Canadian houses are 22% more expensive to buy than to rent. By those metrics, Canada has some of the most unaffordable housing in the developed world.

Interest rates

Record-low interest rates are a clear reason for this overvaluation. At the time of writing, some lenders are offering a five-year variable rate of 0.99%, an unbelievably low rate. Despite this, the number of home sales and mortgage applications has declined in recent months.

To put it another way, buyer demand has hit a peak despite record-low interest rates. Meanwhile, the Bank of Canada has indicated that interest rates could start rising in 2022 and inflation is already running hotter than expected. Canada’s real estate bubble may have finally peaked.

Real estate investments

Just because the market has peaked doesn’t mean it’s about to plunge or correct anytime soon. Prices could remain elevated for years. However, this implies that real estate investment trusts (REITs) have limited upside at these prices and face magnified risks.

Canadian Apartment Properties REIT (TSX:CAR.UN) is a good example. Units are trading near an all-time high of $59.7, while the dividend yield is 2.3%. A recovery in the rental market could push the dividend yield higher, but some of that will be offset by higher inflation. Inflation is already running at 3.6% annually and could rise further in the months ahead.

So, CAPREIT investors face little to no capital appreciation and a rental yield that is negative when adjusted for inflation. They also face the risk of a real estate correction triggered by higher interest rates in 2022. Put simply, this doesn't seem like the ideal time to hold residential REITs.

Investors may want to consider other robust dividend stocks in the telecoms or utility sectors to protect capital or generate passive income.

Bottom line

Canada's real estate is simply too overvalued. The fact that sales have slowed down despite record-low interest rates could be an indication that there is limited upside ahead.

Meanwhile, inflation and rising interest rates present clear downside risks. Investors should consider rotating away from REITs to other dividend stocks for the near term.

CATEGORY

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TICKERS GLOBAL

1. TSX:CAR.UN (Canadian Apartment Properties Real Estate Investment Trust)

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Date
2025/07/22
Date Created
2021/07/08

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