Tradeoff: Lower Home Prices for Higher Debt Burden

Description

Economists believe that Canada's red-hot housing market will finally cool with more rate hikes. The historically low-interest-rate environment that propelled demand to new heights is over. In April 2022, national sales fell 25.7% month over month, while the sales-to-new-listings ratio declined to 66.5% from 75% in March 2022.

Meanwhile, the Office of the Superintendent of Financial Institutions (OSFI) issued a warning that home prices could drop by 10-20% if the Feds raise interest rates further. While lower home prices are a boon for homebuyers, the tradeoff is higher financial burden because of higher borrowing costs.

Largest rate increase

According to **RBC** Economics, the Bank of Canada's aggressive stance will make higher interest rates a reality. It added that Canadians haven't seen a significant increase in such a short period since 2005-2006. Also, variable rates should follow fixed mortgage rates that have gone up materially. Thus, borrowers won't have an escape.

The rate-hike campaign of the central bank and higher mortgage stress test qualifying should also weed out stretched-out homebuyers. Even then, RBC said that higher interest rates will reduce the mortgage size of qualified borrowers. Higher fixed mortgage rates will shrink the maximum purchase budget of households with median income by about 15%.

Defensive assets

On the investment side, property investors can postpone their purchases until real estate prices correct and instead invest in real estate investment trusts (REITs). Dividends from this asset class can take the place of rental income.

NorthWest Healthcare Properties (TSX:NWH.UN) is the only REIT in the cure sector. The $3.09 billion REIT owns and operates medical office buildings, hospitals, and clinics. At $12.96 per share, you can partake of the generous 6.17% dividend yield. This real estate stock is a stable performer owing to its 71.70% (11.4% CAGR) total return in 5.01 years.

In Q1 2022, the 202 properties combined to deliver a net income of $88.25 million, or a 66.7% increase from Q1 2021. Besides the 14.6 years weighted average lease expiry, the occupancy rate is a high of 97%.

Paul Dalla Lana, NorthWest's chairman and CEO, said, "Despite the evolving macro-economic environment and rising inflation and interest rates the REIT is well positioned with more than 80% of global revenue subject to annual indexation."

CT REIT (TSX:CRT.UN) is equally attractive as NorthWest if you want an alternative to direct property ownership. This $3.97 billion REIT benefits from its strategic relationship with its anchor tenant, **Canadian Tire**.

According to its CEO, Ken Silver, the 24.8% increase in net income in Q1 2022 versus Q1 2021 reflect the core attributes of the REIT's strategy and business model. Management also announced a 3.4% dividend hike, the ninth increase since 2013. At $17.02 per share, the dividend offer is 4.93%.

Mortgage affordability

Higher borrowing costs is a gigantic challenge for buyers, notwithstanding lower home prices. The OSFI is more concerned about the ability of borrowers to service their debts than growing debt levels.

RBC Economics revised its housing forecasts and projects home resales to drop 13% and 14% in 2022 and 2023, respectively. It expects a significant slowdown over the spring to fall period, after which sales should stabilize and help correct the market imbalance.

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Date
2025/08/19
Date Created
2022/05/24
Author
cliew