More Rate Hikes in 2022 Could Cause a Steep Drop in Home Prices

Description

Bank of Canada Governor Tiff Macklem intimated last week that the economy can handle — and may need — higher interest rates. He said that rising interest rates aren't expected to derail the nation's economy and may even produce a "healthy" slowdown in the housing market.

While the central bank is determined to get inflation under control, Capital Economics's senior Canadian economist Stephen Brown warned against aggressive rate hikes. He said that home prices could drop significantly, and it could lead the country into a recession.

Housing affordability

Industry data confirmed that home sales and prices have cooled meaningfully across the country since the rate-hike campaign began in March 2022. Brown agrees that a housing slowdown is necessary to bring inflation down, although an increase in the average five-year fixed mortgage rate to 4.5% could have serious consequences.

Brown said, "Even allowing for an acceleration in wage growth this year, an average of those mortgage rates would reduce the maximum house price that a buyer could afford by 23% compared to last year, four times as large an impact as during the prior three tightening cycles."

Focus on household debts

For the Bank of Canada, heavily indebted households take precedence over the impact of any sharp correction in the housing market. The policy makers said they are more vulnerable to higher borrowing costs. Also, they carry less equity to cushion against any significant price drops.

Governor Macklem said, "If the economy slowed sharply and unemployment rose considerably, the combination of more highly indebted Canadians and high house prices could amplify the downturn."

Rising rental rates

Rental, instead of homeownership, is a consideration for many homebuyers because of the affordability and mortgage crises. However, rental expert Paula Azevedo expect landlords to offset extra costs by increasing rental rates for new lease agreements if interest rates continue to rise.

Furthermore, the rental market has a supply shortage too. Rentals.ca Network's CEO, Matt Danison, said, "This problem will keep rents on the rise in most of Canada for the rest of the year." Max Steinman, CEO of Rentsync, predicts that vacancy rates in the broader rental market will continue to drop as supply cannot keep pace with demand.

Quality investment

Killam Apartment (TSX:KMP.UN) is a quality investment if you're looking for indirect exposure to the real estate market. The $2 billion real estate investment trust (REIT) owns and operates apartments and manufactured home communities in Canada. According to management, geographical diversification is the driver of its business strategy.

Besides the strong earnings growth and operating performance to start 2022, its development program should deliver much anticipated growth to the portfolio in 2022 and 2023. In Q1 2022, property revenue and net operating income increased 15% and 12.4% versus Q1 2021. Notably, net income soared 118.9% year over year to $60 million. Killam trades at $17.34 per share and pays a 4.04% dividend.

Price relief

According to the Bank of Canada report, it's too early to tell whether the recent drop in home sales and prices is temporary or the start of a deeper, lasting decline. Thus, prospective homebuyers might have to wait longer for considerable price relief.

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Date
2025/09/18
Date Created
2022/06/13
Author
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