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Real Estate Correction: Why a 20-30% Drop Could Happen

Description

Investing in real estate has lost its charm in recent months. Housing prices across the country were on a stellar run for the better part of a decade. Canadians who owned homes as investment properties before prices soared saw their wealth grow significantly due to rising home prices. However, many Canadians could no longer afford houses due to insanely high prices.

Activity in the Canadian housing market has slowed of late and caused a decline in home prices. The Canadian Real Estate Association (CREA) reported a 12.6% drop in home sales month over month in April.

Housing markets sharply cooled down in many parts of the country in the last few months. The development came largely due to interest rate hikes introduced by the Bank of Canada (BoC) to cool down inflation rates.

The record inflation rates and multiple interest rate hikes could lead to a downward correction in the housing market by as much as 30% by 2023.

What is happening?

Royal Bank of Canada (TSX:RBC), Canada's largest financial institution by market capitalization, has been bullish on the Canadian economy's outlook. However, the bank's regulatory filings have revealed that it anticipates a decline in home prices by next year if its downside scenario plays out.

Home prices could decline by 20-30% to roll back all the enormous gains the market experienced during the pandemic. The bank primarily has three scenarios: a base-case scenario, a worst-case scenario, and a best-case scenario. The base-case scenario could see home prices drop by 3.6% by the end of the year but bounce back at a CAGR of 4.3% by 2027.

The best-case scenario by the bank anticipates a 10.9% increase in home prices by April 2023 and growth at a CAGR of 9.5% for the next four years — it would essentially be a strong run for the housing markets, like in the last five years.

However, the worst-case scenario is a significant concern. The bank predicts that home prices could be a major contraction, similar to what happened during the 90s. Benchmark home prices could decline by up to 30% if the worst-case scenario plays out.

Is it safe to invest in real estate right now?

RBC has presented downside scenarios regarding the real estate market, but they have not played out in recent years. The difference this time is the bank's emphasis on the possibility of the downside. It is possible that the downside scenario might not play out, but it would be a good idea to practice caution.

Investing in real estate without tying down a substantial amount of your capital in the housing market is still possible. Consider looking at real estate investment trusts (REITs) that focus on a diversified portfolio of properties instead of relying entirely on the residential real estate market.

Choice Properties REIT (TSX:CHP.UN) could be an ideal example of such a trust. The $4.65 billion market capitalization REIT headquartered in Toronto is one of the largest residential REITs in the country. However, its portfolio primarily comprises residential units built atop grocery chains in urban centres throughout Canada.

The company invests in, manages, and develops retail and commercial properties throughout the country. Most of its portfolio consists of shopping centres anchored by supermarkets and standalone supermarkets. CHP.UN has a tenant base that can generate significant revenues for the trust, decreasing its reliance on income through its residential units.

Foolish takeaway

The volatility in the housing market could make investing in a rental property too risky for some investors. With interest rates rising, mortgages would also become too expensive in the long run. REITs offer a way to generate rental-like income without the massive cash outlay.

Choice Properties REIT trades for $14.08 per unit at writing and boasts a juicy 5.15% forward annual dividend yield. The trust pays monthly distributions, making it a viable alternative to investing in a rental property to earn monthly revenues.

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