Policy Rate Hike of 75 Basis Points: What Will it Do to Real Estate?

Description

A painful reset in Canada's real estate market is now a reality with the ongoing rate hikes by the Bank of Canada. The 75 basis points increase on September 7, 2022, plus potentially two more before the year is over, will have serious repercussions.

The first significant impact will be a drop in housing prices. Second, borrowers will become collateral damage due to the steep increase in borrowing costs. Third, the aggressive series of rate hikes could eventually lead to a recession. Last, real estate investing could screech to a halt if the downward pressure on prices continues.

Home sales slump

The B.C. Real Estate Association (BCREA) forecasts home sales to slump through next year because of the intense pressure of high mortgage rates on the housing market. In the province of British Columbia alone, the agency sees residential sales declining by 34.4% from a record high of 81,900 units in 2021.

Brendon Ogmundson, BCREA's chief economist, said, "Faced with a dramatic shift in the cost of borrowing, housing market activity is likely to fall well below normal over the next year." For BCREA, it's a foregone conclusion that home sales will finish much weaker this year compared to the record-breaking totals in 2021.

Desjardins Group predicts a 23% decline in prices from the peak by year-end 2023, while **TD** Economics expects a peak-to-trough decline of 19%.

Higher lending rates

Major Canadian banks were swift to follow the lead of the Bank of Canada and match its percentage increase. The Big Six have raised their prime lending rates by 75 basis points to 5.45%. Stephen Brown, the senior Canada economist at Capital Economics, said the result of the move is an immediate jump in borrowing costs for many Canadians.

Besides the higher starting point for lenders' loan calculations, Brown said the hike in interest payments amount to about 0.5% of household income at a national level. He warns that the costs will be heavier on variable rate mortgages as the increase will eat a larger chunk of income.

Alternative investment

Rising interest rates have sidelined homebuyers as well as people buying real estate for investment purposes. With the way prices are falling sharply, a market crash is possible. The next-best alternative to earning monthly passive income is through a real estate investment trust (REIT).

Morguard North American REIT (TSX:MRG.UN) in the residential sub-sector is a viable option for real estate investors. This $948.88 million REIT reported impressive financial results in the first half of the year, notwithstanding the market headwinds. In the six months ended June 30, 2022, rental revenue and net operating income (NOI) increased 10.4% and 13.9%, respectively, year-over-year.

Net income grew 608.5% to $337.69 million versus the same period in 2021. Morguard has 42 active properties (12,983 suites) in its portfolio across North America. The REIT's occupancy rates in Canada and the United States remain high at 95.2% and 96.4%, respectively. It currently trades at $16.85 per share (-2.3% year-to-date) and pays an attractive 4.15% dividend.

Back to 2020 levels

Some industry analysts say a 23% decline will bring home prices back to the 2020 levels. However, it would do little to improve housing affordability in the near-term.

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Date
2025/08/28
Date Created
2022/09/15
Author
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