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Canadian Housing: Cracks in the Foundation?

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Housing related expenditures have become a large component of our economy and have helped to propel Canada to its current status as one of the fastest growing developed nations in the world. The prolonged run in home sales, coupled with price appreciation, has tripled the contribution to GDP during this cycle, according to RBC economics. On Thursday, the Bank of Canada released their semi-annual Financial System Review, which centered on the vulnerabilities of elevated Canadian Household indebtedness and imbalances in the Canadian housing market. Legislative changes in two of our largest metropolises, Toronto and Vancouver, are seemingly taking grip. Moreover, we have seen the pressuring of alternative lender Home Capital Group. As such, we wanted to consider the investment implications that a potential pullback in the housing sector would have for Canadian investors.

During his webcast on June 8th, BoC governor Stephen Poloz noted that the risk of a housing correction is growing over time. This highlights something that is quite apparent to all Canadians. However, the BOC labeled the risk of a housing correction as moderate. They think the impact of a pullback would be limited but that it would still cause financial stress. This is because the vulnerabilities caused by a supply and demand imbalance and by increased household indebtedness are being offset by growth and strength in other parts of the economy. “The resilience is rising in the background, even if the vulnerabilities are rising in the foreground,” said Poloz.

Observers are quick to draw parallels to the American housing market, which catalyzed the great financial crisis in 2008. The reality is that Canada’s situation is quite different (Chart 1). Underwriting standards are much more stringent, delinquency rates are much lower and, in some cases, lenders have recourse to other assets. Lastly, there is much less securitization of mortgage debt because our banks keep most of their mortgages on the balance sheet, unlike other countries that off-load a lot of that debt.

The growing level of household debt (Chart 2) and rising exposure to Canadian housing were cited as some of the reasons that Moody’s downgraded the credit rating of six of the Canadian banks on May 10th.

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Chart 1 - It's Not a U.S. Bubble, It's Our Bubble

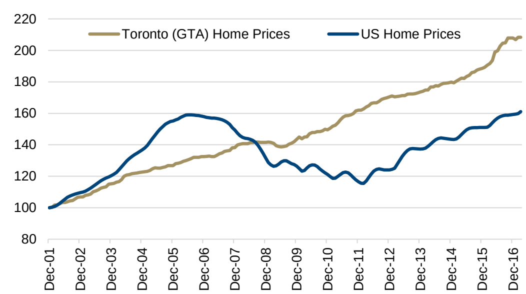
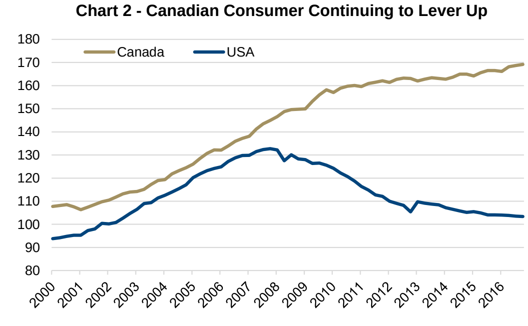


Chart 2 - Canadian Consumer Continuing to Lever Up



Housing exposure across the banks varies (Chart 3), but mortgage lending is a bread and butter business for all of them. Canadian banks are core holdings in all of our mandates. That said, we have a hard time being market weight in the sector since it accounts for 23% of the index. The prolific growth of financial institutions is apparent in their earnings. Remarkably, the sector now accounts for more than 52% of the TSX's net income (Chart 4). Within our portfolios, we are more allocated to banks that have larger contributions from capital market divisions and U.S. operations, such as RBC, TD and BMO.

The financial sector has been a laggard over the past three months, down -4.3% vs the TSX, which was nearly flat (down -0.3%) as of the end of May. The softness could simply be a cooling off after a solid run, but it may also reflect fears that the issues at Home Capital are not isolated. Home Capital fell precipitously in April following revelations of an OSC investigation which unveiled fraudulent mortgage applications (Chart 5). Some investors have concluded that the decline of their share price is an indication of weakness in the housing market, which is not necessarily the case. The quality of their mortgage book is actually quite high, with delinquency rates of just 0.21%. The problem they have run into is an access to capital, as investors have been redeeming High Interest Savings Accounts and GICs, two of their primary sources of funding.

Home Capital is considered an alternative lender, focusing on individuals that do not meet all the criteria laid out by traditional lending institutions. They only account for ~1.5% of all mortgage lending in Canada but their fallout has coincided with what appears to be a sentiment shift in the booming Greater Toronto Area (GTA) housing market. According to the Canadian Real Estate Association, In May, sales in the GTA fell -21%, while listings increased by 49% (Chart 6). This followed a similar type of rebalancing that took place in April. We spoke with a real estate agent who focuses on the Toronto condo market. He believes that the flux of new listings has come from unmotivated sellers that want to see if they can get a premium valuation for their homes. These properties are not being bought as quickly as before but properly priced ones are still being sold.

The other catalyst for the recent change in sentiment could be attributed to the regulatory reforms instituted by Kathleen Wynn and the Ontario government. These were focused on cooling a raging market in the GTA, where prices increased 29% year-over-year in May. On April 20th, they released the Fair Housing Plan, which had numerous measures aimed at helping balance the demand and supply of housing, including a 15% tax on purchases by people who are not Canadian citizens. They also provided measures aimed at the rental market such as expanding rental controls, providing a rebate for construction of new rental units and potentially taxing vacant homes.

The second wave of reform is intended to reign in rental costs, which have been rising quite quickly due to a low supply of vacant units and to high demand from individuals who cannot afford high flying home prices. GMP Research estimates that home ownership in the GTA is roughly 68%, near the same level of the U.S. before the housing crisis. During

Chart 3 - Mortgage Leverage Across the Banks

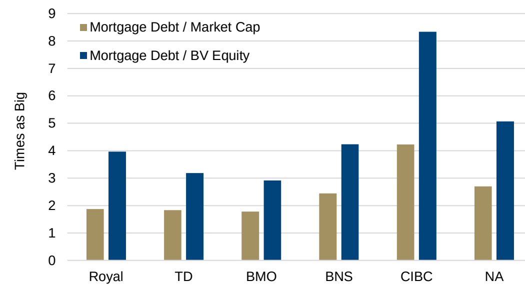


Chart 4 - TSX Net Income by Sector

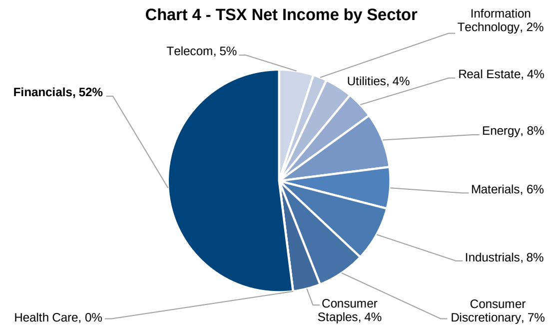
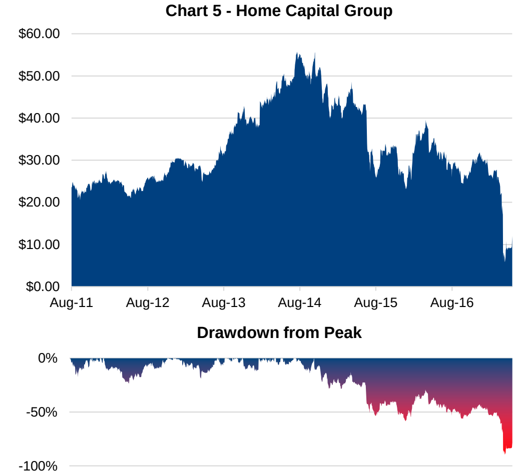


Chart 5 - Home Capital Group

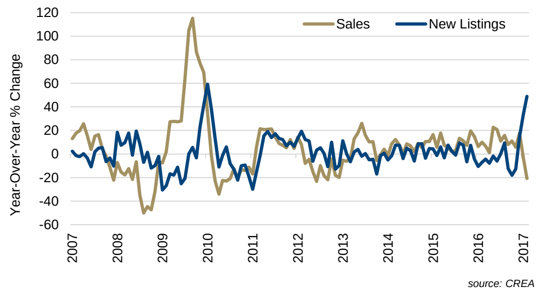


the crisis, homeownership in the U.S. fell 6%. Subsequently, net operating income growth for the largest U.S. apartment REITs increased 35%. If we were to see a fall in ownership rates then that would be bullish for Canadian apartment-focused REITs. During a downturn, it is likely that consumers will migrate to more affordable housing. With condo rent 1.55x (*Source: CMHC, GMP Securities.)* higher than apartments, apartment providers could benefit.

The reality is that homeownership rates do not fall in an expanding economy, nor do you typically see a housing crash. We would likely need to see an economic slowdown or even a recession for a major pullback to occur in home prices across the country. As we wrote about last week, our macro and market cycle indicators do not indicate that we are on the precipice of something catastrophic. Even so, we agree with the Bank of Canada's assessment that the housing market would be highly vulnerable in a recessionary environment.

One group that could be at the tip of the spear in a housing market correction is the Mortgage Investment Corporations (MICs). These alternative lenders focus mainly on providing financing to mortgage applicants that are usually unqualified to access capital through traditional lenders. They then package up these mortgages and offer the income stream to investors. The investment product is attractive because the net asset value is typically fixed, based on the premise that underlying home prices rise or are stable and defaults are minimal. All mortgage payments then flow through to the end investor, less some fees along the way. The quoted NAV stays consistent because mortgages are not marked-to-market unless they default. During a recession or housing correction, that thesis will be tested because less qualified home buyers will most likely default first. These investments have grown in popularity as investors search for yield in the current low rate environment. But after such a good run, and considering we are late into this economic cycle, we would rather be sellers than buyers of MICs.

Chart 6 - Sales Tumble, New Listings Spike in Toronto



Charts are sourced to Bloomberg unless otherwise noted.