January 21, 2019

Market Ethos

The latest market insights from the Richardson GMP team

RICHARDSON GMP

If not the Big Bad Wolf, what will blow the house down?

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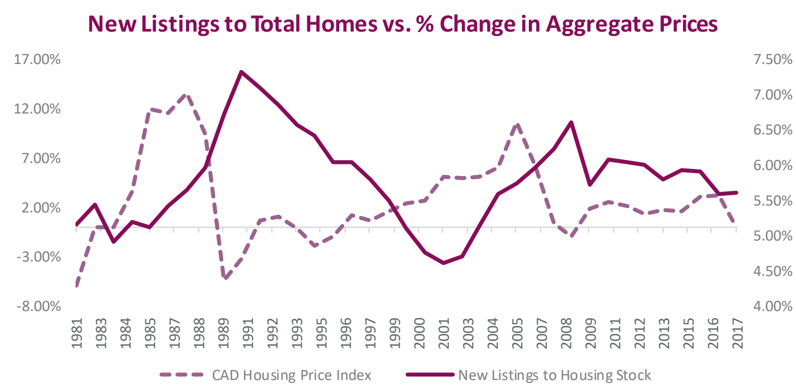
Canadian real estate: Just because it seems to always goes up, doesn't mean it can't go down.

Our decision-making processes are innately flawed. We place a disproportionate weight on information that is easily drawn upon, such as things that have just happened, or seek meaning in otherwise meaningless events. We underweight scenarios we have not experienced or have long forgotten. As a result, investors are left exposed to tail risk. **Tail risk arises when the chances of an investment moving more than three standard deviations from the average move is greater than expected.**

Since 1990, one of the most reliable risk adjusted investments has been Canadian residential real estate. Couple that with the fact that most people employ leverage during the purchase (thereby amplifying the potential return), it's easy to understand why the vast majority of Canadians' think real estate is an ironclad investment that will never go down, invariably underweighting the tail risk. Unfortunately, reality is strikingly different. Such naive sentiment exacerbates danger, because once movement tips in the other direction the result can be more destructive and swifter.



As housing prices start falling, we have seen a spike in new listing, pushing prices even lower.

Past reports

Oh Canada How Cheap it is Best 8 of '18 Is this a repeat of 1998? Whatever you do, don't look now There is Value Out There Bull vs Bear Tug-o-War

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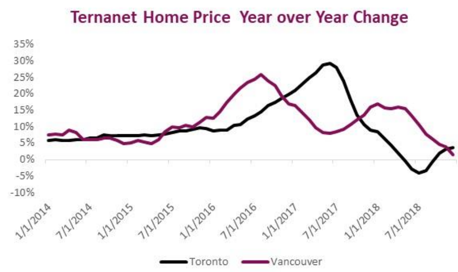
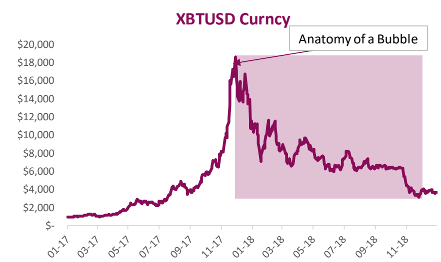
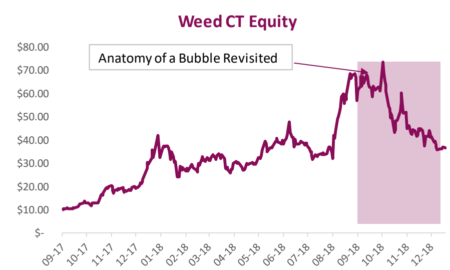
The obvious bubble-mania that was forming in the spring of 2017 has subsided. Demanded waned in Canada's hottest real estate markets; sales dipped -32% in Vancouver and -16% in Toronto in 2018. We no longer see homes selling for, in some cases, hundreds of thousand above asking in ferocious multi-buyer bidding wars. We have written two Ethos in the past year on the anatomy of a bubble. The tenants of any bubble often share similar characteristics: change in regulation, access to capital, use of leverage, mass euphoria. The Canadian housing market, particularly in the GTA (Greater Toronto Area) and GVA (Greater Vancouver Area) have exhibited all these traits in years past: regulation has changed (making it harder to access capital), leverage has been crimped, and sentiment has shifted negatively. Much like the two previous bubbles we highlighted, those being bitcoin and cannabis stocks, trends tend to deflate quickly once pricked (chart). Due to its longevity and less volatile pricing behaviours, housing is clearly a different asset class.





It is hard to see a rapid unwinding of home prices with our economy and job market exhibiting their current strength. Unemployment is at the lowest level in more than 40 years and GDP is expected to grow roughly in line with the Bank of Canada's target 2%. In last week's Ethos we used the adage that "when the U.S. sneezes, Canada catches a cold". Unfortunately, we have seen a deceleration in U.S. home prices and sales, particularly in previous high-flying cities like New York where prices fell -5.8% last year. And it's not just happening in North America. Sydney, Australia (an economy in similar composition to our own, besides this frigid weather), saw home prices fall almost 9% last year. Some local economist think it is just the start. In many major cities around the world, there has been a decoupling between wages and home prices. In cities like Paris, Hong Kong, Singapore, Toronto and Vancouver the price to income levels exceeds 10x. The unaffordability has been pushed even further in Canada by the BoC raising rates 5 times since 2017. Add to that the B20 rules that stress test most buyers against an interest rate 200bps higher than the one today … it has become harder for buyers to qualify for a mortgage. Rates and unaffordability are the key drivers to lower prices.



Components of B20

The Guideline sets five principles for sound residential mortgage underwriting:

1. All lenders must have a policy outlining risk appetite, governance and oversight mechanisms to ensure lenders follow their own policies.

2. Lenders must confirm the borrower's identity, background and demonstrated willingness to service debt obligations on a timely basis.

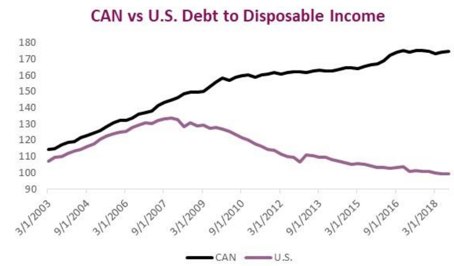
3. Lenders must assess the borrower's capacity to service their debt obligations on a timely basis.

4. Lenders must be satisfied that the value of the property being financed has been confirmed by an independent third party.

5. Lenders must stress test their portfolio of business for unlikely, but plausible scenarios to determine the impact to their business. Lenders are expected to impose a higher level of due diligence on higher risk deals, conduct ongoing risk assessments on the insurers they use and generally pay close attention to the risk attached to their residential mortgage portfolio.

Overextended borrowers and those that do not qualify for traditional lending following the B20 rules are increasingly turning to alternative lenders. The BoC estimates that private lenders account for roughly 8% of the mortgage market, originating $2-billion a quarter. Much of these loans are repackaged, securitized, and sold to investors thirsting for higher yields. Even more concerning is the fact that these increases in household debt have not been uniform. Debt loads have been concentrated in households where debt-to-gross-income exceeds 250%, according the Don Coletti – Advisor to the Governor, BoC. Despite slowing mortgage origination, consumers are showing no signs of stopping their levering up. HELOCs – loans secured by residential property – rose to $244.8-billion at the end of last month, nearly 7% growth from a year earlier.

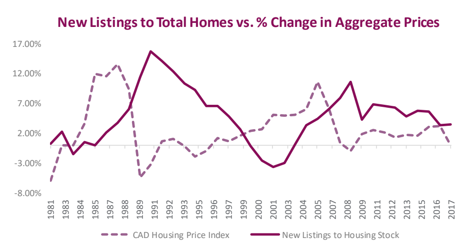
Since the 1980's, Canadian's with 5-year fixed rate mortgages most of the time renewed at lower rates as yields trended downward. Those lower rates were a tailwind for consumer spending, giving home owners a boost in disposable income when their loans renewed. Since mid-2017, the renewal rate will be higher than it was five years earlier that has the opposite impact on spending, forcing consumers to allocate more income to servicing their mortgage debt instead of spending it elsewhere. Consumer spending accounts for roughly 60% of Canada's GDP.



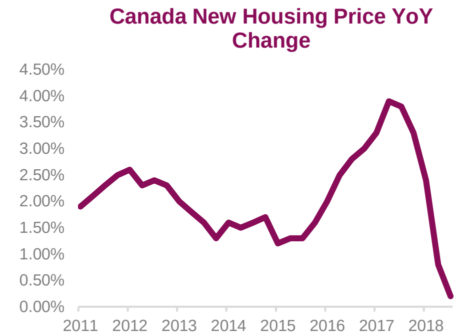
The Canadian government is taking notice. In early January, the Bank of Canada reduced their growth forecast for 2019 and signaled their intention to ease the pace of monetary tightening, as the five rate hikes they made since 2017 are already having a significant impact on the country's economy. Further, it's not just the BoC cutting forecasts. The Canadian Real Estate Association (CREA) cut their 2019 sales forecast from a prediction of 2.1% growth to a decline of 0.5% this year.

The impact of falling home prices goes beyond economic fundamentals and has an impact of human phycology. The "wealth effect" adversely impacts consumer spending as people spend less to offset the decrease in their perceived net worth. Lenders also dial back mortgage originations to minimize defaults. When sentiment changes direction, particularly after reaching an extreme, an equally eyepopping event can occur and move prices back to equilibrium. Investors followed the herd buying up pre-construction shoebox condos, because the strategy was so successful. Watching your, neighbors sell similar homes for astronomical values gives you a greater sense of wealth … it all seems to have hit a tipping point. We have yet to see the acceleration in negative sentiment but are watching closely.

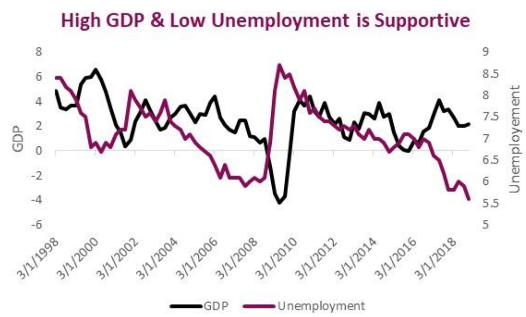
The one thing we are keeping an eye on in particular are new listings as a percentage of housing stock. As rates rise, home ownership costs also increase and reduces the carry-on rental properties. If rates continue to rise, this will weigh on the psychology of home owners and investors who could increase the rate of listed properties, perpetuating a market imbalance. During the 1989 & 1990 housing correction, new listings as a percentage of housing stock peaked at 7.3%, we saw a similar occurrence during the 2008 & 2009 slowdown. That ratio is currently around 5.6%. We had another bout of weakness back in 2000 & 2001, but prices never corrected. The reason could be because new listings did not flood the market, never reaching 5%.



We are seeing evidence that lenders are already starting to tighten their belts and are becoming more hesitant to lend to those more fringe borrowers that require larger loan-value mortgages. Insured mortgages fell -8.3% and uninsured mortgages rose +15.1% over the last year. Insured mortgages are those backed by CMHC, a requirement for those who have less than a 20% down payment. This is also evidence that the B20 rules are having their implied intention. Government intervention in the open market always risks overshooting its mark.

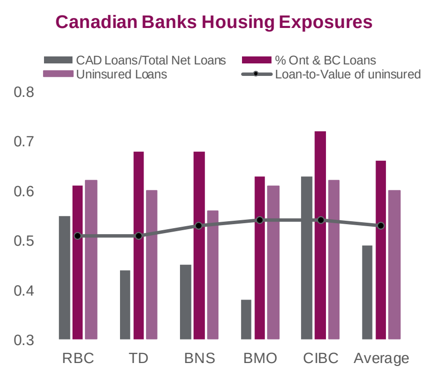


Adding to future supply woes are proposed changes that came out less than a week ago from the Ontario Government, which will make it easier to grow supply in the Golden Horseshoe. The changes included eased density targets. This anti-sprawl measure introduced by the former Liberal government that has been partially to blame for the supply shortage in the region. Additionally, reform is in place for later this year that will restrict Airbnb rentals, bringing units back to the long-term market once full-time transient rentals are banned.



Conclusion

We highlighted last week that Canadian economic growth is just moderating, not grinding to a halt. If the economy and job market remain robust, it's less likely we see a crash and instead see more of a soft landing as the market naturally drifts toward equilibrium. That does mean, however, that the bountiful returns of years past are likely behind us, and the tailwind from foreign capital chasing past performance might also abate as those investors move on to the next asset class.



Should the economy roll over, unemployment rise, and a growing number of Canadians become unable to service debt, that will likely spark a negative feedback loop, leading to a rise in new listings, intensifying the price decline in home prices. In that scenario, alternative lenders and any investment vehicle that is originating new loans to consumers will be negatively impacted. Our banking sector, although higher up the value chain, would not fare well.

At this point of the cycle, we prefer industrial real estate investments. Vacancies nationwide fell to a record low of 2.9% last year and expected to fall lower this year, despite construction continuing to increase. Outside of Canada direct infrastructure investment, backed by governments, have good long-term prospects because of the announced spending plans around the globe aimed a spurring growth.