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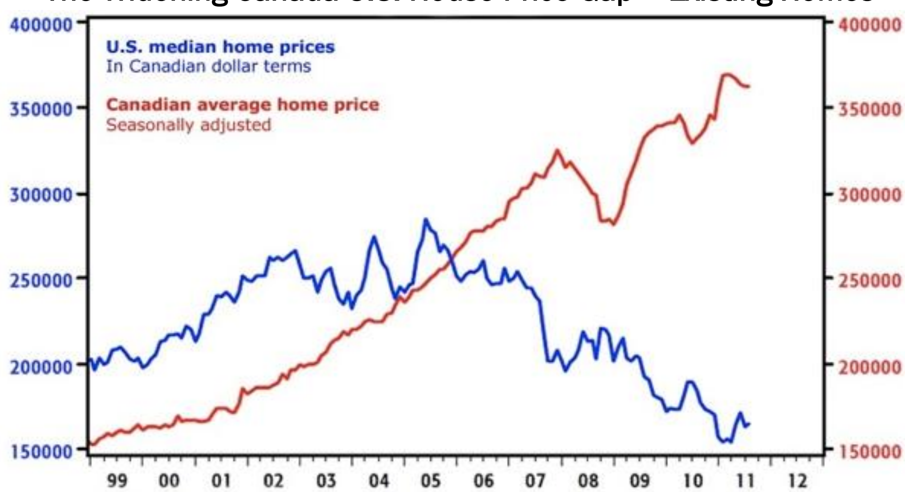
Flaherty Applies the Brakes: Bad News For Housing

The Widening Canada-U.S. House Price Gap – Existing Homes



Source: BMO Nesbitt Burns

Acknowledging that household debt is too high, and that Canada's housing sector is overheated, Finance Minister Jim Flaherty recently announced sweeping changes to mortgage insurance rules:

1. Ottawa will reduce the maximum amortization period to 25 years from 30 years.
2. The maximum amount of equity homeowners can take out on a refinancing is being reduced to 80% from 85%.
3. Mortgage insurance will only be available on homes with a purchase price of less than $1 million.
4. The maximum gross debt service ratio will be lowered to 39% from 44%.
5. The maximum loan-to-value ratio on a Home Equity Line of Credit (HELOC) will drop to 65% from 80%.
6. All borrowers must now provide "reasonable" income verification. Most lenders began eliminating "stated income" lending earlier in the year.

7. The end of "cash back" mortgages will effectively eliminate no-money-down purchases for real estate lending.

These new rules came into effect July 9, 2012.

Mr. Flaherty says the new rules are meant to "lower risk" for taxpayers and curb excessive household debt, which he believes is Canada's biggest economic risk. Statistics Canada recently reported that the ratio of Canadian household debt to income continued to increase -- with the latest reading coming in at 152%.[1] This puts Canadian household debt higher than that of the U.S., the U.K., and the entire Eurozone region.

Without a doubt, these new rules are an attempt to engineer a soft landing in housing, which has been providing the fuel for household-debt expansion. A "soft landing" is a business cycle downturn which avoids a recession. The problem is that, throughout economic history, there is really no evidence that any boom cycle has ever ended in a soft landing. In the U.S., interest rates were slowly increased in 2006 to cool the then-booming housing market. The conventional wisdom was that the U.S. Federal Reserve was on top of the situation; and thus few observers forecast the 2008/2009 recession. The U.S. tapped on the brakes, which resulted in a 36% decline in median property prices.

Despite a brief pause in 2008, Canadian real estate prices kept climbing, and the consensus saw this as evidence that real estate in Canada was not in a bubble; that our market was more resilient than U.S. real estate; and that Canadian prices would continue their upward trend.

The fact is that the U.S. real estate market went bust because of a change in the availability of credit. In 2006, U.S. credit was flowing freely. Today, despite even lower interest rates, credit is much harder to get; and since roughly 70% of real estate deals require some credit, the price of homes has fallen. Conversely, in Canada's post 08/09 recession, credit became even easier to obtain. As of July 9th, however, the brakes are on and credit in this country will tighten up significantly.

Consider the move to 25 year mortgages from 30 years. This alone would either mean higher monthly costs or a reduction of 11% in house prices that buyers could afford. Coupled with the fact that buyers need 12% more income, they would now qualify for 23% less financing.

The largest impact of Mr. Flaherty's changes might be the elimination of available mortgage insurance on homes valued at $1 million or higher. While most homes purchased over this price have down-payments greater than 20% of their value, and therefore are not required to have mortgage insurance, the reality is that the banks have been able to purchase mortgage insurance through government agencies once the mortgage was issued. After the

[1] Statistics Canada. (2012) *National balance sheets accounts, first quarter 2012.* The Canadian economic accounts quarterly review. (Catalogue No 13-022-X0

2008/2009 crisis, banks would insure most of their mortgage loans. In this manner, the banks have been acting like mortgage brokers, not needing to perform the same level of lending and credit analysis. Furthermore, consider that mortgage lending has been in a virtual price war in recent months. At one time, one could get a 5 year mortgage at 2.99% while another Canadian bank offered 3% GICs, providing the bank with little or no profit margin. With no insurance available on these high priced homes, credit will likely be curtailed or interest rates will have to rise to offset the risk of issuing mortgages without insurance. With reduced credit, Canada will likely see reduced buying within the next few months, which should lead to lower house prices.

Many economic forecasts predict a 10% to 15% property-price decline. First, let me say that a 15% national decline could be quite devastating to the Canadian economy. This decline in national house prices would not be evenly distributed. Some regions could see prices fall very steeply, while other areas may not decrease at all. In the hardest hit regions, the price decline could cause significant losses to mortgage-lenders. Canadian house prices are currently 75% above their inflation-adjusted trend line;[2] so a decline in house prices of at least 30% would seem realistic.

There are many lessons to be learned from a real estate decline, as has recently been seen in Europe and the U.S. The first lesson is to avoid bank stocks and other lenders involved in mortgage-lending -- most specifically, lending institutions which have a higher amount of sub-prime lending, such as Home Capital Group or Canadian Western Bank. Not only will loan growth decline, but decreasing house prices will lead to foreclosures, which typically lead to losses.

Secondly, construction of new homes and condos will likely take a steep decline. Construction, which is at an all-time-high, currently accounts for 21% of Canadian GDP.[3] That is on par with Ireland, Portugal and Spain at their peaks, and over 2% higher than the U.S. peak. Conversely, manufacturing activity is at an all-time-low, and now accounts for only 10% of GDP. In other words, Canada has replaced manufacturing jobs with condo building jobs.

Thirdly, rising house prices have allowed Canadians to use their homes as collateral for lines of credit. This has increased consumption, particularly with regards to cars and renovations. Homeowners have, in fact, reduced savings and increased consumption, since many have not felt the need to save because their net-worth statements have shown an increase as a result of the rising value of their homes. Investors should, nonetheless, avoid retailers such as Canadian Tire and mall-owners such as RioCan.

Canada Heading for the Perfect Storm?

In the February 2011 “LePoidevin Letter” titled “Chanos on China Bubble”, I quoted hedge

[2] CREA, Statistics Canada
[3] Statistics Canada

fund manager, Jim Chanos, who was predicting a sharp slowdown in China. The prediction appears to be coming true. HSBC is showing eight straight months of declining manufacturing activity. Although the official Chinese government figures still show 8% growth, a recent New York Times article suggested a possible falsifying of such numbers.

> "As the Chinese economy continues to sputter, prominent corporate executives in China and Western economists say there is evidence that local and provincial officials are falsifying economic statistics to disguise the true depth of the troubles. Record-setting mountains of excess coal have accumulated at the country's biggest storage areas because power plants are burning less coal in the face of tumbling electricity demand."[4]

A slowdown in China would hit Canadians particularly hard. In recent years, China has consumed over half of the world's industrial commodities, such as copper, iron ore and cement. So, coupled with a real estate slowdown, Canada could be facing a major economic contraction.

I would suggest that the best investments right now are to be found in the U.S. While Canadian home prices are extremely inflated, U.S. home prices appear to have bottomed from their lows. Recent figures from the S&P/Case-Shiller 20-city Home Price Index have shown three straight months of home price increases.[5] Furthermore, there are many companies within lower economically cyclical sectors in the U.S. whose dividend yields are between 3% and 5%. Investors should look particularly to U.S. utilities, consumer staples, or pharmaceuticals for safer investments that also provide income.

As the Canadian economy suffers from a declining housing sector and lower commodity prices, Canadians may be able to profit by holding U.S. cash. According to the OECD Purchasing Power Parity measure, the U.S. dollar is undervalued by 20.57% relative to the Canadian dollar.[6] The Canadian dollar remains overvalued in part due to strong commodities and housing. Any housing or commodity slowdown, therefore, is likely to weaken the currency. Canadians could potentially profit from a Canadian dollar decline by converting to U.S. cash at current levels.

Sincerely,

David LePoidevin, CIM
Senior Vice President
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[4] Bradsher, K. (2012, June 22). Chinese data mask depth of slowdown, executives say. *The New York Times*.
[5] S&P/Case-Shiller Home Price Index
[6] OECD Purchasing Power Parity - Bloomberg GRAB, July 9 2012.

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