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Canadian Real Estate - A Crack in the Tree

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“It’s like if the tree in the backyard has a crack in it, you worry it’s vulnerable to a storm. But if no storm happens, it goes on and on, and maybe eventually strengthens through growth. If the right storm comes along and knocks it onto your neighbour’s

house you’ve got a problem.”

This spring, our Bank Governor, Stephen Poloz, described the Canadian housing market this way. I think it’s an excellent metaphor. If the key factors that support real estate stay as they are – low interest rates and a reasonable job market – then prices will stay high. But if one of those factors become hostile, the market is defenseless.

He made a further comment, however, that I disagree with (if I understand it correctly). He said house prices are *“vulnerable but not risky. The distinction is important.”* There may be a distinction, but I think they both apply.

It was Governor Poloz’ comments that prompted me to bundle up the following observations that have been accumulating in my real estate file. Before I start, however, let me provide some context.

Bent but not broken

I’ve been cautious about real estate for a few years and decided to get more vocal in 2012 ([Real estate as an investment? Look elsewhere](#)). At that point, I saw the risk of a bad outcome increasing. The cycle had been going on seemingly forever and all the valuation measures I looked at were at extremes, as was the selling and buying behavior.

As I write about real estate again, I acknowledge that I’m moving out of the category of being ‘early’ to being ‘wrong’. If too much time passes, the two become

indistinguishable. But I still feel the same way and am willing to take the risk of commenting further on this rather passionate topic.

At Steadyhand, we’re always trying to have most of our clients’ money invested in assets that are undervalued and have a margin of safety built in. Conversely, we want as little as possible in overpriced assets. I continue to believe that in general, Canadian residential real estate is in the latter category.

Symmetry

I’ve said many times that there are two things we know for sure about economic and market cycles: (1) it’s impossible to call the beginning or end, and (2) long, spectacular upswings don’t end with a flat period, but rather an equally serious retrenchment. Clearly, my ‘earliness’ has again confirmed number one. As for the second, I can find no reason why this cycle wouldn’t have its usual symmetry.

Notice, I said ‘cycle’. Ultimately this will be a cycle like any other. Even if you don’t agree with my points below, you can’t deny that real estate is a highly cyclical asset.

One way trade

The commentary on real estate contains some diverse views (there are a growing number in my camp for instance), but it’s the behavior of investors, speculators and families that defines the consensus. And their behavior is indicating a strong one. Because the Canadian housing market weathered the 2008/09 storm reasonably well and sailed through the ‘bubble scare’ of 2012, buyers are confident that prices are going to stay high.

The basis for this confidence is based on the belief that we can’t afford higher interest rates, therefore they won’t/can’t go up. This is the strongest consensus I’ve seen in many years. Indeed, its strength was confirmed by a recent question from a client. He asked, *“Can interest rates actually increase?”*

Canadians are in a comfort zone right now, or should we call it a 'complacency' zone. Investors should always be wary when everyone is looking the same way.

Buy, hold or sell?

If I put my analyst hat on and assess residential real estate like a stock or industry sector, I'd have the following notes on my sheet.

- *House prices are running well above their long-term trend*, particularly in Toronto and Vancouver.
- *Mortgage rates are running well below their sustainable level*. The real yield (after adjusting for inflation) on Government of Canada bonds is again approaching zero.
- *Prices are highly dependent on mortgage rates*.
- *Canadian balance sheets are stretched*. A steady increase in the use of debt has helped push house prices higher, but Canadian consumers are now amongst the most levered in the world (I'm not sure who is higher).
- *Affordability is just OK*. According to the [RBC Housing Affordability study](#), it's slightly worse than normal in Ontario and Quebec, and seriously unaffordable in B.C.
- *Price-to-rent ratios are poor*. At current prices, it's tough to earn a reasonable income after all expenses.
- *Price-to-income ratios are also way above trend*.
- *Supply levels are reasonable*. Outside of condos in a few markets, the supply of new and used homes is not excessive. What is not clear, however, is how many properties are in weak hands – i.e. highly levered investors/speculators/developers.
- *Jobs?* My former colleague and economist, Patti Croft, used to tell me that housing was all about jobs. If the job market is OK, housing will be fine. I don't know what to think on this one. Our biggest customer, the U.S. economy, is growing and our job market is tight in many parts of the country, but meanwhile, Canada has had negative job growth for three months this year.
- *Homeownership rates have increased steadily*.
- *Demographics are a long-term headwind*. For certain areas and property types, there appears to be a shortage of supply right now, but over time there will

be more sellers than buyers. The buying cohort (25-34 years old) is starting to shrink as a percentage of the population and the over 65 cohort is growing rapidly.

The Wild Cards

Foreign buyers, inter-generational transfers and the Canadian dollar are wild cards in my analysis.

Canada is a desirable place to live, and invest, and will likely continue to be a magnet for foreign money in search of a safe haven. I struggle with this one, however, because I never base investment decisions on capital flows – they can dry up in a heartbeat. When someone tells me the price of something has to go up because there's so much capital chasing it, I run for the hills.

As for parents helping their kids get into the market, this trend will likely continue as long as their retirement funding is secure.

The impact of currency changes is complex and never clear cut. For instance, a weaker Canadian dollar means the cost of building and equipping houses will go up, but it eventually translates into more jobs in the export industries and better prices for our resources. On balance, a languishing loonie is a good thing for real estate.

Income Statement vs. Balance Sheet

Near-zero mortgage rates make it easier to carry a mortgage on an expensive home. As a result, the consequence of paying up doesn't seem so bad – *"We ended up paying \$100K more than we wanted, but it only amounts to an extra \$450 a month."*

But current affordability is only one consideration when a family is making its most important financial decision. When buying an expensive, illiquid asset, families also need to have a contingency plan. It has to have a cushion in case circumstances deteriorate – mortgage rates rise, job loss, son plays AAA hockey, or a 4th child.

But even more important to financial viability is the family balance sheet (assets minus liabilities = net worth). Debt only goes away if it's paid off. House price inflation makes it more bearable, but without it, the

extra 100k will require years and a big chunk of discretionary income to pay off.

And we should never forget that a highly leveraged balance sheet exaggerates all outcomes (good and bad) and makes it hard to deal with setbacks.

What I worry about

I worry about the young families who have stretched to get into the market in the last five years and are house poor. They've got most of their net worth tied up in their home and have little or no financial cushion.

I worry a little about the retirees who have a vast majority of their wealth tied up in one asset class – their home.

I worry about the impact of a real estate slowdown on the Ontario and Quebec economies (and therefore, the Canadian economy). The job situation in Canada right now is mixed (depending on where you are), even though the construction and real estate industries are very strong.

What I don't worry about

I don't particularly worry about real estate's impact on the Canadian stock market or, by association, our portfolios. Certainly, a serious contraction in the housing market will impact many companies - in our portfolios, TD Bank, Home Capital Group and Loblaw come to mind. But the Canadian stock market is only partially driven by what's going on in our economy. If the Canadian dollar declines as a result of real estate weakness, our exporters would be more competitive and the foreign stocks in our portfolios would be more valuable.

Will the virtuous circle change direction?

Certainly, I can be accused of being too negative, but I think bulls and bears alike would acknowledge we've been in an ideal environment for real estate.

- Mortgage rates have steadily declined.
- Credit has been plentiful – *“Would you like a mortgage with that savings account?”*
- Canadians have been overspending and willing to carry a heavier debt load.
- A boom in construction jobs has offset Canada's poor competitive situation in other industries.

- The Ontario and Quebec governments have delayed making tough decisions about taxes and spending (i.e. also living for today).

What does a less-than-perfect environment look like? If a couple of these price boosters dissipate, or reverse, a chain of events could turn a virtuous circle into a downward spiral.

Higher mortgage rates → softer market → less urgency to buy → sales volumes decline → more supply from people trying to catch the top → prices weaken → banks tighten up → speculators experience a cash crunch → banks tighten up → new projects halted → construction and other real estate jobs decline → no urgency to buy → prices weaken further.

As we sit here today, this scenario may seem implausible, but keep in mind, the cycle has been working in the same fashion for years on the way up.

What was I thinking?

There's an exercise I put myself through every once in a while. I ask myself: In 3 to 5 years, what obvious thing will I be kicking myself for missing?

What might we be kicking ourselves for in a few years?

“Of course interest rates had to go up. Money couldn't be free forever. Duh!”

“How did we ever expect to get a bargain in a bidding war?”

“How could we justify buying an income property that generated no income? We were speculating on prices, not buying an income stream.”

“Why did we think our kids had to own real estate right out of University? We rented a crappy apartment for the first five years of our work life.”

Phew ... A final word

I've been focusing on the negatives intentionally. My former colleague at PH&N, Peter Guernsey, used to say when we were looking at a depressed stock, you need to focus on finding the positives because the warts are easy to see. The Canadian residential real estate market is the opposite. We've been living the positives for a long time, so the warts aren't so obvious.

All the measures I look at are at extremes. On the positive side of the ledger are factors that tend to be transient, subject to change without warning, or just plain flaky (low carrying cost, foreign buying, bidding wars), while the negatives are more lasting (prices, cap rates, debt levels, demographics).

None of the numbers or trends support what economists and real estate executives are suggesting, namely that the market will experience a 'soft landing', with prices flattening out or dropping a little. I can't find a business cycle that has gone on for this long and been this good that has ended with a 'soft landing'.