Is Canada's Housing Bubble 'Different'? by: Pater Tenebrarum of www.acting-man.com

According to this article, CIBC thinks the huge amount of household debt in Canada and the beginning cracks in the housing bubble are nothing to worry about. The main reason for this benign assessment seems to be that there have been a few other credit and real estate bubbles in the world that have grown even bigger than the US one before it burst. What a relief.

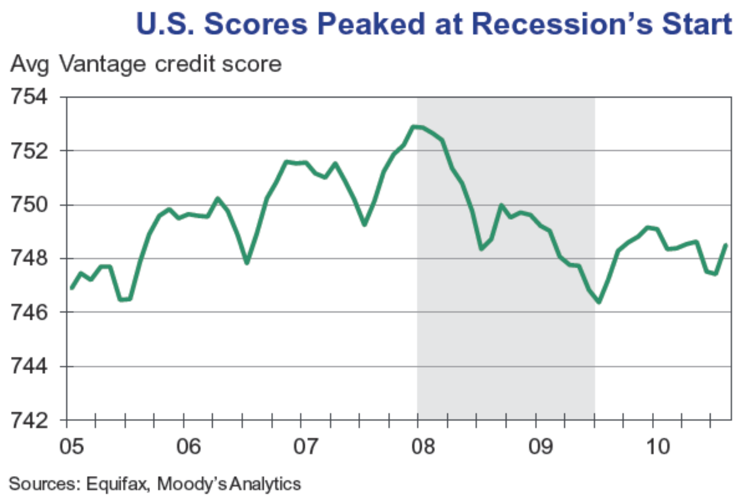
> „The news out of Canada's real estate market isn't good, but the country will avoid a U.S.-style real estate meltdown, CIBC said Tuesday. Economist Benjamin Tal said in a report that even recently released data about high levels of Canadian consumer debt isn't proof that there will be a sudden, big drop in home prices. ***"To be sure, house prices in Canada will probably fall in the coming year or two, but any comparison to the American market of 2006 reflects deep misunderstanding of the credit landscapes of the pre-crash environment in the U.S. and today's Canadian market," he wrote. Tal noted that Canada's debt-to-income ratio has just broken the U.S. record set in 2006, but said other countries have had even higher levels without a crash.***
>
> […]Tal said home prices in large cities like Vancouver and Toronto are overshooting their fundamentals and will likely slip as sales fall. ***"But the Canada of today is very different than a pre-recession U.S., namely as far as borrower profiles are concerned," he wrote. "Therefore, when it comes to jitters regarding a U.S.-type meltdown here at home, the only thing we have to fear is fear itself."***

(emphasis added)

To sum this up: there have been bigger bubbles, so ours can grow bigger too. Moreover, it is different this time.

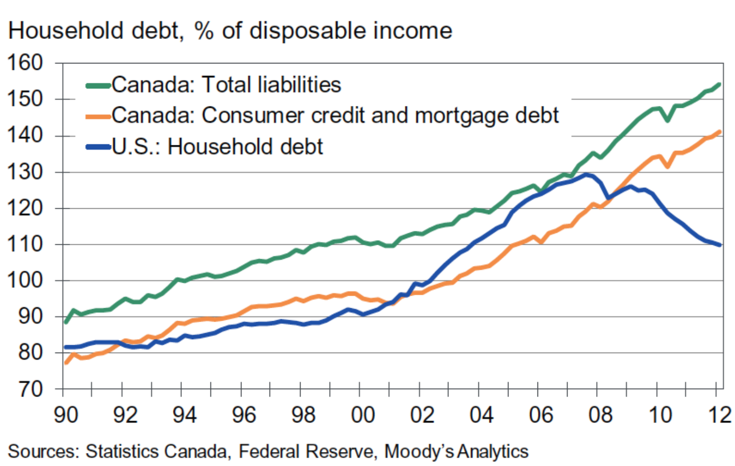
It is actually fairly typical to find this type of thinking near the top of a bubble. The people living inside it cannot believe that it could possibly crash. Of course Canada's economic situation is in many respects 'different' from the US economic situation, but that is the case with every slice of economic history. Not one of them can possibly be exactly the same. Nevertheless, one can come to some general conclusions about credit expansion-induced bubbles. Economic laws will be operative whether or not the precise historical circumstances are similar. When Japan reached the height of its bubble in the late 1980's, it was also widely argued that the overvaluation of stocks and real estate was no reason to worry because Japan was allegedly 'different'.

Regarding borrower profiles, Mr. Tal is mistaken if he thinks that the *current* profiles of borrowers are actually relevant. These profiles *always* look good at the height of a boom. They deteriorate only after the boom ends. To wit, here is a chart of the history of US household credit scores:



During the US housing bubble, even while capital was malinvested and consumed and the *actual* creditworthiness of borrowers constantly declined, 'credit scores' got better and better. The error was only revealed after the boom began to fall apart – click for better resolution.

Canadian household debt as a percentage of income by now vastly exceeds the peak that was seen at the height of the US real estate bubble. So in this sense, Canada is also 'different' – only not in a particularly good way. Note that the chart below actually *understates* the true level of the Canadian debt-to-income ratio by a full 11 percentage points. It does not yet reflect the most recent revision to the numbers (i.e., the ratio is really at 163%).



Two credit bubbles compared side by side: US and Canadian household debt as a percentage of disposable income. The green line should actually be at 163% – click for better resolution.

The 'Soft Landing' Mantra

Canada's housing market has begun to cool markedly. As is usually the case, the first sign of trouble is a sharp drop-off in transaction volumes. Existing home sales in Canada were down by 15.1% in September year-on-year. This seems to be the result measures recently introduced by the government that are aimed at slowing down or reversing house price increases. Prices will no doubt eventually follow transaction volumes.

The WSJ reports on the cooling of the previously red-hot Vancouver market. What is so funny about this report is that government officials are patting themselves on the back for having produced this cooling without realizing that the measures are coming way too late. Yes, they may well lead to a bursting of the bubble, but the hopes for a 'soft landing' are very likely misguided.

> "Canada's finance ministry tightened home-lending requirements, the latest in a series of moves the government has taken to tighten credit amid the real-estate boom. Recently, a number of economists and policy makers, including the country's central-bank chief, have warned about possible overheating in several Canadian markets, notably in the Vancouver and Toronto condo markets. ***This summer, Ottawa cut the maximum mortgage amortization period from 30 years to 25 and reduced the amount of home equity Canadians can borrow against, from 85% to 80%. This month, Finance Minister Jim Flaherty said that the new mortgage-financing rules are beginning to have "some effect," as activity in the housing market has cooled in both Vancouver and Toronto. "We think that's a good thing," Mr. Flaherty told reporters. "I would much rather have a soft landing than a hard landing."***

(emphasis added)

This is a good example for what is known as a '*non sequitur*'. The credit tightening measures are beginning to bite, but it does not at all follow from this that a 'soft landing' will result.

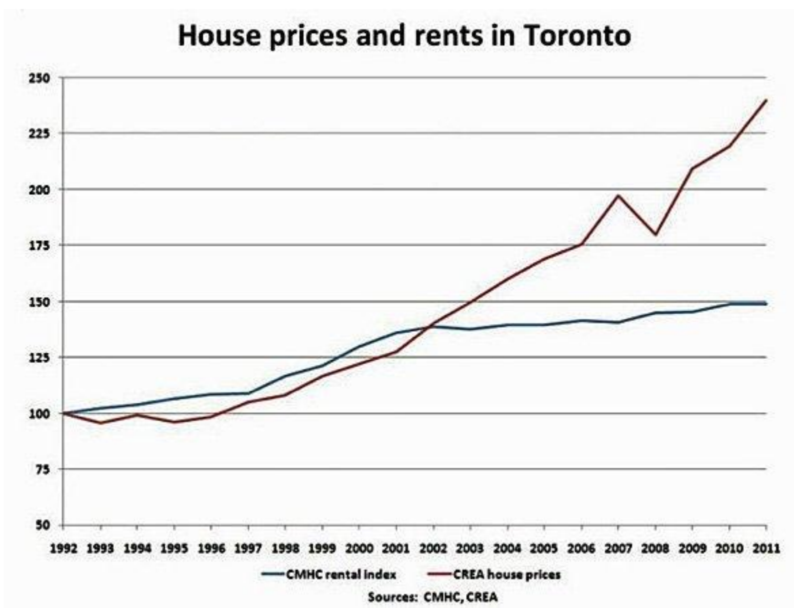
The 'soft landing' mantra is invoked at every opportunity, as if repeating it often enough will make it true. Consider the conclusion of this article on Canada's growing household and mortgage debt burden in the Vancouver Sun:

> "***Ottawa has moved four times in as many years to tighten mortgage rules to keep marginal buyers out of the market, most recently in August. The latest change, which added to monthly payments on insured, first-time purchases, has been partially credited with a recent slowing in home resales***, particularly in previously hot markets of Vancouver and Toronto, and with a moderation in prices. New data released Monday by the Canadian Real Estate Association showed sales of existing homes fell 15.1 per cent in September from a year ago, although last month's numbers were slightly higher than in August. ***Bank of Montreal economist Doug Porter said he believes the trend points to a soft landing for housing, not a crash***."

(emphasis added)

One is tempted to ask: what exactly is it about the 'trend' that 'points to a soft landing'? It sounds more like wishful thinking than a conclusion justified by the evidence.

House prices compared to rents in Vancouver. To say that prices are out of whack with rental returns would be sugar-coating it. This is, in a word, insane. Sales in Vancouver have meanwhile plunged by 32.5% from year ago levels – click for better resolution.



The divergence between prices and rents is far less extreme in Toronto, but it is still obvious that prices are now way above trend – click for better resolution.

Are the Banks Safe?

It is generally held that Canada's banking system is in ruddy health and not in danger from the extended credit and real estate bubble, mainly because a government-owned organization, Canadian Mortgage Housing Corp. (CMHC) insures most of the mortgages with down payments of 20% or less. The company also helps fund mortgages by issuing debt and buying mortgage backed securities with the proceeds.

This kind of thinking has things exactly the wrong way around. It is precisely *because* such a state-owned guarantor of mortgages exists that the vaunted lending standards of Canada's banks have increasingly gone out of the window as the bubble has grown. Today some $500 billion, or 50% of Canada's outstanding mortgages are considered 'high risk' according to the Financial Post. Moreover, HELOCs ('home equity lines of credit', i.e., the use of homes as ATMs) have grown like wildfire, at loan-to-value rates of up to 80%.

Through CMHC and government guarantees for privately held mortgage insurers Genworth Capital and Canada Guarantee, Canadian tax payers are on the hook for more than C$1 trillion in mortgages. In other words, there is no *practical* difference to the role played by the once nominally private GSE's and credit insurers in the US and the Canadian version of them: in both instances these institutions have enabled vast growth in ever more risky lending, while ultimately tax payers are picking up the tab when things go wrong – as they invariably must. In this sense the banking system is 'safe' – the government has already committed tax payer resources beforehand to bail out the mortgage credit market in the event of trouble. However, mortgage debt is only a part of the household debtberg. It stands to reason that the end of the boom will create a lot of economic pain and the banks won't be able to evade it. Moody's has recently put the biggest Canadian banks on 'downgrade watch' for precisely this reason. Of course Canada's economic situation depends greatly on commodity prices, especially the price of crude oil. Similar to Australia, Canada is thus to some extent a 'warrant' on China.

Lastly, the official house price data – as scary as they look, especially in Vancouver's case – don't really capture the sheer insanity of the bubble. To get a sense of what the bubble has wrought, one should take a look at the following web pages. They compare actual 'crack shacks' with Vancouver homes that have been sold at incredibly high prices, but can otherwise hardly be differentiated from the former.

Crack Shack or Mansion?

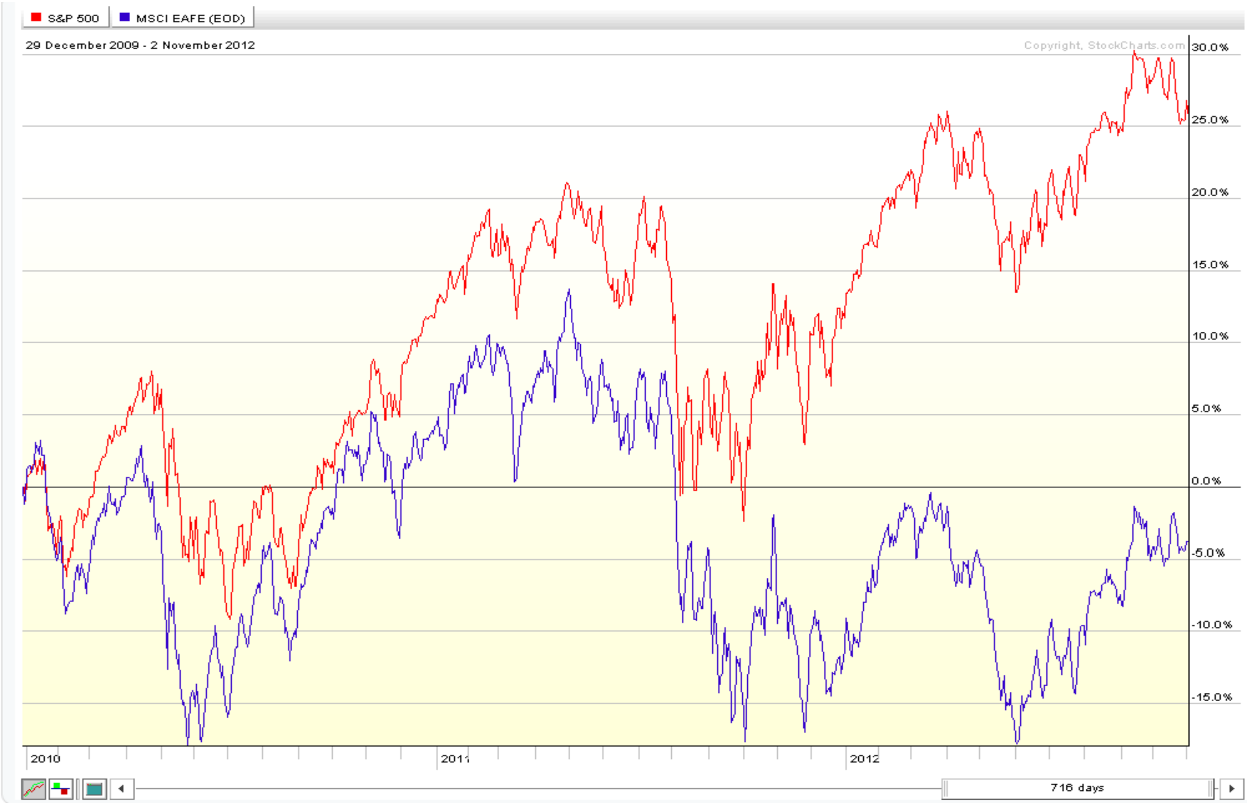
Crack Shack or Mansion, Part two

Charts by: Financial Post, McLeans

Markets
In the past month I have become aware of two major companies that are offering former employees the chance to take an early pension or a special lump-sum distribution. I can only conclude that companies have finally realized how incredibly risky it was for them to guarantee investment returns to their employees. Pension managers and the companies they works for are terrified of the future obligations that are coming due.

Bonds have been in a 30 year bull market, but as I write, a ten year U.S. Government bond is only yielding 1.68%. How much lower can rates go? How will a pension fulfill its mandate to get 8% per annum if the allocation to bonds is yielding less than 2%? How much risk will they have to take to try and find the other 6%?

With bond returns limited, pensions will have to venture further into stock for some of that 6%; and stocks haven't been easy to own. IF you were able to withstand a 17% drop in the S&P 500 (red) in 2010 and a 20% drop in 2011, the stock market has been good to you for the last three years. If you had this crazy notion that you shouldn't put all your eggs in one basket and should diversify your stock portfolio into foreign stocks (blue) it hasn't been so good.



The S&P 500 (red) is up about 25% over the last three years compared to a 5% loss in the foreign stock market index (blue).

We are now in seasonally strong time of the year for stocks, but I am quite concerned that the "risk on" trade has not worked since the announcement of QE3 (money printing 3.0).

Domestique Capital LLC
4601 Old Shepard Place
Ste. 117
Plano, TX 75093
214.556.8904 phone
www.domestiquecap.com