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Bay Street blues

Responding to the early-1990s break in Canadian residential real-estate prices, the Bank of Canada slashed its overnight lending rate to 4% from 14%. It's a cinch that nothing like that 1,000 basis-point pick-me-up will be available during the next slump in the Canadian housing market; today's BoC policy money rate sits at 1¼%.

The thought that some such intervention will eventually be in the cards led colleague and (yes) son Phil Grant to make a flying tour of the Toronto market, to talk with bulls and bears alike and to imagine what lies in store, both for Canada and its concerned neighbor to the south.

Phil Grant writes:

Cash 4 You greets a new arrival on Toronto's highway 409. The billboard draws the attention of speeding motorists to an invitation to borrow "up to C$1,500 instantly." A few kilometers beyond, a well-timed turn-of-the-head reveals no fewer than eight construction cranes. Canadians, to borrow a phrase coined by *Newsweek* circa 2005, are going gaga for real estate. Let us only say that we are not the first visiting Yanks to shake our heads over flyaway house prices and bulging debt. We are, nonetheless, bearish on the North American real-estate market that comes closest to resembling bitcoin (before the break).

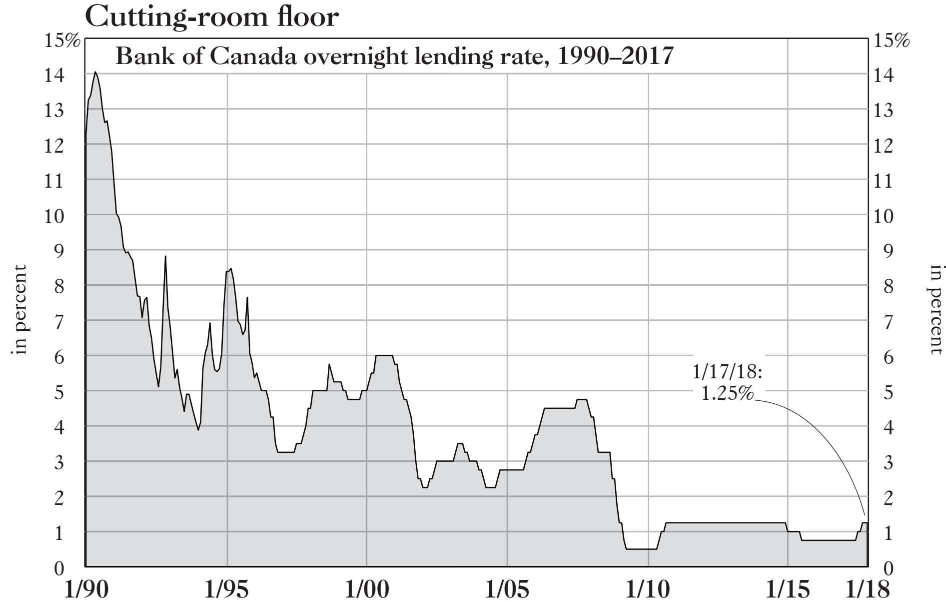
Canadians are gaga for debt, too. Household debt (defined by the Organization for Economic Co-operation and Development as "all liabilities that require payment or payments of interest or principal by household to the creditor at a date or dates in the future") as a percentage of disposable income stood at 173% as of the third quarter, according to Statistics Canada. In the United States, that compares with 105% as of Sept. 30, 2017 and a peak of 133% on Dec. 31, 2007. Nor is heavy encumbrance anything new: That metric has been above 150% since the end of 2009.

You wonder what reaction a proper housing bear market might elicit from the Canadian authorities: negative rates, or quantitative easing? Or both? Speculation to follow, along with a skeptical look at the Canadian Imperial Bank of Commerce, one of the bubble's principal financiers.

As for the United States, a housing-driven economic accident at its northern border could put a dent in the recent upswing in American output (real GDP has grown by an annualized 2.6%, 3.2% and 3.1% in the past three quarters). Canada is America's second-largest trading partner after China, with $545 billion in goods crossing the wall-free border in 2016. In contrast to the heavily net-exporting Middle Kingdom, the split is fairly balanced, with $267 billion of U.S. exports almost matching the $278 billion of goods moving south from Canada. That $267 billion in exports topped the combined total for China ($116 billion), Japan ($63 billion) and Germany ($49 billion) in 2016, according to data from the U.S. Census Bureau.

Prospective Canadian housing bears must take heed that the boom

Cutting-room floor



source: The Federal Reserve Bank of St. Louis has been in full swing since the smoke cleared from the Great Financial Crisis. By October 2009, economists at HSBC Securities ventured, "Beyond 2009 and getting into 2010, if we are continuing to throw off these heightened levels of activity, then [we] will become quite concerned that we are on the cusp of an asset bubble here." By the end of 2010, *Bloomberg Businessweek*, CNN Money and Business Insider had all published articles speculating on a collapse, while in early 2013 analysts at the Bank of Nova Scotia and Toronto-Dominion Bank N.A. called for a "slowdown" and a "gradual, modest downward adjustment." Instead, seasonally adjusted monthly home sales topped 45,000 at the end of last year, up from 35,000 in 2012, according to the Canadian Real Estate Association. The Multiple Listing Service (MLS) Home Price Index Aggregate Composite Benchmark calcultes that the typical Canadian home price rose to C$600,000 at the close of 2017 from just over C$400,000 in January 2013.

Why, after eight years of rising prices, bustling transaction volume and sturdy economic growth, should year nine be any different? We reckon that a dual tightening of the regulatory and monetary screws on a leveraged and overextended consumer might finally do the deed.

A recent drive through the Dovercourt-Wallace Emerson-Junction in West Toronto lends credence to concerns about affordability. Middle-class neighborhoods all, they feature an abundance of cozy two-bedroom homes that have recently sold for well over C$1 million. By comparison, the median family income in Toronto currently stands at C$78,280, according to a 2015 census conducted by Statistics Canada. The Canadian Real Estate Association determines an average sales price in the greater Toronto area of C$743,000 as of December 2017, up by 7% year over year (the same figure rose above C$800,000 midyear before moderating). Vancouver, which sports a median household income of C$79,930, or did at year-end 2015, saw an average sales price of C$1.05 million in December. That's up 15.9% year over year.

In Toronto, bidding wars are common, frequently stoked by a strategically modest initial offer. One semi-detached home at 1337 Lansdowne Avenue in Dovercourt, listed by the seller for C$695,000, sold for C$1.026 million after six days on the market. Another small, but admittedly cool-looking, two-bedroom at 1587 Dupont Street, in the Junction Triangle neighborhood, recently changed hands for C$2.4 million. In 2009, pre-renovation, it had sold for C$425,000. As of the third quarter of 2017, the average house price across Canada exceeded per capita GDP by eight times. In the United States, by comparison, the average single-family home peaked at just over six times per capita GDP in 2005.

Much like the houses and apartments themselves, vacancies are at a premium. The Canada Mortgage and Housing Corporation (CMHC), the Canadian Fannie and Freddie, pegs the condo vacancy rate at just 1.3% in Toronto as of year-end 2016. Ross Healy, chairman of the Toronto-based money manager Strategic Analysis Corp. and a bull on Canadian real estate, identifies a primary cause for optimism: "Immigration is a powerful secular force," he says. "It is ongoing, and it will continue to provide a bid in housing." Indeed, Statistics Canada finds that since the early 1990s, the number of immigrants to the Great White North has averaged approximately 235,000 per year, or almost 1% of the current population of 35.6 million. Remarkable, too, has been the consistency: At least 200,000 have arrived every year since 2001. The less-than-welcoming immigration stance taken by the Trump administration figures to do nothing to upset this secular trend.

Then, too, the argument goes, the cartelized Canadian banks don't fail. They never have, and they never will. Reforms following a severe recession in the early '80s "ensured a much more conservative approach to credit management than was the case with the U.S. banks prior to 2008," according to Healy.

The World Economic Forum, in its 2017–18 Global Competiveness Survey, listed the Canadian banks as the safest in the world, in a tie with Finland's. In 2013, Canada's Office of the Superintendent of Financial Institutions (OSFI) bestowed the "too big to fail" designation on the Bank of Montreal, Bank of Nova Scotia, Canadian Imperial Bank of Commerce, National Bank of Canada, Royal Bank of Canada and Toronto-Dominion Bank, requiring the group to increase their reserves of tier-one capital (meaning equity and reserves) to 8% of risk-weighted assets, from 7%. Over the past five years, shares in the Big Six have racked up gains in the range of 34% (the Bank of Nova Scotia) and 79% (Toronto-Dominion), far outpacing the 21% gain in the TSX Composite Index over that time.

Not everyone is convinced that the favored half-dozen are financially impregnable. In May, Moody's issued a one-notch credit-rating downgrade to each, citing an "expectation of a more challenging operating environment for banks in Canada for the remainder of 2017 and beyond, that could lead to a deterioration in the banks' asset quality, and increase their sensitivity to external shocks."

Faced with an evident supply crunch amid low vacancies, brisk immigration and stretched affordability, developers have become creative. On our brief driving tour, we spotted eight churches that had been turned into housing units (one, a Czechoslovakian Baptist church, still had its denominational nameplate hanging) as well as a former foundry converted into lofts (starting at C$750,000 per unit) and other industrial buildings going through their own metamorphoses.

Asked about the strength in the rental market, Ben Rabidoux, proprietor of the Canada-based research firm North Cove Advisors, cited compositional factors within the data while casting doubt on their sustainability:

> As new condos are completed, they are often listed for rent on the MLS. So it is brand-new, higher-end inventory . . . competing against basically a stock of aged dwellings. So you end up with what appears to be this extremely strong average rent growth. It is a bit overstated. If you're looking for single-family—an entire detached house in the 905 [area code] which is like a suburb—you're looking at a 2% cap rate. It is obscene. You're renting million-dollar homes for less than $2,000 a month. It's insane.

Luckily for buyers and renters alike, help is on the way: According to the Toronto Real Estate Board, new listings in the greater Toronto area ticked up to 6,330 in December 2017, a 51.9% year-over-year increase, and active listings climbed to 12,926, up by 172.4% from the end of 2016. Likewise, total dwellings under construction approached 250,000 as last year ended, up from just over 150,000 in 2011.

You would be correct to guess that real estate is big business up north. There are 48,000 brokers in Toronto, according to Reuters, a 77% jump from 2008. By comparison, Chicago, which has a nearly equal population of 2.7 million, employs fewer than 14,000. Rabidoux calculates that 14% of the Canadian labor force is employed in building, real-estate sales and finance, well above the 11.8% in the U.S. who were similarly occupied at the January 2006 high-water mark (high-water in price if not in prudence and common sense). Residential investment as a share of GDP approached 8% in the third quarter, compared with less than 4% in the U.S. today and about 6.5% at the peak of the American-housing lunacy in 2006.

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Enter, now, the Canadian government. On Jan. 1, the OSFI introduced new regulations known as Guideline B-20, a series of underwriting protocols designed to "reinforce a strong and prudent regulatory regime for residential-mortgage underwriting in Canada," according to Superintendent Jeremy Rudin. Compulsory now for all mortgages is a stress test at "the greater of the five-year benchmark rate published by the Bank of Canada or the contractual mortgage rate plus-2%," according to the OSFI. In addition, "co-lending" arrangements, or bundling of mortgages (a practice which may allow for lenders to skirt loan-to-value restrictions), are now verboten.

A recent report from the industry association Mortgage Professionals Canada estimates that 18% of home buyers would fail the stress test under the new rules. MPC chief economist Will Dunning comments that "50% to 60% of those not qualifying will be able to adjust their expectations and buy a cheaper home but . . . it will leave 40,000 to 50,000 potential buyers a year shut out of the market (equating to a 6–7.5% drop in sales)."

Robust business activity and low unemployment are pushing Canadian money rates higher. On Jan. 17, the Bank of Canada raised its overnight lending rate by 25 basis points to 1.25%, highest since January 2015; markets are pricing two more quarter-point hikes by October. Economists from National Bank of Canada (not to be confused with the BoC) contend that relatively small changes in rates will have an outsize impact on disposable income:

> Historically, [an increase of 100 basis points on five-year mortgage rates] may have had a limited impact on the housing market but this time could be different. Twenty years ago, a 100 basis-point increase in mortgage rates would have caused a deterioration of our national affordability measure by 3.5 percentage points. Today, a similar increase has an impact 60% larger given much higher home prices. The Toronto and Vancouver housing markets are particularly more sensitive to rising interest rates.

The one-two punch of tighter regulations and higher borrowing costs may have their greatest effect on home-equity extraction. In a survey of homeowners, the MPC found that 9% of respondents took equity out of their home in the past year, at an average amount of C$54,500. That equates to C$47 billion in aggregate extraction, or more than 2% of full-year Canadian GDP. HELOC (home equity lines of credit) loans are particularly widespread: Rabidoux calculates that HELOC debt outstanding has hovered near 14% of GDP since 2012. By comparison, that metric topped out at less than 5% in the United States during our housing boom and bust and currently registers at about 2% of GDP.

Asked about potential implications of an abrupt conclusion to the long-running Canadian housing miracle, Rabidoux turned back the clock to the prior housing bear market for guidance:

> It will hammer consumption. It will be a massive headwind for GDP. The Bank of Canada is going to have to pull back hard because it has been such a massive part of the economy both in terms of supporting consumption directly and indirectly. But also, if you start looking into the real-estate industries in terms of their share of GDP output—record highs. If you look at their share of total employment—way above where the U.S. peaked and at record highs. Way above previous cycles including the '89 cycle, which is highlighted as the worst of the worst.
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> There is no question that it would be a tremendous headwind if not an outright massive recession if you saw a real downturn. The problem is that the last time we had an issue with housing in Canada was '89. At that time the Bank of Canada, between '89 and '93 . . . cut the overnight rate [by] 1,000 basis points. House prices in Toronto still fell 25%, and you had this powerhouse manufacturing base back then that responded tremendously to the huge depreciation in the currency.
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> You don't have that today. Instead what you have is an economy that is tremendously levered to housing for both output and employment growth. So to me, there is no easy way out for the BoC. If there is a real problem, it is going to be highly unconventional monetary policy—a floor.

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The leveraged-to-the-gills Canadian homeowner may be in for an unpleasant surprise when the time comes to renew mortgage terms (mortgage rates are structured as a five-year bullet, with the borrower compelled to refinance once the period is over). Ever since the mid-1990s recovery from the prior housing bust, Canadian homeowners have seen generally a positive effect in their mortgage payments at first renewal, with an average savings of C$91 a month for each C$100,000 borrowed, according to Rabidoux. Now, for the first time since the early '90s, the change in monthly payments at first renewal has turned higher. Meanwhile, consulting firm MNP, LLP relays this bit of sentiment from a recent consumer survey:

> Nationally, more than a quarter of Canadian homeowners—27 percent—agreed with the statement that they are "in over their head" with their current mortgage payments, the survey suggests. . . . 77 (per cent) would have difficulty absorbing an additional $130 per month in interest payments on debt.

On the whole, the mortgage industry is trending away from the government-insured variety and towards uninsured. Total CMHC insurance in force stood at C$484 billion as of Sept. 30, 2017, down about 5% from the C$512 billion at year-end 2016. At the same time, total uninsured residential mortgages outstanding jumped to just over C$576 billion as of Sept. 30, 14% above their year-end 2016 level according to the Bank of Canada.

The X factor in this Canadian-housing miracle is mortgage fraud. In 2015, subprime lender Home Capital Group disclosed that a number of its brokers submitted falsified loan documents (thus validating the long-held contention of Home Capital short-seller and friend of *Grant's*, Marc Cohodes; see the issue dated Oct. 14, 2016), agreeing this year to pay a C$30 million fine to the regulating OSC. On Dec. 5, 2017, Montreal-based Laurentian Bank of Canada (LB on the Toronto Stock Exchange) said it discovered "documentation issues and client misrepresentations" in a pool of its own mortgages.

On Jan. 8, Laurentian disclosed that the amount of tainted mortgages it found had risen to C$392 million, from $304 million in the initial announcement (its equity book value stood at C$1.99 billion as of its fiscal year-end on Oct. 31). The bank also noted that some of the loans were "inadvertently insured" and will be repurchased by Laurentian by the end of the fiscal second quarter.

The loans in question had already been packaged and sold to investors. The Toronto *Globe and Mail* observed on Dec. 5: "In late September, an unidentified third party doing a routine audit of securitized loans purchased from Laurentian uncovered issues with some mortgages."

In fiscal-year 2017 ended Oct. 31, the Canadian Imperial Bank of Commerce (a.k.a. CIBC, whose ticker is CM on the New York Stock Exchange) reported 35% growth in uninsured mortgage-loan volume, to C$115.7 billion from C$85.9 billion, against a book value of C$29.2 billion and total assets of C$565 billion. That growth laps the competition: CIBC's Big Six peers saw uninsured mortgage growth between 10% and 20%, while the aforementioned Laurentian came in at 25%. Queried on its strategy by *Grant's*, CIBC declined to come to the phone.

Rabidoux comments: "The pace of CIBC's uninsured loan growth (double their peers) raises questions about its risk management, or worse, given anecdotes we're hearing from industry contacts regarding their underwriting." CIBC trades at about 1.8 times book value and managed a net interest margin of 1.66% in 2017, up from 1.64% in 2016. Rated A1/single-A-plus at Moody's and S&P, CIBC is leveraged at 22 times, with total assets of C$565 billion supported with C$24.7 billion in tier-one equity capital. Nonperforming assets footed to 0.6% of the total (so, C$3.3 billion), against which the bank held a loan-loss reserve of C$829 million, down from C$1.05 billion in 2016. Sell-side ratings include nine buys, six holds and three sells according to Bloomberg.

With a market cap of $54 billion, CIBC earned an 18% return on equity in 2017, down from 20% and 19% in 2016 and 2015, respectively. Short interest is about 1%, and shares are available to borrow at "top rate" (most favorable for investors).

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