

How Can Governments Cool the Property Market: A Lesson from North America

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To answer the question of cooling property markets, one must understand the factors causing a property market downturn, what governments can do or have done, and evidence from another country where some of these factors have caused the downturn.

Acknowledging that household debt is too high and that Canada's housing sector is overheated, Canadian Finance Minister Jim Flaherty announced the following sweeping changes to mortgage insurance rules, effective July 9, 2012.

- The maximum amortization period is reduced from 30 years to 25 years.
- The maximum amount of equity homeowners can take out on a refinancing is reduced to 80% from 85%.
- Mortgage insurance is only available on homes with a purchase price of less than CAD\$1 million.
- The maximum gross debt service ratio is lowered to 39% from 44%.
- The maximum loan-to-value ratio on a Home Equity Line of Credit (HELOC) is dropped to 65% from 80%.
- All borrowers must now provide reasonable income verification. Most lenders began eliminating "stated income" lending earlier in the year.
- The end of "cash back" mortgages effectively eliminates no-money-down purchases for real estate lending.

The Minister said that the new rules were meant to lower risk for taxpayers and curb excessive household debt, which he believed was Canada's biggest economic risk. Statistics Canada reported that the ratio of Canadian household debt to income continued to increase, with the

latest reading coming in at 163.99%, according to its 2013 National balance sheet accounts, first quarter 2013, The Canadian economic accounts quarterly review (378-0123 CANSIM TABLE). This puts Canadian household debt higher than that of the US, the UK and the entire Euro-zone region.

These new rules were an attempt to engineer a soft landing in housing, which provided 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 US, interest rates were slowly increased in 2006 to cool the then-booming housing market. The conventional wisdom was that the US Federal Reserve was on top of the situation and thus few observers forecasted the 2008/2009 recession. The US 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 the market was more resilient than US real estate and that Canadian prices would continue their upward trend.

The fact is that the US real estate market went bust because of a change in the availability of credit. In 2006, US 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 9/12 however, the brakes were on and credit in this country has tightened 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 these changes might be the elimination of available mortgage insurance on homes valued at CAD\$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 2008/09 crisis, banks would insure most of their mortgage loans. In this manner, 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% guaranteed investment certificates, 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, which should lead to lower house prices.

Many economic forecasts predict a 10% to 15% property-price decline. A 15% national decline could be quite devastating to a country's economy as it could cause significant losses to mortgage-lenders. According to Statistics Canada, Canadian house prices are currently 75% above their inflation-adjusted trend line, hence a decline in house prices of 30% would seem realistic.

As far as investors are concerned, there are three lessons to be learned from a real estate decline as has been seen from recently in Europe and the US. The first is to avoid investing in bank stocks and other lenders involved in mortgage-lending, most specifically, lending institutions which have a higher amount of sub-prime

lending. Not only will loan growth decline, but decreasing house prices will lead to foreclosures, which typically lead to losses. The second lesson is that construction of new homes and condominiums will likely take a steep decline. According to Statistics Canada, construction which is at an all-time high, currently accounts for 21% of Canadian GDP. That is on par with Ireland, Portugal and Spain at their peaks and over 2% higher than the US peak. Conversely, manufacturing is at an all-time low with only 10% of GDP. In other words, Canada has replaced manufacturing jobs with condo building jobs. The third lesson is 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. Home-owners 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 (fair value accounting). Investors should then avoid major retailers and mall operators.

Outside of North America, HSBC is showing eight straight months of declining manufacturing activities. Although the official Chinese government figures still show 8% growth, a New York Times article (Bradsher, K., 2012 June 22; Chinese data mask depth of slowdown, executives say, The New York Times) suggested a possible falsifying of such numbers. A slowdown in China would hit not only Canadians hard, but also globally, as China has consumed over half of the world's industrial commodities, such as copper, iron ore and cement. Coupled with a real estate slowdown, Canada could be facing a major economic contraction.

Investors globally should assess whether in their country or locality, the real estate values have reached the bubble stage and whether governments in such country or locality are likely to initiate those measures as in Canada. If so, some of the factors causing real estate downturns as experienced in the US, may be repeated.