Canadian Housing Market

RSP Reminder

The deadline for 2013 RSP contributions is Monday, March 3rd, 2014. The limit is $23,820 for the 2013 tax year and for 2014 it rises to $24,270.

Your personal limit is on your Notice of Assessment from your 2012 Tax Return. If you're having trouble understanding the calculations, please give us a call.

If you currently do your banking online, you can send your Assante contributions via internet banking. (Please call Barb McKenzie to find out how!)

2014 TFSA Limit

CRA announced that the TFSA limit for 2014 will remain unchanged at $5,500.

If you don't have a TFSA and would like to open one or if you would like to transfer an existing TFSA held elsewhere, please contact Barb.

I have made the point over the years that investment success is not a matter of rapid trading, inside information, or high IQ. The biggest opportunities – and dangers – are marked by information that is there for everyone to see.

This essay is a mini-illustration of value analysis, applied here to Canadian real estate, but it is applicable to any investment. Long-time clients will recognize the thought process.[1] It should be instructive because Canadian housing is at an interesting juncture.

The biggest challenge in assessing overvalued or undervalued markets is recognizing and dealing with the great perception errors (anchoring, availability, overconfidence, etc. see Psychological Illusions www.chrishoran.ca).

As Mark Twain said, 'It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so'. What he means is it's faulty assumptions – things you were sure about - that cause the trouble.

We'll start with some facts:

- All major asset classes worldwide have seen serious price corrections in the past 7 years except Canadian real estate and bonds, which have been going up for 20 and 30 years respectively (bonds did decline in 2013).

[1] The thought process led us to minimize US stocks and avoid tech stocks completely in the late 1990s, weight towards resource stocks in the early 2000s, weight to Canada in the mid-2000s, and overweight the US starting a couple of years ago.

Assante Capital Management Ltd.
130 Adelaide Street West
Suite #3401
Toronto, ON M5H 3P5

Phone: (416) 216-6532
Fax: (416) 216-6512
Email: choran@assante.com
Website: www.chrishoran.ca

- The Economist survey of global real estate indicates Canadian real estate is 78% overvalued in terms of rent and 34% overvalued in terms of personal income[2].
- Deutsche Bank, the IMF, and Fitch, a credit rating agency, all say Canadian housing is 20% - 60% overvalued.

You could stop right here and say that real estate in Canada is overvalued by 30 - 50% … but our brains don't want to process that … so we need to keep going.

- Real estate tends to be purchased with debt and is therefore affected by interest costs. Interest rates are now artificially suppressed to 50-year lows, therefore having a corresponding opposite effect on housing, i.e. artificially boosting prices.
- The prospect of normalizing (higher) rates seems to be pulling in future buyers who want to capture the low rates, adding further – but temporarily - to demand.
- Real estate is traditionally the last asset class to correct, because it is a big-ticket item and trades infrequently.
- US residential real estate nationally fell 25% and remains 16% below its 2007 highs. While 10% of US cities have recovered, 90% remain on average 25% - 50% lower than 2007[3].
- Canadian house prices are up 23% from 2006 to 2012[3], and household debt levels are as high as the US was at the peak in 2007[4].

Meanwhile, construction continues: Toronto had 260 condo projects under construction in 2013, including more hi-rise condos than any other city in the western hemisphere[5].

Assessing Value

One way to assess value is by the income that something produces.

Taking the investor's perspective, a house in North Toronto currently worth about $2 million can be rented out for $3,500/month, or about $42,000/year[6]. After property taxes of about $12,000 and maintenance of $10,000 the owner would have income of about $20,000/yr. This represents a pretax return or yield of about 1% on your $2 million investment.

A return of 1% only makes sense if you are counting on future price increases. See Mark Twain above.

---

[2] Economist, January 12th, 2013. Only France is higher valued vs. income, at 35%; Canada's overvaluation vs. incomes is highest in the world except for Hong Kong and Singapore. The Economist tracks the ratio of house prices to rents and personal income from 1974; the IMF is similar. Fitch per Financial Times.

[3] Data from Zillow, a real estate information service, reported in the Globe and Mail, December 30, 2013, and The Financial Times, a London newspaper, Feb. 7, 2013.

[4] US household debt has declined from 90% GDP in 2006 to 78%, while Canada's has continued to increase and now stands at 92%, according to The Economist.

[5] Towers over 150m (about 45 storeys), Financial Times, February 2013

[6] Forest Hill Real Estate, listing on Dawlish Ave in North Toronto

From the consumer perspective, it is far cheaper to rent than to buy. If you were to borrow say half the purchase price i.e. $1,000,000, the mortgage payments (at 3%) would be $4,700/month. If you renewed at 7% (rates were 7% in 2007) the payments would be $7,000/month. Apples to apples, borrowing the $2 million would cost over $14,000/month. For an asset that you could rent for $3,500.

This is why the Economist says housing is 78% overvalued vs. rent.

Make all the excuses you want (need a place to live, lifestyle decision, long term view etc.) but the price of housing in Toronto is far higher than its economic value warrants. Major differences in historical norms like this eventually revert towards the long term trend. Which means rents will either rise or house prices decline.

But rents are not likely to increase much, because house prices are out of line with both incomes and rent, as the Economist survey points out. It's the high price that's the anomaly, not the rent.

Investment real estate is similar to bonds in that it produces a stream of income. Bonds have also been artificially forced to lifetime high prices by low interest rates; just as rising interest rates will force the prices of bonds lower (they move in opposite directions), rising interest rates will exert downward pressure on real estate.

Complete Reversal

The *zeitgeist* today is a complete reversal from 1994, the bottom of the last housing cycle. Back then, you could borrow the entire cost of a Mt. Pleasant house, and the rent would easily cover the mortgage payments – at interest of about 10%! Toronto real estate was a bargain in 1994, but people didn't **want** to buy – when it had fallen 30% - yet today, people are in bidding wars after it has doubled.

This is one of the most powerful observations one can make about a market – *any* market.

When the general public view of something is favorable or optimistic, chances are that some number of people have already acted on their view, and have bid prices higher. Rising prices create a positive feedback loop, which combines with the perception errors of availability, anchoring, and overconfidence to perpetuate the trend and eventually overshoot.

The clue for danger is when popular optimism persists in the face of data indicating something is overpriced. The clue for a bargain is when public pessimism persists in the face of data indicating something is cheap. This is probably the greatest lesson in investing.

My view is that today, *many people cannot imagine interest rates going higher than 5%, nor can they imagine housing prices falling.* These are classic perception errors that mark a classic market top. See Mark Twain above.

Market Distortion[7]

Nevertheless, it isn't necessarily all a bubble. Data indicates a 2-part market developing: Toronto's intensification and Ontario's greenbelt policy has encouraged development of hi-rise condos at the expense of single-family homes, thereby distorting the market.

The condo construction boom is running into resistance from consumers, who seem to prefer single-family homes. This has led to an oversupply of condos and record low inventories of houses, completely reversing traditional inventory levels. As of September 2013, the inventory of houses available for sale was down 50% from only 2011, while available condos have doubled. Looking further back, in 2001 there were almost 3 times as many houses as condos available; now there are 3 times as many condos as houses.

Buyer preference for houses and lack of supply is driving a divergence in prices: since 2011 house prices have increased over 20% while condo prices have fallen about 4%. This has widened the price gap between houses and condos from its normal around $75,000 to a record $226,000 today.

[7] All data in this section from: Realnet Canada Inc., a real estate consulting firm.

So it is possible that single-family property prices in Toronto remain firm, supported by government policy favoring hi-rises and restricting house construction. Houses may become affordable only by the very highest income earners, while condos suffer losses.

But a market supported by government policy is a dangerous animal. How long will government policy force condos on people who want to raise their children in houses?

My advice? If you must own real estate (like me you want to live somewhere), *if* your costs are reasonable, *if* you don't plan to sell, and *if* you don't mind seeing the price go down, then you have nothing to worry about. If you have a mortgage, make sure the payments will be easily affordable if you renew at 6 - 9% (5 year rates were 7% before the crisis). Make sure you aren't assuming price increases will skate you onside (see Mark Twain above).

My bet: interest rates will rise; each increase will squeeze out a layer of property owners who can't afford their mortgages, and will push high-priced housing out of reach for new buyers. The result will be soft prices.

Toronto condos will be softest. If a downtrend persists, or if rates rise faster than expected, condos will be ugly as overleveraged or foreign buyers head for the exits. Leverage and speculators are classic elements in investment tragedies, and Toronto has them both. Single family houses with short commutes will suffer least. Renters will rejoice.

Outlook 2014
The Market Climbs a Wall of Worry

So I don't like the prospects for real estate. What about everything else?

Positive, and then a word of warning.

The best thing about the beginning of 2014 is that the US market (S&P500) has run solidly through the previous highs of 1999 and 2007 and now is a little over 1800. The return for 2013 is 30%, the largest single year return since 1997[8].

Aside from the very positive psychology of a good year, the underlying data are positive: the US growth should be about 1.7% for 2013 according to The Economist. This is very good because it was in the face of fiscal contraction (i.e. lower government spending) of about 1.5% under the budget 'sequestration' cuts. This means underlying growth was about 3% for the year, which is excellent.

It gets better: The Economist estimated US GDP growth in the 4th quarter at 3.6%, while the 3rd quarter was revised *upward* to 3%. Growth of 3% in a large modern economy is excellent, and is the proof of recovery that the markets needed to shake their gloomy funk.

---

[8] Market Watch, Wall Street Journal service.

US unemployment is down to 7%, (Canada 6.9%) and the US budget deficit, last year's worry *du jour*, fell to 4% in 2013 and is forecast to fall further this year on stronger tax revenue and lower spending.*

The US economic recovery has been slower than past recoveries because the consumer has reduced debt by a total of 12% of GDP since 2007, representing a headwind of 2% of GDP/year. But now house prices in the US have stopped falling, so consumer confidence is improving. The US economy is operating normally.

Looking forward, the worry is the Federal Reserve 'tapering' of its money-printing exercise, called QE or quantitative easing. In my view, the only benefit of QE was to possibly force longer term rates a little lower than they may have otherwise been. The risk to stopping QE will be that rising rates will be a nasty surprise to people with too much debt (see Mark Twain above).

China

China's so-called 'slowdown' is also going very well, with GDP growth estimated at just under 8% for the year, including a blockbuster 4th quarter estimated at over 9% (all data from The Economist).

Growth of 'only' 6% per year would still double the size of the Chinese economy in only 12 years, a feat that is probably not going to happen, simply because it is already the 2nd largest economy in the world. But even a 50% increase in the next 10 years would have profound – and positive - effects around the world. Just think of the possibilities as more than a billion people lift themselves from poverty.

Europe

The Europeans remain locked in their disastrous experiment in socializing currency and banking called the Euro. The unfortunate fact is that any interest and/or exchange rate (they are linked) will be too low for the northern countries and too high for the less productive mostly southern countries. Thus the northern economies will tend to be too hot (inflationary), and the southern ones too cold (deflationary).

The good news from Europe is that things remain quiet there. The Euro may well survive (Latvia joined January 1st) for another 20 years. The longer things remain quiet, the better the chance that the banks can position themselves for someone to depart the Euro without detonating the financial system.

Warning

The last decent correction was a 19% decline in the S&P500 through the summer of 2011. Since then we have run up about 600 points or 50%, which is a good run by any measure. So we are due for at least some sort of correction.

You may be surprised to learn that the average fluctuation in the US market within any one year is 15%[9]. This is why we say markets are volatile: where the long term average return is 10%, the average intra-year volatility is 15%. Also keep in mind that 25 of the last 33 years have had positive returns – that's 75% odds.

I make the comment now, as a reminder, lest you be surprised. The thing about a correction now is that many people remain nervous about a repeat of 2009; a 10% or 15% correction now will look exactly the same to them as the first 15% downstroke of the awful 57% decline in 2009. They will be tempted to flee.

[9] Intra-year declines refer to the largest drop from a peak to a trough within a calendar year, source: Nick Murray newsletter, January 2014.

* Data in this section from The Economist

To me, today is reminiscent of the 1980s, when the market rocketed away from the 1982 lows, barely pausing for breath. Then, as today, the skepticism, the fear, the disbelief was widespread, even as the market left the '82 lows behind *forever*.

As I said earlier, the signal for value is when the popular view is doubt. It's the old adage, 'The market climbs a wall of worry'.

My advice: dust off your notes from our last meeting, review your Downside Risk test, (also known as The Lifeboat test) and be ready for a correction, if it happens. If you want to reduce your downside risk (and the potential return), call me and we'll discuss.

My bet: 2013 was the year we finally broke through market levels of 1999, 14 long years ago. Long periods of no gain have happened only twice before in modern history: in the 1930s and the 1970s. After each of these, the 10-year returns were significantly higher than average. While we will certainly experience corrections, 10 years from now you won't believe how much higher things will be. Except maybe Canadian real estate.

Finally, congratulations to all of you, because you have had the patience and courage to weather the storm of 6 years ago. I deeply believe that your patience has been vindicated, and you have begun to reap the rewards.

©2014 Christopher Horan, all rights reserved.

This material is provided for general information and is not to be construed as an offer or solicitation for the sale or purchase of securities mentioned herein. Every effort has been made to compile this material from reliable sources however no warranty can be made as to its accuracy or completeness. Before acting on any of the above, please make sure to see me for individual financial advice based on your personal circumstances. Neither Assante Capital Management Ltd. nor any of its affiliates accepts any liability whatsoever for any loss arising out of this report's contents. The opinions expressed are mine and not necessarily those of Assante Capital Management Ltd. Commissions, trailing commissions, management fees, and expenses may all be associated with mutual fund investments. The indicated rates of return are the historical annual compounded total returns including changes in unit/share value and reinvestment of all distributions/dividends. They do not take into account sales, redemption, distribution or optional charges or income taxes payable by any security holder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Please read the prospectus and consult me before investing. Assante Capital Management Ltd. is a member of the Canadian Investor Protection Fund and is registered with the Investment Industry Regulatory Organization of Canada.

Assante is an indirect, wholly-owned subsidiary of CI Financial Corp. ("CI"). The principal business of CI is the management, marketing, distribution and administration of mutual funds, segregated funds and other fee-earning investment products for Canadian investors through its wholly-owned subsidiary CI Investments Inc. If you invest in CI products, CI will, through its ownership of subsidiaries, earn ongoing asset management fees in accordance with applicable prospectus or other offering documents.