# Real estate contagion

RICHARDSON GMP

## Hilliard MacBeth

Hilliard's Weekend Notebook – Friday May 12, 2017

Real estate contagion is the topic of the month in Canada. Will the recent troubles that have surfaced with at least one Canadian alternative lender spread to the wider real estate finance industry and the Canadian economy? How does a Canadian investor find a safe haven from possible spillover effects?

I covered this topic in "When the Bubble Bursts: Surviving the Canadian Real Crash" where I discuss some options to protect stock market investors from the fallout. Here's an update.

Rob Carrick, personal finance columnist with the Globe and Mail, did a reasonable job in an article on May 4, 2017 called "How to protect your finances against real estate contagion." In the past I've exchanged emails with Rob on the housing topic and, while we sometimes disagree, I find that his articles are always worth reading. But he might be wrong when he encourages investors to hold on to their bank stocks because "they're great long-term money makers." That comment sounds like it's predicting the future but it's only true of the past two decades. While it's always hard to predict turning points in a market, the current situation in Toronto real estate should make investors pause to think long and hard about the allocation of their investments.

The banking sub-sector on the S&P/TSX has made enormous gains since the mid-90s. But, as the saying goes, past performance is no guarantee of future results.

The financial sector earns more than 75 percent of all the profits while the banking sub-sector garners almost 50 percent of profits generated by companies listed on the S&P/TSX. And the financial sector, which includes insurance and real estate companies, makes up more than 33 percent of the value of the index.

OUR PARTNERS

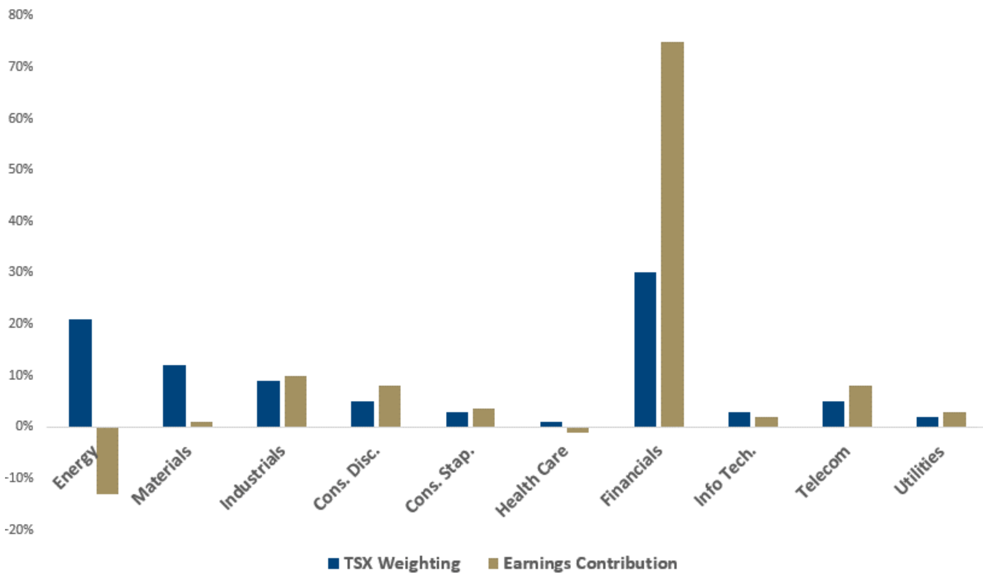
The MacBeth Group

Richardson GMP
10180 101 Street, Suite 3360
Edmonton, AB T5J 3S4

**Tel.** 1.780.409.7735
**Fax** 780.409.7777
www.TheMacBethGroup.com

**Hilliard MacBeth**
Director, Wealth Management
Portfolio Manager
**Tel.** 780.409.7740

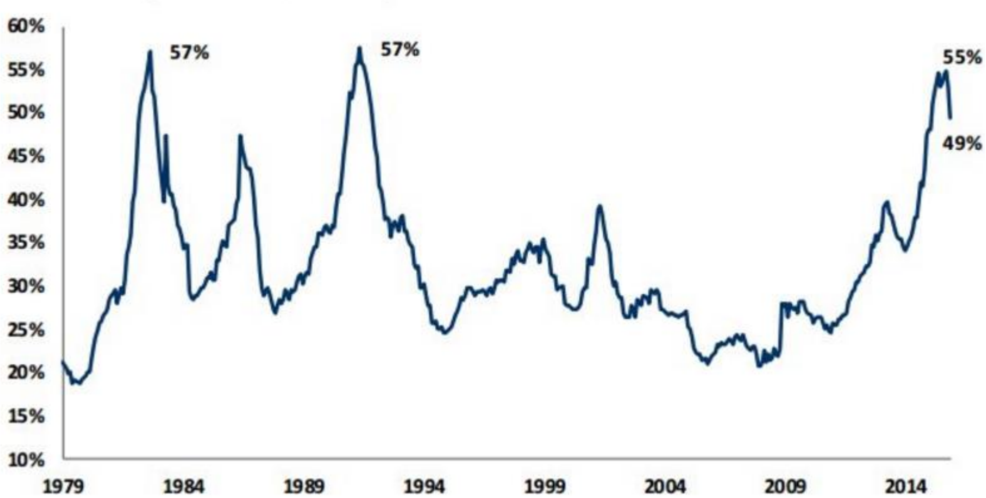
% weight in the index vs. % earnings contribution (trailing 12-months)




Source: RBC CM Quantitative Research

The above chart makes the key point very clearly — the Canadian stock market is very dependent on the financial sector for the bulk of its value. The banking sub-sector is by far the largest component of the financial sector. Most of the weighting in that sub-sector is in just three companies, Royal Bank of Canada, TD Bank and Bank of Nova Scotia.

% share of trailing 12-month S&P/TSX earnings – Bank sub-sector




Source: RBC CM Quantitative Research; Through 11/30/16

Source: RBC CM Quantitative Research

We can see clearly that banks' earnings are cyclical, and their profit cycle appears to track the real estate cycles. There were two housing crashes, or corrections, in the Canadian housing market in the last four decades, in the early 1980s and in the 1990s. Both times Canadian banks' profits corrected substantially and their share prices followed. There's hasn't been a substantial correction since the mid-1990s as real estate prices have risen to reach bubble proportions.

In Part Three of the book, page 217, I state that the key factors for this 20-year uptrend in bank share prices were “an exponential increase in household debt … a relaxed regulatory environment … and rules that permitted almost unlimited leverage as long as mortgages were insured by the CMHC or one of the private insurers.” It’s a good bet that these past advantages might be changed or disappear altogether. For example, CMHC rules were dramatically tightened last year. The Minister of Finance is mulling over changes to risk-sharing on insured mortgages.

When deciding to allocate funds in an individual investor’s portfolio, an individual that owns Canadian real estate, a home and perhaps a second property, and is the beneficiary of a Canadian pension plan that holds real estate and Canadian bank shares, it’s important to assess the degree of concentration in assets that depend on the continuation of the current housing bubble in Canada. And, if that concentration is too high, it’s even more urgent to reduce that exposure by diversifying outside of the financial sector and, perhaps, outside of Canada.

Don’t be lulled into complacency by those who say, “The Canadian banks have always done well for me, and they always will.”

There’s a lot of people saying that, but that doesn’t guarantee that it will be true.

Hilliard MacBeth