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Canada housing: On short notice

By Camilla Hall

Record prices and low interest rates have fuelled fears of a bubble that has excited hedge funds

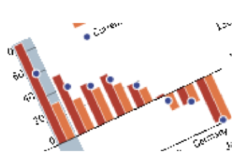
Skyward limits: Toronto's prices are up 37 per cent since 2008

Ben Rabidoux was teaching at Georgian College, a small campus an hour's drive from Toronto, when he started writing a blog about the Canadian housing market. His job teaching economics and finance gave him access to reams of real estate data, which he used to back up his contrarian – and unpopular – case that Canada was in the midst of a housing bubble.

Do you think Canada is the next bubble?

Make your case in the comments section below

Bubble worries



Canada's property market

The blog won a small but loyal following. In late 2011 Mr Rabidoux received a call from one fan, Mark Hanson, the analyst known for forecasting the US housing crisis. Soon, Mr Rabidoux realised many of his avid readers worked for hedge funds and were eager to bet against Canada's housing market.

"Before you get into the hedge fund world you don't recognise the names," says Mr Rabidoux, 32. "It was large institutional investors here in Canada, in the US and some in Europe." After collaborating with Mr Hanson for a year, he set up North Cove Advisors, his own private research shop.

Take a quick look at the statistics and it is easy to see why hedge funds are licking their chops. In the past five years, while other big developed economies have been suffering through the financial crisis, the average Canadian home price has risen 38 per cent to C$389,119 (US$355,000), according to data from the Canadian Real Estate Association. This has been driven in part by Toronto, where a condominium boom has driven prices to record highs.

At the same time, Canadian households have been on a debt binge fuelled by easy bank lending, low interest rates and government-insured mortgages. The household debt-to-income ratio rose to a record 163.7 per cent in the third quarter, close to the US peak of about 165 per cent on an adjusted basis.

Many of the investors and economists sounding the alarm about Canada's housing market are veterans of the US subprime crisis. They include Mr Hanson, the analyst, Steve Eisman, an investor, and Nouriel Roubini and Robert Shiller, the economists. Whether they will be right a second time is the source of a heated debate on both sides of the border.

Economists have warned of the risks of global credit bubbles born of extraordinary measures by central banks to prop up economies, primarily quantitative easing and ultra-low interest rates.

The negative bet on Canada is just one of the scenarios on which global hedge fund investors are focused as they ponder the shift away from these emergency measures.

"The US has been printing money since 2009 and it has helped set off a series of echo housing bubbles around the world – Canada is only one of the echo housing bubbles," says Seth Daniels, founder of JKD Capital, who is advising a new short-focused fund in Toronto. "If the US tapers QE, it could set the process in reverse and trigger the collapse of these echo credit bubbles, including Canada."

Canada's banking sector has been held up as one of the best regulated in the world – it was the envy of western countries during the financial crisis – and is among the favourites of the rating agencies. Any hint of a bubble would come as a blow to Mark Carney, who was picked to head the Bank of England after insulating Canada from the crisis.

While some of the bigger hedge funds are choosing to stay on the sidelines, Canada, and to a greater extent Australia, are top of the watch list.

"Once you start to see [Canadian] banks showing credit deterioration they'll all pile in," says Mr Eisman, founder of Emrys Partners and noted for his role in forecasting the US subprime crisis in Michael Lewis's book *The Big Short*.

Betting against Canadian assets is not new and has not necessarily been a winning strategy. "Investors broadly tend to want to see all the information and act on it when things are clear," says Vijai Mohan, fund manager at Hyphen Fund Management in San Francisco. "That usually means that your price opportunity is gone. You need to act before things are entirely 100 per cent certain."

Mr Mohan's biggest bet is shorting the Canadian dollar, a trade that he has had on for 18 months. The "loonie" weakened 7 per cent against the US dollar last year, a trend that has accelerated this year, pushing the loonie to its weakest level in four years. His fund is also shorting the Canadian banks, a bet that lost money last year when financial stocks rallied.

He is not alone in betting against the currency: Goldman Sachs has advised clients to short the Canadian dollar.

Sporting a blue-grey checkered cap, Mr Rabidoux has become an unlikely tour guide for hedge fund investors considering whether they should short or reduce their exposure to Canada. A typical tour might involve a meeting with mortgage brokers or a taxi tour of tower blocks.

A project planned in the heart of downtown Toronto embodies the vigour of the city's condominium boom. David Mirvish, a developer, is battling the city authorities for permission to build three towers designed by Frank Gehry. The 3,000-unit project will dwarf anything in the surrounding area.

Yet some of the high-end luxury condominium projects are showing signs of weakness.

At Trump residences, an attractive guide shows prospective buyers around the suites that cost as much as C$4.7m for a two-bedroom property. An oyster shell filled with caviar on the dining room table and cut-glass whisky decanter project an image of a luxurious life in the tower, where occupancy rates stood at only 30 per cent in December.

The half-built waterfront district of Mimico, an area of Toronto that had been set aside for development, has already disappointed residents with its limited infrastructure. Promises of "incredible value" may turn out be far-fetched.

"We can't just keep on feeding domestic demand. It's not going to work," says Ed Clark, chief executive of TD Bank, the country's second-biggest lender.

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The Canadian government is playing an important role in the mortgage boom. The government encourages banks to insure mortgages with more than an 80 per cent loan-to-value ratio with the national housing agency, meaning that mortgages with 20 per cent deposits and under are counted as close to sovereign risk.

"The vast majority of the mortgage book is insured by the government. This naturally protects the banking system but it does create a big taxpayer liability," says Craig Alexander, chief economist at TD Bank, the country's second-biggest bank.

"If you had large-scale losses and that insurance came into effect it would end up with the Canadian taxpayer."

Banks have piled into housing, racking up hundreds of billions of dollars in mortgage loans, a large portion of which are backed by the government through the Canada Mortgage and Housing Corporation. Consumer lending helped the banks to report record earnings in 2013.

The federal government is also guaranteeing up to 90 per cent on claims in the case of insolvency of private insurers in an effort to level the playing field between the private sector and the national housing agency. That is capped at C$300bn.

One of the biggest concerns is the duration of Canadian mortgages. The typical mortgage is refinanced every five years, unlike in the US, where the 30-year fixed-rate mortgage is the standard.

There is little doubt that Canadians who borrowed in the past few years of low rates will pay more at their next refinancing.

“At some point interest rates are going to have to rise and it’s going to be a shock to a lot of Canadians,” Mr Alexander says.

But most of Mr Rabidoux’s countrymen disagree with the view that the real estate market is close to collapse.

“We don’t see that there’s a housing bubble,” says Martin Reid, president of Home Capital Group, a big Canadian mortgage lender. “There is some elevated risk in certain markets but, in general, we see the housing market as reasonably healthy.”

Gordon Nixon, chief executive of Royal Bank of Canada, the country’s biggest bank, says that while “there’s always potential for a correction”, the bears are wrong about the housing market.

“When you look at the fundamentals in Canada [they] tell a very different story than sometimes the headlines or the hedge funds do,” he says.

Mr Nixon and others point to important differences with the US subprime market, including tighter underwriting standards and the absence of tax relief for maintaining a mortgage in Canada. The country has not seen the same boom in the repackaging of mortgage-backed securities as in the US.

. . .

The bears have a technical issue working against them, too. “It’s very difficult to express this trade,” Mr Daniels says. “Partly because of CMHC insurance, there is nothing like the ABX Index or CDOs to short in Canada. Also, the US has much deeper markets.”

The other factor working against the shorts is the strength of the market. In May last year Mr Eisman singled out Home Capital Group as a potential short equity trade. But he then saw the stock rally 27 per cent by the end of the year. And the six big banks, shorted by some hedge funds last year, have their government insurance to wave at the doomsayers. Canada’s S&P/TSX banking index rose 17.7 per cent in 2013.

The government has taken steps to rein in the credit swell.

Jim Flaherty, the finance minister, has addressed the topic repeatedly. “We have to watch out for bubbles – always – in markets around the world, including our own Canadian residential real estate market, which I keep a sharp eye on,” he said in November. “I’ve intervened four times in the last several years and I’ll intervene again if I have to make sure we don’t create a housing bubble.”

The government shortened the maximum amortisation – or the period in which the entire mortgage could be paid off – to 25 years from 30 years. It has also limited the amount Canadians can borrow when refinancing to 80 per cent from 85 per cent of the value of their home.

It has also stopped government-backed insured mortgages to homes bought for more than $1m. This year, Canada imposed a “risk fee” on mortgage insurance provided by the country’s housing agency, to compensate taxpayers for potential losses.

Despite the government’s measures, Toronto’s cranes and surging skyline tell a different story. But even those in the hedge fund industry know that betting on a Canadian housing collapse is not a sure thing.

“For every Eisman or [John] Paulson, there’s someone that went out of business for shorting subprime too early,” says Mr Daniels.

Mortgages: Doubt hovers over banking saviour’s future

As Canada attempts to manage its housing boom, the country faces tough decisions about the future role of the national housing agency, the Canada Mortgage and Housing Corporation.

The International Monetary Fund has been among those to raise concerns over the scale of the state’s role in the mortgage market, which has insured mortgages up to C$560bn.

“What we are questioning is whether there is too much government involvement, whether it can be scaled back and how it can be scaled back? It’s a tricky question,” Roberto Cardarelli, IMF mission chief to Canada, told the Financial Times.

For some, the CMHC is what saved the banks during the crisis as bad mortgages were not packaged and sold to the same degree as in the US. Canadian banks were not penalised for holding them as risky assets, meaning they often kept them on the balance sheet.

But five years after the financial crisis there is mounting pressure to reduce taxpayer liability and create a fairer environment for private insurers. Banks, however, point to the risk of shocks to the mortgage market as a result of scaling back the CMHC.

“There is a risk that we over-tighten this and get the bad thing that we’re trying to avoid,” says Ed Clark, chief executive of TD Bank.

“This is government, politicians wanting to encourage first-time homebuyers to buy with the least amount down and so I think it’s a legitimate public issue to say ‘if you think that’s driving people to be too risky, tighten up the criteria’ . . . you’ll find all the banks say, ‘we’re up for that’.”

Change has been afoot at the top of the CMHC, paving the way for a new direction at the agency that has promoted the government-backed securitisation of mortgages in Canada.

Both Bob Kelly, the new chairman, and Evan Siddall, the new chief executive and president, are bankers by trade.

Mr Kelly, the former chief executive of Bank of New York Mellon, saw the US subprime crisis unravel from the inside, at the head of one of the big trustees of mortgage-backed securities. Mr Siddall worked as an investment banker at both Goldman Sachs and Lazard.

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