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CANADIAN REAL ESTATE REPORT

BUBBLE, BUBBLE, TOIL & TROUBLE?

Joelle Fricot, Associate
joelle.fricot@europac.ca

Christopher Callahan, Associate
chris.callahan@europac.ca

CANADIAN REAL ESTATE
BUBBLE, BUBBLE, TOIL & TROUBLE

By Joelle Fricot & Christopher Callahan

It is almost four years after the global financial meltdown of 2008 and many parts of world are still trying to recover. Given the impact of the crisis, which rocked financial markets across the globe, it is shocking to many that Canada seems to be following many of the same lending trends as we saw in the United States in 2006. These trends were at the core of the subprime mortgage crisis, which led to the global recession of 2008.

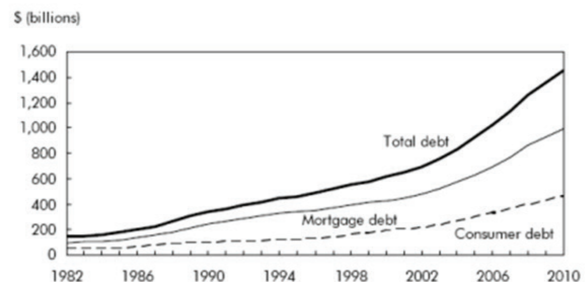
In the year and a half leading up to the crash housing prices rapidly increased in the United States, with a corresponding increase in subprime lending. We are now seeing the same trends in Canada. When analyzing the Canadian housing market, housing prices increased almost 100% since 2000, with the average home in Canada costing roughly $348,000. This is almost double our U.S. counterparts.

Early in 2012, after being unable to find a purchaser for their Canadian Consumer Finance business, HSBC decided to shut down the unit completely. The unit's main business was both prime and subprime mortgages, unsecured loans, as well as a private label credit card unit. HSBC stated during the announcement that they were going to stop accepting new loan applications and would shut down operations "as soon as practically possible".

HSBC is not alone in halting lending for Canadian mortgages. TD Canada Trust announced in early March that TD Financing Services Home Inc (TDFS Home) would no longer be accepting new mortgage applications come the end of March. TDFS Home was previously a fallback financing option for clients who did not fit the normal TD lending guidelines. There is no question that the reason for this is that TD doesn't want these high risk loans on their books. It is a conservative move for the bank, and may prove to hurt a lot of their retail clients who have less desirable credit ratings. These clients will now be forced to find alternate sources of financing.

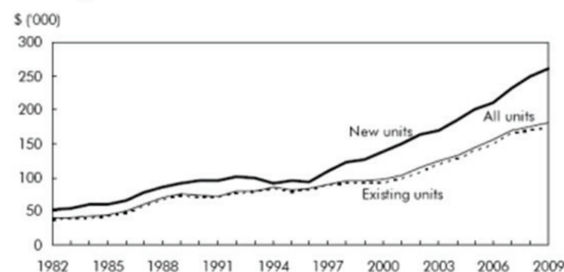
CIBC has been shopping around for a buyer for their First Line Mortgage operation since March and, after being unsuccessful, declared on June 20th, 2012 that the bank will be closing that business within the bank. CIBC's First Line Mortgage business was one of the largest mortgage brokers in Canada. The business will stop selling new mortgages and CIBC will sell solely the CIBC branded mortgages, which in 2011 grew at 10%, 3% higher than the national average. First Line Mortgage will stop approving mortgages July 31st, 2012 at close of business; for clients who have pre approved rate guarantees they will no longer be valid at this time as it will no longer be through the same brand.

Chart A Trends in consumer, mortgage and total debt



Sources: Bank of Canada, CANSIM vectors v36408 (total debt), v122698 (consumer debt) and v122736 (mortgage debt), 1982 to 2010.

Chart B Trends in average mortgages for new and existing dwellings



Source: Canada Mortgage and Housing Corporation, CANSIM table 027-0017, 1982 to 2009.

Size of Canadian Residential Mortgage Market

	2011	2010	2009	2008	2007	2006
Outstanding Residential Mortgage Credit in Canada	$1,079B	$1,010B	$940B	$664B	$787B	$687B
Average mortgage size		$146K	$131K	$127K	$164K	$127K

Source: CAAMP Annual State of the Residential Mortgage Market 2006-2011

Canadian Mortgages by amortization period

	2011	2010	2009	2008	2007	2006
Up to 25 years	78%	78%	82%	84%	91%	N/A
More than 25 years	22%	22%	18%	16%	9%	N/A
Including...						
30 years	9%	8%	7%	5%	5%	N/A
35 years	8%	8%	6%	4%	2%	N/A
40 years	5%	6%	4%	6%	2%	N/A

Source: CAAMP Annual State of the Residential Mortgage Market 2006-2011

Canadian Mortgages by Term

	2011	2010	2009	2008	2007	2006
1 year or less	N/A	6%	10%	9%	12%	10%
1-2 years	N/A	7%	5%	5%	9%	7%
2-3 years	N/A	7%	7%	10%	11%	11%
3-4 years	N/A	6%	5%	5%	7%	7%
4-5 years	N/A	66%	62%	61%	52%	51%
5-10 years	N/A	7%	8%	7%	8%	12%
More than 10 years	N/A	1%	4%	3%	1%	1%
Total	**N/A**	**100%**	**100%**	**100%**	**100%**	**100%**

Source: CAAMP Annual State of the Residential Mortgage Market 2006-2011

Big banks have become stricter with lending policies, and have upped the stakes for those looking for mortgage financing. This has created a huge market for sub-prime lenders in the marketplace that didn't exist before because more and more people who would have been approved five years ago are now being turned away. There is now a huge shift in the lending marketplace. Once small, Canada`s subprime mortgage industry is now booming. More and more Canadians with highly questionable credit are highly benefiting from the available financing.

GOVERNMENT ACTIONS

The Canadian Government has been moving quite aggressively in attempts to cool down the Canadian housing market. As home prices are soaring there are fears that there is a bubble in the making. This is evident through the recent actions of Finance Minister Jim Flaherty who is now acting for a fourth time, reducing the maximum amortization period for government issued mortgages from 30 to 25 years. On top of this he is also lowering the amount of equity that can be borrowed against a property to 80% down from 85%.

The impact of these two policy changes aims to reduce the housing prices by approximately three percentage points and sales by nine percentage points. Though the actions will take a year to fully filter through the system the government still believes they will help slow the booming market before it becomes a more severe threat to the stability of the economy.

Mark Carney, the Governor of the Bank of Canada, has warned Canadians time and time again that there is an incredible threat to Canadian consumers should there be another significant financial shock, as we saw in 2008. The rising unemployment in the country is also an area of concern for the government given the degree to which the average Canadian is now leveraging themselves.

The government is attempting to the further tighten the lending practices that are allowing many Canadians to become so leveraged. BMO Nesbitt Burns has stated that the change in amortization period is equivalent to an increase in mortgage rates by 0.9 of a percentage point.

Given the new amortization restrictions, the 92% of Canadians currently on terms less than five years will be facing rate increases as they come to a new renewal period. 13% of Canadians are on amortization periods of more than 30 years, the new limit set by the government.

THE CANADIAN MORTGAGE AND HOUSING CORPORATION

The CMHC was founded after the Second World War to house returning veterans. By legislation, any mortgage for which the down payment is less than 20% must be insured for the full amount and for the entire amortization period, as long as 30 years. Should the borrower default, the insurer pays the outstanding balance, up to 18 months of accrued interest, plus foreclosure and maintenance costs.

The CMHC currently insures all mortgages that are approved by the banks. In fact, banks won't even touch a majority of mortgages unless otherwise insured by the CMHC. Due to this, a majority of the mortgages in all of Canada show up on the balance sheet of the CMHC.

More than $500B of Canada's estimated $1.1T housing market are considered to be high-risk mortgages. Recently Ottawa began increasing its scrutiny of the CMHC for allowing this level of high-risk mortgages to rise to the level that it's at now.

The Conservative Government has started putting stops to banks using mortgages insured by the CHMC as collateral on covered bonds. In addition new legislation will be implemented to ensure that corporations will have to give more consideration to the broader implications of their decisions. Essentially the CHMC is being told that, for every mortgage they insure, they will have to put consideration into the potential risk that mortgage put on the full Canadian economy.

The CMHC has dramatically expanded use of insurance by banks for covered bonds. These securities are made up of a package of mortgages, which is partly due to the steep rise in CMHC`s mortgage portfolio according to Jim Flaherty, Canada's Finance

Minister. CMHC has a legal limit of 600B for mortgage insurance which it is fast approaching. The $600B limit has already been raised twice since the end of 2007.

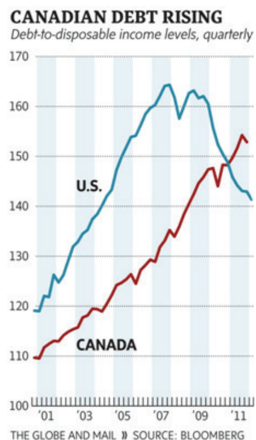
If these high risk mortgages run into problems, the Canadian taxpayers are the ones on the hook for the loss of investment on what could prove to be toxic assets. In addition to the CMHC, the government also insures 90 percent of the portfolios of Genworth MI Capital and Canada Guarantee. When taking these corporations into account, the Canadian people have over 1T in exposure to insured mortgages.

Jim Flaherty has very clearly stated that he expects the CMHC to remain within the 600B limit for outstanding insurance. In April of 2012, Jim Flaherty placed the CMHC under supervision of the Office of Superintendent of Financial Institutions. He also hinted that the CMHC might one day be forced to exit underwriting altogether.

Of the $1.1T worth of outstanding mortgages in Canada, roughly half is insured by CMHC. "It's the 60,000-pound gorilla in that space, and our collective risk exposure has been increasing with each passing day," says Queen's University finance professor Louis Gagnon.

If CMHC were to exit underwriting, CMHC's liabilities would diminish slowly over time. Its private-sector competitors would reap market share, but they, too, enjoy federal backing. Jim Murphy, CEO of the Canadian Association of Accredited Mortgage Professionals, says that guarantee was intended to place private insurers on equal footing with CMHC. "If the government's no longer in the business, it can be argued, why do you need it?" he says.

CANADIAN HOUSEHOLD DEBT



It is clear that loan regulations are tightening all over the country, which is a direct result of the growing concerns that the Canadian market is overheating. On top of the overheated market, Canadians are carrying even higher debt burdens.

Though debt growth in Canada has slowed from recent years, it is eclipsing with income growth and this is why it has become such a threat to the Canadian economy. Canadians have been accumulating debt at slower rates, but incomes have been rising at an even slower rate in the country. This is a trend the Bank of Canada predicts will most likely continue.

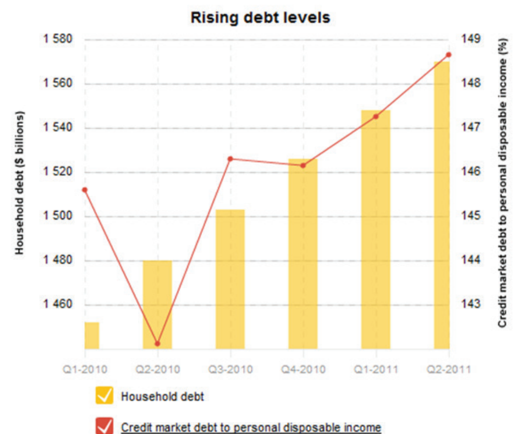
The debt to disposable income ratio among Canadian households has reached almost 155%, a statistic believed to be higher had the government and major financial institutions not already taken measures to tighten lending. This ratio, when it reached 160%, is not a far cry from the current Canadian standpoint and is what sparked problems in both the U.S. and British economies in the past.

HOME EQUITY LINES OF CREDIT

Another significant type of lending in Canada is Home Equity Lines of Credit (HELOCs). HELOCs are loans which are secured by the equity of a borrower's home. These types of loans in Canada have increased almost 170% since 2001 (which is double the rate of increase on Canadian mortgages). In 2011 they accounted for approximately half of total Canadian consumer credit.

HELOCs have been one of the most controversial, and most popular, lending practices in Canada. HELOCs have soared in popularity over the past few years. Even after this type of lending helped inflate the U.S. housing bubble Canadian banks do not seem to be pulling out of the market as they are doing with sub-prime mortgages and are in fact defending this type of lending.

Household debt in Canada stands at record highs, reaching over 150% compared to disposable income. The central bank of Canada has warned time and time again that this surge in household debt is the single largest threat to the Canadian economy. Though a large portion of this debt can be attributed to mortgages, the next big chunk is HELOC's lending.



Source: CBC.ca

Last year 13% of the Big Five's domestic loans in Canada were HELOCs and this creates a market of approximately C$183B. The increase in popularity of this type of loan ultimately comes down to two main selling features: For the borrowers it is most often cheaper than a second mortgage and for the lenders it allows them to keep customers they might lose if they didn't provide alternative methods of financing.

Canadian regulators have recently been taking a closer examination of the lending practices and making some critical points, the most significant being that some issuers are issuing HELOCs with a loan-to-value ratio as low as 80%. The Bank of Montreal is the only Canadian bank to disclose its HELOC ratios and they average about 54%. This is not however the case for all banks and regulators are concerned about the amount of leverage these banks are taking on from HELOC loans. Just last month, The Office of the Superintendent of Financial Institutions Canada (OSFI) drafted guidelines for banks to drop the maximum HELOC ratio from 80% to 65% and to amortize these forms of financing over shorter, fixed periods.

REVERSE MORTGAGES

Recently Canada has also introduced a new form of home financing. Taken from the Financial Consumer Agency of Canada the following describes this new form of financing:

What is a reverse mortgage?

A reverse mortgage is a loan that is designed for homeowners 55 years of age and older (if you have a spouse, the age qualification applies to both of you). A reverse mortgage is secured by the equity in the home, which is the portion of the home's value that is debt-free. It allows homeowners to obtain cash, without having to sell their home. Not all lenders offer reverse mortgages.

How does it work?

Unlike an ordinary mortgage, you don't have to make any regular or lump sum payments on a reverse mortgage. Instead, the interest on your reverse mortgage accumulates, and the equity that you have in your home decreases with time. If you sell your house or your home is no longer your principal residence, you must repay the loan and any interest that has accumulated.

The loan amount can be up to 50 percent of the current value of your house. However, you must pay off any outstanding loans that are secured by your home with the funds you receive from your reverse mortgage.

This new type of financing has been extremely controversial since its debut in the Canadian marketplace. From an optimist's perspective, there are many benefits. There is no need for regular payments, you can receive cash for the value of your home, the money is a tax-free source of income which doesn't affect Old-Age Security or Guaranteed Income Supplement and you are able to maintain ownership of your home.

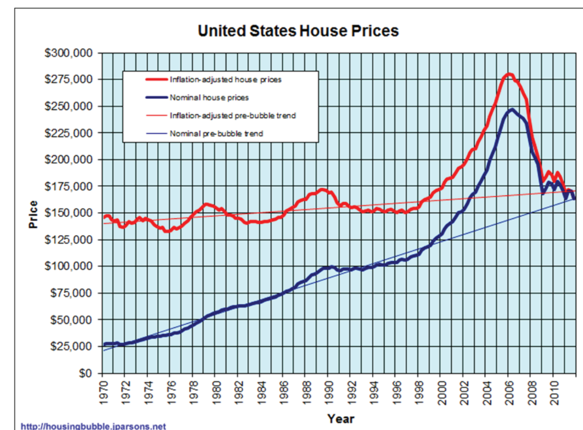
From a skeptic's viewpoint, however, there are many aspects which make reverse mortgages a bad financing option. The reverse mortgage is subject to higher interest rates than most other mortgages, the equity you hold in your home will decrease over the years, and following your death your estate is responsible for the repayment of the loan and accumulated interest.

In Canada, the main source of most reverse mortgage products is the Canadian Home Income Plan (CHIP), which is offered through HomEquity Bank.

THE US HOUSING BUBBLE

When analyzing the U.S. housing bubble from the point at which it started to form to a point that it is at now, it is possible to see that the U.S. national housing bubble has completely deflated. There are however many local housing bubbles, specifically in many of the northwest and west coast metropolitan areas.

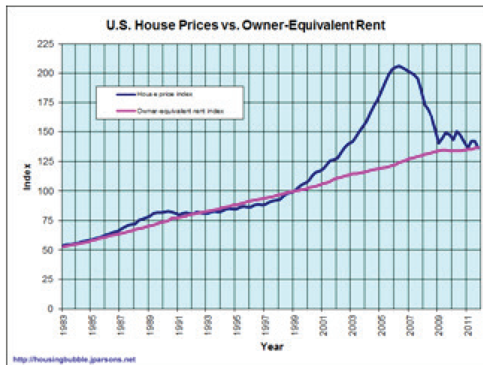
The chart below estimates the market value of today's median-priced house over a 40-year period, thus controlling for the fact that housing sizes have changed over time. The thick red line represents real house prices - prices adjusted for inflation. The thick blue line represents nominal house prices. The thin lines represent the pre-bubble (1970-1999) trend lines.



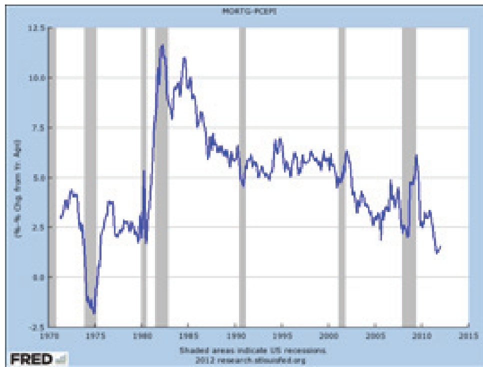
Inflation-adjusted house prices
Source: http://housingbubble.jparsons.net

Nominal house prices compared to owner-equivalent rents

This chart below shows the change in nominal home prices vs. the change in nominal rents since 1983. Over the long run, home prices and rents should increase at roughly the same rate.



Change in nominal home prices vs. the change in nominal rents since 1983
Source: http://housingbubble.jparsons.net

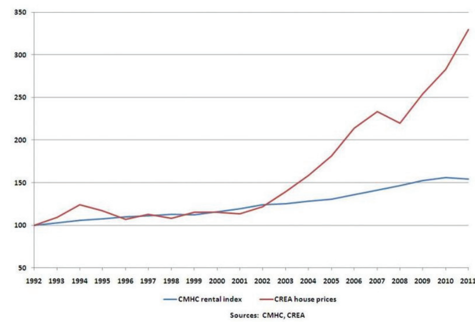


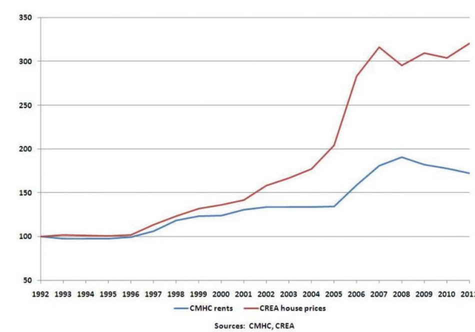
Inflation-adjusted mortgage rates
Source: FRED

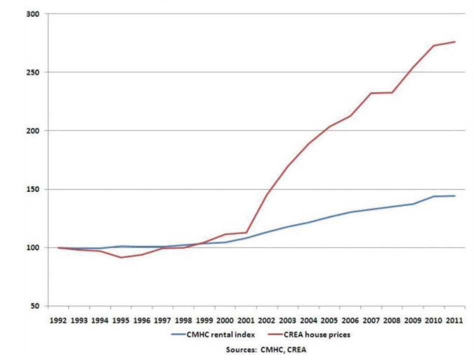
HOUSING PRICES IN RELATION TO RENTAL COSTS

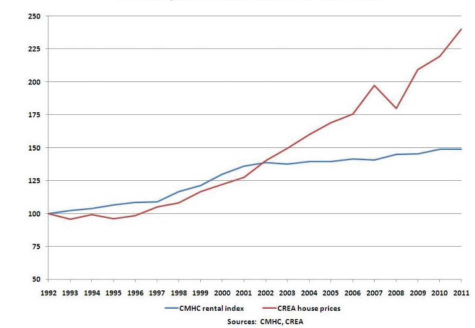
It could be expected that when house prices rise significantly beyond the cost of renting an equivalent dwelling, people would choose to rent rather than own - but that is not always the case. The drop in demand would put a downward price pressure on real estate, maintaining an equilibrium between growth in rents and growth in house prices. Home prices are typically tethered to growth in rents when analyzing trends across most of Canada and over long time periods.

When examining the growth in house prices and rents in cities across Canada this is no longer clearly seen. Using a rental index created from CMHC rental data it is possible to see how closely rents and prices track each other in most cities. However since the early 2000`s this relation has disappeared. This can be seen clearly in the regions of Vancouver, Calgary, Toronto and Montreal when comparing the CMHC rental index to CREA house prices.









Change in nominal home prices vs. the change in nominal rents since 1983
Source: http://housingbubble.jparsons.net

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Euro Pacific Canada Inc.

Toronto	**Montreal**	**Vancouver**
130 King Street West, Suite 2820	1501 Mc Gill College Avenue Suite 1450	One Bentall Centre, 505 Burrard Street,
Toronto, ON, M5X 1A9	Montréal, Québec H3A 3M8	Suite 710, Box 76, Vancouver BC V7X 1M4
416-649-4273 | 888-216-9779	514-940-5096 | 888-216-9779	778-331-5048 | 888-216-9779

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