QV UPDATE

Weekly Commentary | October 21, 2016

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De-risking our economy

The rapid rise of home prices in Canada since the financial crisis, coupled with the record high level of Canadian household indebtedness, is often cited as the biggest threat to the Canadian economy. The Bank of Canada considers both these imbalances to be the greatest source of vulnerability to our financial system. Thus far, the Canadian housing market has defied predictions of a US-style housing collapse thanks to a tightly regulated banking sector, low interest rates, strong demographic trends, and the surging housing markets in Vancouver and Toronto.

The Vancouver and Toronto housing markets are characterized by high demand, limited supply, strong employment, and rampant real estate speculation by investors looking to quickly turnover property for financial gain. Foreign buyers have also influenced prices in these markets, particularly in Vancouver.

Over the past number of years, government policy measures to mitigate the risk presented by high consumer debt did little to cool the housing markets. Those measures focused on minimizing the risk to Canadian taxpayers by restricting the availability of government mortgage insurance to homes valued under $1 million, shortening amortization periods, and increasing down payments for homes valued over $500,000. Further, in an attempt to curb the rise in property speculation in the Vancouver market, the Government of British Columbia (BC) implemented a 15.0% tax on Vancouver home purchases by non-residents in August.

While housing sales have declined in Vancouver since the advent of the foreign buyer tax, the continued high level of consumer indebtedness leaves our economy vulnerable in the event of an economic shock. In September, Canada's household debt to income ratio hit a record high of 167.6%. The proportion of insured mortgages with high loan to income ratios also continues to rise, particularly in Ontario and in BC.

With the Bank of Canada firm in their resolve to keep interest rates at extreme lows, and demographic trends supporting a rise in demand for housing, perhaps it was not a surprise when the federal government introduced even tighter mortgage rules in October. The new measures require any insured mortgage to be tested against a borrower's ability to finance a mortgage if actual rates were as high as the five year posted mortgage rates. Currently, only borrowers with less than a 20.0% down payment seeking a variable term are subject to these rules.

These new mortgage rules will make it harder for buyers to qualify for a loan, especially in Vancouver and Toronto. From the Bank of Canada's perspective, the new rules focus on changing behaviours of the borrowers by ensuring Canadians are able to meet their debt obligations when lending rates eventually rise. From a risk management perspective, they see these new rules as improving the "quality of the borrowers", by reversing the rising trend of high loan to value and loan to income mortgages over the past three years.

We are expecting the Canadian economy to be negatively impacted by these rule changes in the short term. The housing sector alone contributed close to 1.0% to real GDP growth in BC in 2015. The Bank of Canada is forecasting a 0.3% drop to Canadian GDP by 2018 due to these rule changes.

Despite the short term economic headwinds, these changes should improve Canada's economic foundation. We welcome these new mortgage rules which we hope will improve consumer debt ratios and lessen the impact to borrowers and lenders should rates rise, whether by policy changes or by market forces. Excessive home prices and debt levels are the unintended consequences of the prolonged low interest rate environment. Low interest rates push asset values higher. Lax oversight can create the environment for speculators to flourish. The accelerated use of debt to purchase exaggerated housing assets is a recipe for asset impairment, and the negative impact to our economy could be widespread. We see these changes as positive to the credit profile of our Canadian bank holdings, and investment in Canadian mortgage lender, Home Capital Group. While mortgage originations may be negatively impacted, we expect the financial health of their end customers to improve.