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A Canadian mortgage meltdown? Unlikely

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The supposedly elevated level of Canadian household debt levels relative to Americans has ignited a lot of talk about whether it is an opportune time to short Canadian banks.

Media reports suggest some U.S. hedge funds are doing just that, amid expectations of a Canadian mortgage market meltdown similar to the one in the United States in 2008-09.

Does this really make any sense?

The often-cited household debt-to-income measure saw a modest decline in the first quarter of 2015 to 163.3 per cent from the record high of 163.6 per cent at the end of 2014, while the analytically preferable debt-to-asset and debt-to-net worth ratios saw more significant declines, with each hitting seven-year lows in the first quarter. The former was down to 17.5 per cent from 17.9 per cent in each of the previous three quarters while the latter improved to 21.3 per cent from 21.9 per cent. These measures give a better indication of household solvency, given that financial obligations could be met with the disposition of assets.

What we are seeing is that debt is being used to finance asset purchases – either investing in real estate (holdings rose by $55-billion or 1.2 per cent in the first quarter) or financial assets (up $246-billion or 4.4 per cent to mark the strongest one-quarter increase on record back to 1990). These in turn are boosting overall household wealth and thus, mitigating some of the concern about the overall indebtedness of Canadian households. The balance sheet data emphasize the fact that assets are worth more than 5 1/2-times that of debt.

Indeed, the debt-to-income ratio is elevated versus its historical levels, but there are many mitigating factors, such as the strength of the asset side of the balance sheet, the fact that Canadian homeowners have substantial skin in the game, and the fact that the cost of carrying this debt touched yet another record low in the first quarter.

The debt service ratio in Canada is at its historically lowest level of 6.74 in the first quarter, nearly half the ratio in the early 1990s. We would need either a massive rate shock or a massive unemployment problem to generate a bad default experience.

Canada's unemployment rate at 6.8 per cent in May at first looks elevated relative to the unemployment rate of 5.5 per cent in the United States, but on an apples-to-apples basis, Canada's unemployment rate is 6.0 per cent which is not far above the U.S. level. Moreover, the broad R8 employment measure (that includes those marginally attached to labour force because of economic reasons) in Canada is at 10.1 per cent compared to 10.8 per cent stateside.

Meanwhile, the average weekly wage rate in Canada is accelerating. As of May, the year-over-year trend accelerated to more than three per cent, the strongest growth since October 2012.

What about the banks and supply side of the mortgage market?

The share of insured residential mortgages on Canadian banks' balance sheets currently stands at 54 per cent, more than double the share when the banks last got in trouble in the late 1980s to the early 1990s.

Canadian banks historically have a high exposure to credit card loans, but since 2011 this share out of the non-mortgage loans declined from nearly 11 per cent to roughly 8 per cent in the first quarter of 2015.

Another argument for having a bearish outlook on the performance of Canadian banks is their exposure to energy companies.

Non-mortgage loans to oil and gas industry surged 70 per cent in the last year to record high. However, the matter of fact is that the share of loans to oil and energy companies out of the non-mortgage loan book is only 1 per cent compared to 6 per cent in 1985-86.

Those hedge funds shorting Canadian banks that have a 4-per-cent yield better know what they are doing, because nothing nefarious is happening to the local real estate market until the Bank of Canada begins the process of raising rates and boosting carrying charges.

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