

# HEDGING THE CHINA FORNIA HOUSING SURPRISE

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There's a difference between the interest that housing holds for Canadians and Americans, especially when the markets in question aren't our hometowns.

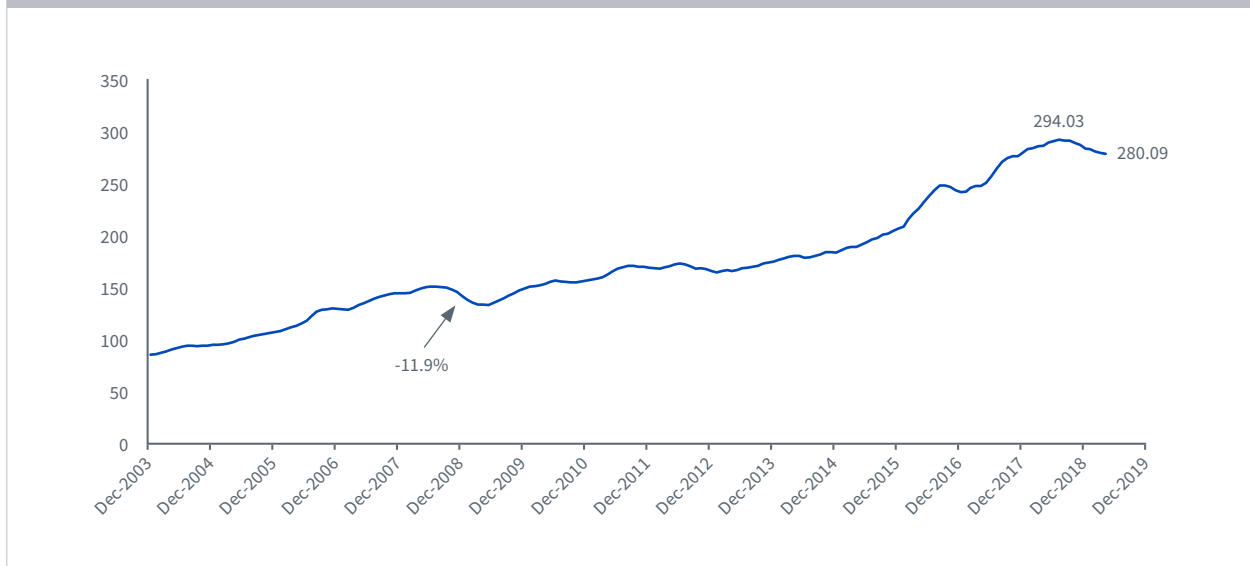
In Canada, every macro discussion comes back to Toronto and Vancouver real estate, even if you're in Halifax. But in the U.S., house prices on the other side of the country are way down the list of topics to discuss. In Canada, it's a national sport; in the U.S., not so much.

Recent news from the Real Estate Board of Greater Vancouver (REBGV) is disturbing. In April, there were just 1,829 residential property sales, down 29% from 2,579 the year before.

Initially, Vancouver's housing market was able to slog through the 15% (now 20%) tax on non-citizen/non-resident property buyers that was imposed out of concern for the priced-out middle class. A common complaint is that many foreign speculators' second homes aren't rented out; they sit vacant in the blind faith that the big gains of prior years will continue.

Eventually though, the prohibitive stamp tax was like water on the flames. It's still early days—home prices only peaked last year—but figure 1 is disconcerting.

Figure 1: Teranet-National Bank House Price Index, Vancouver



Sources: Teranet, National Bank, 4/19.

The index's decline is just 4.7% thus far. But another measure, the Canadian Real Estate Association's (CREA) MLS Home Price Index for Greater Vancouver is off 8.5% in the year to April. These small declines mask the uglier story of the tug-of-war between the sellers, who can't believe prices are actually down, and the buyers, who are now skittish.

Consider again Vancouver's 29% yearly sales fall to April. It's horrendous by any measure, but it's even worse than it looks. Back in March the REBGV was talking about the lowest number of transactions for that month since 1986; this can't be far off. Critically, around that time (in 1990), urban Vancouver had just 1.56 million people. Today, the city's number of residents is double that, meaning sales volumes at 1986 levels don't mark a slowdown—they mark a collapse.

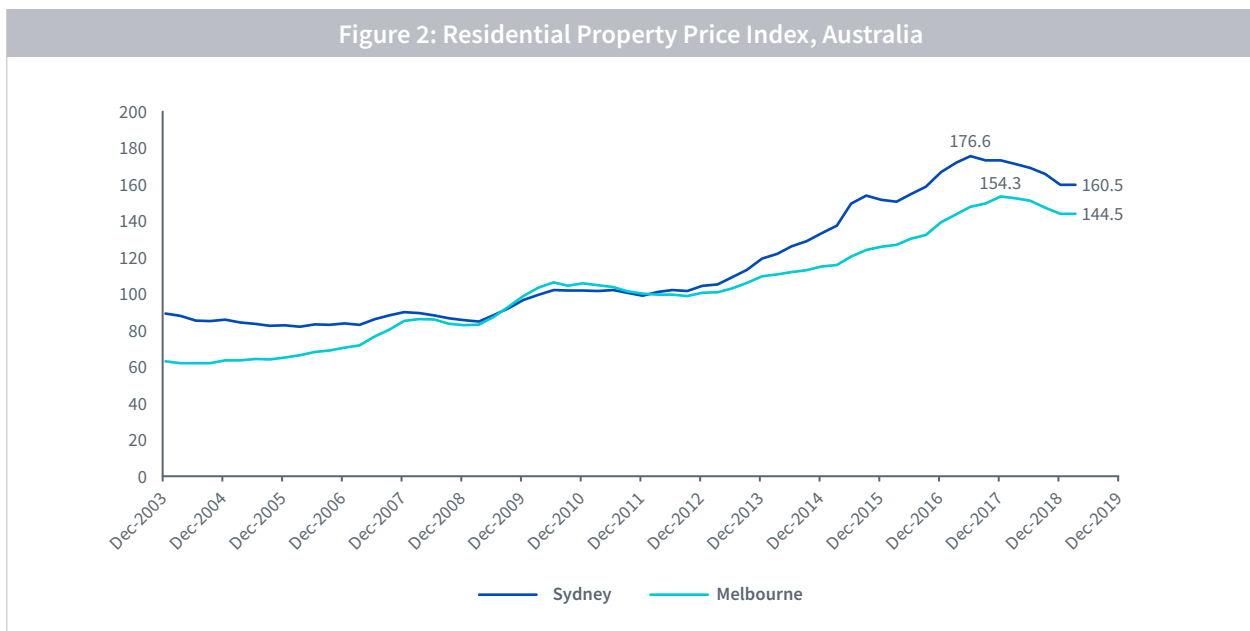
Interestingly, CREA's MLS Home Price Index for the whole country fell again in the year through April for the first time since the global financial crisis. However, Vancouver wasn't the sole driver. Prices were down in cities as distant from the Pacific Ocean as Calgary, Edmonton, Regina and Saskatoon. Out east, the news was much better: Toronto held up, while Greater Montreal was up 6.3%. With a sigh of relief, the Teranet-National Bank House Price Index for Canada is still showing 1.2% year-over-year gains.

Contrast Canadian housing weakness across half the country with the blissful normalcy of the U.S. The S&P CoreLogic Case-Shiller 20-City Composite Home Price NSA Index of U.S. home prices is still up 2.7% in the year through March and there isn't a single tough market in the whole lot; all 20 cities show gains from last year. Canadian eyes are glued to the data because so many eyes are focused on the housing saga. Not so in the U.S., where guards are down.

Follow the trail. The housing malaise started in Australia in 2017, then filtered into Vancouver by 2018. But a chunk of the U.S. West Coast doesn't realize it could be next on the list in 2019. Therein lies the opportunity: CAD bears abound in Vancouver and in Toronto, where housing fear is prevalent. What makes USD any better than CAD if Vancouver's problems trickle south? Not much. Counterintuitively, Vancouver's woes may be the reason to accumulate CAD. Sellers have already sold the loonie, but anticipators of the Chinafornia Housing Surprise are few.

## CHINAFORNIA

Chinese and Chinese-Canadians—just a small minority in British Columbia a few decades back—were the force that launched Vancouver into the stratospheric home price-to-income coterie of global money centres that includes Paris, London, Hong Kong and Singapore. Sydney and Melbourne are on that list, too. Easy come, easy go (see figure 2).

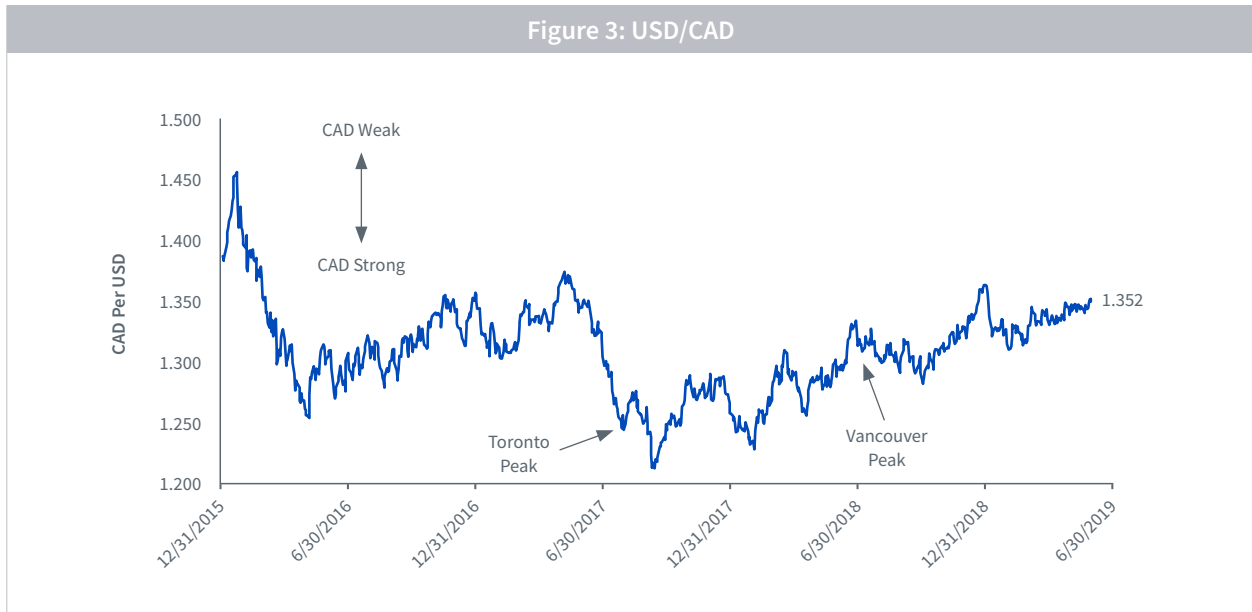


Source: Australian Bureau of Statistics. Data through 12/31/2018.

Here's the issue: if it were just Vancouver, a weak CAD thesis might play. But if the hit to Australia and Canada came from falling marginal demand from the Chinese diaspora, then get out the map, because there is no shortage of wealthy Chinese-Americans along the Pacific Coast.

Figure 3 is intriguing. CAD has been selling off since Toronto housing reached its inflection point two years ago. When it was just Vancouver and Toronto, CAD weakness continued apace. But what if San Francisco and L.A. join the scary list? Throw a wrench into California housing and you could get USD/CAD turning on a dime.

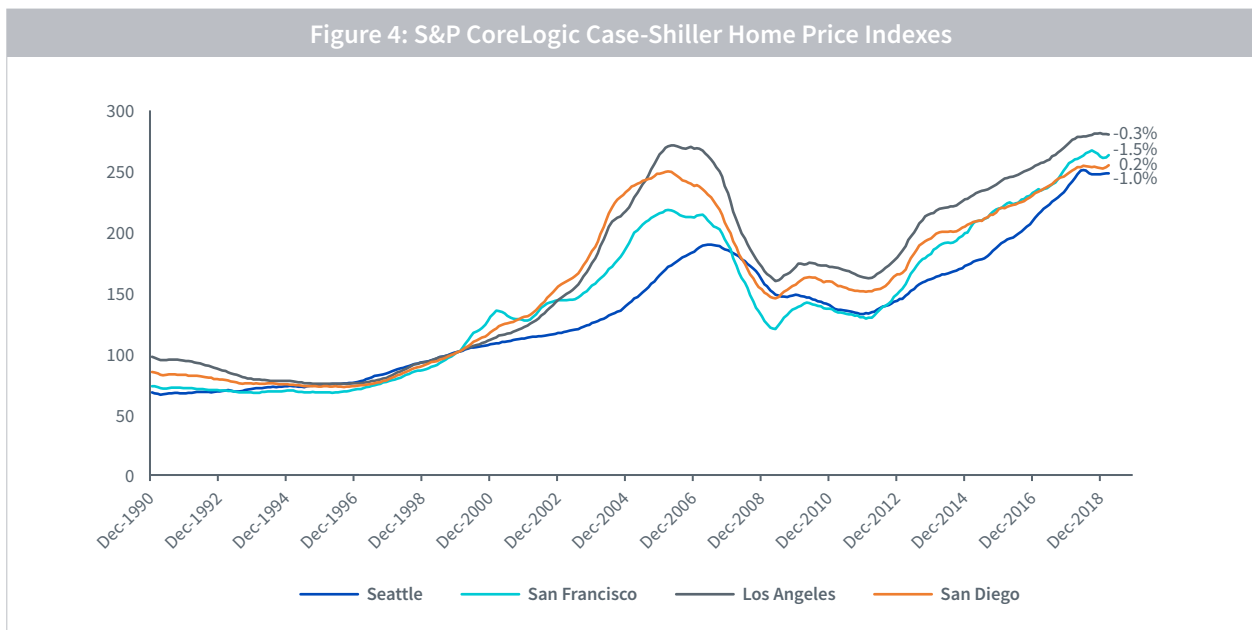
Figure 3: USD/CAD



Sources: Bloomberg, WisdomTree, 5/31/19.

It is early days, but Seattle, Washington’s tech-heavy metropolis, is posting negative year-over-year sales growth. Down the road, California (the population monster that would have the fifth-largest GDP in the world if it was a sovereign nation) looks toppy in the four metro areas in which the S&P CoreLogic Case-Shiller Home Price indexes collect numbers. Maybe it is just a blip in a generational bull trend, but figure 4 looks positively Vancouverite.

Figure 4: S&P CoreLogic Case-Shiller Home Price Indexes

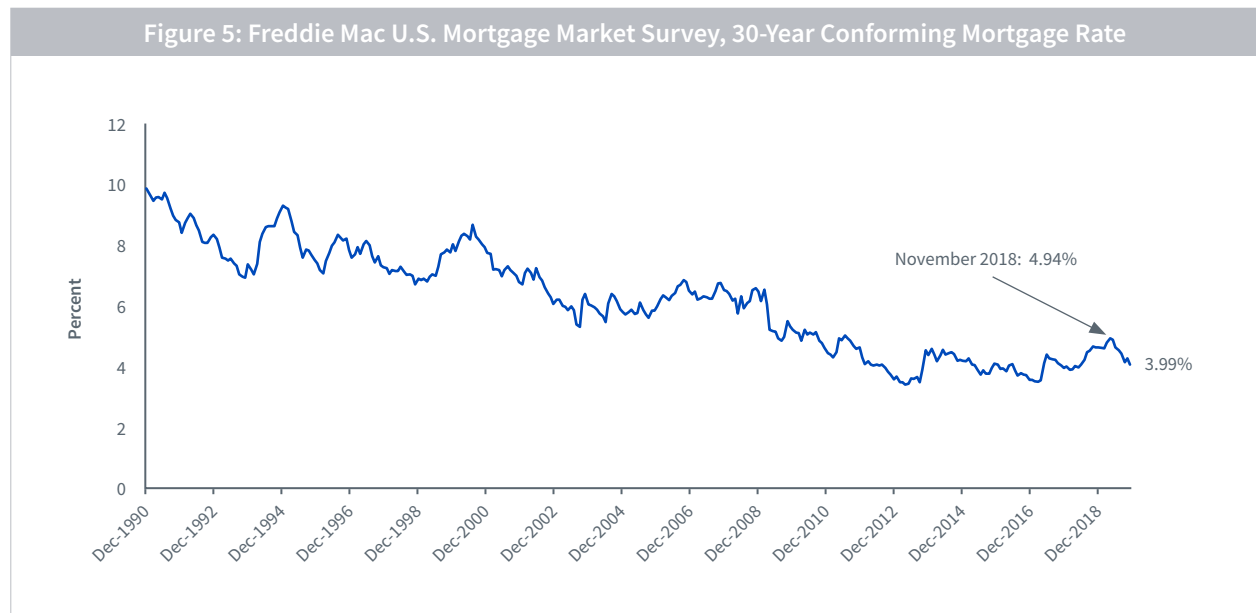


Sources: WisdomTree, CoreLogic Case-Shiller, 3/19.

If Vancouver’s sisters down the coast struggle to catch a bid by this summer, then the Chinafornia Housing Surprise is your CAD-long thesis, because there are two reasons that U.S. housing has no excuses this summer:

- + First, the S&P CoreLogic Case-Shiller Home Price indexes use three-month averages. That means the March number captures January and February. Those months were right near the high point in the 30-year conforming mortgage rate, which had typical Americans locking in 4.94% on loans up to US\$453,100 in late 2018, the highest cost of money since 2011.
- + Second, the stock market was in turmoil in in Q4, but gains have been large in 2019. No one should be surprised that housing took a breather while 401(k)s were plunging, but the springtime data has no such scapegoat.

Interest rates have declined in 2019. Rather than threatening to pierce the psychologically critical 5% level, a sub-4% conforming mortgage rate was touched in late May. (see figure 5).



Source: Freddie Mac, 5/31/19.

Now, as the clock ticks and the Q1 data rolls off, we get to the moment of truth. What will prices look like this spring, when there will no further excuses in the U.S. West Coast?

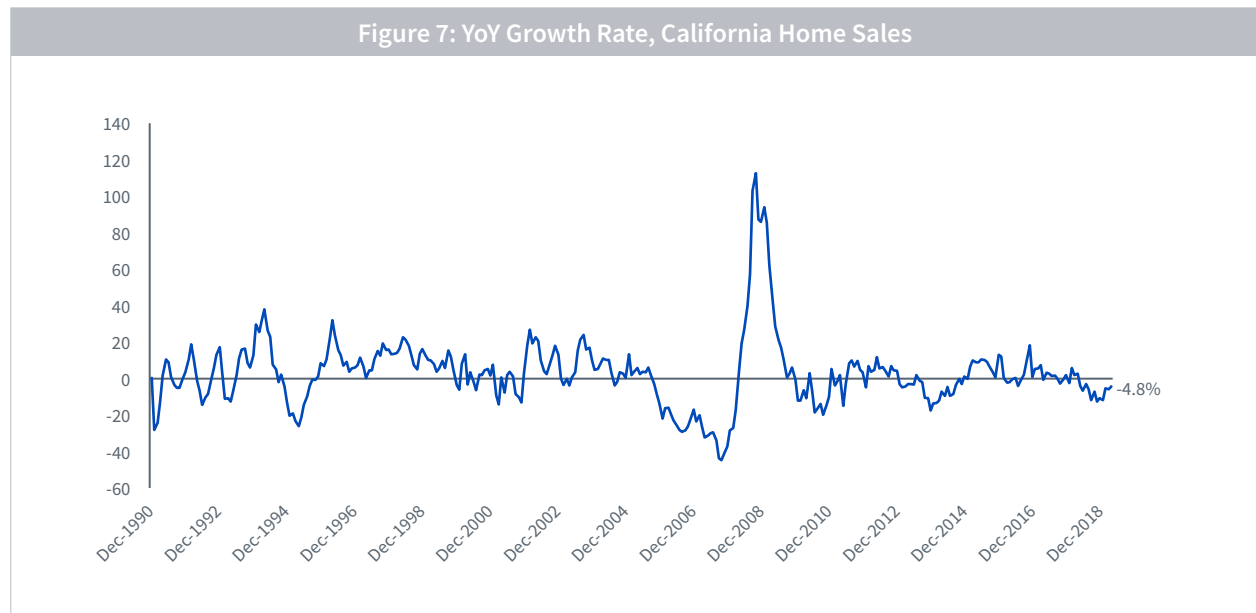
Assuming rates chop sideways from here, the summertime Case-Shiller data will need to avoid the front page of the newspaper. If prices can’t find footing with mortgage rates around 4%, there will be a large swath of Americans empathizing with their northern neighbours. While CAD has already been punished for two years, at least partly because Toronto and Vancouver were softening in a vacuum, we think USD bulls on the CAD pair are giving little credence to the Chinafornia Housing Surprise.

There is another critical factor. If the foreign buyer tax is what bit British Columbia, then the U.S. tax code changes could have a similar effect. Consider the now somewhat-faded appeal of the mortgage interest deduction, as American as Mount Rushmore. Before the 2017 tax reform, many married renters could take a US\$12,700 standard deduction. But after the tax cuts, such couples can take a US\$24,000 deduction, nearly double the amount. This change was fought tooth and nail by the National Association of Realtors because it reduces the incentive for home purchases. The couple, now able to take a much larger standard deduction while renting, is less likely to buy a home and itemize deductions that include mortgage interest. Let's keep renting, they say. Demand curve, shift.

The aging cohort who may want to sell the big family house now that the kids are grown is also incentivized to shift the supply curve. With that US\$24,000 standard deduction on the table, sticking around and servicing the mortgage to get the tax benefit from itemizing makes less sense.

At the city-by-city level, Portland has witnessed a decline in activity over the last year, though the S&P CoreLogic Case-Shiller index for that city hit a new high in March. Seattle's King County witnessed a high single-digit yearly sales fall in April, though home prices are only slightly off the highs. But California is more troubling. Its annual sales growth rate has been in the red for 12 straight months, and the softness is hitting north, south, east and west (figure 7).

Parts of the Washington-Oregon-California corridor may be on the verge of encountering the same dilemma that has gripped Vancouver: owners unwilling to wrap their minds around falling prices butting heads with buyers reluctant to pay top dollar in a soft market.



Source: California Association of Realtors, 4/19.



## HEDGING THE CHINAFORNIA SLOWDOWN

If we are right, and the housing trouble that struck Sydney, Melbourne and Vancouver is about to hit the U.S. West Coast, then CAD could surprisingly catch a bid as U.S. risk assets price in what Canadians have known for a couple years: home prices cannot go up forever.

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