Money Matters: Castle and fortress

Investors Syndicate Limited
A MEMBER COMPANY OF THE INVESTORS GROUP

By John Green

"The House of everyone is to him as his castle and fortress"

It was Sir Edward Coke, Chief Justice of England in the early 1600's who made the comment in one of his many judgments from the bench. Probably nothing has remained more constant in our estimation of financial value than our home. Most of us cannot afford a castle even if we wanted to live in one and we would have to move to Europe to find that type of real estate in any choice and variety. However, in Canada we have placed enormous emphasis on our primary residences and vacational properties as the main sources of our net worth financially. We have done so to a much greater extent than our American cousins to the south where investments in stocks and bonds forms a greater part of their net worth.

The last few years have witnessed a drop in real estate values not only in Canada but globally. We all feel the poorer for the result although it's only a paper loss from market highs until we sell our home or cottage. Even then, if we have bought in the early 80's or earlier, we still have a reasonable amount of equity though not as much as we probably would like. Real estate - like other investment areas - goes through its cycles and we are in a down one at the moment.

However, another aspect of our over changing economy needs to be considered if we persist in seeing our home as our ultimate source of financial security. We seem to be entering into period of low inflation and a such, not only do house prices not appreciate as much but generally speaking, neither do wages and salaries. Ironically, inflation has benefited property owners and those in the work force over the last two decades.

In its August housing report on the Toronto market which includes Halton Region, the Canada Mortgage and Housing Corporation has an interesting review of what will happen to house prices in a world of zero inflation. One consequence seems to be beneficial, a second is more debatable.

First time house buyers who have traditionally rented are now entering the market as buyers. They are able to do so because of the reduced cost of housing and the low interest rates. These potential buyers are finding that they can afford to purchase a modest apartment and handle the mortgage, tax and utility payments for the same or marginally more than the rent they were paying in the headier days of real estate prices. They will at least have the security of home ownership for their later years.

For the trade up market, the story may be very different. In the past inflation and higher interest rates meant fewer people could afford to buy homes but for those who could, their higher payments were usually compensated for by real growth in their housing equity. In a low inflation and low interest rate world, the opposite happens. Slow growth of income and housing equity means few can afford to trade up.

Let's look at some hard figures. In an inflationary world, let's assume that the buyers income increases by 5% per annum. After 10 years, mortgage payments which initially represented 30% of income will consume only 18% of the new higher income.

In a zero inflation world, lower interest rates mean a much more expensive home can be afforded initially on the 30% of income calculation. However, assuming that income only rises by 1% a year (real income increasing because of productivity growth), after 10 years, the percentage of income spent on the mortgage falls only marginally to 27%. It follows that trade up buyers will find it increasingly difficult to divert resources to other needs such as paying for children's education or saving for retirement.

The CMHC comments,

"Those who can foresee this in advance may conclude that they should not move up. Current expectations and financial plans have been developed based on two decades of inflation. Home buyers will have to adjust their long-term personal financial planning to meet their future needs in a low inflation world."

Clearly, this is not meant to sound the death knell on the real estate industry nor to suggest home ownership is less desirable for Canadians for a whole variety of practical and psychological reasons. Rather it is a prudent reminder to see things in perspective and to plan rather than gamble that your home and its equity will meet all your long term goals.

John Green is a Milton resident and an Account Executive with the Investors Group in Oakville. The opinions expressed in this column are of a personal nature and any general investment advice should not be acted upon without consultation with a qualified adviser. If you have any questions about financial planning matter, you may contact John at 875-0511 or 842-4630.