



The Edge Report

September 2021

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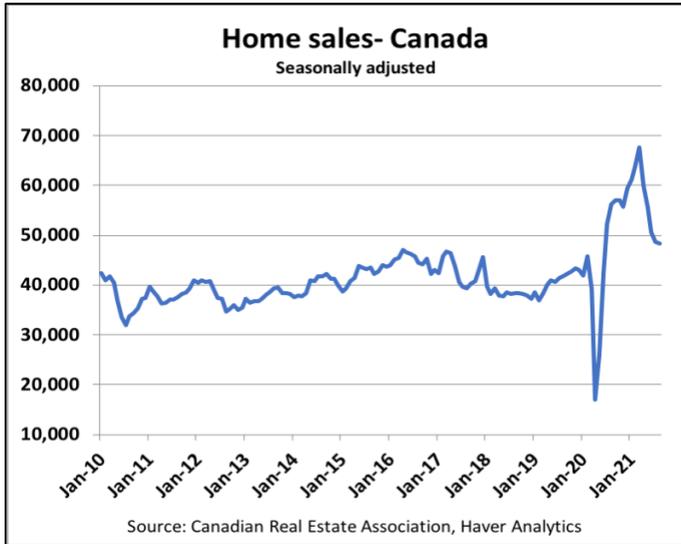
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1) National home sales update: Sales stall, resale inventory hits fresh lows

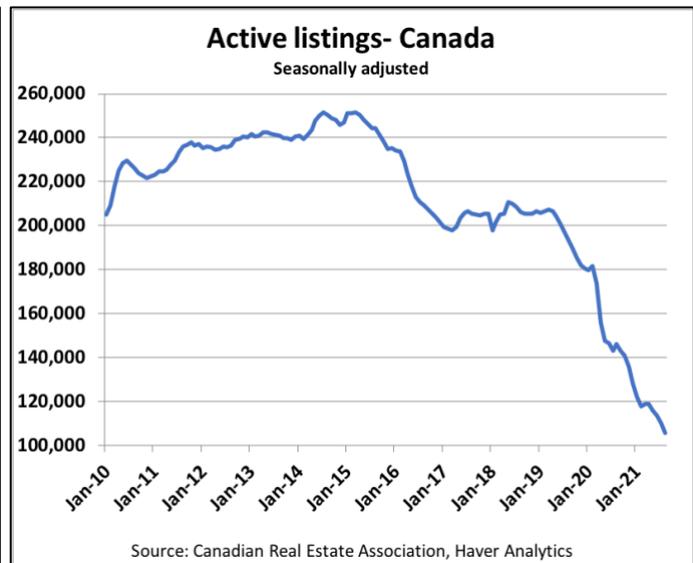
i) Sales decline but inventory falls further in August

Sales of existing homes fell 0.5% nationally in August and are now down 28.4% seasonally adjusted from the March peak. Still, it has to be said that demand is very robust compared to any point in history that is NOT Q1 2021. That period was truly insane, and what we're seeing now is still an exceptionally robust market even with the recent pullback:



Sales declines last month were concentrated in Ontario and Quebec while BC and Alberta saw sales increase 2.6% each.

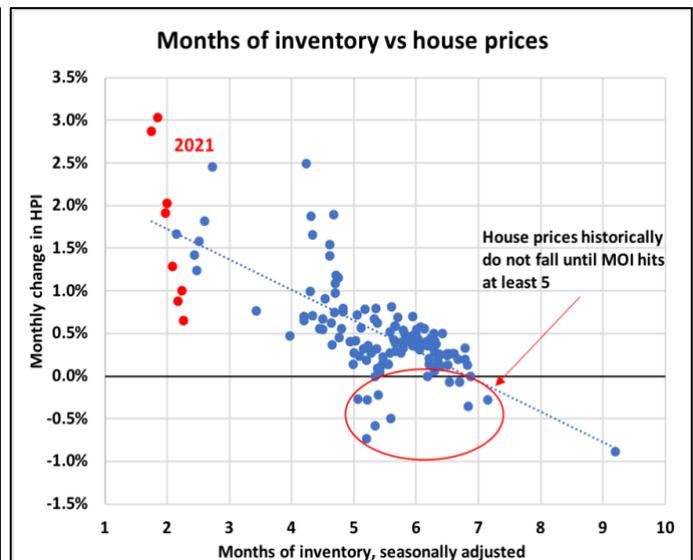
The bigger story remains the lack of available inventory. New listings coming to market did rise 1.2% m/m but were 18% below year-ago levels. **And total active inventory was down another 4.2% seasonally adjusted to hit fresh 20-year lows.** The decline in supply has been absolutely relentless, and until that changes, we have to expect prices to continue to march higher:



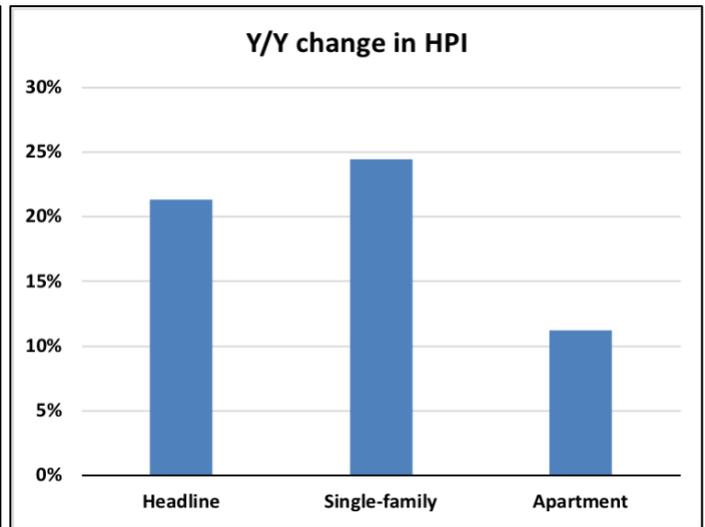
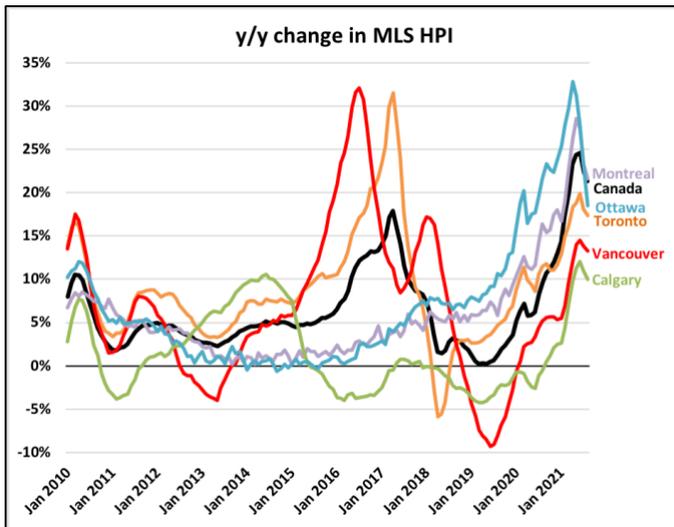
The table below shows a breakdown by province:

	Sales		New listings		Active inventory	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	-13.9%	-0.5%	-18.1%	+1.2%	-27.7%	-4.2%
BC	-8.0%	+2.6%	-22.2%	+7.3%	-37.3%	-5.4%
AB	+23.6%	+2.6%	+5.0%	-1.7%	-6.9%	-2.3%
ON	-19.2%	-1.7%	-26.4%	-2.1%	-39.2%	-7.6%
QC	-28.1%	-2.1%	-21.0%	+8.2%	-30.0%	-0.5%

Months of inventory fell to 2.2 in August. Prices don't start to soften until we hit 5, which means we need roughly 130% increase in resale inventory or something on the order of a 60% decline in sales (or some combination of the two) before we can even start discussing a landing of sorts:

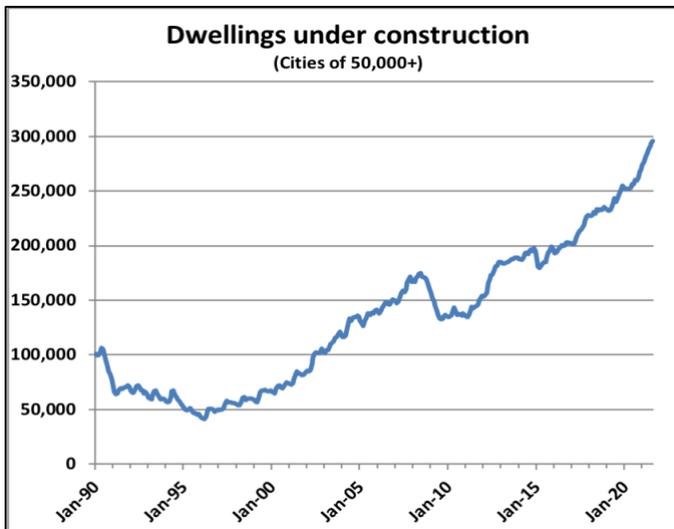


Price gains have now clearly peaked as we're starting to lap the crazy numbers from mid-2020, but the MLS HPI was up 21% y/y and up a solid 0.9% m/m seasonally adjusted last month:



ii) An exercise to highlight the incredible lack of supply

I want to drill into this a little and emphasize just how far we are from a balanced market. Consider that there are nearly 300,000 new dwellings under construction in larger metros across the country. That's by far a record, and it's easy to look at that and think that we may swing to an oversupplied market as those complete.



Take for example this morning's note from RBC Economics:

RBC Economics

Focus on Canadian Housing

Home builders are tackling Canada's housing supply shortage

- Housing starts over the past 12 months were the strongest since the mid-1970s.
- Housing completions should accelerate in the coming year.

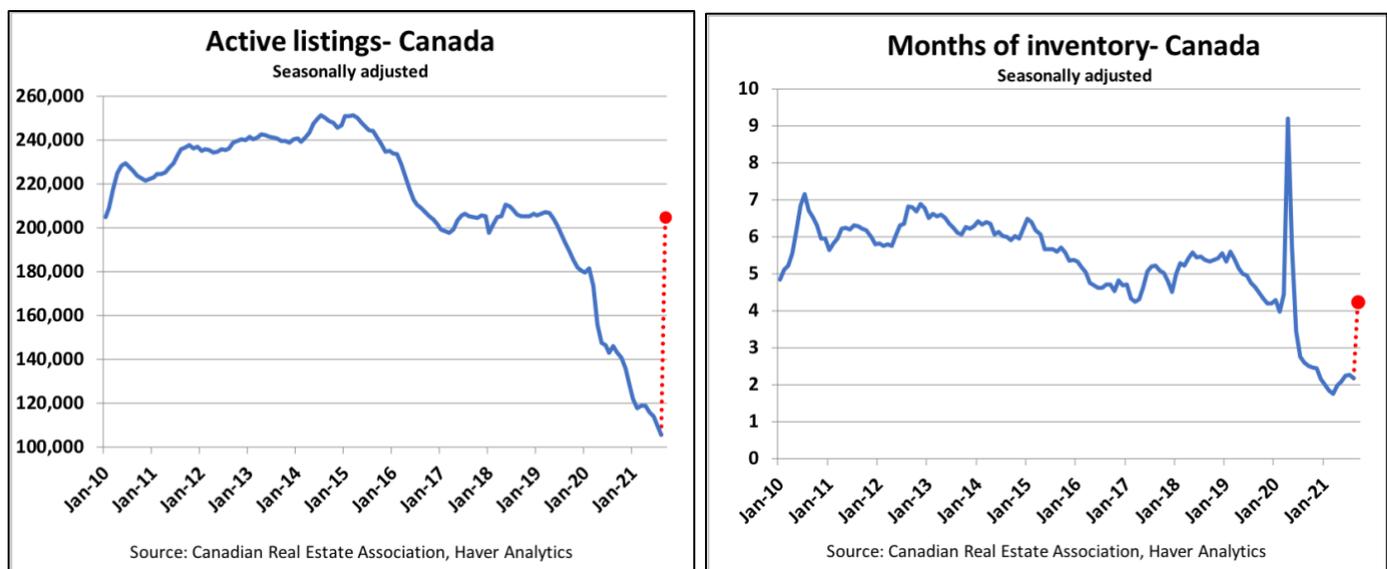
Let's play out a hypothetical that should illustrate just how far we are from actually "tackling" this supply shortage.

We'll start by removing the 97,000 rental units currently under construction since they don't represent potential resale supply of residential homes. That leaves a little under 200,000 condo and single-family homes in the construction pipeline.

Let's assume that ALL of them complete next month. Those completions would result in an increase in resale supply, but not 1-for-1. Not everyone who moves into a newly-built home has to sell an existing home. For example, some new homes will be occupied by people who are currently renting while some existing homeowners will keep their current homes as investment properties when they move into their new one.

So let's say that those 200,000 completions would result in 100,000 resale listings hitting the market. I have no idea what the exact share would be, but it's not really important for this exercise.

If we added those 100,000 new units into the existing resale supply, we would end up at a level that is still 20% below where it was just 5 years ago. Months of inventory (assuming current sales levels) would rise to barely more than 4. That's still not high enough to bring about a sustained decline in prices:

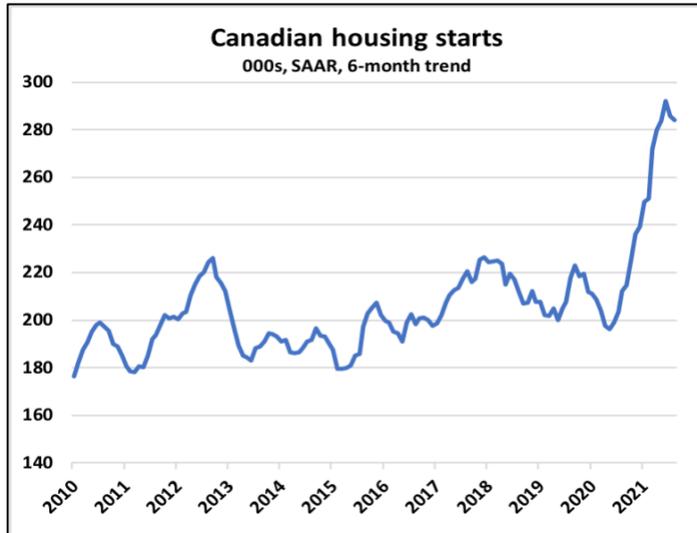


Even if all 200,000 became resale listings next month, we would see months of inventory rise to 6.3. That's high enough to bring about a softening in prices, to be sure, but 6.3 is roughly the average reading from 2010 to 2015, and the wheels didn't exactly fall off the market back then.

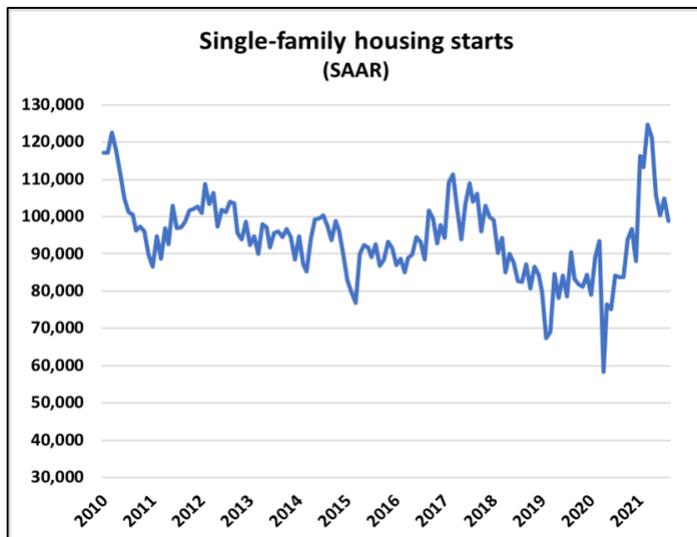
The point is, we are still so far away from anything resembling a balanced market that even the new supply in the pipeline won't move the needle meaningfully unless we see a significant pullback in sales or a sharp rise in new listings from current levels.

2) Supply/demand deep-dive: Housing starts cool, international students return

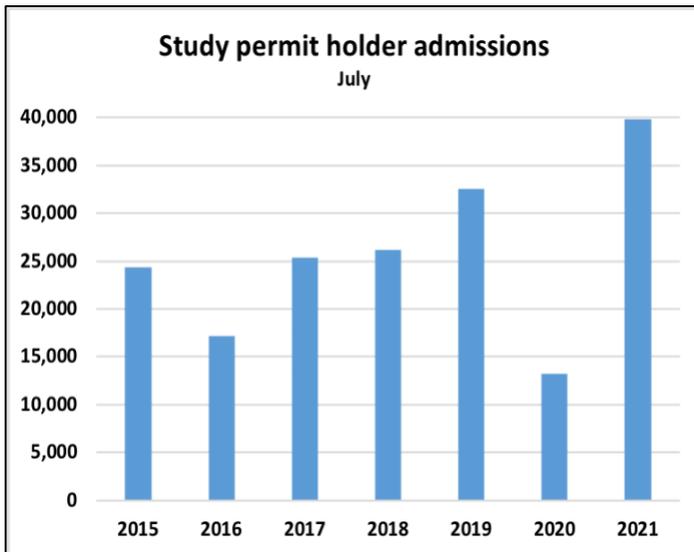
Housing starts have finally started to cool. We knew they had to since we just couldn't sustain a run rate so far in excess of household formations. Housing starts peaked at the equivalent of 333,000 annual units in March and have fallen 22% ever since, including a 3.8% monthly decline in August. Still, the 6-month trend, which helps smooth out the month-to-month wiggles, remains north of 280,000 which tells us that there's still a pile of new construction activity happening.



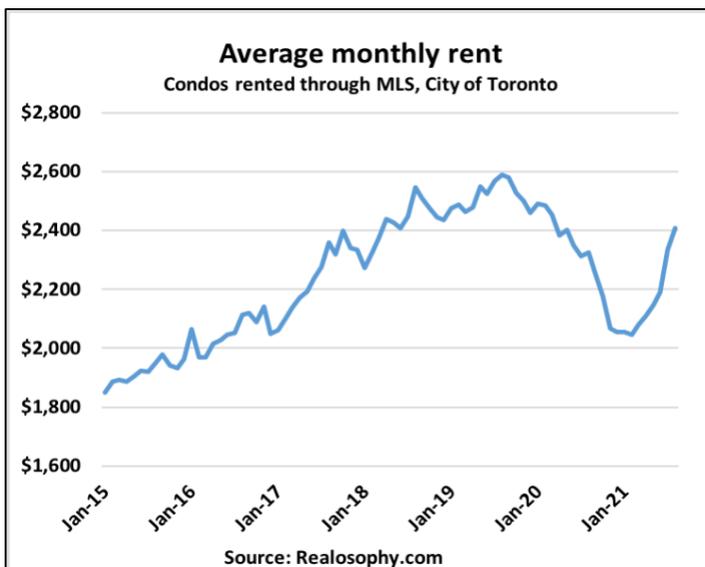
One concerning development is the sharp pullback in single-family housing starts in recent months. After hitting a high of 125,000 on an annualized basis in March, they've since pulled back to 99,000. That's not great news for this chronically under-supplied segment:



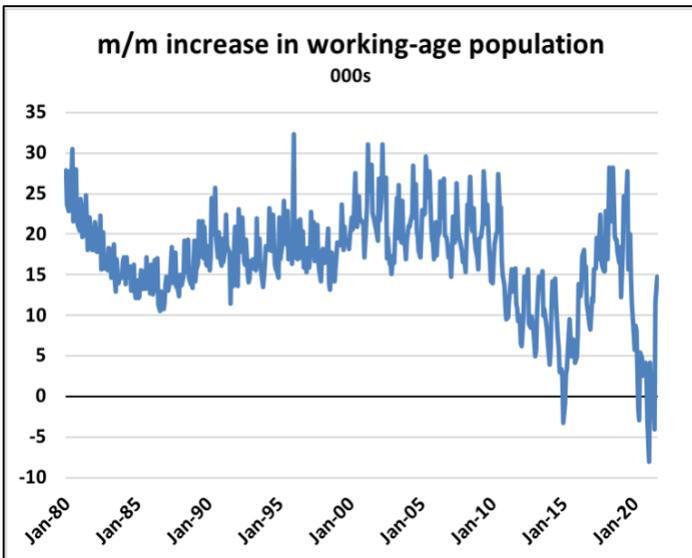
On the population front, things continue to improve. We knew already that immigration surged in July to record levels (see last month's infographics). Now we also have information on non-permanent resident admissions including study permit holders (ie international students). Admissions in July surged 200% compared to 2020 and hit the highest level on record for that month:



The return of international students has already had a pronounced effect on the rental market in places like Toronto where condo rental rates have surged 10% in the past 2 months alone! Whether that rebound can be sustained beyond the Fall will be an important signal to watch going forward.



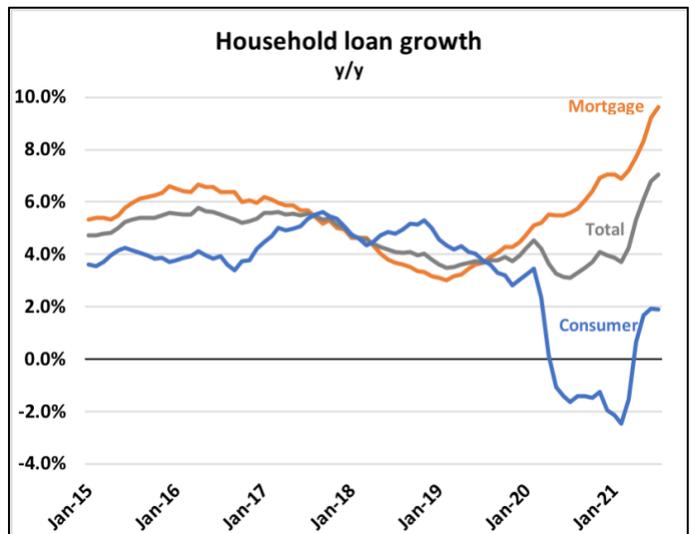
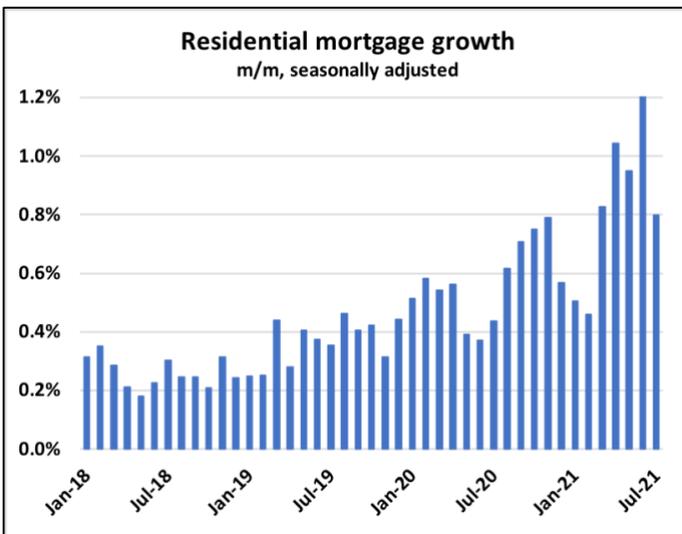
The Labour Force Survey also pointed to an ongoing recovery in population growth. The working-age population estimates suggested a solid 15k monthly increase in August, the strongest since September 2019. We're not back to pre-COVID levels yet, but it's a massive improvement from where we were just 3 months ago:



3) Household credit update: Mortgage debt continues to surge

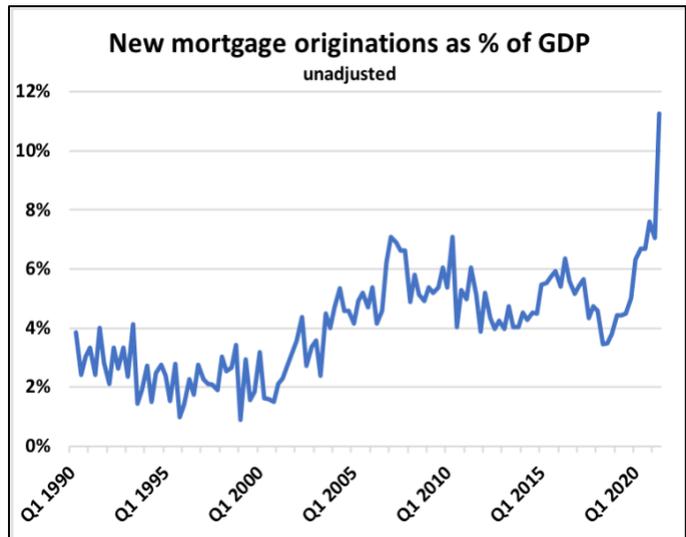
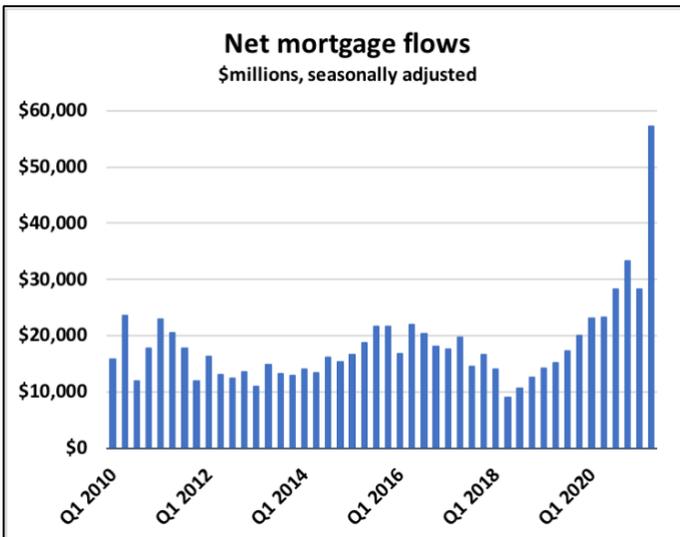
i) Mortgage growth hits 13-year high, originations nearly double previous record

Domestic residential mortgage debt jumped 0.8% m/m seasonally adjusted in July, pushing the y/y growth rate to 9.6%. You have to go back to Q3 2008 to find that level of credit growth.



The recent surge reflects record home sales from earlier this year. Most of those sales closed and would have required financing 60-90 days later....hence the spike in mortgage growth over the past couple months. We've likely peaked for the time being.

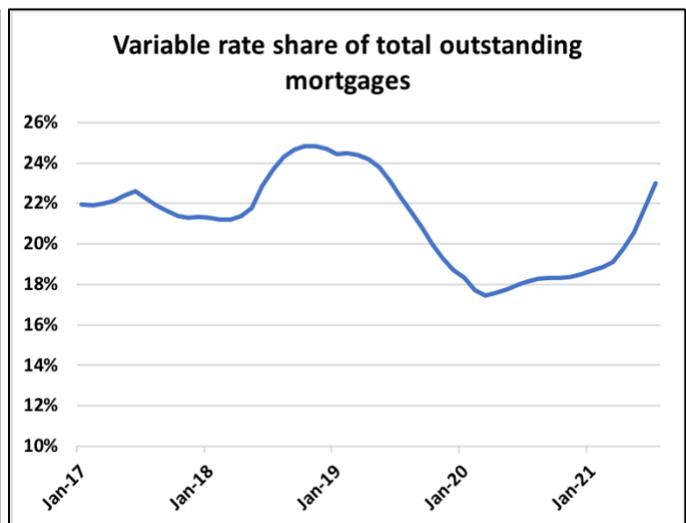
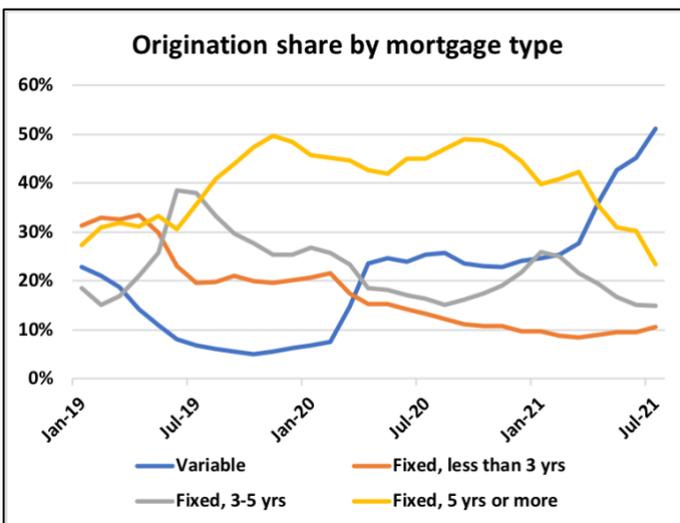
With the Q2 data now available, we can more fully appreciate the magnitude of the credit boom last quarter. The net increase in mortgage debt hit the highest on record and by nearly a factor of 2. And if we normalize to GDP, we can see the net flows were by far the highest going back over 30 years.



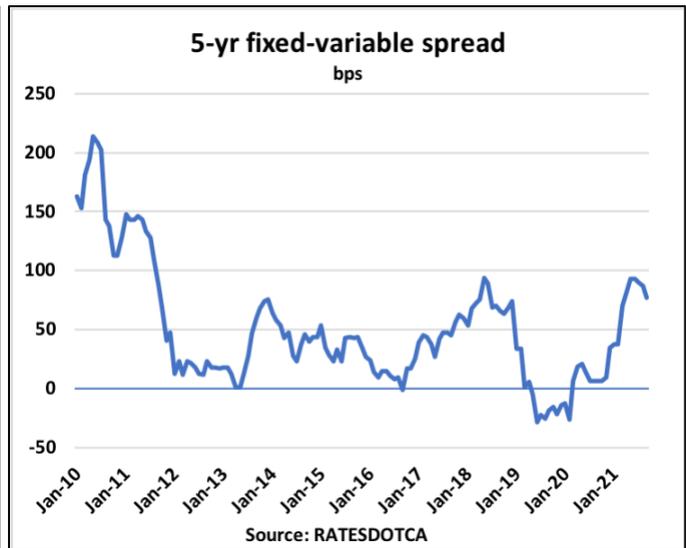
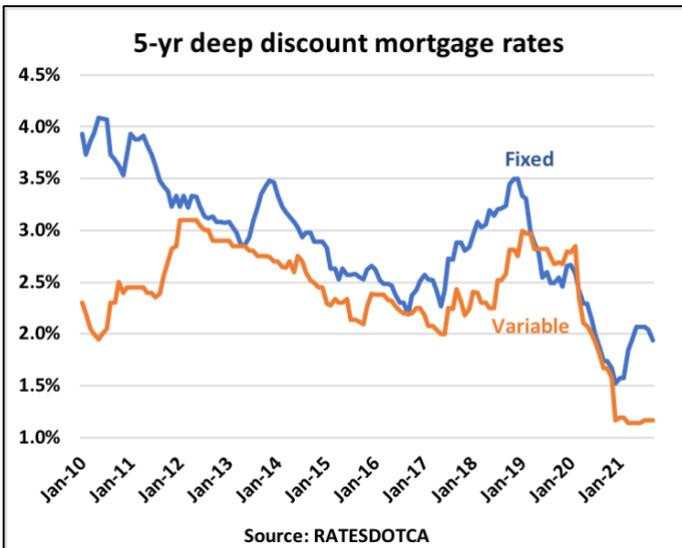
Insane!....and not the sort of thing regulators will be thrilled to see. **If there isn't a meaningful cooling through year-end, I'd expect to see OSFI follow New Zealand's lead and tighten underwriting on secondary properties and possibly explore a debt-to-income cap on new mortgages early in 2022.**

ii) Variable rate mortgages reach 50% of total new originations

Variable rate mortgage originations continue to surge and accounted for over half of all new mortgage volumes in July. But even with their recent popularity, variable rate mortgages still only account for 23% of all outstanding mortgage balances. That's up sharply from less than 18% at the start of 2020, but it's roughly in line with the long-term average:



Consumer preference for floating rate mortgages is not at all surprising given that discounted variable mortgage rates remain nearly 80bps below fixed according to our friends at RATESDOTCA:



And to be clear, I think staying variable makes a ton of sense right now. Yes, inflationary pressures are mounting, but let's keep the Bank of Canada's musings front and center. They are *strongly* signaling that they will let inflation run hotter than in the past before contemplating hiking the overnight rate. Variable rates should stay pinned here for a while:



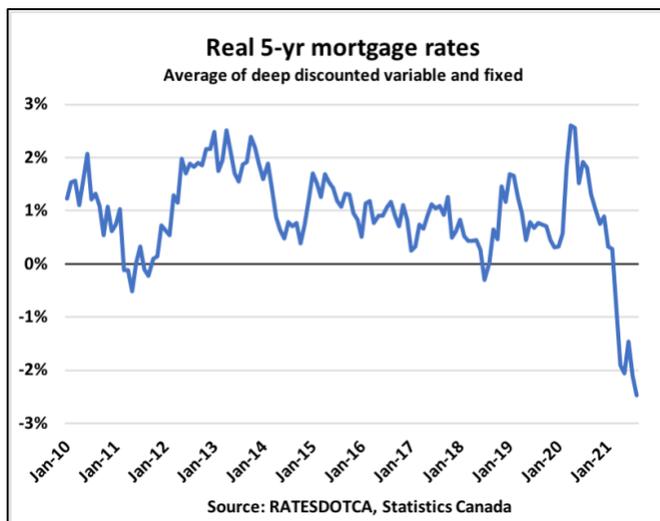
Staff Analytical Note/Note analytique du personnel — 2021-16
Last updated: July 19, 2021

Exploring the potential benefits of inflation overshooting



iii) Real rates still deeply negative

Inflation hit 4.1% in August, the highest since 2003 (more on that below). It's absolutely bonkers to think that we've got average discounted mortgage rates in the 1.6% range with inflation that high. It means that real rates (ie after subtracting inflation) are negative to the tune of 250bps, which as far as I can tell is unprecedented.



In that context, booming mortgage debt last quarter makes sense. If banks are going to make loans where they are losing money in real terms, why wouldn't consumers take them? Or said differently, taking on debt at negative real rates allows borrowers to lock in their debt levels while inflation pushes asset values (and hopefully incomes) higher.

4) Consumer check: Household balance sheets continue to improve

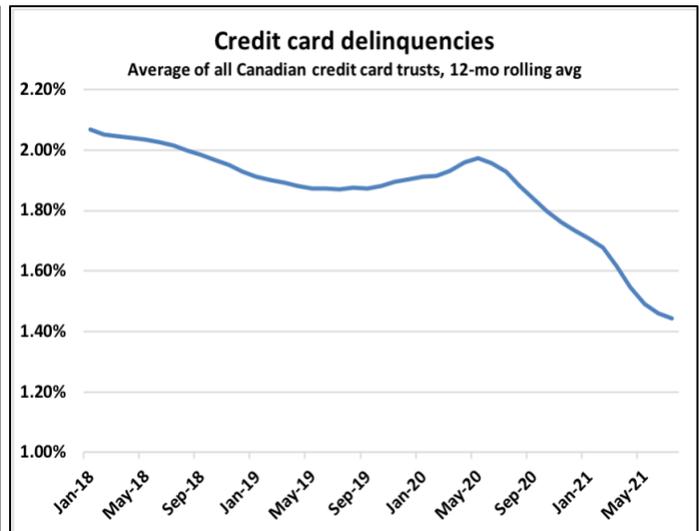
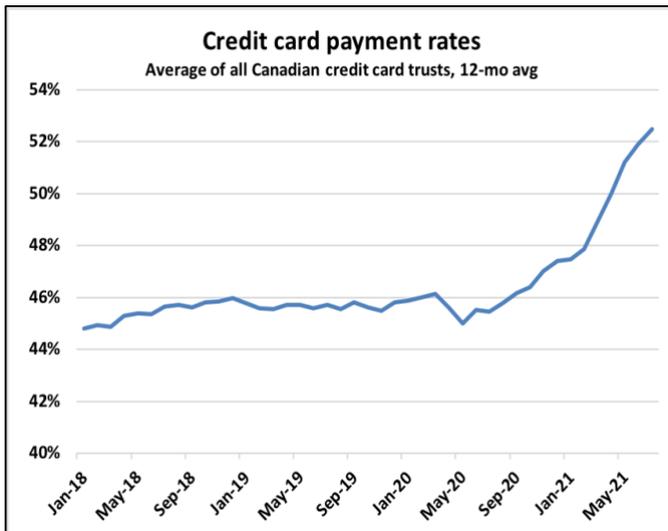
i) Insolvencies plunge, credit card delinquencies hit new lows

As a reminder, the best forward-looking indicator of household financial distress is not mortgage arrears. That data lags badly, and by the time it's released publicly, it's almost meaningless. The much better indicator is the trend in credit card trusts.

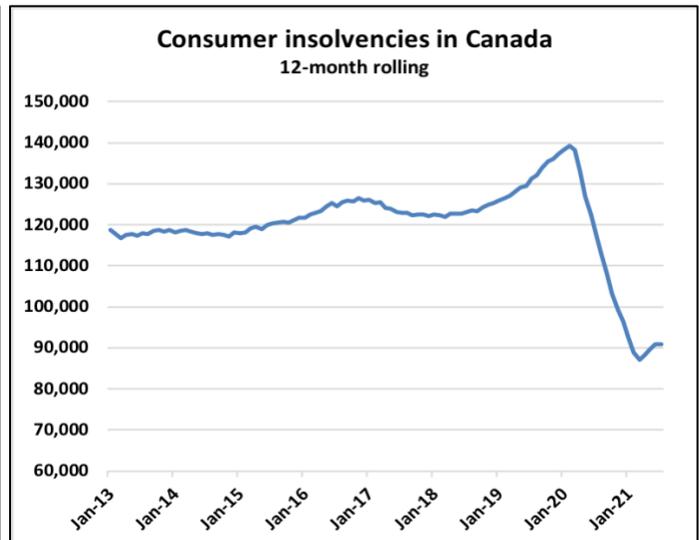
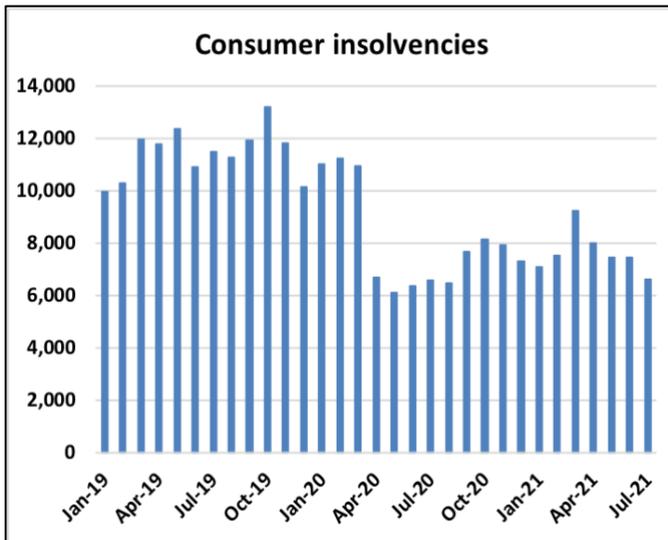
For starters, the data is FAR more timely than what we get regarding mortgages. But more importantly, very few households default on their mortgage before first missing credit card payments so it's worth looking here for any early signs of stress.

On that front, there are still absolutely no signs of any stress in these trusts. And until that changes, we just won't see any deterioration in mortgage credit.

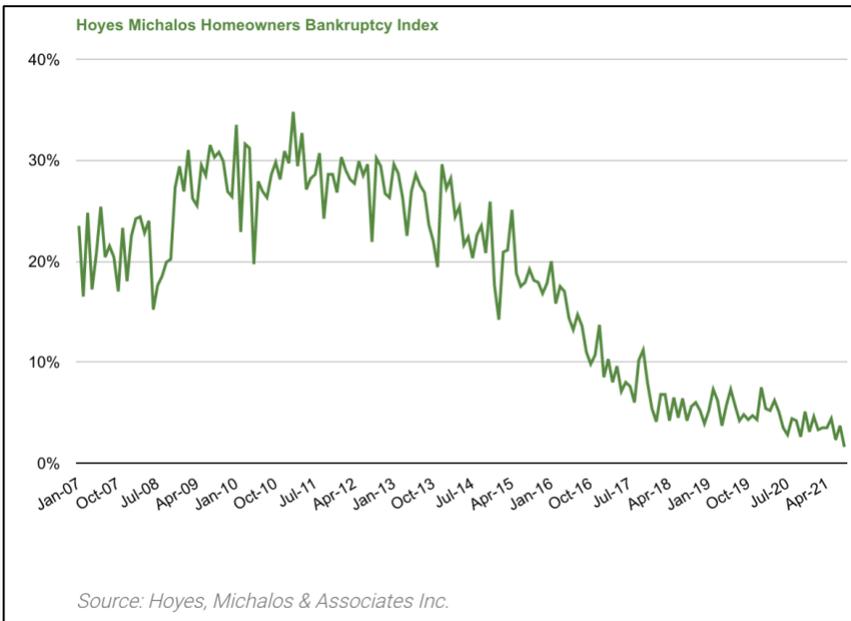
Look at what's happening with payment rates. Think of this as the share of credit card balances that are paid each month. When payment rates are high and rising, it mean households are flush with cash. And right now, it's at an unprecedented high. Related, delinquency rates, which measures the share of accounts that are over 30 days behind on payments, has fallen to a record low:



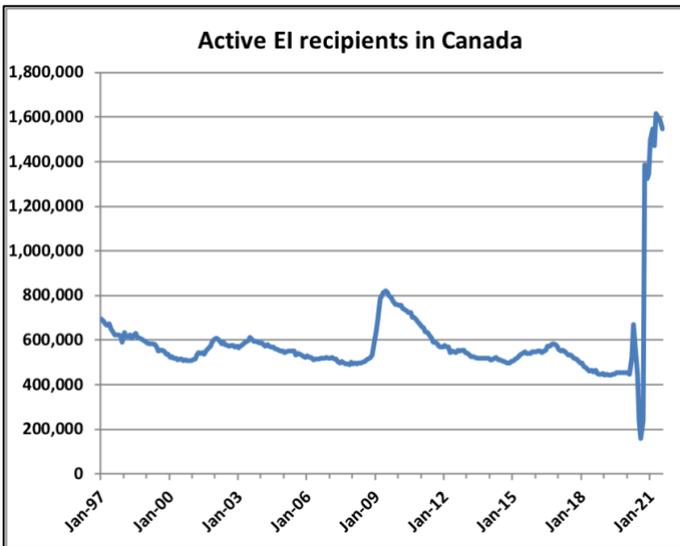
Not surprisingly, consumer insolvencies also remain near 30-year lows. Filings in July were down 43% from the same month in 2019:



In part this remains a function of the incredibly strong real estate market. The Hoyes Michalos Homeowner Bankruptcy Index, which measures the share of insolvencies filed by homeowners at their Ontario practice, hit new lows of 1.7% in July:



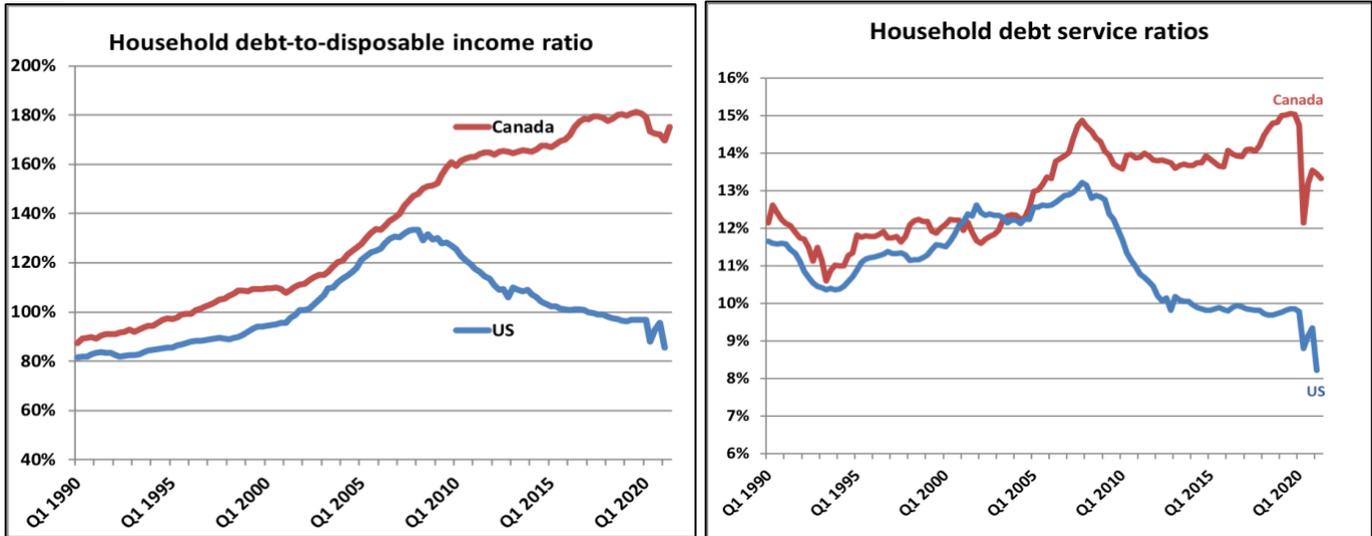
But it's also a reflection of enormous government support measures. There are still 1.55 MILLION Canadians receiving employment insurance benefits, including the new Canada Recovery Benefit. That's down almost 70,000 over the past 3 months but it still almost double the levels we saw at the peak of the Financial Crisis in 2008-2009:



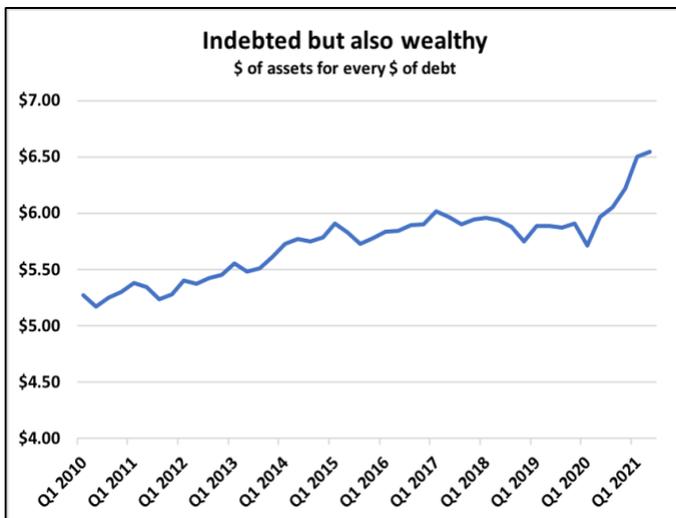
ii) Debt-to-income ratios tick up but household assets outpace debt growth

Household disposable income grew by 2.2% last quarter. Setting aside Q2 2020 when government transfers exploded, that was the single strongest quarter of disposable income growth in over a decade and the first time we've seen consecutive quarters of +2% growth since 1992.

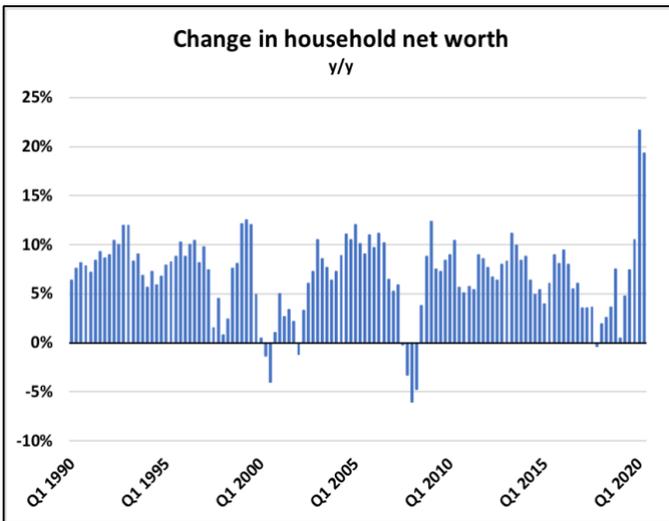
But even with that strong income growth, the widely-followed household debt-to-disposable income ratio jumped to 175% from 169% previously. What it did help was the household debt service ratio, which measures the share of disposable income needed to service all debt and is arguably a better metric of households' financial health. Rising incomes and falling interest rates pushed that ratio down to 13.3% from 13.5% previously. It remains near 15-year lows:



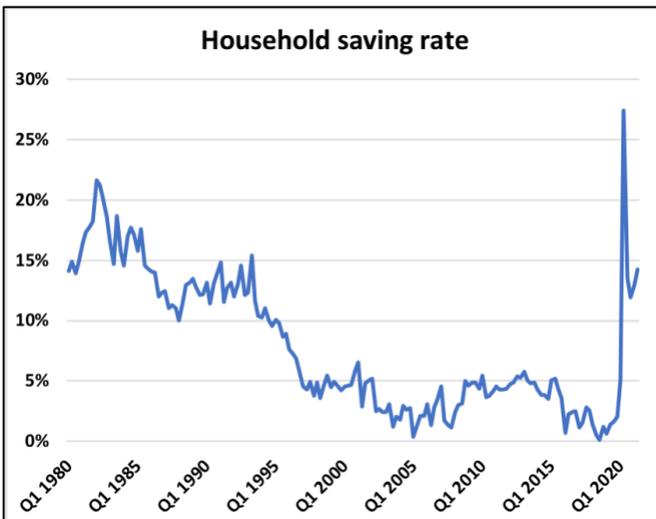
Household indebtedness gets a lot of headlines in Canada, and in some ways rightfully so. But it's also a mistake to ignore the asset side of the balance sheet. What we've seen in Canada over the past year is that the growth in household assets has well outpaced the growth in debt. In fact, households now hold over \$6.50 in assets for every dollar of debt, the highest ratio in almost 20 years:



With asset values surging, household net worth rose another 3.7% last quarter, building on the massive 6.1% increase in Q1. That puts the y/y change in net worth at a stunning +19%:

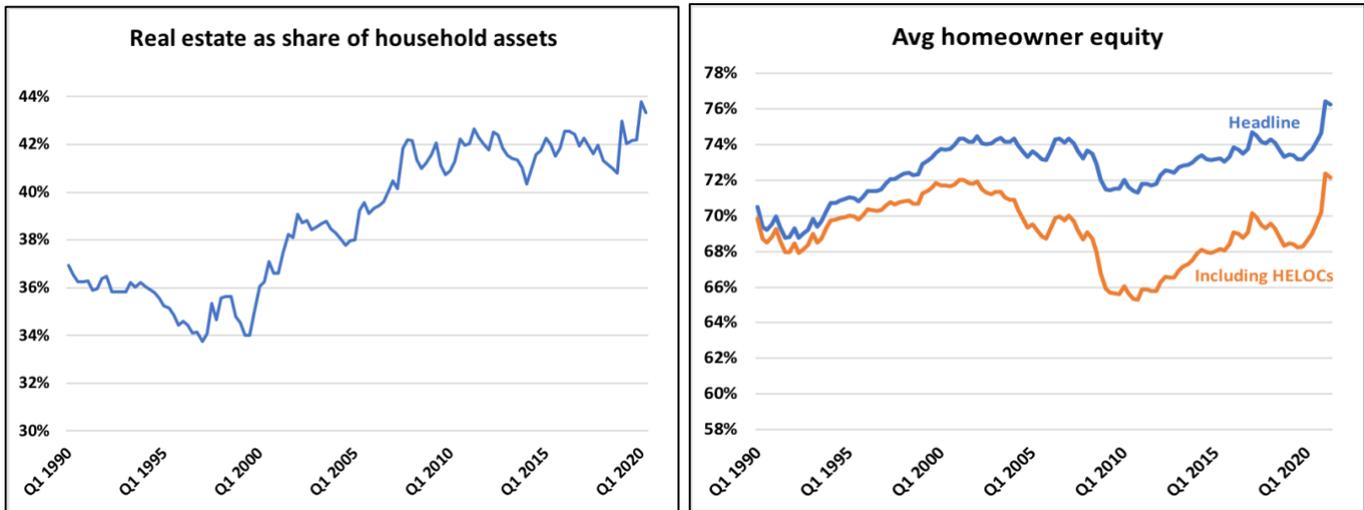


The household savings rate ticked up to nearly 15% which suggests that as long as confidence remains strong, there's plenty of room to support consumption as this rate moves down towards long-term norms and households divert savings back towards consumption.



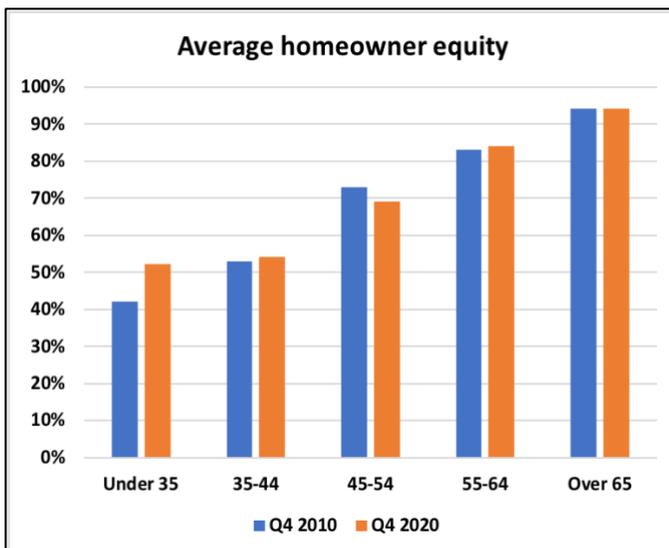
iii) Homeowner equity remains near record levels

Real estate continues to make up a record share of household assets which leaves them vulnerable to a balance sheet shock should we see any sort of price correction. But the good news is that there's a considerable buffer overall, with average equity levels of 76% and 72% once HELOCs are included:



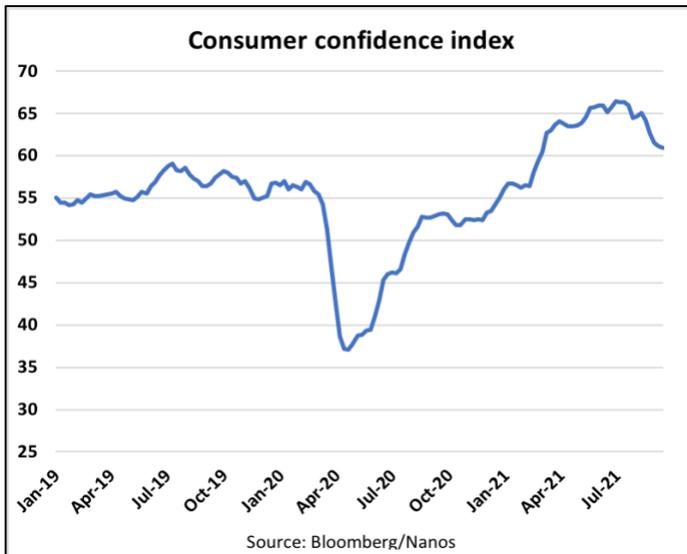
New data from Stats Canada also shows that average equity positions are increasing most sharply in the under-35 crowd. This is important since typically the households most vulnerable to a housing shock are those that have purchased most recently.

The under-35 group is the only cohort that has seen average equity levels increase meaningfully over the past decade, and there's perhaps no chart that better illustrates the effect of the "bank of mom and dad". We know from anecdotes that new buyers are getting substantial down payment assistance from family members in part to qualify under the new stress test or to bypass it altogether.

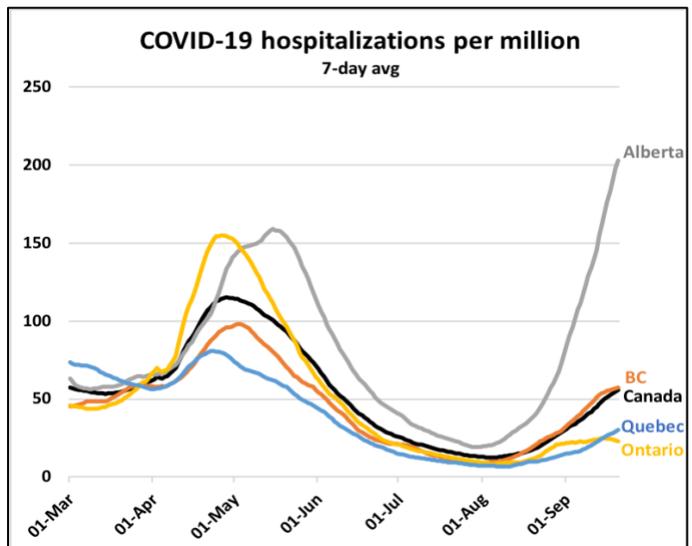
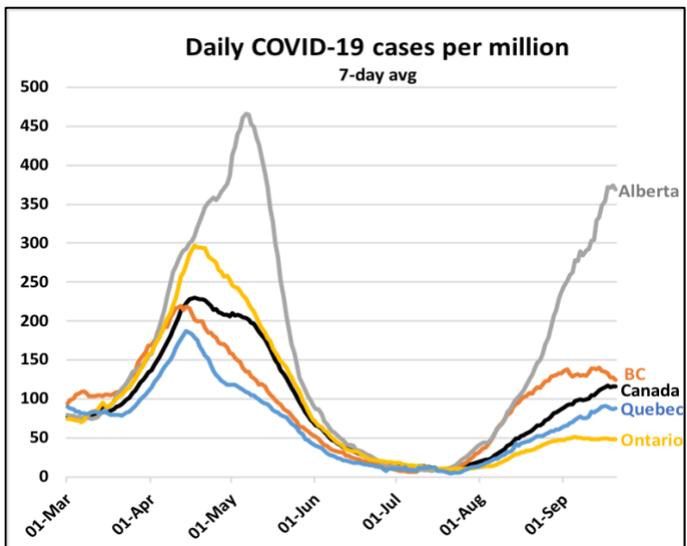


iv) Confidence slips amid Delta concerns

So much of the economy is a confidence game, and it's a bit of a concern that we now have 5 consecutive weeks of declining consumer confidence. We're still well above pre-COVID levels, but the decline is worth monitoring since it has the potential to bleed into big ticket spending like housing:



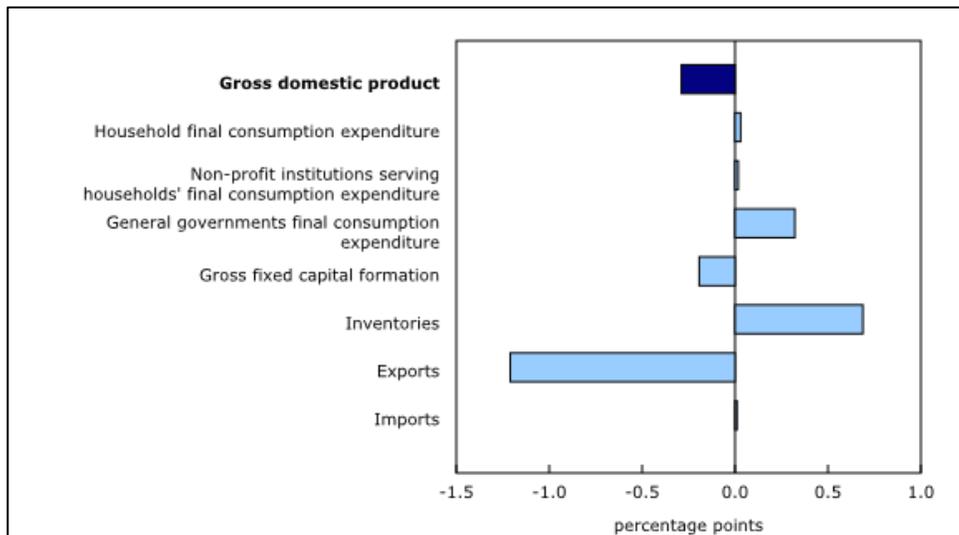
Chalk this up to concerns around the Delta variant. For now it's really a western Canada phenomenon with cases really spiking in Alberta and Saskatchewan. Daily new cases have actually rolled over in Ontario and Quebec and BC and hospitalizations are starting to flatten out:



5) Housing weighs on GDP

There was a notable softening in the macro data in the past few weeks.

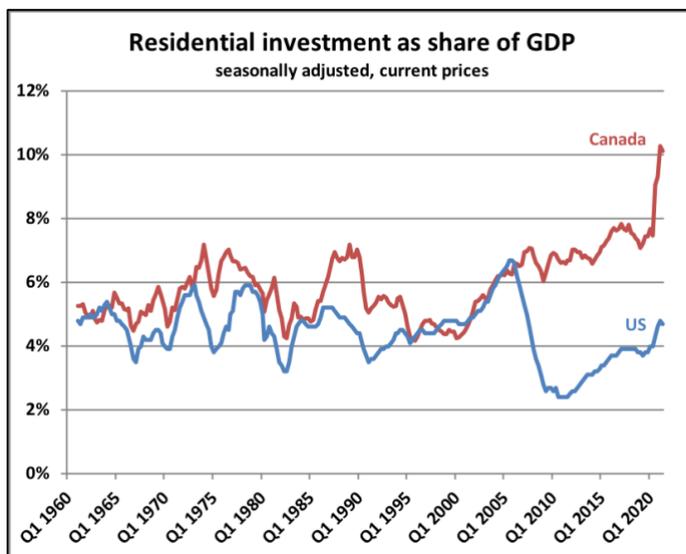
For starters, Q2 GDP was expected in the 2.5% annualized range but instead missed by a country mile and came in at a -1.1%, the first decline since lockdowns were in full swing in early 2020. Declines in gross fixed capital formation (primarily due to a slowdown in housing investment off the Q1 highs) and a steep drop in exports accounted for the miss:



Making matters worse, the handoff to Q3 was very weak with activity in July falling 0.4%.

The Q2 GDP report once again highlighted just how levered the economy has become to the real estate boom.

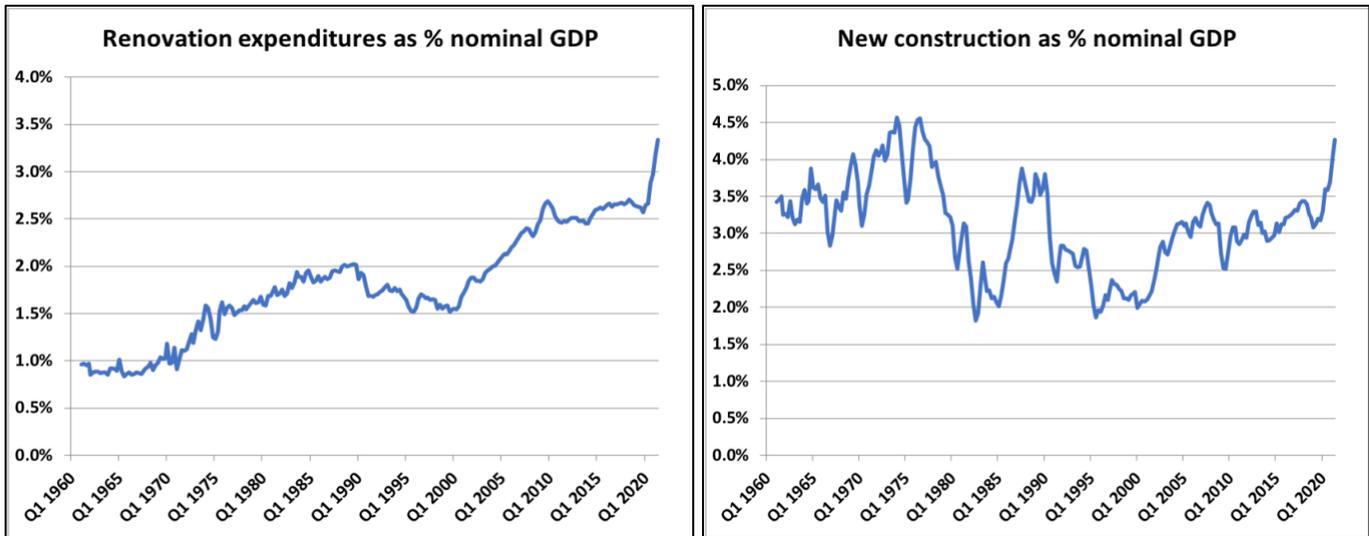
Yes, residential investment slowed slightly in the quarter, but this one component has accounted for nearly 2/3 of the increase in activity off the pandemic lows, and it's driven more than 50% of real growth over the past 4 years.



The decline in residential investment was primarily due to a pullback in ownership transfer costs, purely a function of slowing home sales off the Q1 highs.

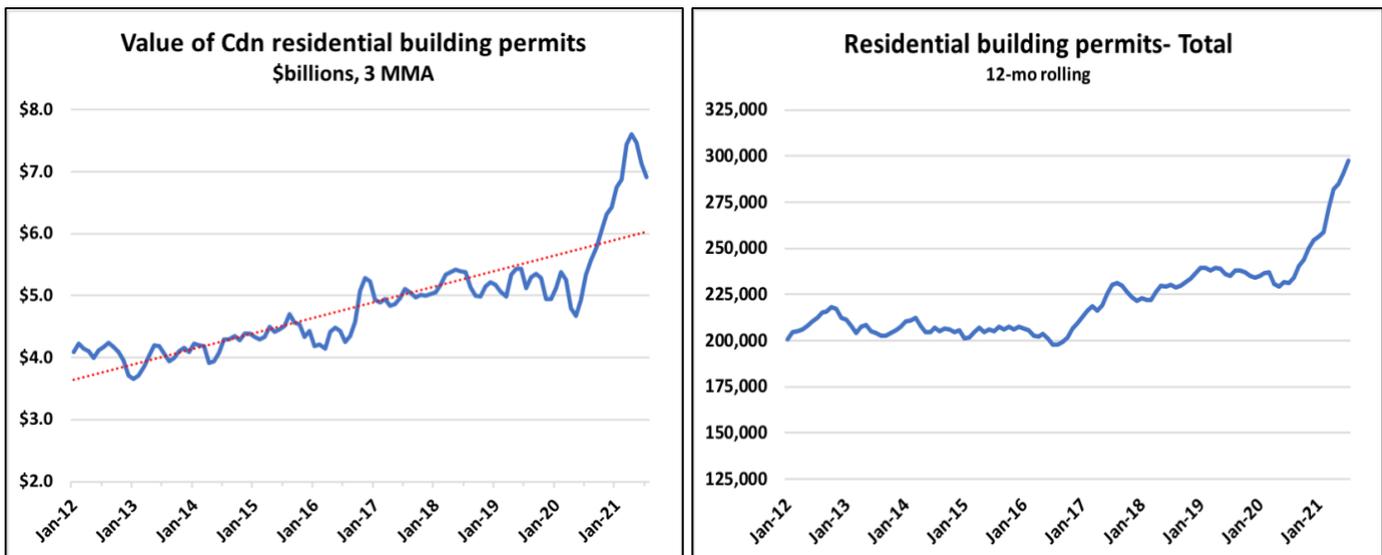
Focusing on the other two components we find that renovation expenditures continue to make new highs and now

account for almost double the long-term share of GDP while new construction is surging, and its share of GDP is now above the late 80s cycle highs and closing in on levels last seen in the 1970s:



A slowdown in housing activity, particularly construction, will weigh considerably on growth should it materialize.

Already there are some signs of a slowdown in construction activity. The value of residential building permits fell 3.1% m/m in July and there's plenty of potential downside given how far permits remain above trend both in terms of dollar value and the 12-month rolling total which is now just shy of 300,000.....a record by a wide margin:



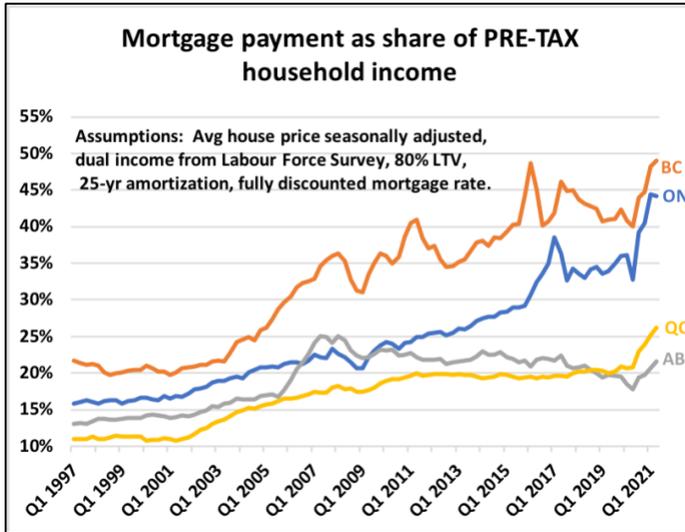
And this morning's retail sales data for July showed a 0.6% drop in sales, in large part due to a 7.3% decline in sales of building materials.

All of this highlights a point I've made repeatedly: Policy makers can talk all they want about the need to cool the housing market, but they have to tread lightly. Housing IS the economy right now, and in my opinion it's untouchable until we see other parts of the economy pick up the slack

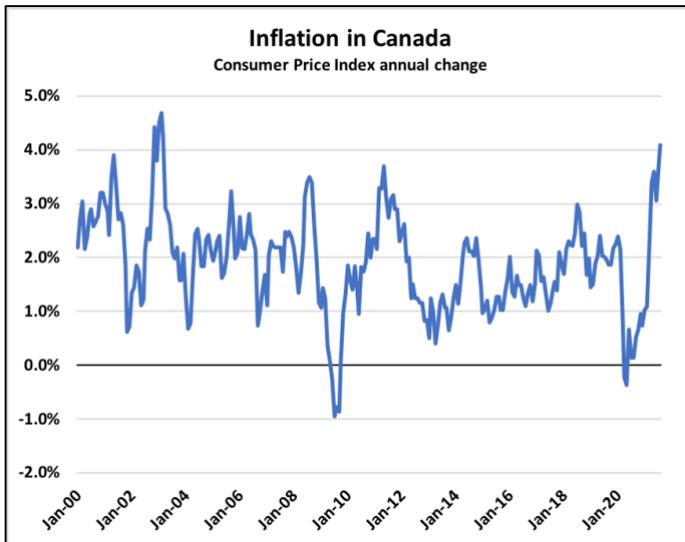
6) Inflation hits highest level since 2003

If there's one risk to housing in the near term it's a sustained rise in inflation that could push bond yields (and hence fixed mortgage rates) higher. It could also force the hand of the Bank of Canada to raise rates sooner than they may otherwise wish.

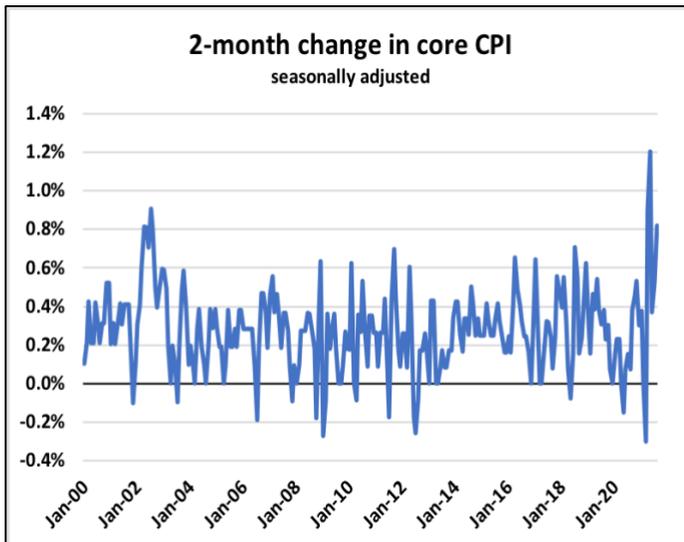
It's not a huge risk at present, but it's something to monitor, especially given how precarious the affordability situation remains:



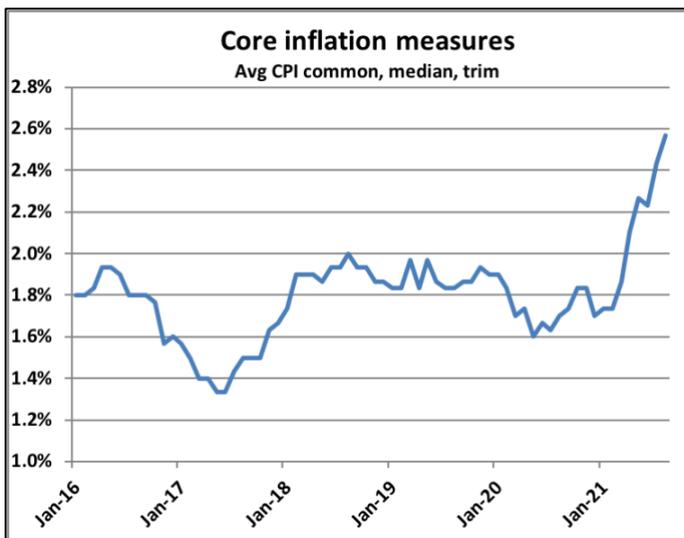
Headline inflation jumped to 4.1% y/y in August, the highest since 2003:



But more important than the comparison to last year is the monthly increase in inflation which was +0.4% seasonally adjusted in August, building on a spicy 0.6% reading in July. Even stripping out food and energy we find that the 2-month change in core CPI is running at the hottest level since 2002 if we set aside the spike in May this year:



The Bank of Canada's preferred measures of core inflation (which strips out volatile components like food and fuel) are also accelerating and are closing in on 2.6% y/y:



In normal times the Bank of Canada would have already signaled a tightening bias if not kicked off another hiking cycle, but these aren't normal times. To some extent the inflation we're seeing is a function of supply chain issues, and hiking rates in Canada does nothing to alleviate microchip shortages in Taiwan. So for now we wait and hope that this is indeed transitory.

The problem is that we've got +4% inflation and wages that are running at less than half that. That's a concern for consumer spending going forward, . But hiring intentions continue to surge. Consider:

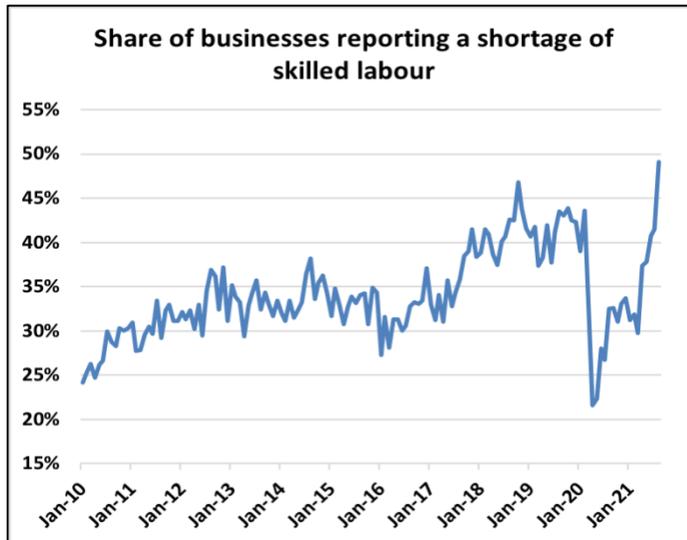
Canadian employers' hiring intentions soar to among highest in the world -*Financial Post*¹

[...] In a survey released Tuesday, ManpowerGroup asked more than 1,000 Canadian employers about their hiring intentions for the fourth quarter compared to the current quarter.

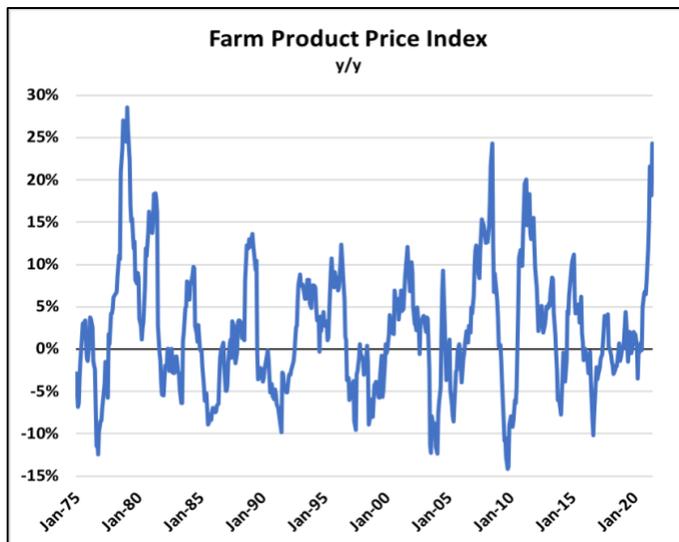
¹ https://financialpost.com/executive/executive-summary/posthaste-canadian-employers-hiring-intentions-soar-to-among-highest-in-the-world?utm_term=Autofeed&utm_medium=Social&utm_source=Twitter#Echobox=1631621209

More than 50 per cent of those surveyed said they plan to increase their staffing levels in the fourth quarter of 2021 [...] It was the strongest hiring sentiment among Canadian employers since the survey began more than four decades ago.

And with the shortage of labour already the most acute on record, it seems unlikely that this hiring binge happens without wages rising significantly from here.

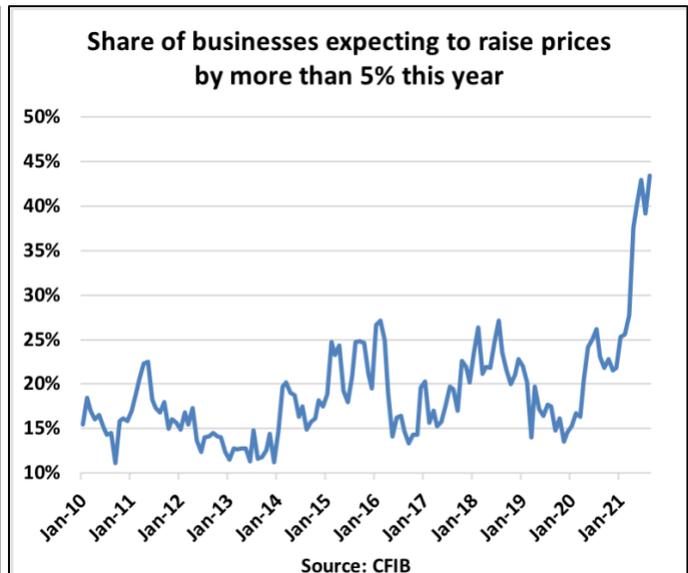
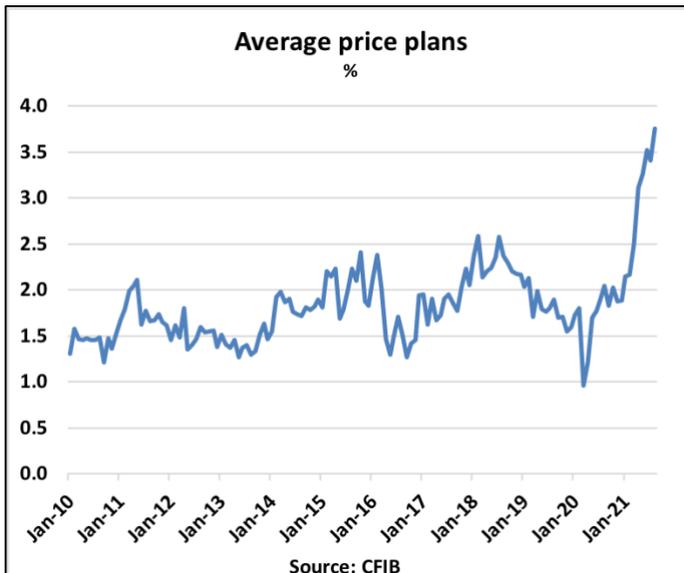


Meanwhile, food prices are set to rise further based on the Farm Product Price Index which hit 24.4% y/y in July, tied for the highest print since the 1970s:

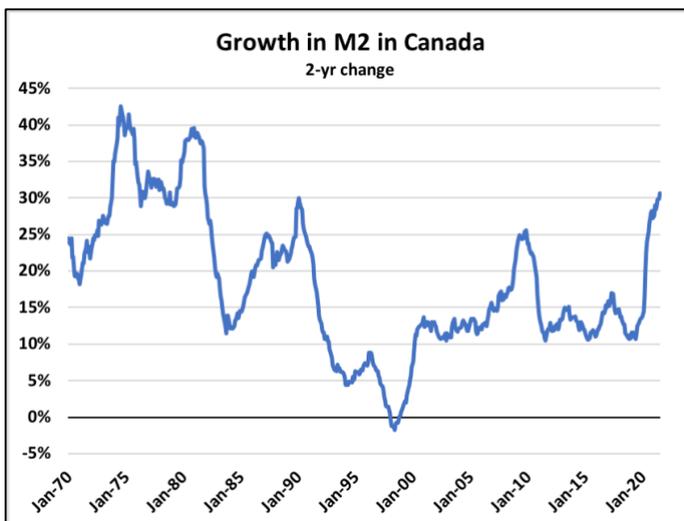


This is looking less and less transitory over time, and we haven't even started to see the wage-inflation feedback loop begin to kick in yet.

Business owners in turn are planning to pass some of this on to consumers. Overall pricing expectations hit 3.8% in August, the highest since at least 2009. A record 45% of respondents will be raising prices in excess of 5% in the next year:



Meanwhile, the money supply continues to surge. Base effects are starting to slow the headline growth figures, but it's still notable that M2 broad money supply growth was running at 11.8% y/y in June and is at a 40-yr high when we look at the 2-year change:



My base case is still that a good portion of the current inflation will indeed be transitory, but we won't be settling back to the 1.5% range we've been accustomed to. The key data point to watch as we move through the remainder of the year and into 2022 is what happens with wages. If they rise as meaningfully as I think they might, it risks kicking off a wage-price spiral that would cause more durable inflationary pressures.

7) A look at the Liberal election promises: Workable vs window-dressing

With the election behind us, we can look at the Liberal housing platform and break out some of the promises into a couple buckets. Let's call these "could move the needle", "window dressing", and "need more details":

<p>Could actually move the needle:</p> <ul style="list-style-type: none"> • \$4B housing accelerator fund • Move forward with a publicly accessible beneficial ownership registry • Strengthen federal oversight of the housing market by establishing the Canada Financial Crimes Agency 	<p>Comments:</p> <ul style="list-style-type: none"> • The sleeper in the Liberal housing platform, this new fund will attach a cash “bonus” of sorts that is aimed at incentivizing municipalities to exceed their housing delivery targets. The details have yet to be released, but anything that empowers municipalities to give the middle finger to the NIMBY crowd is a good thing. • To the extent that elicit capital is finding its way into Canada, this is the #1 tool for disincentivizing it. The idea here is that currently non-resident buyers can own through a numbered company that obscured the actual ownership. This would clarify it. And if you’re, say, a wealthy Chinese businessperson who got rich through some form of corruption and wants to remain outside of the purview of Beijing, this is a scary proposition. • We’ll need to see details here, but anything that funds more oversight of Canada’s exceptionally porous anti-money laundering framework is a good thing in my books.
<p>Almost certainly window-dressing:</p> <ul style="list-style-type: none"> • Ban blind bidding and disclose all participants in a transaction • Anti-flipping tax on residential properties, requiring properties to be held for at least 12 months • Ban new foreign ownership of Canadian houses for the next two years 	<p>Comments:</p> <ul style="list-style-type: none"> • See Australia where most homes are sold in a literal public auction yet prices are still just as insane. It’s not terrible policy, it’s just not the sort of thing that fundamentally changes housing market dynamics. • If they want to target speculators, fine. But remember that speculators are attracted to assets that are perceived as being scarce. The way to deal with speculators is to create more supply, plain and simple. • This is window dressing until the beneficial ownership registry is live since foreign buyers can simply purchase through a numbered company as is the current practice.
<p>Need more details:</p> <ul style="list-style-type: none"> • \$1 billion in loans and grants to develop and scale up rent-to-own projects 	<p>Comments:</p> <ul style="list-style-type: none"> • It’s not clear how they will roll this out and try to incentivize developers to take this on. Sounds like a logistical nightmare.

- Ensure banks and lenders offer mortgage deferrals for up to 6 months

- This one could actually be very interesting. We'll need to see more details around qualification requirements. The mortgage deferral program was exceptionally successful during the pandemic. It created breathing room for borrowers without incurring additional costs for lenders. It will absolutely become a recurring tool in the government's arsenal in future economic crises.

Regards,
Ben