



The Edge Report

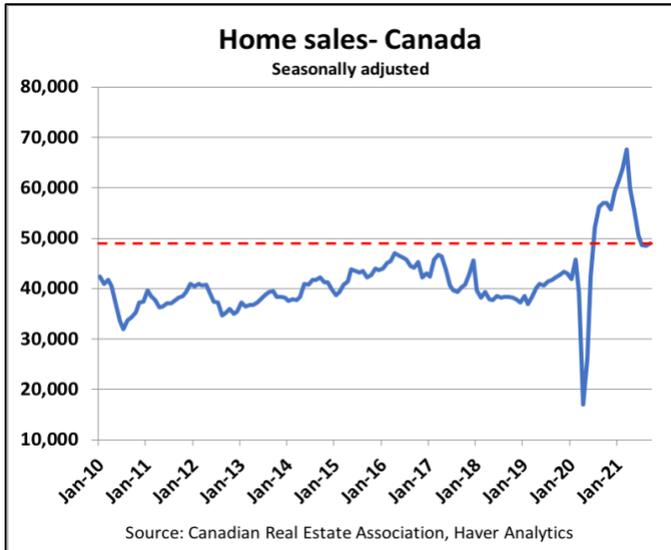
October 2021

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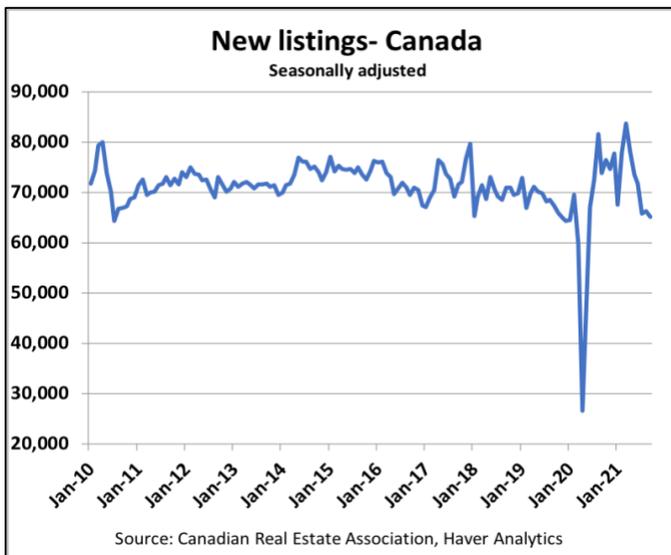
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1) National home sales update: Market reaccelerating again

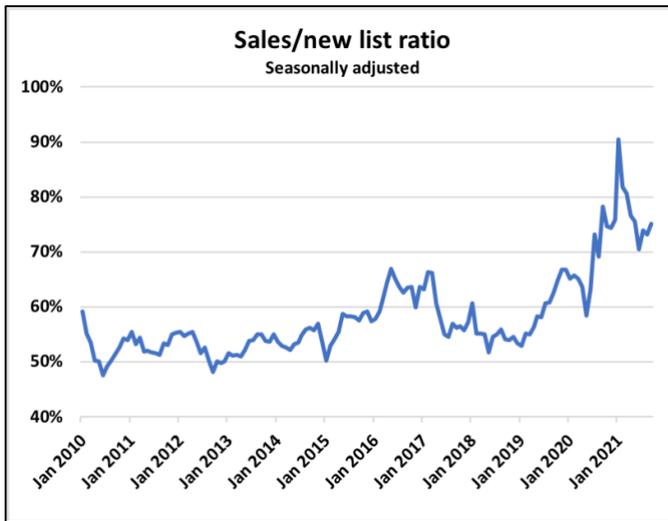
The housing market across the country is picking up steam again. Home sales in September rose 0.9% m/m nationally, the first increase since March. Notwithstanding the period from late '20 to early '21, sales are still hovering at what would be record levels:



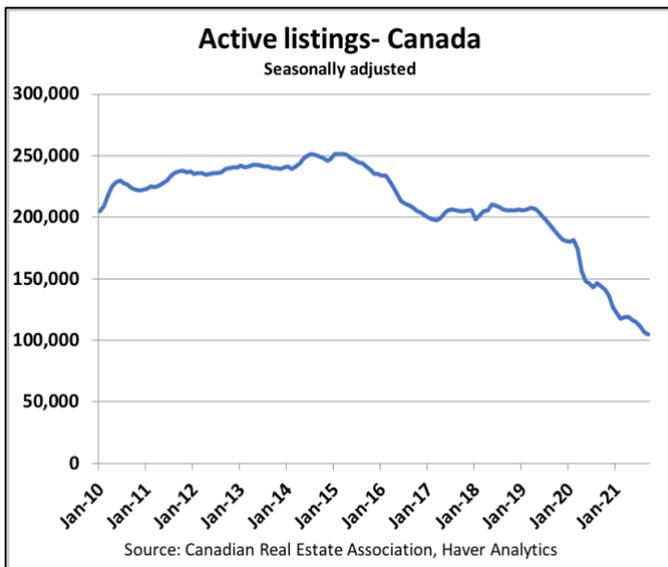
New listings were down another 1.6% m/m to just 65k seasonally adjusted in September, the lowest since May 2020. That compares to the 10-yr average of over 71k. We keep waiting for the post-COVID supply surge and it's just not coming yet.



With sales up and new listings slowing, the sales-to-new listings ratio jumped to 75%, way above the ~50% threshold that generally indicates a well-balanced market:



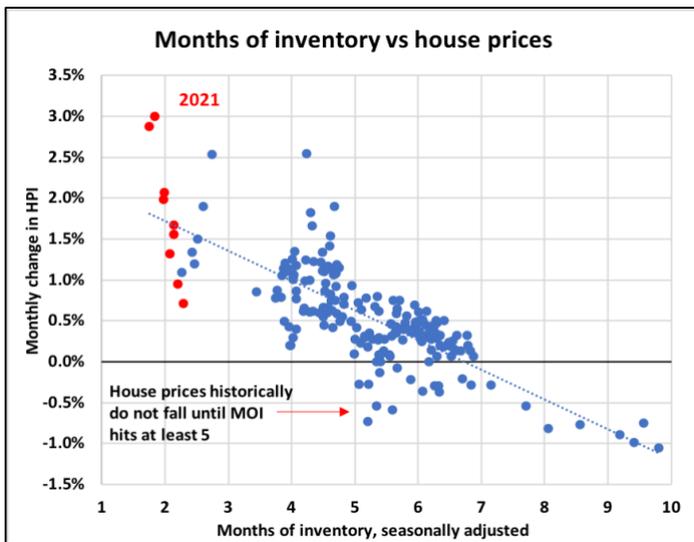
This is an exceptionally tight market, and we can see that in the relentless decline in active listings which fell another 1.9% m/m to fresh 20-year lows:



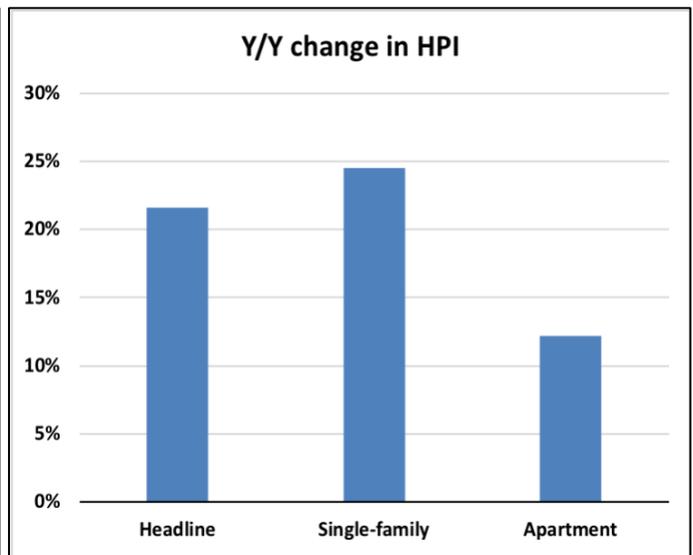
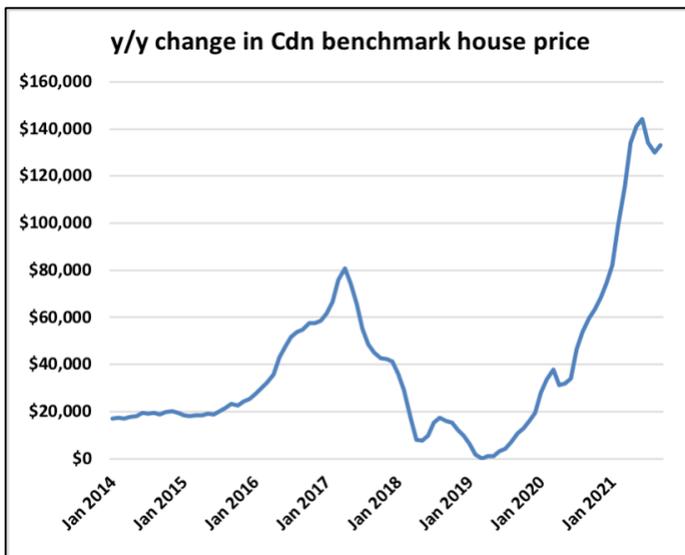
The table below shows a breakdown of key metrics by province:

	Sales		New listings		Active inventory	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	-14.2%	+0.9%	-11.7%	-1.6%	-27.0%	-1.9%
BC	-16.9%	-1.9%	-11.1%	-1.6%	-36.1%	-1.0%
AB	+24.5%	+0.8%	+2.0%	-0.9%	-2.8%	-1.9%
ON	-18.0%	+2.0%	-16.8%	-2.8%	-38.1%	-2.3%
QC	-22.0%	+1.9%	-16.3%	+3.4%	-25.7%	-0.3%

Months of inventory (MOI) came in at a razor-thin 2.1 in September. Prices don't flatten out until MOI hits AT LEAST 5. It has to more than double from here before we can even start talking about a potential "landing" for housing:

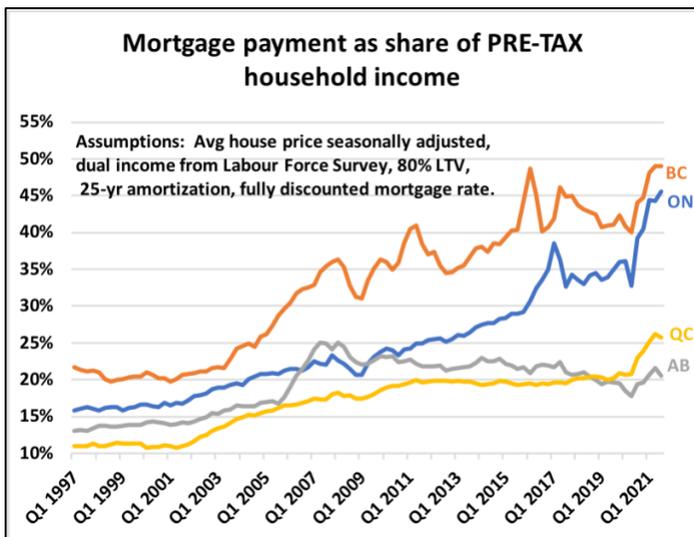


The seasonally adjusted House Price Index rose 1.6% m/m to hit a new record of \$750,400 nationally. That's a 21.6% increase over last year and it represents a \$133,000 jump in the value of the typical home. Once again, single-family prices led the increase, up nearly 25% y/y:



With equity values rising that quickly and with banks happy to lend, it's no surprise that credit trends look exceptional. Insolvency trustee Doug Hoyes of Hoyes Michalos has stated that only 0.4% of their insolvency filings in September involved homeowners...and that's a record low by a wide margin.

This market is clearly not without risk. Affordability continues worsen, notably in Ontario (but as an aside, check out Alberta where affordability is still better than it has been over the past 15 years!). That leaves the market vulnerable to rising rates which are no longer a hypothetical risk. More on that below.



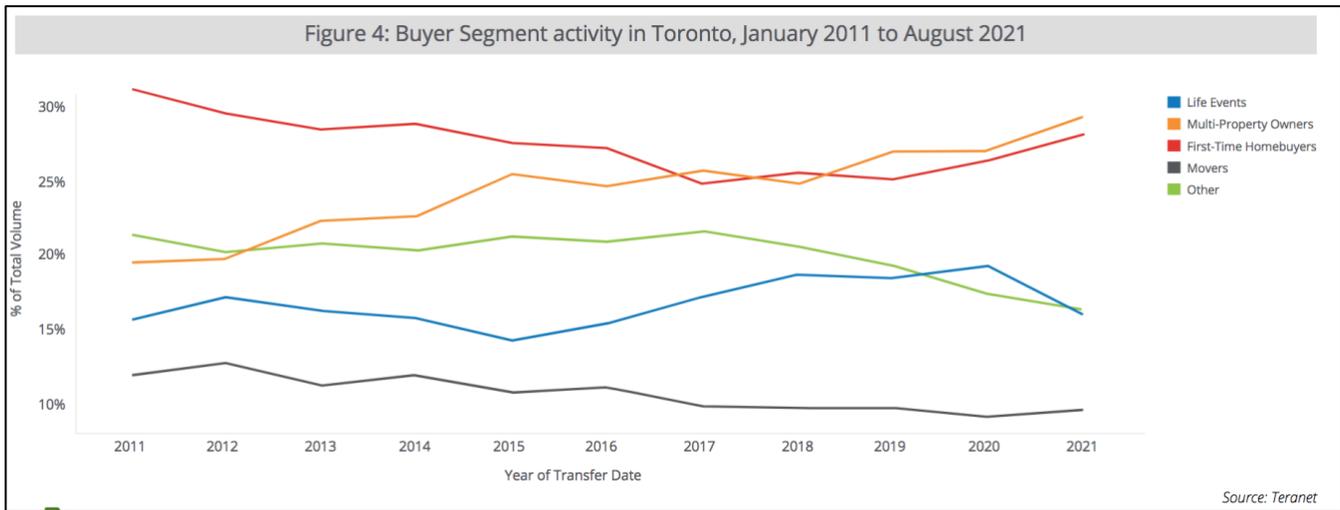
But the real risk is in the massive increase in investor participation. Here I would flag an exceptional report this week from Teranet which controls the land registry database¹ in Ontario. They found a significant increase in the share of homes being purchased by owners who already have at least 1 other property. From the report:

Purchases by Multi-Property Owners have climbed steadily and represent over 25% of total transactions from January to August 2021.



That figure rises to nearly 30% in Toronto:

¹ <https://financialservices.teranet.ca/acton/attachment/2216/f-637ac64b-a4b6-4ec4-a1c9-474121b4d723/1/-/-/-/Teranet%20Market%20Insight%20Report%20Q4%202021.pdf>

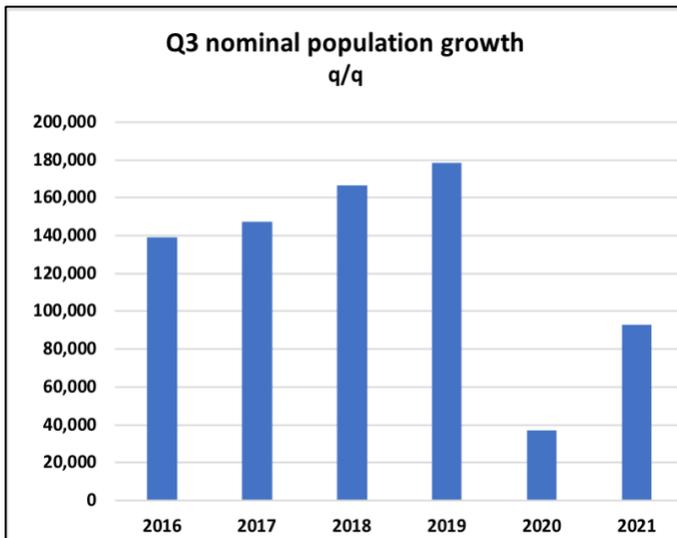


This level of investor demand creates a self-reinforcing dynamic, but it has a tendency of overshooting and resulting in a bad outcome. The issue is in the timing, and these cycles almost always run much longer and further than anyone expects, but investor-driven markets seldom correct by going sideways.

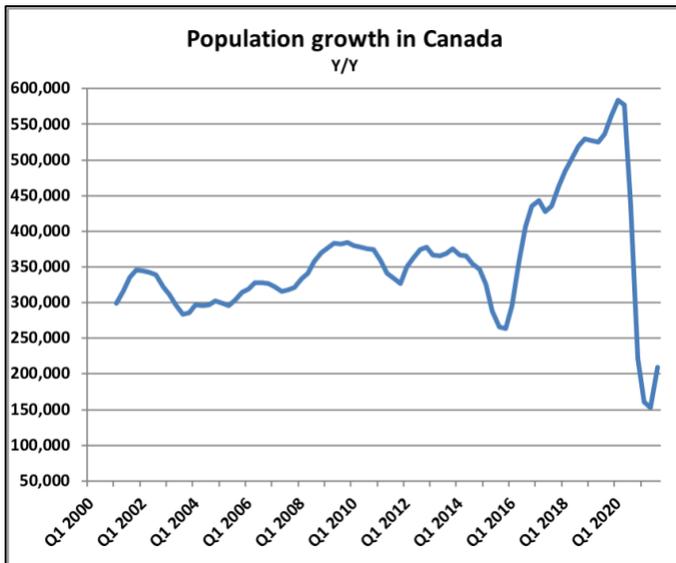
2) Supply/demand deep-dive: Housing starts pull back, population growth still soft

Stats Canada released their Q3 population estimates in late September. They show that population growth that is still near record lows but it is improving sharply relative to last year.

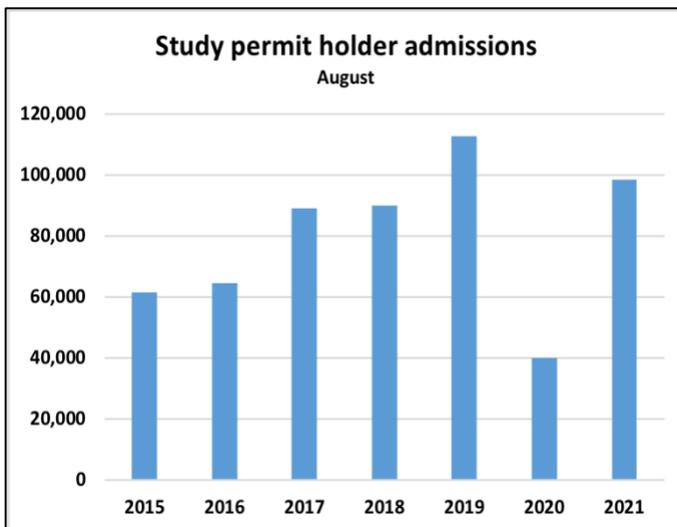
Canada added just over 90,000 people to the total population in the quarter, more than double the same quarter last year but way below levels seen before the pandemic:



The y/y growth rate improved to 209,000 in Q3 from 153,000 the prior quarter. A solid improvement but still miles from the almost 600,000 y/y clip seen just before the onset of the pandemic:



Things should continue to improve from here. The latest data shows a surge in non-permanent resident admissions in recent months. Study permit holder admissions in August surged 150% compared to 2020 and hit the second highest level on record for that month. The return of international students goes a long way to explaining why the rental market has tightened as much as it has in big cities like Toronto:

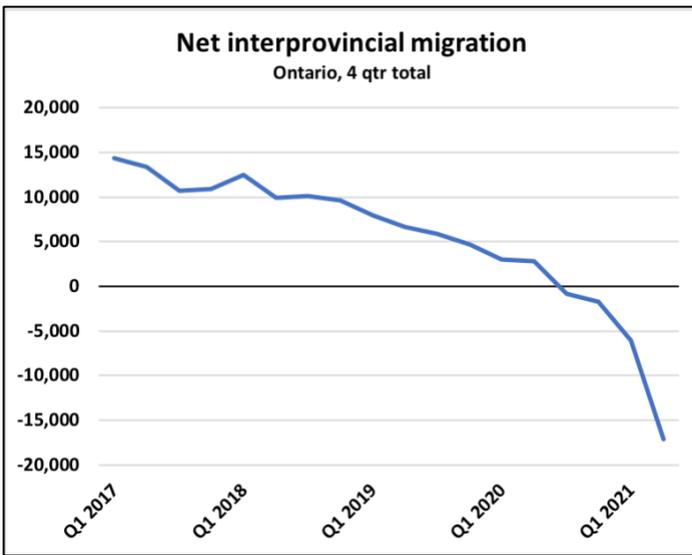


One thing to watch is the disproportionate slowdown in population growth in Ontario which remains almost 70% below peak levels and is hovering near the lowest level nominally in 40 years. Contrast that with the Atlantic provinces where population growth is down 'only' 25% from peak.

One anecdote I've been hearing for a while is that there's a growing trend of Ontarians leaving for other provinces, mostly due to cost of living. From one real estate broker:

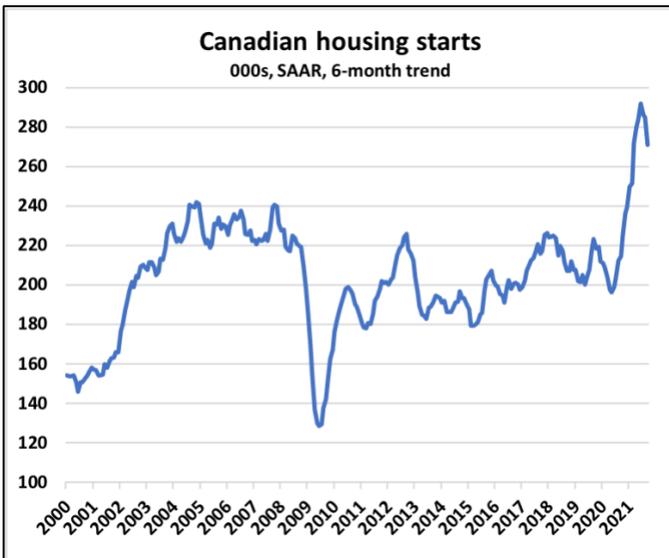


The net interprovincial migration data bears this out. We are indeed seeing a big surge in people leaving Ontario for other provinces, notably out east:

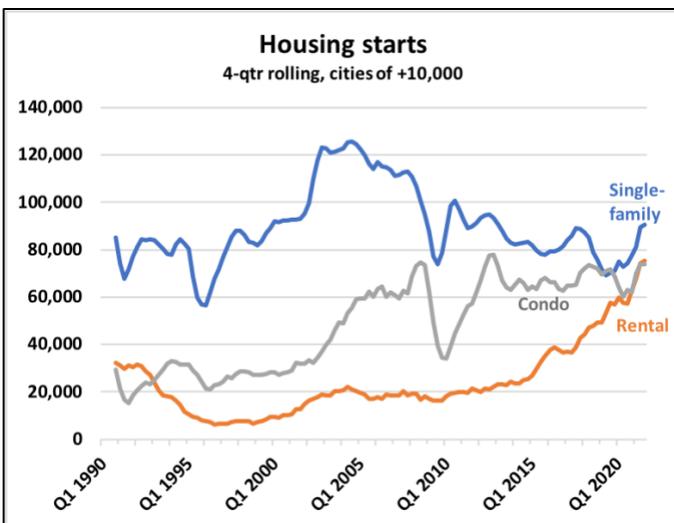


It's a good reminder that affordability issues can change population flows. And even as Canada returns to more normal growth rates, it may not benefit Ontario as much as some less expensive parts of the country.

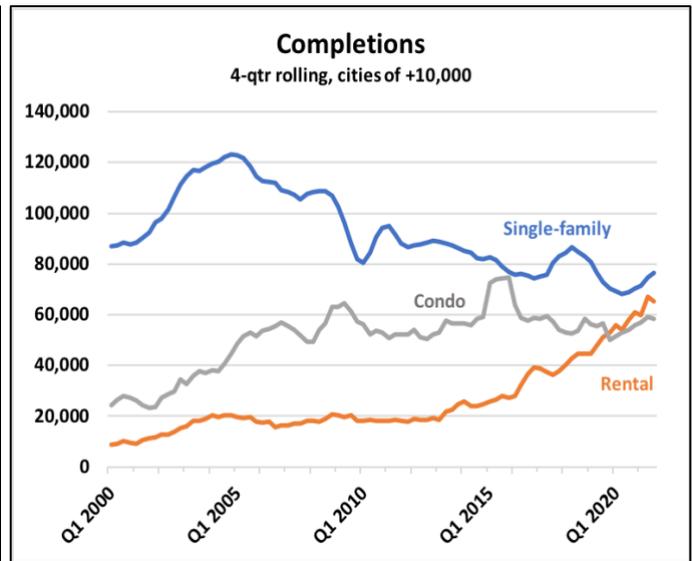
On the supply front, housing starts continue to cool from the crazy Q1 highs. The 6-month trend is still at 270,000 on a seasonally adjusted annualized rate (SAAR), which is near the highest on record:



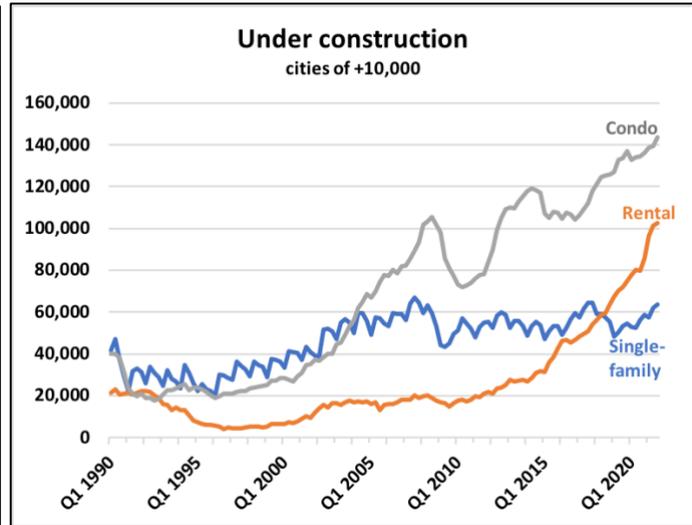
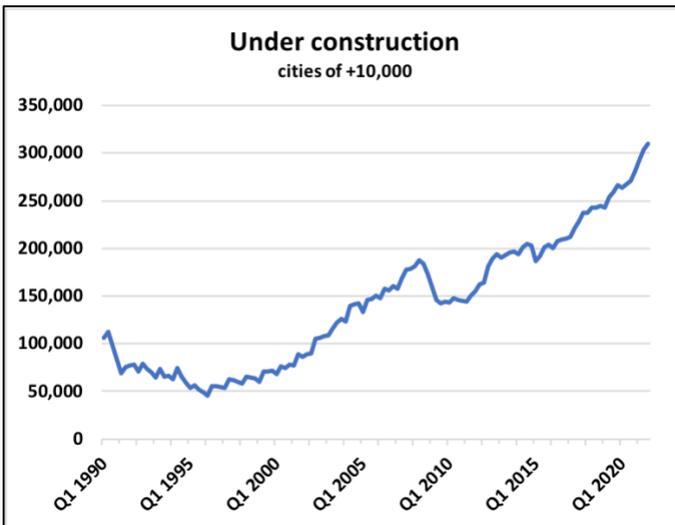
But with the Q3 data now available, I've updated the chart below to show housing starts broken down into single-family, condo, and rental. Here the issue is immediately clear. While single-family starts have risen relative to last year, they remain at levels seen way back in the 1990s. It's the apartment segment, notably rentals, that are driving the spike in housing starts:



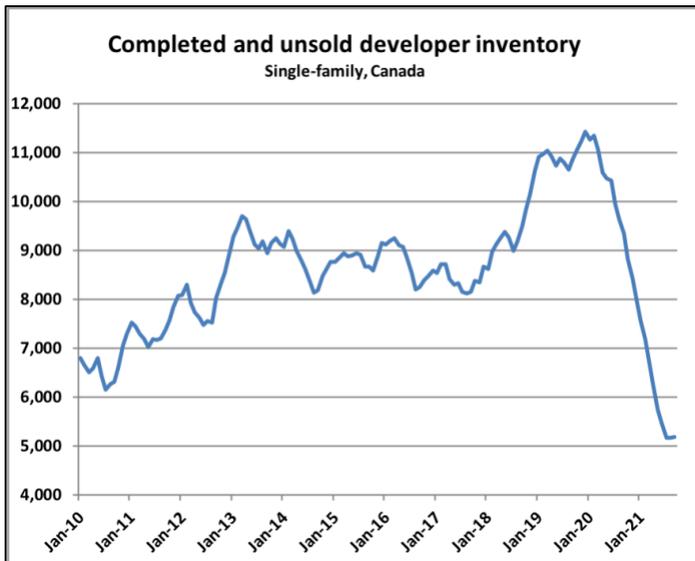
The same is true when we look at completions. We've seen very high completions over the past year, at just under 200,000 in total. But that doesn't tell the real story. Single-family completions are WAY below levels seen in the early 2000s while rentals have surged in recent years:



I don't want to belabor the point, but when I look at units under construction, it's the same story. Headline number at a record, but that hides a massive trend divergence within segments:



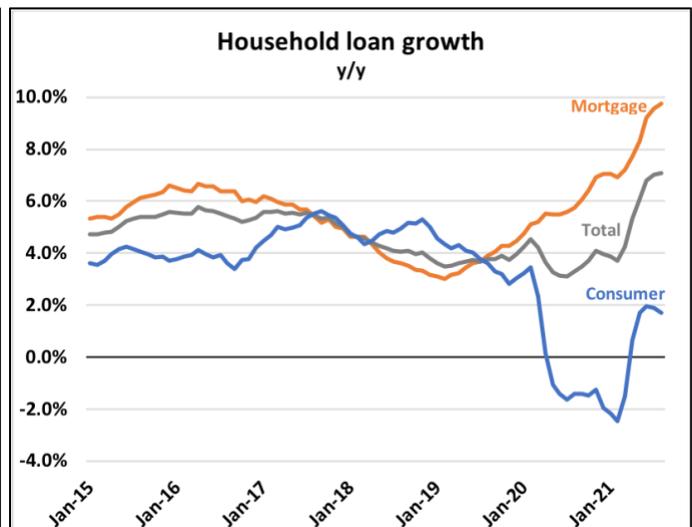
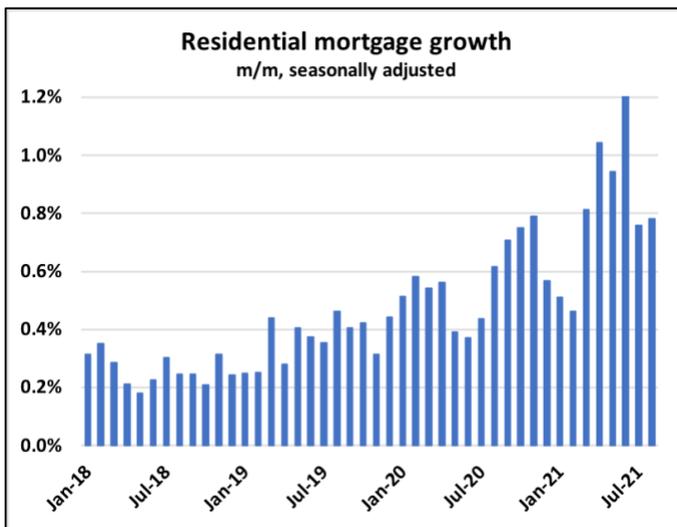
So the bottom line is that headline housing starts suggest a healthy level of construction activity, but it masks the reality that **we are still under-building the segment that remains most in demand**. And nowhere is that more clear than when we look at completed and unsold single-family developer inventory across the country. The shortage continues!



3) Household credit update: Mortgage debt growth closes in on 10% y/y

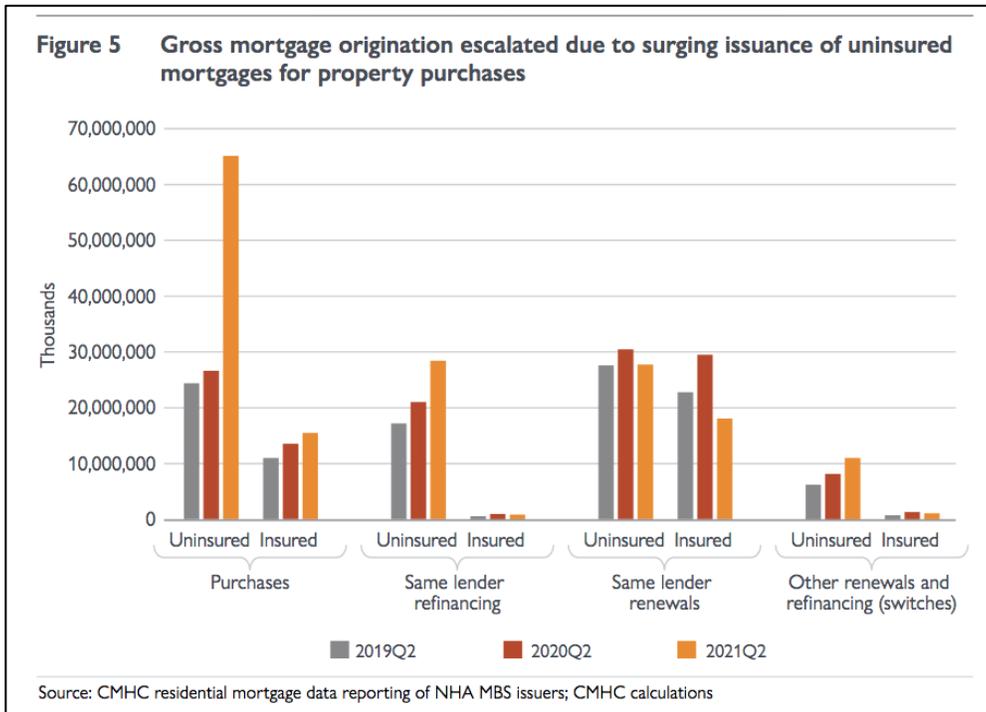
i) Mortgage growth hits highest since 2008

Domestic residential mortgage growth posted another solid month in August, rising 0.8% m/m seasonally adjusted and closing in on +10% y/y. September 2008 was the last time we saw mortgage growth running at this clip:

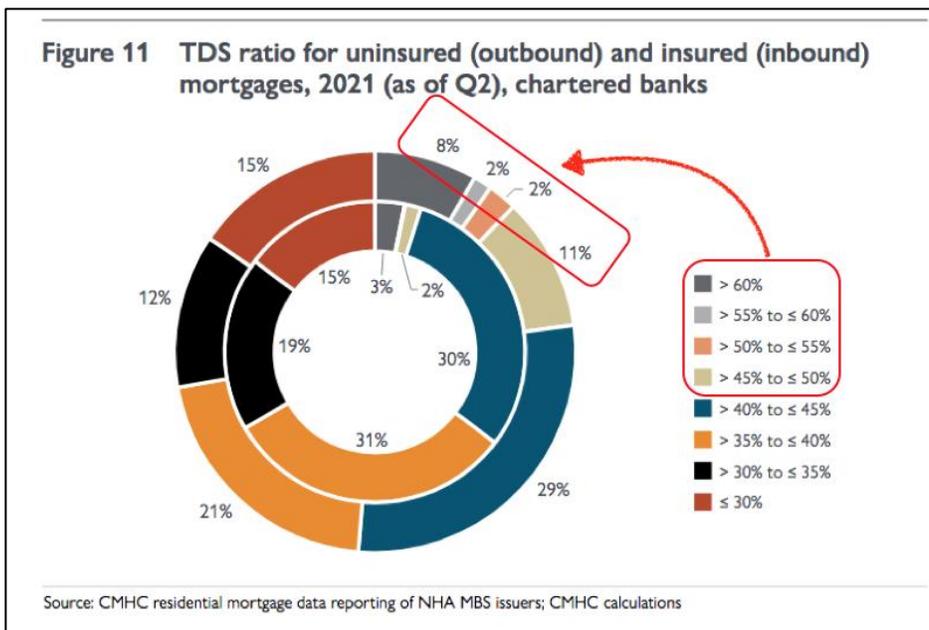


The bulk of the increase is coming from uninsured mortgages where chartered banks are seeing loan growth of 19% y/y and nearly 24% for the likes of CIBC. The chart below from CMHC² shows new originations in Q2. The increase in uninsured purchase originations (far left) is stunning:

² <https://assets.cmhc-schl.gc.ca/sites/cmhc/professional/housing-markets-data-and-research/housing-research/research-reports/housing-finance/residential-mortgage-industry-report/2021/residential-mortgage-industry-report-2021-10-en.pdf?rev=b1d19728-7eb6-4bcf-a5b3-56b82f318427>



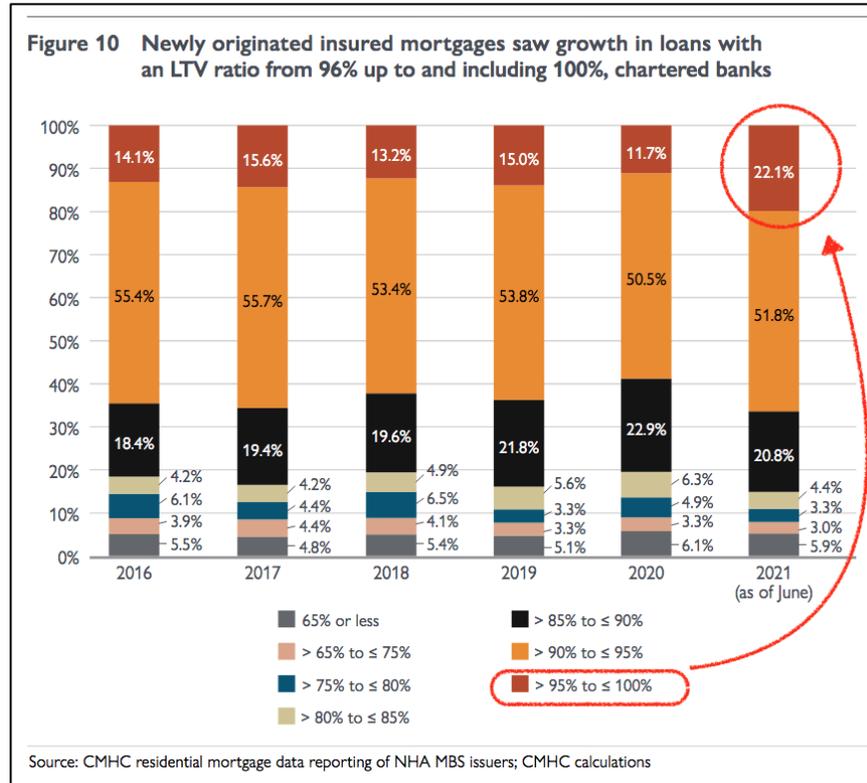
Channel checks with lender contacts continue to suggest that banks are increasingly granting debt service ratio exceptions to help qualify borrowers and effectively soften or bypass the stress test requirements. New data from CMHC confirms the anecdotes. Their data show that up to June of this year, 23% of new uninsured mortgages issued by chartered banks had total debt service ratios above 45%, which is higher than their stated 44% limits:



This is the sort of thing that OSFI won't love to see, and there's a chance that if this continues, they will seriously consider implementing a debt-to-income limit rather than a debt service ratio limit. OSFI has discussed this in the past (they seem to anchor on a 4.5x debt-income limit), and we've already seen this rolled out New Zealand, so there's some precedent here already.

As for the insured segment, total balances continue to decline with insured loans on bank balance sheets down 5.5% y/y and down 22% from 2016 levels. But that could change if the Liberals follow through with their promise of raising the insured purchase limit to \$1.25MM from \$1MM currently.

Of new originations, it's interesting that we're seeing an increasing share in the 95%-100% LTV range. Yes, insured mortgages require a minimum 5% down payment, but the insurance premium is added to the balance and amortized, so a buyer with a minimum qualifying down payment ends up more in the 98% LTV range.



The takeaway here is that underwriting quality is slipping a little, which may suggest that we're starting to get to the bottom of the barrel of well-qualified buyers. And if it continues, it wouldn't be a shock to see OSFI tighten lending again in early 2022, likely targeting second property purchasers and perhaps implementing a debt-income limit on new originations.

ii) Variable rate mortgages surge to 55% of total

Fixed rate mortgage rates continue to creep higher with deep discounted rates now in the 2.2% range from a low of 1.5% earlier this year. The increases continue. From Rob McLister last week:



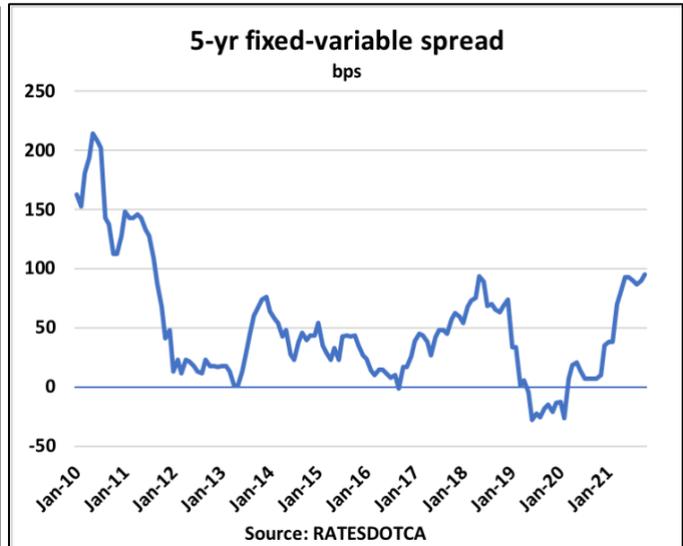
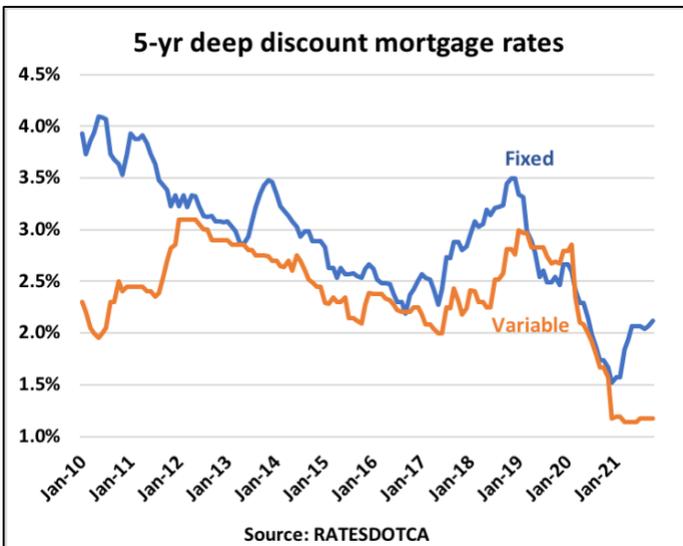
Rob McLister @RobMcLister · 15m

With Canada's 5yr bond closing above 1.30% for the first time since Feb 2020, rate pacesetter, @RBC, has boosted its 2, 3, 4 & 5yr rates again. This time, by 15 bps.

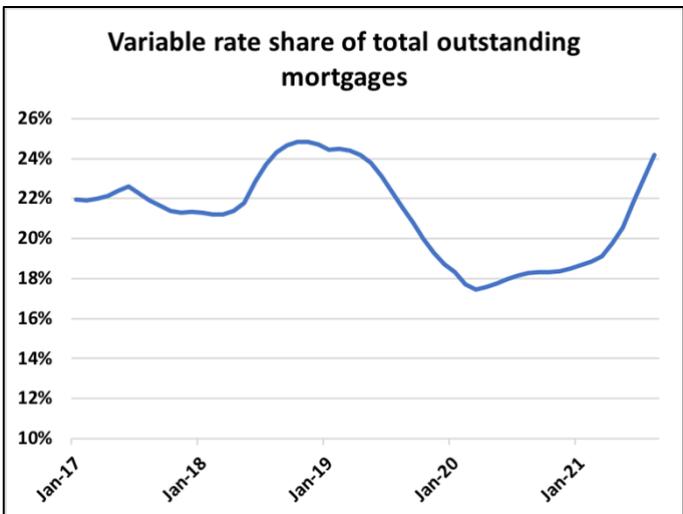
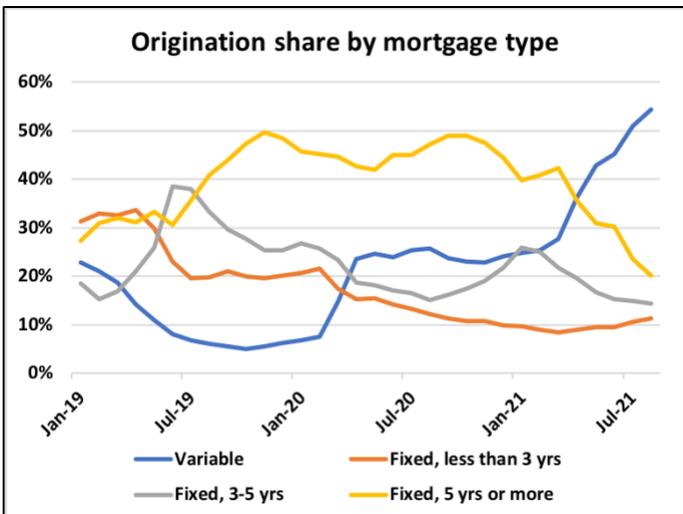
Big Blue's 5yr fixed goes from 2.44% to 2.59%. Even its variable went up, from 1.55% to 1.60% (prime - 0.85%).

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With fixed rates rising and variable still near all-time lows, the spread between the two has risen to nearly 100bps, the highest in a decade:

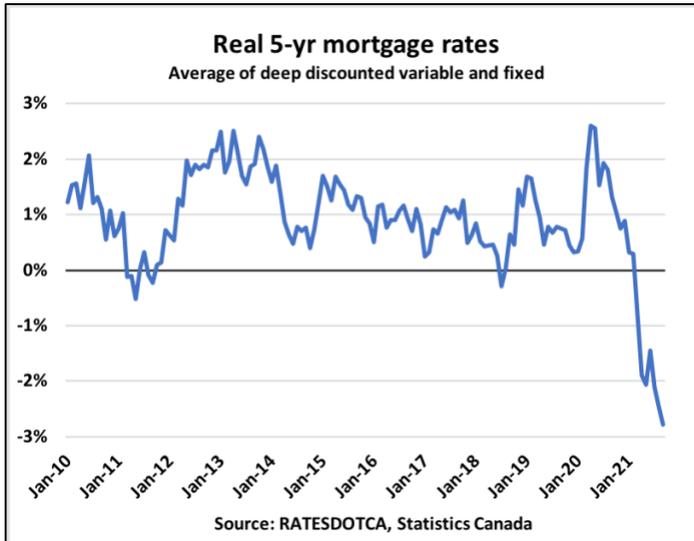


It's no surprise that variable rate mortgages now account for 55% of new origination and are closing in on a quarter of all outstanding mortgage debt, up from 17% at the onset of the pandemic:



iii) Real rates still deeply negative

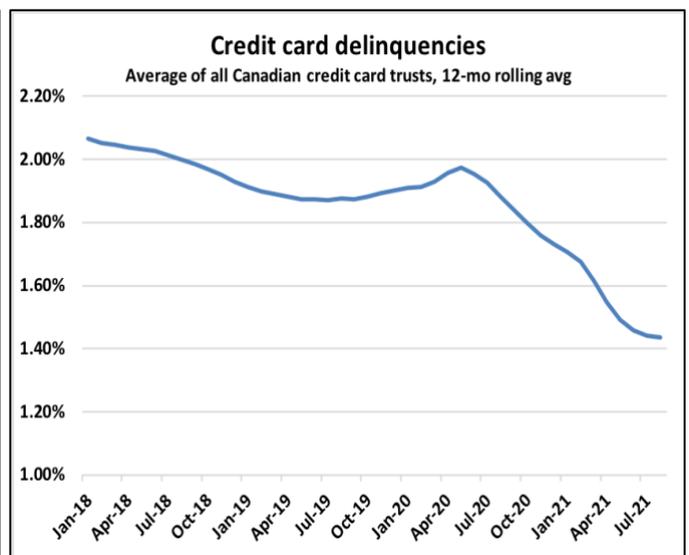
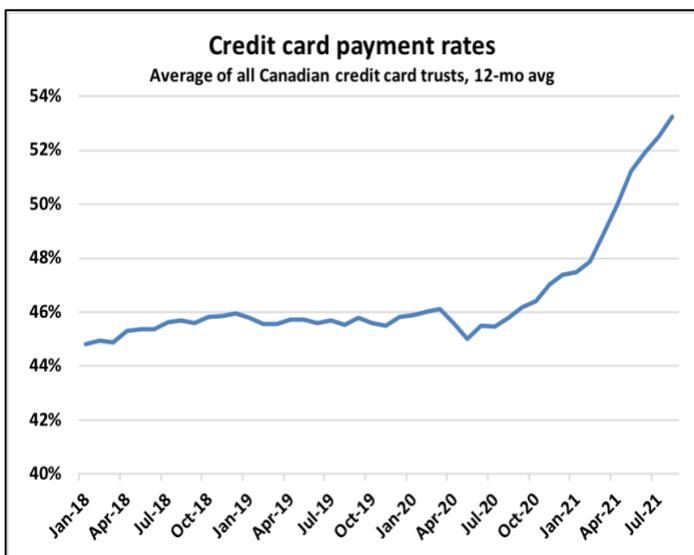
With inflation rising to fresh 13-year highs last month, the real interest rate (ie rates adjusted for inflation) paid by borrowers continues to decline and is now negative by nearly 3%. These negative real rates are very positive for house prices going forward:



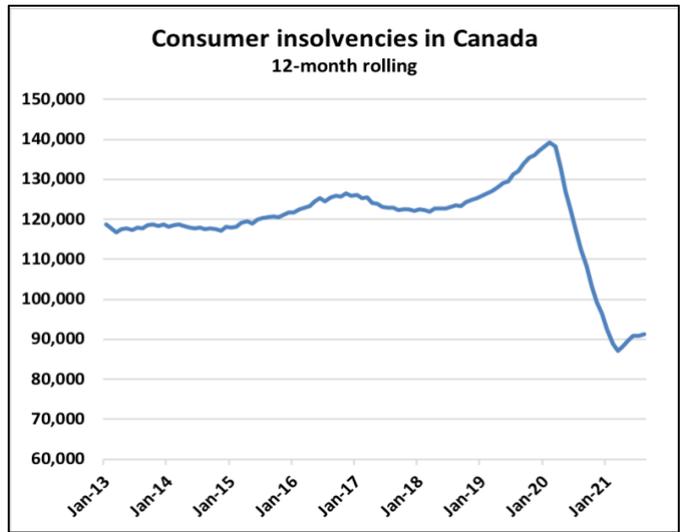
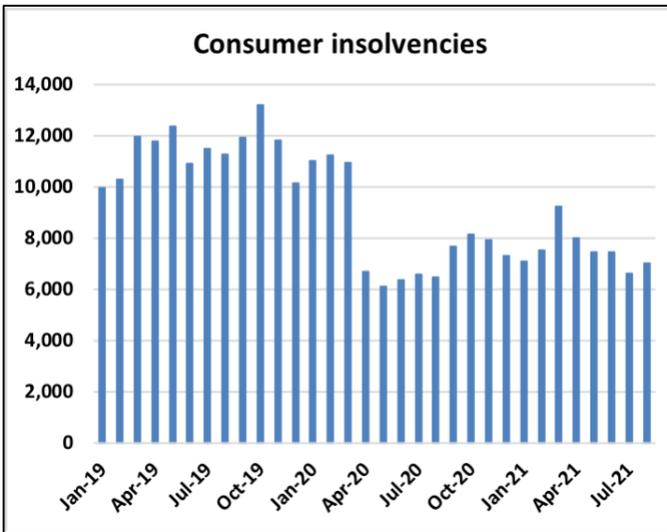
4) Credit check: Insolvencies still near record lows, credit card trends look fantastic

Credit card data remains the best predictor of future mortgage trends. After all, very few borrowers will miss a mortgage payment without first missing a credit card payment.

Payment rates continued to hit new highs in September. This suggests that borrowers are still flush with cash. Similarly, delinquencies are making new lows and closing in on just 1.4%.....a record low by a wide margin.

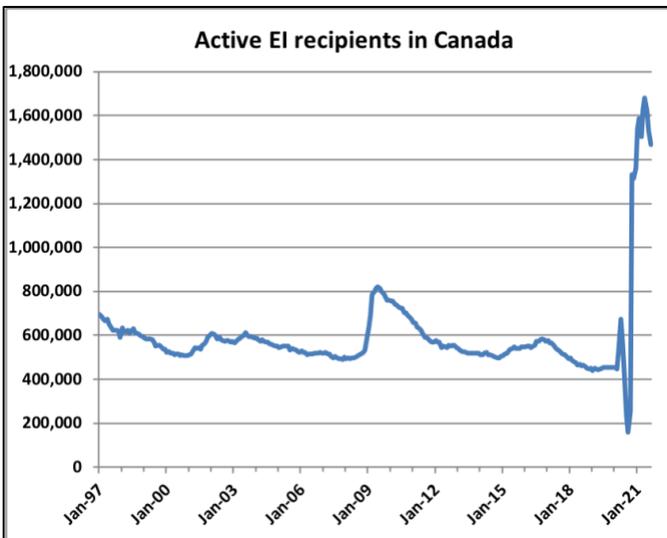


Similarly, consumer insolvencies remain exceptionally low. Yes, they rose 8.5% y/y in August, but they remain 38% below 2019 levels and continue to sit near the lowest levels of the past 2 decades:



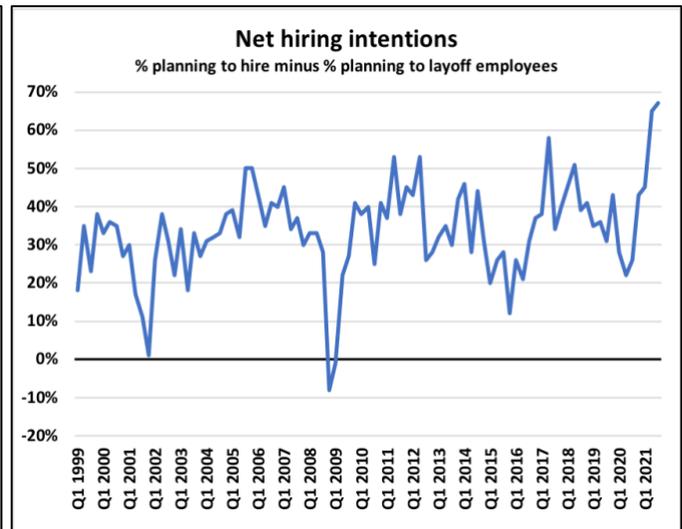
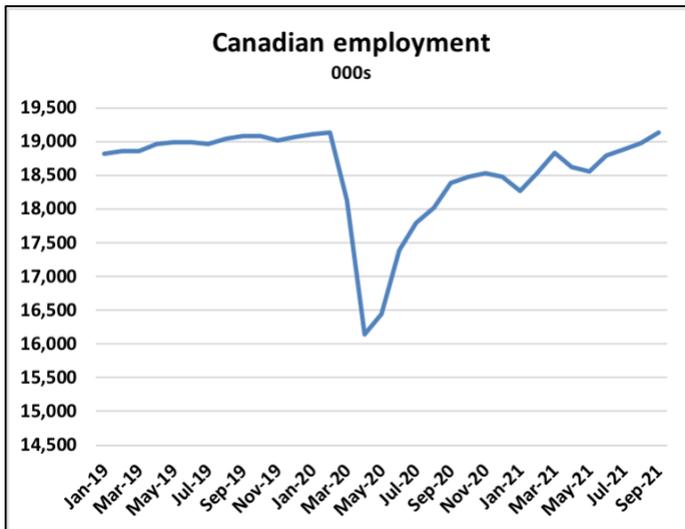
I suspect we'll see a low in credit card payment rates within the next month or two, with mortgage delinquencies likely bottoming in early 2022.

In part this is due to the elimination of the Canada Recovery Benefit (CRB). As of late summer, there were still nearly 1.5 MILLION Canadians receiving some form of Employment Insurance benefits, mostly the CRB. As those wind down this month, we should expect to see payment rates in credit card trusts start to slow, and then delinquencies start to tick up off these artificial lows shortly thereafter:



To be clear, while delinquencies will likely rise from these artificially low levels, it won't be a disaster by any means. The labour market is recovering nicely and has now recouped all jobs lost during the pandemic. That's no small feat!

And if we look at net hiring intentions (ie the share of businesses planning to add jobs minus those planning to cut jobs), it's the highest on record according to new data from the Bank of Canada. We should expect strong job growth well into next year:



5) Monitoring key risks

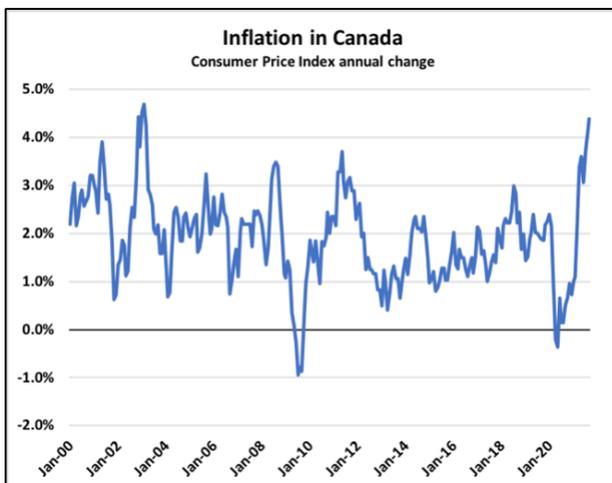
i) Inflation continues to rip higher, Bank of Canada finally concerned

There are two big issues with inflation. The first is what it does to consumer spending, the second is what it typically does to interest rates. We'll leave the second point for now and address it below.

I've been very optimistic on the Canadian consumer based on the massive savings hoard....currently approaching 10% of GDP. All else equal, that should be rocket fuel to propel the economic recovery.

But rising costs are threatening to derail things.

For starters, headline inflation just hit the highest since 2003 at nearly 4.5% y/y in September:

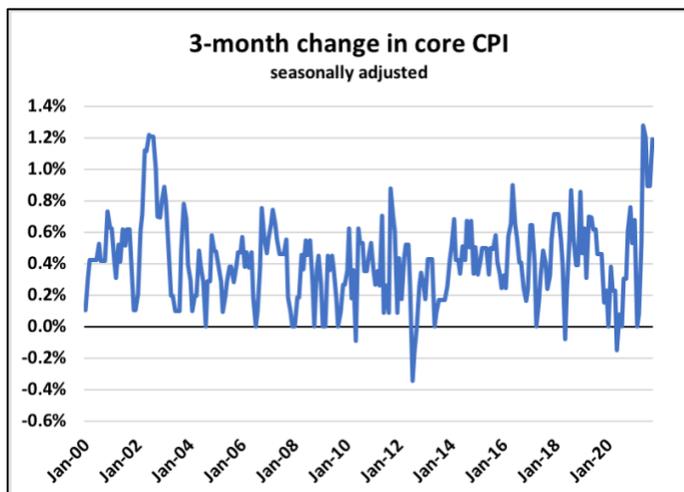


Now the view from the Bank of Canada previously was that this dynamic was temporary and related to supply chain issues from the pandemic as well as from base effects from weak inflation last year at this time. But they had a sharp change in tone in this morning's Monetary Policy Report. The key line:

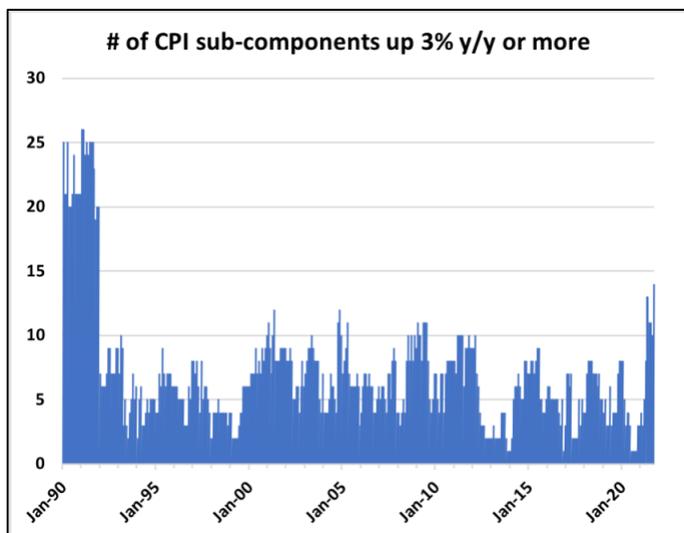
The recent increase in CPI inflation was anticipated in July, but the main forces pushing up prices – higher energy prices and pandemic-related supply bottlenecks – now appear to be stronger and more persistent than expected.

That’s potentially a game-changer.

Let’s look at what’s got the Bank nervous. The first major concern is that core inflation (the measure that most concerns them) is rising in real time. The 3-month change in core CPI is as hot as it’s been in 20 years. What that means is that the inflation we’re seeing is not simply a function of weak readings from last year:



Second, inflationary pressures are broadening beyond just a few sectors affected by supply chain issues. We now have 14 CPI sub-component groups seeing inflation above 3%. That’s the highest since the early 1990s:



As to future inflationary pressures, it’s important to note that the money supply continues to expand aggressively. That means more money in the system chasing goods and services. Inflation!

M2, a broad measure of money supply, has grown 2.6% in just the past 3 months alone. On a 2-year rolling basis, growth is the highest it’s been since the early 1980s:

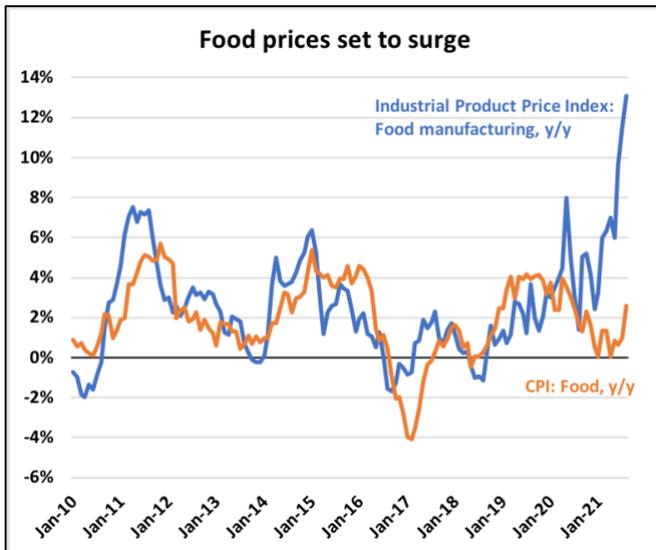


But what really hurts consumer pocketbooks is rising food and fuel prices. This is where the average Canadian feels it the most.

Already gasoline prices across Canada are at record highs of just under \$1.50/liter. I happen to think oil prices are likely to go substantially higher from here before they find a peak, but even if gasoline prices stay here, it's enough to hurt household spending:



As grocery bills, food prices are already rising but they look sure to go substantially higher from here based on the normal relationship between food production costs and food prices in the grocery store:

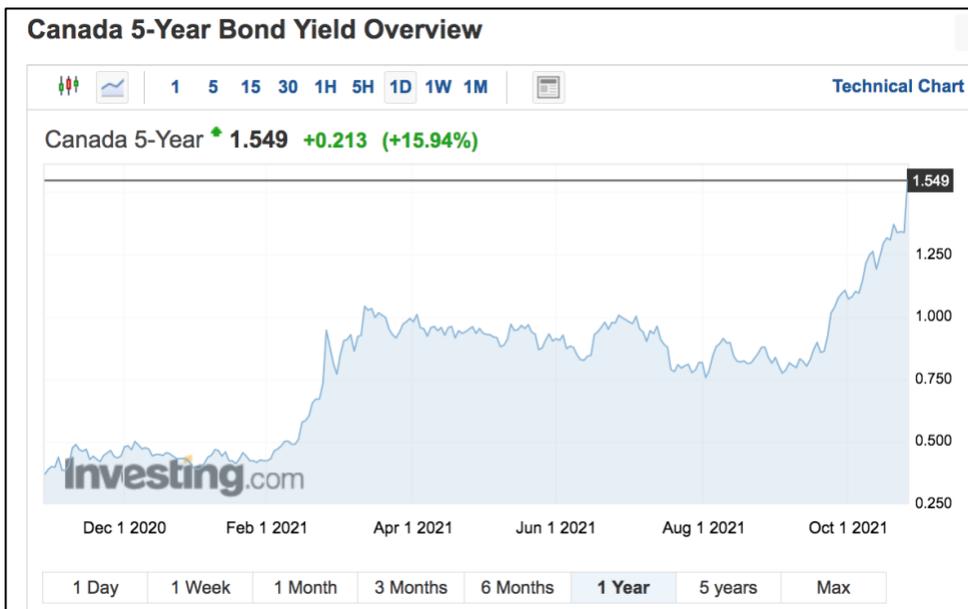


That's a real problem that threatens what should be a major consumption boom. I'll be watching this closely.

ii) Rising interest rates could curb demand, further threaten affordability

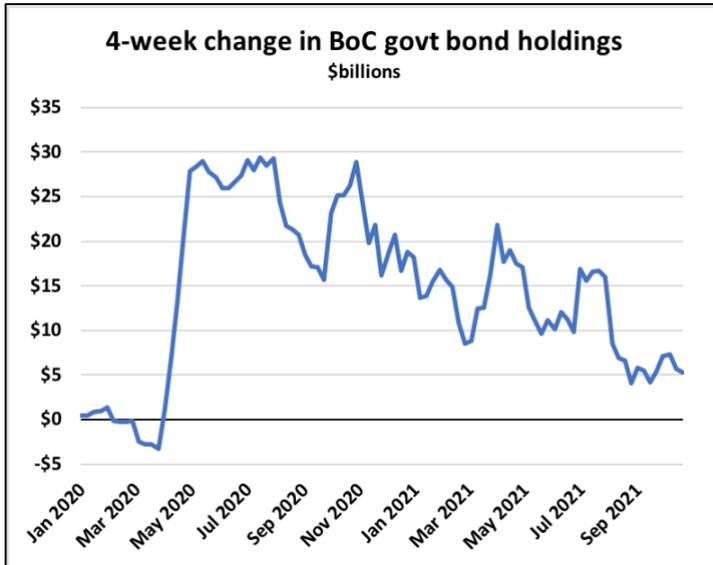
Rising inflation changes the rate at which people are willing to lend money. After all, few people will lend to the government at 1% for 5 years if they know inflation is going to average 4% over that time frame. They are guaranteed to lose purchasing power over time.

That dynamic is exactly what we're seeing in the bond market where investors are demanding higher rates to lend to the government. And it's precisely the 5-year bond yield that determines fixed mortgage pricing. That benchmark bond yield has risen almost 80bps since the start of September....including 21bps this morning alone after some concerning comments from the Bank of Canada.



That means fixed mortgage rates are set to rise. In fact, last time 5-yr bond yields were this high, deep discounted 5-yr fixed mortgage rates were in the 2.7% range. That implies about 60bps of hikes are coming in the next few weeks unless bond yields reverse course.

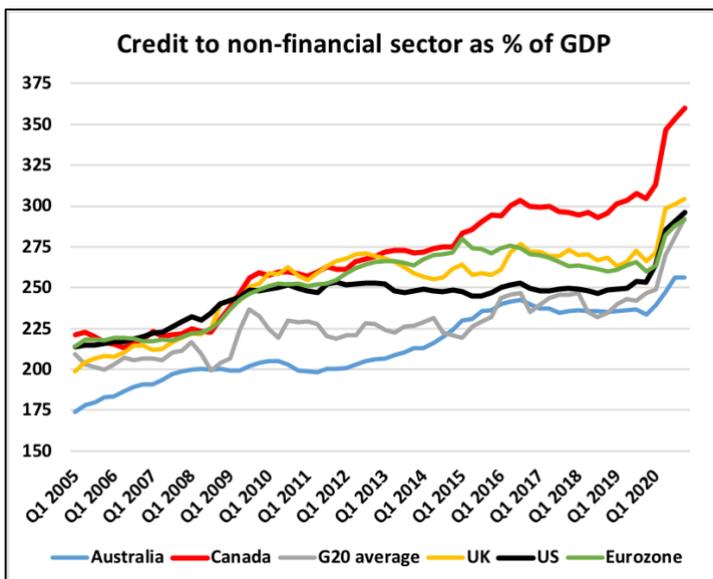
Part of the issue is that the Bank of Canada has dramatically slowed their bond purchasing program and announced this morning that they would end it altogether. This program had the explicit goal of pushing interest rates lower than they otherwise might be. Bond holdings at the Bank of Canada increased just \$5B in the past 4 weeks compared to a \$15B run rate back in July. It's now set to drop to zero, and that means we'll lose the artificial downward pressure on bond yields going forward:



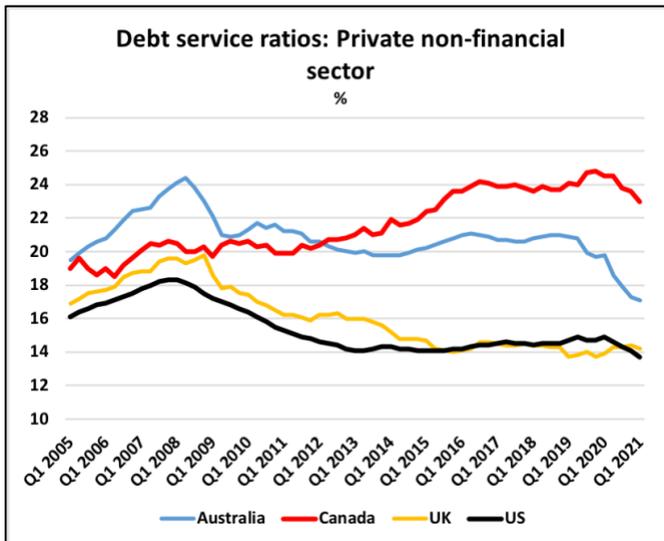
All of this only affects fixed rate mortgages. The real concern would be if the Bank of Canada was backed into a corner by rising inflation and felt compelled to begin raising the overnight rate. That wasn't much of a concern even two months ago, but market expectations of rate hikes have surged since early September and participants are now pricing in almost four rate hikes by the end of next year and another 2-3 in 2023.

Scotiabank made headlines last week with a forecast of four rate hikes in 2022, followed by four more in 2023...which would leave the overnight rate at 2.25% in just over 2 years. You have to go all the way back to November of 2008 to find the last time the overnight rate was that high.

The difference now (and it's a BIG one) is that non-financial sector debt (ie households and non-financial businesses) is currently over 360% of GDP in Canada compared to just 225% back in 2008. To put that in context, the G20 average is about 290%. Canada loves its debt, and that leaves us more vulnerable than most to a rate hike cycle.



The debt service ratio of the entire private non-financial sector is 23% in Canada currently. Again, this captures households and non-financial businesses. That's down from pre-pandemic levels but still well above where it was in 2008:

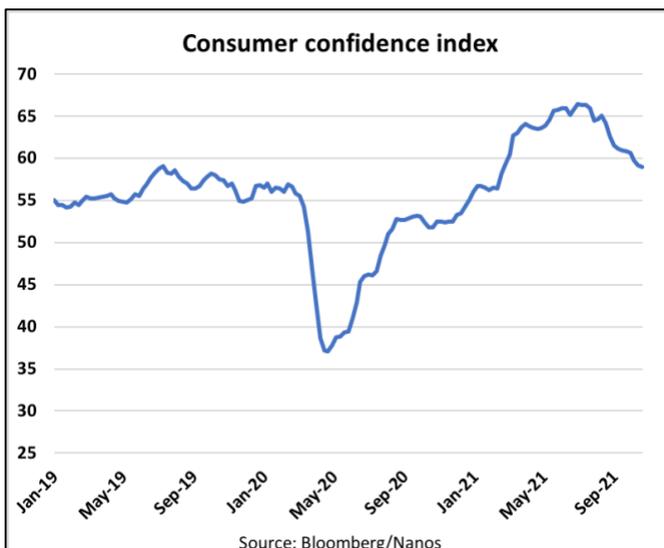


All that to say this: I think the Bank of Canada is far more constrained in their ability to raise rates without inflicting serious economic harm than the folks at Scotiabank suggest. So the key takeaways as I see them:

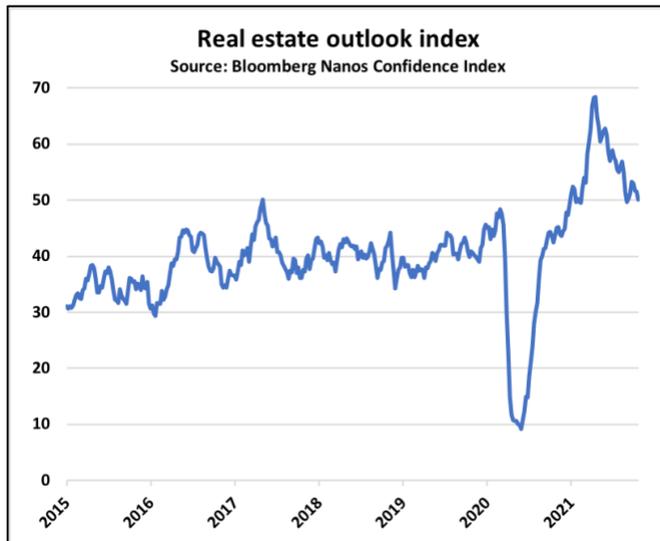
- The fear of rate hikes is likely overblown, and 8 in the next 2 years is close to a pipe dream in my opinion.
 - Now if I'm wrong on that, I'll need to seriously rethink my expectations for consumer spending, home sales, and delinquencies/insolvencies.
- The spread between fixed and variable rate mortgages is likely to widen even further and it looks like a good time to stay variable.

iii) Consumer sentiment continues to weaken, real estate outlook plunges

It's hard to overstate how important consumer sentiment is to the overall economy. Household spending and investment in residential housing account for 2/3 of the Canadian economy. So when we see consumer confidence fall for 10 consecutive weeks (and 12 of the past 16), it's cause for concern.



Importantly for housing observers, the real estate expectations index has fallen sharply off the spring highs. It's elevated by historical standards, to be sure, but the trend is not favorable right now. And you can bet that every media publication will run stories of rising interest rates in coming days....so that won't help matters.



In closing:

- Housing dynamics look solid, and I expect price gains right into early 2022 at a minimum
- We're nowhere near addressing the shortage of single-family homes in this country
- Canadian households remain flush with cash, and any issue with delinquencies or insolvencies is likely a Q2 2022 story at the earliest
- Interest rate and inflation risks are rising, and this is by far the biggest threat to the market at the moment, but I'm inclined to bet against market expectations for 7 hikes before the end of 2023. Pipe dream!

Regards,
Ben