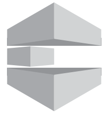

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The Edge Report

November 2021

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   ii) Visualizing Canada's insane house price boom and the risk it poses

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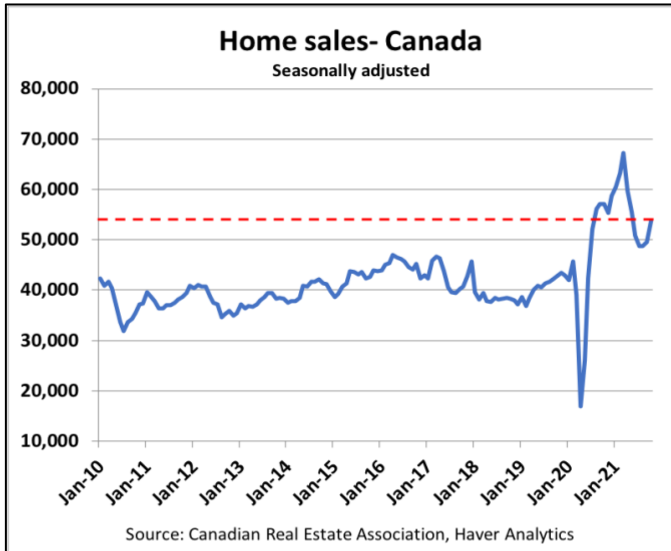
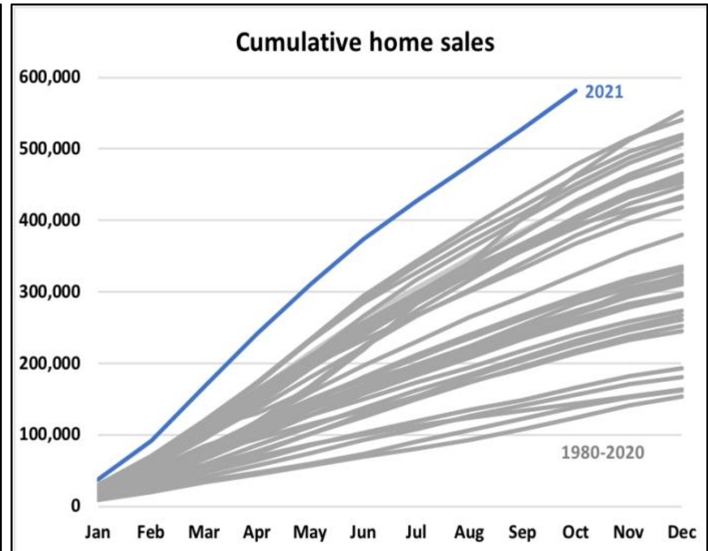
Prepared For:

1) National home sales update

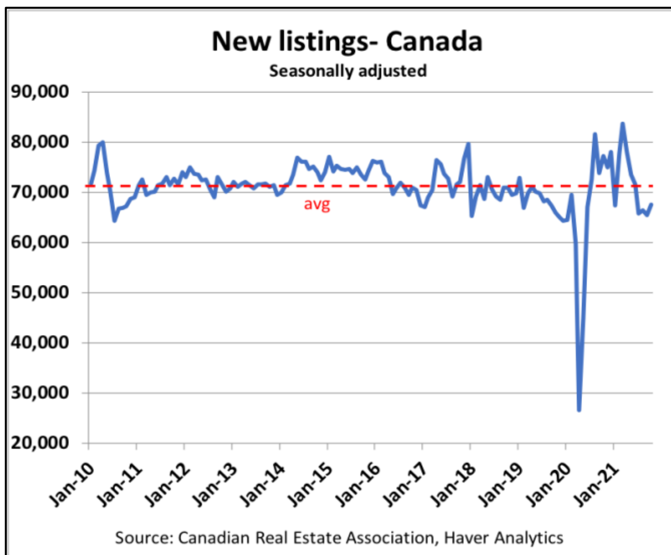
i) Records fall as demand surges

The threat of rising interest rates has pushed some prospective buyers off the fence. Home sales jumped 8.6% m/m in October, the largest increase since the post-lockdown surge in mid-2020. Cumulative home sales have now set an annual record…with two months still to go:





Even with sales surging, new listings remain below normal levels. They did rise 3.2% m/m in October but were still 5% below decade averages:



There was yet another sizable decline active listings across the country, down 4.4% m/m seasonally adjusted. . By my estimate, there were barely 100,000 homes for sale across the country at the end of the month, a 50% decline from early 2019 levels:

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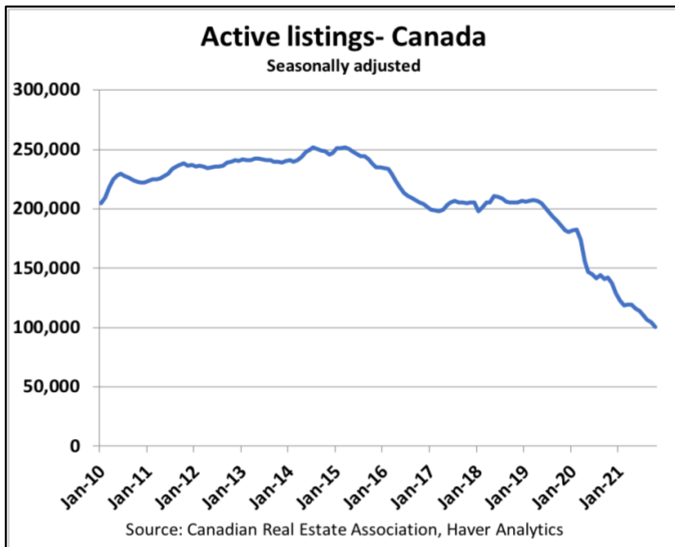

The table below shows a breakdown of key metrics by province:

	Sales		New listings		Active inventory	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	-5.8%	+8.6%	-12.4%	+3.2%	-29.6%	-4.5%
BC	-7.2%	+8.6%	-13.5%	+2.5%	-38.4%	-4.6%
AB	+22.0%	+9.4%	+3.6%	+3.5%	-14.5%	-2.9%
ON	-7.2%	+9.7%	-19.0%	+3.3%	-43.0%	-8.6%
QC	-17.7%	+7.6%	-14.5%	-0.3%	-27.4%	-3.9%

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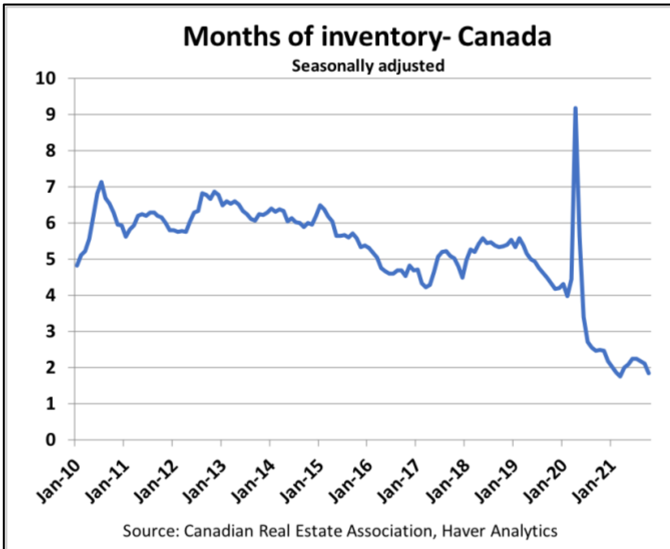
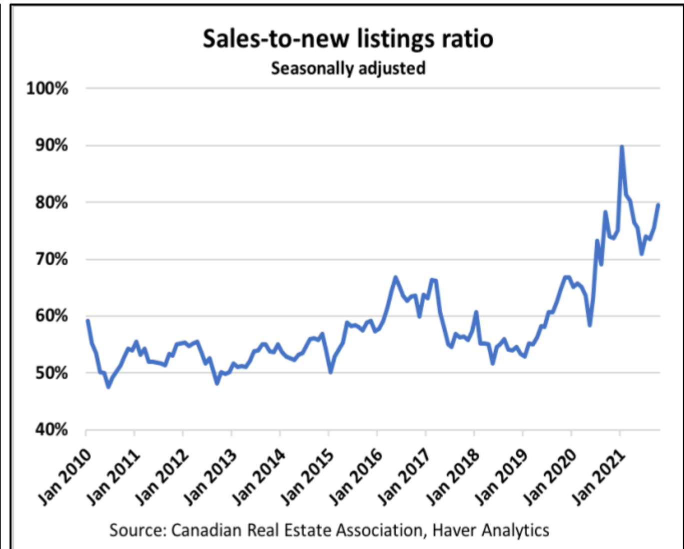
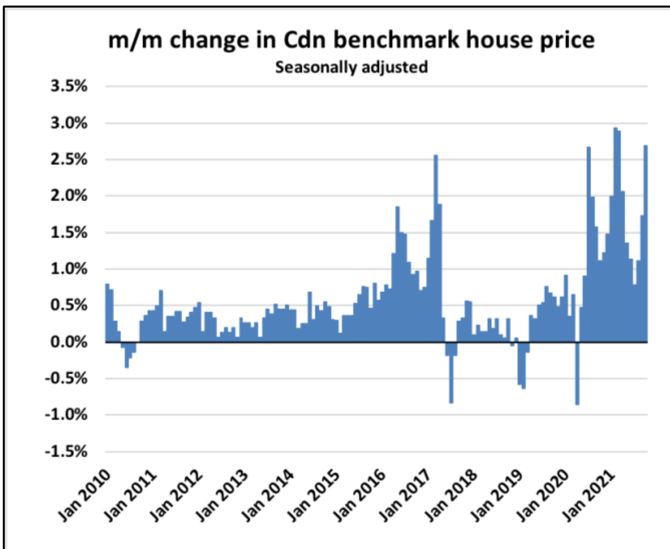
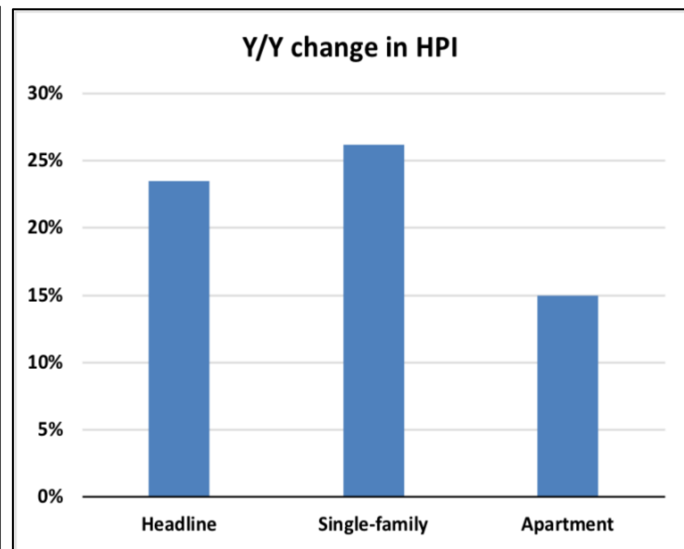
It's difficult to overstate just how tight the market is currently. Months of inventory fell below 2 in October, led by a record low of 0.8 in Ontario. The sales-to-new listings ratio was just under 80%, the fourth highest on record. For context, a balanced market is 50-60%. Both of these measures point to an exceptional, almost unprecedented, seller's market:





With the market balance tightening, the MLS House Price Index shot up 2.7% on the month and just under 24% y/y. The benchmark price hit a new high of $770,000. That equates to a $147,000 y/y increase in the value of the typical home in Canada.





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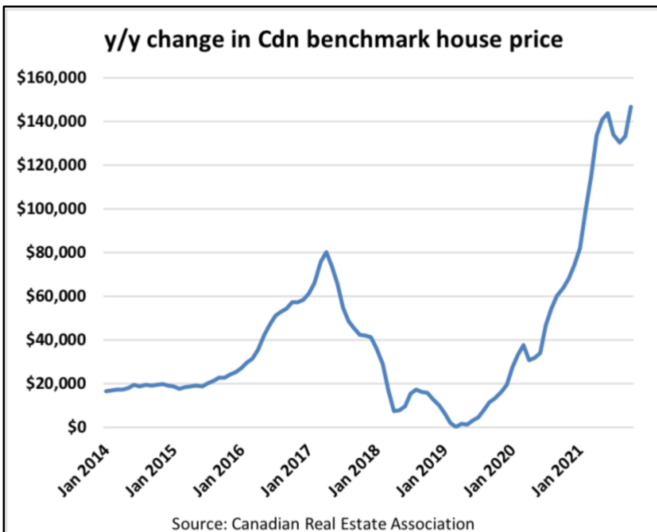
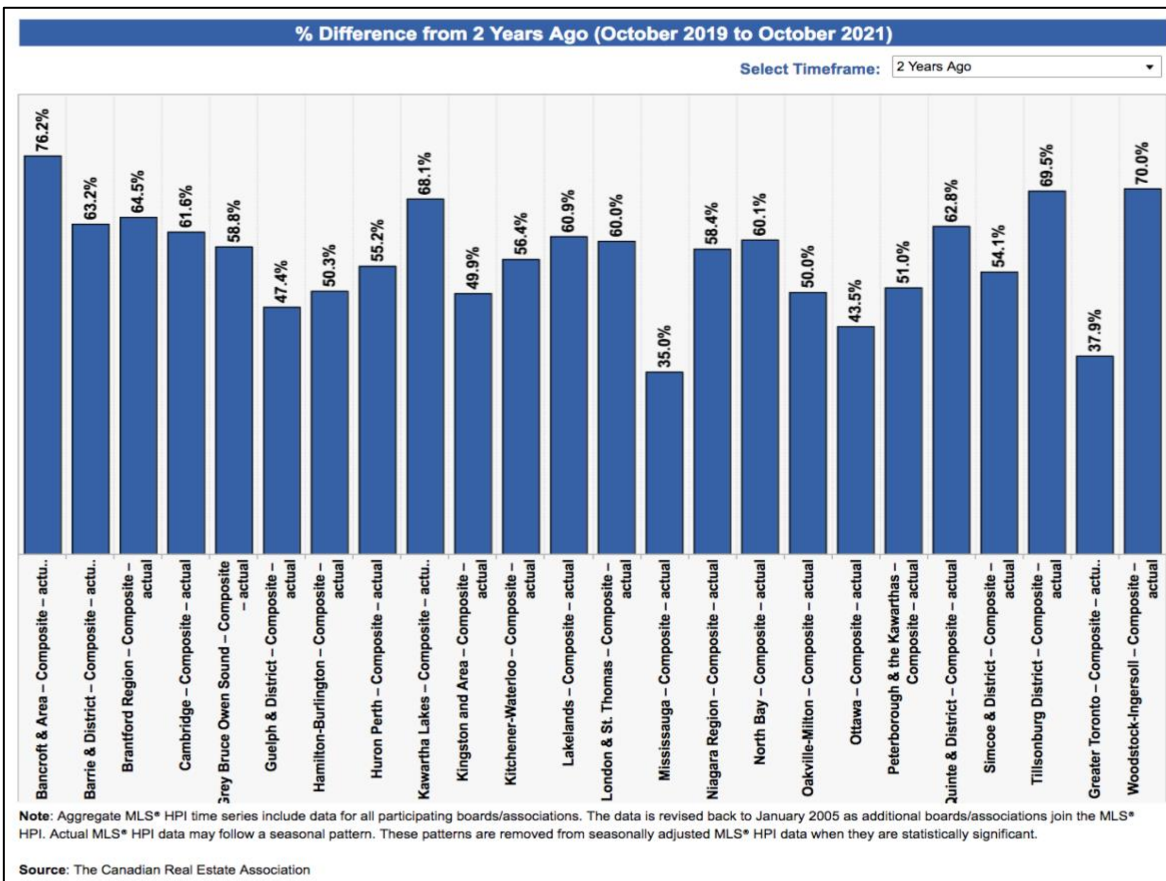


Nowhere has the house price boom been more intense than in Ontario where many smaller metros have seen price increases in excess of 60% over the past 24 months:



What we're now seeing is a shift in leadership away from smaller regional markets back towards the big cities. Price increases in those smaller metros have slowed in recent months while Toronto just posted a 4.8% MONTHLY surge in the seasonally adjusted House Price Index. That's an unprecedented increase, and it suggests that incremental demand is flowing away from smaller metros back to the big cities.

Toronto is now leading the country in terms of house price increase among larger metros:

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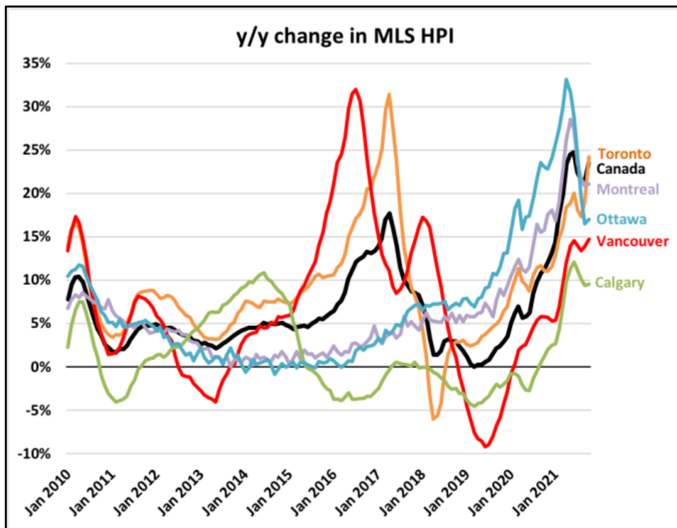


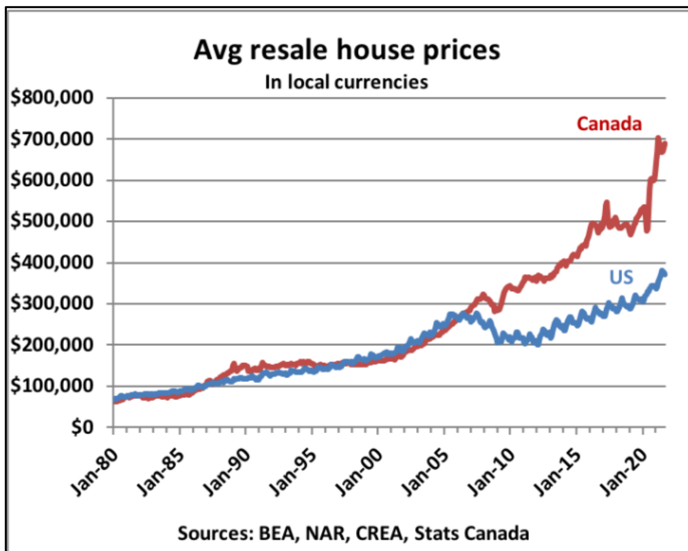
ii) Visualizing Canada's insane house price boom and the risk it poses

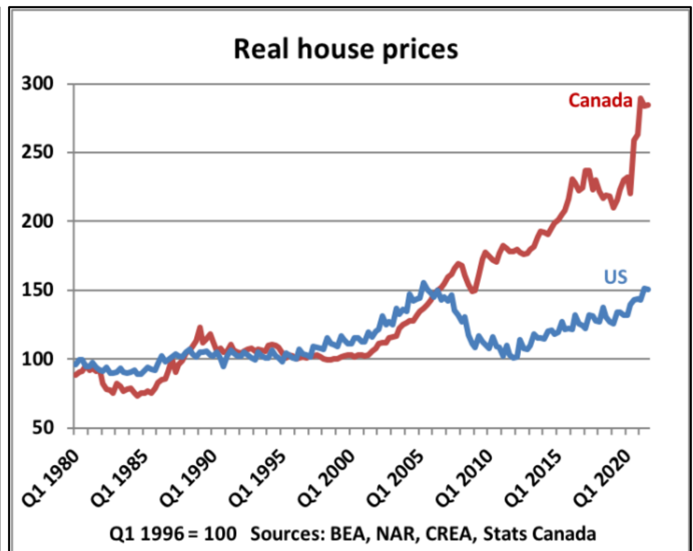
I've updated a few charts to help visualize the magnitude of the current housing boom. Included are comparable US metrics, but there are some important caveats when making these comparisons. They are not apples-to-apples, and they are far from perfect, but that's not to say they can't provide us with some important takeaways.

First, some caveats. As much as Canada is an enormous landmass with low population density overall, the reality is that just 2 metros, Toronto and Vancouver, account for 40% of the dollar volume of homes sold. Both are supply constrained and consequently the most expensive metros in the country. Imagine what average house prices in the US would look like if San Francisco and Manhattan accounted for a similar share.

But on the flip side, US average house prices reported by the National Association of Realtors (NAR) include only the single-family segment while condos are broken out separately. In Canada everything is lumped together, and all else equal, the inclusion of lower priced condos helps pull the average price lower than it otherwise would be.

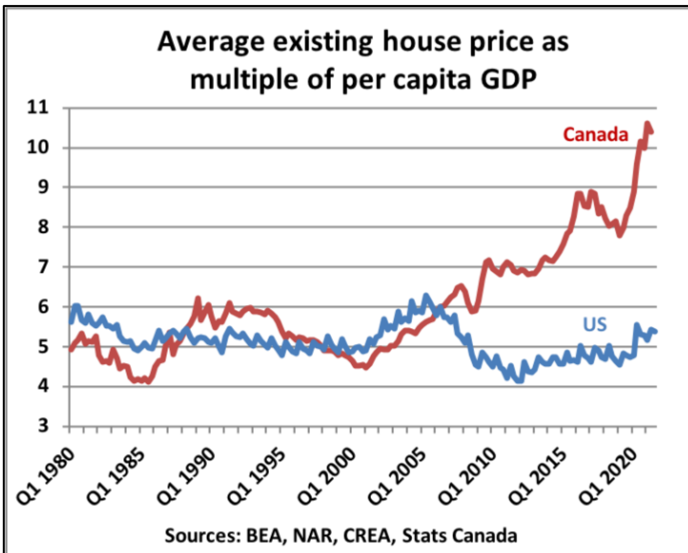
I don't know how to discount all of that exactly, but I do know that prices between the two countries tracked closely from 1980 until the late 2000s but have diverged wildly since then. That's true in both nominal (below left) and real terms:



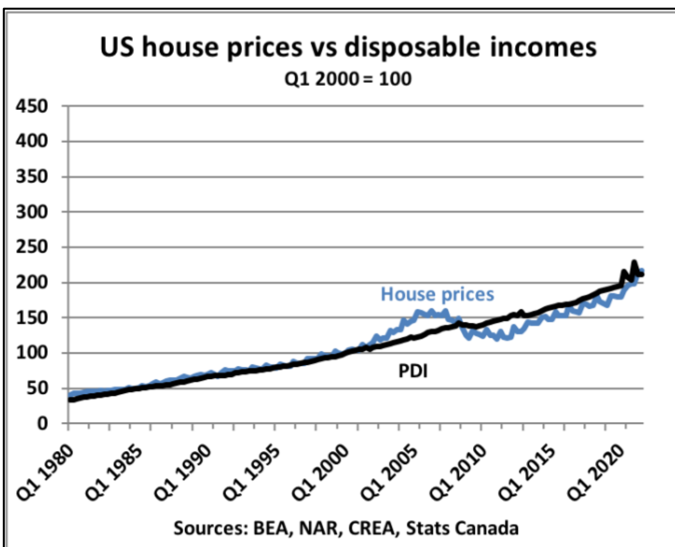


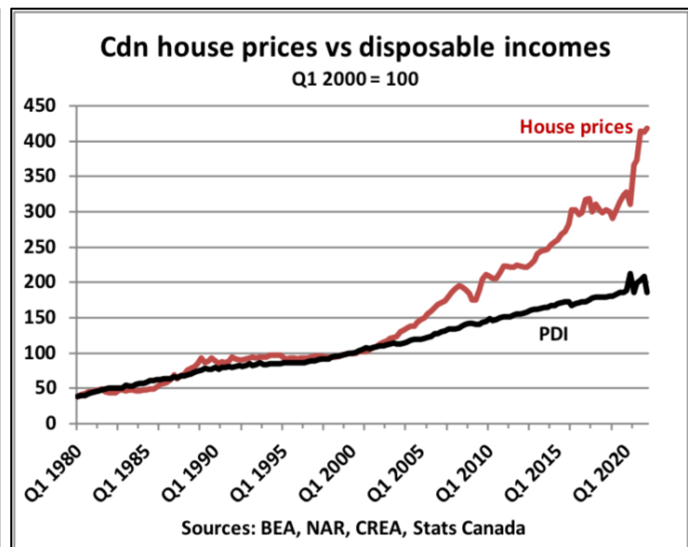
Prepared For:

Where things get crazy is when we look at prices relative to underlying growth in the economy and personal incomes. Houses in Canada now trade at an average of 10 times per capita GDP, roughly twice the US multiple:



It gets even more absurd when we look at house prices relative to personal disposable income per capita. Where the US has seen prices and incomes more or less track each other with the exception of the mid-2000s, the trend couldn't be more different in Canada:





The out-sized contributions of Toronto and Vancouver matter a lot, but they don't tell the whole story. Below is an interesting visual from Zillow looking at the Niagara Falls area. Setting various search parameters regarding listing price, it's not hard to spot the US-Canada border:

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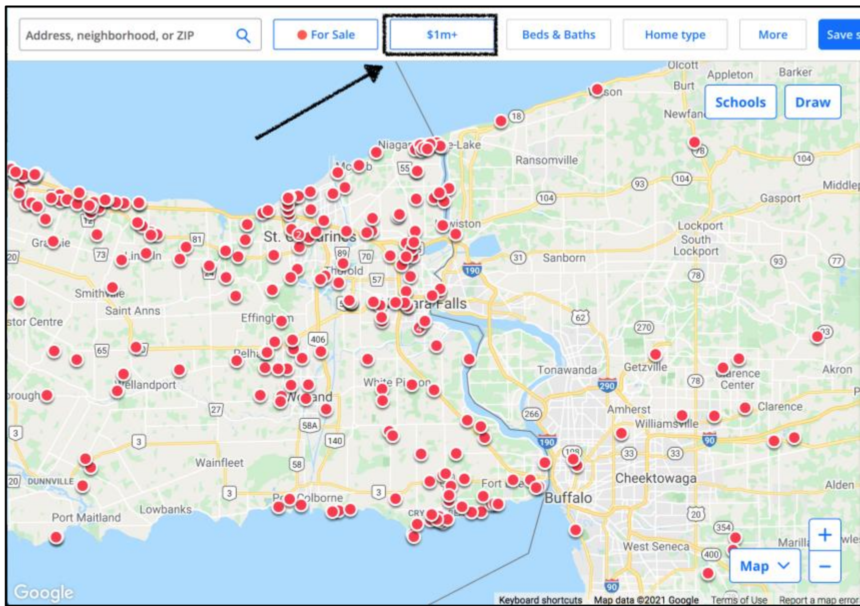

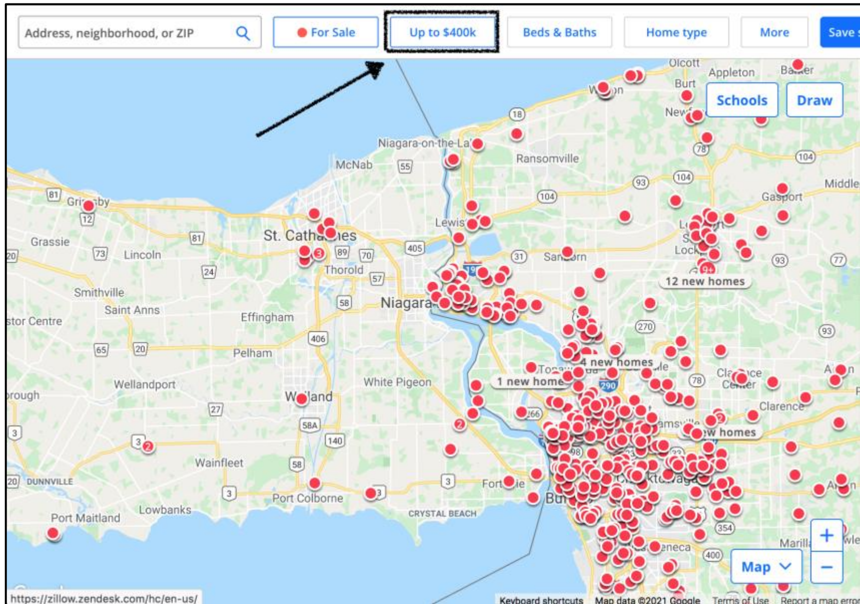

Granted that doesn't account for the exchange rate, but it's still a striking visual.

To contextualize it a little more, consider the US and Canadian side of Niagara Falls.
Niagara Falls, NY had median household income of only $36,000 USD in 2019 vs $60,000 CAD on the Canadian side. So right off the bat we should assume that house prices on the Canadian side trade more expensive simply as a function of better economic fundamentals.

The Home Value Index for the US side is $138,400 according to Zillow vs a House Price Index of $652,000 CAD on the Canadian side according to the Canadian Real Estate Association.

In other words, homes in the US side trade at roughly 5x incomes while the Canadian side are closer to 10x. I can't fully get my head around why the Canadian side warrants such a massive premium.

Canadian house prices are very stretched and that's particularly true in Ontario where affordability measures have blown out in the past 2 years even as mortgage rates have plunged:

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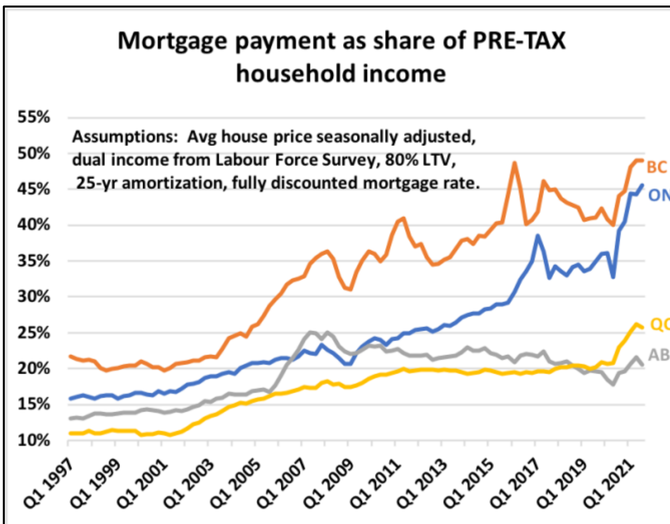
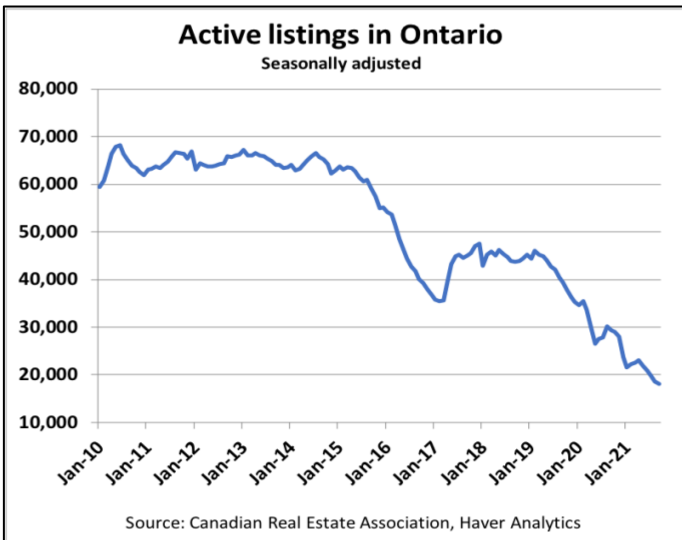
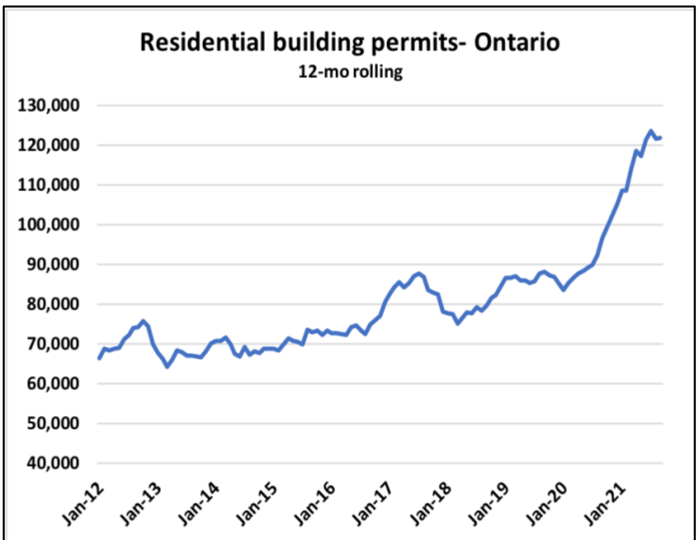


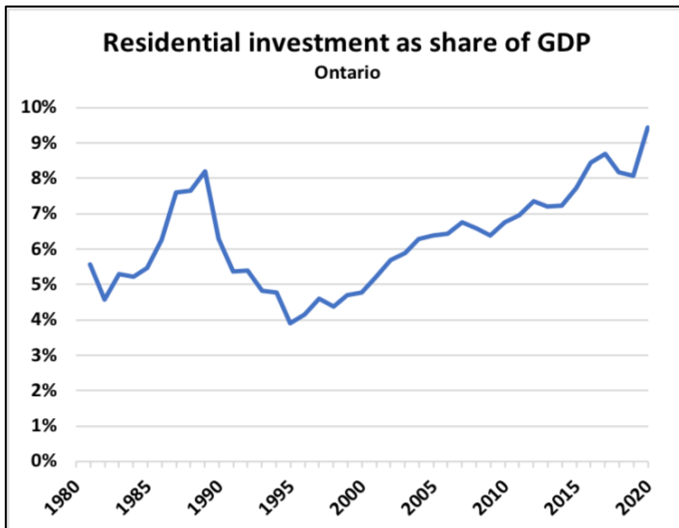
Surging prices in large part are a function of razor-thin inventory levels across the province that remain 70% below 2015 levels in spite of a significant run-up in construction activity, so it's not as if there aren't real fundamentals underpinning the market:





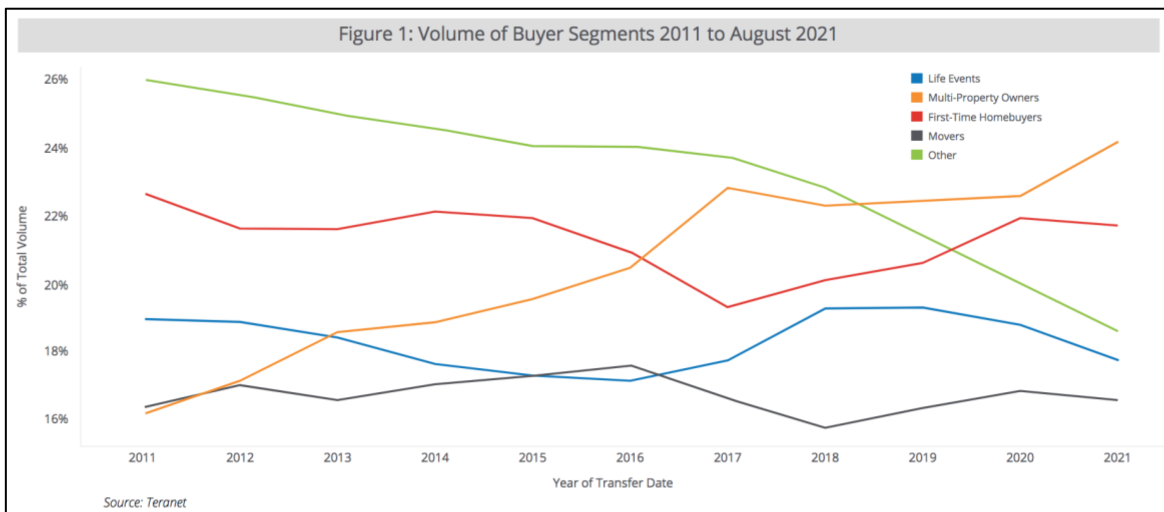
Prepared For:

But where I get concerned is when I look at how real estate is cannibalizing the economy. The exceptional strength in the resale market and surging construction activity pushed residential investment to a new record share of GDP in the province in 2020…well above the previous high from the late 1980s that ultimately saw a significant correction in prices that lasted until the mid 1990s:



There are a pile of warning signs but none more so than the rapid rise in investor interest. On that point, I'm starting to think that I may be underappreciating the degree to which these investors are inflating demand.

Recall that Teranet had a great report recently looking at home purchases by multi-property owners in Ontario. Note that this segment captures recreational property buyers as well as investors, but the net result is the same in that both groups push demand beyond what underlying demographics would warrant. The share of homes purchased by this group has risen from 16% in 2011 to almost 25% in 2021.



Ontario saw 190,000 homes sold back in 2011. The most recent 4-quarter rolling total as of Q3 was 276,000. Accounting for the rising share of multi-property owner purchases over this time, it means this group accounted for 46% of the total increase in home sales in that period.

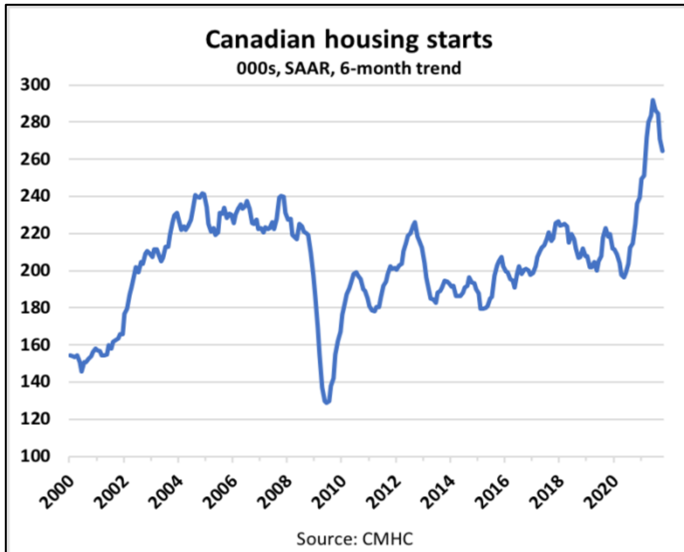
We've got a long ways to go to get back to any semblance of balance in Ontario's resale market, but that can change quickly. Markets that are driven to this extent by investors seldom correct by going sideways, and if that's the case, there could be very severe ripple effects through the rest of the economy.

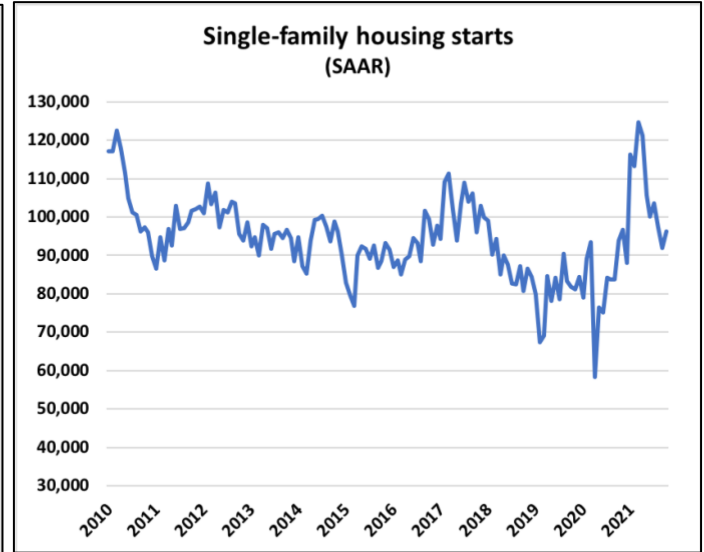
Prepared For:

2) Supply/demand deep-dive: Housing starts continue to cool

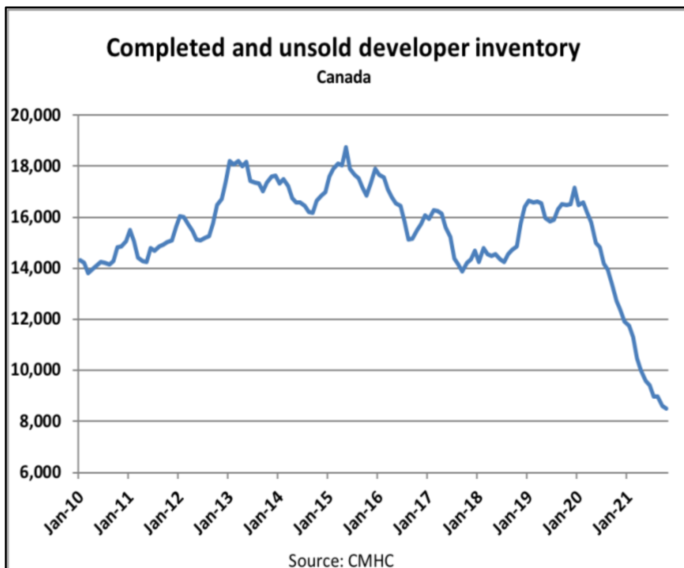
i) Housing starts continue to cool, unsold inventory plunges

Housing starts fell 5.3% m/m in October, the 5th straight monthly decline. The 6-month trend is still running at 264,000 on an annualized basis, but that's way off the highs from earlier this year. And what's particularly disappointing is that single-family starts have slumped by nearly 30% from the Q1 peak. Given the persistent lack of resale inventory across the country, this is not a great development.





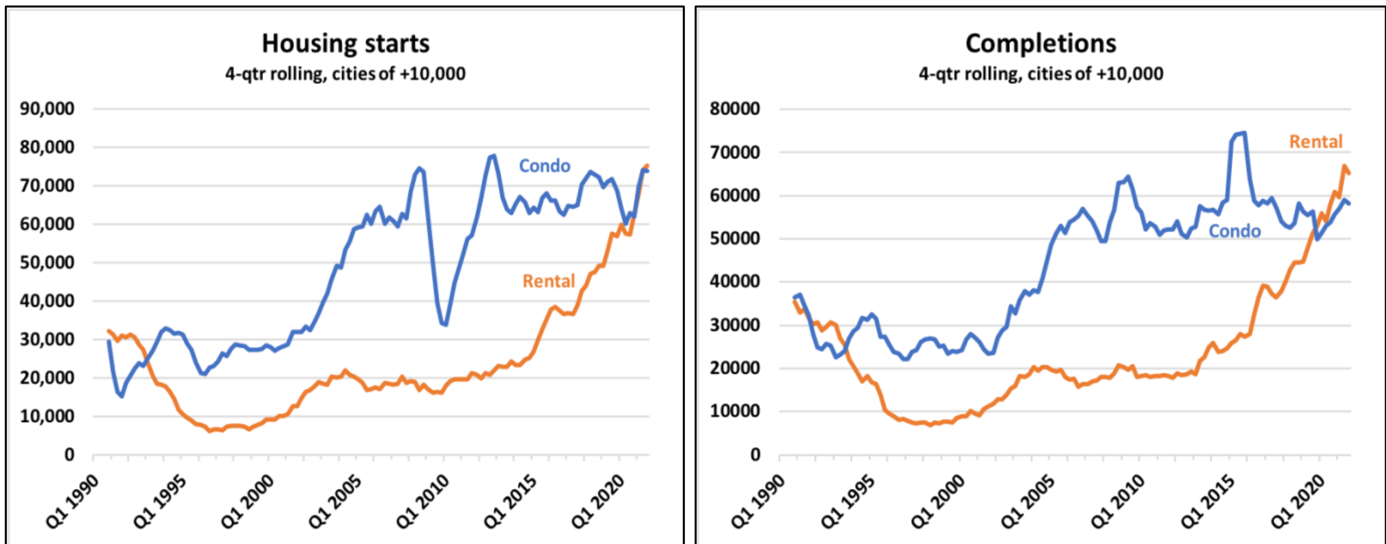
In a sign that demand continues to outstrip supply, the inventory of completed and unsold new homes fell to fresh decade lows in October:



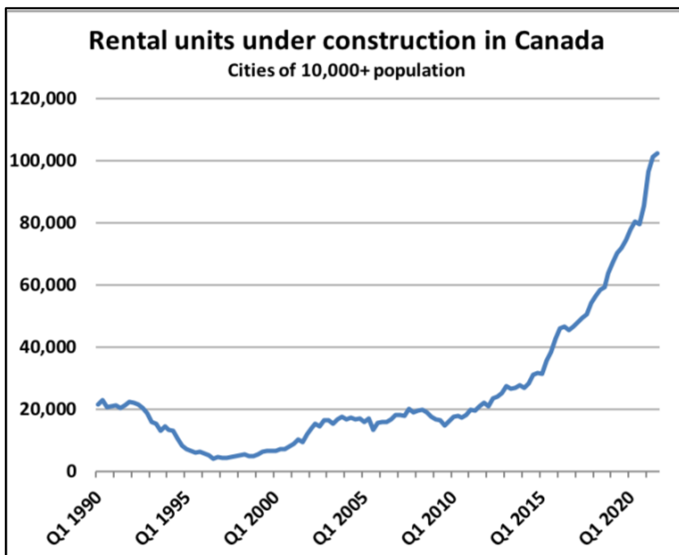
Prepared For:

ii) Rental construction overtakes condos for the first time since the 1990s

If you ask anyone if there's overbuilding in the housing sector, they'll likely point to the cranes and half-built condo buildings dotting to Toronto skyline. But most would be surprised to learn that for the first time in almost 30 years, rental housing starts and completions are now higher than condos on a 4-quarter rolling basis:



Canada has crossed 100k rental units under construction for the first time in at least 30 years….a 5x increase in the past decade alone:



Construction in the rental segment is booming, and it brings me back to a point I've made before: If there's potential overbuilding in the Canadian housing market, it's probably in the rental space or condo space as opposed to single-family.

Let's zoom in on Toronto for a moment. Interestingly condo rents declined slightly last month, but there's unquestionably been a dramatic tightening in that market since the lows in late 2020:

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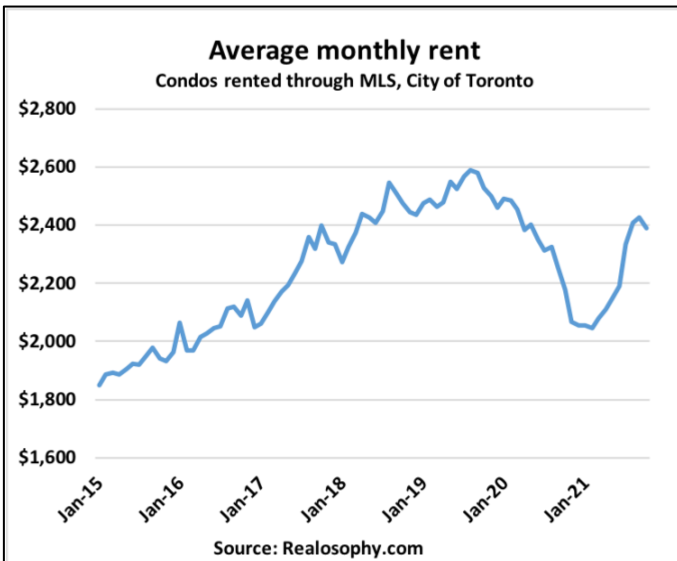
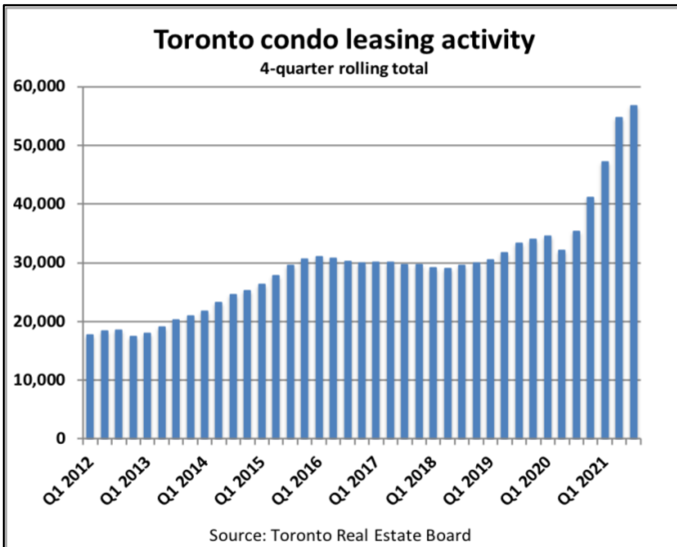
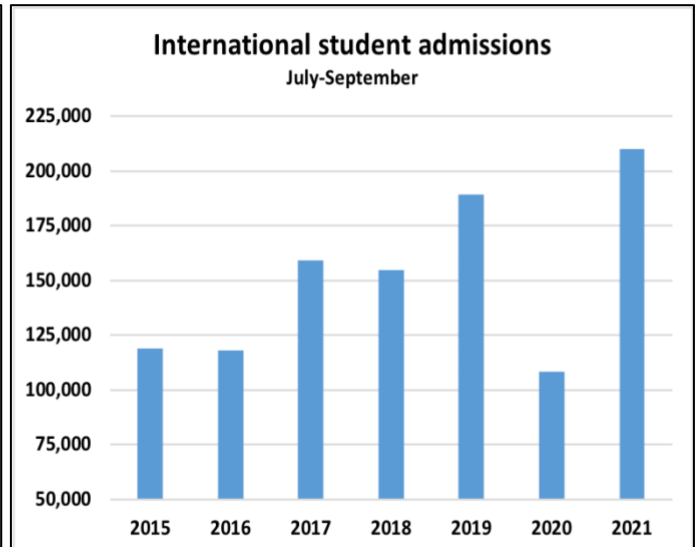


In Q3 we had a massive surge in rental demand that pushed total leasing activity to new highs. This was largely a function of the increase in international student admissions this summer relative to 2020:





Prepared For:

But even with that one-time boost from the surge in returning students, the lease-list ratio (a measure of demand relative to supply) remains below where it was pre-COVID:

That's a surprising stat, and it suggests that for all the improvement in recent months, the market is still nowhere near as strong as it was before the pandemic.

I wouldn't be at all surprised to see a bit of a softening in the supply/demand balance now that the initial wave of returning students is behind us. In addition to new rental supply in the pipeline, there's a pile of investor activity, which means we're seeing a lot of conversion of existing resale supply into rentals. Consider the insights below from John Pasalis:

John Pasalis
@JohnPasalis

Interesting observation.

Over the past 6 months in central Toronto

# of houses listed for sale: 1527
# of houses listed for lease: 1391

You don't sell unless you have to!

More For Lease signs vs For Sale because homes sell in days while rentals take weeks to find a tenant

> **Craig** @CraigPolecrone · 18h
> Replying to @JohnPasalis
> Anecdotally, in midtown Toronto, houses for lease signs far exceed those for sale. Been the case for a while. Agree that when possible, people will keep and rent out vs. sell existing when moving. Helocs and great rates certainly help.

6:27 PM · Nov 15, 2021 · Twitter Web App

Indeed MLS rental listings for detached homes has surged in recent quarters, almost certainly a reflection of rising investor participation:

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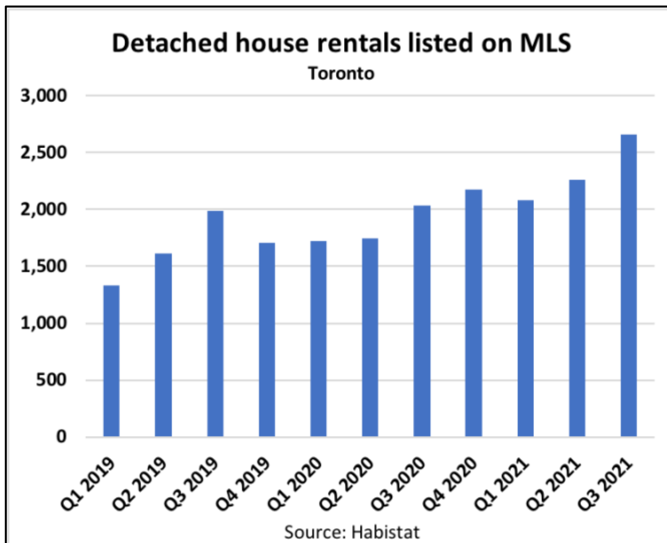
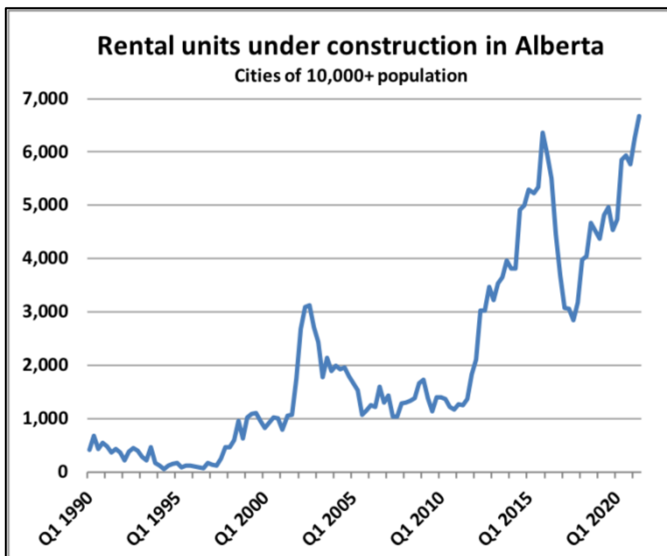


While it's hard to find a part of the country that hasn't seen a huge runup in rental construction, one area to watch is Alberta. Rentals under construction have now surged past the 2015 highs:



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RENX, a real estate news site, had this to say on the situation in Calgary[1]:

> **Calgary sees flood of new rental apts.: 100 projects in 5 years**
>
> Calgary has experienced an explosion of interest in the purpose-built rental market with 100 buildings launched over the last five years. Those buildings comprise 12,814 units across seven sub-markets, including Airdrie and Cochrane just outside the urban area.
>
> The boom has raised concerns about potential overbuilding and whether Calgary can absorb all that new product.

[1] https://renx.ca/calgary-flood-new-rental-apartments-100-projects-5-years/

> […] "Looking at the average vacancy for all projects in Calgary, the vacancy decreased by two per cent when compared to the previous quarter and by 10 per cent when compared to the third quarter of 2020," Brown said during a panel discussion on the multiresidential market.
>
> "The vacancy for all projects is higher at 8.2 per cent, compared to the stabilized 4.1 per cent. This is due to the new products that have launched during the last couple of quarters.
>
> […] Brown said 96 other projects have been approved by the City of Calgary, with 37 currently under construction. Of these, 20 are expected to hit the market over the next couple of years.
>
> Those 96 projects total an additional 21,977 units to the city's purpose-built rental market.

While I'm constructive on the Alberta economy and housing market broadly, the rental market may actually underperform.

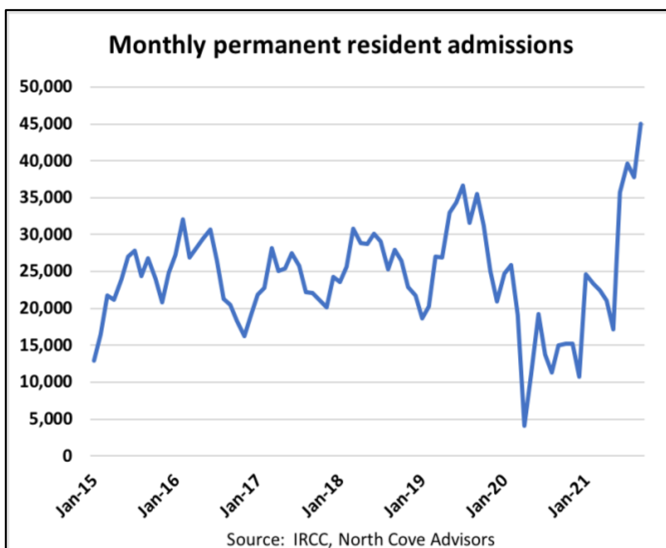
In addition to record supply, we'll likely see demand pulled away from the rental space into the ownership pool.

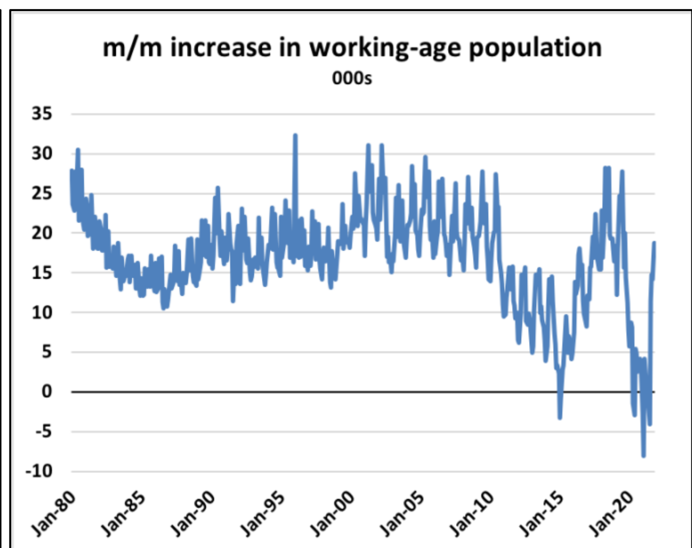
Consider that condo prices are flat over the last 15 YEARS in Calgary and are more affordable on a carrying cost basis than they've perhaps ever been. I don't believe there's a single other top-20 metro in the country that has seen any housing segment get MORE affordable over the past few years.

iii) Canada back on track to hit immigration targets

On the population front, the feds are still trying to hit their 401,000 immigration target. Canada "admitted" 45,000 new permanent residents in September, the highest monthly figure since 1913!

There's an important footnote to the term "admitted" in the preceding paragraph. Most of the permanent resident admissions are for people already counted as in the total population as temporary residents. The result is that the actual population growth remains less than what would be implied by the robust immigration numbers, and we can see that even in the October Labour Force Survey population estimates which show the monthly growth in the working-age cohort is still not back to pre-COVID levels:



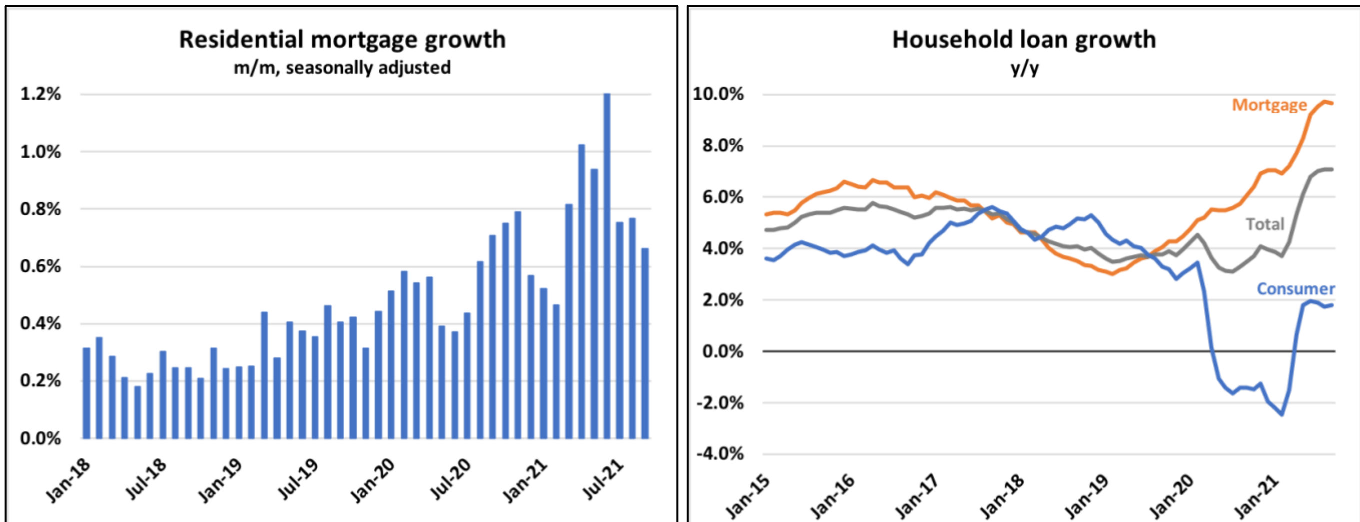


Prepared For:

3) Household credit update: Mortgage growth cools but variable originations surge

i) Household credit growth moderates in September

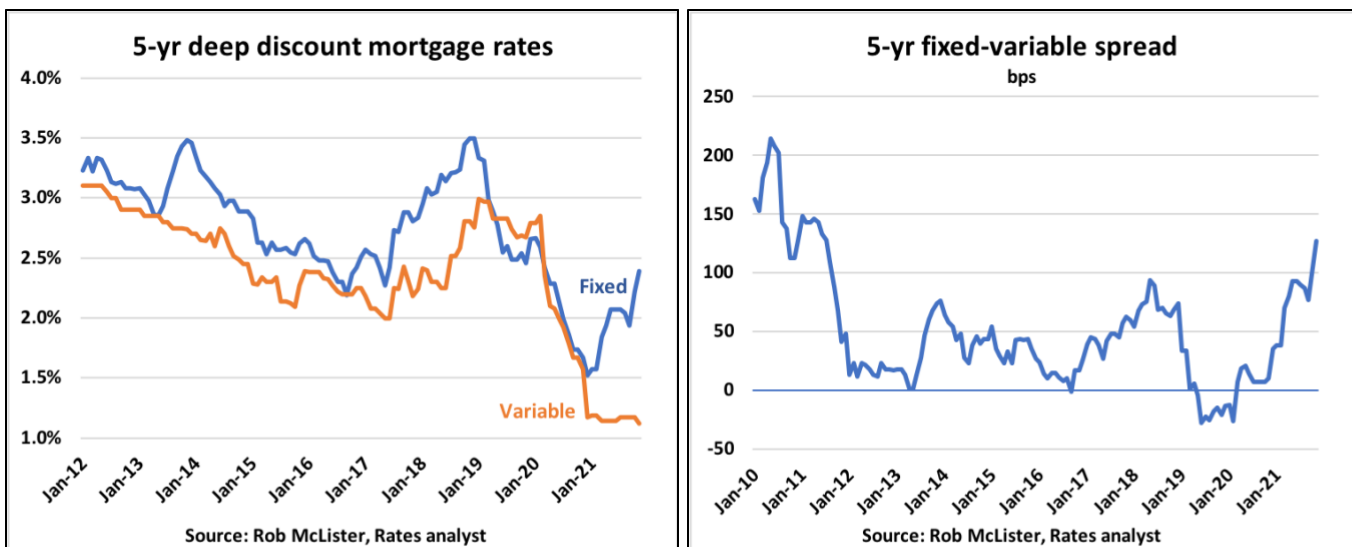
Canadian households tacked on another 0.5% to their debt burdens in September. Mortgage balances grew by 0.7% seasonally adjusted, the lowest reading in 7 months, while non-mortgage consumer credit grew by 0.2%.



The y/y growth rate in mortgages appears to have peaked at just under 10%, but given the recent surge in home sales, we may see credit growth reaccelerate when buyers close on those sales in ~3 month.

ii) Fixed mortgage rates rise, variable originations surge

Discounted 5-yr fixed mortgage rates have risen to 2.4%, a 90bp move off the lows. With variable rates still at rock-bottom levels, the fixed-variable spread has shot up to 130bps:



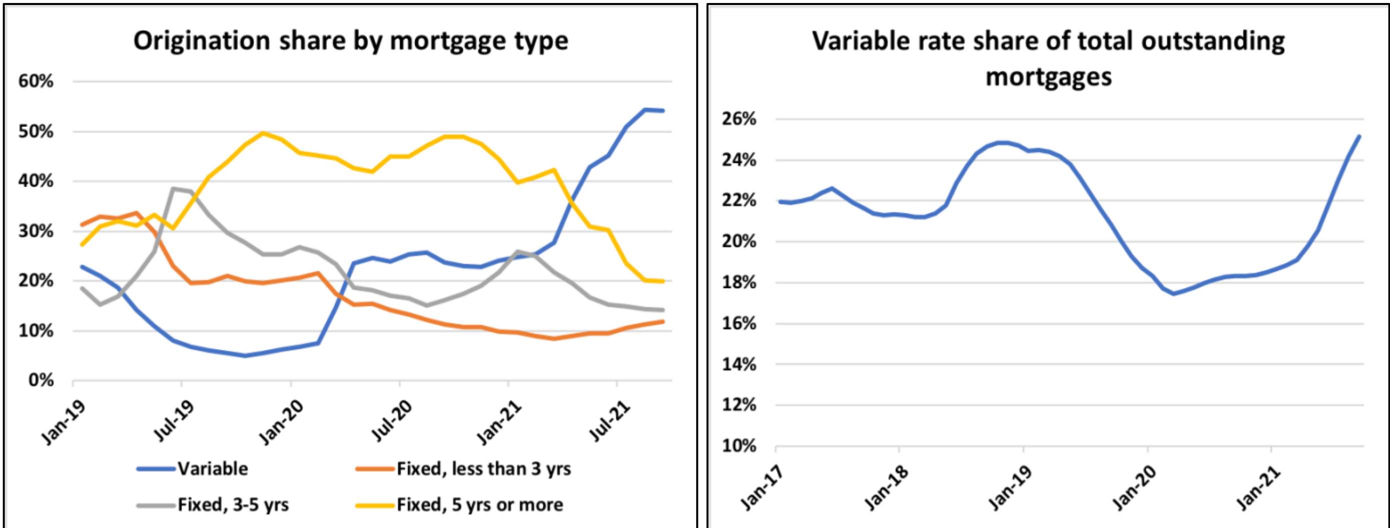
Borrowers are now heavily incentivized to opt for adjustable rate mortgages, which is perhaps ironic given the aggressive tightening currently reflected in bond prices .

Prepared For:

Total originations were down 19.6% y/y in September off record levels in 2020, but the split between fixed and variable is stunning:

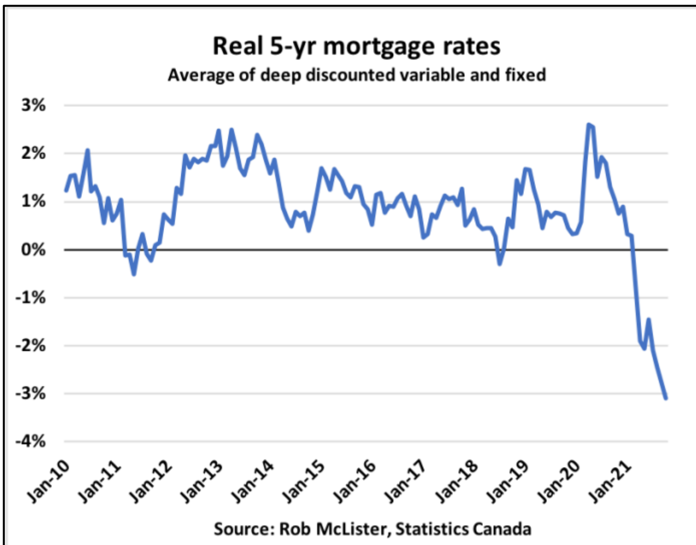
Variable origination volumes: **+84.2% y/y**
Fixed origination volumes: **-51.7% y/y**

With variable products accounting for 54% of new originations in September, the total share of adjustable mortgages outstanding is over 25%, the highest since the data set begins in 2016:



iii) Real rates hit -3%

With inflation still rising faster than mortgage rates, the real interest rate hit -3% last month.



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4) Credit check: Household savings slow, delinquencies bottom

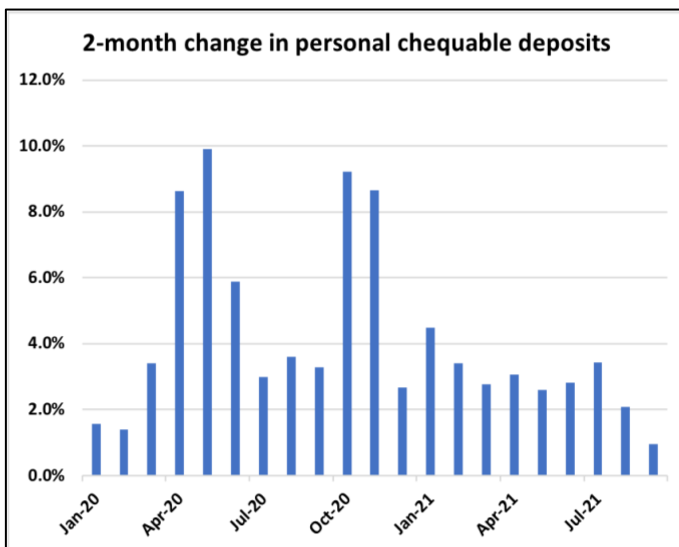
i) Early warning signs as household savings slow

Households in Canada generally don't default on debt before 2 things happen:

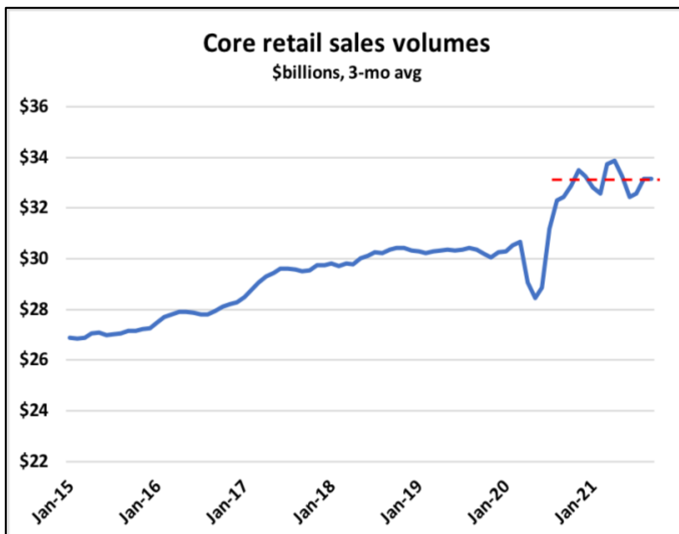
- They exhaust savings
- They pull back on discretionary/non-essential spending

In other words, both savings and discretionary spending are leading indicators of consumer credit trends. I mention it here because for the first time since the onset of the pandemic, there are signs that these dynamics are in fact beginning to weaken..

On the savings front, the 2-month change in chartered bank chequable deposits has fallen to the lowest level since mid-2019. While it's not a perfect proxy for household savings, it's pretty good. It points to a sharp slowdown in savings in Q3:



Meanwhile, the latest retail sales print was rather soft, but particularly so when we look at core sales which strip out fuel and autos. When we adjust for rising prices we find that core retail sales volumes were down a sizable 0.8% m/m in September and are now flat since late 2020:



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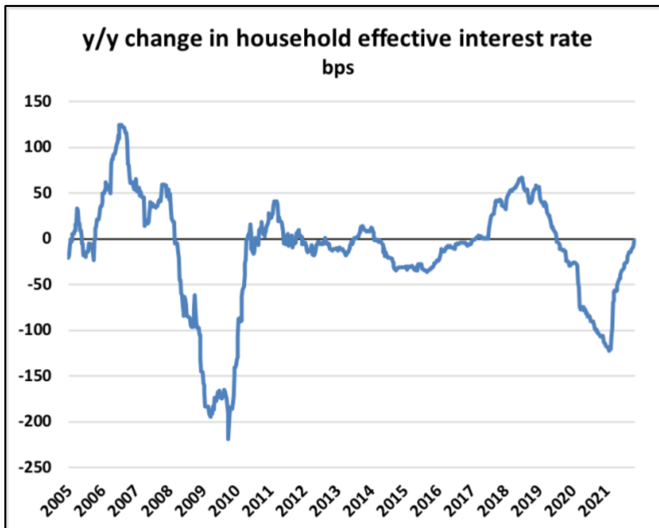
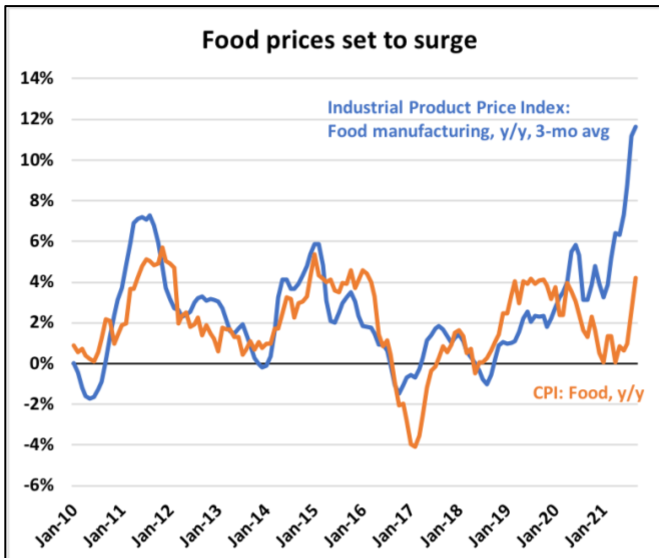
So that's a bit of a concern as it suggests that delinquencies may begin to normalize within the next couple months. As to what's causing this, I see three issues:

- The effective interest rate paid by households is now flat on a y/y basis for the first time since mid-2019. Yes, rates are still low, but they are no longer falling, and that means the tailwind from falling rates is now behind us. And that's before the Bank of Canada even begins to tighten:



- Rising food and fuel costs. Pretty straight forward here…when gasoline prices surge 50% in one year and food prices are rising and have only one way to go, it's a drain on household cashflows.



- Government support rolling off. This is probably the big one. EI and other income support programs are running off. Active recipients are plunging as key programs like the Canada Recovery Benefit come to an end. There were still just under 1.3 million Canadians receiving government assistance in September, but that represents a drop of 187,000 from the prior month:

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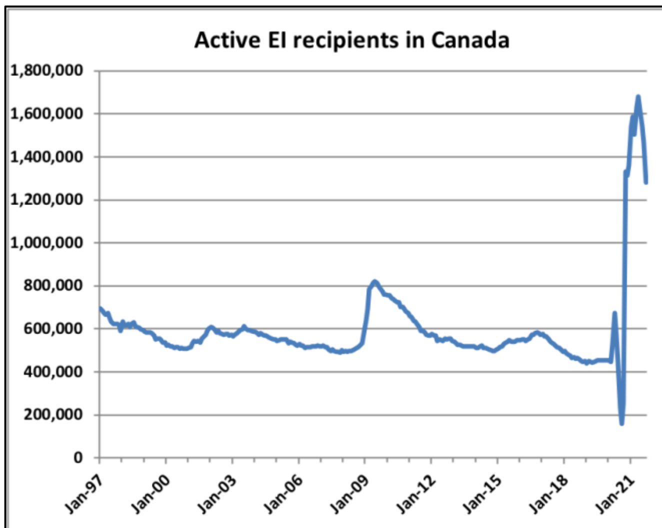


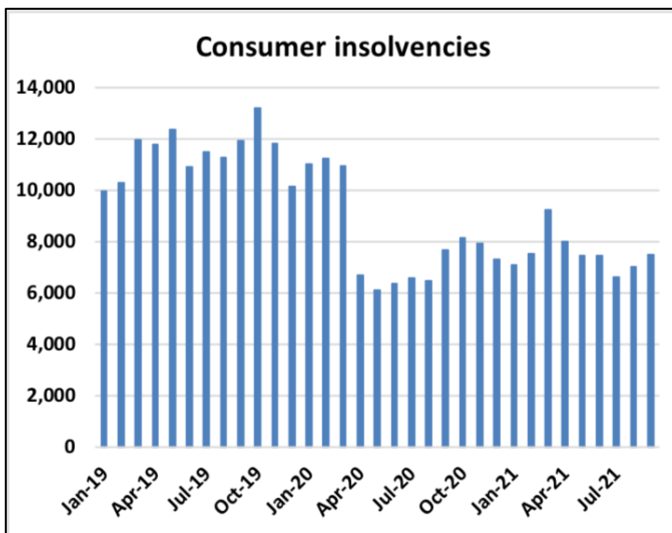
My suspicion is that within the next couple months, we'll see credit card delinquencies bottom. By Q1, insolvencies will have also hit a low and will be clearly back on the upswing.

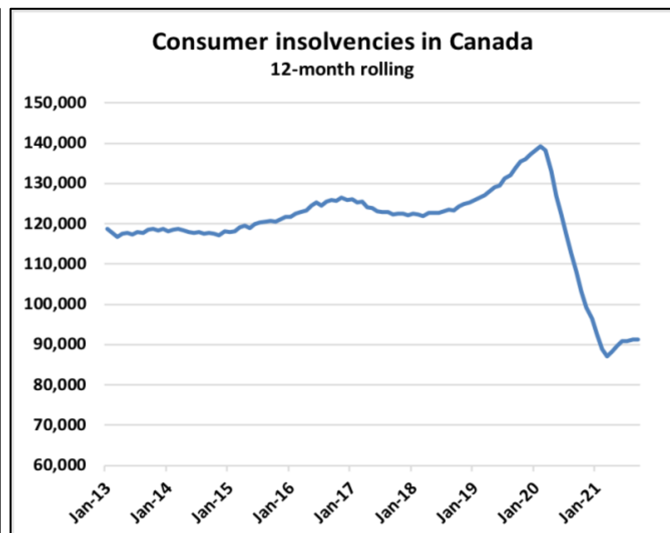
ii) No uptick (yet) in consumer insolvencies

For now, consumer insolvencies look fantastic, down 2.1% y/y in September and down 37% compared to 2019.

Bankruptcies fell 14.3% y/y and were 53% lower relative to 2019 levels. Until real estate prices soften, we should expect bankruptcies to remain extremely low. When house values go up $140,000 in a year and owners can readily turn that equity into credit, it's very hard to go bankrupt.

Alberta remains one province to watch. Insolvencies were up 13.5% y/y last month including a 28% jump in proposals.





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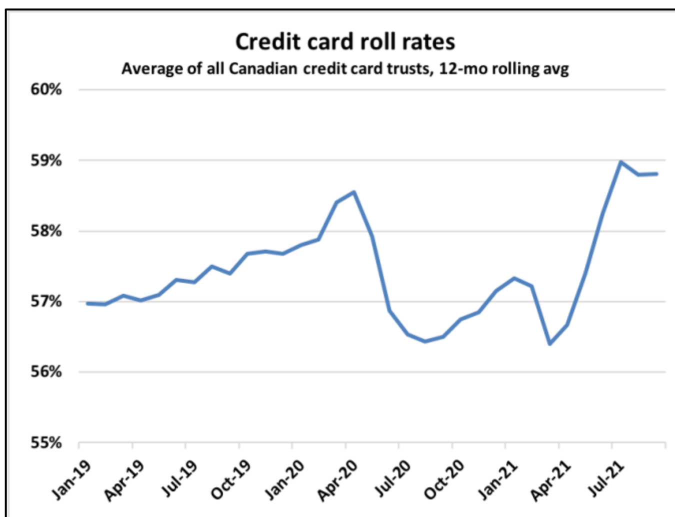
iii) Credit card trust data: As good as it's going to get

Remember, credit card trusts are the best leading indicator of consumer credit stress. It's what people skip first. No one defaults on a mortgage until the miss a few credit card payments. Credit card trusts report delinquencies monthly, which means they are also much timelier indicators than official mortgage delinquencies which lag by 90 days.

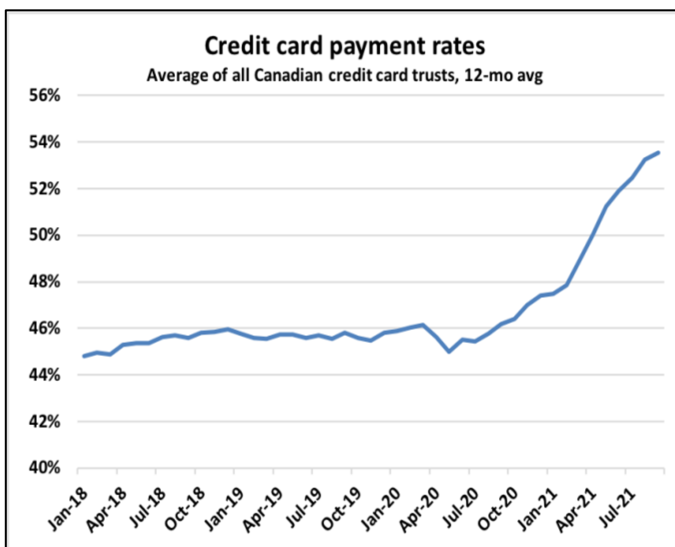
While there are no signs of any meaningful deterioration in credit card trust data, there are some tentative signs that things may be about as good as they're going to get.

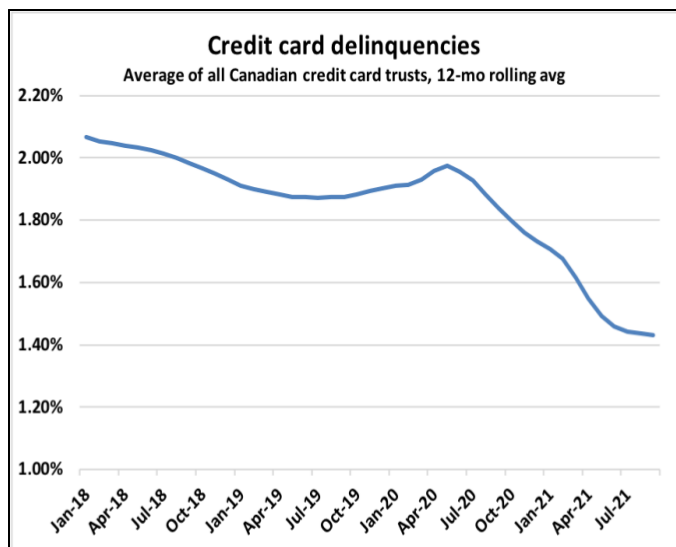
For starters, roll rates have risen to above pre-pandemic levels in recent months. This measure reflects the share of early stage delinquent accounts (30-60 days delinquent) that "roll" into a later stage, more serious delinquency bucket (+60 days delinquent).

A low/falling roll rate suggests that borrowers are able to get caught up and 'cure' delinquencies, and it is often a reflection of ample cash flow for households. Rising roll rates suggest the opposite and tells us that it's getting harder for delinquent borrowers to get caught up:



Similarly, there are also some signs that payment rates are topping out while total delinquencies are bottoming:





There's nothing to suggest a major deterioration in credit trends in the near term; The employment backdrop still looks

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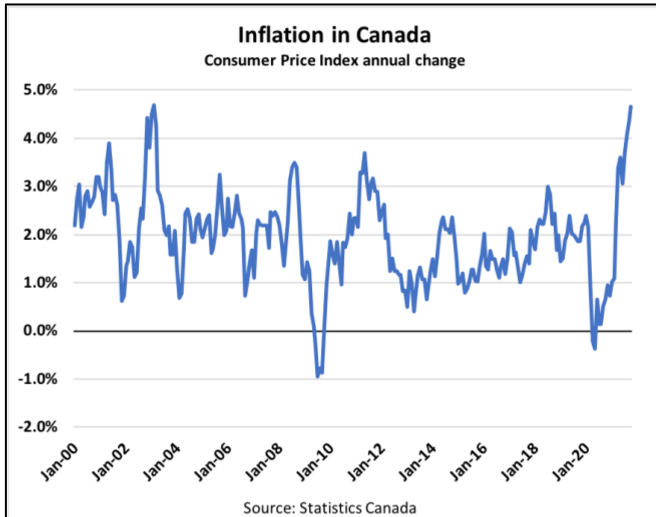
exceptionally solid, with total employment already back to new highs with hiring intentions still at record levels. But I think in terms of credit trends, this is probably about as good as it's going to get, and the long climb back to 'normal' will likely be evident within a couple months.

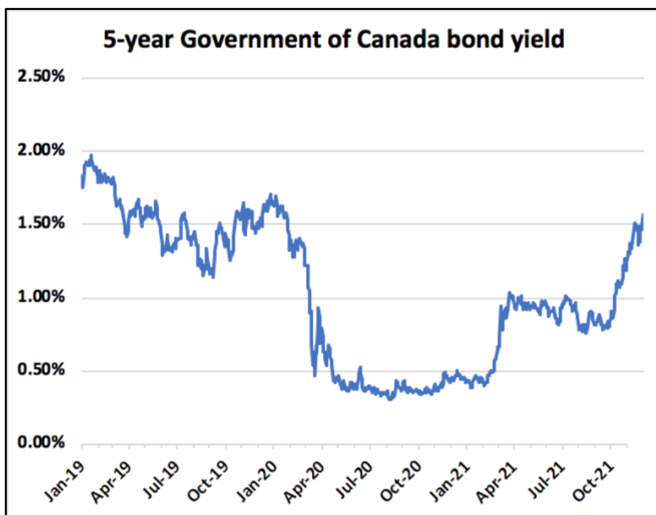
5) Monitoring key risks

i) Bond yields jump to 2-yr highs

Investors are increasingly betting that the Bank of Canada will have to hike rates earlier than previously expected to combat rising inflation which hit 18-year highs in October:



5-year bond yields, which largely determine fixed mortgage pricing, are now up to 2-year highs at just under 1.6%. That means we may yet see further upward pressure on fixed mortgage rates.



The October Edge Report contained a lengthy discussion of why I don't believe we'll see anywhere near 8 hikes by the end of 2023 (which would push variable rate mortgages into the 3.5% range). I won't rehash that here, but it again bears repeating that this is the biggest threat to the housing bull market over the next year.

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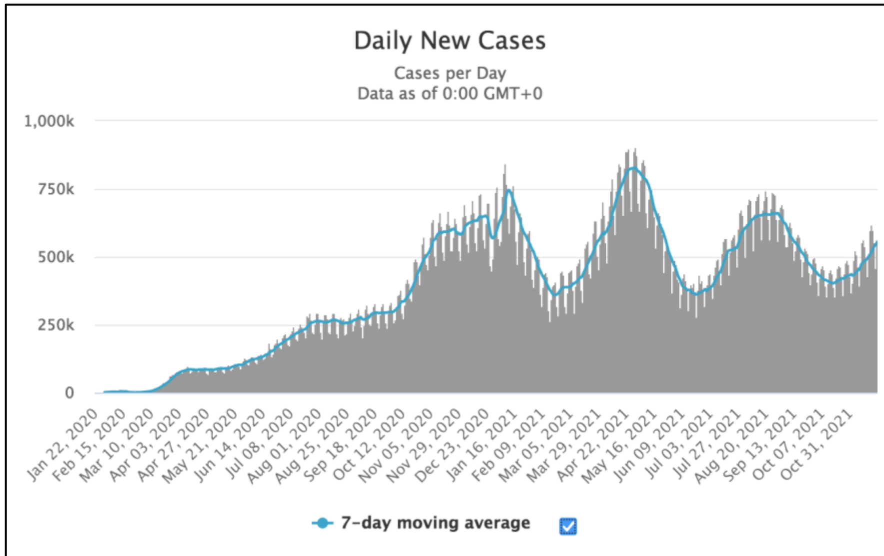
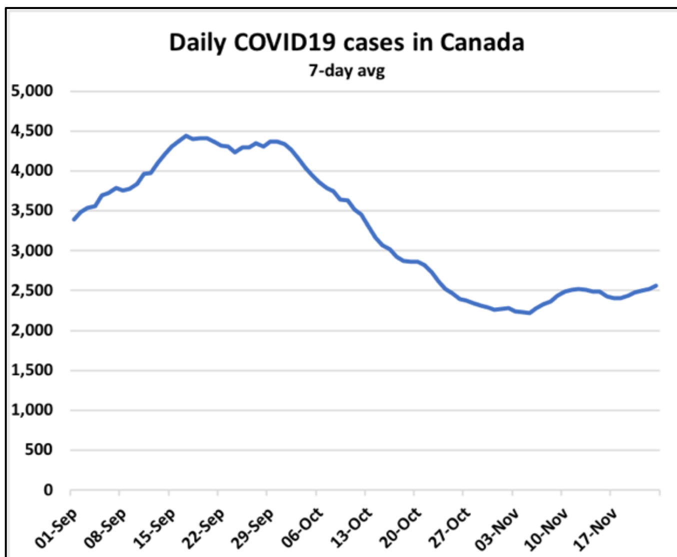
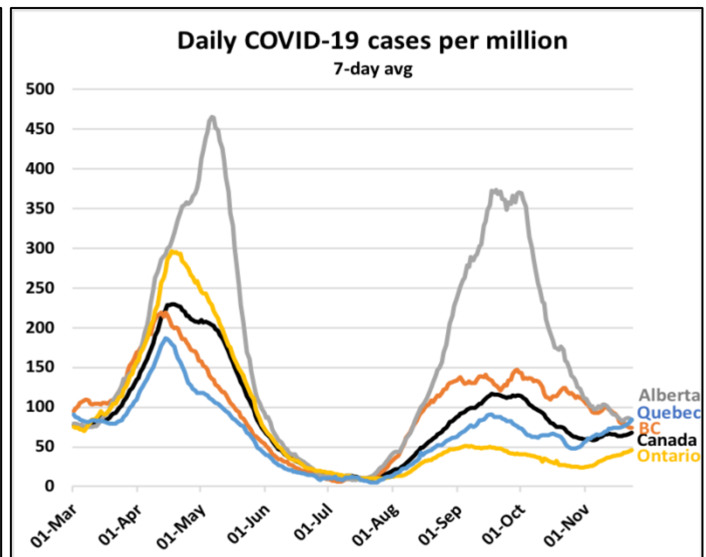
ii) COVID resurgence?

COVID-19 cases globally are back on the rise and heading for another winter wave:



So far there's been only a modest uptick in daily cases in Canada, mostly centered in Ontario and Quebec…and we have yet to see any increase in hospitalizations:





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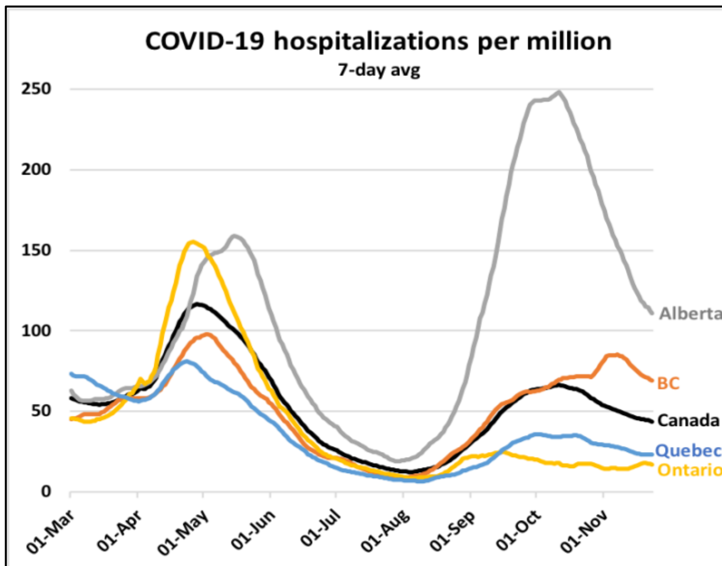
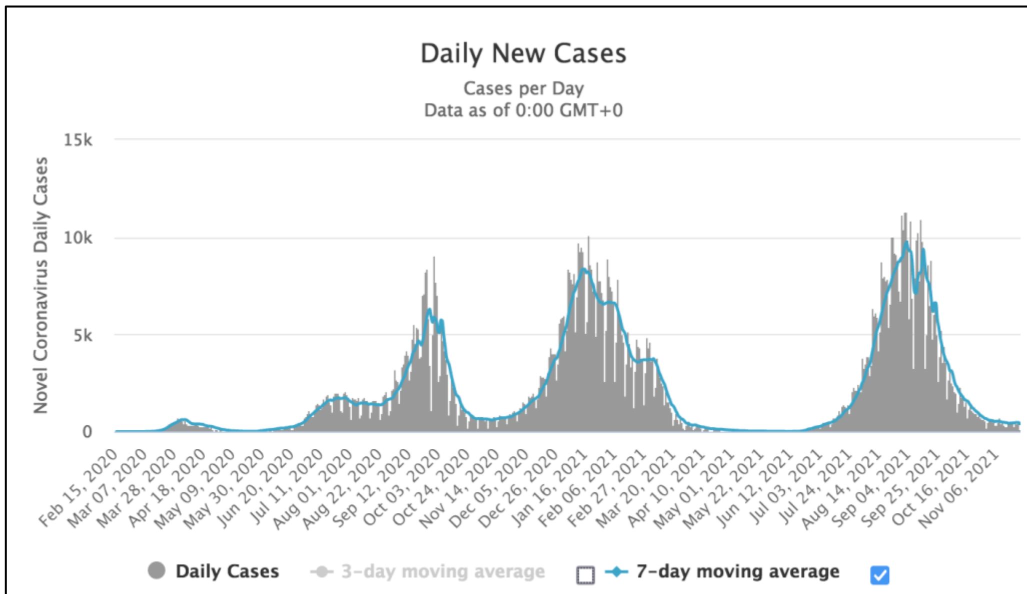


It's important to note that every successive "wave" has had a smaller impact on the economy, and there's no reason to think that this one (if it materializes) will be any different. We may see some regional restrictions that could weight on the recovery, particularly since the Canada Recovery Benefit is rolling off, but I don't imagine it will be a major issue.

We can look at Israel as an example of what we might reasonably expect. They had a surge in cases in September in spite of widespread vaccinations. They quickly rolled out boosters for the most vulnerable populations, and by mid-October, they were almost back former levels:



We also have the phenomenal news from Pfizer regarding the anti-viral pills that reduce severe outcomes for infections by up to 90%. I think that's a bigger deal than people currently realize. If we can de-fang this virus and bring hospitalizations down 90%, there's a good chance we can put lockdowns and other restrictions behind us for good and learn to just live with it. But still, it's a risk that warrants a mention here.

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iii) Regulators continue to hint at mortgage tightening

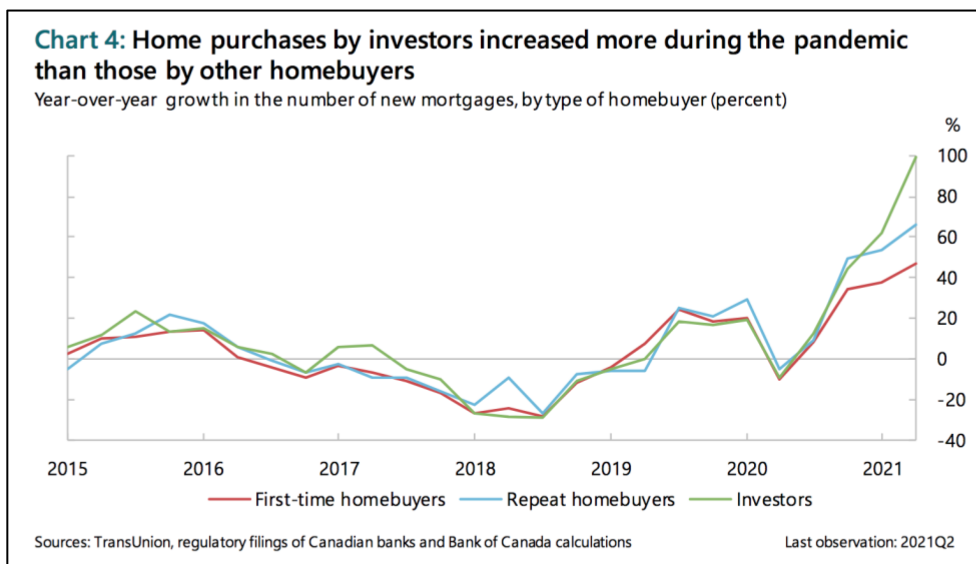
Remember two things when it comes to mortgage regulations:

- Regulators don't like to "surprise" people if they don't have to. They prefer to drop hints ahead of time.
- Regulators respond to the news cycle, which means they are more likely to respond to an issue as it gets more press.

We got a glimpse into how the Bank of Canada is thinking about financial risk among households this week in an important presentation by Deputy Governor Beaudry. Among the key takeaways:

> […] A sudden influx of investors in the housing market likely contributed to the rapid price increases we saw earlier this year. In such a case, expectations of future price increases can become self -fulfilling, at least for a while.
>
> That can expose the market to a higher chance of a correction. And, if one occurs, the damage can spread far beyond the investors. That's because, for many households, their wealth and access to low-cost credit are tied to the value of their home.

They included the chart below showing the relative increase in investor activity this year:



The Bank is NOT HAPPY with what they are seeing among investors. And it's made worse by the fact that it's increasingly getting media coverage as well, which puts pressure on policy makers to act. Consider:

> **Investors now make up more than 25% of Ontario homebuyers, pushing prices higher, experts warn -CBC**
>
> https://www.cbc.ca/news/canada/toronto/investors-in-ontario-real-estate-market-1.6258199

The presentation went on to highlight "deteriorating quality" of new mortgages. Here they point to higher loan-to-income ratios:

> […] we also found that the deteriorating quality of new mortgage borrowing during recent quarters is now likely the bigger driver of household indebtedness.
>
> […] The takeaway is that, overall, vulnerabilities linked to elevated household debt appear to be rising again after a slight pause.

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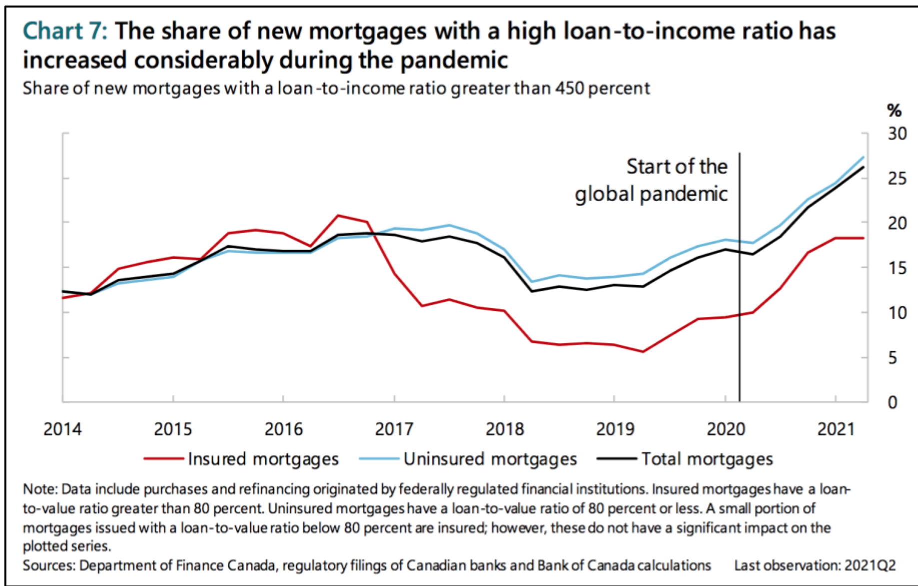

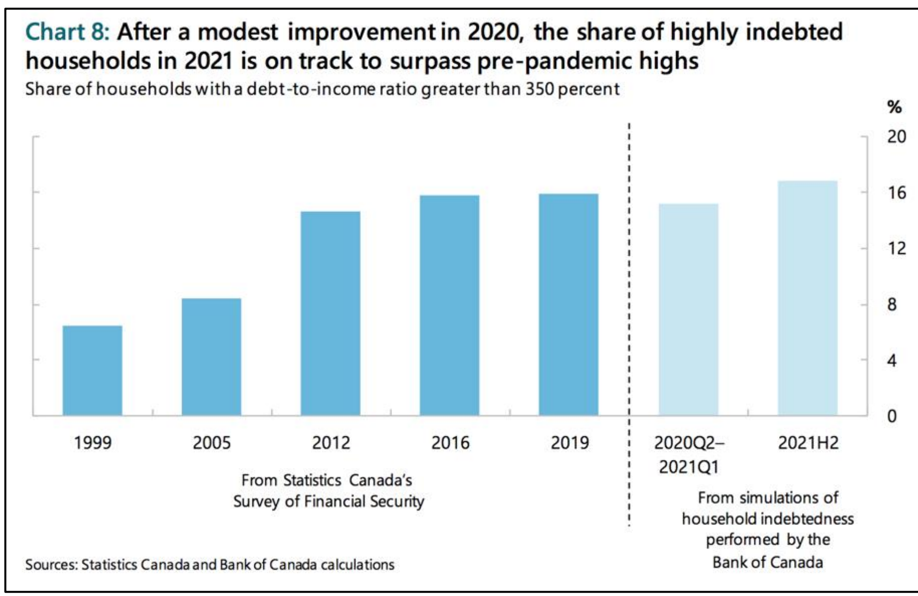

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Now remember, the Bank of Canada sits on the Financial Stability Board along with the Department of Finance and OSFI. So when the Bank frets about investors and overleveraged homeowners, other policy makers hear about it.

The key point here is that risk of further mortgage tightening is high and rising. Should more tightening measures be announced, they will almost certainly target investors (think higher down payments, exclusion of borrowed money for down payments, etc). And they may also look again at a hard loan-to-income cap rather than debt service ratio limits.

We may see those measures early in the new year unless we see tangible signs that the market is cooling on its own.

In closing:

- Housing demand is reaccelerating again, in part due to fear of rising rates.
- Inventory shortages continue, and it points to strong price appreciation right through the winter.
- Housing starts are falling off the very high levels earlier this year, including a steep decline in the chronically undersupplied single-family market.
- There are VERY tentative signs that consumers are beginning to feel a bit of a pinch. We're likely to see insolvencies and mortgage delinquencies bottom in Q1 2022.
- Regulators are hinting at new mortgage regulations that could hit early next year if housing doesn't cool on its own.

Regards,
Ben

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