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Canada Housing Market: Values, Volumes and Vertigo

INTRODUCTION

The Canadian housing market is running hot but will slow down in 2021, though the exact timing is difficult to predict. The combination of restricted mortgage lending and the expectation of higher mortgage rates suggests that house prices are likely to experience a slowdown in the next year and a half. Moreover, affordability as measured by the ratio of median dwelling price to median family income is also at a record low, making it difficult for house prices to maintain the same momentum as before.

The short-term house price outlook calls for slower appreciation over the next year and a half, with a subsequent pickup. House price appreciation in Toronto, Montreal and Vancouver will go through a short but significant slowdown that will bring prices closer to long-term trend values. House prices in Calgary and Edmonton are below their trend value and will moderate slightly. Despite this slower short-term outlook, the medium- and long-term outlook is looking substantially better, due in part to the deceleration of house prices in Toronto and Vancouver. More stringent mortgage lending will improve housing affordability and debt service ratios in the long term, reducing the possibility of an extended house price correction.

Canada Housing Market: Values, Volumes and Vertigo

BY ABHILASHA SINGH

The Canadian housing market is running hot but will slow down in 2021, though the exact timing is difficult to predict. The combination of restricted mortgage lending and the expectation of higher mortgage rates suggests that house prices are likely to experience a slowdown in the next year and a half. Moreover, affordability as measured by the ratio of median dwelling price to median family income is also at a record low, making it difficult for house prices to maintain the same momentum as before.

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Recent Performance

The national housing market's stellar performance has continued through the first few months of 2021 and shows very little sign of abating. The RPS 13-metro area transaction-weighted composite house price index rose 1% in May from the previous month and soared 15.2% year over year. House prices have appreciated more than 10% on a year-ago basis in each of the last nine months, the fastest rate since 2007.

Regionally, almost all of the country is participating, with seven of the 13 major markets experiencing double-digit house price appreciation on a year-ago basis. Toronto, Vancouver, and smaller neighboring metro areas that entered the pandemic with sound housing markets, such as Hamilton, Ottawa and Victoria, have strengthened further. Markets that were in the doldrums, such as Calgary, Edmonton and Saskatoon, have re-emerged.

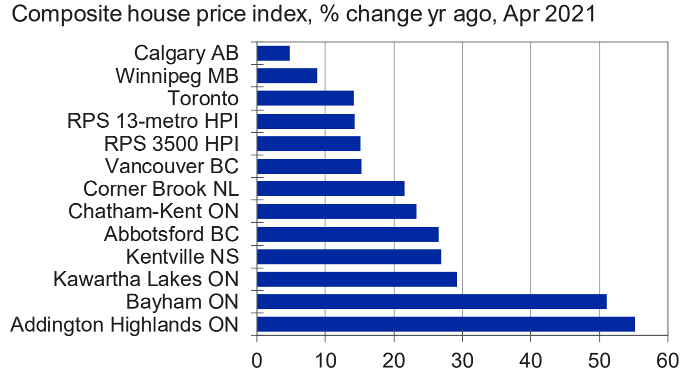
Soaring house prices and insane bidding wars are not limited to major metro areas. In fact, small cities and cottage towns are growing at a faster clip. This is evident from the faster house price appreciation of the RPS 3500 weighted house price index compared with the RPS 13-metro area weighted house price index (see Chart 1). Small cities and cottage towns such as Addington Highlands, Bayham, Kentville, Kawartha Lakes and Abbotsford are seeing tremendous competition among buyers, with prices appreciating north of 20% year over year as the pandemic has shifted consumer preferences towards larger properties farther from downtown urban cores.

Housing demand has surged, with home sales in recent months as strong as they have ever been. Mortgage rates remain near historic lows, employment in higher-paying industries has recovered, and fiscal stimulus is shoring up household finances. Moreover, the pandemic has fueled a shift in housing preferences and motivated a large cohort of younger households to switch from renting to buying.

Supply is limited and relatively inelastic compared with other goods and services in the short term. Over the past decade or so, there has been a dramatic shift in the Canadian housing market towards condo construction. The growing popularity of condos has

Chart 1: Cottage Towns March Ahead

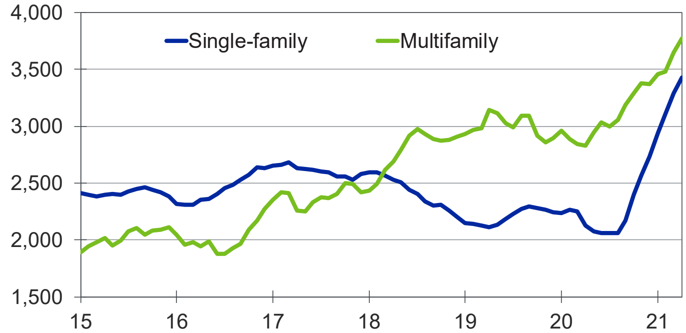
Composite house price index, % change yr ago, Apr 2021



Sources: RPS, Moody's Analytics

Chart 2: Single-Family Building Takes Off

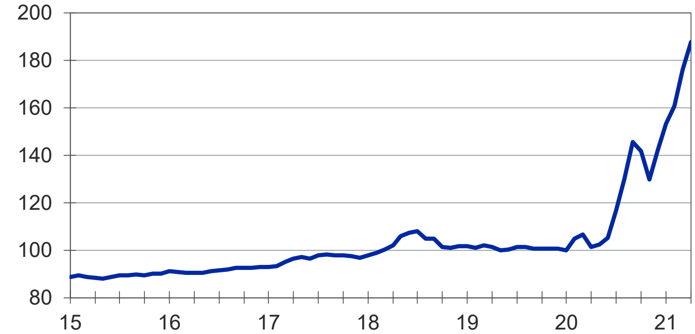
Permits value, C$ mil, 6-mo MA



Sources: Statistics Canada, Moody's Analytics

Chart 3: Lumber Prices Explode

Lumber and wood products, PPI, Jan 2020=100



Sources: Statistics Canada, Moody's Analytics

been even more prevalent in urban centers given strong population growth and limited space. And, that is not what a large cohort of consumers want right now, but supply cannot adjust fast enough. The existing inventory on the market plumbed record lows by historical standards despite above-average new listings; the months' supply of homes for sale is about 2, whereas the norm is around 5. Consequently, sellers remain firmly in control of the market and have been able to hike prices.

Tight supply and demand conditions are pushing buyers towards the new-home market, putting upward pressure on prices across the board. Taking their cue from prices, builders are embarking on new projects at a breakneck pace to catch up with the shift in demand (see Chart 2).

In turn, demand for construction materials has intensified. Since the start of 2020, the product price index for lumber has surged nearly 88% (see Chart 3). Supply of lumber will slowly ramp up, but there is no immediate relief in sight for lumber costs and, in turn, the price of new homes.

The market for condo apartments is usually overshadowed by the single-family market, but there is reason to be cautious for real estate investors in some markets. The condo apartment market is being impacted by changing preferences of homebuyers, together with lower immigration, work-from-home arrangements, online schooling, and the impact of the pandemic on the labor market, especially for younger workers. Condo apartment price growth has slowed to just 2.2% year over year, or a record 13.4 percentage points below the growth in single-detached homes—the widest gap on record.

Slowdown in house prices ahead

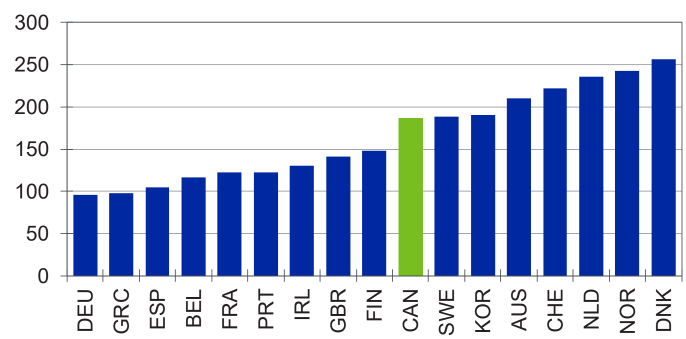
Even though the unemployment rate in Canada remains elevated in the wake of COVID-19 lockdowns and restrictions, house prices are increasing. However, the conditions that have resulted in rapid house price appreciation are unlikely to persist through the next year.

Canadian households exhibit one of the highest debt-to-disposable income ratios in the advanced world (see Chart 4). Over the last year, the ratio of average homeownership costs—of which mortgage debt service is the largest component—to average household disposable income has started to trend up. Housing affordability has eroded as home values have raced ahead while incomes have substantively lagged (see Chart 5). This is the primary danger signal in the eyes of housing market analysts.

Higher debt-to-income ratios make household spending behavior more sensitive to interest rate changes. Historically, this was evident during the previous housing boom of 2016-2017. Tougher mortgage rules and rate hikes in 2018 improved the quality of mortgage lending and slowed household borrowing. As the supply of housing is essentially fixed in the short term, house prices came to

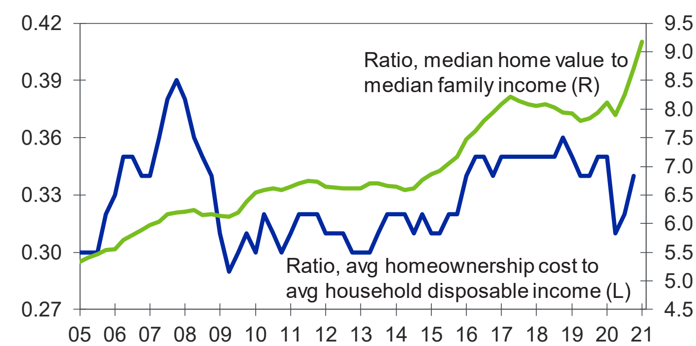
Chart 4: Canadians Highly Indebted

Household debt as % of net disposable income, 2019



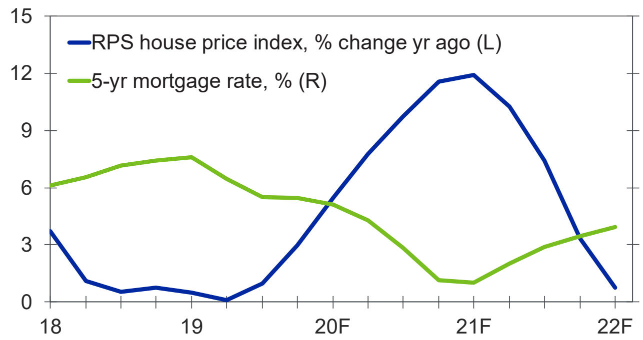
Sources: OECD, Moody's Analytics

Chart 5: Affordability Is Deteriorating



Sources: RPS, Bank of Canada, Statistics Canada, Moody's Analytics

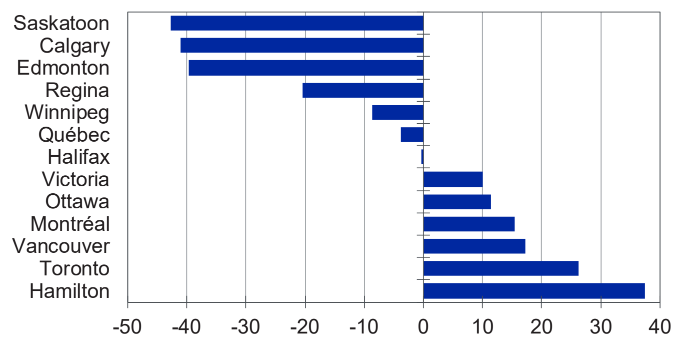
Chart 6: Mortgage Rates Will Drag Prices



Sources: Bank of Canada, RPS, Moody's Analytics

Chart 7: Toronto, Vancouver Defy Trend

RPS house price index, % deviation from trend, 2021Q1



Sources: RPS, Moody's Analytics

a standstill with rising mortgage rates. We expect that a similar series of events will play out in late 2021 and early 2022.

The Office of the Superintendent of Financial Institutions tightened the mortgage stress test earlier this month, increasing the qualifying rate for uninsured mortgages to either 5.35% or the mortgage contract rate plus 2%, whichever is higher. This will take some would-be homeowners out of the market for a house in the suburbs, lowering demand for single-family units and addressing growing concerns of rising Canadian debt burdens.

An improving economy along with generous fiscal stimulus will push government bond yields higher, in turn putting upward pressure on mortgage rates. Rates will start to rise as the Bank of Canada starts tapering its quantitative easing program in late 2021 and raises short-term rates during the second half of 2022, earlier than previously expected. Moody's Analytics projects the five-year mortgage rate will reach 3.7% by the end of 2021 and 4% by the end of 2022.

Impending increases in mortgage rates will cool down the red-hot housing market (see Chart 6). Rising mortgage rates and shrinking affordability will cause the pool of potential buyers to dwindle. Distressed households will also no longer have access to mortgage deferrals. With unemployment still elevated in 2021, loan performance will deteriorate, though banks will be able to absorb the modest losses.

On the supply side, the lack of inventory experienced over the last year will begin to ameliorate. Housing starts on a six-month average basis are running at 279,000 annualized units, the strongest on record. Soaring building material costs are reducing the profitability of new projects and rising prices are causing the pool of potential buyers to shrink. The pace of new construction is likely to cool in late 2021 and into 2022 as the entire housing market comes under pressure from rising interest rates. Also, the end of the pandemic will boost inventories as homeowners become more willing to sell.

Between an increasing home build-out, shifting demand, and policy actions, house prices are sure to correct. It is a matter of when, not if. Over the next few months, however, prices will likely continue to rise, as it will take time for these actions to materialize. Year-over-year price appreciation will slow in the first half of 2022. Rising mortgage rates will chill prices in the short run, as they did in 2018. However, Canada's high population growth relative to other industrialized nations supports an upbeat long-run outlook. A more robust pace of price appreciation should return in 2023 as heightened immigration and a more completely healed labor market re-energize wage and salary growth. The revival of in-office work, indoor dining, and large social gatherings will bring back demand to the urban core.

The regional forecast

The macroeconomic forecast implies a deceleration of national house price growth as higher mortgage rates and restrictions on mortgage borrowing kick in. If all regional housing markets were being driven by the same underlying economic and demographic drivers, then the effect would be approximately uniform across the provinces, but that is not the case. On the contrary, the differences in industry drivers, demographics and wealth inflows are pronounced.

Table 1 presents the current regional condition for single-family house prices and the subsequent short- and medium-term forecasts. The first column looks at the percentage deviation of the house price level in the first quarter of 2021 from the trend house price level determined in the forecast model. The main determinants of the trend house price are economic fundamentals such as real median family income multiplied by the metro area population, the Canada new-house and land price tracked by Statistics Canada, and the inflation-adjusted Canadian stock market index (S&P/TSX Composite) used as a proxy for household wealth. The divergence between the current price and this long-term trend price determines the degree of over- or undervaluation.

The deviation of house prices from trend highlights an implicit forecast for long-term stability. In geographies with highly overvalued housing, house price appreciation will undergo a downward drag due to a combination of reduced affordability, excess construction, and a possible decline in mortgage debt performance leading to distressed sales. Highly undervalued metro areas are likely to experience a wave of opportunistic purchases, either to flip dwellings or to make them available on the rental market, resulting in faster appreciation.

The Golden Horseshoe metro areas of Toronto and Hamilton plus the Vancouver/Victoria region of British Columbia have prices significantly above economic and demographic fundamentals (see Chart 7). Indeed, smaller metro areas such as Oshawa and

Hamilton near Toronto are more overvalued than Toronto, while Abbotsford is more overvalued than Vancouver. Another metro area that is overvalued more than 10% outside of Ontario and British Columbia is Montréal.

Single-family homes in Montréal are now moderately overvalued, as a tighter housing market has started to push prices up at a faster pace than median income, but overvaluation is still quite manageable compared with Toronto and Vancouver. By contrast, the Prairie metro areas—Calgary, Edmonton, Regina and Saskatoon—show moderate to serious undervaluation due to slower demographics and demand since the 2015 oil price correction.

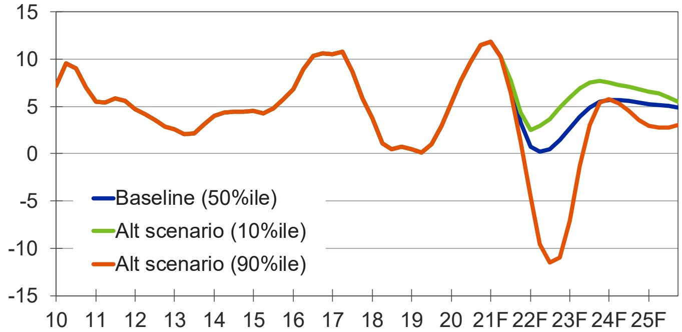
The general overvaluation of the largest metro areas will result in an additional downward pull on house prices over the coming year and is also an important factor in the national house price forecast; only metro areas in the Prairies and, to a lesser extent, some Atlantic metro areas will see any upward pressure from undervaluation. However, a high degree of over- or undervaluation does not necessarily imply a rapid reversion to trend involving house price declines, espe-

Table 1: Canada Subnational Forecast, Composite House Price

	% deviation from trend price, 2021Q1	% change annualized, 2021Q2	% avg annualized house price growth, 2021	% avg annualized house price growth, 2022-2025
Canada		16.91	3.77	3.12
Alberta	-0.19	6.78	2.45	9.38
Calgary, census metropolitan area	-0.41	7.59	2.42	9.62
Edmonton, census metropolitan area	-0.40	6.99	2.75	9.15
British Columbia	0.03	17.37	3.67	3.83
Abbotsford, census metropolitan area	0.23	41.42	13.63	1.59
Kelowna, census metropolitan area	-0.02	19.21	8.93	8.12
Vancouver, census metropolitan area	0.17	17.02	3.45	3.78
Victoria, census metropolitan area	0.10	14.62	3.25	5.23
Manitoba	-0.05	8.28	0.00	6.10
Winnipeg, census metropolitan area	-0.09	9.10	0.09	6.13
New Brunswick	-0.05	12.55	1.71	4.20
Moncton, census metropolitan area	-0.16	15.68	3.88	6.05
Saint John, census metropolitan area	-0.03	7.57	-0.98	2.42
Newfoundland and Labrador	-0.12	10.20	4.37	6.20
St. John’s, census metropolitan area	-0.28	9.39	4.15	6.13
Nova Scotia	0.09	10.69	-1.42	1.38
Halifax, census metropolitan area	-0.00	11.23	-1.26	1.36
Ontario	0.17	18.84	5.07	1.98
Barrie, census metropolitan area	0.29	28.77	10.52	2.33
Brantford, census metropolitan area	0.33	19.31	6.66	1.06
Greater Sudbury, census metropolitan area	0.25	24.23	6.06	0.00
Guelph, census metropolitan area	0.30	27.97	11.51	1.67
Hamilton, census metropolitan area	0.37	26.34	8.01	0.40
Kingston, census metropolitan area	0.24	21.76	6.81	1.84
Kitchener, census metropolitan area	0.25	23.57	8.32	2.30
London, census metropolitan area	0.35	27.06	10.08	0.99
Ottawa-Gatineau, census metropolitan area	0.11	18.82	5.06	3.33
Oshawa, census metropolitan area	0.35	33.05	14.11	2.68
Peterborough, census metropolitan area	0.40	25.81	8.85	-0.07
St. Catharines-Niagara, census metropolitan area	0.45	26.20	8.22	-0.66
Thunder Bay, census metropolitan area	0.15	2.22	-6.17	1.61
Toronto, census metropolitan area	0.26	14.60	2.95	2.15
Windsor, census metropolitan area	0.40	37.76	15.81	0.49
Prince Edward Island	0.24	6.91	-2.41	-1.71
Quebec	0.11	16.78	2.25	0.77
Montreal, census metropolitan area	0.15	17.61	2.32	-0.29
Quebec, census metropolitan area	-0.04	10.40	2.05	5.10
Saguenay, census metropolitan area	0.02	5.06	-2.01	3.67
Sherbrooke, census metropolitan area	-0.00	16.40	3.73	3.79
Trois-Rivieres, census metropolitan area	0.05	9.49	0.57	2.92
Saskatchewan	-0.12	1.47	-2.04	9.11
Regina, census metropolitan area	-0.20	-0.97	-4.03	7.50
Saskatoon, census metropolitan area	-0.43	2.29	-1.08	10.27

Chart 8: House Prices Will Moderate

RPS 13-metro composite house price index, % change yr ago



Sources: RPS, Moody's Analytics

cially if net wealth inflows are high. However, house prices will face significant downward drag in coming years.

The second column shows annualized house price growth as of the first quarter of 2021, the last quarter with historical data. Most of the overvalued metro areas have strong current house price growth, and even the Prairie metro areas have started to recover in the last few months.

The latest forecasts are shown in the third and fourth columns. The regional house price forecasts have two major dynamic determinants in addition to economic drivers such as incomes, mortgage rates and unemployment rates.

The first is persistence: Strong house price growth in the first quarter will at least partially carry over to the next few quarters as buyers bid against each other for limited housing supply.

The second determinant is mean reversion: the tendency of house prices to converge back to their long-term trend if they are strongly over- or undervalued.

Both persistence and reversion effects tend to vary by metro area in different provinces. Toronto, for example, has historically tended to have weaker mean reversion effects than other Canadian metro areas. In other metro areas with fewer capital inflows such as in Alberta or the Atlantic provinces, mean reversion effects tend to be stronger.

The third column is the average annualized rate of house price growth in 2021, incorporating one quarter of history and three forecast quarters, which are significantly influenced by previous house price gains. The fourth column shows the average growth rate for 2022-2025, where the persistence effects of the most recent house price appreciation have faded and reversion effects have become relatively stronger, in addition to the effects of climbing mortgage interest rates.

In general, house price growth is expected to decelerate nationwide by 2021-2022. Among the five larger metro areas, house price appreciation will slow to a greater extent in Vancouver and Montréal, where low affordability and overvaluation will likely end the steep appreciation that started in late 2019.

Toronto is much less sensitive to mean reversion effects and has only a slight deceleration, caused mainly by higher mortgage rates. Improving fundamentals will help to lift Calgary and Edmonton house prices again in the medium term.

Risks

The path, timing and sustainability of the labor market's recovery and expected changes in monetary and fiscal policy entail significant implications for interest rates and the housing market. The outlook is highly dependent on the achievement of herd immunity to COVID-19 (see Chart 8).

If the coronavirus crisis persists longer than expected because of a slowdown in vaccine distribution or a fourth wave, then travel restrictions, limits on gatherings, and business closures could starve businesses and consumers of revenue for an extended period. Loan delinquencies and defaults would escalate quickly, leading to excess housing supply in the market and putting downward pressure on house prices.

On the upside, if herd immunity is achieved earlier than expected along with improved consumer confidence and faster employment and income growth, then the housing market will accelerate. The annual pace of house price appreciation would slow from its current double-digit pace but still post significant gains over the next two years as the much-improved labor market delivers substantial income growth.

Expanded work-from-home options have fueled increased housing demand and higher prices in suburban districts while job losses among low-wage and young workers, online learning, and reduced immigration slowed rental demand. As public health measures improve, city living should become desirable again, leading more people to return to offices and schools—reviving the rental market.

Although the sustainability of these trends is uncertain and hard to predict, their impact on housing markets, and housing forecasts by extension, could be profound.

About the Author

Abhilasha Singh is an economist at Moody's Analytics, where she leads model development, validation, and forecasting for global subnational economies. She is responsible for coverage of emerging markets as well as U.S. and metropolitan area economies. She is also a regular contributor to Economic View. Abhilasha completed her PhD in economics at the University of Houston, where she taught microeconomics. She holds a master's degree in finance from Pune University in India.

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About the RPS – Moody's Analytics House Price Forecasts

The RPS – Moody's Analytics House Price Forecasts are based on fully specified regional econometric models that account for both housing supply-demand dynamics and long-term influences on house prices such as unemployment and changes in mortgage rates. Updated monthly and providing a 30-year forward-time horizon, the forecasts are available for the nation overall, its ten provinces, 33 metropolitan areas, and more than 2500 sub-metro areas and cover three property style categories, comprising single-family detached, condominium apartments and aggregate, in a number of scenarios: a baseline house price scenario, reflecting the most likely outcome, and six alternative scenarios.

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