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ANALYSIS
APRIL 2022

Canada Housing Market: Prices Will Moderate as Demand Pulls Back

Prepared by

Abhilasha Singh
Abhilasha.Singh@moodys.com
Economist

Contact Us

Email
help@economy.com

U.S./Canada
+1.866.275.3266

EMEA
+44.20.7772.5454 (London)
+420.224.222.929 (Prague)

Asia/Pacific
+852.3551.3077

All Others
+1.610.235.5299

Web
www.economy.com
www.moodysanalytics.com

INTRODUCTION

Residential real estate markets have been defying both gravity and expectations across metropolitan areas. The rapid elevation of prices has put the cost of a home out of reach for many potential buyers. With the Bank of Canada now raising its target for the overnight policy rate, the country's housing market has reached a turning point. Though not a full-blown national correction, the environment is one of decidedly slower demand growth and house price appreciation over the next few years. This policy intervention is neither arbitrary nor intended to put the housing market out of reach of purchasers. The main objective is to prevent further deterioration in affordability.

Higher rates and the significant deterioration in housing affordability will reduce the number of potential new buyers. Given that Canadians' high debt loads make them relatively more sensitive to changes in interest rates, we expect that national house price appreciation, which has been strong for the last two years, will slow significantly later this year as higher mortgage rates takes hold. We anticipate only a brief and mild national house price decline in 2023, after which house price growth will resume, albeit at a significantly slower rate. Given that previously house price growth was outpacing income growth, the downward shift in house price appreciation will not be all bad news.

Canada Housing Market: Prices Will Moderate as Demand Pulls Back

BY ABHILASHA SINGH

Residential real estate markets have been defying both gravity and expectations across metropolitan areas. The rapid elevation of prices has put the cost of a home out of reach for many potential buyers. With the Bank of Canada now raising its target for the overnight policy rate, the country's housing market has reached a turning point. Though not a full-blown national correction, the environment is one of decidedly slower demand growth and house price appreciation over the next few years. This policy intervention is neither arbitrary nor intended to put the housing market out of reach of purchasers. The main objective is to prevent further deterioration in affordability.

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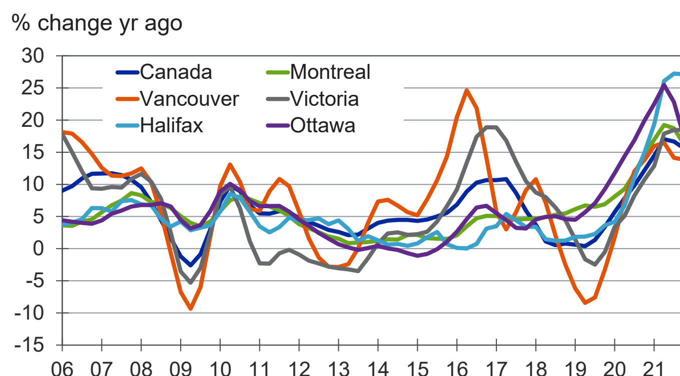
Recent Performance

Demand for both existing and new homes has outstripped supply by wide margins throughout the country, fueled by migration, low interest rates, and structural shifts in the economy, including the rise of remote work. Although the demand-supply imbalance was most acute in Ontario, every province in the nation has experienced accelerated house price growth over the past year.

Chart 1: Record House Price Growth



Sources: RPS, Moody's Analytics

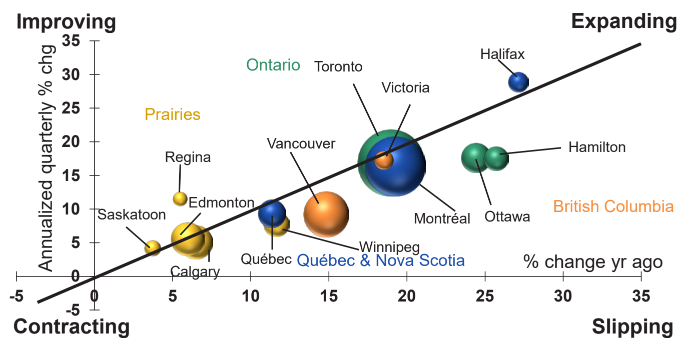
House price growth remains strong by historical standards, though price increases are decelerating in many markets (see Chart 1). The RPS Metropolitan Composite index, which is a weighted average of 13 major metropolitan areas, was up 13.8% year over year in February, slowing from the summer's 17.4% rate. Meanwhile, the RPS Canadian Composite index, which is a median average of 1,500 forward sortation areas, has slowed to 16.4% from a high of 20% in June last year.

The slowdown is even more evident when examining house price dynamics in the six months between August 2021 and February 2022, as shown in Charts 2 and 3. Montreal and Ottawa slowed considerably because of reduced affordability during this time. Although Toronto, Vancouver, Hamilton and Halifax house prices are still rising strongly, they have started to decelerate.

Other indicators also show that the housing market is returning to normal. Strong home sales in 2021 have persisted with around 700,000 existing homes sold in February on an annualized basis, according to the Canadian Real Estate Association. While this was down 6.4% from last February, it was well above the 500,000 pace observed in 2019 and in the previous five years. Lack of inventory, strained affordability, and buyer fatigue are all translating into lower sales. Rising interest rates and increased uncertainty due to rising gas prices may cause even more buyers and sellers to hold back.

Chart 2: Good HPI Growth Early in Year…

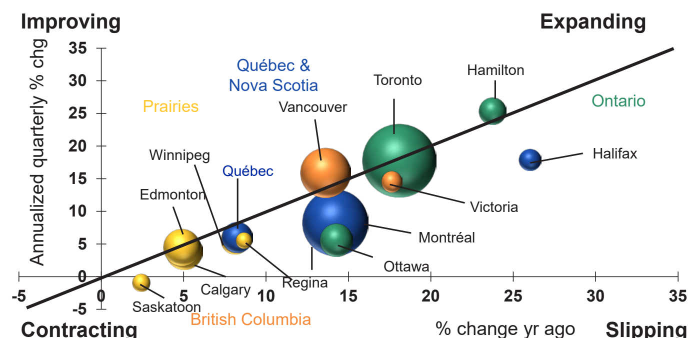
Composite index, 1-yr vs. 1-qtr performance, 3-mo MA, Aug 2021



Sources: RPS, Moody's Analytics Note: Bubble size indicates # of households

Chart 3: …But It Has Started to Slow

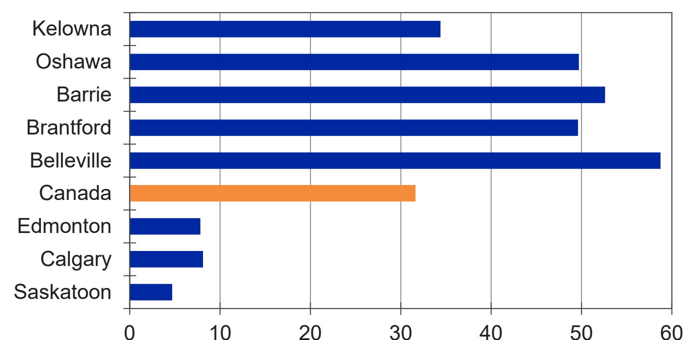
Composite index, 1-yr vs. 1-qtr performance, 3-mo MA, Feb 2022



Sources: RPS, Moody's Analytics Note: Bubble size indicates # of households

Chart 4: Tight Markets Drive Overvaluation

% change since 2020Q1



Sources: RPS, Moody's Analytics

On the supply side, the inventory of homes available for sale was extremely lean entering 2022. At the current sales rate, there are less than two months of homes available for sale, a record low. A balanced market is generally considered to be five to six months of inventory.

Homebuilding activity remains robust. Though the pace of new housing starts has slowed noticeably, it remains elevated by historical levels. According to Canada Mortgage and Housing Corp., housing starts registered 247,256 units at a seasonally adjusted annualized rate in February, down 14% from the peak reached in June 2021.

The number of homes under construction now tops 330,000, which is a historic high. However, completions slowed late last year as labor constraints and supply bottlenecks remain.

Construction material costs have risen. Lumber prices rose sharply in December and January, increasing 19.2% and 11.8% month over month, respectively. Likewise, fabricated metal and construction materials increased 35% since January 2021.

Still, the strong demand for housing has been able to absorb price increases. Applications for housing permits reflect builders' enthusiasm. After sitting well above the long-run average, permit levels have experienced a degree of mean-reversion and the housing market finally appears to be settling down to longer-term historical levels.

Real estate market still red-hot

The pace of Canadian house price appreciation over the past two years has been nothing short of spectacular. House prices have risen nearly 30% since February 2020, far outpacing growth rates during the housing boom that preceded the Great Recession.

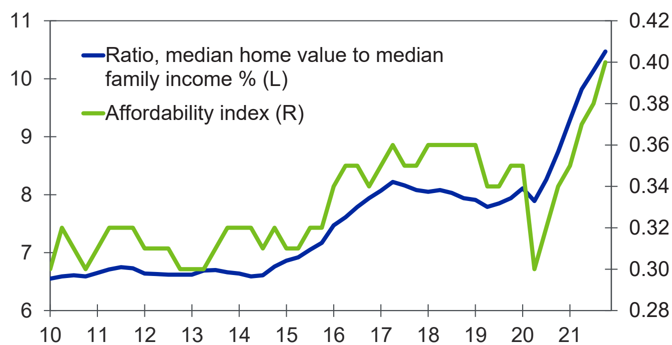
Not only was the strength of the Canadian national house price index remarkable, but the breadth of increases across provinces and metropolitan areas was equally breathtaking. Prices rose by more than 10% in 28 out of 33 metro areas over the past year. This contrasts with the 10 out of 33 metro areas that grew by more than 10% during the 2006 housing boom. Even the province with the slowest growth, Saskatchewan, saw house prices rise by nearly 5% over the previous 12 months. The metropolitan area with the slowest growth, Saskatoon, managed to eke out a price gain over the prior year despite the economic hardships brought on by the COVID-19 pandemic and the sharp decline in oil prices in 2020. Lack of supply of both existing and new homes was the primary factor driving prices higher, but demand drivers also contributed to the accelerated pace of growth.

Migration patterns show a clear relationship between the rate of house price growth and the areas that saw the greatest inflow from other provinces and metropolitan areas (see Chart 4). Migration out of the metropolitan areas in the Prairies and into the west coast was already underway prior to 2020, but the pandemic amplified the rate of relocations. The ability to work remotely further juiced demand as workers fled cities in search of more spacious and picturesque settings. British Columbia metropolitan area Kelowna is among the top destinations for interprovincial migrants by share of population and experienced some of the strongest growth in house prices.

Many of these moves were across provincial lines, but some households simply moved from urban to suburban or rural areas within the same province. As a share of population, more people left Toronto—but stayed in the same province—than any other metro area. Again, they did not travel too far, as Oshawa, Barrie, Brantford and Belleville experienced some of the strongest growth in both migrants and house prices.

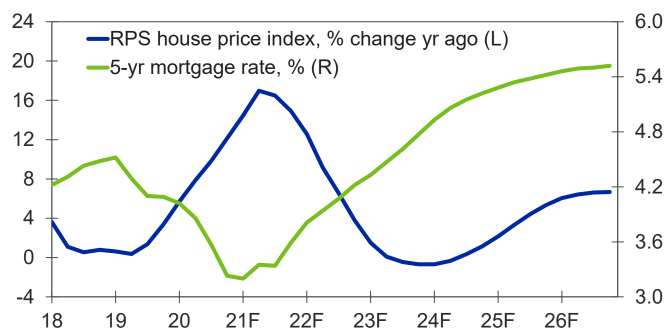
Low interest rates resulting from the BoC's accommodative monetary policy led to higher house prices as buyers took ad-

Chart 5: Affordability a Concern



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

Chart 6: Mortgage Rates Will Drag Prices



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

vantage of cheap financing to bid up prices. Given still-strong demand and ongoing supply constraints, house price appreciation is expected to remain strong in the short term. Prices will moderate further in the second half of 2022 as interest rates rise but demographic forces continue to support values for both owner-occupied and rental housing.

Affordability a concern

While the sustained double-digit increase in house prices over the past year is a boon to homeowners, it raises concerns of a housing bubble. Analysts and homeowners are increasingly worried about the potential for a sharp correction in prices given declining affordability in many markets as home values have raced ahead while incomes have substantively lagged.

The ratio of the national median home value measured by RPS to median family income was steady at approximately 8 from 2016 to 2019 but has since increased and now stands above 10 (see Chart 5). Only low mortgage rates have prevented the deterioration in this ratio from eroding demand, so far. However, the ratio of average homeownership costs—of which mortgage debt service is the largest component—to average household disposable income has also trended up, as measured by the BoC's affordability ratio.

To monitor the risk of housing bubbles, researchers at the Federal Reserve Bank of Dallas and Lancaster University have created an exuberance index, which utilizes enhanced unit root tests to detect and date periods when house prices display explosive behavior that is out of alignment with economic fundamentals.[1]

Countries, such as Canada, with an index measure that has remained above its critical value for five or more quarters are deemed as having bubble markets.

However, the exuberance should be interpreted as an early warning indicator rather than as a predictor of price corrections. For example, Canada's housing market exceeded the five-quarter threshold in 2016 only to see prices continue to rise over the next five years. Canada's market may very well be overvalued, but we should not interpret the exuberance index as a sign that a correction is imminent.

With mortgage rates likely to go up more over the course of the coming year, the ratio of homeownership costs to income will likely not fall before the end of 2022 at the earliest, pointing to a drag on short-term housing demand. Rising wages will help the market return toward equilibrium. However, prices will need to grow at a constant pace over an extended time to allow incomes to catch up and restore the historical price-to-income relationship.

Higher rates to cool demand

After two years of rock-bottom interest rates, the BoC has started raising its target for the overnight policy rate, marking the start of what should be a two-year tightening cycle. We expect that the bank will hike rates by 25 basis points at alternating meetings through 2022 and 2023. This translates to a total increase of 100 basis points for each year. The tightening cycle will likely end in early 2024 when the overnight rate reaches 2.5%, which we estimate as the neutral long-term rate—that is, the rate that neither stimulates nor constrains economic growth.

The rising policy rate has implications for the entire yield curve and, perhaps most crucially, the five-year mortgage rate. Higher rates and the significant deterioration in housing affordability will reduce the number of potential new buyers.

Canadian households exhibit one of the highest debt-to-disposable income ratios in the advanced world.

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, the baseline forecast anticipates that a boom-stall cycle—like what happened between 2016 and 2018—is likely to unfold, where after two years of skyrocketing prices, rising interest rates caused home values to turn flat (see Chart 6).

Homebuyers in Toronto, Vancouver and Victoria will feel the impact of rising rates more acutely than their counterparts in less expensive markets. That is because the larger mortgage payments in higher-priced metropolitan areas are much more sensitive to a change in rates. A rising rate environment

1 Pavlidis, E., A. Yusupova, I. Paya, D. Peel, E. Martínez-García, A. Mack and V. Grossman, "Episodes of Exuberance in Housing Markets: In Search of the Smoking Gun," The Journal of Real Estate Finance and Economics, Vol. 53(4), pp. 419–449 (2016).

would maintain the appeal of smaller, more affordable markets.

Demographics will lend support

The combination of rising interest rates and additions to the number of homes available for sale as supply-chain bottlenecks are resolved will dampen the upward momentum in house prices going forward.

However, strong demographic tailwinds will keep both housing demand and prices from collapsing. Though household formations were weak in 2020 because of the pandemic, the economic rebound in 2021 and 2022 should propel more households to form. Based on census population estimates, Canada continues to have strong immigration inflows, with the rate of immigration already exceeding its pre-pandemic level. These strong demographics should put a floor under home values and limit the extent of possible declines.

The baseline forecast

There is little doubt that house prices are elevated and that affordability is crimping the ability of buyers—especially first-time homebuyers—to come up with down payments and make monthly payments. With inflation at a 30-year high and interest rates rising, household budgets are coming under greater pressure from two different directions. Most households will not see an immediate increase in their debt-service burdens as the standard five-year mortgage product delays the realization of higher interest costs, but those larger monthly payments will come sooner or later.

Demand is expected to soften as a result while supply-chain bottlenecks continue to weigh on housing completions and sales in the short term. As a result, house price growth is expected to moderate throughout 2022 and 2023. However, the housing market will likely avoid a significant correction as the inventory of homes for sale remains extremely thin and as increased construction costs will keep the price of new builds high.

Rising interest rates will be a drag on demand, but favorable demographics will continue to lend support and prevent prices from collapsing. Provided unemployment remains low, the ensuing income gains will help households smoothly adjust to the higher interest rate environment.

By the end of 2023, the BoC's tightening cycle should be nearly complete with unemployment stabilizing slightly above its pre-pandemic average and GDP growth normalized to its long-run average. Mortgages taken out during the pandemic boom will begin resetting at higher rates given that the standard Canadian mortgage product resets every five years. Although Canadian households' elevated debt levels have long been a source of concern, so long as the labor market remains in top shape, the ensuing income gains should allow consumers to adjust to the larger monthly payments without significantly moderating their spending.

The regional forecast

The macroeconomic forecast implies a deceleration of national house price growth as higher mortgage rates kick in. Some of the undervalued housing markets, especially in Alberta and Saskatchewan, will do better despite weaker economic fundamentals precisely because they have retained better affordability, while Montréal will see downward pressure on house prices for at least the next year.

Table 1 presents the dynamics of the short-term forecast for single-family home markets. The first column shows the rate of over- or undervaluation for all metro areas. In geographies with highly overvalued housing, house price growth would normally start to slow because of a combination of reduced affordability, excess construction, and a possible decline in mortgage debt performance leading to distress sales.[2] It is worth noting that nationally, mortgages in arrears are 0.17%, compared with an average of 0.27% for the past 10 years, and are at the lowest levels recorded in the past 30 years, as reported by the Canadian Bankers Association. Highly undervalued metro areas are likely to see more opportunistic purchases, either to flip dwellings or to make them available on the rental market, with resulting appreciation as such purchases start to act on a limited supply of homes.

Toronto and most of the metro areas in the surrounding Golden Horseshoe region suffer from overvaluation. However, their house prices have also shown less sensitivity to overvaluation in the historical data since 2005, so they will likely experience less downward price pressure.

British Columbia housing markets are overvalued, not just for Vancouver but for the other three metro areas as well. Given their overvaluation, the British Columbia metro areas will continue to have downward pull on their house prices due to reduced affordability.

By contrast, overvaluation is not a problem in the Prairie regions. In fact, the Calgary, Edmonton, Regina and Saskatoon metro areas are all seriously undervalued despite recent price increases.

Québec presents important contrasts. Montréal and Trois-Rivieres are the only metropolitan areas in Québec not in the "correctly valued" range of plus or minus 10% and will continue to experience a downward pull on their house prices due to reduced affordability. House prices in Montréal have also shown greater sensitivity to overvaluation in the historical data since 2005. They will likely experience more downward price pressure compared with Toronto or Vancouver.

The second column of Table 1 shows house price appreciation in the fourth quarter of 2021, an important consideration given that pricing inertia tends to carry over into the subsequent three to four quarters. The strongest appreciation rates were observed in smaller Ontario metro areas, including Brantford, Barrie, Kitchener, Thunder Bay and Oshawa, as well as Moncton in New Brunswick and Halifax in Nova Scotia. None of the metropolitan areas reported declines in the last quarter of 2021.

The third column of Table 1 shows average forecast appreciation over the next four quarters, which tends to be significantly influenced by house price growth in the last historical quarter. Of the large metro areas, we expect that only Montréal will see a decrease in prices, with others such as Toronto and Vancouver having a slight appreciation at best. House price appreciation will strengthen in the Prairies, advancing at the fastest rate along with Newfoundland and Labrador. This reflects affordability conditions that are solid by historical standards.

The fourth column shows house price growth from the first quarter of 2022 to

2 The usual caveat for measuring overvaluation continues to apply: A high degree of overvaluation is not a surefire guarantee that house prices will start to correct in the near future, especially if wealth inflows affecting local housing markets continue unabated.

the third quarter of 2023, when persistence effects from the last quarter of history have faded out and house prices respond mainly to valuation and changes in mortgage rates.

In line with slowing national appreciation, most of the metro areas in Ontario are expected to undergo a slight depreciation. The British Columbia metro areas will revert to flat prices to a slight appreciation. Montréal house prices are expected to continue to decrease, hamstrung by overvalued prices. House price appreciation will strengthen in the Prairies, advancing at the fastest rate along with Newfoundland and Labrador.

Risks

The most important risks to the outlook are due to interest rates. Strong wage growth and higher energy prices because of the Russia-Ukraine military conflict leading to inflation may well prompt further interest rate tightening, which will drag on affordability.

Affordability is a growing risk to the stability of the housing market, as the runup in home values and the expected increase in mortgage rates would increase monthly mortgage payments significantly for first-time homebuyers. If affordability pressures put homeownership out of reach, demand would fall, placing downward pressure on sales and prices.

Prime Minister Justin Trudeau proposed a two-year ban on foreigners buying homes to cool the housing market. However, the impact will be limited as the proposal exempts permanent residents and foreign students and workers, as well as those buying their primary residence. Moreover, nonresident owners form a marginal portion of the national Canadian housing market. While the nonresident share is higher Toronto and Vancouver, it still represents only a modest fraction. Further, since the ban would only affect future demand and not current owners, the impact will be limited.

Downside risks include supply-side constraints, which will drive up prices in the short term and could cause frustrated buyers to sour on the prospects of homeownership.

Favorable demographics and an improving labor market provide the most significant upside risks.

Household balance sheets are strong overall, with savings exceeding pre-pandemic levels for many households. Many young adults continue to aspire to become homeowners provided they can find homes to buy within their price range.

Overall, the risks are equally balanced, with demographics providing structural strength and interest rates and supply-chain bottlenecks presenting cyclical challenges.

As with other aspects of the economic outlook, the future trajectory of the housing market remains tied to the COVID-19 pandemic. A speedy resolution of the pandemic would improve consumer and builder confidence and energize sales and construction activity. Ongoing waves of infections, hospitalizations and deaths would inject uncertainty and challenge future growth.

Table 1: Canada Subnational Forecast, Composite House Price

	% deviation from trend price, 2021Q2	% change annualized, 2021Q4	% avg annualized house price growth, 2022Q1-2022Q4	% avg annualized house price growth, 2022Q1-2023Q4
Canada		14.43	1.49	-0.57
Avg across metro areas	22.90	14.53	2.32	0.11
Alberta	-22.12	4.73	4.59	5.64
Calgary, census metropolitan area	-31.97	5.00	4.80	5.97
Edmonton, census metropolitan area	-28.96	5.13	4.31	5.18
British Columbia	0.33	12.13	1.71	0.36
Abbotsford, census metropolitan area	47.45	28.39	4.45	-1.27
Kelowna, census metropolitan area	4.03	13.98	6.39	5.39
Vancouver, census metropolitan area	22.26	9.63	1.03	0.03
Victoria, census metropolitan area	19.74	15.31	3.55	1.22
Manitoba	-6.94	9.00	3.37	2.94
Winnipeg, census metropolitan area	-4.00	9.08	3.37	2.94
New Brunswick	2.41	12.64	1.68	-0.32
Moncton, census metropolitan area	-6.21	19.76	5.40	2.96
Saint John, census metropolitan area	10.04	12.24	-2.40	-4.05
Newfoundland and Labrador	-13.93	0.54	1.68	3.52
St. John's, census metropolitan area	-17.57	-0.19	1.68	3.52
Nova Scotia	25.26	20.50	-1.20	-5.87
Halifax, census metropolitan area	12.99	23.01	-1.20	-5.87
Ontario	17.06	17.78	2.23	-0.75
Barrie, census metropolitan area	67.08	23.63	4.40	0.37
Brantford, census metropolitan area	66.99	23.41	3.95	-0.18
Greater Sudbury, census metropolitan area	30.51	18.99	3.69	0.17
Guelph, census metropolitan area	57.22	21.56	3.56	-0.16
Hamilton, census metropolitan area	78.07	23.28	3.76	-0.58
Kingston, census metropolitan area	43.60	16.76	1.29	-1.39
Kitchener, census metropolitan area	51.40	23.85	4.98	0.91
London, census metropolitan area	69.01	18.92	1.93	-1.43
Ottawa-Gatineau, census metropolitan area	28.83	4.67	-3.30	-3.52
Oshawa, census metropolitan area	62.98	28.86	7.28	2.34
Peterborough, census metropolitan area	107.83	21.67	1.95	-2.09
St. Catharines-Niagara, census metropolitan area	106.91	21.84	2.13	-2.03
Thunder Bay, census metropolitan area	25.94	20.16	3.05	-0.65
Toronto, census metropolitan area	43.58	17.27	2.31	-0.54
Windsor, census metropolitan area	100.52	10.52	-3.00	-4.96
Prince Edward Island	23.57	-0.12	-10.81	-9.82
Quebec	17.68	11.38	-3.04	-5.92
Montreal, census metropolitan area	30.26	9.92	-4.62	-7.57
Quebec, census metropolitan area	-2.81	5.39	2.79	0.97
Saguenay, census metropolitan area	3.97	26.01	9.43	2.87
Sherbrooke, census metropolitan area	7.76	15.29	3.42	-0.16
Trois-Rivieres, census metropolitan area	12.33	21.38	4.96	-0.23
Saskatchewan	-21.68	6.09	4.64	5.64
Regina, census metropolitan area	-18.74	14.17	6.67	5.71
Saskatoon, census metropolitan area	-38.01	1.23	3.09	5.59

Sources: RPS, Moody's Analytics

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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