Canadian housing: Reset

Benjamin Tal benjamin.tal@cibc.com and Katherine Judge katherine.judge@cibc.com

Housing activity in Canada has declined for eight consecutive months before showing a modest improvement in October. This has been the longest stretch of falling sales on record. And it's not really over yet. The sense of urgency to get into the market due to Covid induced ultra-low mortgage rates led to a wave of front-loading activity, with buyers borrowing not only money, but also activity from the future. And in March 2022, the future arrived, along with the Bank of Canada's first tightening move. As of October, unit sales were down by 35% from the February peak and the average price had fallen by close to 20%. So what is this? A crash, a correction, or simply a realignment and reallocation of activity over time?

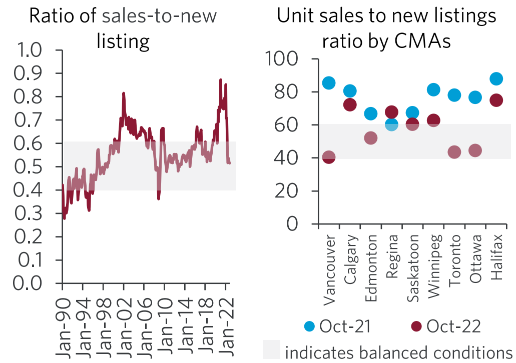
Listings drought

Current market conditions are notably worse than what was seen during the pandemic, but in absolute terms, the market is in balanced territory, with the sales-to-new listing ratio at just over 0.5 (Chart 1, left). Centers such as Vancouver, Toronto, and Ottawa are at or close to buyers' market territory, while conditions in cities such as Calgary, Regina, and Halifax are still consistent with sellers' markets (Chart 1, right). Available inventories (at close to 4 months of current sales activity) are double the level seen during Covid, but are still well below the levels seen prior to the pandemic. In Toronto and Vancouver, that level is now back to its 2019 reading, but in both cities inventories are still notably below their long-term average.

Zooming in on demand and supply conditions, the drop in unit sales has been the steepest on record (Chart 2, left), but the pace of the decline is starting to slow (Chart 2, right). That's true for most cities including Toronto and Vancouver. More interesting is the trajectory of supply of units in the resale market, which is down notably since the beginning of the correction (Chart 2, left), as sellers sit on their hands, showing hardly any signs of distressed selling to date.

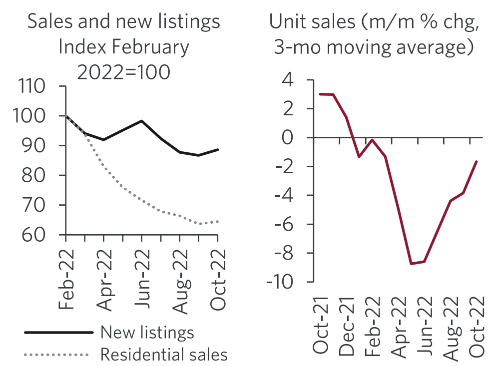
Now, this is very different than any other experience of a notable decline in the sales-to-new listing ratio (Chart 3). The abnormal behavior of supply this time around has, so far, worked to limit the magnitude of the price decline.

Chart 1: Still balanced conditions



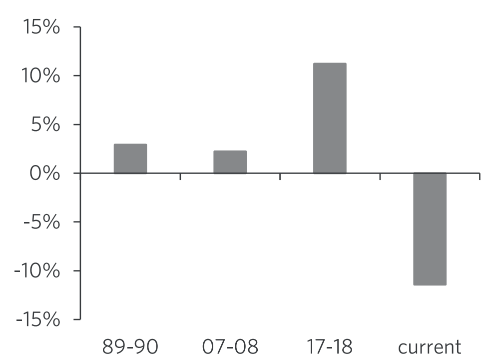
Source: CREA, CIBC.

Chart 2: Both sales and new listings have declined



Source: CREA, CIBC.

Chart 3: New listings in periods of significant decline in sales-to-new listings



Source: CREA, CIBC.

Price correction: a question of perspective

On the subject of prices, with the average price down by 20% since February, the current price correction is already the steepest on record (Chart 4, left). But every descent must be viewed from the perspective of the preceding ascent. And from that angle, the current correction is by far the mildest (Chart 4, right).

There is another point worth making regarding the price trajectory. While so far we have discussed the change in the average price, this is in many ways a deceiving indicator, as it simply averages all prices with no regard for the changing composition of activity (for example, increased sales of less expensive units can lead to a decline in that index even if prices are actually rising). Therefore, our preferred index is the CREA composite index which accounts for that shortcoming by focusing on price changes in similar properties. Chart 5, left, illustrates the gap between the simple average index and the composite index. And that gap is now at a record low. In practical terms, that means that close to 50% of the overall 20% decline in the average price since the February 2022 peak is due to the compositional factor, reflecting reduced activity in the low-rise (expensive) segment of the market. And the price mechanism is clearly reflecting that reality, with the largest drop in prices seen in detached houses and the smallest in the condo market (Chart 5, right).

The mortgage market feeling the pressure

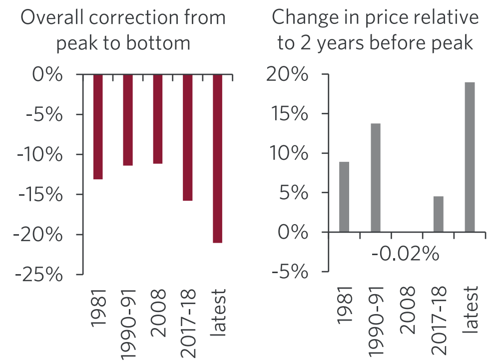
Reflecting this environment, activity in the mortgage market is slowing rapidly. The number of mortgages in the market is starting to fall while the average size of a new mortgage is down by 10% or $50k since its early 2022 level, but it's still a full $100k above 2019 levels. Overall mortgage originations are now falling by close to 30% on a year-over-year basis, while mortgages outstanding are now rising by an annual rate of less than 5%- the weakest showing since mid-2020 (Chart 6).

Despite the fact that higher mortgage rates are working to offset the positive impact of lower prices on affordability, there are no signs of real stress in the system so far when it comes to debt payments. The 30-day delinquency rate on sub-prime mortgages (a good leading indicator of trouble ahead) is still well behaved (Chart 7), although we might be seeing some very early signs of stress.

And that stress will intensify. We estimate that in 2022, the rapid rise in mortgage rates directly and immediately impacted one quarter of borrowers, and there will be more pain in store in 2023, as mortgages resetting will average even higher relative to rates seen five years earlier than they did in 2022 (Chart 8, left). Although 5-year rates and the prime rate will descend in 2024 as the Bank of Canada starts to cut rates (Chart 8, right), mortgages that are resetting that year will still be well above rates relative to five years earlier. As a result, spending on debt financing will increase by an additional percentage point of disposable income in 2023, with an only modest decline expected in 2024 (Chart 9). And with the unemployment rate likely to rise in 2023, that additional cost is likely to lead to some increase in mortgage delinquency rates.

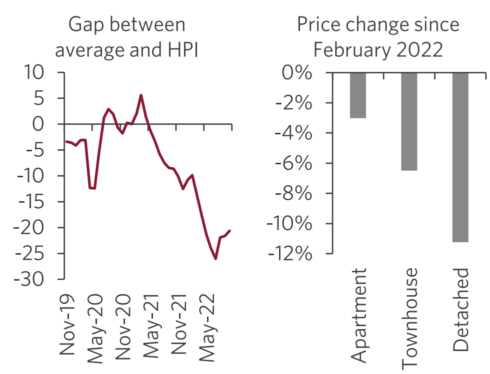
This reality of rising financial stress on current and potential home buyers suggests that conditions will continue to soften, albeit at a slowing pace. The coming quarters are likely to see further declines in sales, before signs of stabilizing are seen around the spring. Overall, following a close to 25% drop in sales in 2022, we expect sales to fall by an additional 10-15% in 2023, before rebounding modestly in 2024. A lower 5-year rate, and pent-up demand amplified by demographics will work to establish a bottom in prices by the spring of 2023. However, any recovery in prices will be limited by increased supply in the resale market, as stabilizing conditions will encourage sellers to list at greater numbers.

Chart 4: Price corrections from peak (left), and from 2 years before peak (right)



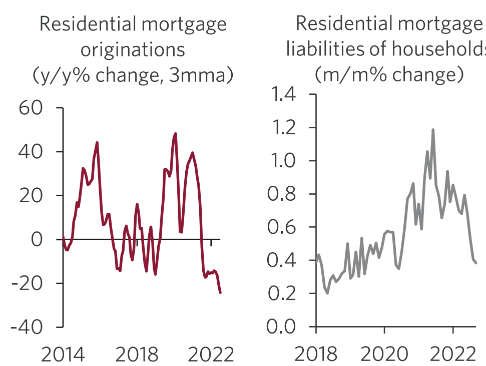
Source: CREA, CIBC.

Chart 5: Wide negative gap between average and composite index (left), more expensive units see larger price decline (right)



Source: CREA, CIBC.

Chart 6: Mortgages originated and outstanding are slowing rapidly



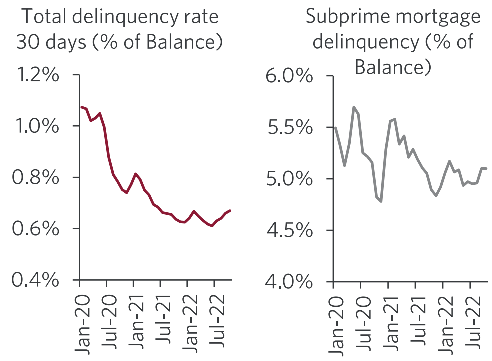
Source: StatCan, CIBC.

Rental market will become even tighter

While the for-sale market is slowing, the for-rent market has never been tighter. With no less than an estimated 700,000 individuals entering Canada in 2022 (including new immigrants, foreign students, non-permanent residents, and newcomers from Ukraine on a special 3-year visa), demand for rental units is at a record-high (and this is without accounting for the sizeable under-counting of demand coming from local university students that we highlighted in previous research). At the same time, the economies of renting vs. owning have changed dramatically over the past year, with the cost of owning rising much more rapidly than the cost of renting a similar unit (Chart 10). The same force is working to reduce investor demand in the condo market — a major source of supply in the rental market.

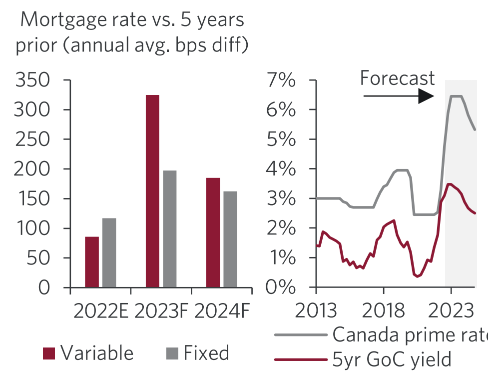
We estimate that before the pandemic, no less than one-third of investors were in negative cashflow territory. Given the tightening in monetary policy that has occurred since then, and the additional rate hikes that are still forthcoming, that negative cash flow position is certainly broader and deeper than it was pre-pandemic. Add that to the recent notable decline in condo-presale activity and the delays/cancellations of purpose-built projects due to escalated costs, and you have a sure-fire recipe for an even tighter rental market in 2023.

Chart 7: Very early signs of stress?



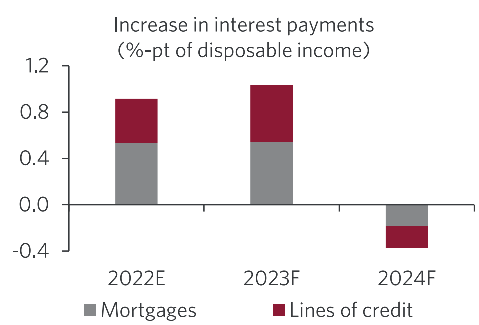
Source: Equifax, CIBC.

Chart 8: More pain ahead from mortgages resetting through 2024



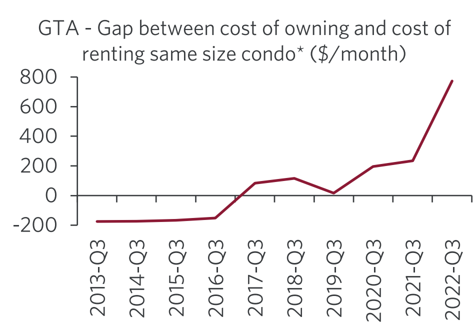
Source: Bloomberg, StatCan, CIBC.

Chart 9: Change in debt financing as a % of disposable income



Source: StatCan, CIBC.

Chart 10: Rising gap between cost of owning and renting



*Based on 25 years amortization, 80% LTV mortgage, avg int rate for mortgage advanced, property taxes and condo fees.

Source: Urbanation, CIBC.

About CIBC Capital Markets

CIBC Capital Markets works with domestic and international organizations looking for a banking relationship that combines in-depth industry knowledge with comprehensive capital markets, corporate banking and investment banking capabilities to address their most pressing needs. We strive to forge strong and deep relationships with our clients to understand the demands of their business and bring distinctive and appropriate solutions to the table.

cibccm.com

Contacts:

Benjamin Tal	Katherine Judge
416 956-3698	416 956-6527
benjamin.tal@cibc.com	katherine.judge@cibc.com