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In Focus

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A Housing-Friendly Recession: Will it Last?

by Benjamin Tal

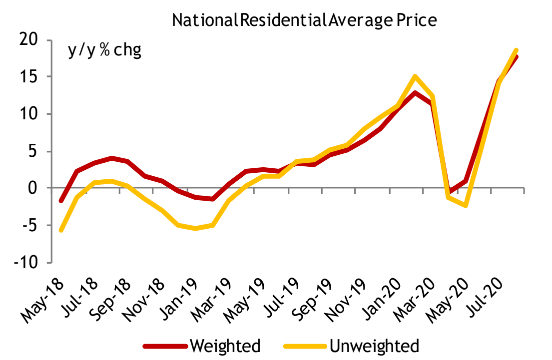
Is there logic behind the madness in the housing market? Does it make any sense that home prices are rising by almost 20% when the economy is in the midst of a major recession? We take a closer look to get some answers.

Bouncing Back

By any measure, the V-shaped recovery in the Canadian housing market is mind boggling. The level of real economic activity is still an estimated 4.7% below its pre-recession reading, and the labour market is still miles below its pre-crisis level, but home sales are rising by north of 30% on a year-over-year basis. Housing starts are continuing to surprise on the upside, while the average home price is now rising by close to 20% on an annual basis (Chart 1).

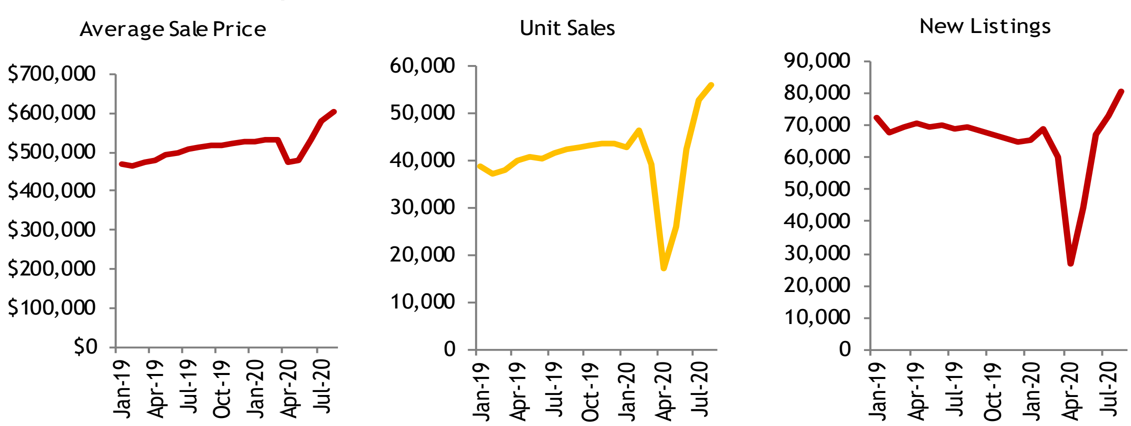
The meteoric ascent in housing activity is broadly based. The gap between CREA's unweighted price index (a simple average) and the weighted index (weighted by provincial proportions of privately-owned housing) is basically nil (Chart 2). That suggests that home price inflation cannot be attributed to a disproportionally stronger volume of activity in more expensive cities such as Toronto and Vancouver.

Chart 2
Narrow Gap Between Weighted and Unweighted Indices Implies No Regional Factor Behind Price Increases



Source: CREA, CIBC

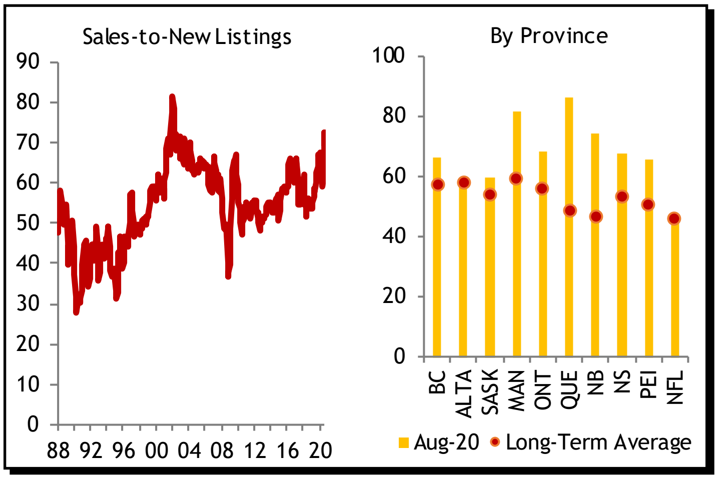
Chart 1
The Mother of All V-Shaped Recoveries



Source: CREA, CIBC

Chart 3

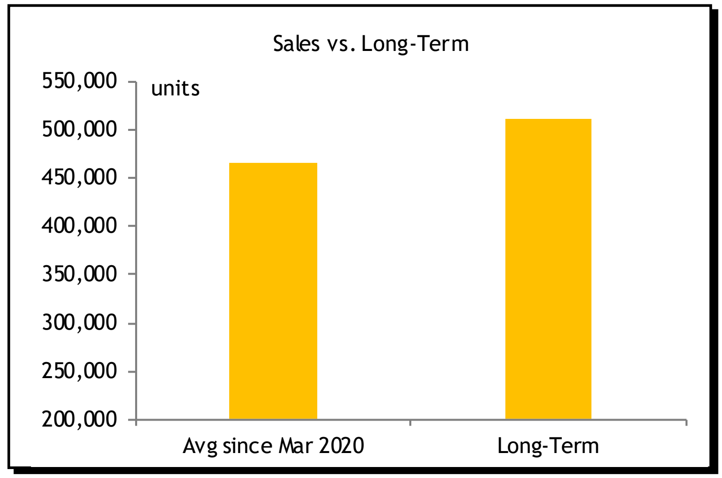
Sales-To-New Listings Ratio Elevated in Most Provinces



Source: CREA, CIBC

Chart 4

Activity Since The Beginning of the Year Still Below Normal Level



Source: CREA, Statistics Canada, CIBC

What's more, the sales-to-new listings ratio is at a 15-year high and it is only a few ticks below the record-high level seen in 2002. And as illustrated in Chart 3, that is the case in most provinces, with current readings miles above long-term averages. Even in Alberta, with its struggling economy, that ratio is not below its long-term level. As a result, at only 2.6 months, inventories are as tight as they have ever been.

Perspective

The narrative of course is that this swing in activity is due to utilization of pent-up demand that was accumulated during March and April, in an environment of historically low interest rates. That is true, but the question is: To what end? Can low interest rates lift activity back up to pre-recession levels and keep it there, despite the fact that the economy will not close the performance gap until mid-2022?

Take a quick look at Chart 4. While current year-over-year growth in sales is sky high, the reality is that the average level of sales seen since the beginning of the year is still 10% below the 510K level we see as a normal annual level of activity. At this rate, that gap will close in a few months.

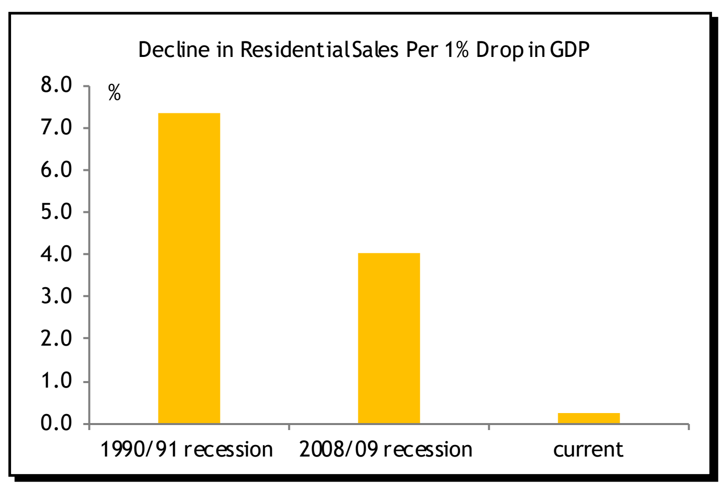
But of course, there is nothing normal about the current environment, as we are still in the worst recession on record. So it would be more appropriate to compare the current level of housing activity to previous recessions. Chart 5 does exactly that, and from it we learn that the current recession has been much gentler on housing than any previous recession.

What's Behind the Swing? Is it Cheap Money?

The question is why? Surely low interest rates play an important role here. But while market rates are at historically low levels, qualifying rates are not. At this point, given deep discounts from posted rates, both variable and 5-year fixed term mortgages have to be qualified at the Bank of Canada's posted rate, which is

Chart 5

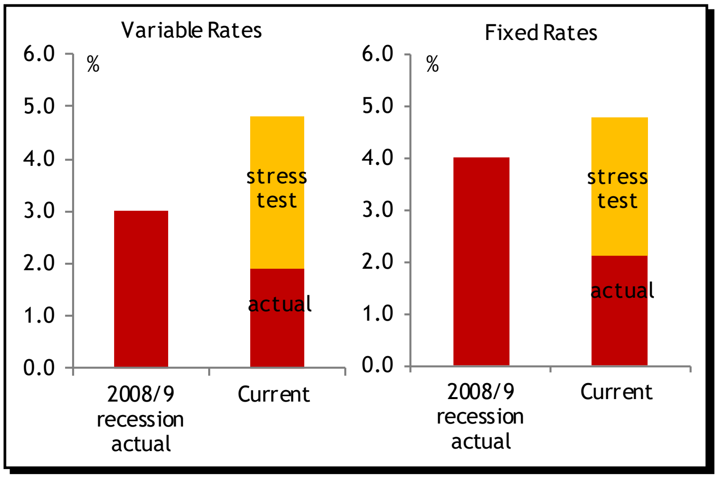
Housing Market Performance Stronger Than In Any Other Recession



Source: CREA, Statistics Canada, CIBC

Chart 6

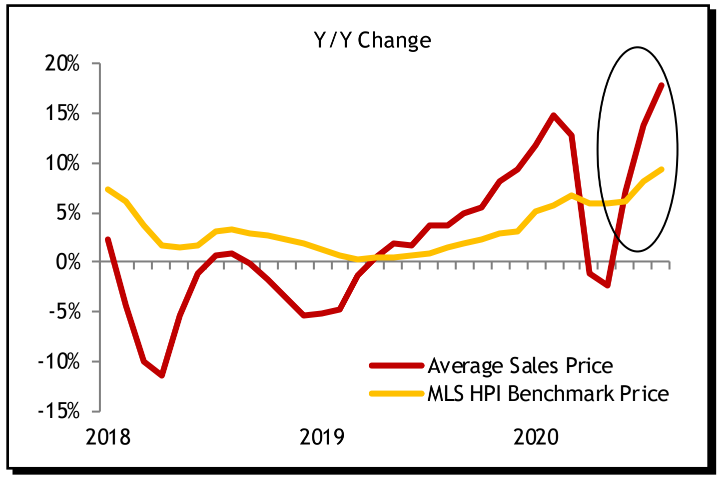
Current Stress Test Requirements Bring Qualifying Rates To Higher Levels Than Seen During 2008/09 Recession



Source: Bank of Canada, CIBC

Chart 8

Recent Gap Between Average Price and Benchmark Price Indicates Large Compositional Effect on Home Price Inflation



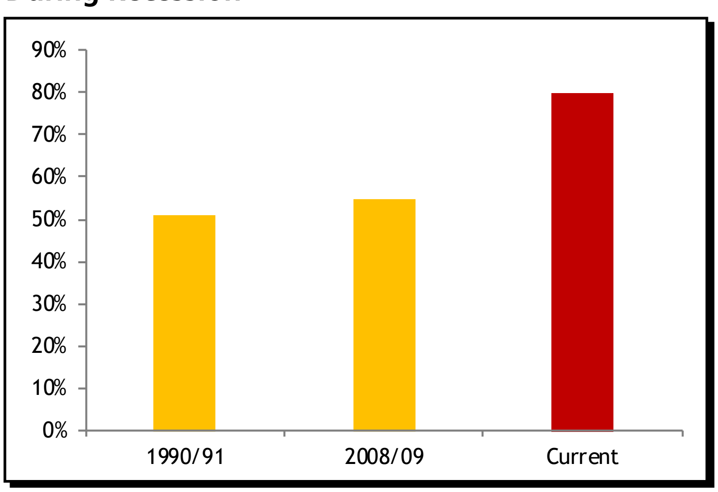
Source: CREA, CIBC

currently at 4.79%. We dug deep into the archives to see what kind of discounts borrowers received during the 2008/9 recession to create Chart 6. And here we learn that after applying the qualifying criteria, today's rates (for qualification) are, in fact, higher than they were during the financial crisis.

So interest rates do not tell the whole story. Much more important here is the nature of the current recession. More specifically, the asymmetric damage seen in the labour market as we discussed in our recent piece (*link here*).

Chart 7

Share of Low-Paying Jobs in Job Losses During Recession



Source: Statistics Canada, CIBC

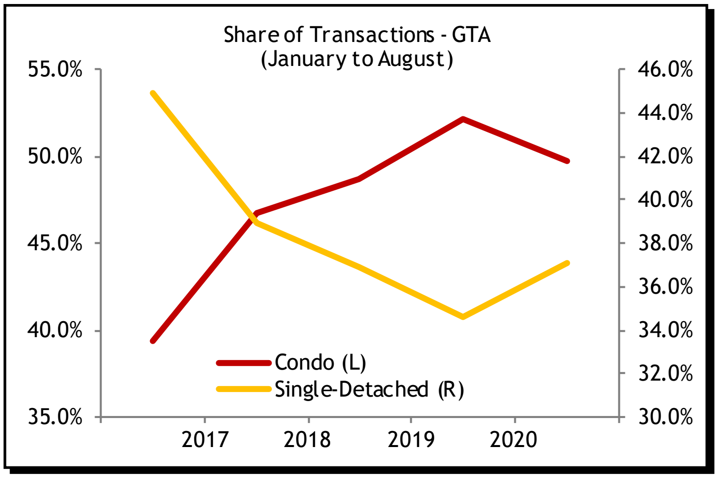
Chart 7 tells the tale. The services-oriented nature of the current recession has led to a situation in which no less than 80% of jobs lost since February were in low-paying occupations, a notably higher share than in any other recession. That is, with a relatively large segment of the labour market not experiencing income disruption, more households are in a better position to take advantage of low interest rates — and that combination is the key factor behind the strong housing market performance that we are currently witnessing.

Given that observation, we are now in a better position to try to make sense out of current home price inflation readings, with the average year-over-year rate approaching 20%. Let's start with Chart 8. Note the gap between the average home price and the benchmark home price index. The former is a simple average of all transactions regardless of type of property, while the latter compares apples-to-apples by zooming in on the price level of similar properties. Having already established that a regional factor does not play a role in the recent price trajectory (take another look at Chart 2), we conclude that roughly 50% of the widely-quoted average home price inflation is due to a compositional factor in which activity in more expensive units (read: larger) is rising faster — adding to the overall average.

In fact, we see this trend clearly in the rising share of ground-oriented units at the expense of high-rise units (Chart 9)[1] — a trend that makes sense given the nature of the crisis.

Chart 9

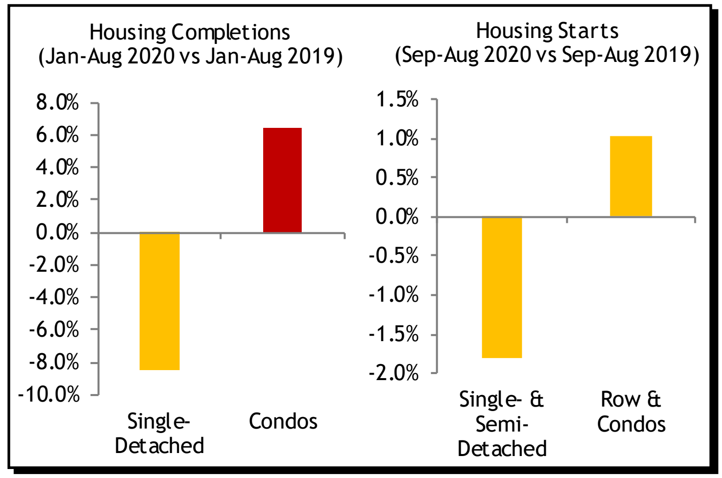
Share of Detached Units in Transactions Rising Since The Beginning of the Year



Source: Teranet, CIBC

Chart 11

Mismatch in the Market Will Not Be Corrected Soon



Source: CMHC, CIBC

And this reality is being reflected immediately in the price mechanism. With a very limited supply of low-rise properties (Chart 10, left) and rising demand, low-rise prices are rising much faster than what is being seen in the high-rise segment of the market (Chart 10, right).

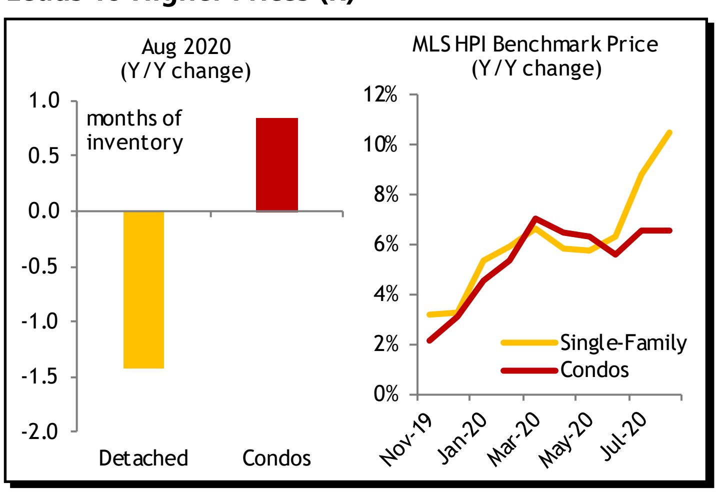
And the supply/demand mismatch will not come to an end soon. The number of condo completions so far this year has outpaced low-rise, while the growth in housing starts shows a similar trend in the pipeline (Chart 11).

Price Inflation by Level of Price—A Tale of Two Cities

To get even better insight, we dug deeper and looked at trajectories within categories. That is, we examined price inflation by price level in order to better understand the distribution of price inflation. Chart 12 shows the results for both The Greater Toronto Area (GTA) and the Greater Vancouver Area (GVA).

Chart 10

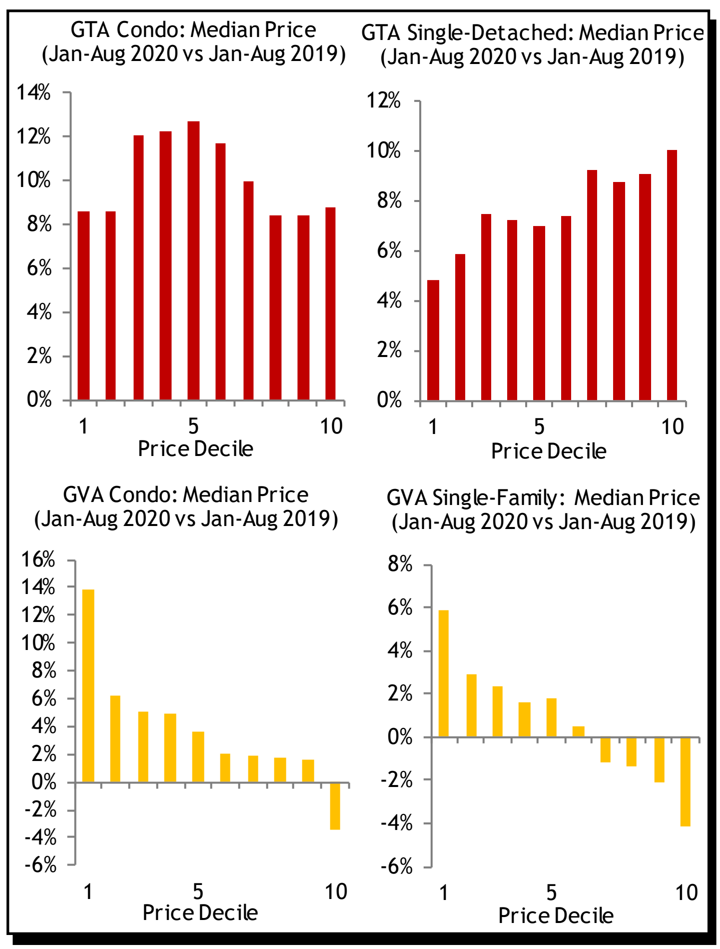
Limited Supply of Detached Units (L)[2], Leads To Higher Prices (R)



Source: Urbanation, CREA, CIBC

Chart 12

House Price Inflation By Price Level - GTA vs GVA



Source: Teranet, CIBC

Zooming in on the condo market in Toronto, price pressures were somewhat stronger in the middle of the price range. As for the detached segment of the GTA, it's interesting that price inflation intensifies as property values rise, an observation that might suggest stronger move-up activity within the detached category — consistent with growing demand for larger units.

As for the GVA, the trajectory there is very different. There is a clear negative correlation between price inflation and price level, in both the condo and detached segments of the market. That is, cheaper properties are seeing prices rise faster than more expensive ones. We attribute the difference in outcomes between the GVA and GTA to two factors: the reduction in foreign investment activity that was so important in the higher-end segment of the Vancouver housing market, as well as the fact that the GVA is more exposed to sectors that were negatively impacted by the crisis.

What's Next

We doubt that the current level of activity is sustainable. The pace of economic growth will drop alongside temperatures. A second wave of the virus will have a negative impact on confidence and job security will start to erode, as the longer duration of the crisis will result in negative spin-offs that will start to impact sectors and jobs that so far have been unaffected by the virus. We therefore expect sales to stabilize at a level below their long-term potential, while home price inflation will moderate notably, and, in fact, might fall into negative territory as we approach the winter months. Consistent with the analysis above, we expect ground-oriented units to show comparably better performance than the high-rise segment of the market.

Notes:
(1) We use GTA data here due to data limitations
(2) Data for GTA