Where Are We in the Canadian Housing Slowdown?

by Benjamin Tal and Royce Mendes

It was a good run while it lasted, but the sun has officially set on the days of heady housing market growth fueling Canada's national economy. The combination of restrictive macroprudential policy measures and higher interest rates has taken a major bite out of housing activity. That's a development which will show up in cooler GDP growth readings ahead.

For Canada, the housing market is more important to the overall economy than at any other time on record. Residential investment makes up 7½% of the Canadian economy, just off the historical peak (Chart 1, left). And, while Canadian employment statistics leave much to be desired in terms of how far back they go, the available data similarly reveal that the share of residential construction workers and those employed in the real estate industry is also just off its historical peak (Chart 1, right). As a result, any slowdown will be magnified in terms of its impact on the Canadian economy relative to an equal decline in activity during past cycles.

Silver Linings?

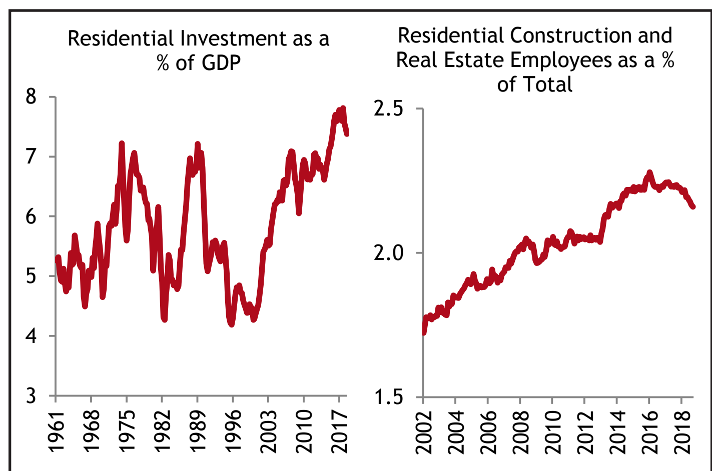
Policymakers have pointed out that safer mortgage and more stable housing markets are the silver linings, although that's hardly apparent just yet. True, over time, tighter lending standards will slowly improve the quality of borrowing, but the current stock of outstanding mortgages is still largely based on past, less restrictive lending rules.

The Bank of Canada also keeps arguing that the worst is now behind us and that housing markets are stabilizing. But, from our vantage point, it's difficult to agree. The central bank's own workhorse model says it takes six quarters before the full impact of any rate hike is felt in the economy. So it's concerning for the outlook then, that only five quarters since the first move of this cycle, let alone subsequent rate increases, we're already seeing a slowdown in housing-related indicators. As a result, we're not as optimistic as the Bank of Canada for the contribution to GDP growth from housing over the next few years (Chart 2).

Some might argue that while housing starts have fallen, they're only back to levels that were believed to be healthy in early 2016 (Chart 3, left). But, that misses a key point. The nature of homebuilding has changed. Total building activity is now skewed more heavily toward condos and townhouses as opposed to single-family homes which add up to a greater bump in GDP. Looking ahead, land constraints combined with lower absorption

Chart 1

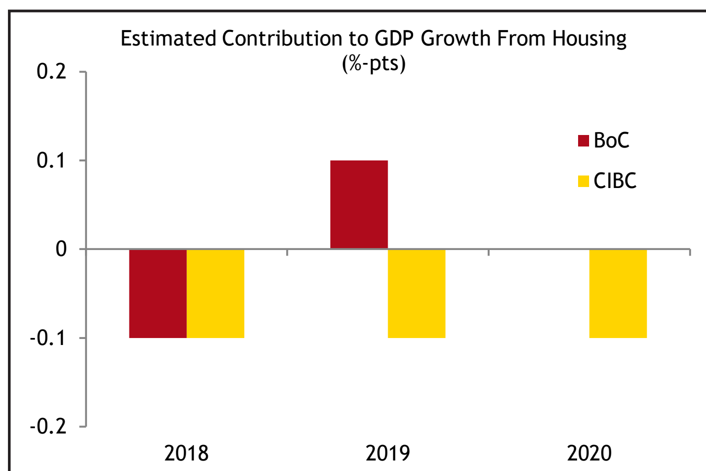
Residential Investment as a Share of GDP (L) and Housing Related Employment as a Share of Total (R) Just Shy of Historical Peaks



Source: Statistics Canada, CIBC

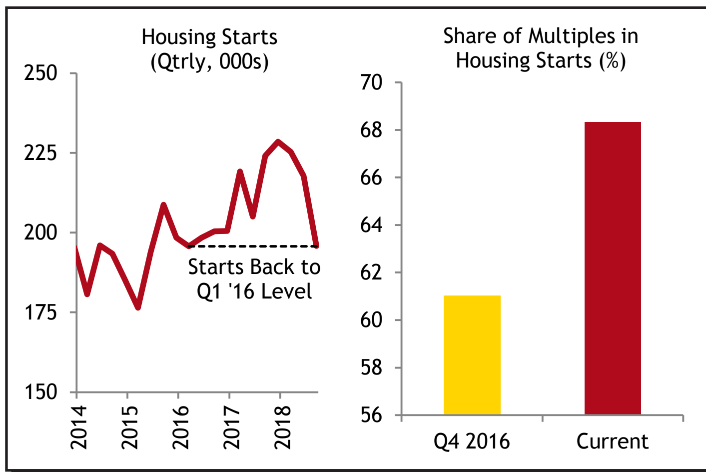
Chart 2

BoC Could Be Set Up For Disappointment From Housing Market



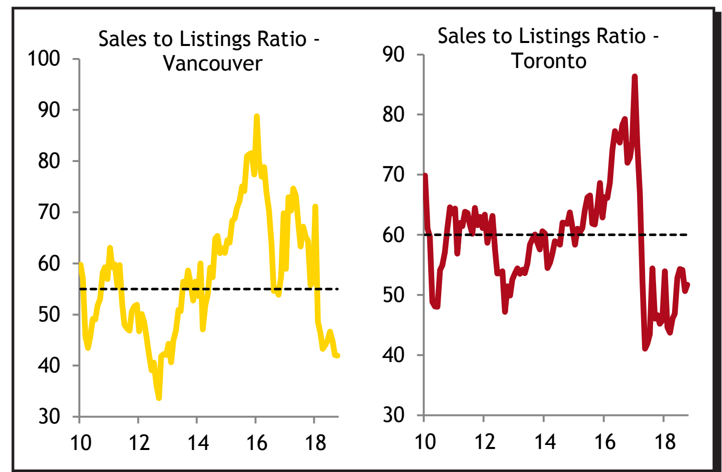
Source: Bank of Canada, CIBC

Chart 3
Headline Starts Back to 2016 Levels (L), But Breakdown Means Less Contribution to GDP (R)



Source: CMHC, CIBC

Chart 4
Undoing the Crazy Years in Vancouver (L) and Toronto (R)



Source: CREA, CIBC

rates for single-family homes than multi-units at the national level (the first time that's happened since 2009) mean that trend could continue (Chart 3, right).

A Tale of Two Cities

At the end of the day, when policymakers restrict borrowing eligibility, and in general when people discuss Canadian housing risks, what they have in mind is not St. John's, Newfoundland. Toronto and Vancouver are clearly the centre of attention here.

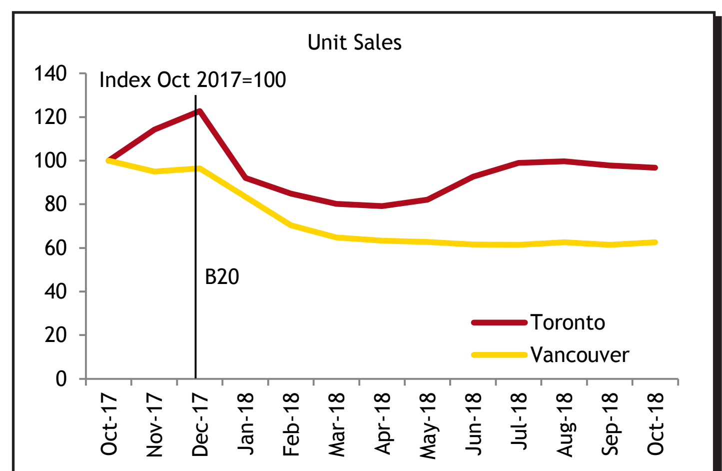
Let's start with Vancouver. Up until 2015 we were able to makes sense of the Vancouver market. Supply factors along with healthy demand were supporting activity and valuations. But then something happened in 2015 that none of our brilliant models were able to capture.

We believe that 2015, and part of 2016, saw a significant increase in speculative activity, leading to an unsustainable surge in Vancouver home prices. Since then, the market has softened due to its own gravitational force, along with policy changes and, more recently, higher interest rates. In many ways what we've seen over the past few years is an undoing of gains made during an abnormal period (Chart 4, left). The same is true for Toronto, where house prices in 2016 and early 2017 demonstrated bubbly conditions which appeared detached from fundamentals (Chart 4, right).

Now, while you're still on Chart 4, take a glance at the recent trajectory of both cities. It appears that Toronto is stabilizing while Vancouver is still correcting. Sales in Vancouver are down dramatically since the introduction of the B20 rules and tightened provincial regulations, while the damage in Toronto was more limited (Chart 5). That's not a big surprise since the regulations probably affected Vancouver to a greater degree given the more stretched affordability.

Looking ahead, we expect more of the same. Population growth in Vancouver has been lagging behind Toronto's over the past two years (Chart 6, left), while supply, mainly in the high-rise segment, has risen strongly. The end result? The number of completed and unabsorbed units in Vancouver is on the rise, while that measure is still trending down in Toronto (Chart 6, right). As of the third quarter, the ratio of units under construction

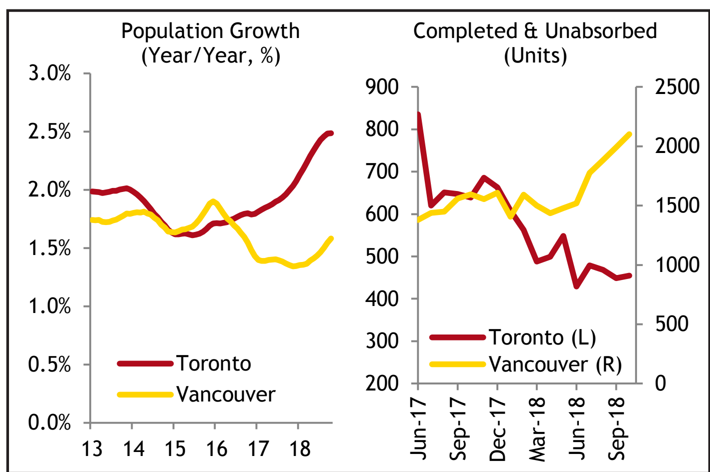
Chart 5
Since the Introduction of B20, Vancouver Housing Sales Have Fared Worse Than Toronto



Source: CREA, CIBC

Chart 6

Vancouver's Population Growth is Lagging (L), Leaving More Units Unabsorbed (R)



Source: CMHC, CIBC

to household formation in Vancouver was elevated in relative and absolute terms, while Toronto was still in line with long-term averages.

Toronto's Not Out of the Woods Yet

While Toronto is faring better than Vancouver, not all is well in the GTA either. In fact, the Toronto market is a tale of many markets. So far, the low-rise segment has been the real casualty of rule changes and higher interest rates, but even within that market there has been a significant divergence between pre-sale (new) and existing homes.

Historically, the price gap between those two markets was relatively constant, and while both saw notable price inflation in 2016, the increase in the pre-sale market was much more dramatic, taking the price gap to a record-high in 2017 (Chart 7). Since then, the adjustment in the low-rise pre-sale market has been dramatic, with prices falling much faster than in the resale market. In fact, in many ways the low-rise pre-sale market is in a price searching mode with developers trying to find a way to sell 2017 inventories and repackage new products in a way more consistent with today's market conditions.

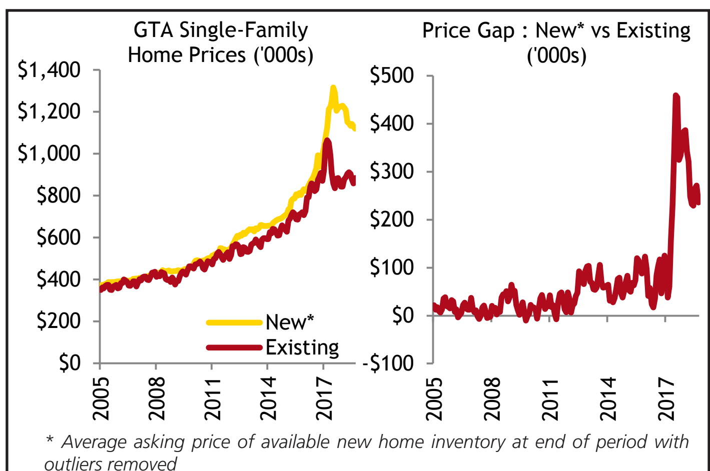
That process is not over and we expect the pre-sale low-rise market to continue to soften in the coming quarters. With a growing number of developers choosing to postpone new openings, limited supply will ensure that the market finds a new equilibrium in the not-too-distant future.

The high-rise segment of the market has seen a similar divergence in prices since 2016, with pre-sale units rising much faster than resales. However, that gap is currently at a record-high (Chart 8). We expect that segment of the market to follow the low-rise example with reduced demand from investors being the main catalyst. Having said that, we expect any adjustment in that market to be relatively swift and limited, given the less-elastic demand there.

The adjustment in the Canadian housing market in general, and in Vancouver and Toronto in particular, is not over yet, with the Toronto condo market likely to soften in the coming year. But, we believe that market forces suggest prices will find equilibrium next year even if slowing activity continues to weigh on GDP.

Chart 7

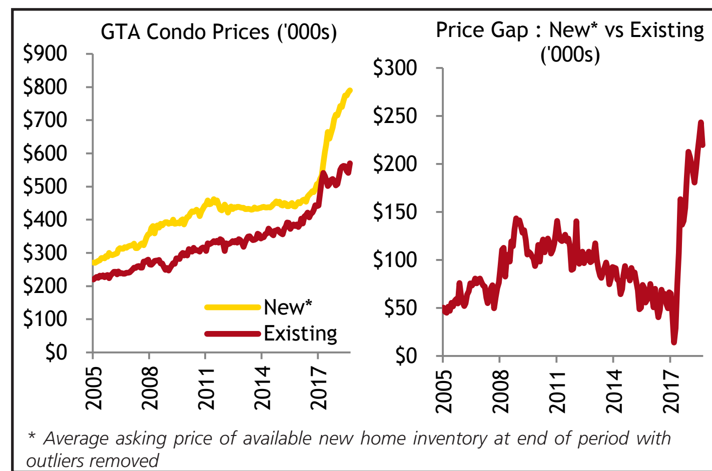
Single-Family Home GTA



Source: Altus Group (new homes) and TREB (existing homes) data, CIBC

Chart 8

Condominiums GTA



Source: Altus Group (new homes) and TREB (existing homes) data, CIBC