ECONOMICS

Avery Shenfeld
(416) 594-7356
avery.shenfeld@cibc.ca

Benjamin Tal
(416) 956-3698
benjamin.tal@cibc.ca

Andrew Grantham
(416) 956-3219
andrew.grantham@cibc.ca

Royce Mendes
(416) 594-7354
royce.mendes@cibc.ca

Nick Exarhos
(416) 956-6527
nick.exarhos@cibc.ca

http://economics.cibccm.com

In Focus

November 14, 2017

The Housing Market: When the Fog Clears

Benjamin Tal

There are a few lessons to be learned from recent developments in the housing market. First, markets are capable of responding swiftly to abnormal market conditions. Second, housing policy can notably impact the trajectory of the real estate market. And third, if those policies are not directed at the core issues facing the market, their impact will be temporary at best.

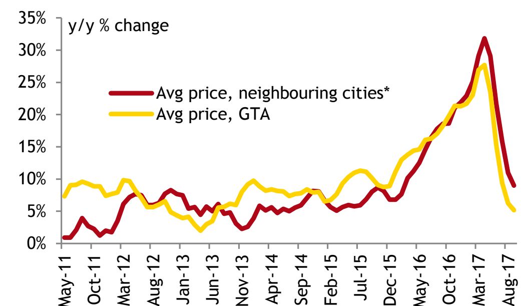
We are in the midst of an important transition period in the trajectory of the Canadian housing market in general, and Vancouver and Toronto in particular. The level of activity is likely to stabilize and perhaps soften in the coming quarters as markets adjust to recent and upcoming regulatory changes. But when the fog clears it will become evident that the long-term trajectory of the market will show even tighter conditions. The supply issues facing centres such as Toronto and Vancouver will worsen and demand is routinely understated. Short of a significant change in housing policies and preferences, there is nothing in the pipeline to alleviate the pressure.

The Best View of the Toronto Real Estate Horizon is from the Vancouver Harbour

While we are starting to see some acceleration in activity in cities such as Montreal, Ottawa and Winnipeg, the reality is that the centre of attention from a macro perspective remains on Toronto and Vancouver. The affordability issue in those cities that is leading to the "drive until you qualify" phenomena works to amplify their influence on neighbouring real estate markets. As illustrated in Chart 1, the correlation (and causality) between activity in the GTA and nearby centers is unmistakable.

Chart 1

GTA and Neighbouring Cities Highly Correlated

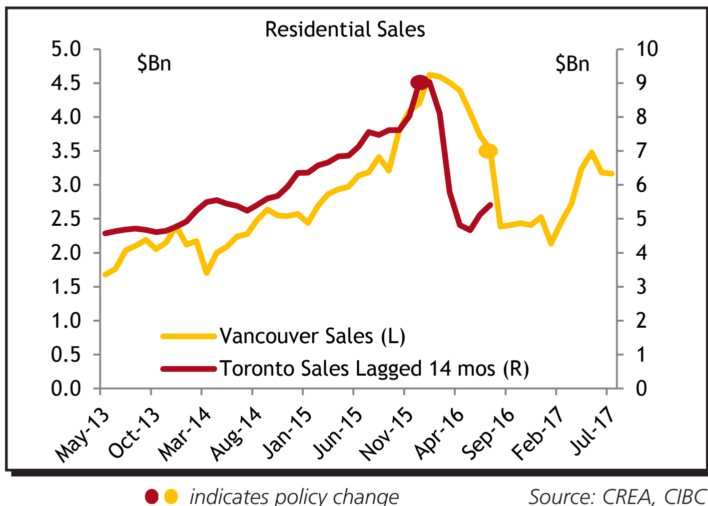


* Barrie, Cambridge, Guelph, Hamilton-Burlington, Kitchener-Waterloo, Oakville-Milton

Source: CREA, CIBC

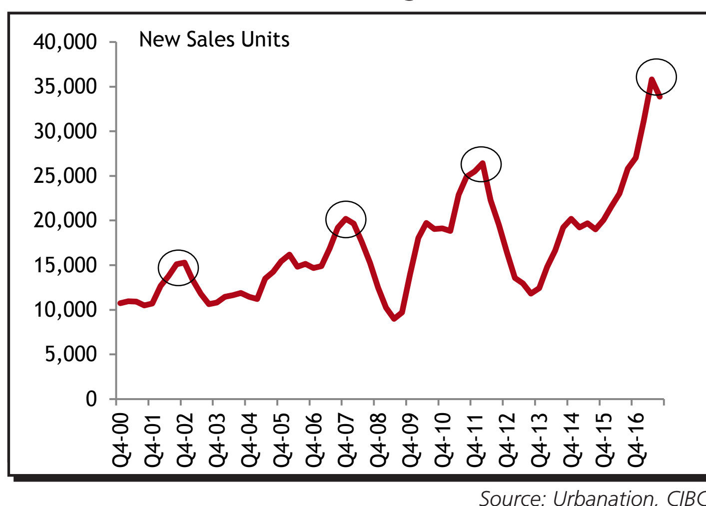
Both Greater Vancouver and the GTA have experienced a significant adjustment recently, with Vancouver leading the way (Chart 2). Following an abnormally strong 2015, the level of activity in Vancouver started to slow down in early 2016. This slowing was largely due to real estate gravitational forces as homeowners/speculators took profit and potential buyers hesitated to enter the market. That slowing was exacerbated by the 15% tax on foreign buyers introduced in August 2016. The main impact, in our assessment, was not the actual tax, but rather its impact on the psyche of potential domestic buyers.

Chart 2
Toronto Following Vancouver's Footsteps



●● *indicates policy change* *Source: CREA, CIBC*

Chart 4
GTA's Condo Market Reaching a Peak



Source: Urbanation, CIBC

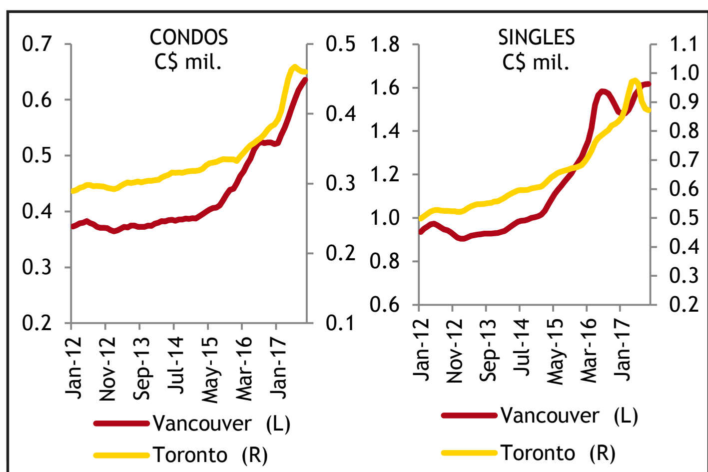
And after a brief adjustment, the Vancouver market is currently in a recovery mode.

The Toronto market experienced a similar trajectory with the abnormal level of activity taking place in 2016 and early 2017, no doubt fueled by accelerated speculation activity. The Ontario government's Fair Housing Plan coincided with the market's gravitational forces already in place, and led to an even more dramatic adjustment than seen in Vancouver. But again, without dealing with the real fundamental issues facing the GTA, these changes are only able to provide temporary relief as evidenced by the recent recovery in the GTA. In many ways, what we have seen in Toronto in the past six months is the undoing of the unexplainable surge in activity in 2016.

Importantly, in both cities, the adjustment was most notable in the single detached segment of the market, with prices in the condo market, in fact, continuing to rise (Chart 3). This however, is likely to change—mainly in the GTA. At a current annual pace of 36,000 unit sales, the condo market is more than offsetting a very weak 2016. We believe that the market is currently reaching a peak and a slowing trajectory toward the 20,000 unit sales per year is likely to develop in the coming year (Chart 4). There are already early signs of softening with unsold inventories on a rise, albeit from a very low base.

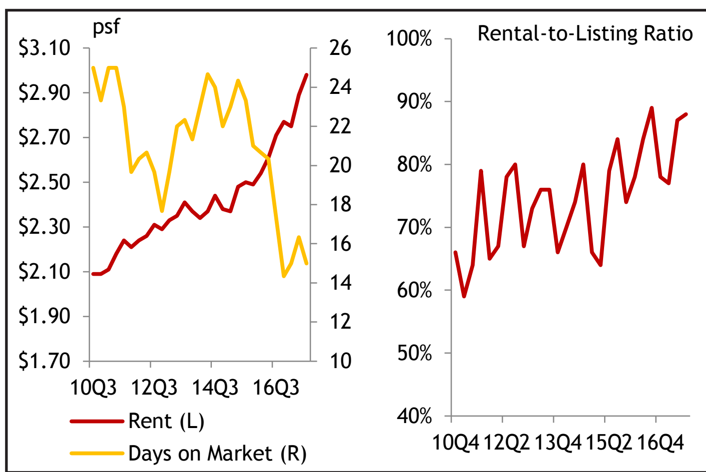
Crucial here is the behavior of condo investors that currently account for no less than 50% of buyers. While the GTA rental market is still extremely tight (Chart 5), rent inflation managed to rise by only half the rate seen in condo prices over the past year. Consequently, many recent investors are experiencing negative cash flow on their rental property. Add to it the reduced ability to raise rent due to the recently introduced rent control limitations

Chart 3
In Both Cities, Most of the Damage in Low Rise Units



Source: CREA, CIBC

Chart 5
GTA Rental Market Very Tight



Source: Urbanation, CIBC

in Ontario, and we are running the risk that investors will be less enthusiastic in the future.

Accordingly, getting into the head of those investors is critical to understanding the future trajectory of the condo market. If most investors view a condo investment as a replacement for a GIC, then reduced demand should be expected. But if most view that investment as a long-term endeavor, with expectations for capital appreciation in the long-term, we might see continued strong demand. Our sense from discussions with many players in the market is that the latter is the more dominant motivation at the moment.

A healthy functioning condo market in both Toronto and Vancouver is of crucial importance as one should not understate its role as a stabilizing force—mainly in the GTA. Using 2000 as a base, over the past 16 years the condo market in the city substituted for the decline in land-oriented units almost at a ratio of one-to-one (Chart 6, left). That compositional change (replacing expensive low rise units with cheaper condo units) was an important factor limiting house price inflation in the GTA until the surge of 2016 which, as discussed earlier, was detached from fundamentals. That compositional factor was also at play in Vancouver but to a lesser extent (Chart 6, right)—a fact that resulted in Vancouver seeing a somewhat faster price trajectory than Toronto for the better part of the past decade and a half.

B20 – How Big is the Damage?

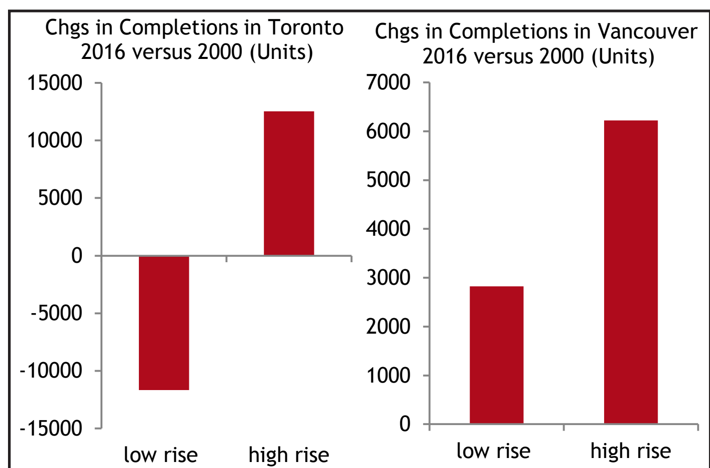
The hesitant recovery we are currently witnessing in both cities will be tested by the combined impact of higher interest rates and recent regulatory changes by the Office of the Superintendent of Financial Institutions (OSFI). The most immediate and significant issue is the increased qualification rate on the non-insured segment of the market. On the surface that change reduces the purchasing power of typical buyers by close to 20%, and we estimate that no less than 10-15% of mortgage originations will be impacted by that move. However, the actual reduction in demand is likely to be much less significant.

In the past, borrowers have seen tremendous ability to adjust to new situations and we doubt that things will be different this time. The average amortization period in the overall mortgage market has been steadily declining as borrowers took advantage of low rates to accelerate prepayments. With aggregate principal payments now at a record high, many borrowers will have the option of increasing amortization to avoid the sting of higher mortgage rates.

The same goes for new buyers that need to qualify at higher rates; they might opt to go with a higher amortization period and/or an adjustable rate in order to qualify. Furthermore, the qualification rule is not written in stone and financial institutions can grant exceptions in some cases (for example, a borrower that does not qualify but possesses significant assets). Credit unions that recently lost some market share will probably regain it and more (Chart 7), as at this point they are not subject to those changes. But the largest gain would probably be seen in the private lending space as demand in that space from unqualified potential buyers is likely to rise notably. We estimate that private lending (mostly Mortgage Investment Corporations) in Ontario currently accounts for a record-high 10% of new transactions (Chart 8), a

Chart 6

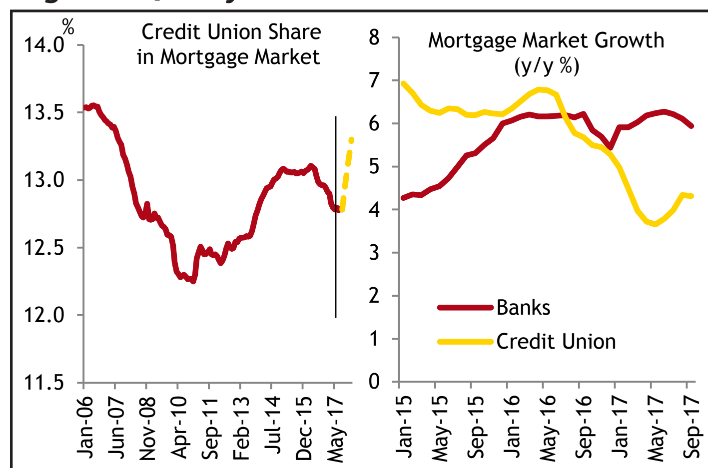
In Toronto, High Rise Substituted For Low Rise 1:1, Not in Vancouver



Source: CREA, CIBC

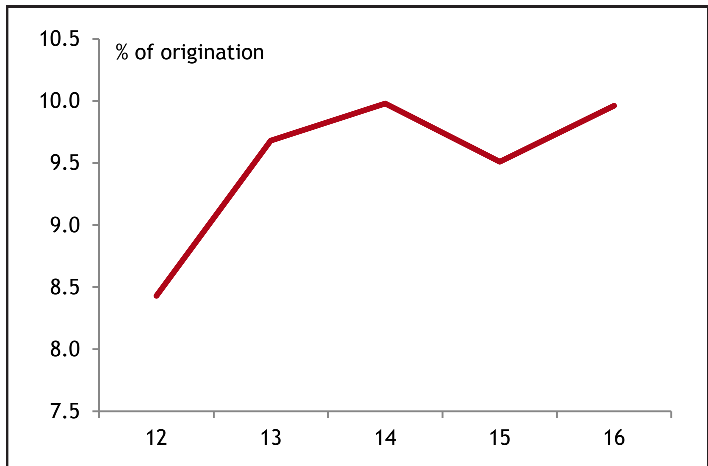
Chart 7

Credit Unions Lost Market Share Recently ... But Will Regain it Quickly



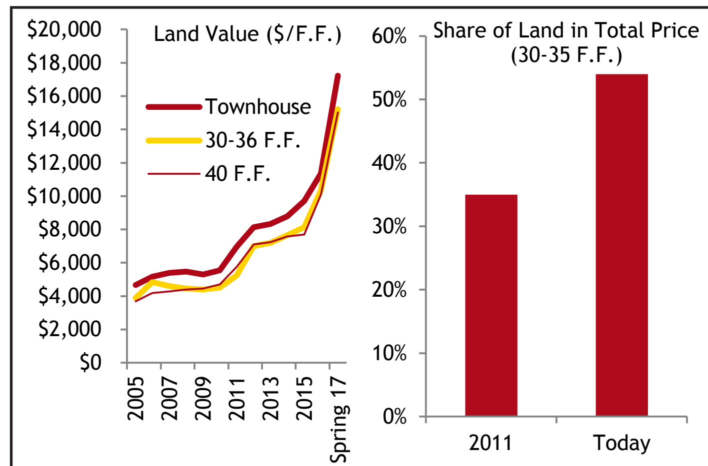
Source: Statistics Canada, CIBC

Chart 8
Private Mortgage Lending



Source: Teranet, CIBC

Chart 9
Land Value in GTA Took Off in Spring 2017



Source: MCAP, Teranet, CIBC

rate that is most likely to rise in the coming year. That transfer of risk from the regulated segment of the market to the unregulated (and in many ways unobservable) segment of the market is troubling.

We suggest that the combination of the creative imagination of borrowers, some exceptions to the rule and increased activity among alternative lenders will soften the blow to the market as a whole with actual demand slowing by only 5-7% in the coming year.

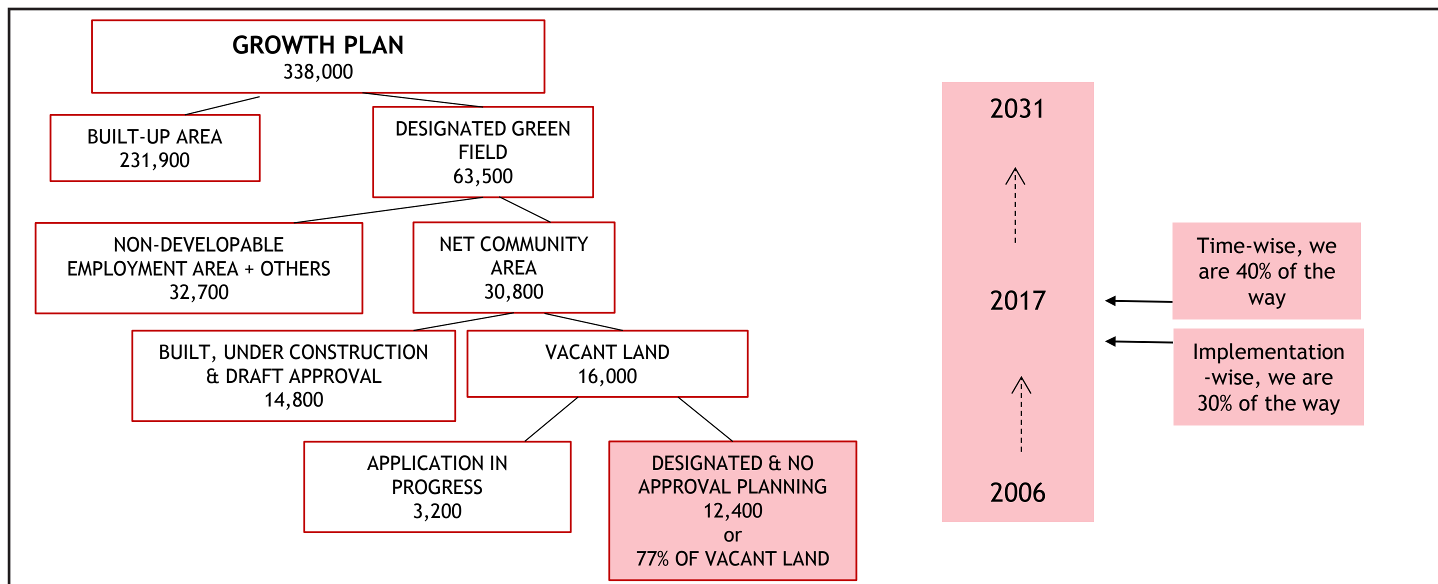
Beyond Regulations and the Cycle

As indicated earlier, the healthy adjustment seen in both Vancouver and Toronto brought both cities back to conditions more consistent with their long-term fundamentals. And those fundamentals remain strong and maybe stronger than perceived.

Zooming in on the GTA market, as we have indicated in the past, the main issue facing this market is a significant and worsening lack of land supply. And the numbers don't lie. Land prices in the GTA have risen strongly over the past year with the share of land in total sale price rising to a record high of more than 55% (Chart 9).

Chart 10 is a bit busy but it tells the tale. The Places to Grow Act introduced in 2006 established the regulatory land framework up to the year 2031, in which land is released based on projected population growth and density targets. We are already 40% into that trajectory, but implementation of the plan is already 10% behind

Chart 10
Implementation of Growth Plan — Behind Schedule



Source: Malone Given Parsons, CIBC all figures hectares

(right side of the chart). And that gap will widen in the future as the implementation process to date dealt with the low-hanging fruit, given that much of that land was already designated or approved and in many cases was already under construction.

Now pay close attention—it contains a lot of numbers but it's worth it. The left side of the chart gives us some perspective. The growth plan works with total area of 338,000 hectares in the GTA and Hamilton area, of which 70% is in the built-up area where developments must take place on existing land (intensification). The other 30% is the Designated Greenfield area where new land is released for low-density housing. Out of that segment, less than 50% is community area—designated for residential units and other land usage associated with residential living such as schools. Out of that portion, almost half is already built or under contract/draft approval—leaving close to half of that land vacant. And out of this portion only 23% is at a stage where applications are in process. The other 77% is not remotely close to being designated or approved. And at this rate, much of that land will take years to find its way to the market.

So the issue is not land, the issue is the speed at which that land comes to market. At this point in the game, a complete implementation of the 2031 planned Greenfield supply of low-density housing can be delayed by 7-10 years. And it can be even longer as recent changes to the Growth Plan will make implementation even more difficult.

Now the widening gap between population growth and the ability of the region to supply the necessary land to house that growth means that more pressure will be directed at the built-up area (intensification) to close that gap. In that context, the recent decision regarding the replacement of the Ontario Municipal Board (OMB) with a local planning appeal tribunal will work to reduce and slow approvals for high-density land use in the GTA—making the achievement of that goal even more difficult.

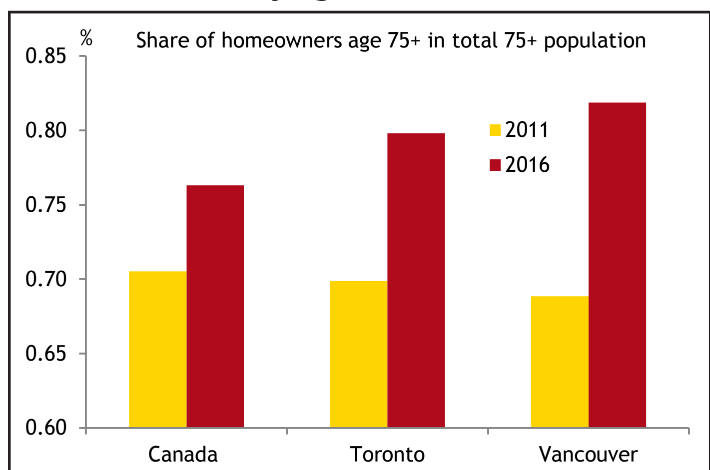
And don't expect any notable supply increase from the existing stock of detached houses—the main winner of the current situation. That stock of housing is static and will remain static. There is growing hope that houses sold by older Canadians in that space will work to release the pressure. But as illustrated in Chart 11 older Canadians are in no rush to sell. In fact, the share of homeowners age 75 and over has risen notably in the past five years. We estimate that over the next decade, that factor will add only 4,000 units a year of extra supply in the resale market—hardly a game changer.

Demand—Understated

So land supply is already failing to meet projected demand, and we suggest that actual demand is in fact stronger than official estimates. We are all aware of Canada's recent increase in the annual immigrations quota from 250,000 new immigrants to 300,000—on its way to 450,000. Land use plans made more than a decade ago do not fully capture that change.

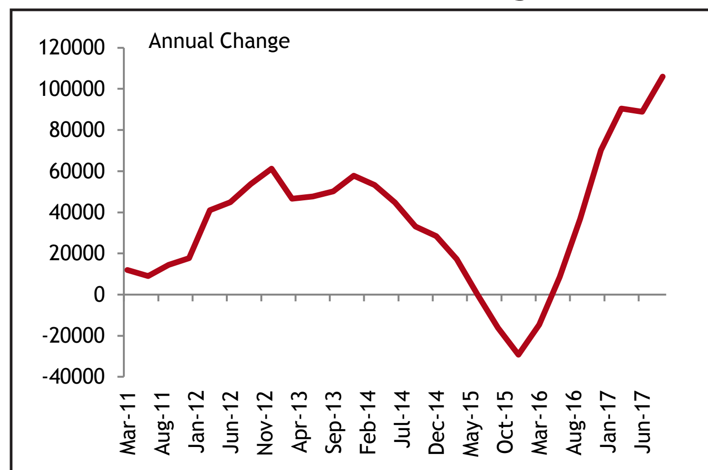
Another often ignored source of housing demand is non-permanent residents (NPRs)—mostly students and foreign workers whose numbers have risen notably in recent years (Chart 12). What's important here is not only the increase in their number and their heavy concentration in Toronto and Vancouver, but also the way that number is being translated into housing demand. Official statistics

Chart 11
Older Canadian Staying at Home



Source: Statistics Canada, CIBC

Chart 12
Non-Permanent Residents: A Growing Force



Source: Statistics Canada, CIBC

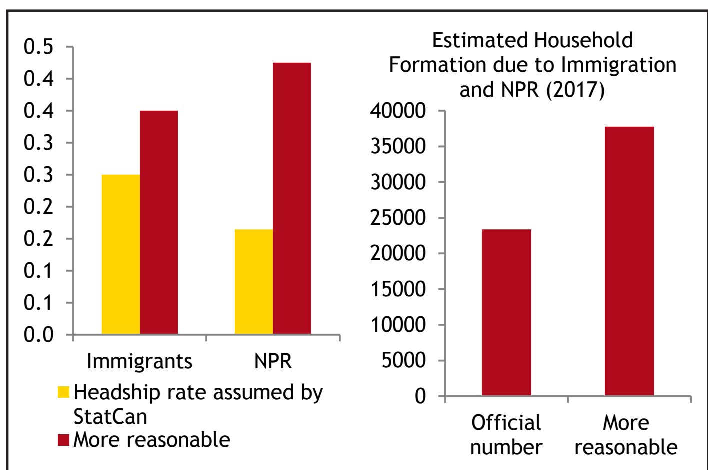
of household formation in Canada apply the same headship rate to immigrants and NPRs as observed in the population as a whole. That is an inaccurate account of household formation in that group, as new immigrants and more so NPRs are on average, much younger than the adult population as a whole.

Correcting for those shortcomings by applying a headship rate more consistent with their age profile suggests that the household formation rate is much higher. For example in the GTA the official estimate of household formation is 10,000 below the adjusted rate (Chart 13). That is, actual demand is much stronger than official numbers often used to determine the extent to which we overbuild relative to household formation.

And that demand could have been even higher if the affordability issues facing young Canadians did not keep them at home. The share of young adults age 20-35 still living with their parents has risen from 33.2% in 2011 to 34.8% in 2016 (Chart 14). It doesn't sound like much but it translates into pent-up demand of no less than 9,000 households in Canada, of which 6,500 are in Toronto. That army of potential buyers can be seen as an insurance against long-lasting significant price decline.

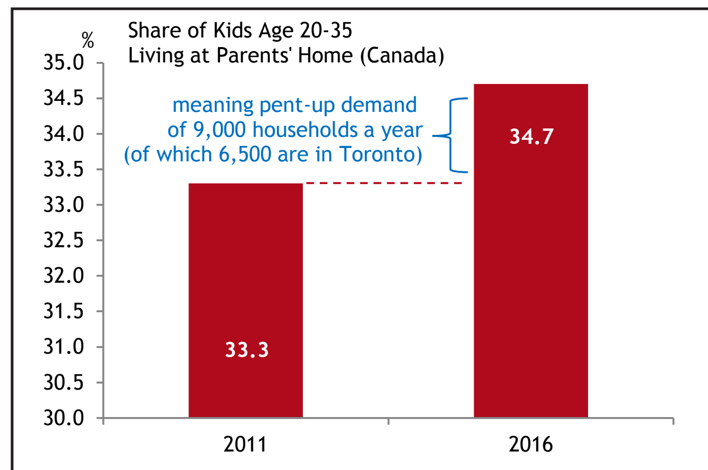
The housing market is about to face its most significant test in a decade as the combination of higher interest rates and regulatory changes will work to reduce purchasing power. The impact will be noticeable but probably short-lived—mainly in the GTA and Vancouver where supply issues will continue to dominate long-term housing trajectories. At this point we do not see any real relief. In fact, the opposite is the case. Without significant changes to land and rental policies alongside a dramatic change to housing preference among buyers, those centers will become even less affordable.

Chart 13
Household Formation Understated



Source: Statistics Canada, CMHC, CIBC

Chart 14
Staying At Home



Source: Statistics Canada, CIBC

CIBC World Markets Inc., CIBC World Markets Corp., CIBC World Markets Plc., CIBC Australia Limited and certain other corporate banking and capital markets activities of Canadian Imperial Bank of Commerce operate under the brand name CIBC Capital Markets.

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice.

This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2017 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.