The Edge Report

April 2022

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1) Thoughts on cyclical vs secular downturns

I'm about to discuss some kind of scary data regarding interest rates and what they might mean for housing going forward. But before I do that, I want to share a simple framework for thinking about real estate valuations since it will help understand what might be around the corner.

What drives house prices?

In the long term, these fundamentals matter more:

- Productivity and employment growth (ie rising incomes)
- The level of new supply (ie overbuilding vs under-building)
- Population growth

But in the short term, other dynamics often overwhelm long-term fundamentals:

- Credit (both cost AND availability)
- Sentiment / speculation

This is by no means an exhaustive list of factors, but the point is that valuations are influenced by different factors depending on the time frame in question. If we're talking about the next decade, population and supply matter immensely. But if we're talking about the next year or two, credit and sentiment can often matter more. And we may be about to enter a period where they matter a lot.

Cyclical vs secular downturns

Housing downturns can be thought of as *cyclical* or *secular*.

Cyclical downturns occur when short-term dynamics deteriorate temporarily but longer-term fundamentals are still intact. The drop in prices can still be relatively steep, but prices tend to recover within a couple years. A good example of a recent cyclical downturn is the 2017 housing slump in York Region. After a sharp runup in prices, sentiment abruptly soured following the implementation of the non-resident buyer tax, while credit was tightened following to implementation of OSFI's B20 lending guidelines. Prices fell sharply, and there were significant losses for speculators. But because the long-term fundamentals were still intact, prices recovered relatively quickly.

Secular downturns tend to occur when short-term AND long-term fundamentals turn negative. They involve deep, prolonged downturns that take years or even over a decade to recover. A recent example would be Calgary's housing market from 2007 to 2020 where prices fell and remained below peak levels for over a decade as a result of slowing population growth and oversupply.

An even starker example of a secular downturn occurred from the late 80s until early 2000s in Ontario. Back in the late 1980s, there was massive overbuilding in Ontario coupled with low population growth. The long-term fundamentals were terrible. When interest rates rose rapidly, it kicked off a downturn that saw house prices fall 25% and remain below peak levels for over a decade. And they didn't recover their inflation-adjusted peak for 15 years!

Imagine trying to explain to young buyers today that a house bought in 1989 didn't recover in price until almost 2000. Their minds would be blown.

Canadian housing about to enter a cyclical downturn?

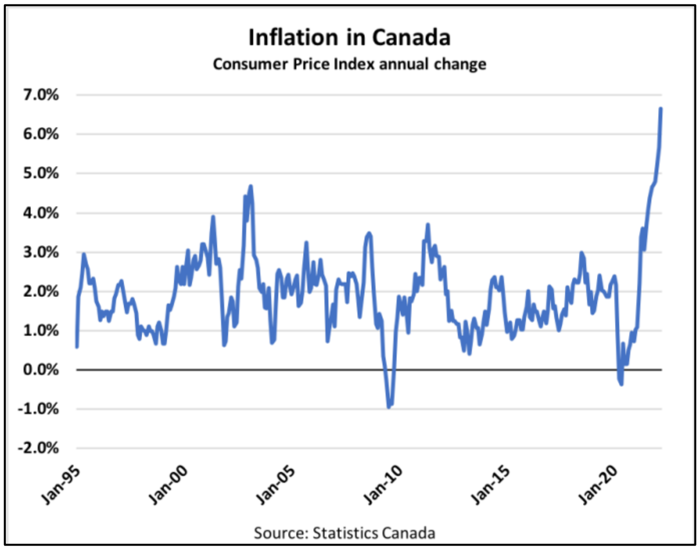
In Canada right now, the long-term fundamentals are still quite positive. We have very strong population growth, an inadequate new supply response (at least for single-family), solid employment but with mediocre productivity growth. Call it 2.5 / 3.

But short-term fundamentals are deteriorating sharply, and there's now a rising risk of a cyclical downturn that, while relatively short in duration, could still be rather painful in places where affordability is already stretched thin….I'm thinking about southern Ontario and parts of BC in particular.

2) Inflation stunner means more tightening ahead from Bank of Canada

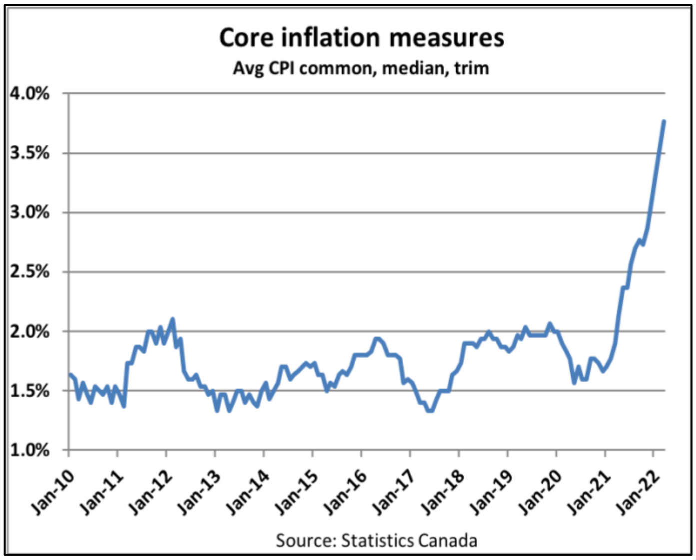
It's hard to believe that the Bank of Canada could make the largest one-time rate hike since 2000 and still find themselves even further behind the inflation 8-ball. Think about what we learned AFTER the Bank's 50bp hike earlier this month:

- March CPI came in at a sizzling 6.7% y/y, well above consensus expectations of 6.1%.
  - This is the fastest rate of increase since the GST was implemented in 1991, and it's the largest non-tax related jump in pricing since the early 1980s!

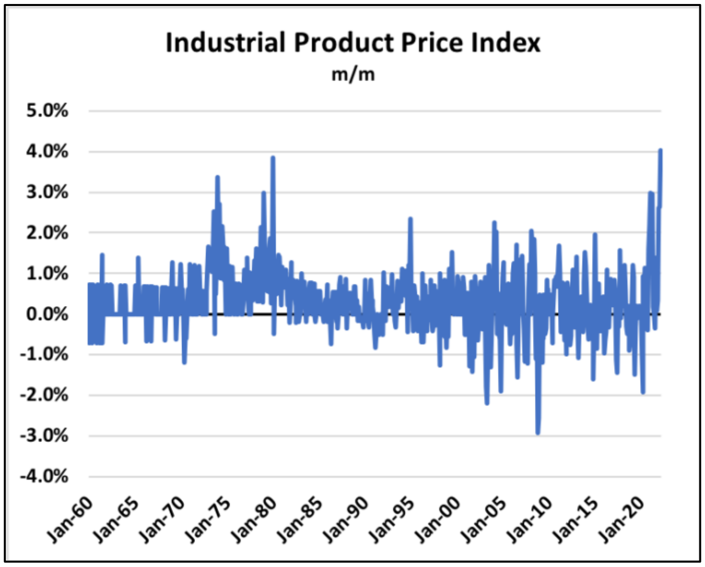


- What's even more striking is that inflation is still accelerating. The seasonally adjusted monthly CPI rose 0.9% m/m, the largest monthly gain since 2005. And even stripping out food and fuel, core CPI has spiked by 1.0% in the past 2 months alone. That's the largest 2-month increase since at least 1992. So much for transitory!

- The BoC remains focused on core inflation, which strips out volatile components like food and fuel. They have 3 preferred measures of core inflation, and those three are now averaging nearly 4%...way above the Bank's target band of 1-3%.

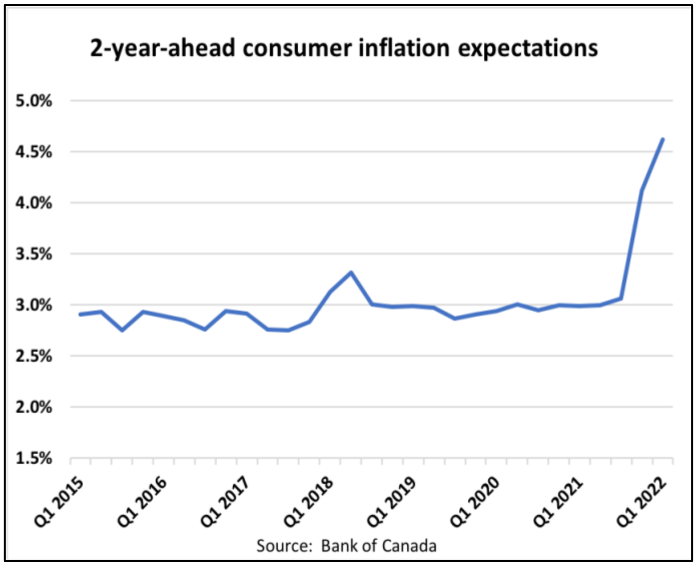


- The Industrial Product Price Index, which measures the cost of goods as they leave factory gates, posted the single largest monthly increase on record in March.

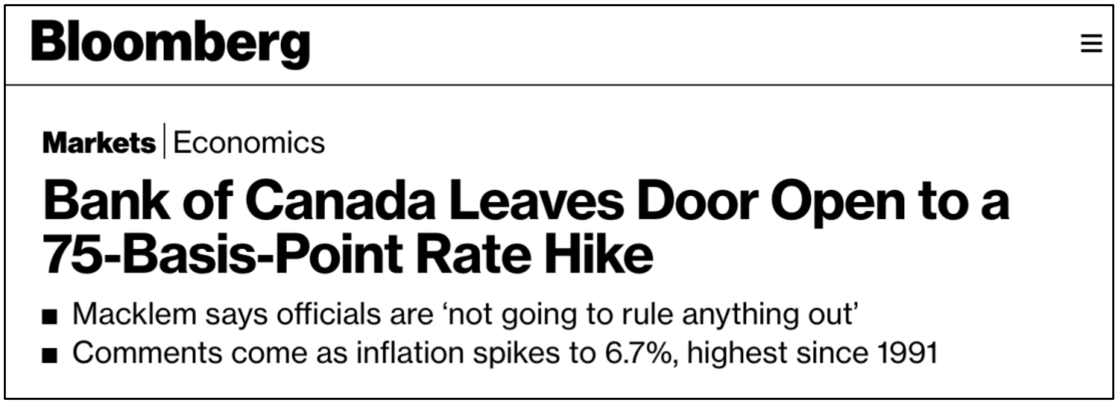


- The price of raw materials jumped 11.8% in March alone…the third highest monthly reading on record. If factories are paying 12% more for basic materials IN ONE MONTH, what do we think that means for consumer prices down the road? It's not good.

Now keep in mind inflation expectations are already spiking, which is something the Bank of Canada is very concerned about. When people expect prices to keep rising, they spend more today….which can create rising prices in a self-feeding dynamic.



BoC governor Tiff Macklem suggested that the overnight rate needs to rise to 2-3% just to reach a "neutral" level that is not creating additional demand. That's another 100-200bps above current levels just to get to neutral, All of this means we can probably pencil in ANOTHER 50bp rate hike on June 1 and there's a chance we may see even more. From Bloomberg. Yikes!


Bloomberg

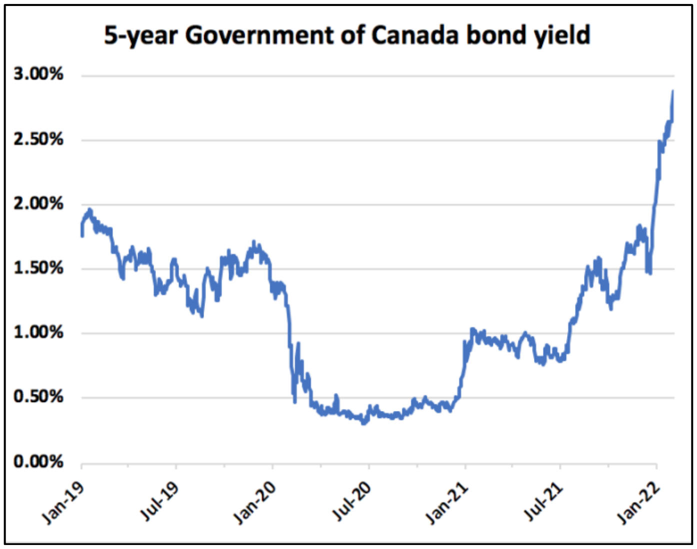
Markets | Economics

Bank of Canada Leaves Door Open to a 75-Basis-Point Rate Hike

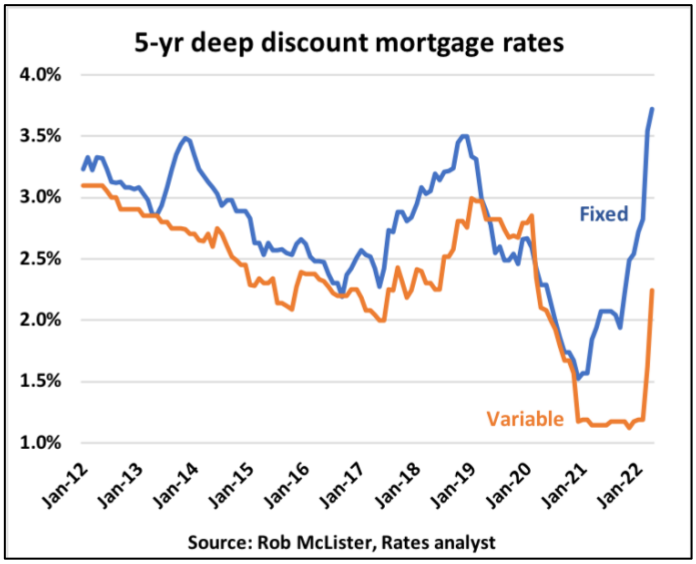
- Macklem says officials are 'not going to rule anything out'
- Comments come as inflation spikes to 6.7%, highest since 1991

3) Interest rates are about to seriously mess things up!

The stunning rise in bond yields continues unabated, and we're now only about 10bps away from the 5-year bond yield breaching the 3% level for the first time since 2008:



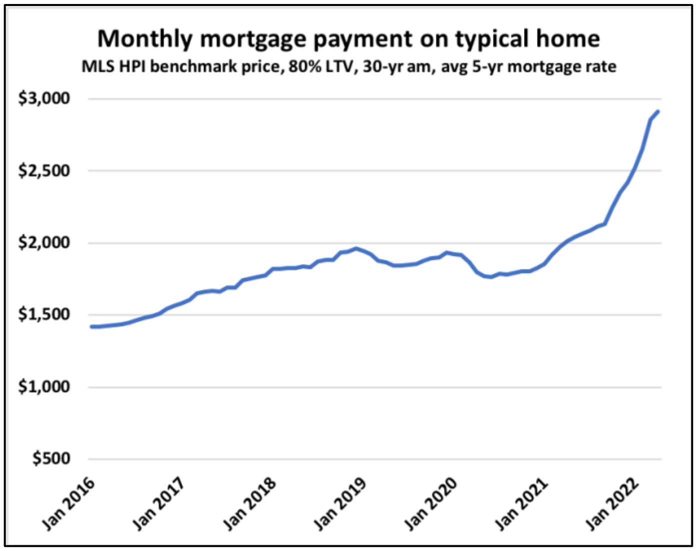
Until this trend changes, we should expect a steady grind higher in fixed rates. Already deep discounted 5-yr fixed rates are up about 180bps in just the past 7 months and have more than doubled from the late 2020 lows of close to 1.5%:



We're in a very different economic climate than just a few months ago. There's a lot to worry about with a move of this magnitude. Below are a few observations in no particular order.

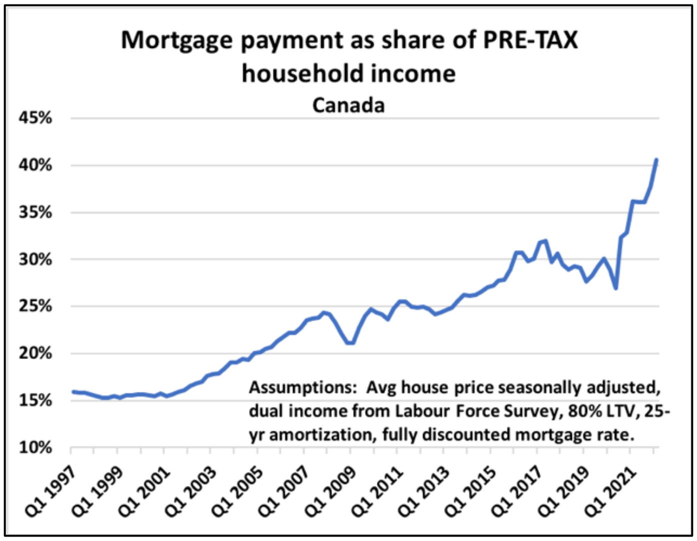
i) Affordability is getting crushed

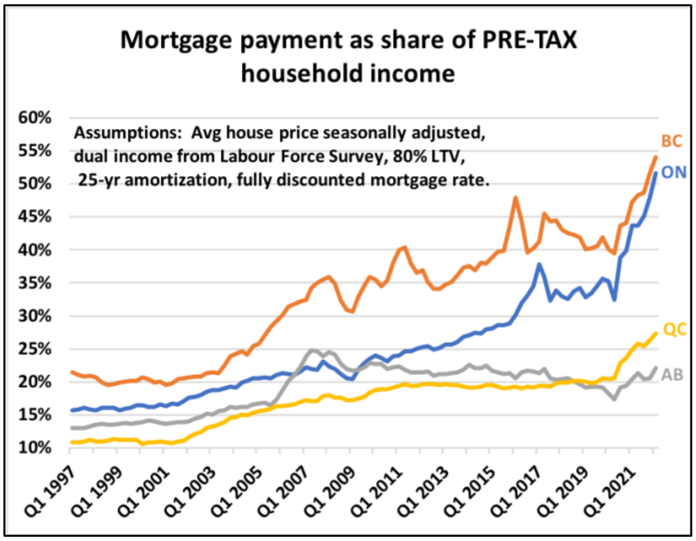
We can talk about lack of supply and a strong economy all we want, but when the monthly payment needed to service a mortgage on a typical newly-purchased home shoots up by $700 in 6 months, it's a real problem.



This is crushing affordability. The charts below are updated to reflect the Q1 numbers. Two big takeaways:

- Rising rates are going to hurt in Ontario and BC
- There's still lots of cushion to absorb rising rates in the likes of Alberta

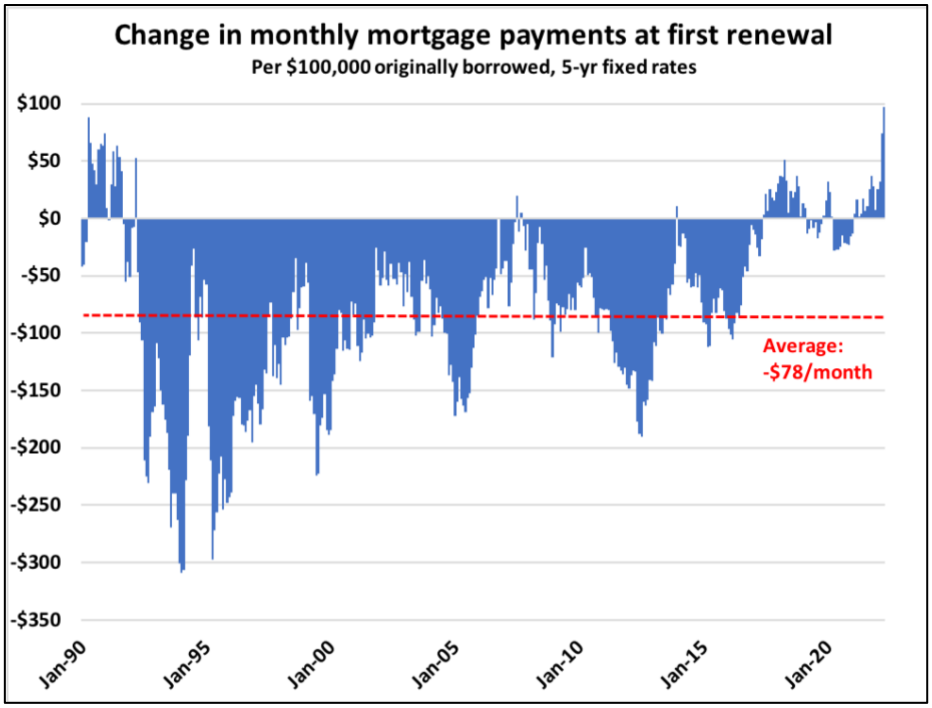




ii) Mortgage renewal gap surges 30-year highs

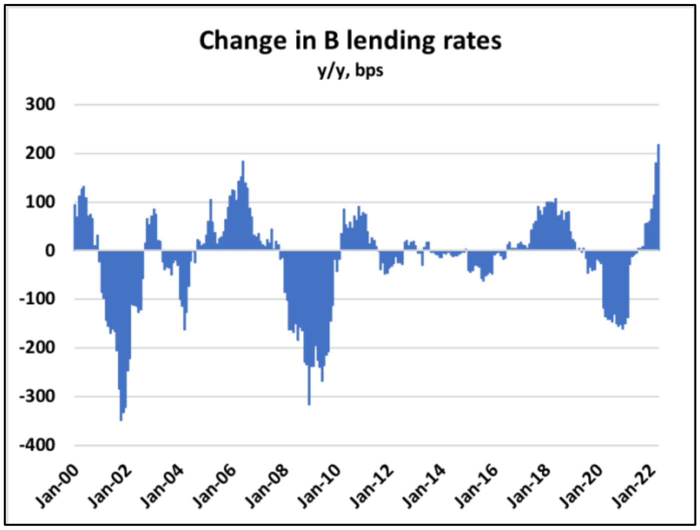
5-yr fixed rate mortgages are the most common type in Canada, accounting for just under half of all mortgages in the country. The chart below is one of the most important macroeconomic charts to watch right now. It estimates the change in monthly payment at renewal for borrowers with fixed rate mortgages.

Borrowers who took out mortgages in 2017 are today seeing payments jump nearly $100 per month for every $100,000 originally borrowed when they renew:



All else equal, this means less discretionary spending across the economy. It's not good.

But where things get really concerning is for non-prime borrowers with B-side mortgages (think Equitable or Home Trust-type lenders). These loans are overwhelmingly 1-yr mortgages that will soon be renewing at TWICE the rate they were originated at just last year. This is steepest annual increase in at least 20 years.



You have to think that if there's stress in the system, it will show up here first.

4) National home sales update: Sales fall, inventory still low but rising quickly

The highlights:

- We are likely to see a 40% pullback in sales in coming months coupled with the largest inventory build since 2010.
- House price indexes do a poor job of picking up sharp inflection points. Prices are already down from the February peak in major markets, but it will take several months before this shows up in HPI data.
- Price gains nationally are moderating and may register declines later this year. Market balance is weakening but with months of inventory still just 1.8, it will take several more months of deteriorating trends before headline prices officially print negative.
- In Ontario, sales are down, inventory is building rapidly, and some buyers are starting to have problems closing. It's beginning to look a lot like 2017.
- Headlines/news coverage of Canadian housing is about to turn decidedly negative.

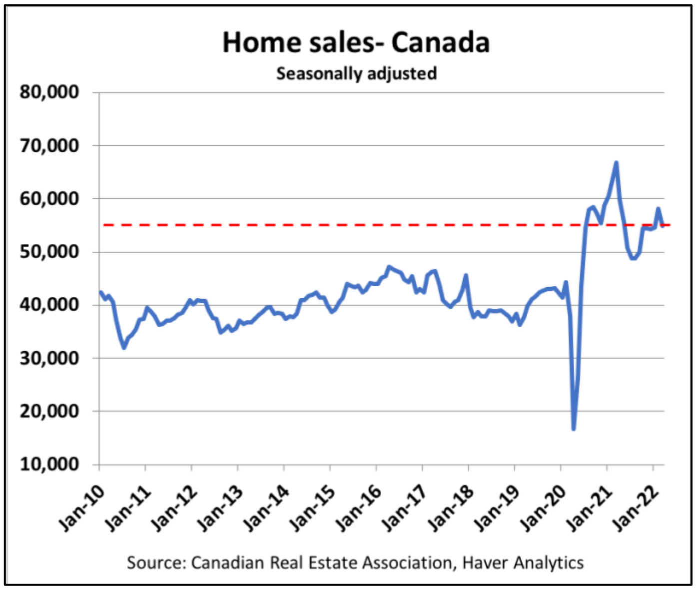
Key metrics below:

	Sales		**New listings**		**Active inventory**		**House prices (HPI for Canada, average for provinces)**	
	y/y	**m/m seasonally adjusted**	**y/y**	**m/m seasonally adjusted**	**y/y**	**m/m seasonally adjusted**	**y/y**	**m/m seasonally adjusted**
Canada	-17.8%	-5.4%	-12.7%	-5.5%	-19.0%	+5.3%	+26.9%	+1.0%
BC	-25.9%	-0.8%	-14.8%	-16.9%	-11.3%	+13.7%	+14.5%	-2.4%
AB	+28.5%	-5.3%	+2.5%	-8.3%	-26.4%	-3.0%	+6.7%	-3.6%
ON	-26.7%	-10.6%	-12.3%	-1.8%	-10.6%	+16.5%	+18.5%	-2.3%
QC	-14.4%	-3.5%	-15.4%	+3.1%	-20.0%	-0.7%	+14.2%	-0.5%

Main takeaways from the March housing data:

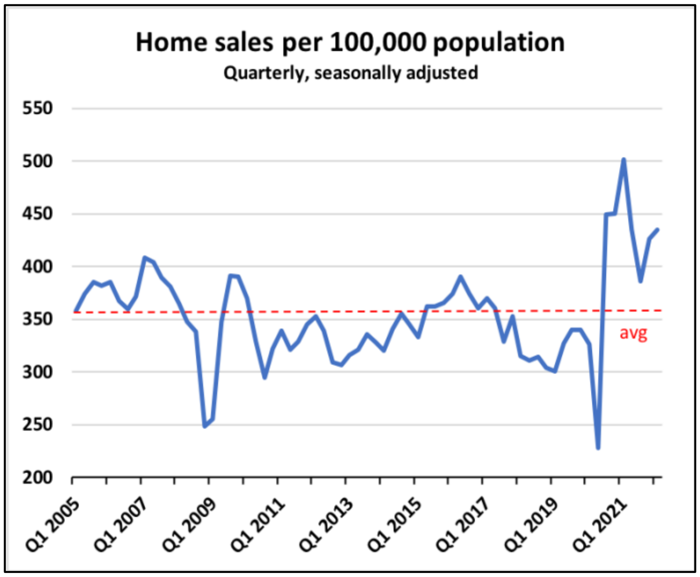
i) Sales fall

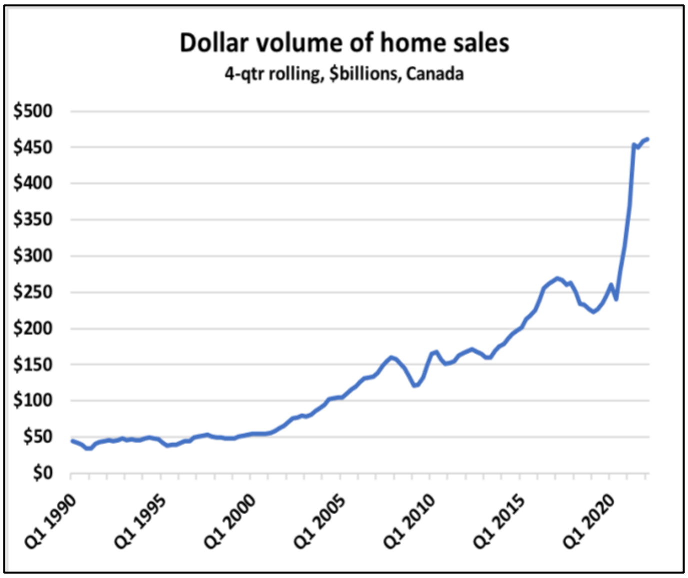
Home sales slumped 5.4% m/m in March in large part due to steep declines in Ontario (-10.6% m/m).



Even accounting for strong population growth, sales remain nearly 25% above long-term norms. The dollar volume of home sales is 90% above pre-COVID levels.

Regular readers will know that I was calling for a significant "demand gap" in the back half of the year. Given how much demand has clearly been pulled forward, coupled with the recent rise in interest rates, it's unlikely that sales will simply return to the mean, which would imply a 20% decline from current levels. A steeper decline, possible in the magnitude of 40% from current levels, looks entirely possible here:

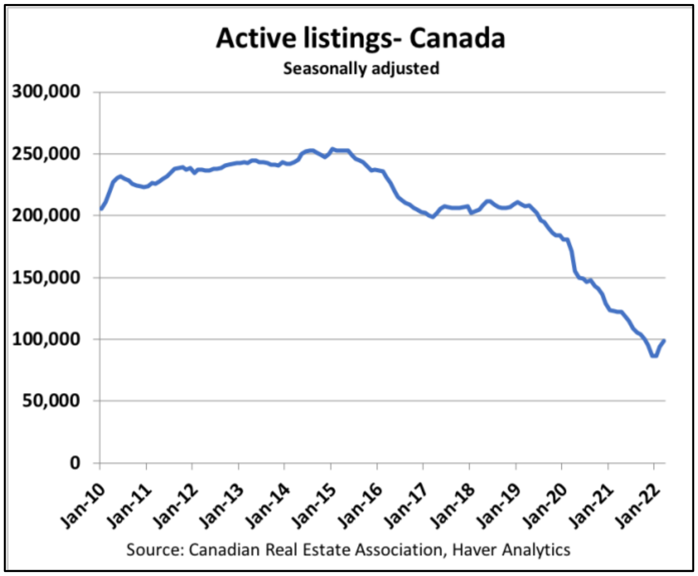


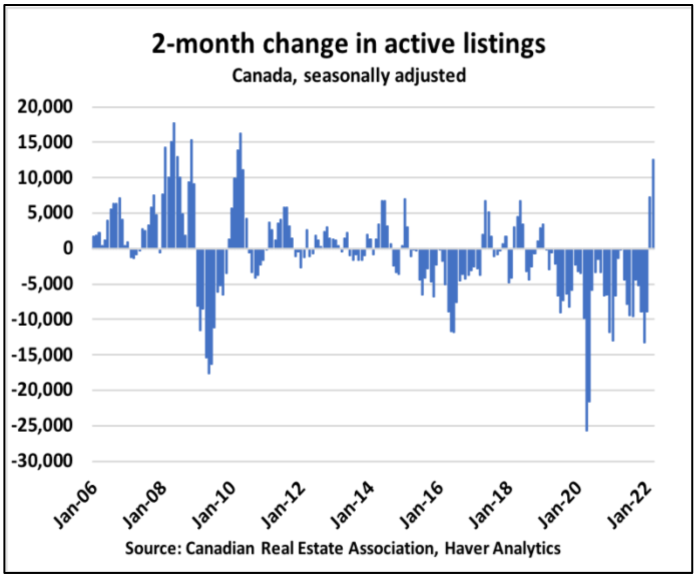


ii) Another big jump in inventory

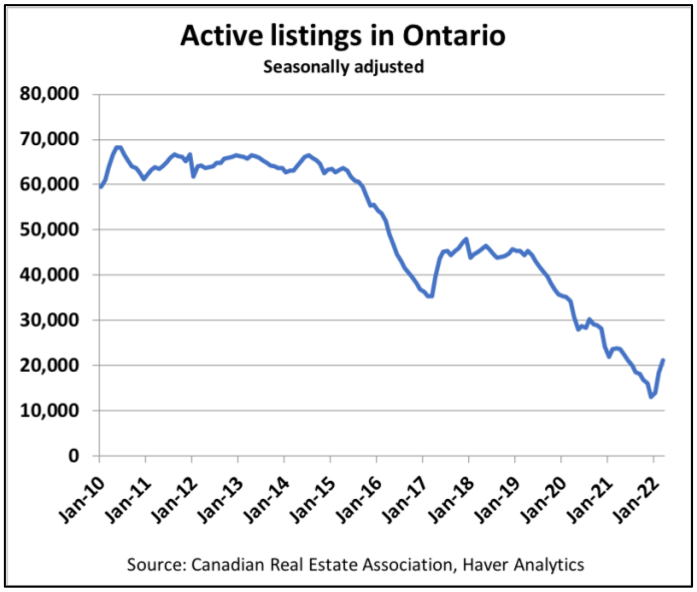
New listings coming to market pulled back 5.4% m/m in March after surging 24% in February. But even with fewer new listings, active inventory still posted another strong increase. Total inventory jumped 5.3% m/m including a massive 16.5% increase in Ontario.

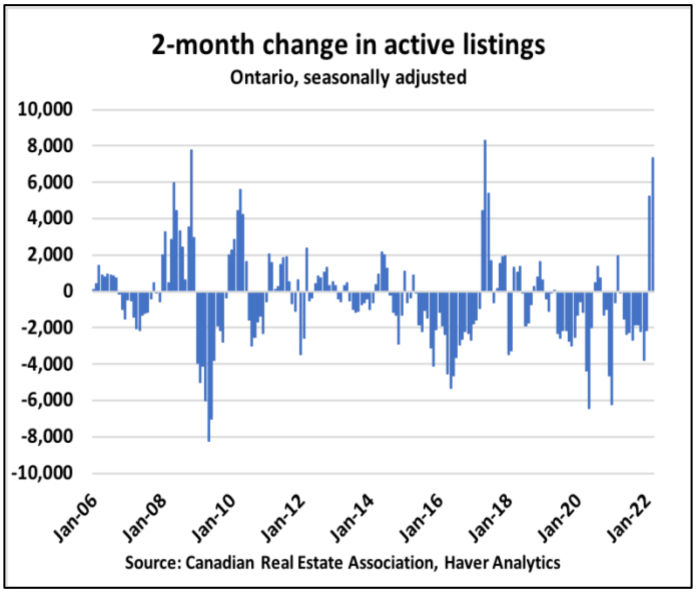
There are now 13,000 more listings nationally than just 2 months ago, and that's accounting for normal seasonality. You have to go all the way back to 2010 to find the last time inventory built that quickly.



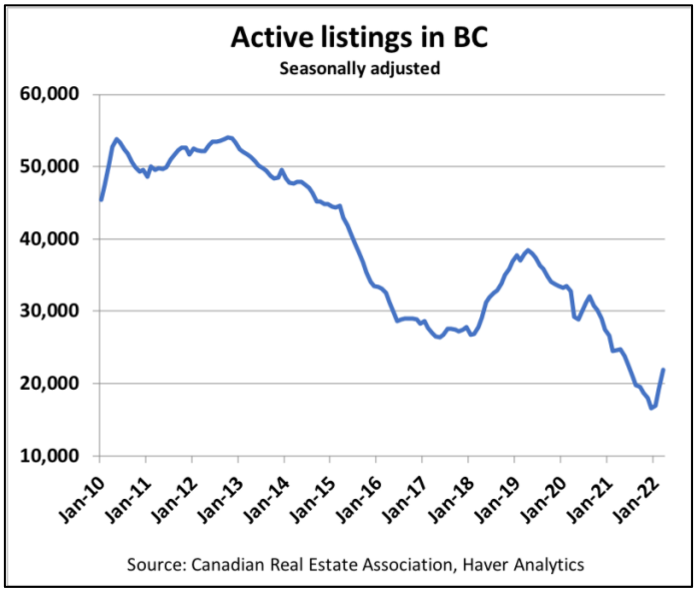


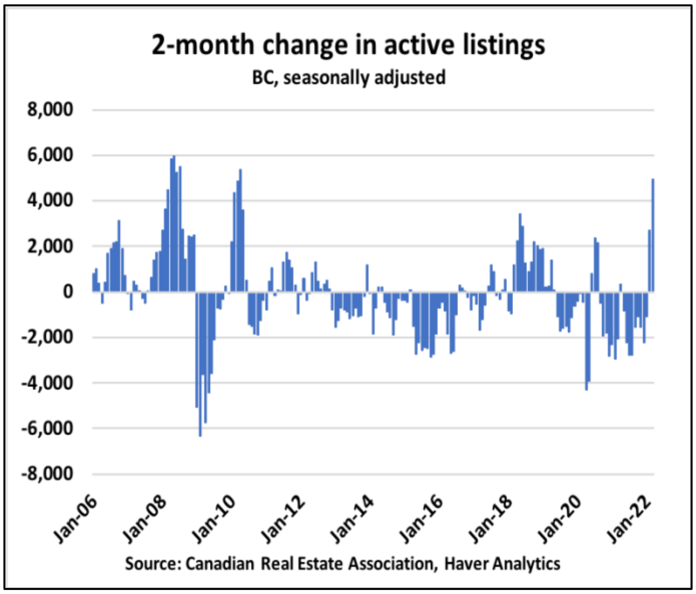
In Ontario, the inventory build is now the largest since 2017.





And in BC, the increase is the largest since 2010:

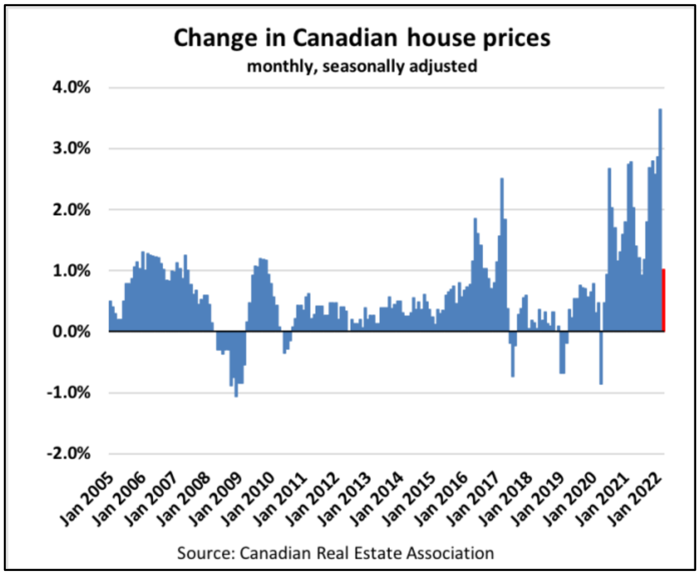




Inventory levels are clearly still well below normal, but if sales slide from current levels and new listings continue to come online at a solid pace, things can change quickly.

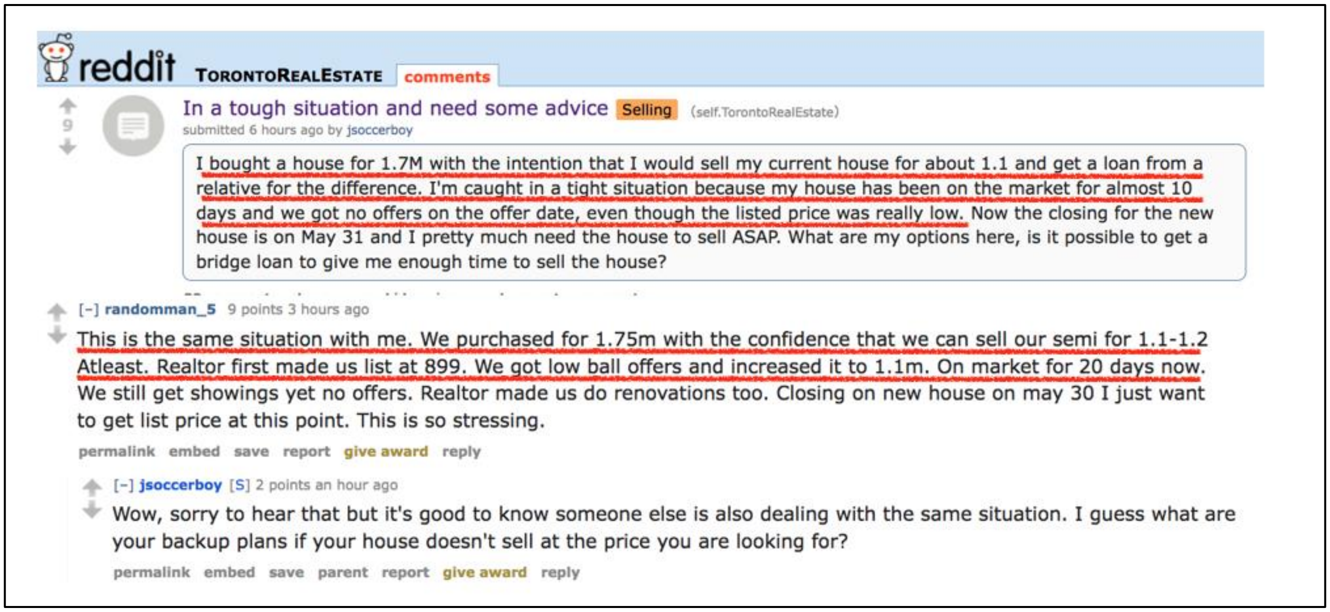
iii) Price gains moderate

Months of inventory are still at just 1.8 nationally but is up from 1.6 in February. The supply-demand balance still points to positive price trends for a few more months at least, but it's notable that the seasonally adjusted MLS House Price Index rose just 1.0% on the month, the weakest increase since July 2021:



The MLS HPI is a good index but it fails to capture sharp inflections, which I believe is what we've seen in the past 8 weeks.

I think prices are already 5-10% below February levels in Toronto and Vancouver suburbs. Because of that, we're now seeing appraisal issues surface:



reddit TORONTOREALESTATE comments

9

In a tough situation and need some advice Selling (self.TorontoRealEstate)

submitted 6 hours ago by jsoccerboy

I bought a house for 1.7M with the intention that I would sell my current house for about 1.1 and get a loan from a relative for the difference. I'm caught in a tight situation because my house has been on the market for almost 10 days and we got no offers on the offer date, even though the listed price was really low. Now the closing for the new house is on May 31 and I pretty much need the house to sell ASAP. What are my options here, is it possible to get a bridge loan to give me enough time to sell the house?

[–] randomman_5 9 points 3 hours ago

This is the same situation with me. We purchased for 1.75m with the confidence that we can sell our semi for 1.1-1.2 Atleast. Realtor first made us list at 899. We got low ball offers and increased it to 1.1m. On market for 20 days now. We still get showings yet no offers. Realtor made us do renovations too. Closing on new house on may 30 I just want to get list price at this point. This is so stressing.

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[–] jsoccerboy [S] 2 points an hour ago

Wow, sorry to hear that but it's good to know someone else is also dealing with the same situation. I guess what are your backup plans if your house doesn't sell at the price you are looking for?

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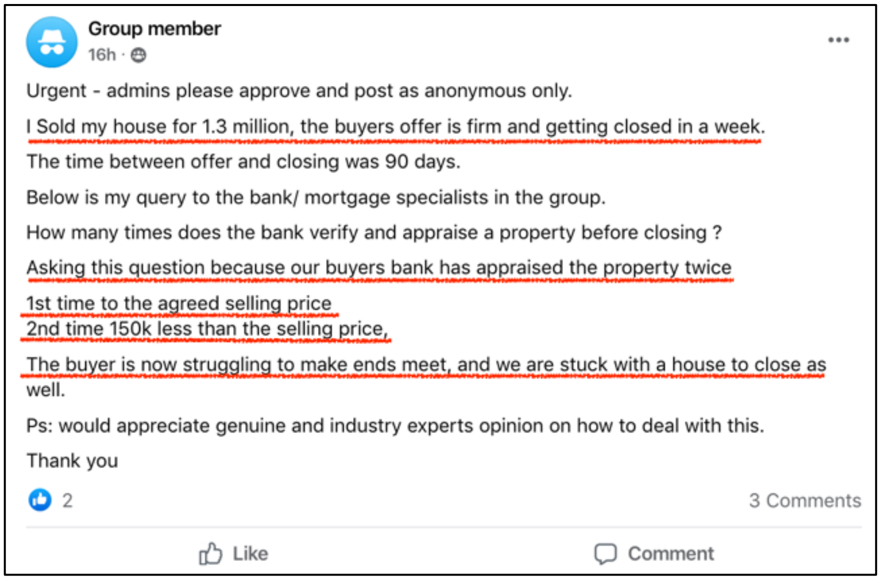


Group member

16h ·

Urgent - admins please approve and post as anonymous only.

I Sold my house for 1.3 million, the buyers offer is firm and getting closed in a week.

The time between offer and closing was 90 days.

Below is my query to the bank/ mortgage specialists in the group.

How many times does the bank verify and appraise a property before closing ?

Asking this question because our buyers bank has appraised the property twice

1st time to the agreed selling price
2nd time 150k less than the selling price,

The buyer is now struggling to make ends meet, and we are stuck with a house to close as well.

Ps: would appreciate genuine and industry experts opinion on how to deal with this.

Thank you

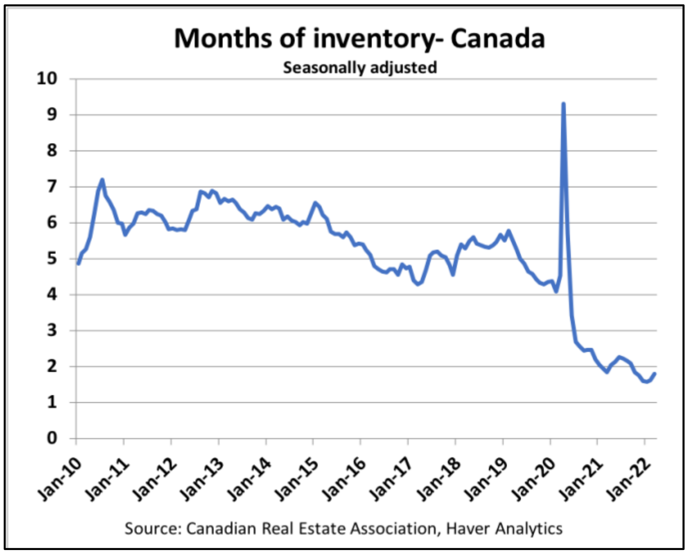
2 3 Comments

Like Comment

I don't believe the media has yet keyed in to how quickly the situation has changed, particularly in Ontario. I expect it will get significant press coverage over the next month or two which could further weigh on sentiment.

iv) Market is still very strong overall

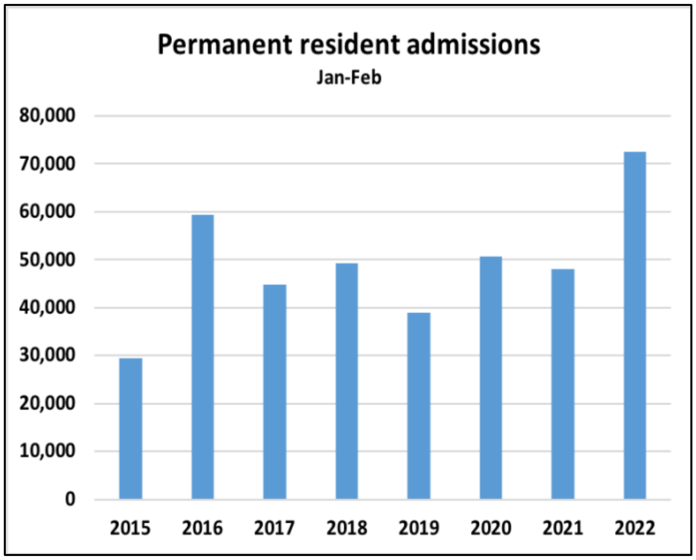
Perspective is needed here, and I don't want to overstate things. The market is still very strong right now. Both the sales-to-new listings ratio and months of inventory point to a market that is still firmly in seller territory overall.

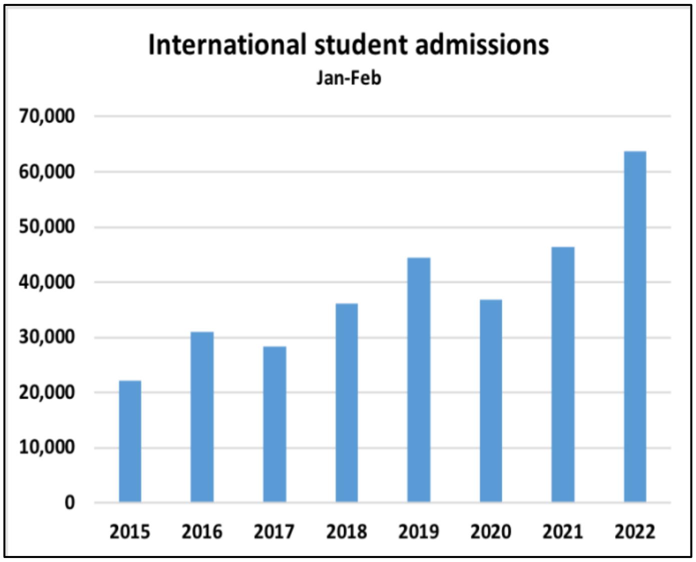


5) Supply/demand deep-dive: Huge surge in new resident admissions so far in 2022

With all the scary interest rate data, it's easy to lose sight of the fact that the long-term fundamentals are still very strong.

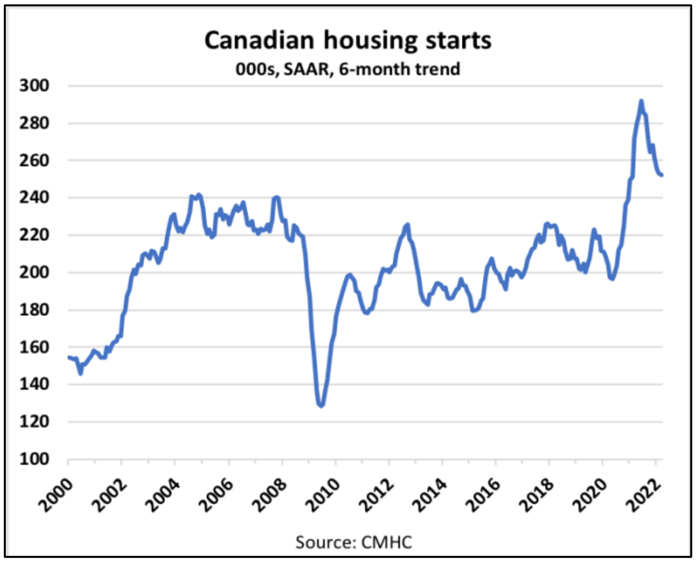
Let's start with population. This week we got the latest monthly immigration data. Not surprisingly, January and February have set a new record for both permanent resident and international student admissions:



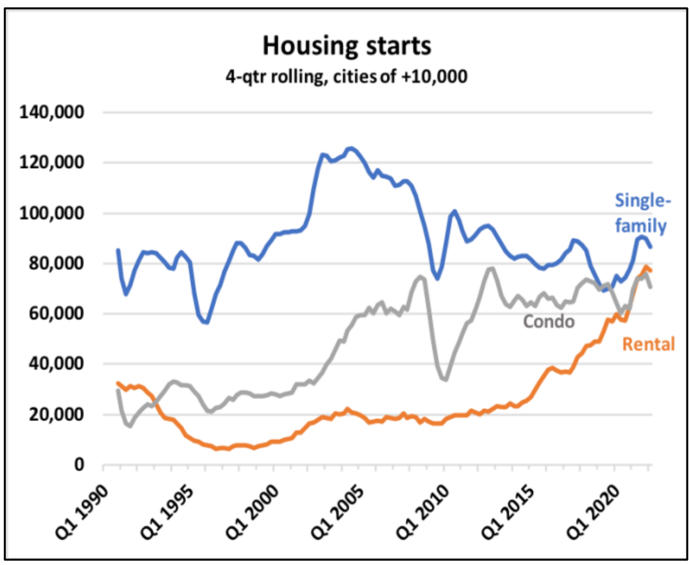


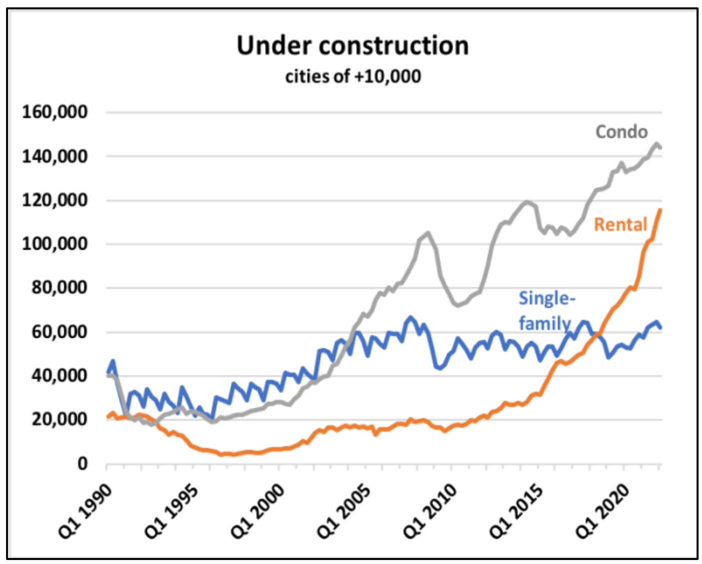
Canada is well on its way to hitting the ambitious immigration target of 432,000 in 2022.

On the supply front, housing starts continue to slow off the record highs seen in mid-2021. Starts are now averaging just over 250,000 on an annualized basis:



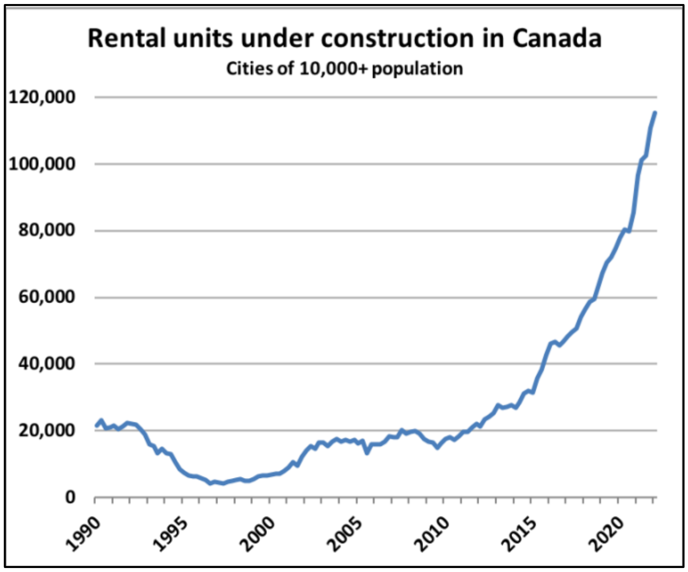
As always, the devil's in the details. Single-family starts (including rows and semis) are still below levels seen in the early 2000s. The real increase has been on the rental side. The same is true when we look at dwellings under construction where the number of single-family homes under construction is flat as a pancake over the past 20 years:





It should go without saying that these favorable supply/demand dynamics will ultimately be what puts a floor under housing over the long term regardless of variations in interest rates in the near term.

I have to zoom in once again on rental construction. If there's one area where we may see some overbuilding, it's in this segment in certain geographies. Not much commentary is needed here. These charts speak for themselves:


Rental units under construction in Canada
Cities of 10,000+ population
120,000
100,000
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60,000
40,000
20,000
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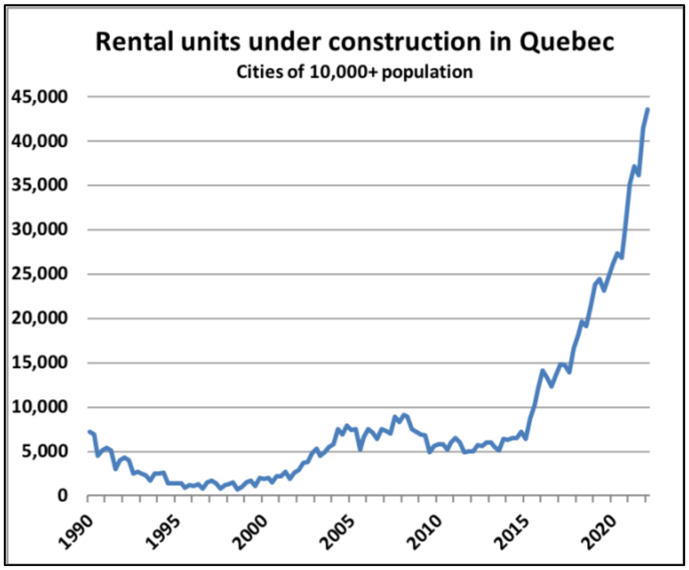
Rental units under construction in Quebec
Cities of 10,000+ population
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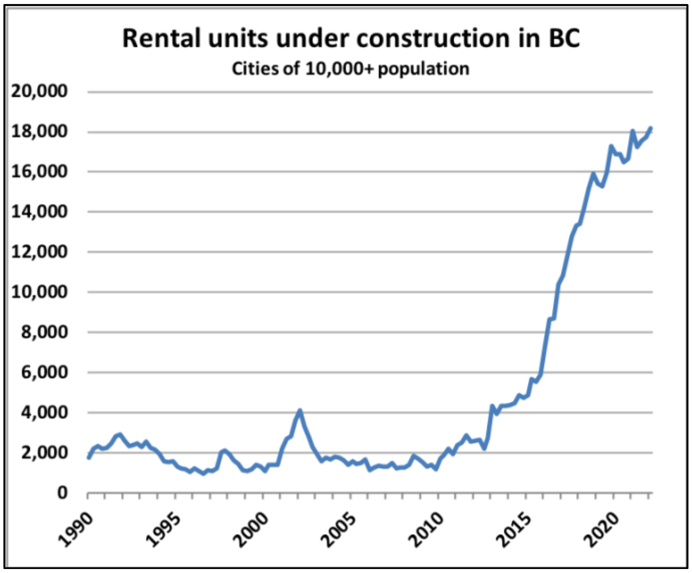
Rental units under construction in BC
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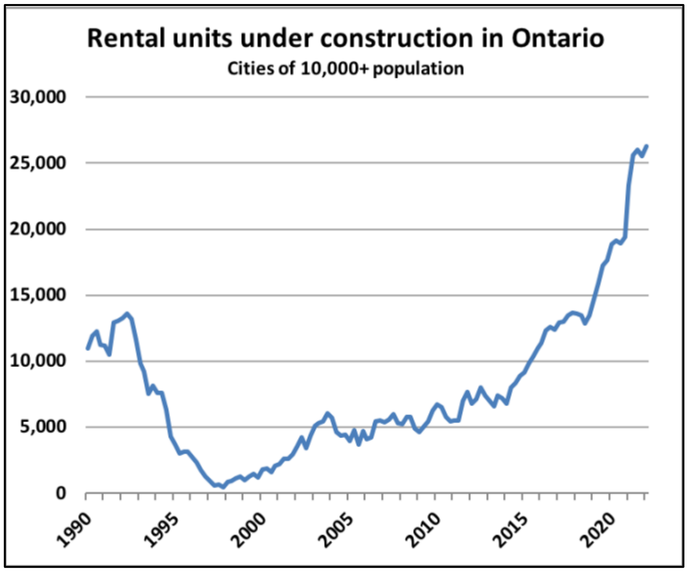
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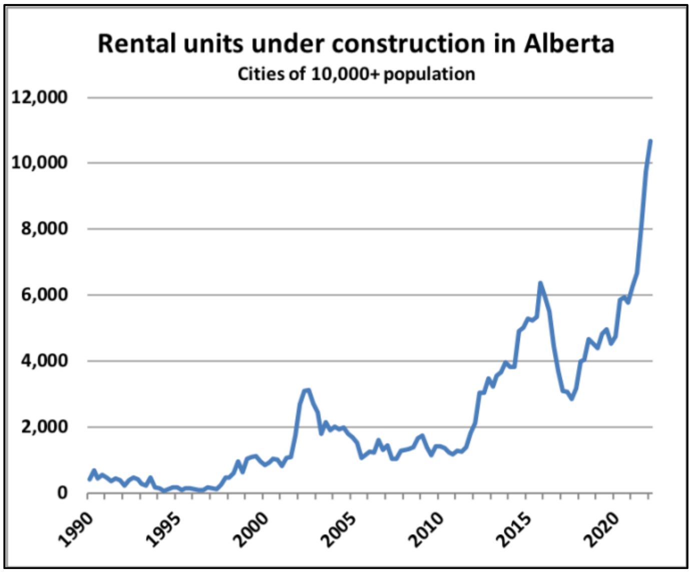
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12,000
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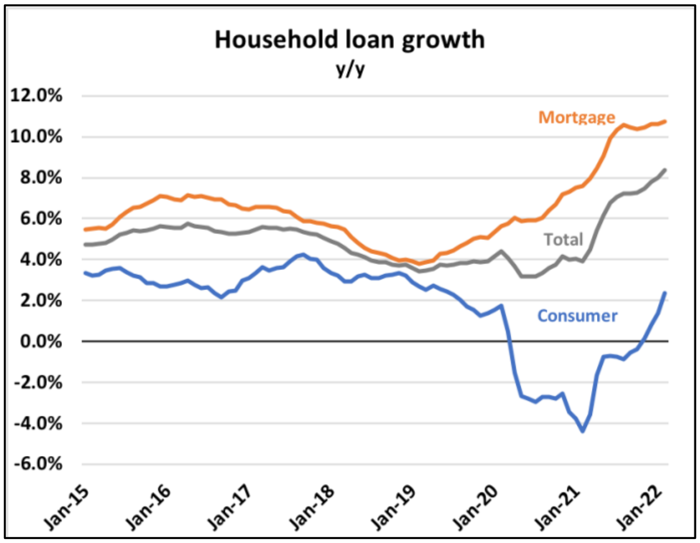
2020

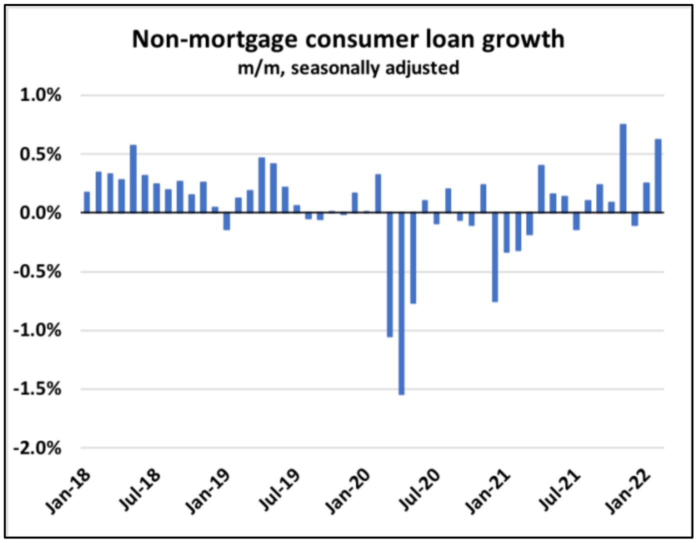
6) Mortgage growth hits 14-year high, variable rate popularity surges

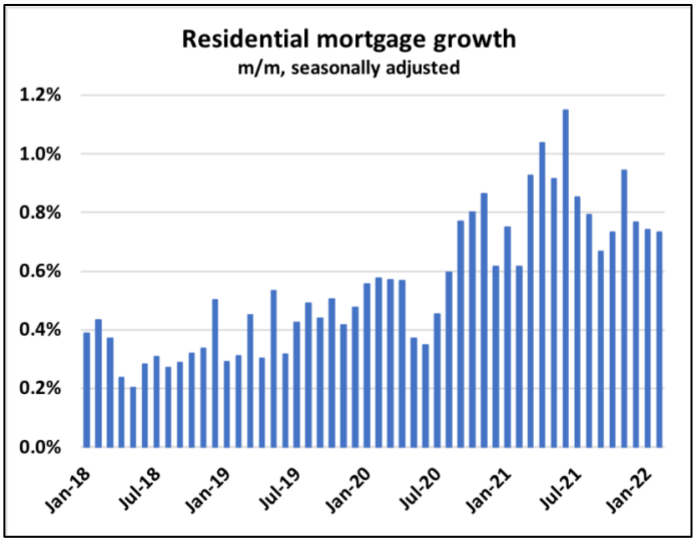
i) Feb household credit growth hits highest levels since 2009

Household loan growth hit 8.4% y/y in February, highest since early 2009. Mortgage growth hit 10.8% y/y, a 14-year high.

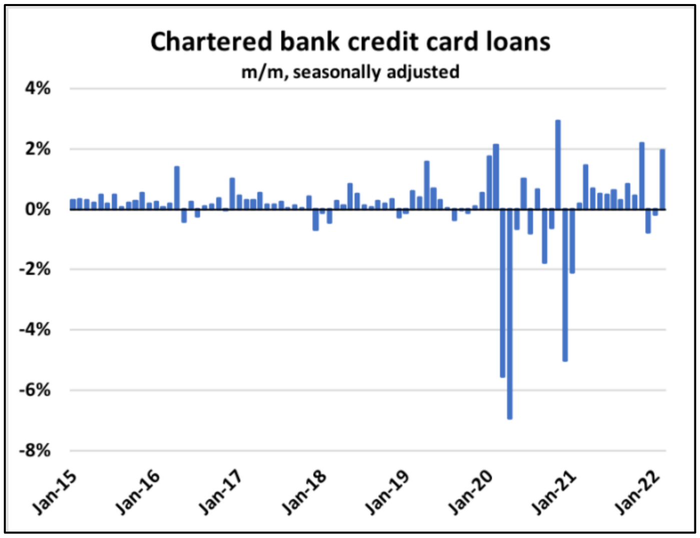


Non-mortgage consumer loans posted a solid 0.6% monthly gain while mortgage growth came in at 0.7% m/m:

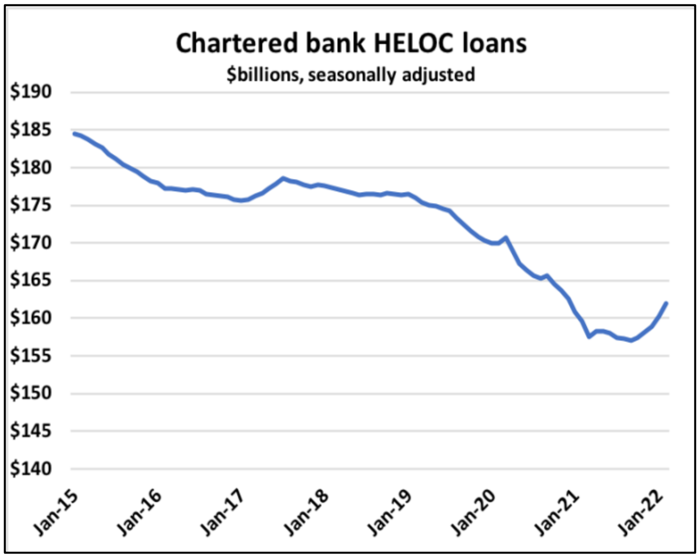


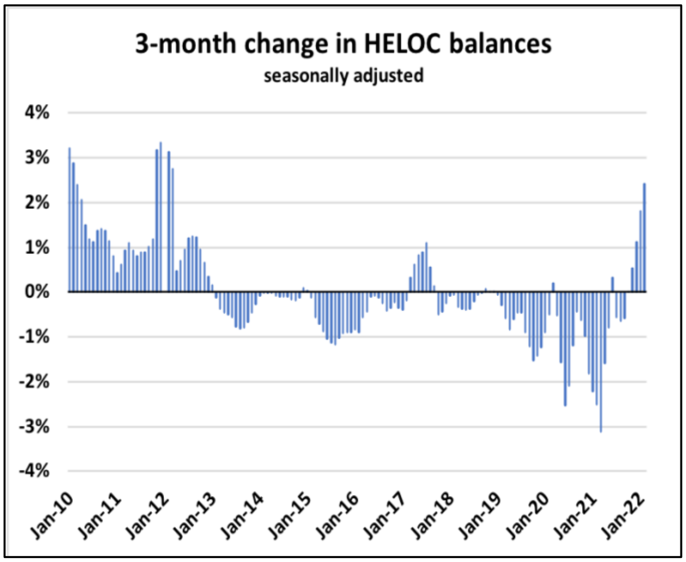


Credit card balances were up nearly 2% on the month, one of the largest increases in the past 6 years:



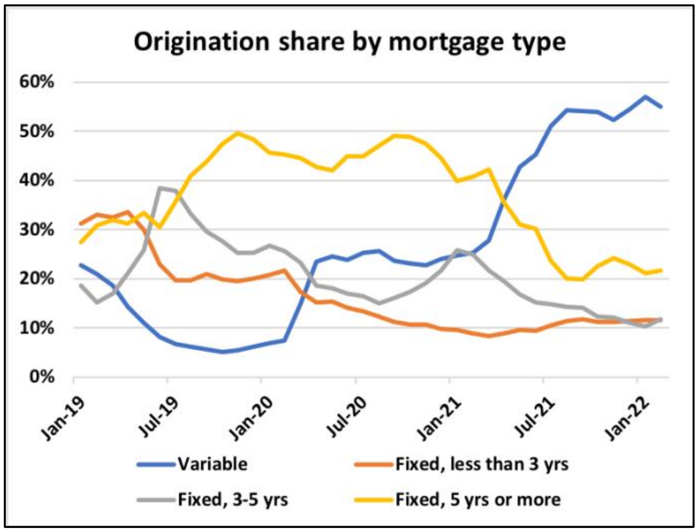
HELOC balances continue to grow after falling steadily since 2019. Balances increased by 1.0% in February, the largest monthly increase in a decade. The 3-month change is now up to 2.5%, the most since 2012:

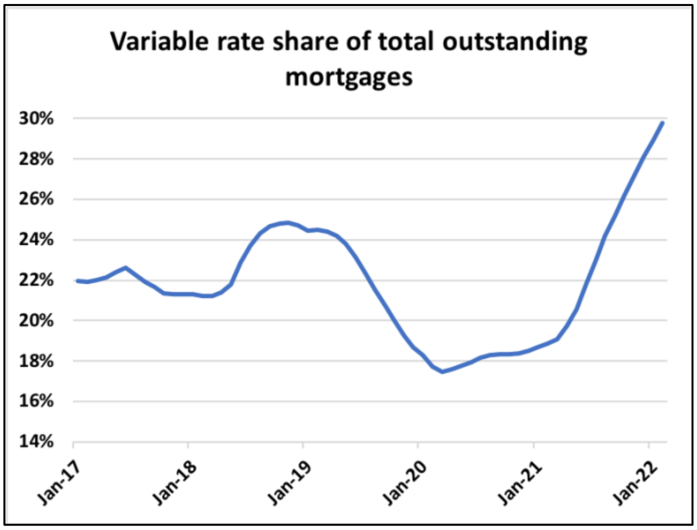




ii) Variable still accounts for over half of new mortgages

Variable rate mortgages remain extremely popular, accounting for over half of new mortgages and 30% of all outstanding mortgages (up from less than 18% in early 2020).



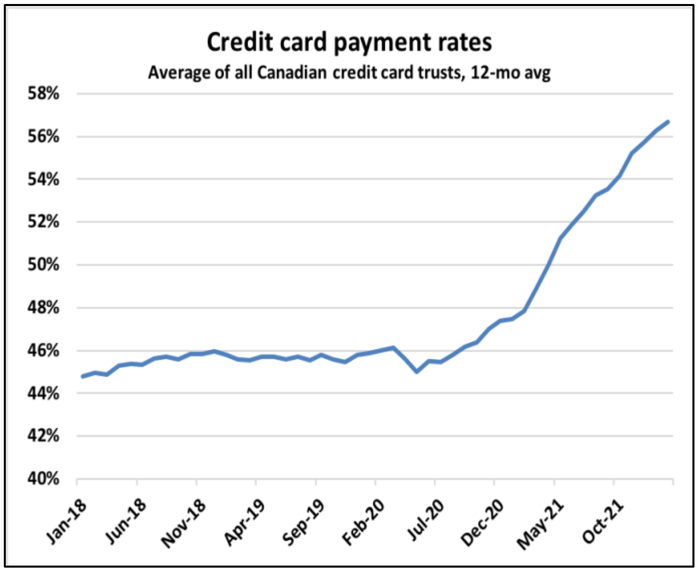


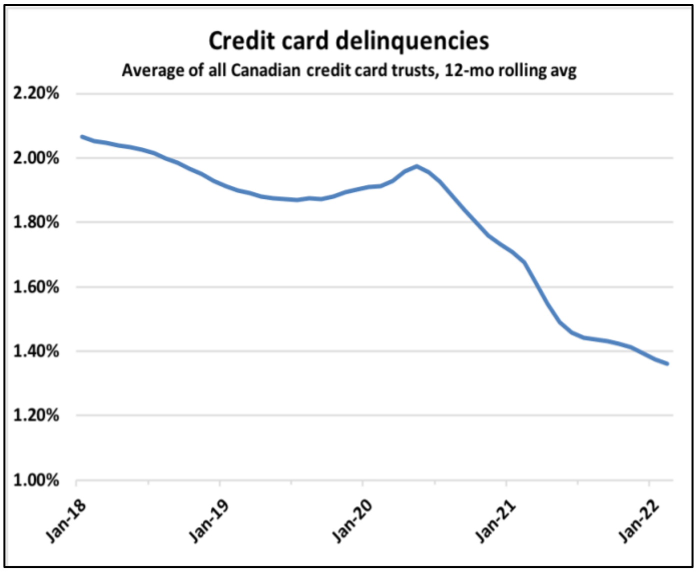
There are 2 reasons why variable rate mortgages remain popular:

- Fixed mortgage rates are still an unusually wide 150bps above variable.
- The OSFI stress test pushes borrowers into variable. Borrowers currently have to qualify at the HIGHER of the contract rate +200bps OR 5.25%.
  - A borrower wanting a fixed rate would have to qualify today at 5.69% (contract rate of 3.69% + 200bps) but variable rate borrowers would be qualified at the benchmark rate of 5.25% since it's higher than the contract rate of 2.12% + 200bps.

iii) Still no signs of stress among borrowers

There are still no signs of stress in credit card trust data. Payment rates continue to hit fresh highs which means consumers still have plenty of cash while delinquencies continue to make new lows. Until this changes, we can expect very strong credit trends in mortgage portfolios:



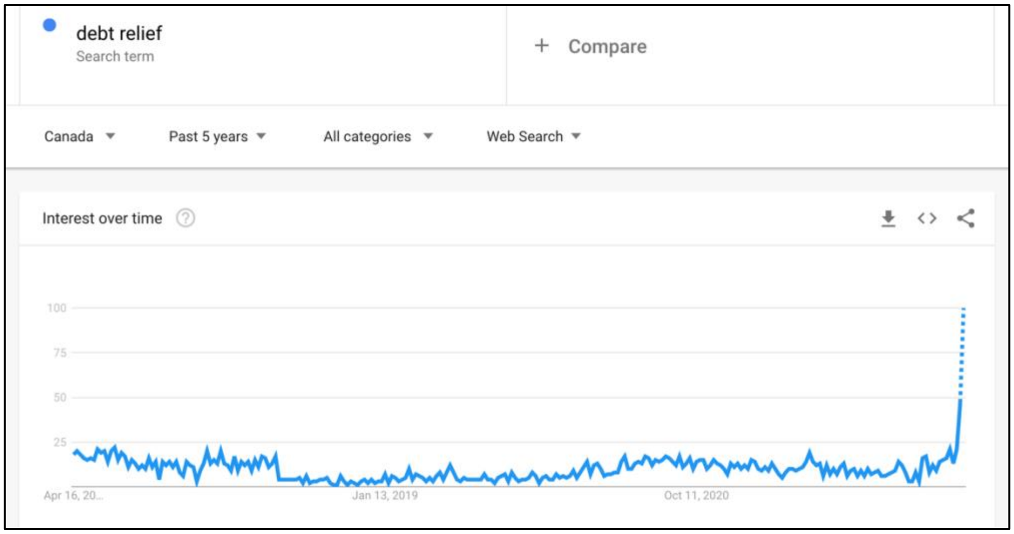


Now things aren't entirely rosy. Credit counsellors are reporting a sharp increase in inquiries following the recent rate hikes:

> **Bank of Canada interest rate hike prompts more calls to Credit Counselling Society**[1]
>
> […] With the central bank bumping up its key rate by half a percentage point to one per cent, Scott Hannah, president and CEO of the Credit Counselling Society, says they're already noticing an increase in calls.
>
> "It's a number of issues. In some cases, people have utilized home equity lines of credit during the pandemic to improve their homes, purchase large-ticket items, and now they're faced with higher monthly payments," he explained.
>
> This isn't a temporary situation either. The Bank of Canada has signalled it will hike its interest rate further.
>
> "It's a bump in activity. People are calling because the rate now is starting to cause some worry — not necessarily because of this bump in interest rates, but what's going to happen down the road. Given the fact that people are already dealing with inflationary issues, high gas prices, climbing food prices, this is just like the icing on the cake that's causing a lot of concern for consumers not knowing if they're going to be able to manage in the year ahead."

Indeed, a quick look at Google Trends for terms like "debt relief" show a recent uptick:

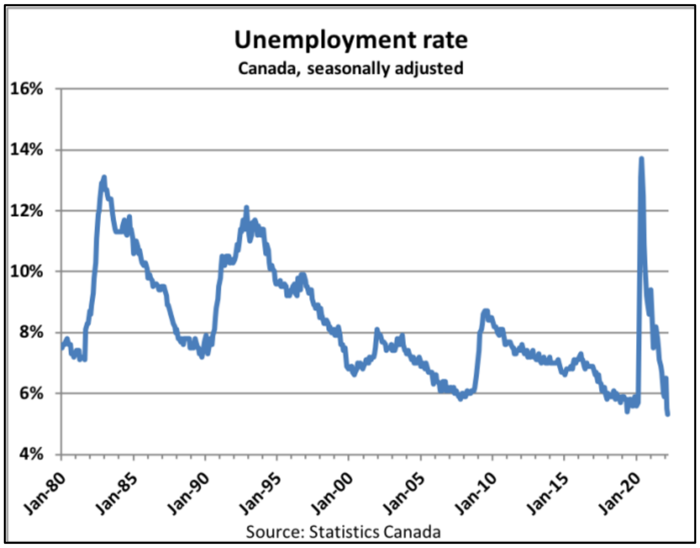
[1] https://ottawa.citynews.ca/local-news/bank-of-canada-interest-rate-hike-prompts-more-calls-to-credit-counselling-society-5271719



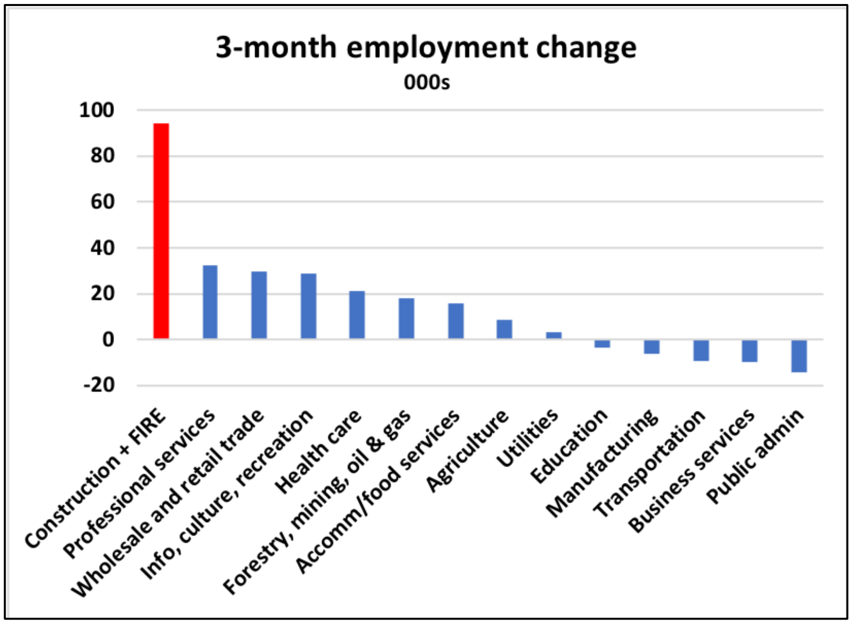
Something to watch as the interest rate hikes filter through to consumers.

iv) Macro indicators still look solid

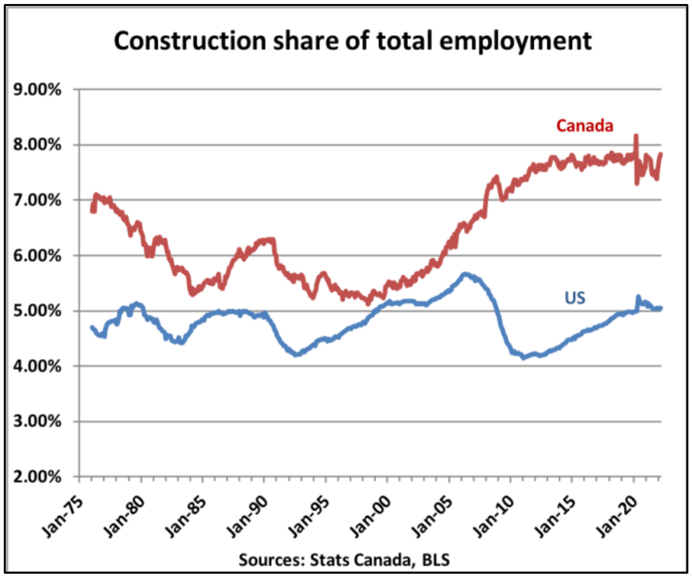
The unemployment rate hit an all-time low in March at just 5.4% after Canada added another 73k jobs in March:

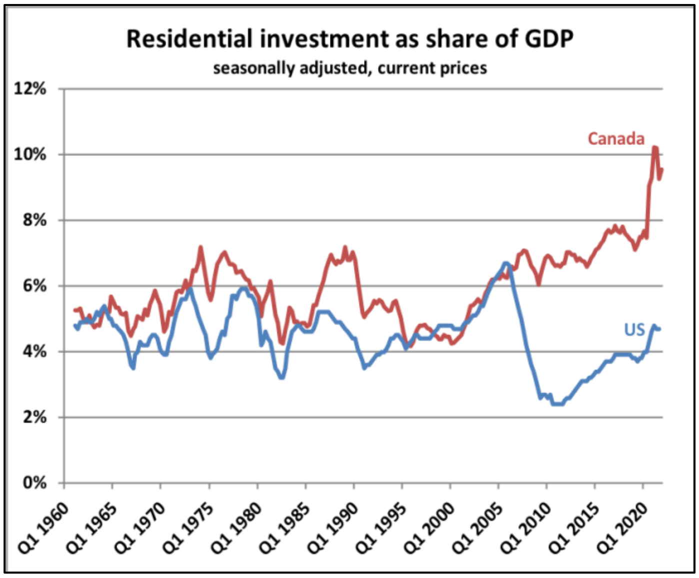


Canada has created 210k new jobs since the start of the year, but note the composition below. There's been a massive skew towards construction and FIRE industries (finance, insurance, real estate):



It's yet another reminder of the extent to which the economy and labour market have levered growth off the current housing and credit boom. That fact, more than anything else, argues that the Bank of Canada will eventually be forced to rethink its tightening bias if housing begins to seriously wobble:





7) Monitoring key risks: OSFI puts mortgage market on notice

Clearly inflation and interest rates are far and away the most pressing concern at the moment. With plenty of ink spilled on those topics already, I'll turn briefly to the topic of regulation.

Mortgage growth is still running quite hot, and that has regulators nervous. This week OSFI, the main bank regulator, released its annual risk outlook[2]. Among the key lines:

> […] Recent supervisory reviews identified several common issues around underwriting, specifically income verification in areas that have been raised as being problematic in the past including business for self, rentals, exceptions to income sustainability as well as collateral management.

Translation: Expect fewer debt service ratio exceptions and a clamp down on document fraud which has become a serious concern in the past year.

> […] as part of the domestic implementation of the Basel III reform package in banks' fiscal Q2-2023, we are increasing the risk weights, and thus capital required, for investor mortgages compared to the risk weights for owner-occupied properties.

Translation: Expect to pay a high mortgage rate and/or tighter financing conditions like lower LTVs for non-owner occupied dwellings starting next year.

I think this is a nod to the fact that OSFI is very concerned about the rising share of investors in the market and is looking to tamp down on demand. I still think it's likely that we'll see higher minimum down payment requirements on second properties this year, but the sharp increase in rates has probably removed some urgency as OSFI may want to see how the market reacts to higher financing costs before they make significant changes to policies.

Conclusion and key takeaways:

- Rising rates are a problem and will almost certainly weigh significantly on demand through the remainder of the year unless things change quickly.
- Resale markets across the country are still exceptionally tight, but we are now seeing a significant inventory build the likes of which we haven't seen since 2010.
- Fundamental supply/demand dynamics are still supportive of housing and suggest that if we are facing a downturn it will very likely be (relatively) short-term and cyclical in nature rather than a secular decline.
- Consumers are still in great shape. No signs of credit stress yet, but one has to think that the move in rates will soon have an impact on borrowers who are most close to the edge.

Regards,
Ben

[2] https://www.osfi-bsif.gc.ca/Documents/WET5/ARO/eng/2022/aro.html