The Edge Report

February 2022

Hyperlinks:

1) **Bank of Canada rate hikes baked in for March**

2) **National home sales update**
   - i) **I'm calling it: We are witnessing peak insanity**
   - ii) **Setting up for a significant slowdown in the back half of the year?**
   - iii) **Alberta housing: Still quietly booming**

3) **Supply/demand deep-dive: Big increase to federal immigration targets**

4) **Household credit update: Insolvencies fall, consumer spending slows**
   - i) **Consumer spending slows: Was it really Omicron or is there more at play?**
   - ii) **HELOCs back in vogue**
   - iii) **Consumer insolvencies remains low for now**

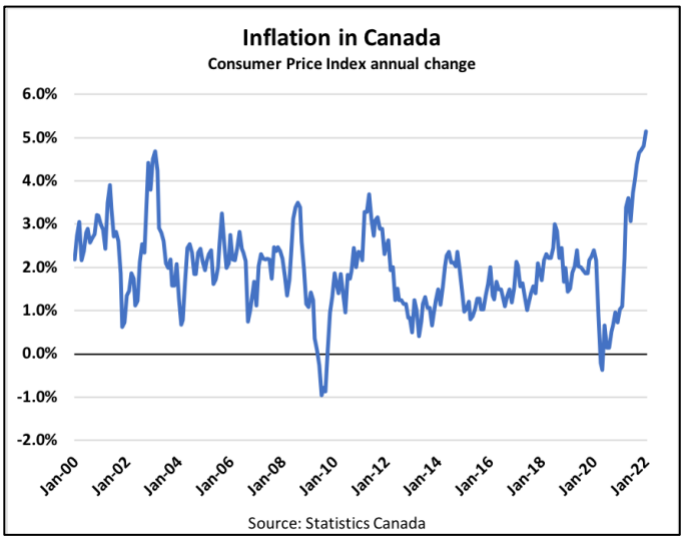
5) **Mortgage market update: Borrowers still love variable rates**
   - i) **Household credit growth slows in December**
   - ii) **Fixed mortgage rates continue to rise, variable originations surge**

1) Bank of Canada rate hikes baked in for March

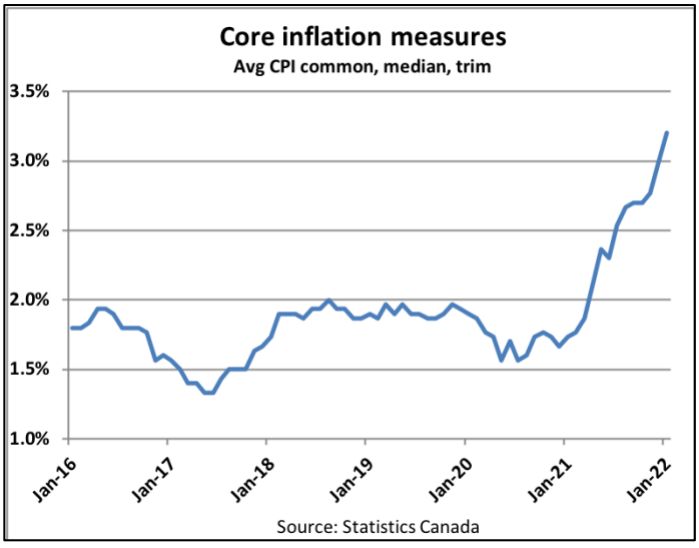
Well I was wrong last month when I said there was a good chance of a Bank of Canada rate hike at the February meeting, but barring something major to push them off course, I think we can safely pencil in the next rate announcement on March 2 as the day the overnight rate officially moves.

To review the developments over the past couple weeks:

- Headline inflation hit 5.1% in January, the highest level since 1991.



- Core inflation measures now average above the Bank of Canada's 1-3% target band. Not to get too technical here, but the Bank has 3 measures of "core" inflation that they track closely. Core simply means that they've stripped out the excessively volatile components that are more easily impacted by supply chain issue so as to give a better measure of the sort of inflation that their policies can influence.



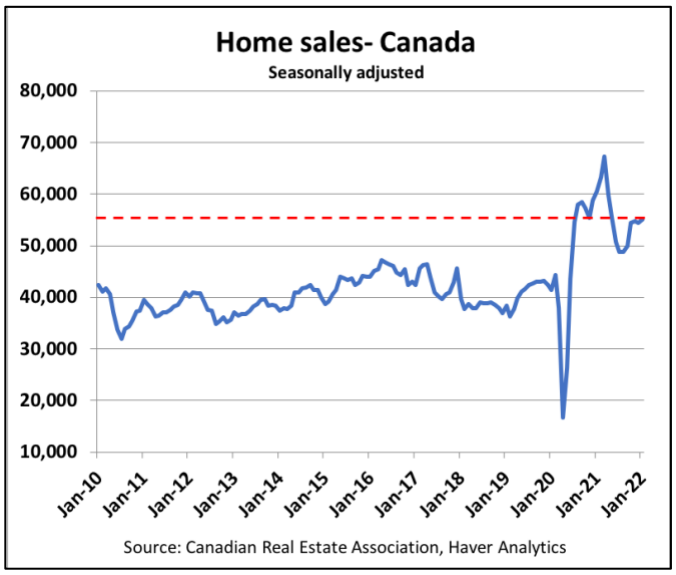
If you're the Bank of Canada and your stated mandate is to keep core inflation in the 1-3% range, and it's now above that, you're kind of backed into a corner….all the more so when consumer and business expectations for future inflation are ripping higher as discussed last month. I don't believe the Russia-Ukraine situation will fundamentally alter the Bank's path going forward. Expect a 0.25% rate hike in 2 weeks with likely another 2-3 hikes before the end of the year. The calls for 6-8 rate hikes still strike me as very unlikely.

2) National home sales update

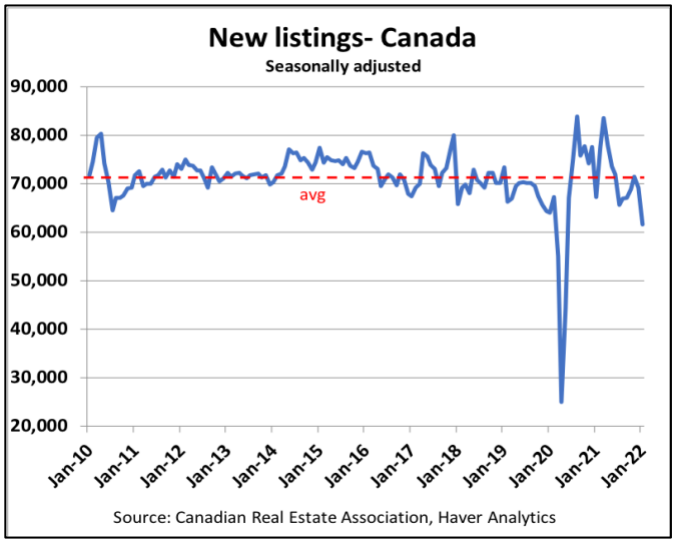
i) I'm calling it: We are witnessing peak insanity

Okay I'm going to say it: January was peak insanity for house prices. We likely have another couple months of very hot sales activity, but I think price gains begin to moderate from here.

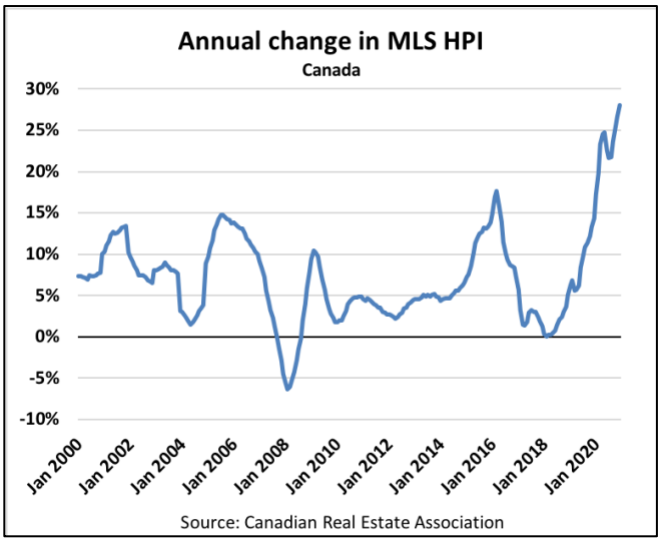
January was wild! Yes, the demand was solid again, up 1.0% m/m seasonally adjusted and still ~35% above pre-COVID levels:



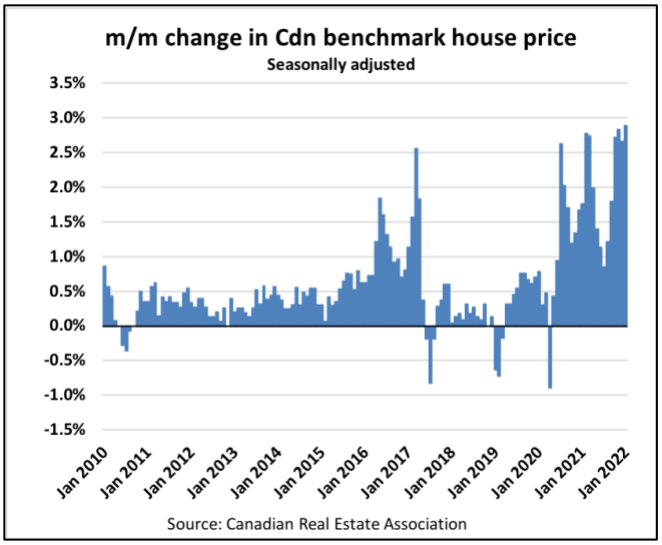
But the real story remains a lack of supply. What in the world is going on with new listings? They were down 11% m/m in January and came in at the lowest levels in 15 years outside of March-May 2020. The sales-to-new listings ratio, a crude measure of supply and demand, exploded to 90% for only the second time in history:



Months of inventory held steady at a record low of 1.6. With such an imbalance in supply and demand, price ripped higher by a record 2.9% (or $24,000) in January alone. The y/y increase hit a record 28%:

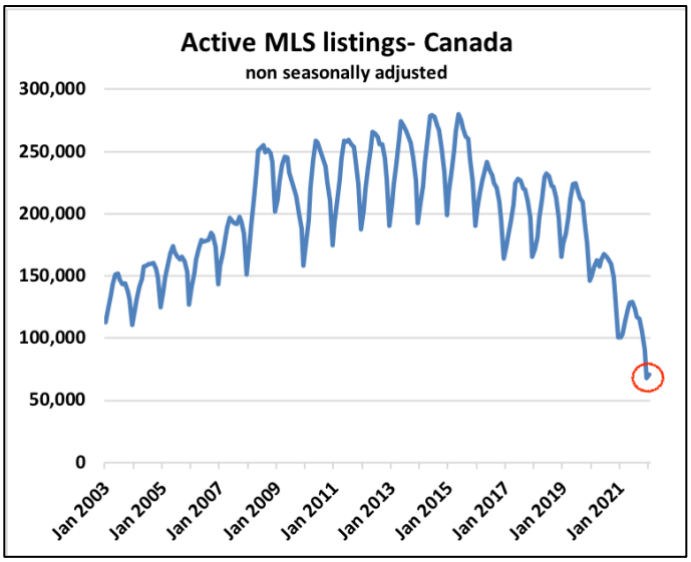


To put in perspective just how hot this market is, consider that we have seasonally adjusted pricing data from the MLS HPI going back to January 2000. In that time, there have been only 8 months where prices nationally rose in excess of 2.5%. Six of those months have occurred in the past year, including two record-setting monthly gains in the past 3 months alone:



So why do I think this was the peak?

The winter months always have the lowest levels of active inventory. As any housing professional knows, there's a lot of seasonality in both sales and inventory trends, and both tend to be lowest in December and January. There were only about 70,000 homes listed for sale on the MLS at the end of last month. That's as low as it's been in at least 30 years. This is quite the chart:



Now when you pull forward demand into a period of seasonally low supply, as we saw in December and January, prices tend to squeeze higher. And when the supply is not just low but at 30-YEAR LOWS, the chance for dramatic moves in prices is magnified. I think that's exactly what we just saw in the last 2 months.

I think as we head into the spring selling season, we'll see new listings pick up, and that should help alleviate some of the crazy monthly price gains we've seen over the winter.

All the important metrics are in the table 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	-9.0%	+1.0%	-8.4%	-11.0%	-29.9%	+0.1%	+28.0%	+2.9%
BC	-13.4%	+5.5%	-13.4%	+0.1%	-36.4%	+2.5%	+23.2%	+3.0%
AB	+26.4%	+7.4%	-3.8%	-2.5%	-27.6%	-6.3%	+9.8%	+4.4%
ON	-9.4%	+0.5%	-6.0%	-20.3%	-35.8%	+10.0%	+25.4%	+7.8%
QC	-23.1%	-2.9%	-3.5%	+1.4%	-23.4%	+3.8%	+16.3%	+2.3%

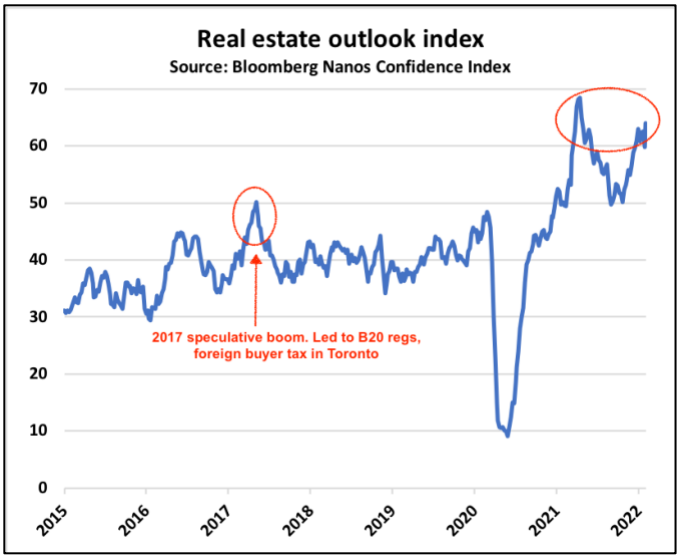
ii) Setting up for a significant slowdown in the back half of the year?

My base case is that we'll see a very strong, if not chaotic, spring selling season as buyers try to front-run interest rate hikes (and potential mortgage rule tightening for investors) into a market with low inventory.

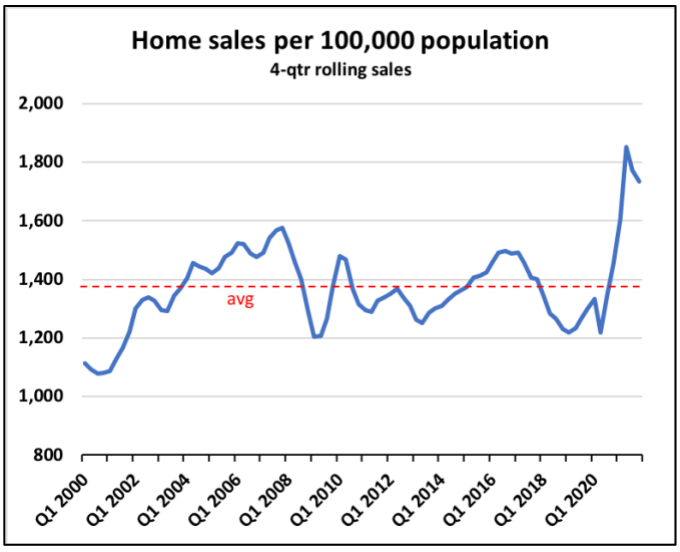
The craziest price gains are probably behind us, but this spring will still be exceptionally strong by historical standards.

I'm growing a bit more concerned about the back half of the year. The signs of speculative froth/FOMO are getting hard to ignore.

For starters, real estate sentiment is close to as high as it's ever been has surpassed the 2017 peak by a wide margin:



Yes, some fundamentals are solid, notably strong immigration trends which are discussed below. But even accounting for population dynamics, it's clear we've pulled forward considerable demand from the future:



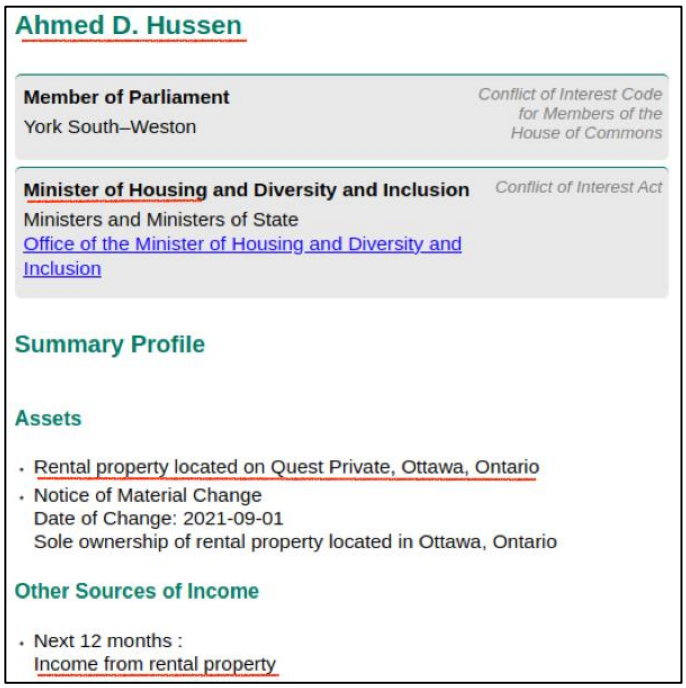
At some point we'll have to contend with that demand gap.

What's accounting for all this increased demand? By my math, based on data from the Bank of Canada and Teranet, slightly more than half of the INCREASE in sales since 2015 is attributable to the rising prevalence of investors and second property owners in this market.

The anecdotes are pretty compelling here:

It's not just the average Canadian either. Earlier this month, members of provincial parliament in Ontario made their annual financial disclosures. A total of 28 MPPs, or nearly ¼ of the house, declared rental income on their disclosures…an increase of 7 compared to last year.

And at the federal level, it's perhaps telling that the honorable Ahmed Hussen, the minister tasked with making housing more affordable for Canadians, is also himself a landlord according to his most recent disclosure:



And from the Globe and Mail[1]:

[1] https://www.theglobeandmail.com/business/article-real-estate-investing-is-off-the-charts-ramping-up-demand/

Real estate investing frenzy rips through Canadian housing market

> […] "We have never seen so many new investors reach out," said Simeon Papailias, senior partner with REC Canada, which specializes in condo sales. "It is off the charts. Everyone is seeing the market go up by 30 per cent." Mr. Papailias said the demand for every new condo project is "nuts," with thousands of requests to purchase.

If nothing else, it's an interesting sign post of where we may be in this cycle. At some point, investor demand will wane, and I suspect an interest rate hike next month plus the prospects of some regulatory changes (ie mortgage qualification tightening) should take some significant froth come off the market by late spring.

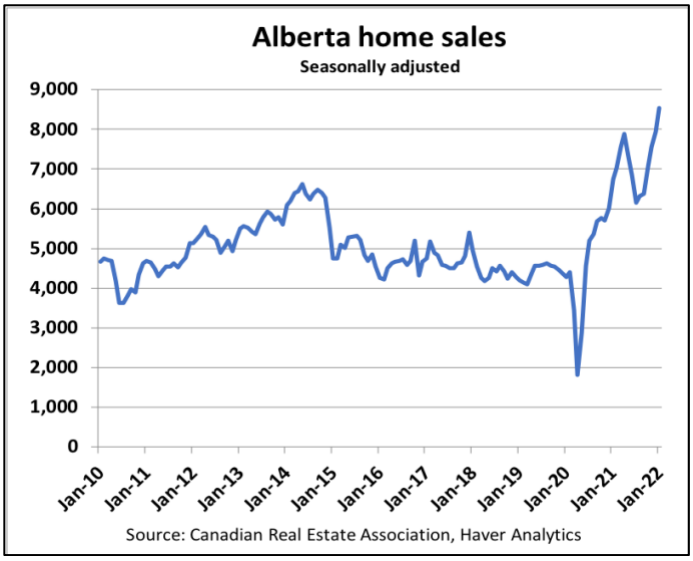
The problem is that when you take just a bit of froth off a market like this, it creates potential financing issues for the most recent buyers. Homes today are selling at levels well above any comparables…It's one record after another. It would be a problem for appraisers except that by the time a home purchase is set to close 60-90 days later, the market has risen so much that the comparables are there to support the purchase price and satisfy the lender.

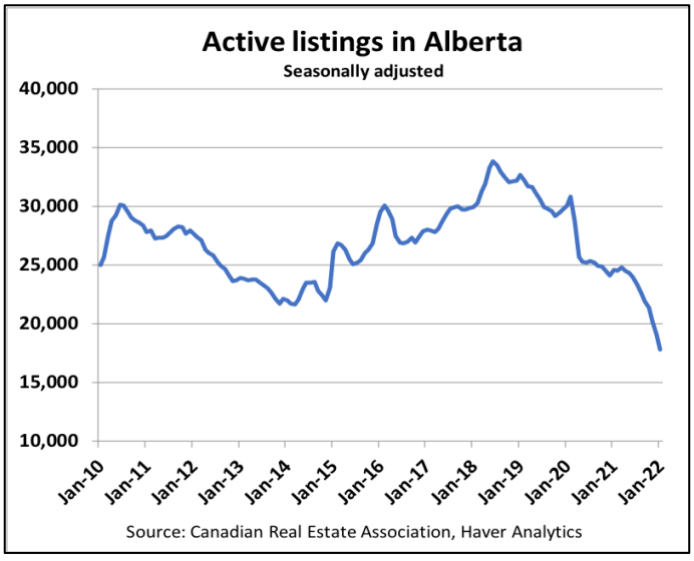
At the tail end of a boom like this, it is nearly inevitable that the most recent group of buyers will be caught offside. And it doesn't take much for that to happen when buyers are paying 10% above any other recent sale. If prices simply stagnate, those buyers can't close without coming up with significantly more capital.

Failed appraisals were one of the earliest signs of stress in the 2017 downturn that hit York Region particularly hard, and I suspect it will be a leading indicator of a market turn this time around as well. Watch closely for these anecdotes as they can be an important signal that the market is shifting gear.

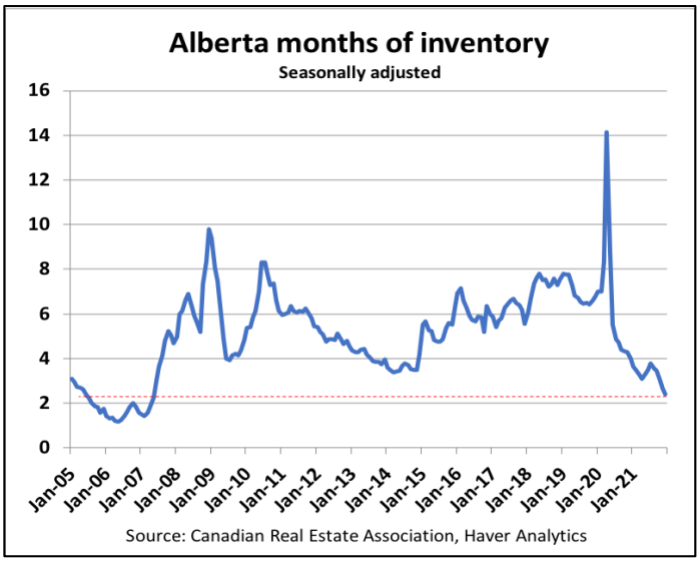
iii) Alberta housing: Still quietly booming

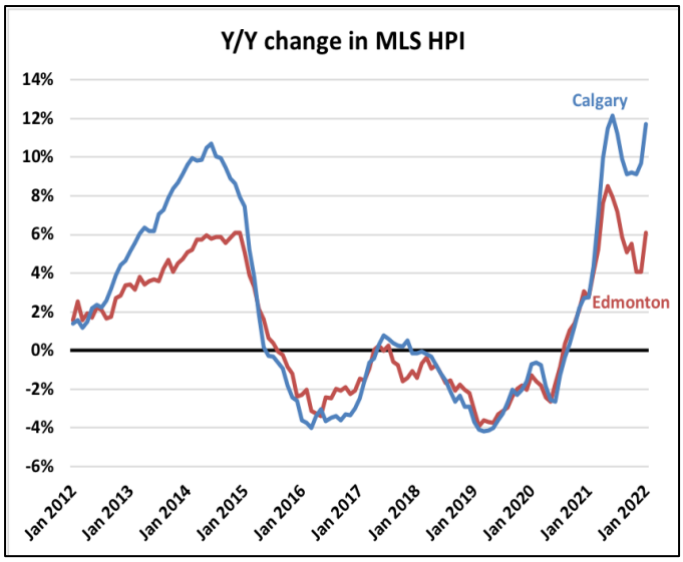
I don't want to keep pounding the table on Alberta, but it seems to me that people are still not fully appreciating how strong this market has become. Sales continue to set new highs and inventory has fallen to decade lows across the province:





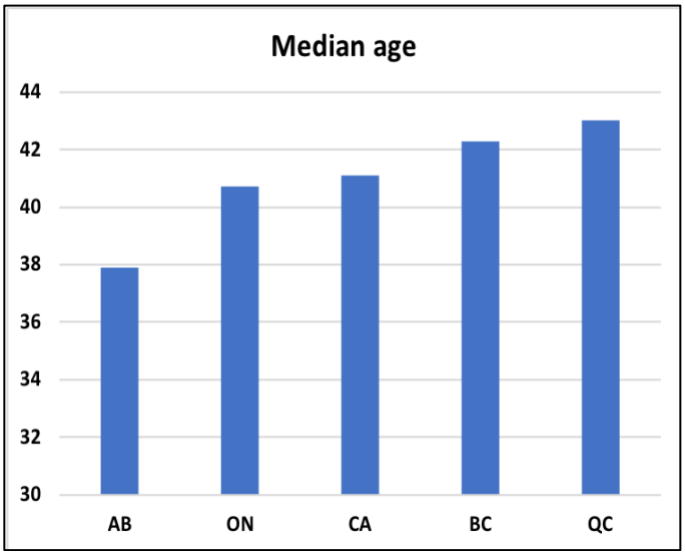
Months of inventory have fallen to barely more than 2, the lowest since 2007. Back then, prices were rising in excess of 30% y/y compared to 6-12% currently:



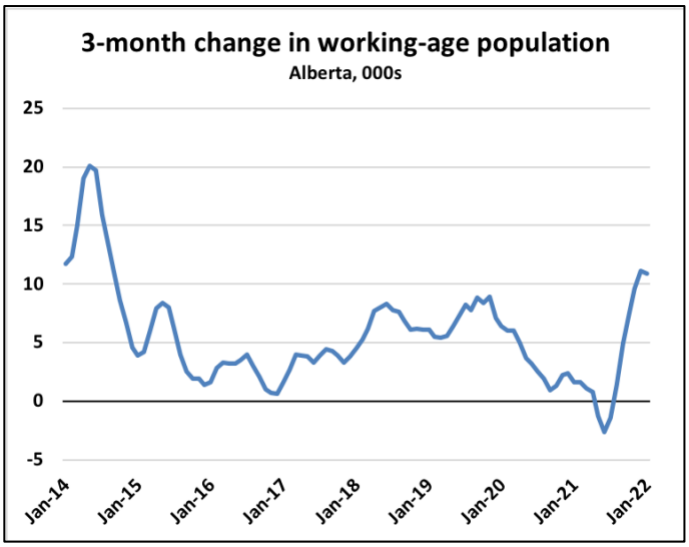


Sometimes it pays to not overthink a thesis. As it relates to Alberta, here's what I see:

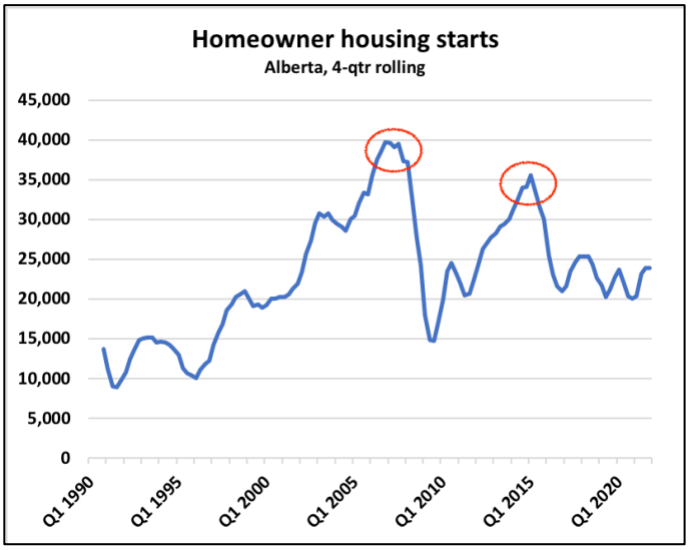
- Incredibly affordable housing. You can still buy a house for the same price you could in 2007. Monthly carrying costs as a share of income have fallen sharply over that time period.
- A work force that is both highly educated and among the youngest in the country.

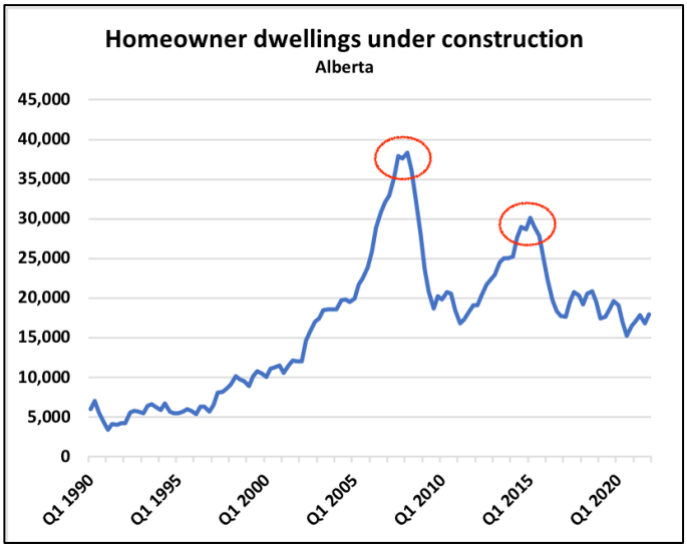


- Cheap start-up costs and competitive tax structure that will encourage new business formations and facilitate a transition to a more diversified economy and labour market.
- Population growth accelerating as net intraprovincial migration turns positive (ie more people coming to Alberta from other provinces than leaving for other provinces). Population estimates in the Labour Force Survey suggest the strongest growth since before the oil crash in 2014:



- Construction activity that is still way below prior cyclical peaks. This is an important one. The last time that sales were this strong and inventory this low was back in 2007. There was another mini-boom in 2014. Both of those cycles saw a major upswing in construction activity for condos and single-family homes, as shown in the charts below. This time is very different. We have yet to see a meaningful supply response from developers, and that tells me this current cycle still has some legs.

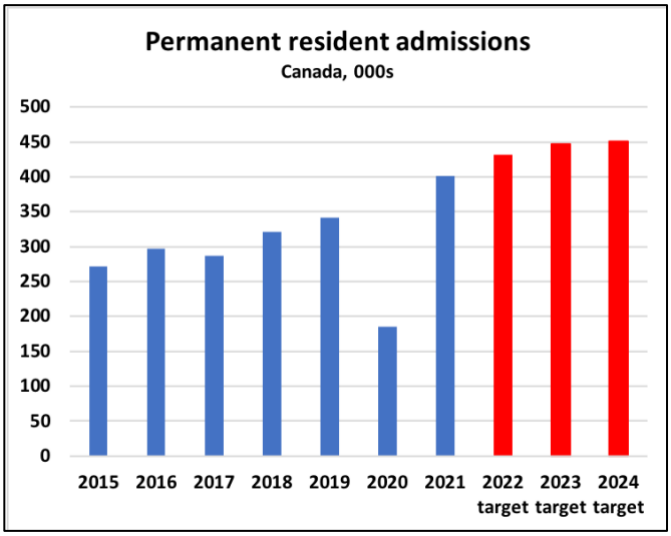




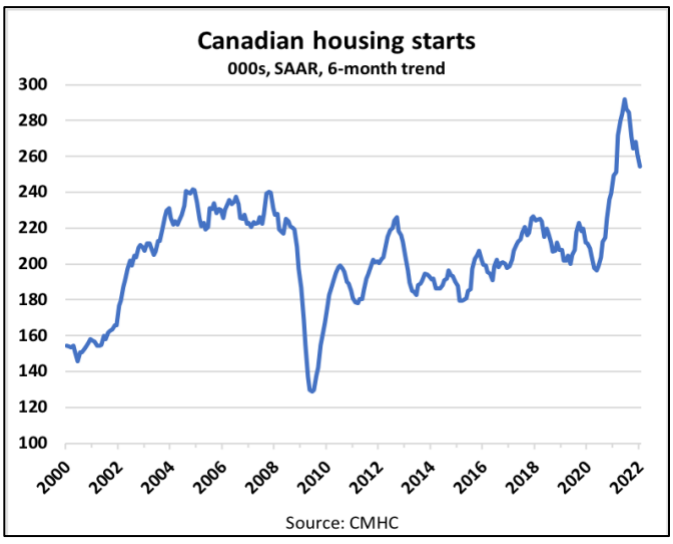
The fundamentals are looking good in Alberta. For most of the past 20 years, house prices in Calgary traded at a premium to the national average. They now trade at a 40% discount. I think that discount narrows very sharply in coming years.

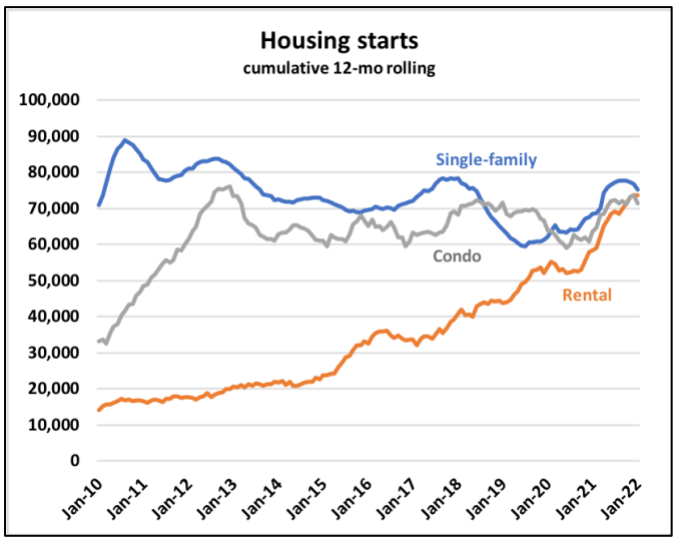
3) Supply/demand deep-dive: Big increase to federal immigration targets

The big news this week was the feds raising the immigration targets, including bumping up this year's target from 411,000 to 432,000. The government is now expecting to welcome 1.3 million new Canadians in just the next 3 years:

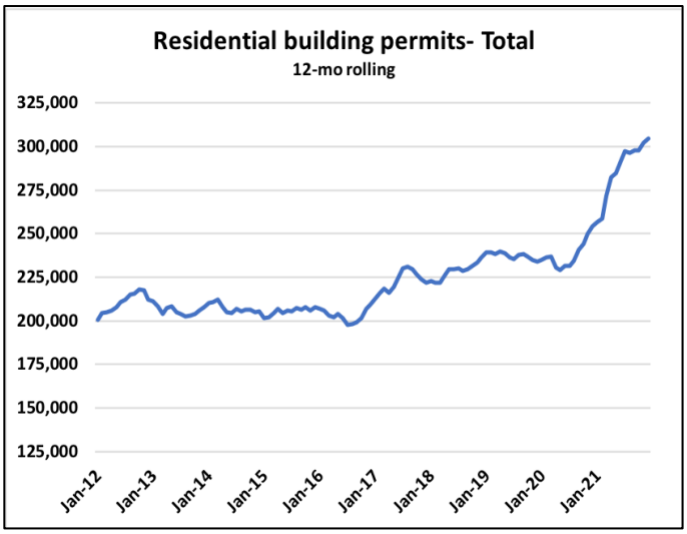


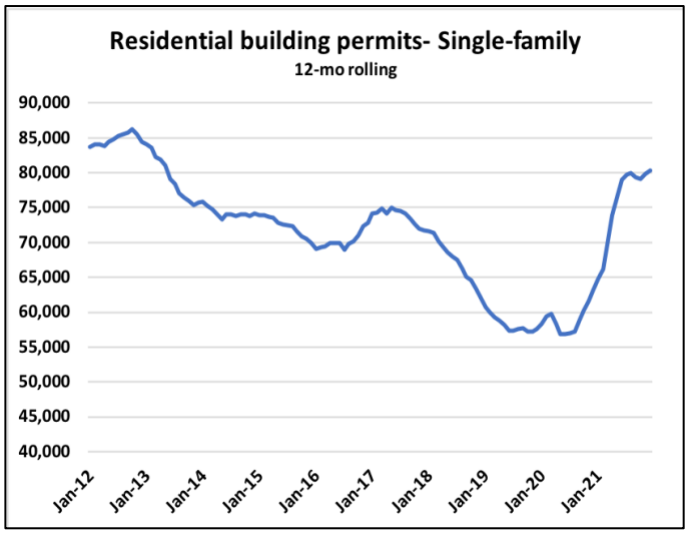
That's a lot of new housing demand. On the supply front, housing starts continue to cool off the record pace in 2021. Starts in January came in at 231,000 on an annualized basis, the lowest reading since December 2020. When we break them down into various buckets, we see that single-family starts and condos have rolled over but rentals keep rising:



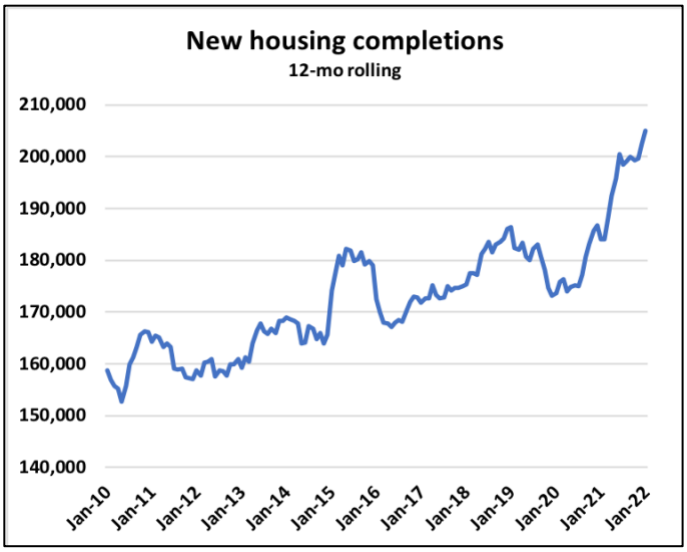


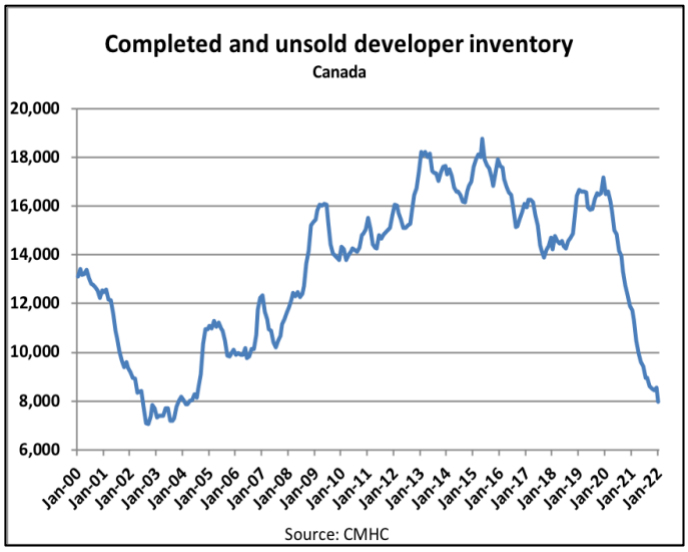
The good news is that building permits remain at record highs, which signals strong future development activity, all else equal. And what's particularly encouraging is that single-family permits are at the highest levels since 2013:





Developers are bringing plenty of new supply to market, it's just that it's all being readily absorbed. Completions have surpassed 205,000 over the past year, but the inventory of completed and unsold homes is at the lowest it's been since 2004:





The takeaways remain the same:

- There's plenty of demand via strong population growth with more still to come
- Developers are building a lot but it's arguably still not enough of the "right" kind of supply (ie single-family)
- What is being built is being quickly absorbed

4) Household credit update: Insolvencies fall, consumer spending slows

i) Consumer spending slows: Was it really Omicron or is there more at play?

Retail sales fell 1.8% m/m in December including a 2.4% decline in core sales (ie once gas and new autos are stripped out). When we adjust for the effect of prices we find that volumes fell a massive 3.4% in the core segment.

It's easy enough to chalk this up to restrictions related to Omicron, but there may be more at play than meets the eye.

First off, consider that sales fell across all provinces, including places like Alberta which saw a 2.4% decline in spite of no meaningful public health restrictions.

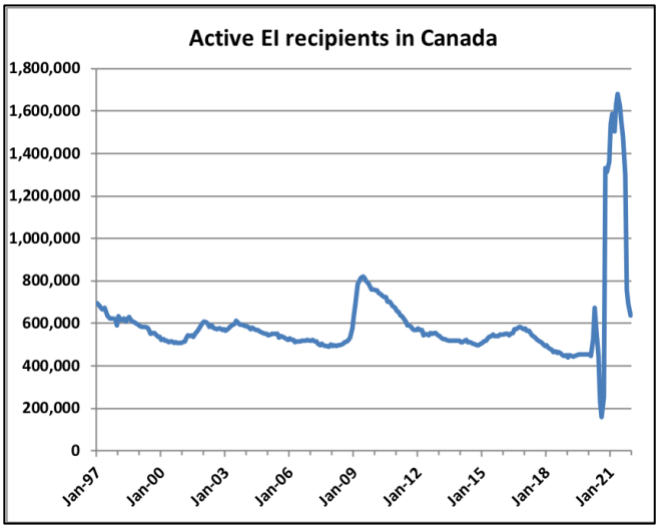
But what really ought to jump out is the 10.3% m/m plunge in ecommerce sales. It was this segment that boomed as soon as lockdown measures were implemented in 2020, surging 23% in March and a further 55% in April that year. And then in early 2021 when the renewed lockdowns kicked in, we saw a massive 19% monthly jump in January. This most recent decline stands in stark contrast.

It's also perhaps telling that the segments that really took it on the chin were highly discretionary, notably furniture and home furnishings (-11.3%), building materials and garden equipment (-5.0%), clothing and accessories (-9.5%), and sporting goods and hobby retailers (-2.5%).

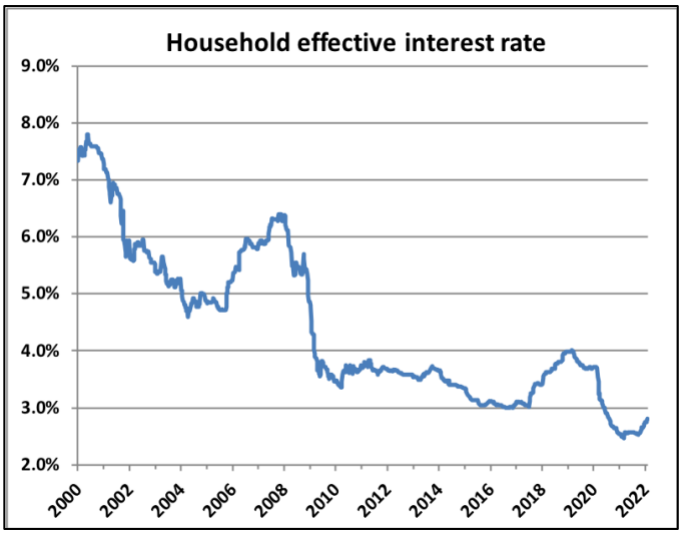
This is important since a decline in discretionary spending can sometimes foretell a deterioration in household finances. I'll be watching this closely over the next couple months.

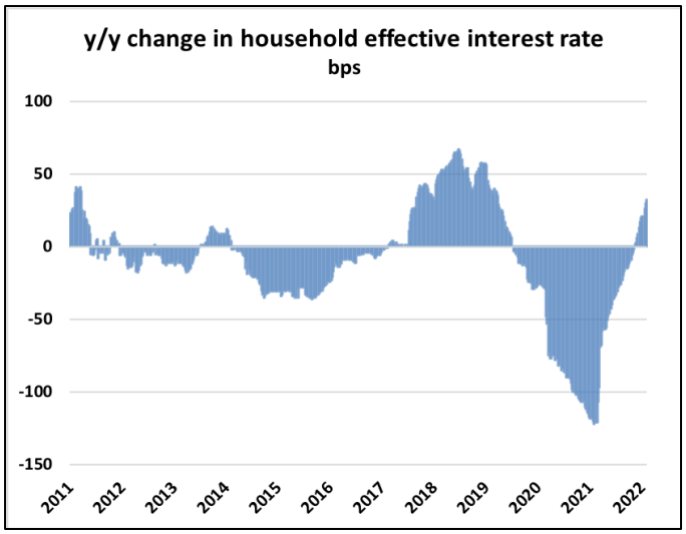
Perhaps the better explanation is not Omicron but rather that consumers are feeling the effects of reduced government income supports, rising rates, and an environment of overall falling liquidity.

On the first point, note that EI recipients continue to plunge, down another 56k in December, and are down by over a million in just the past 5 months:



The weighted average interest rate paid by households across all debt continues to rise and is now 35bps higher than it was a year ago….and that's BEFORE the BoC even lifts a finger:



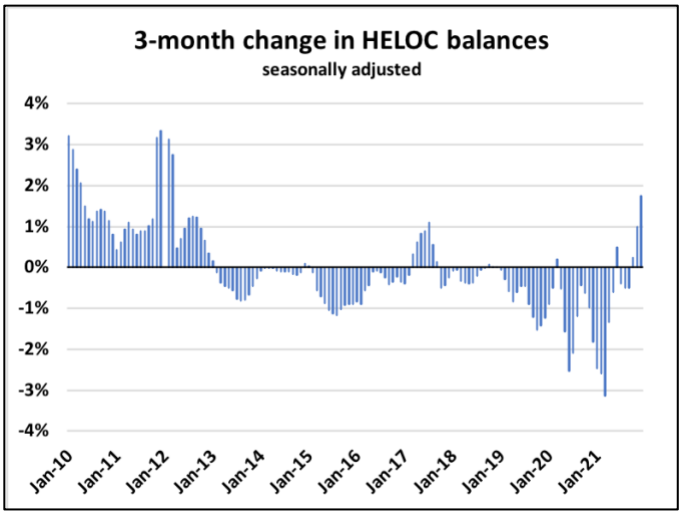


Finally, on the liquidity front, the latest monetary aggregates from the Bank of Canada show a surprising 0.4% seasonally adjusted monthly DECLINE in M2 money supply in December. It was only the second such decline in the past 5 years and the largest since 2001! As a reminder, M2 = cash, checking deposits, and easily convertible "near money" like money market funds, so this is yet another signal that households have moved from saving to dissaving, in part due to the central bank tapping the brakes on new money creation.

If in fact what we are seeing here are the first signs of a consumer slowdown as a function of falling income supports and rising expenses, it's likely that we'll begin to see it show up in consumer credit in coming months in the form of rising credit card delinquencies.

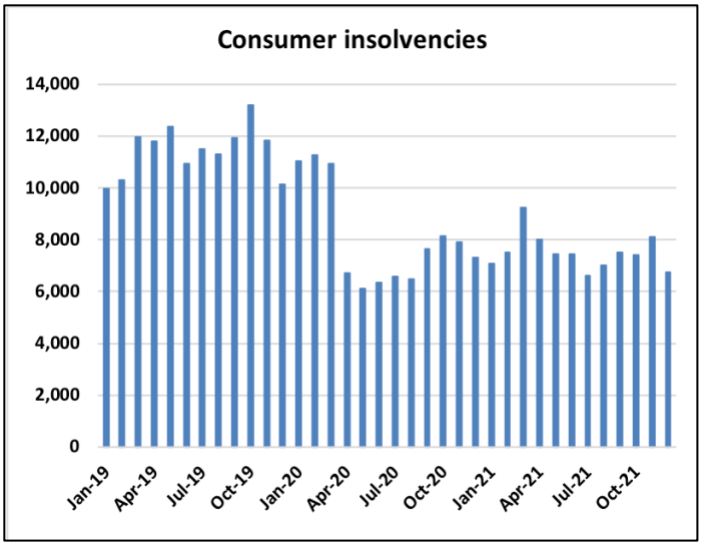
ii) HELOCs back in vogue

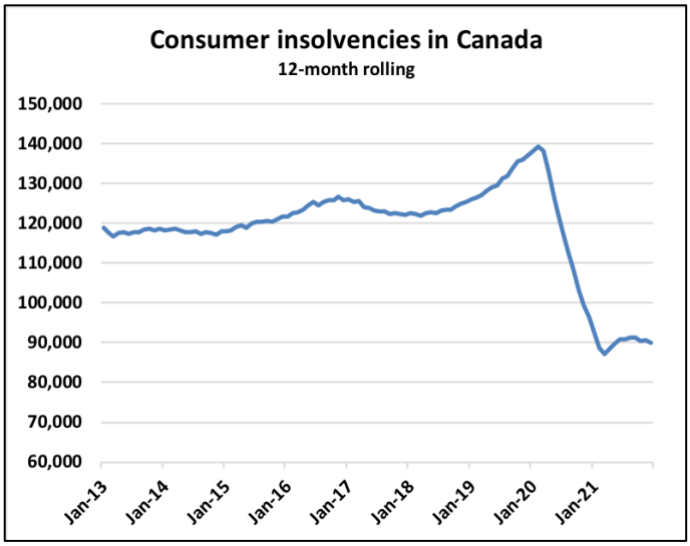
With the typical home in Canada having risen in value by $183,000 over the past year, it should be no surprise that HELOC balances are once again growing. Balances at chartered banks have now posted back-to-back 0.7% monthly gains that have pushed the 3-month increase to the highest since 2012.



iii) Consumer insolvencies remains low for now

Consumer insolvencies fell another 7.7% y/y in December and were 33% below 2019 levels. Insolvencies remain at 20-year lows across the country:

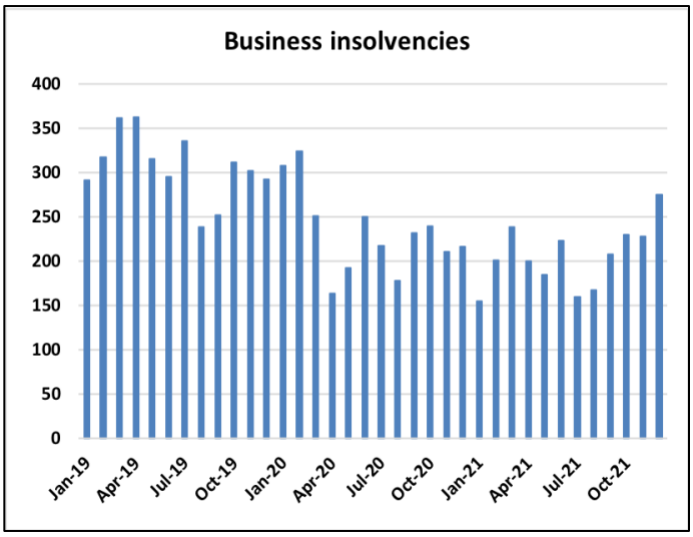


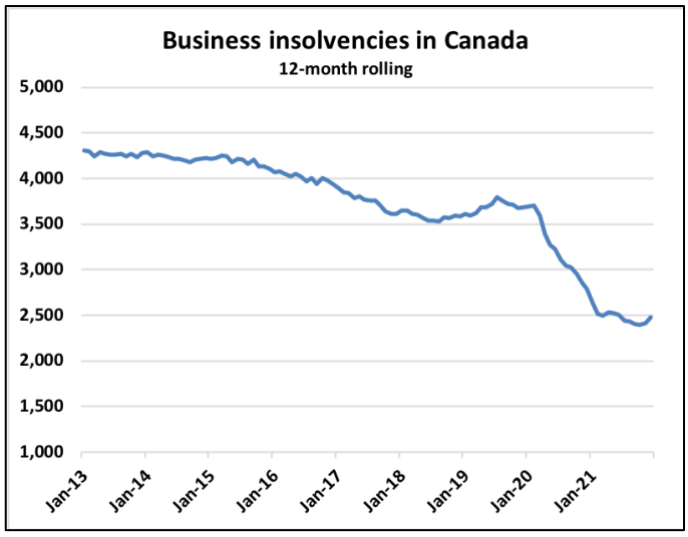


The folks at Hoyes Michalos are reporting a rising share of their clients who have serious tax debt issues which they believe could drive a significant increase in insolvencies in 2022 as various relief measures run off. From their latest report:

> […] Tax debts have returned as a primary debt driver of consumer insolvencies in 2021, with 4 in 10 insolvent debtors owing taxes at the time of filing. This is despite a slowdown in collection action by the Canada Revenue Agency (CRA) and the implementation of a temporary interest holiday on past-due taxes.
>
> We believe that this increase in tax insolvencies is the tip of the iceberg. We expect three changes in 2022 that will likely increase tax-driven insolvencies even further:
>
> **Stronger CRA collection actions on tax debts will resume**. During much of 2021, CRA was limited in its ability to enforce collection. With collection agents working from home, the ability to issue Requirements to Pay, garnishment notices, or freeze bank accounts was limited, and CRA policy seemed to remain soft on collection activity during much of the pandemic. This cannot continue indefinitely, and we have already seen a slight uptick in collection behaviour by the CRA. We expect more aggressive action to resume in 2022.
>
> **Ending of interest relief on Covid-19 benefit tax obligations**. Individuals with a taxable income of $75,000 or less who received Covid-19 benefits in 2020 automatically received interest relief on outstanding tax obligations for 2021 tax filings. This program is set to expire on April 30, 2022, and some taxpayers will be unable to pay their 2021 taxes owing.
>
> **Upcoming 2021 tax filing obligations**. With the upcoming filing deadline for 2021 taxes, more Canadians will face an outstanding tax bill when they file their taxes, especially those who received continued

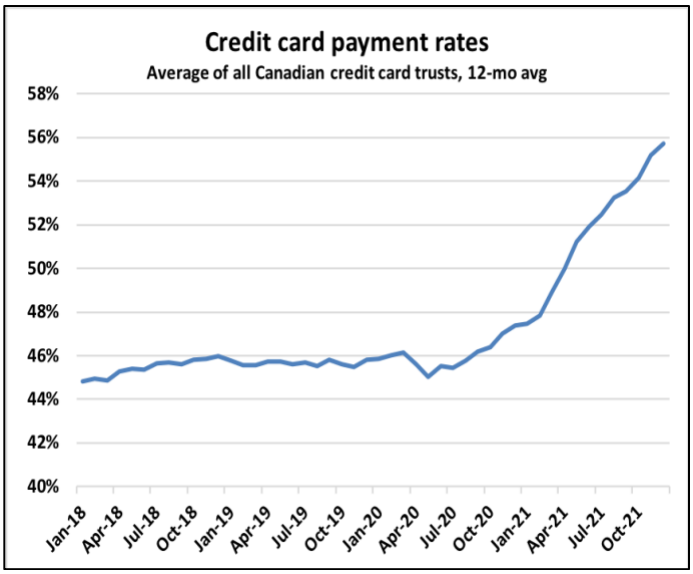
While consumer insolvencies were bumping along the lows, insolvencies among businesses actually jumped last month, up 27% y/y to hit the highest level since the pandemic began. Notable was the 37% y/y increase in Ontario and 24% jump in Quebec:

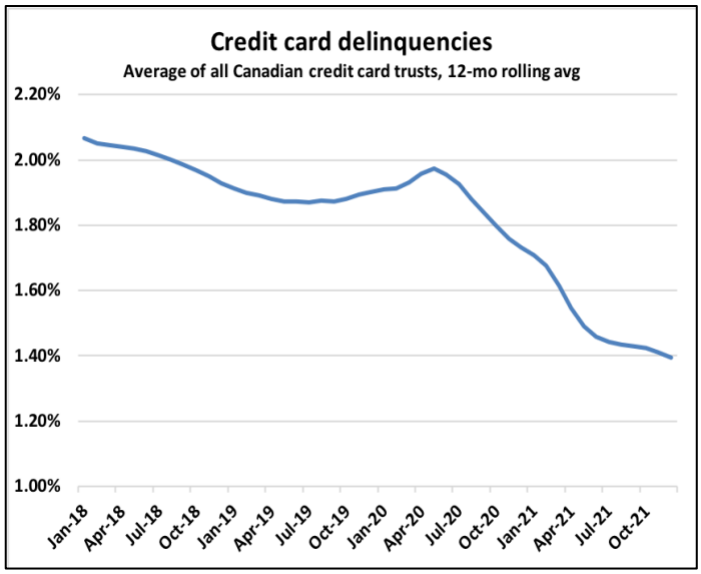




My view remains that the best forward-looking indicator of household credit stress can be found in credit card trusts. These trusts report monthly, and since consumers seldom default on a mortgage without missing some credit card payments, they are a great indicator of mortgage performance several months out.

The good news is that there are still no signs of stress in credit card trust data. Payment rates hit new highs and delinquencies hit fresh lows. It is however notable that 4 of the 8 big trusts are now reporting early stage delinquencies (ie 1-30 days late) rising and now higher than a year ago:





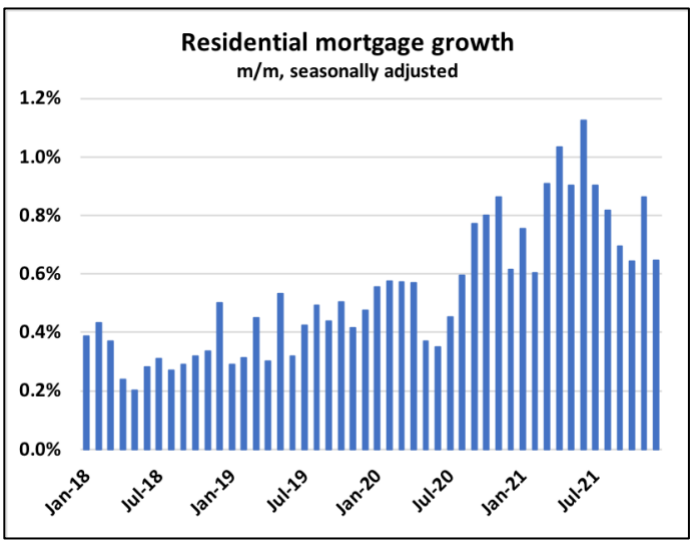
The takeaways:

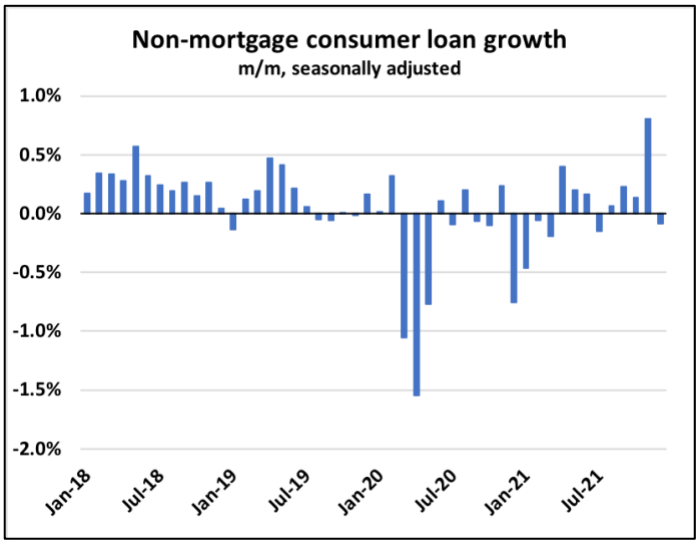
- Consumers are still in good shape but there are some tentative signs that spending may be hitting a headwind.
- Consumer credit trends look great for now, but I suspect within the next couple months we'll start to see signs that these trends are normalizing.

5) Mortgage market update: Borrowers still love those variable rates

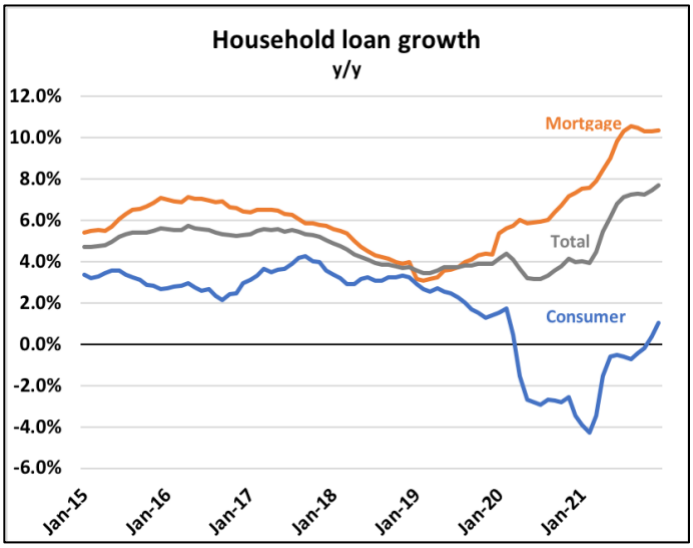
i) Household credit growth slows in December

Mortgage and non-mortgage consumer credit growth slowed in December, with the latter even declining slightly on the back of a 1% drop in credit card balances:



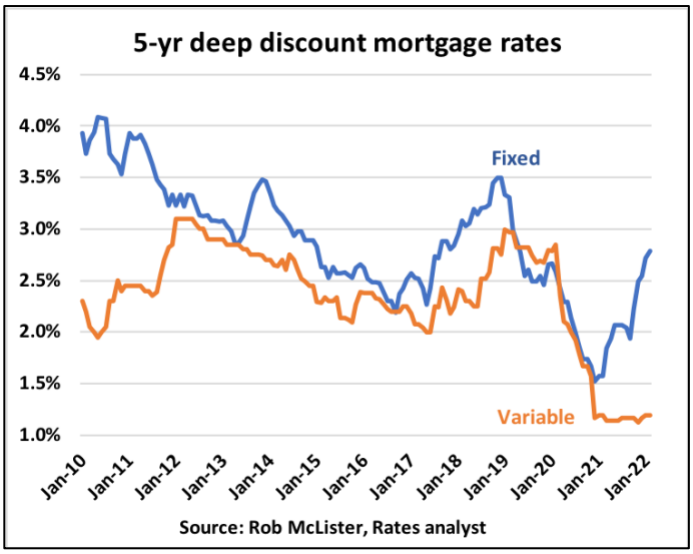


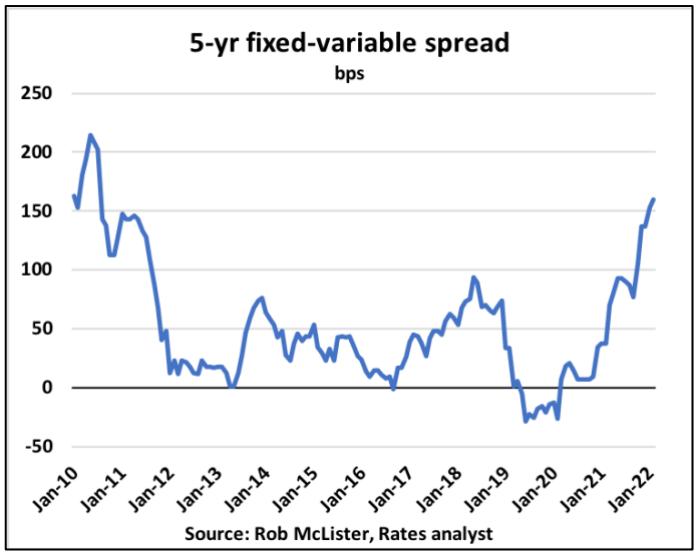
Mortgage loan growth is still running north of 10% and total household credit growth is close to 8%, the highest since January 2010:



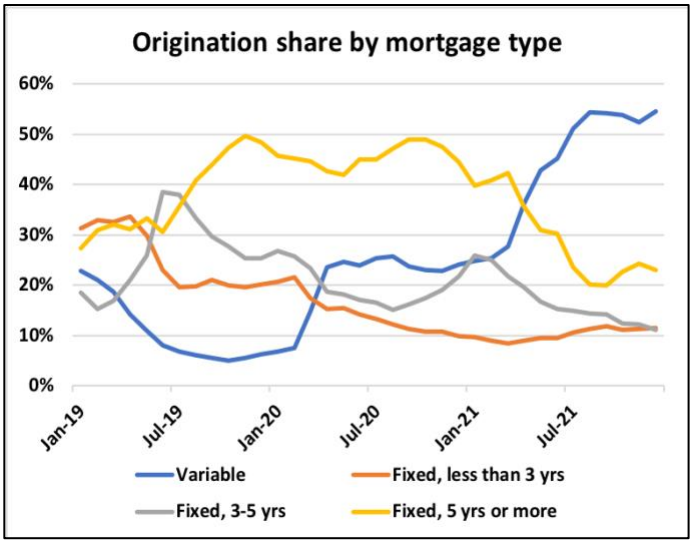
ii) Fixed mortgage rates continue to rise, variable originations surge

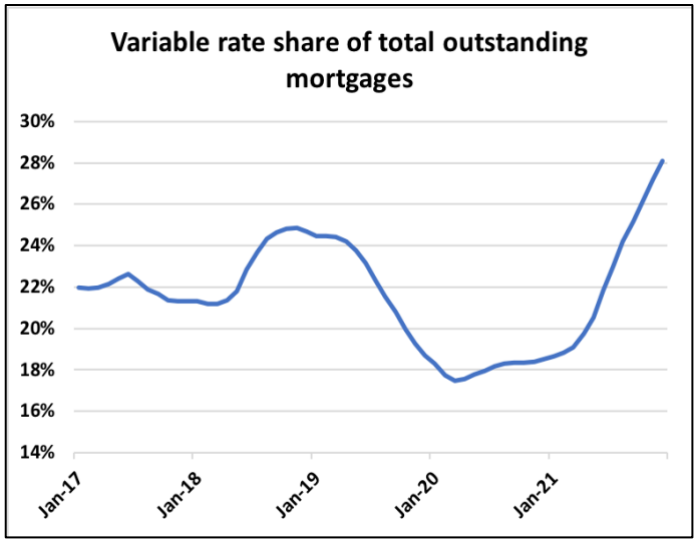
The best discounted 5-yr fixed mortgage rate is now just under 2.8%, up 130bps off the December 2020 lows. But with variable rate mortgages still in the 1.2% range, there is still plenty of cheap financing available for now. The gap between fixed and variable rates has widened to 160bps, the most since 2010:



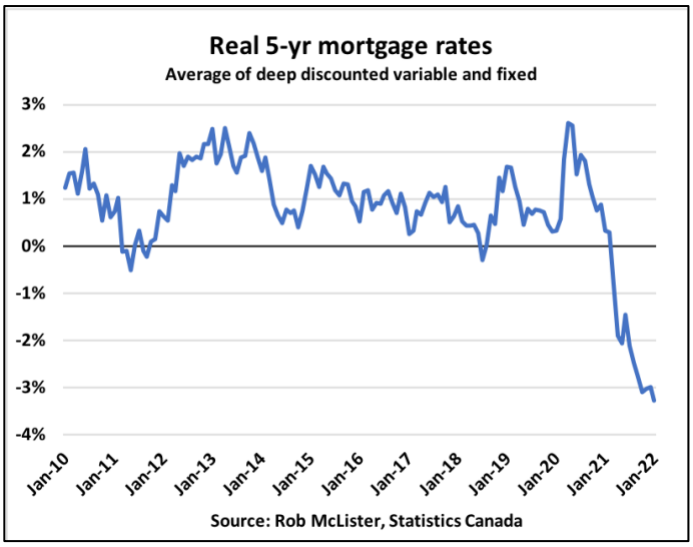


Total mortgage originations were down 19% y/y in December, but that hides a sharp divergence between variable (+84% y/y) and fixed rate originations (-58% y/y). Variable rate mortgages remain extremely popular, accounting for 54% of all new mortgages in December, and they now account for over 28% of all mortgage debt outstanding:





With rates still low and inflation running at the highest level since 1991, real mortgage rates are currently steeply negative:



I'll leave it here for this month. It's a bit too early to opine on potential effects of the Russia-Ukraine conflict, but me early view is that it shouldn't have a material effect on Canada's economy or the path of interest rates going forward.

There's not much to report on the regulatory front, and so I'll leave the usual section on potential risks to the housing market until next month.

Regards,
Ben