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The Edge Report

July 2022

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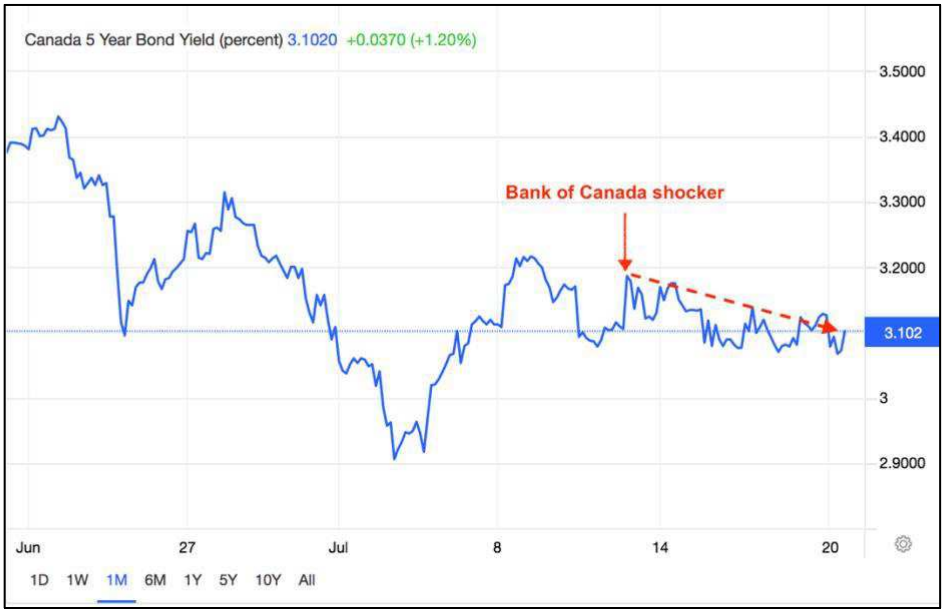
1) Finally signs that inflationary pressures may be easing?

Bank of Canada does monster rate hike and bond yields….fall?

The Bank of Canada surprised the markets last week with a monster 100bp (1%) rate hike. That was a shock for sure, but the big story is what happened in the bond market. The all-important 5-year bond yield, which drives fixed mortgage pricing, is LOWER today than when the Bank made their surprise announcement:



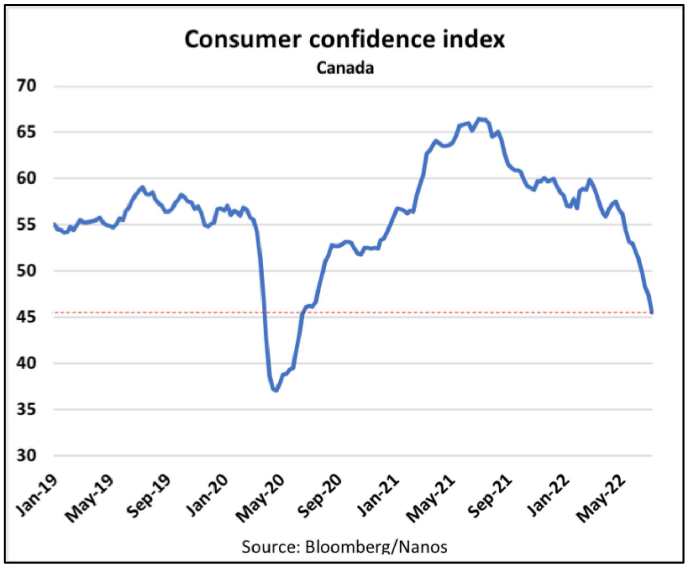
Since bond yields price in expectations of future interest rates, there's appears to be a clear message here: Unless something dramatic happens on the inflation front, the end may be in sight for this rate hike cycle.

For those looking for inflation to begin to ease, consider:

- The June inflation reading was 8.1%....the highest since 1983. BUT, that was lower than expected, and the monthly seasonally adjusted slowed to 0.6% from 1.1% previously.
- Industrial product prices (ie the price of factory goods), which do a great job of predicting inflation trends 6 months down the road, just posted the largest monthly DECLINE since the COVID lock downs in April 2020.
- Commodity prices such as oil, natural gas, copper, and agricultural products have fallen by 15% since mid-June according to the Goldman Sachs Commodity Index.
- Canada shed 43,000 jobs in June while the May GDP report showed a slight contraction.

I said previously that the Bank of Canada is on a tightening path until 2 things happen: Inflation rolls over AND inflation expectations cool. In other words, they would be hiking until people feared recession more than they feared inflation.

In the past 6 weeks we've seen a massive decline in consumer confidence to the point where we're now within reach of the lows seen in the early days of the pandemic. It certainly looks to me like we're getting close to mission accomplished.



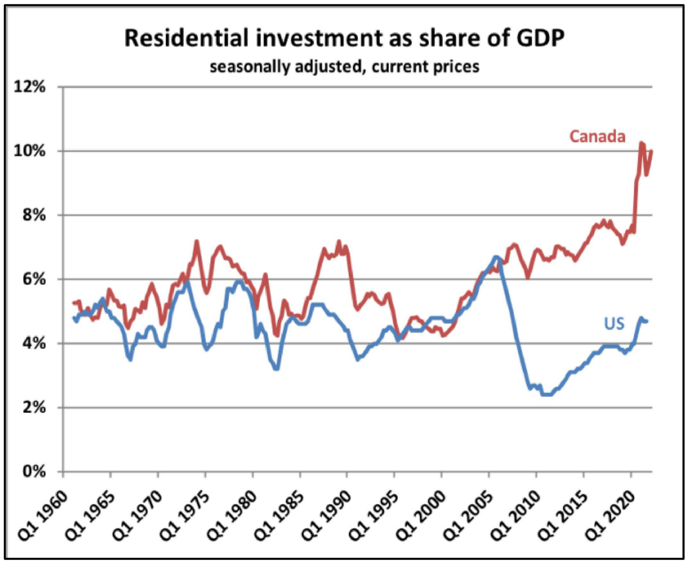
I think at this point we'll see another rate hike in September….likely another outsized 50bps. By then we should have more concrete signs that inflationary pressures are starting to ease at the margins which will give the Bank some leeway to pause and assess the impact.

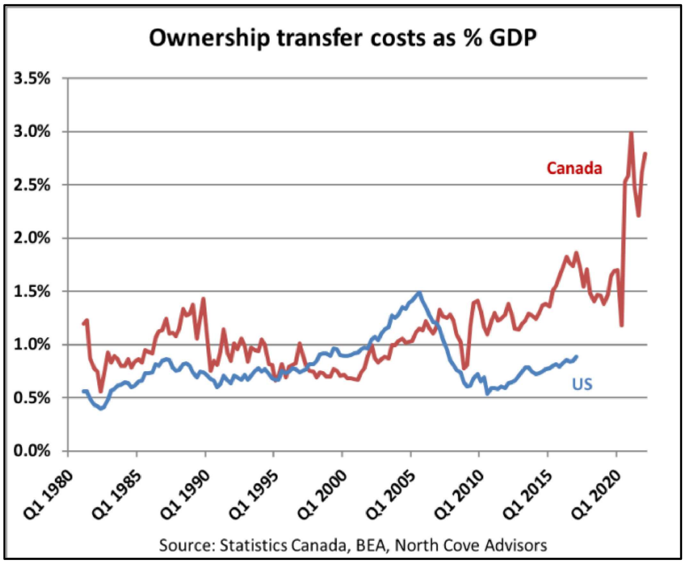
This is NOT to say that we're heading back to 1.5% mortgage rates any time soon. I don't think that's in the cards. But we may have seen a peak in fixed rates for a while unless inflation really takes off again.

Economy wobbles in May

April GDP was in line with consensus at +0.3% m/m, but the surprise was the -0.2% m/m forward estimate for May which, if it holds, will represent the largest monthly decline in a year.

It's worth remembering that residential investment now accounts for 10% of total GDP, of which nearly 3 percentage points are directly attributable to ownership transfer costs (realtor commissions, legal fees, taxes).



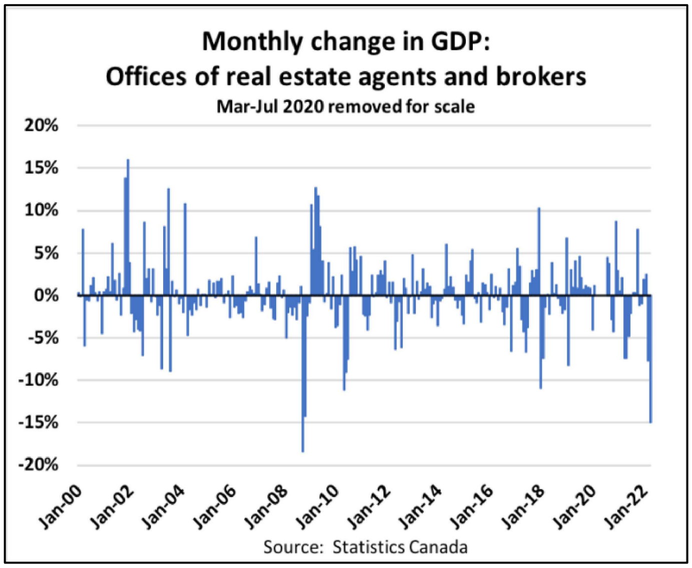


In other words, 3% of Canadian GDP is a straight function of resale housing market liquidity which puts it nearly on par with all machinery and equipment and R&D expenditures across all industries.

Let's zoom back in on the April data for a moment. From Statistics Canada:

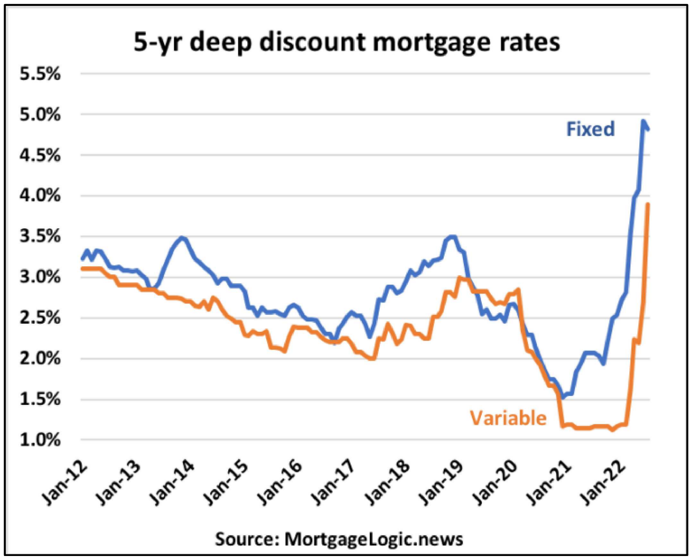
> Activity at the offices of real estate agents and brokers dropped 15.0% in April, the largest contraction since April 2020. The rising cost of borrowing contributed towards a continued cooling of the home resale market across the country, with Ontario, British Columbia and Alberta accounting for most of the decline.

Setting aside the COVID lockdowns, the drop in activity at real estate agent and broker offices is the largest since the Financial Crisis which tells us just how quickly this market is cooling:

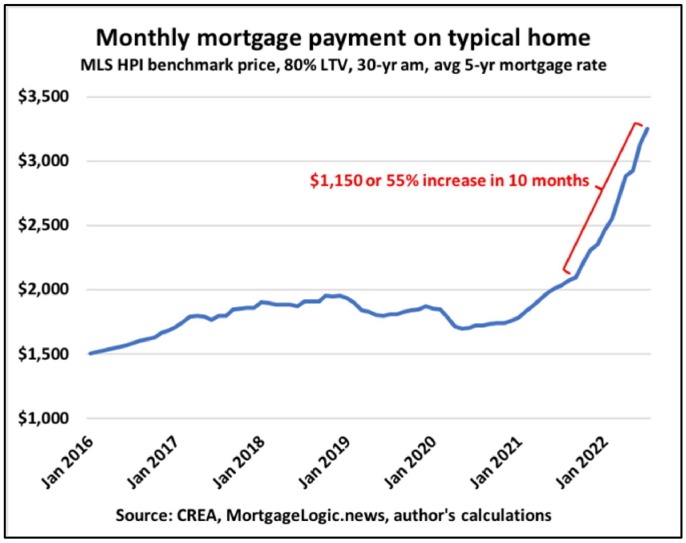


2) Updating the most important chart

The big rate hike last week has already filtered through to variable rate mortgages (but note that fixed rates haven't budged and likely won't):



With rates where they are, I've updated the chart below, which I believe is the most important economic chart in Canada right now:



The takeaway is this: Even with falling house prices, if you bought a house today at prevailing rates, your monthly payments are 55% higher than if you had bought 10 months ago. This is a profound deterioration in affordability that likely only gets resolved via falling rates (unlikely) or falling prices.

The affordability issues in Canada are starting to enter the realm of the absurd. Consider the snippets below, taken from a report to Toronto city council detailing how the planning department can't find and retain talent and now have a 13% job vacancy rate. One of the main issues: High cost of housing. You can't make this stuff up.

TORONTO

REPORT FOR ACTION

Employee Talent, Retention and Attraction - City Planning

Date: June 20, 2022
To: Planning and Housing Committee
From: Chief Planner and Executive Director, City Planning
Wards: All Wards

City Planning has an approved complement of 477 full time equivalent staff. The vacancy rate as of April 30, 2022 was 12.8%. Given constant promotions, resignations and retirements, there is substantial change happening in the staff complement. Twenty five percent (25%) of the staff are new to the Division since January 2020, indicative of the dynamics discussed below.

Cost of living: typically, people are spending much more than 30% of their income on housing in Toronto; depending on where you might be in your life, whether you have children or other dependencies or whether you require daycare or what your transportation needs are for a commute. These are all factors that make Toronto a comparatively expensive city for prospective employees.

3) Takeaway from June home sales: Weak demand, record drop in house prices

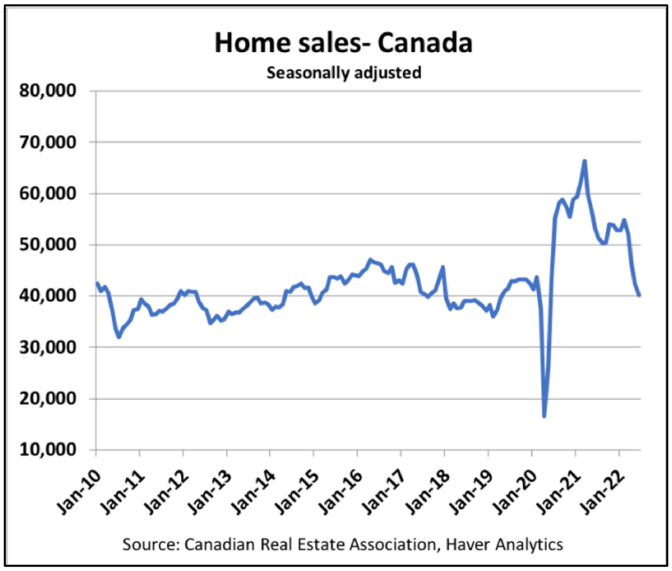
The high level summary in a nutshell:

- Another steep drop in sales
- Inventory continues to build
- Record monthly and quarterly drop in prices
- Southern Ontario is taking it on the chin
- The prairies and Atlantic Canada have been relatively stable so far

	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	-24.3%	-5.6%	+9.5%	+4.1%	+10.4%	+7.1%	+15.0%	-1.9%
BC	-33.2%	-10.2%	+1.2%	+2.4%	+20.8%	+6.1%	+5.4%	-1.8%
AB	-4.2%	-7.3%	+1.7%	+0.6%	-11.1%	+2.6%	+4.5%	-0.7%
ON	-36.6%	-8.1%	+11.1%	+1.4%	+59.7%	+7.5%	+3.4%	-4.8%
QC	-10.1%	+0.7%	+20.3%	+12.3%	+2.3	+12.9%	+12.0%	-1.5%

Sales stumble again in June

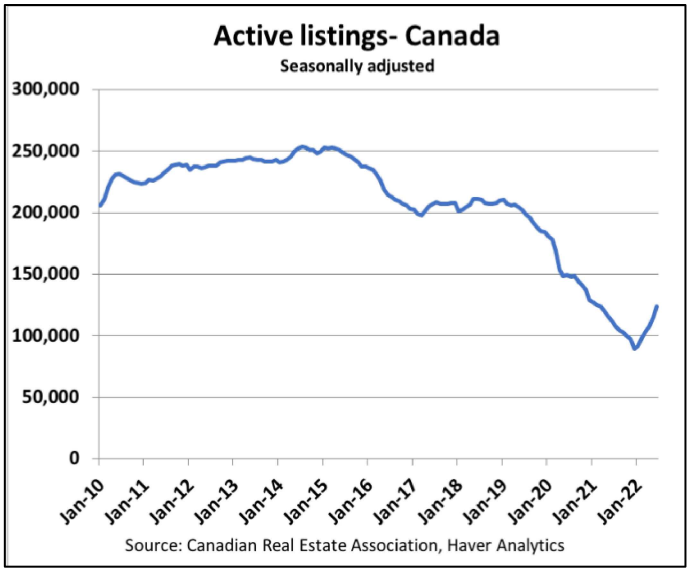
Home sales nationally fell another 5.6% m/m seasonally adjusted in June, with BC (-10.2%) and Ontario (-8.1%) leading the decline. Note that we are only now back to decade averages for sales volumes. This is not a "washed out" market yet. I think sales still have some downside to come.

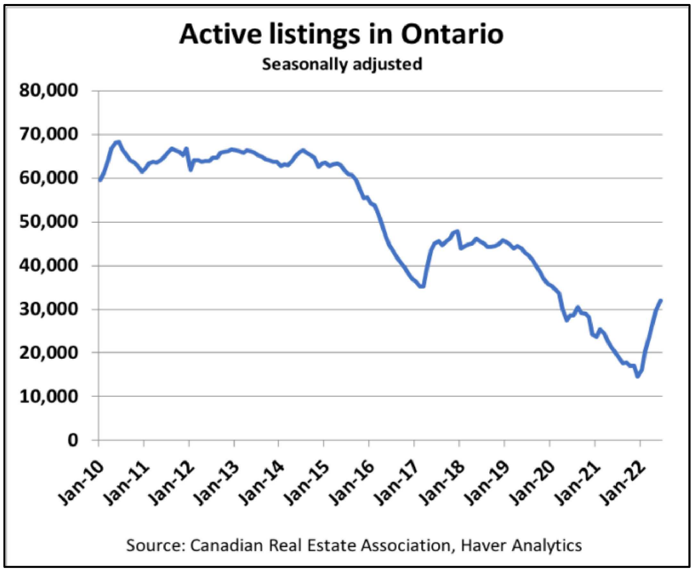


Inventory on the rise

For the second straight month we saw a sharp increase in new listings, up 4.1% sequentially.
The sales-to-new listings ratio is at the lowest point since 2015.

Inventory continues to build nationally (+7.1% m/m) though it's still at less than half of "normal" levels. The increase has been most pronounced in Ontario where there are now 60% more active listings than last year at this time.





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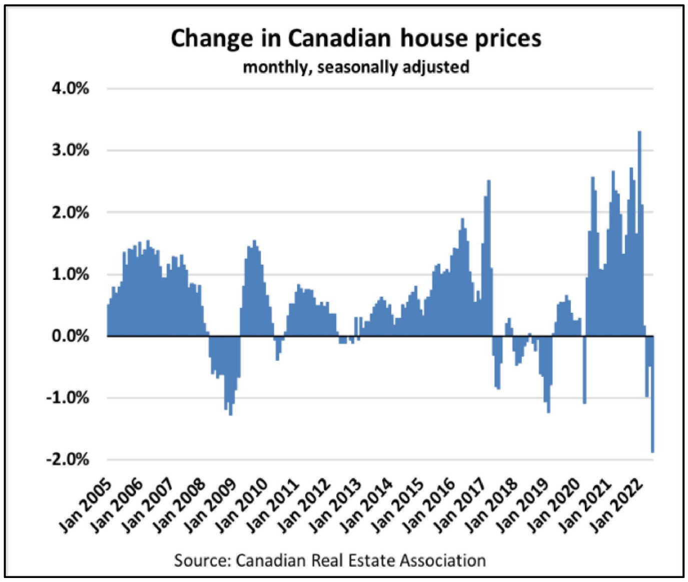
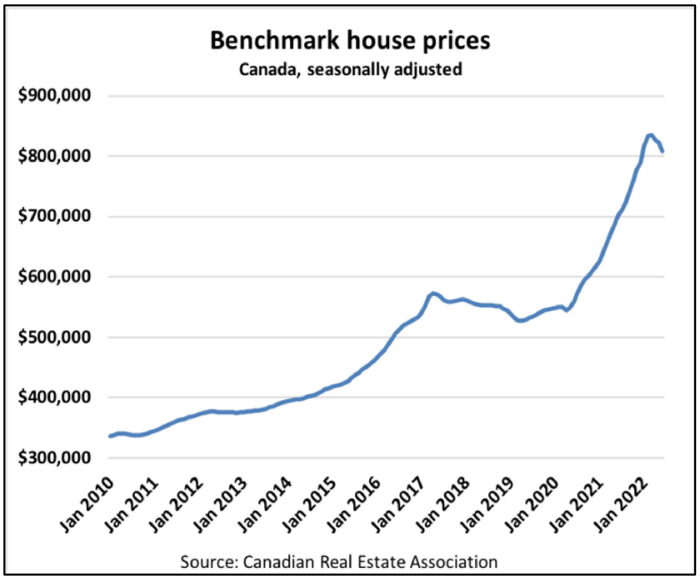
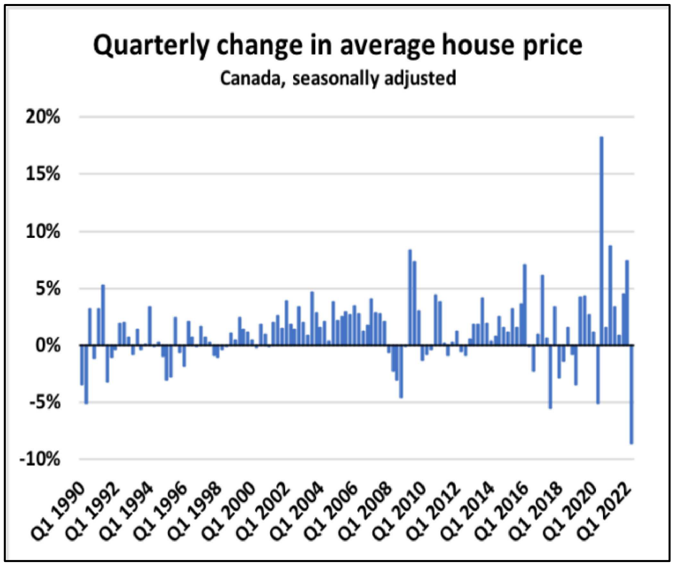
Record drop in prices

There's no way to spin the latest house price data…it's just bad. The MLS HPI benchmark just posted the largest seasonally adjusted monthly decline on record going back to 2005:

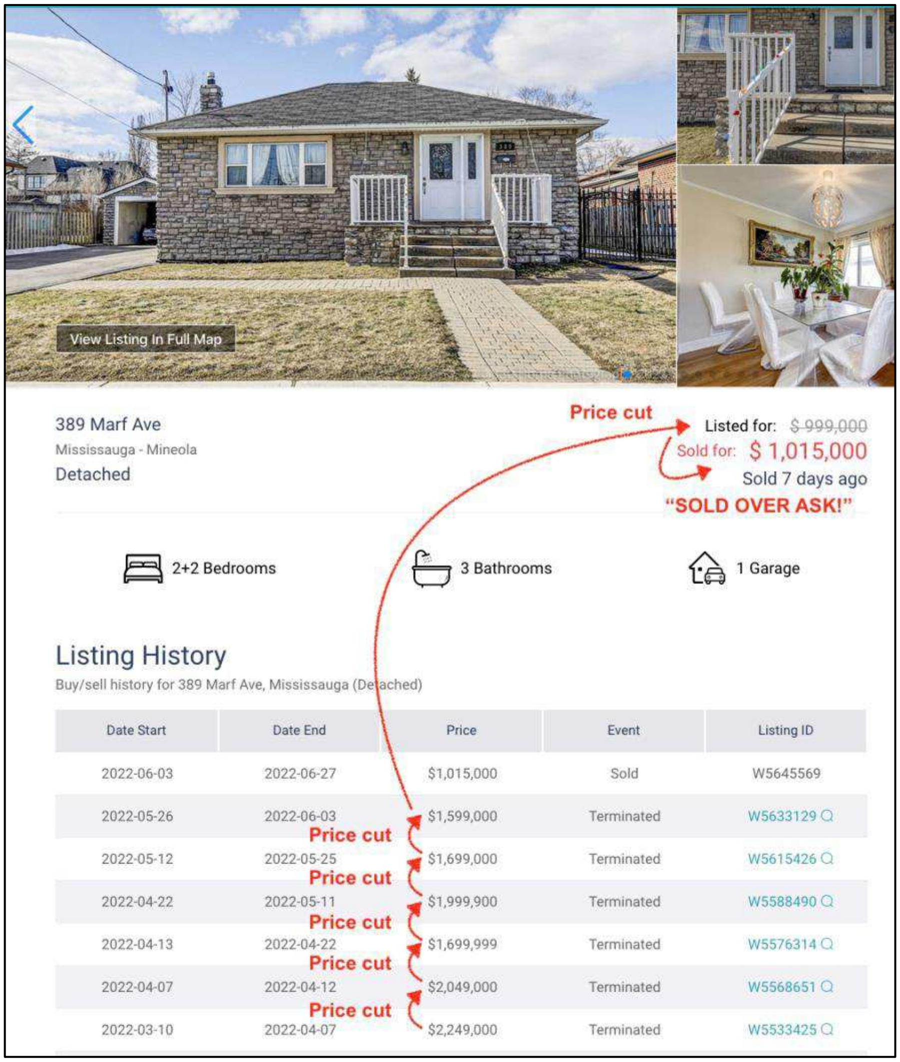




We know the HPI does a poor job of capturing sharp inflections and is almost certainly understating the decline. If we look at seasonally adjusted and weighted average prices, we just saw the largest quarterly decline going back to at least 1990:



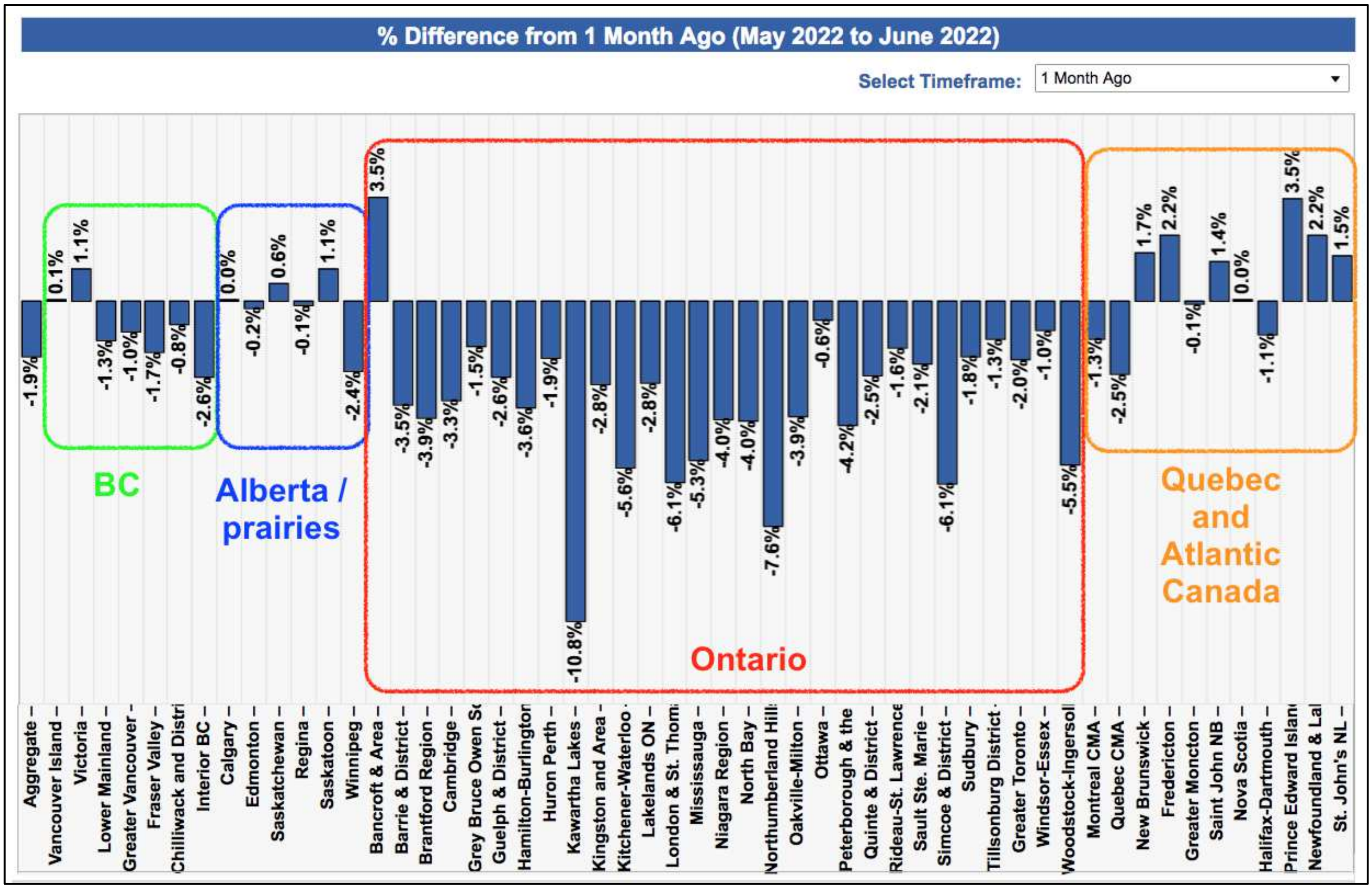
It's a challenging market that's leading to some wild examples of price discovery. The listings below definitely takes the cake:



Blame Ontario….again!

A quick look at the monthly change in prices in real estate boards across the country makes it clear that Ontario is bearing the brunt of this current downturn….the prairies and Atlantic Canada much less so.

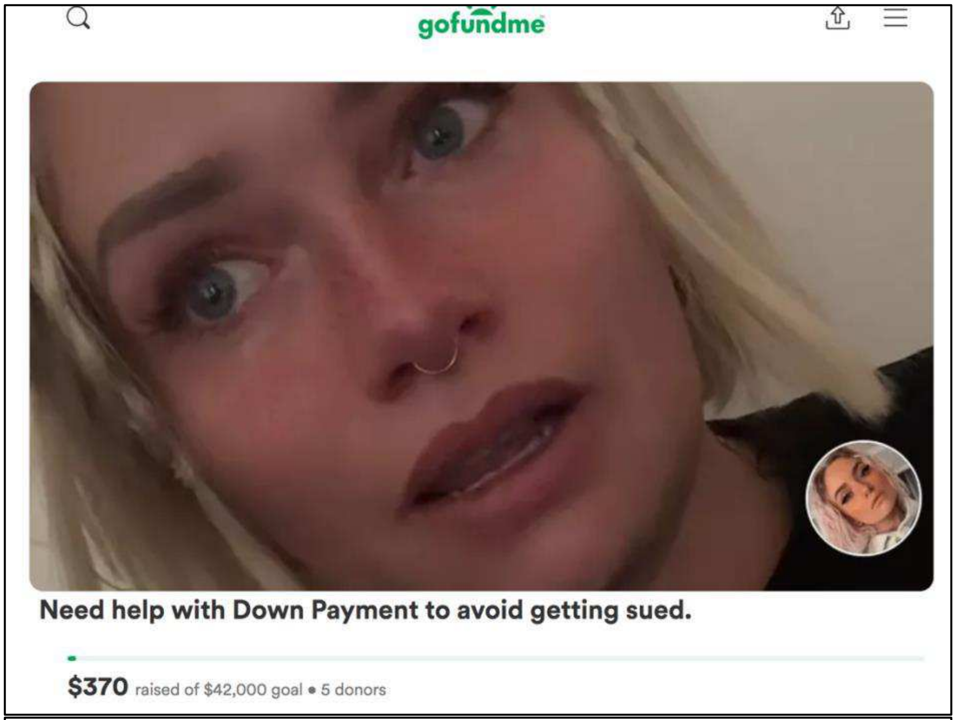
And how about that 10% MONTHLY decline in Kawartha Lakes? It's almost hard to believe, but I've previously warned that recreational properties are hyper cyclical. When the market does well, they do REALLY well, but when the market turns, they often turn hard.



Distressed selling still driving prices

It's important to note that even with the steep drop in sales recently, total months of inventory is still only at 3.1 which is WAY less than the long-term average. I know it's little comfort for folks trying to navigate this chaotic market, but this market is not dramatically oversupplied by any means:

The issue remains that distressed selling, in large part due to failed closings, is causing price declines that are disproportionately large relative to the market balance. The GoFundMe campaign below is a perfect “sign of the times”.



Hi, my name is Nicole & you may have seen my story on TikTok.

I was working with a broker who advised how much he would be able to get approved for us. I signed an agreement to purchase a home in May for that amount which gave us 90 days to figure out the mortgage. This broker was very uncommunicative and any time we did hear from him it was always “don’t worry, don’t worry”. He has now gone dark on us and we haven’t heard from him in weeks. We are now working with a new broker who says that what the previous broker was offering is not doable.

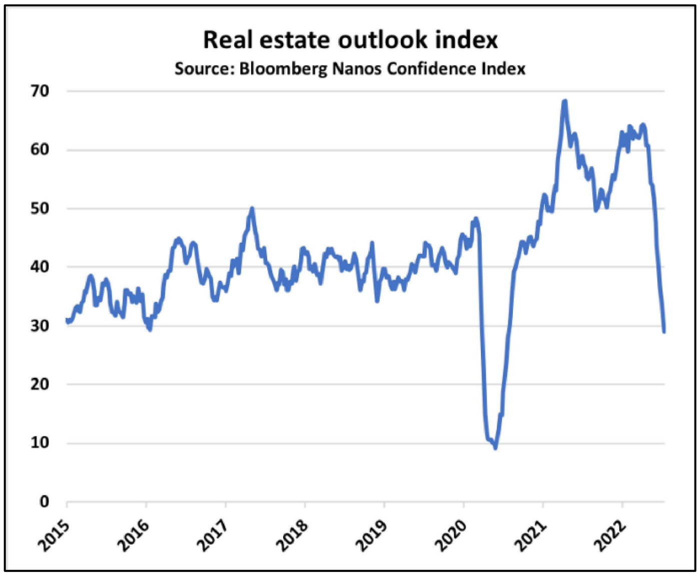
I have 2 options now; I need to find a way to come up with $100,000 or I need to back out of the sale which means I will lose my deposit and very likely get sued and have to file for bankruptcy.

Obviously, I understand that this is a privileged problem to have and times are tough for everyone. But I was grossly misled and put into a situation that is going to largely affect my life.

Any help is appreciated.

Real estate sentiment in the dumps

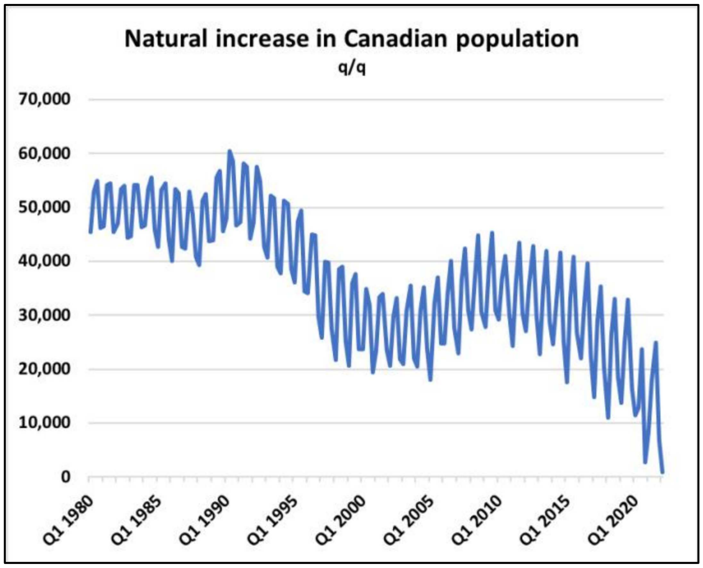
Sentiment towards real estate is souring in Canada. Notwithstanding the early days of the pandemic, the outlook is now the weakest since at least 2015:



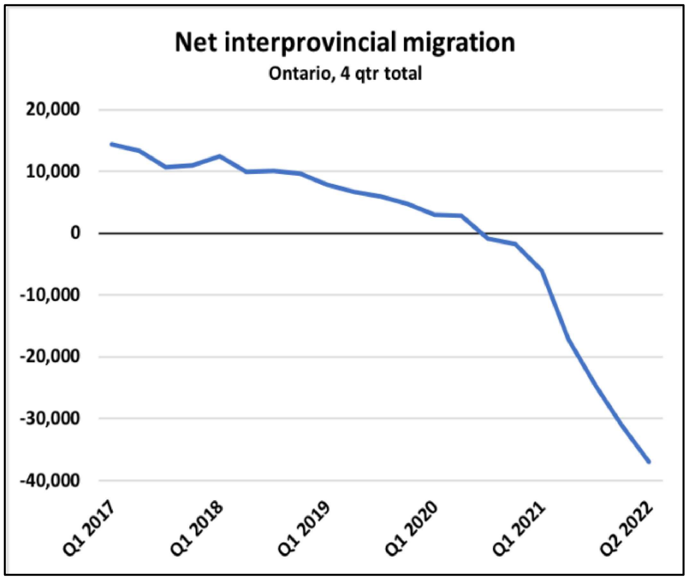
4) Supply and demand: Housing starts jump, immigration hits yet another record

Thank goodness for immigration

Something happened this quarter that we've never seen before. The number of deaths basically equaled the number of births in Canada, which means the "natural increase" fell to zero. In other words, there is now NO INCREASE in the population outside of immigration.

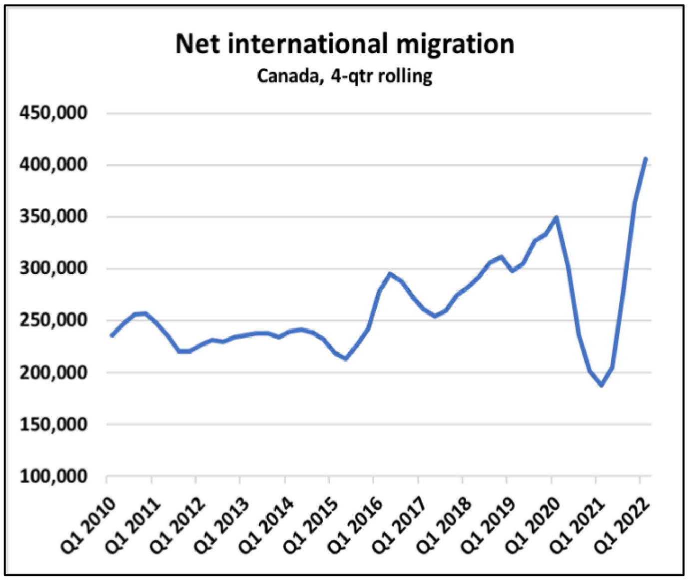


It's particularly important for provinces like Ontario where, not only is natural increase slowing, but there's a strong flow of people leaving the province for greener (more affordable) pastures….namely Atlantic Canada and the prairies. Net interprovincial migration in that province is now the most negative on record:



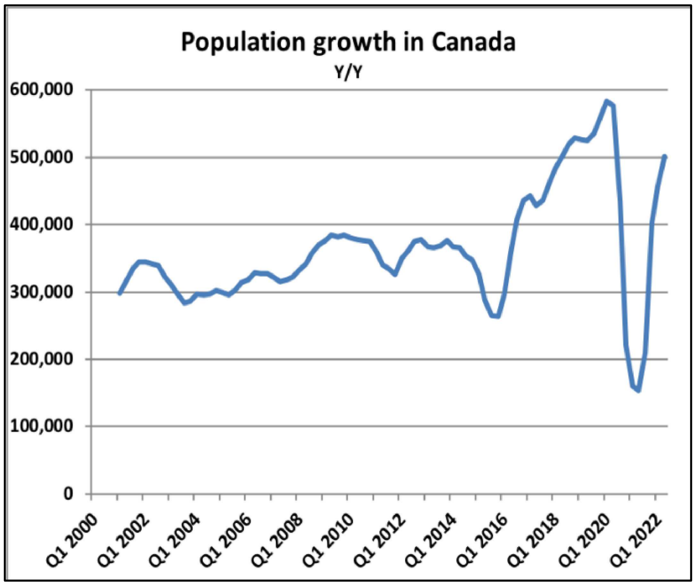
Immigration hits record in Q2

Canada's population may not be growing organically, but thankfully we have record immigration filling the gap. We've now welcomed 400,000 new residents over the past year alone:



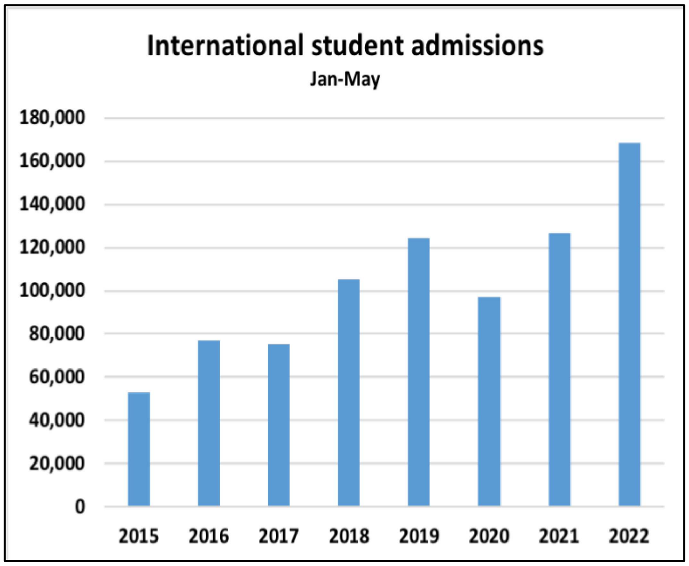
Total population growth ticks up

Total population growth in Canada is back above 500,000 over the past year, within striking distance of the all-time highs from 2019.



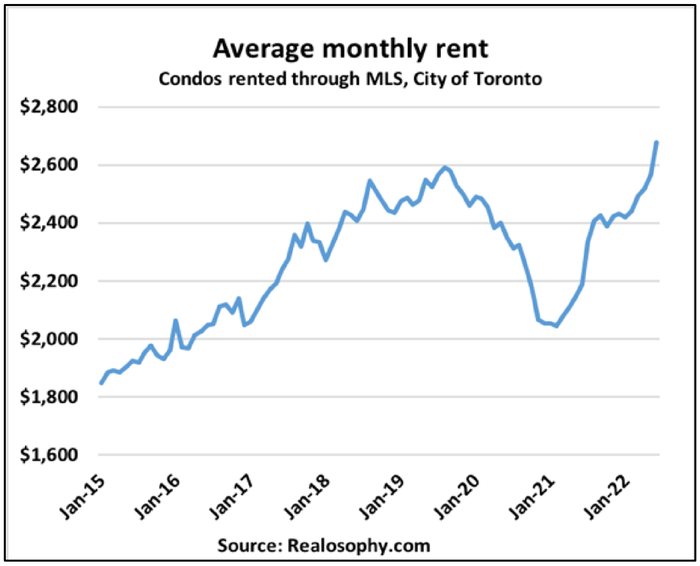
Record international student admissions

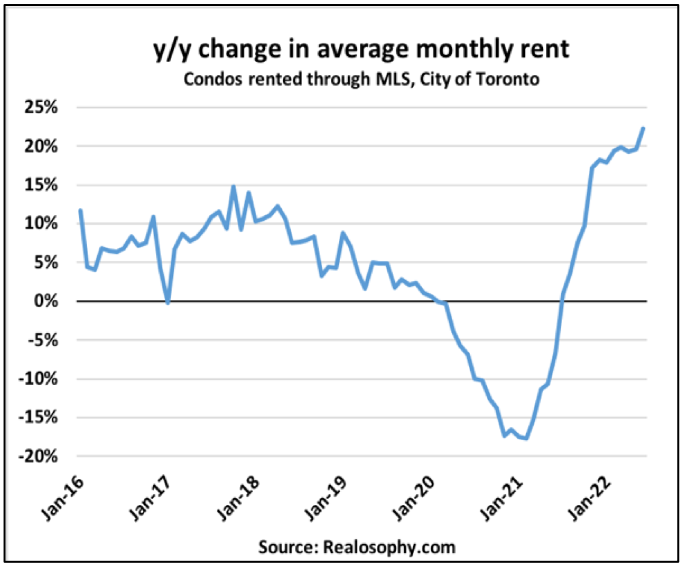
As a reminder, population growth is made up of natural increase (births minus deaths) plus immigration plus non-permanent residents like international students. When it comes to the latter, it's notable that international student admissions are at record levels through May of this year. This is a major source of rental demand in big cities:



Rental market is surging

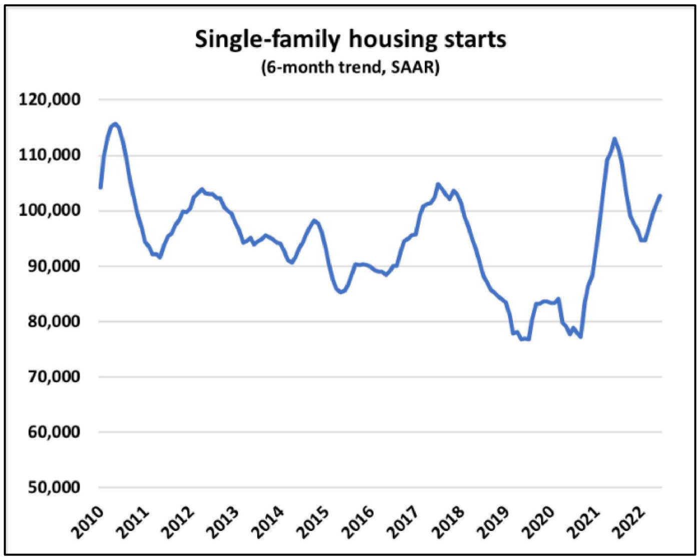
People have to live somewhere. If the population is growing but home sales are falling, by default there has to be more rental demand. That's exactly what we're seeing right now. Rents in big cities across the country are surging. Below is Toronto where average condo rents are 23% higher than last year:

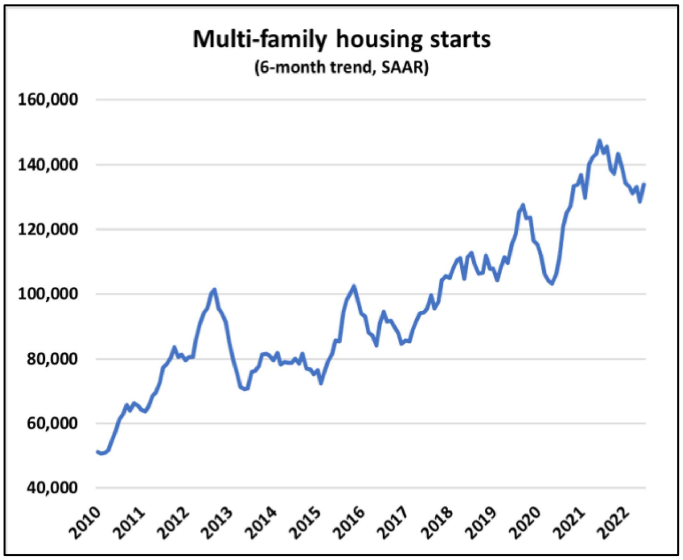




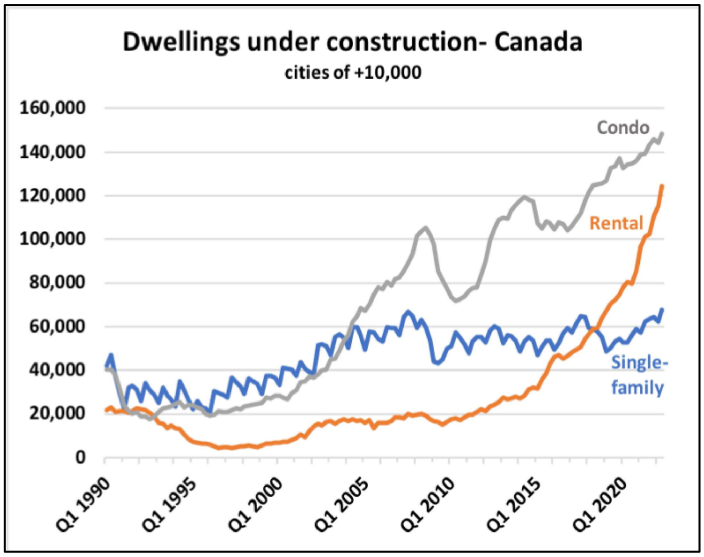
Construction boom in Q2

Housing starts across the country jumped by 13% in Q2 over the prior quarter to hit 270,000 on an annualized basis. Even accounting for strong population growth, that's a lot of new supply:





It becomes even more evident when we instead look at what's currently in the construction pipeline. Single-family homes, condos, and rentals are ALL at the highest levels since at least 1990.

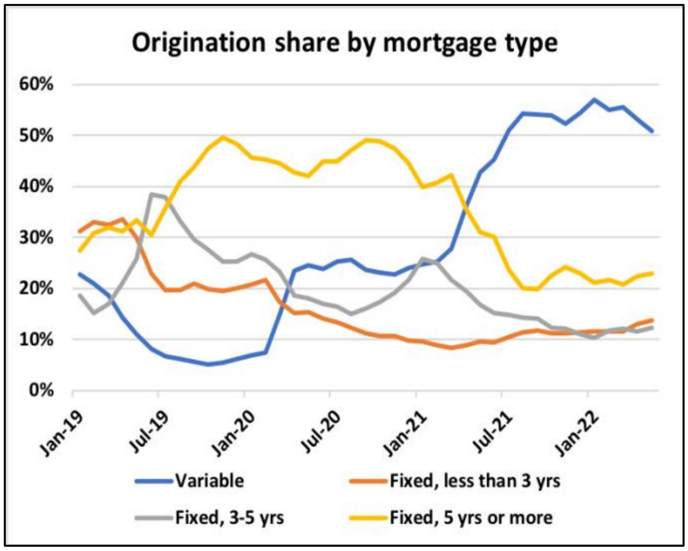


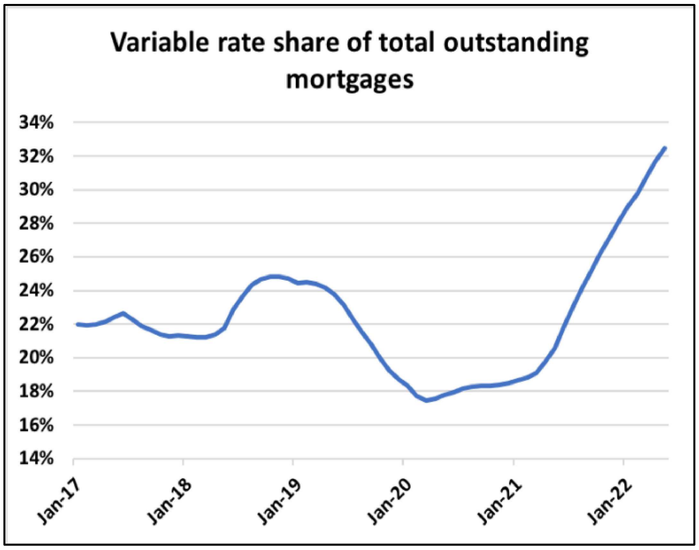
To be clear, this is not Florida/Arizona 2006 level overbuilding, but it does suggest that there will be a healthy level of new supply coming online this year against a backdrop of relatively weak demand. It's not ideal timing, to say the least.

5) Mortgage market update

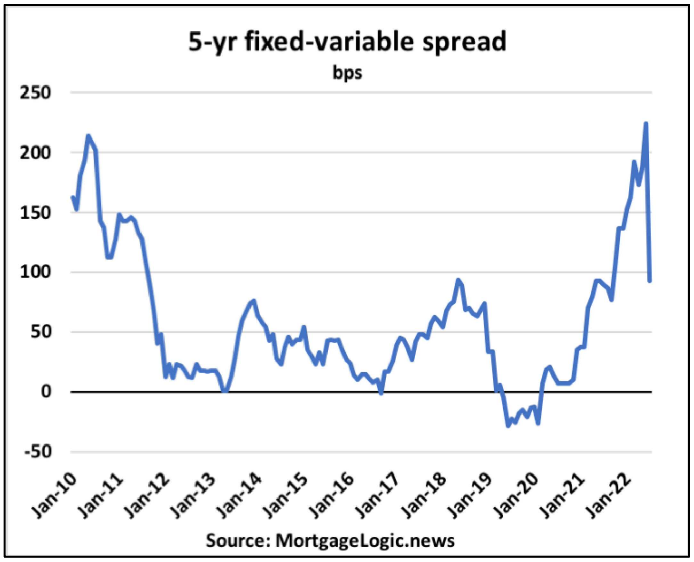
Shift into variable continues

A whopping 54% of new mortgages this year have been the variable variety, including over half originated in May. That brings variable's share of total mortgage debt outstanding to just under 33%, up from 18% in early 2020:



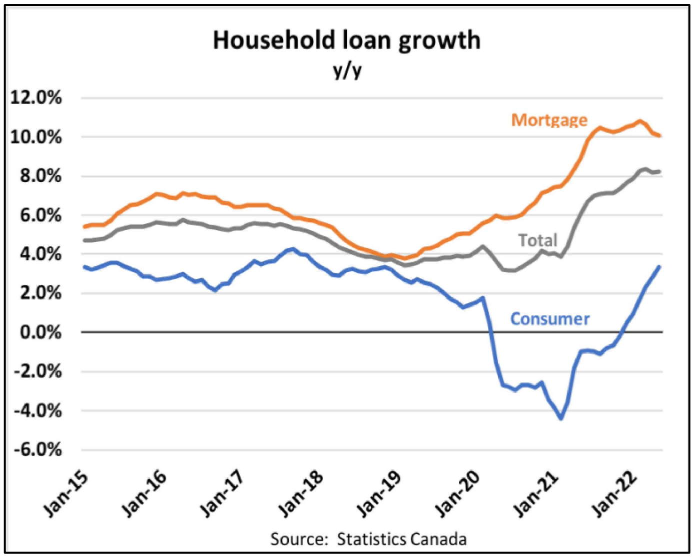


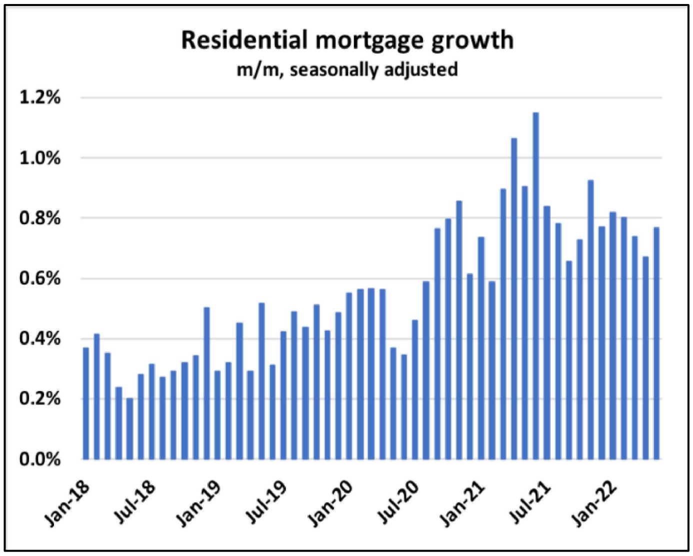
This may continue for a while yet. Even with the big move in variable rates last week, the fixed-variable mortgage rate spread is well above normal levels:



Mortgage growth remains strong in May

Mortgage debt outstanding is showing signs of slowing. It grew by 10% y/y in May, down from the 14-year high of 11% earlier this year. Expect this to continue to slow sharply as we move through the year.



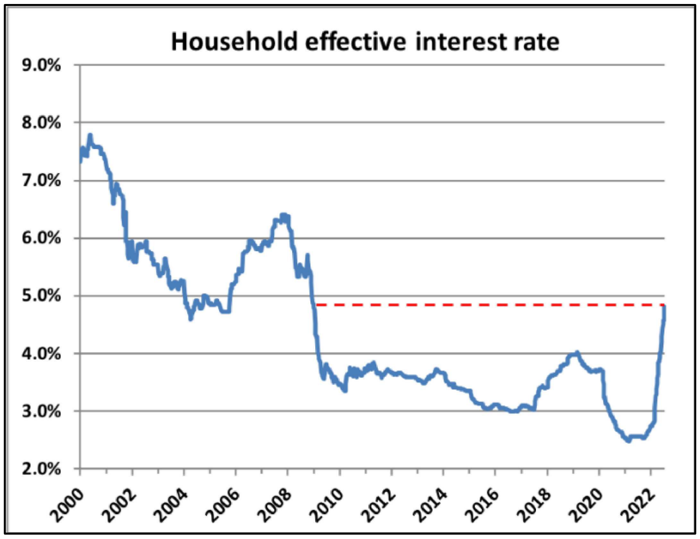


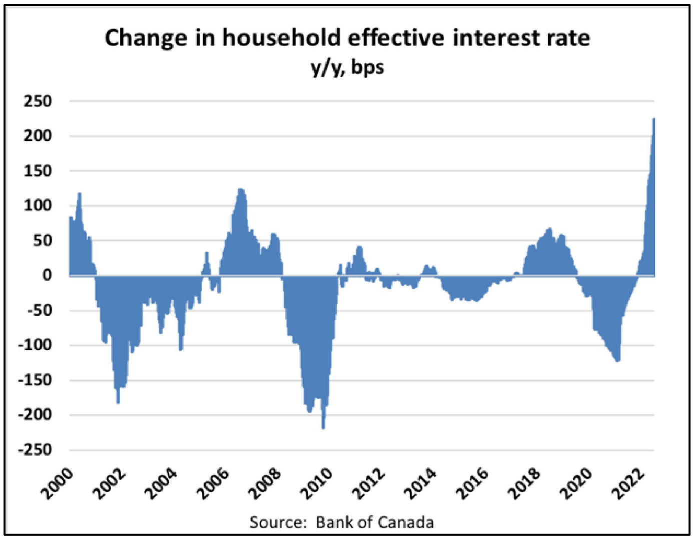
6) Consumer check: Rising rates begin to bite

Interest burdens rising quickly

It's crazy to think that just a year ago, households were paying just 2.5% average interest rates across ALL outstanding debt….credit cards, auto loans, mortgages, HELOCs….all of it.

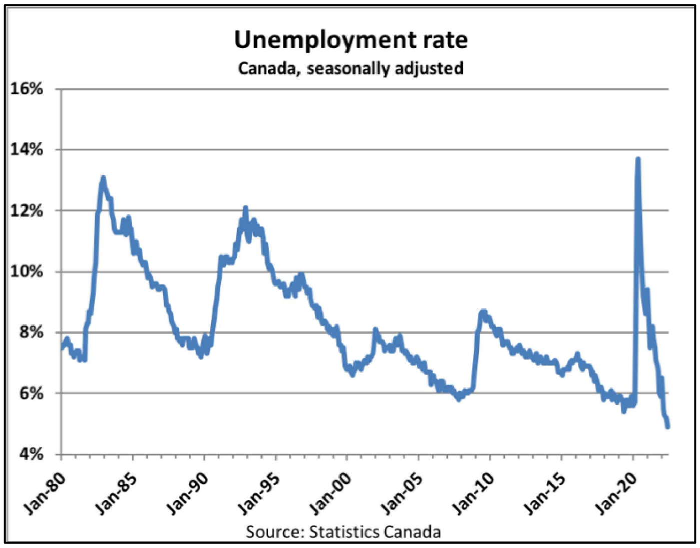
Today it's nearly 5%. That's the steepest 1-year move since at least the 1990s, and there's just no way that this won't begin to crimp spending going forward:





Labour market still solid

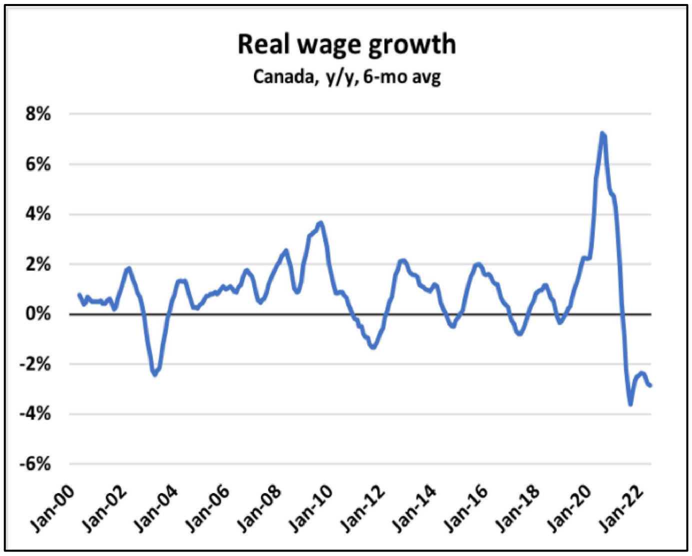
In spite of a small pullback in employment last month, the unemployment rate actually fell once again to hit a fresh record low of just 4.9%....the first time on record that we've ever had unemployment in the 4s.



Wage growth picks up but still negative in real terms

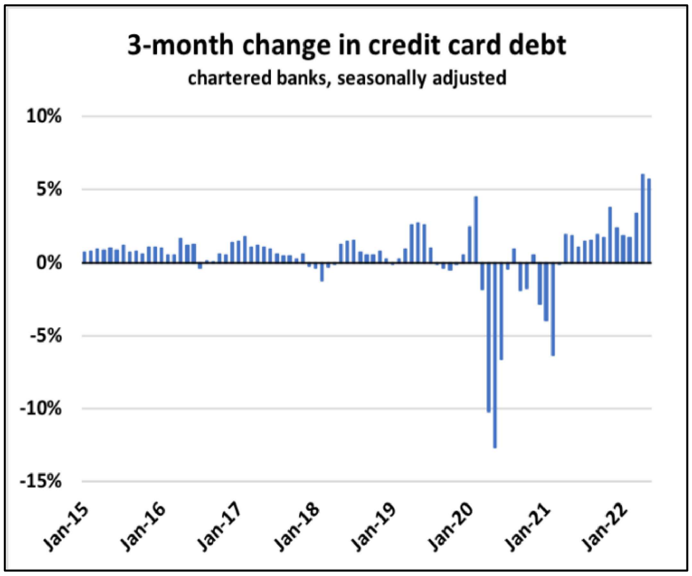
With the labour market so tight, we're now starting to see a big move in wages. Wage growth came in at 5.6% y/y in June, which is the best showing since the 1990s if we set aside some of the weird data distortions associated with the COVID lockdowns in early 2020.

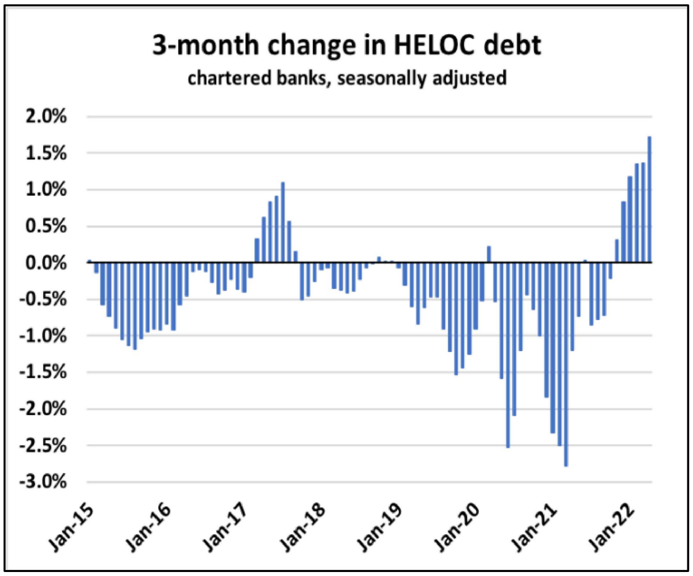
The issue however is that inflation is still running above wage growth, which means REAL wages are still negative to the tune of 2.5%:



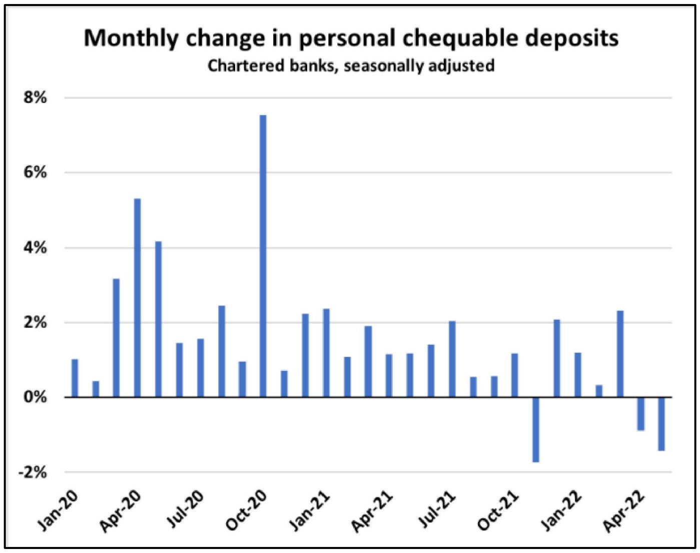
More signs of consumer dis-saving

With interest rates rising and real wage growth negative, it appears consumers may be drawing on savings and taking on consumer credit to support consumption or just stay afloat. Consider that credit card and HELOC debt both jumped sharply again in May:





At the same time, we've now seen chequable deposits fall for 2 straight months in a sign that savings are now dwindling after building steadily throughout the pandemic:



Consumer insolvencies begin to rise

Canadian consumer insolvencies are still 40% below pre-pandemic levels, but they are showing signs of beginning to move in the wrong direction after rising 13.3% y/y in May. However, the move is miniscule at best, and we're not seeing any material deterioration in credit card trends. I think we can safely say that the best is behind us, insolvencies and arrears will almost certainly begin rising from here, but the trajectory is to be determined.