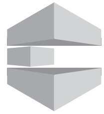

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The Edge Report

March 2022

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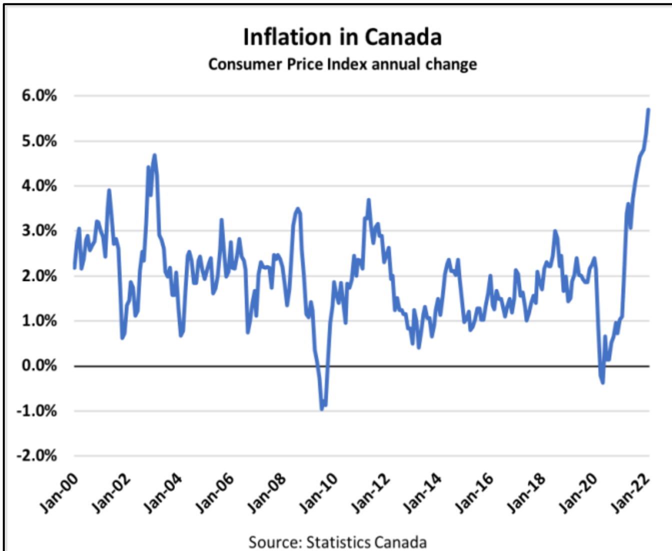
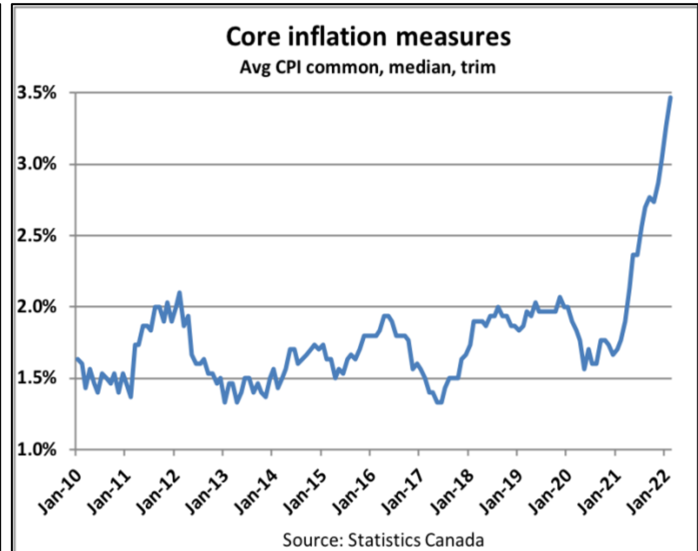
1) Bank of Canada hikes, signals more to come as inflation rages

As expected, the Bank of Canada raised the overnight rate at the March meeting to 0.5% from 0.25% previously. In the press release, the Bank noted that, *"As the economy continues to expand and inflation pressures remain elevated, the Governing Council expects interest rates will need to rise further."*

No kidding! Headline inflation came in at 5.7% in February, a fresh 30-year high. Importantly for the Bank of Canada, their measures of core inflation continue to spike and now average 3.5%....well above their target band of 1-3%.

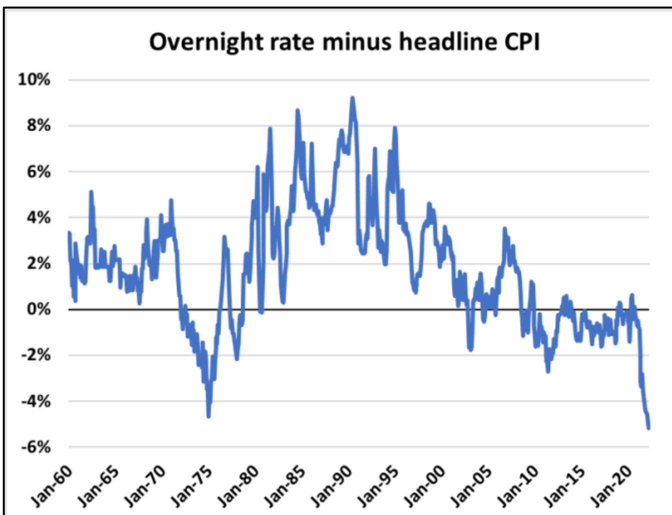


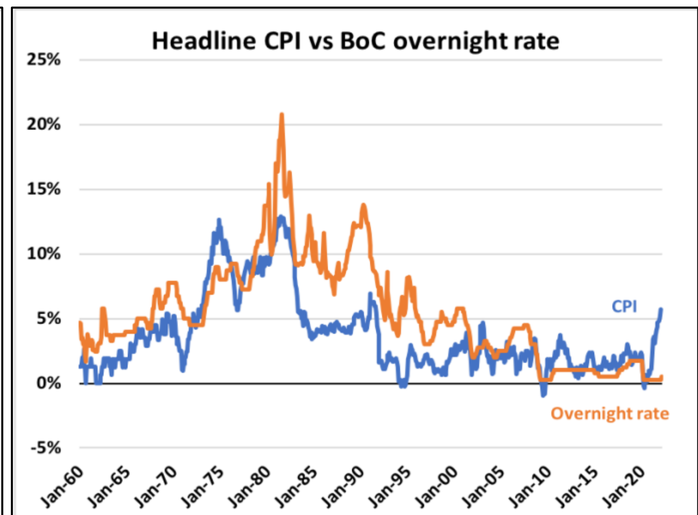


Keep in mind this was before the Russia-Ukraine issue. The fallout for energy and food prices has yet to be felt by consumers in Canada outside of a runup in gasoline prices. There may be much more still to come. As an example, the Raw Materials Price Index has spiked by 12.9% in just the two months of January and February alone! If manufacturers are paying that much for materials, you can bet that consumer prices haven't peaked yet.

The Bank of Canada can only stand on the sidelines for so long. They are dramatically behind the 8-ball and they now risk losing control of inflation expectations. And as I discussed previously, expectations drive consumer behaviour and can create a self-reinforcing dynamic.

My call for 2-3 rate hikes in 2022 was predicated on CPI peaking in Q1 this year, but it's becoming clear that inflationary pressures are much stronger and more persistent than I envisioned. Even after a 25bp hike last week, the overnight rate remains the most negative in real terms in over 60 years.





We've never see this sort of divergence in inflation and interest rates. At some point it doesn't really matter whether the factors driving inflation are temporary, the Bank has to act decisively. Risks are rising that we'll see more than 3 hikes this year, which means the risks of a second half slowdown are mounting.

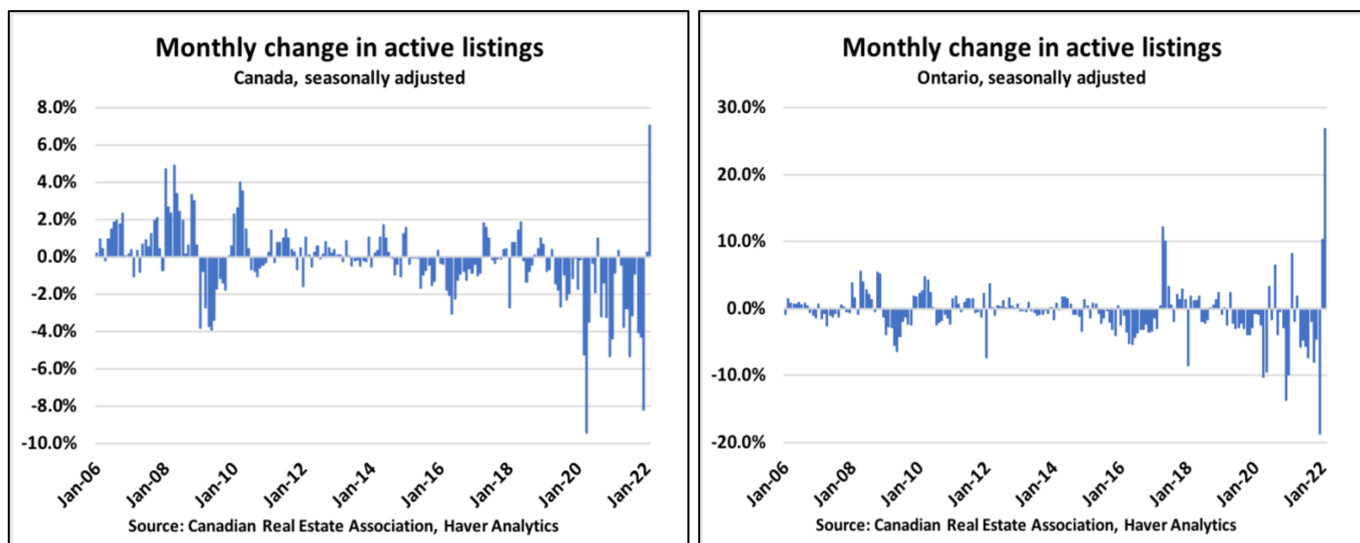
2) National home sales update

There's a lot to talk about in the latest national home sales data. The key takeaways as I see them:

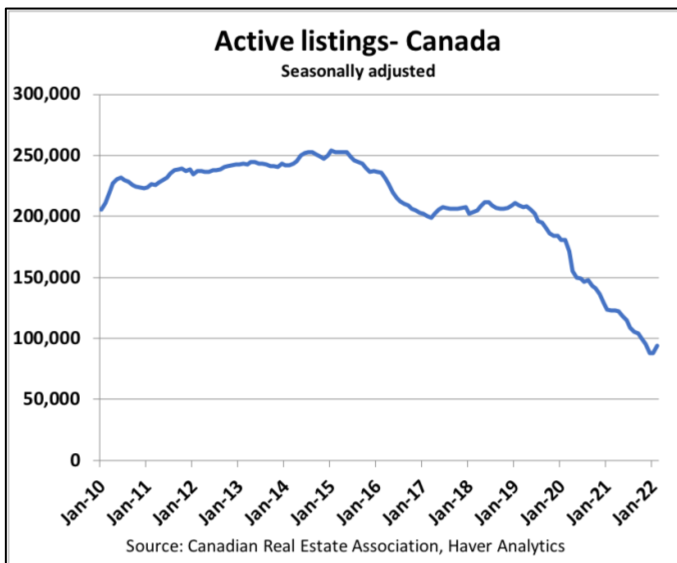
i) Largest increase in active listings since 2010

I'll jump right to the most interesting tidbit: Active resale inventory across the country ended February 7% higher than January on a seasonally adjusted basis. In percentage terms, that's the largest increase since data is available back to 2003. In unit terms, inventory jumped by over 6,000 in one month….the largest jump since April 2010.

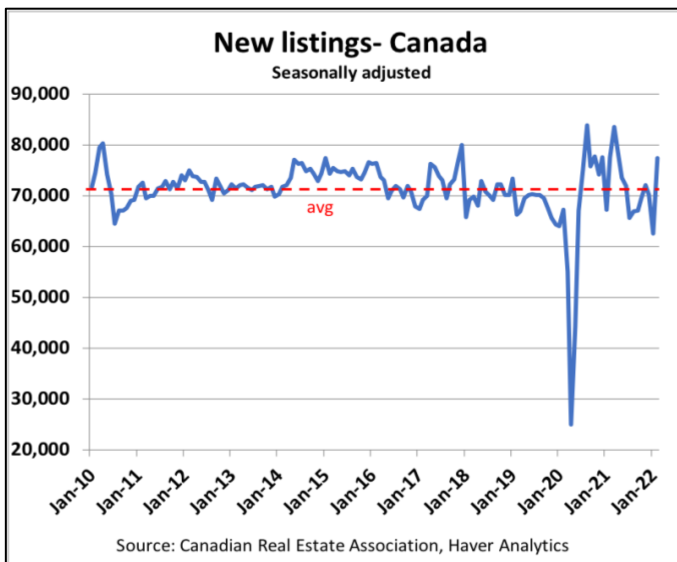
The increase was particularly notable in Ontario where I previously flagged the unusually large build in inventory in Toronto, which likely accounts for the sudden and widely-reported slowdown in bidding wars.



Context is still needed here. There are still fewer than 100,000 active listings nationally, roughly 50% below pre-COVID levels. We've got a long way to go to get back to "normal". We shouldn't read too much into one month, particularly since it happens to be at a time when inventory is seasonally very low which can make for unusually large swings in the seasonal adjustments. But it's certainly a notable development worth flagging:



The sudden increase in inventory is primarily due to a massive 23.7% m/m surge in new listings coming to market:

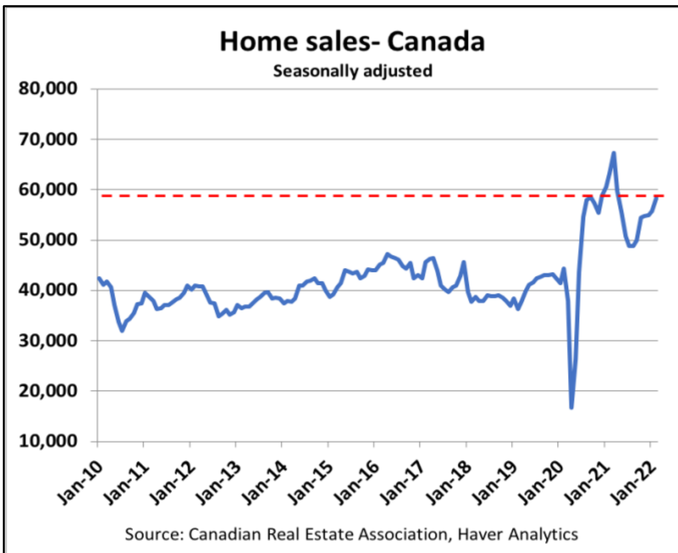


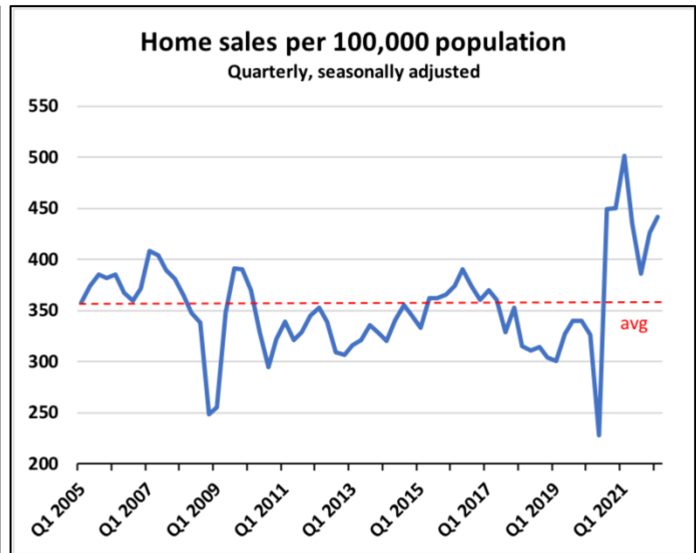
I expect we'll see a high of new listings continue right through the spring in part due to some "pent up selling" pressure from unusually low new listings over the past year, but also due to rising completions of new homes.

We've now seen 205,000 new homes completed in the past year with a record 310,000 still under construction. And housing starts in February came in at 247k SAAR, well above expectations and roughly equivalent to a 2.25MM SAAR print in the US. Construction activity is very high, and we should expect completions to remain near record levels right through the year, and that means more supply to trickle into the resale market.

ii) Pullback in demand still likely as sales remain 25% above normal levels

Home sales nationally jumped 4.6% m/m last month. They remain 25% above average levels on a population-adjusted basis:

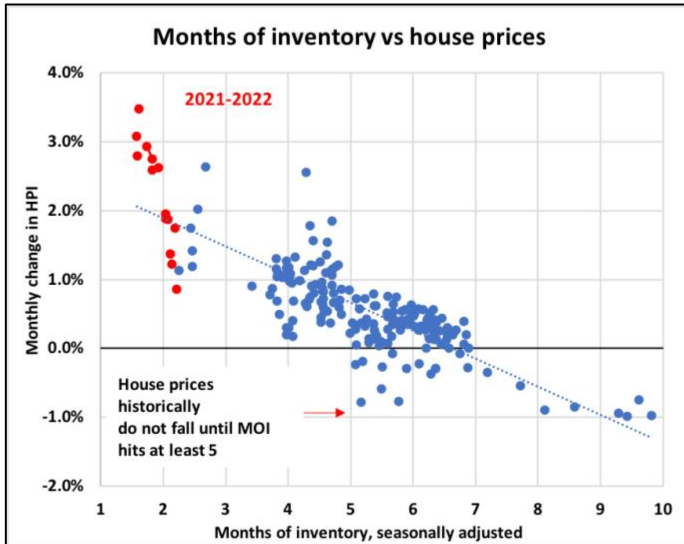




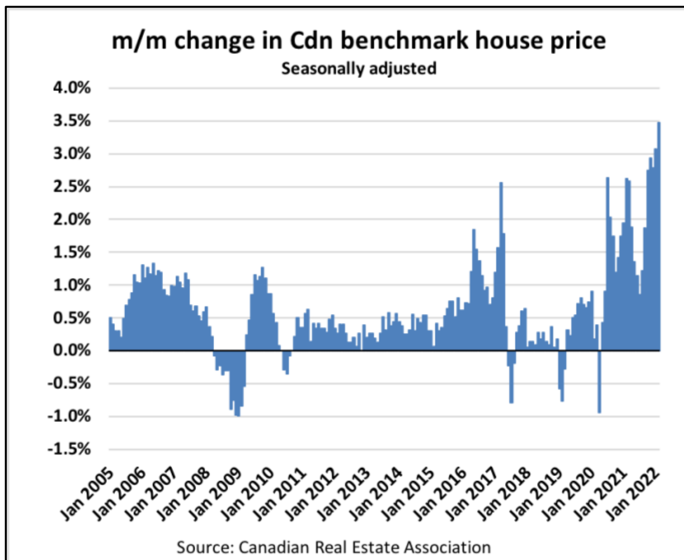
This strongly suggests that we are still seeing significant demand pulled forward, likely as buyers attempt to front-run further Bank of Canada rate hikes. This further strengthens my view that we will see a significant demand overhang with much weaker sales in the back half of the year.

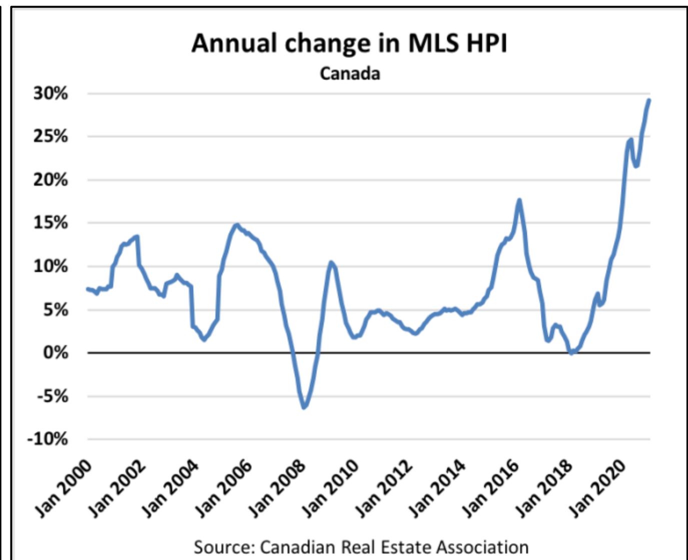
iii) Market still extremely tight, record jump in price

Even with the significant supply build, months of inventory remained stable at a record low of 1.6 where it's hovered now for 3 months. That level of tight supply all but assures positive pricing trends likely right through the spring selling season.

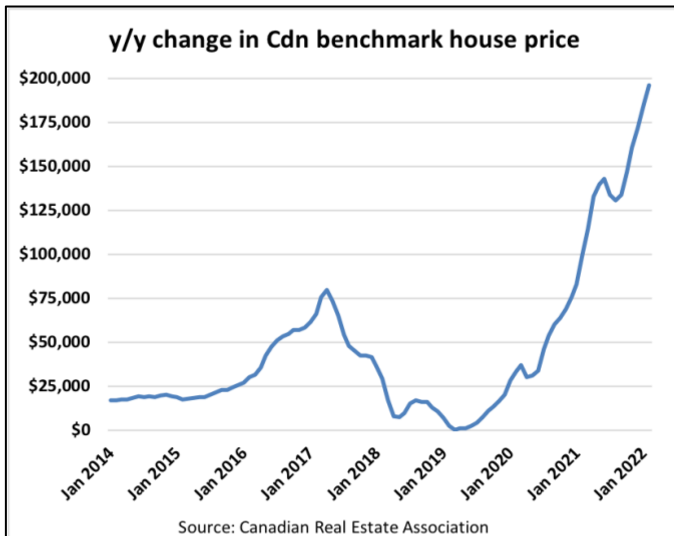


In fact, February saw the single largest monthly increase in the seasonally adjusted national HPI on record at 3.5% m/m and 29% y/y:





The typical home in Canada is now $200,000 more expensive than a year ago.



At some point, the feds need to be seen as "doing something" to help. I still think we'll see OSFI tighten underwriting on secondary properties before the spring selling season is done, which would only exacerbate a weakening demand backdrop in H2.

The key metrics are below:

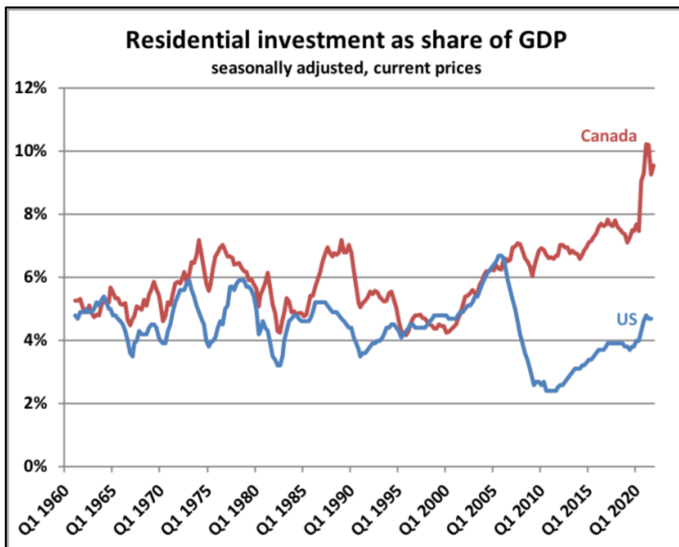
	Sales		New listings		Active inventory		House prices (HPI for Canada, average for provinces)	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	-8.1%	+4.6%	-0.2%	+23.7%	-23.2%	+7.0%	+29.1%	+3.5%
BC	-18.1%	-0.2%	+4.8%	+14.6%	-20.5%	+14.1%	+24.2%	+1.8%
AB	+42.7%	+14.6%	+25.6%	+36.7%	-24.9%	+2.9%	+15.5%	+5.2%
ON	-12.3%	+6.3%	-4.5%	+34.1%	-22.9%	+26.8%	+25.3%	+1.7%
QC	-15.5%	-1.9%	-9.2%	+1.5%	-20.4%	-0.6%	+18.2%	+3.5%

3) A massive misallocation of capital or the new normal?

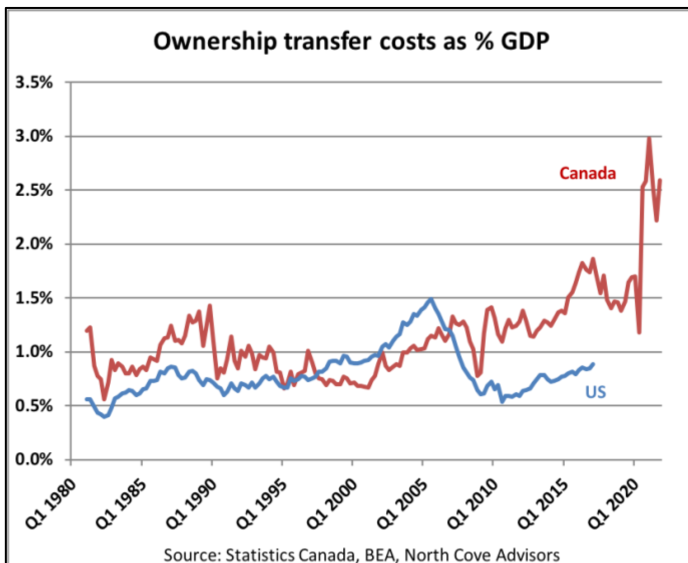
Q4 GDP came in a tad better than expected, primarily on the back of a massive inventory build that contributed 4.2 percentage points to the headline annualized growth rate of 6.7%. Outside of Q4 2020, this was the largest contribution from inventories in 20 years.

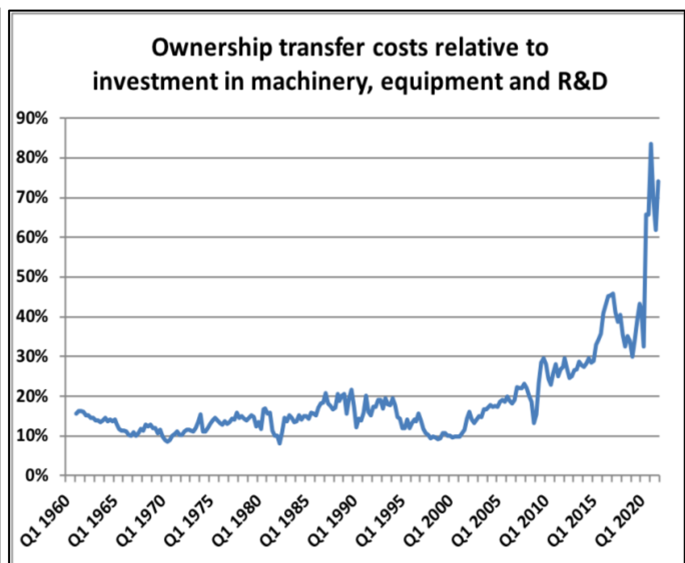
But my eye always goes to housing and household consumption, as these two components have accounted for 85% of real GDP growth over the past 5 years. It's going to be exceedingly difficult for the Bank of Canada to rein these in without causing significant collateral damage, one of the reasons why I'm skeptical that we'll see 8 hikes by the end of 2023.

On the housing front, residential investment (new construction + renovations + ownership transfer costs) jumped to 9.6% of GDP, the second highest reading on record and fully 3 percentage points above where the US peaked.

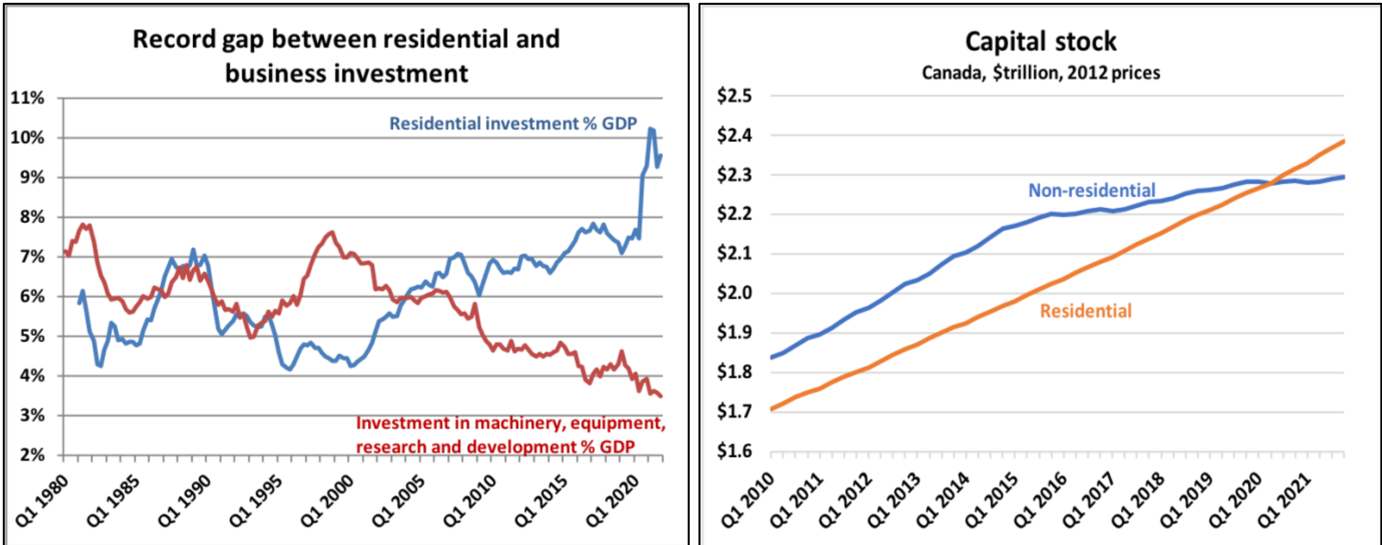


Yes, both new construction and renovation expenditures are at record levels, but what should really jump out is ownership transfer costs which were 2.6% of GDP last quarter. That's more than double the long-term norm and nearly twice where the US peaked. If that doesn't immediately strike you as absurd, consider that this one component, which is primarily comprised of realtor fees, is now 75% as large as all investment in machinery, equipment, and R&D by all businesses acorss the country:





This certainly screams of a potential misallocation of capital and a challenge for long-term productivity growth. In fact, total residential investment is now nearly 3 times as large as business investment in machinery, equipment and R&D. This dynamic pushed the residential capital stock (ie the value of all houses) above non-residential (ie the value of all businesses) in 2020 for the first time on record, and the divergence continues to widen:

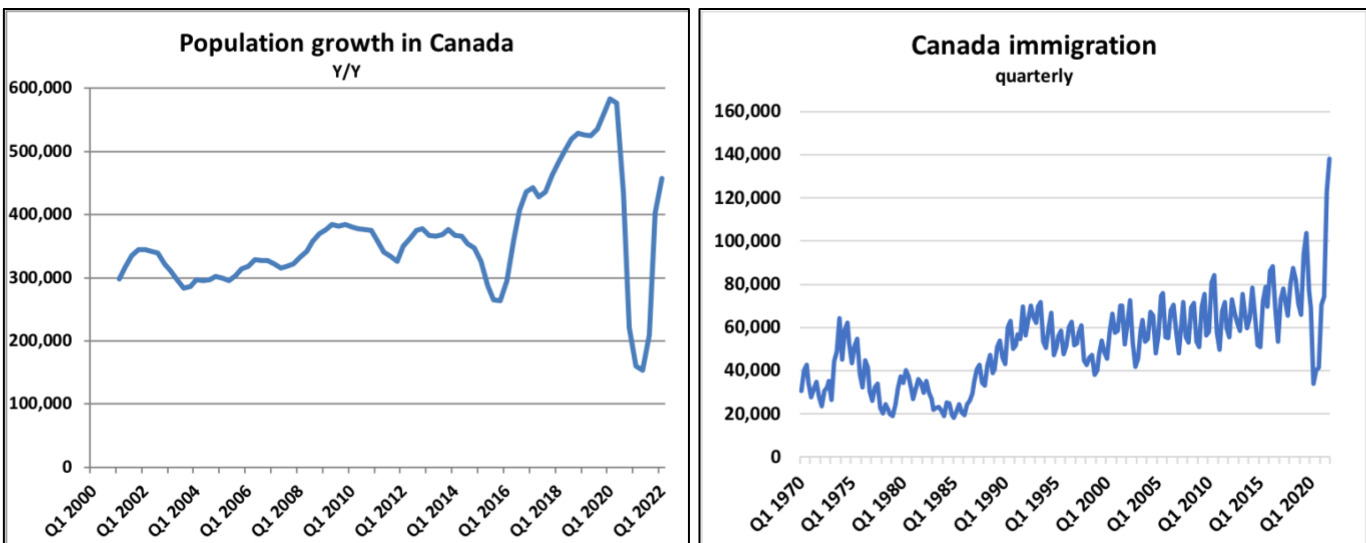


Residential investment in Canada remains north of 40% of all investment in the country. That's a remarkably high level that in the past 20 years has only been hit by a select group of OECD countries, namely Ireland, Greece, and Spain in the mid-2000s at the height of their respective bubbles.

It should be a reminder to Canadian policy makers that there's an upper limit to how far we can push housing valuations and consumer credit growth without also expanding the productive capacity of the economy to service those debts.

4) Supply/demand deep-dive: Immigration hits new highs just as housing starts slow

Population growth continues to recover from the COVID lows, hitting 460k y/y last quarter. Chalk this up to the single largest quarterly increase in immigration on record….with potentially higher to go if the feds are to hit their 432,000 target this year.



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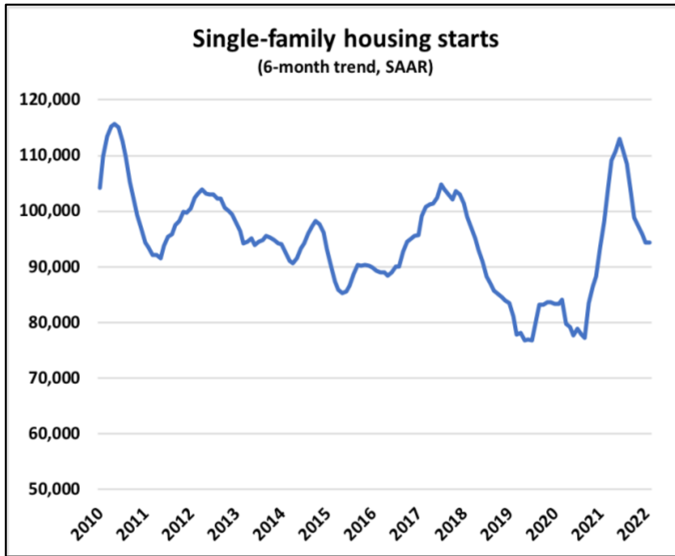
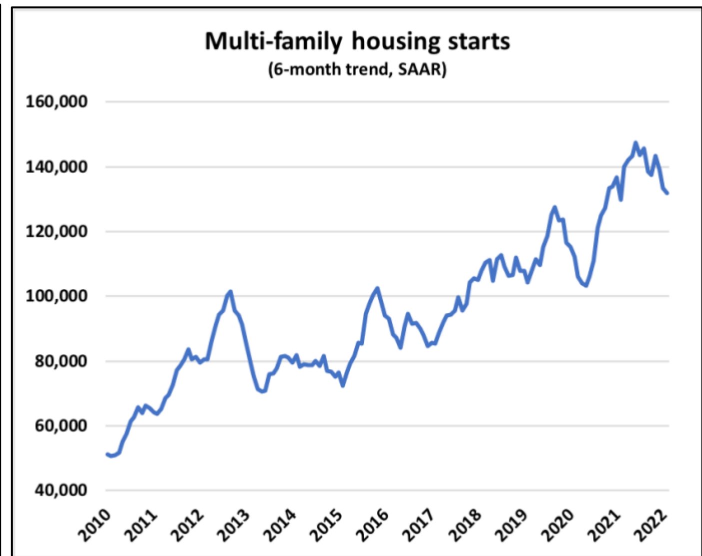
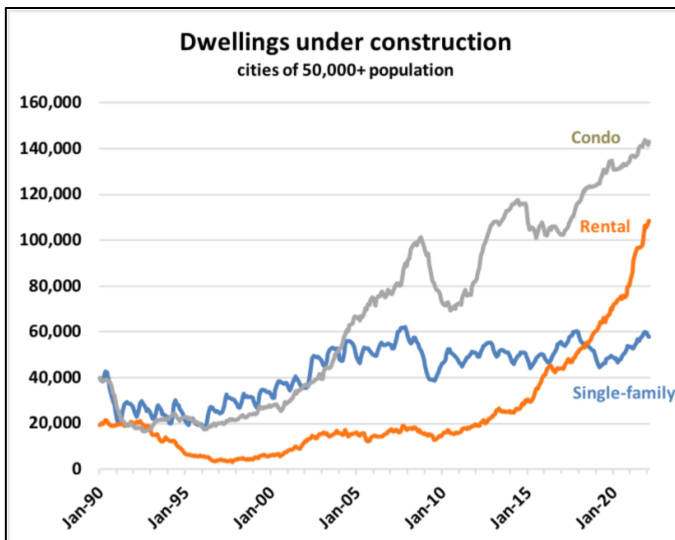
On the supply side, housing starts have cooled in recent months, with the 6-month trend falling to 252,000 annualized from a high of 291,000 in the middle of last year. Note below that the trend in single-family starts is well off the 2021 recent highs and is now back to slightly below average for the past 10 years.

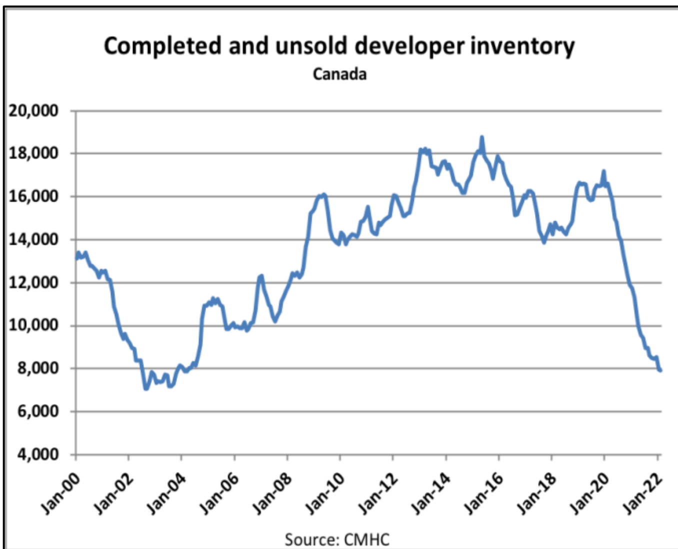




Dwellings under construction hit fresh all-time highs in February, but again the issue is in composition. Lots of condos and rentals, not enough single-family:



One more data point to hammer this point home. The number of completed and unsold homes in Canada hit a new 18-year low last month. If developers can build it, it's getting snapped up. This points to a continued under-supply of new homes, particularly in the single-family segment.

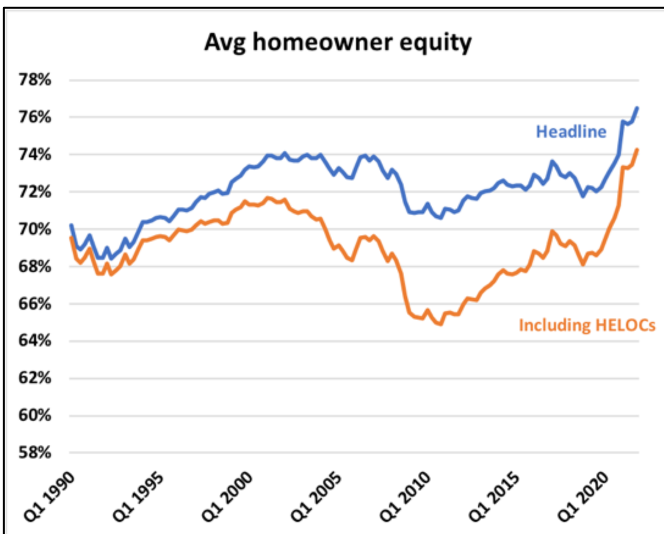


5) Household credit update: Insolvencies stable, balance sheets look solid

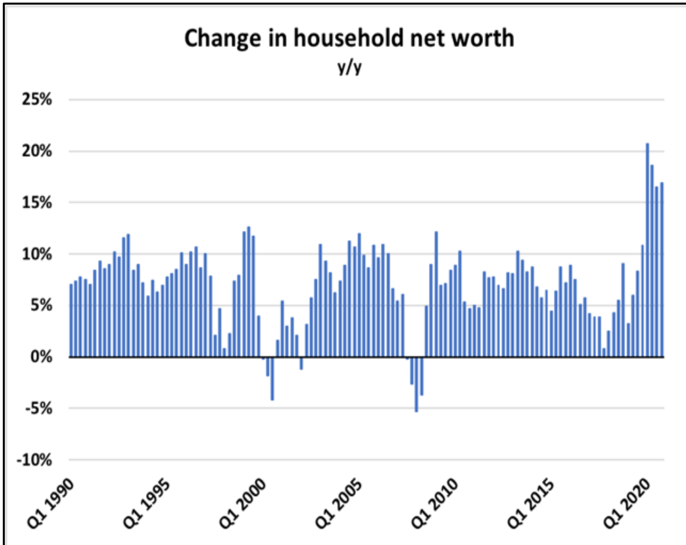
i) Household balance sheets still look very solid in Q4

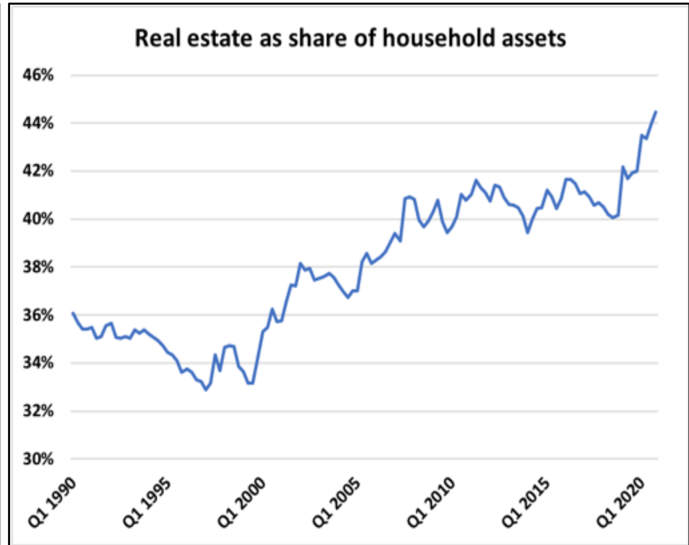
Some tidbits from the Q4 balance sheet data:

- Homeowner equity hit new all-time highs at nearly 77% (74% once HELOCs are included). That means that the average homeowner has a mortgage worth 23% of the value of the home. Now that's a bit of a wonky stat since roughly a third of homeowners have no mortgage at all, but it's still notable that the value of homes is outpacing the growth in mortgage debt.

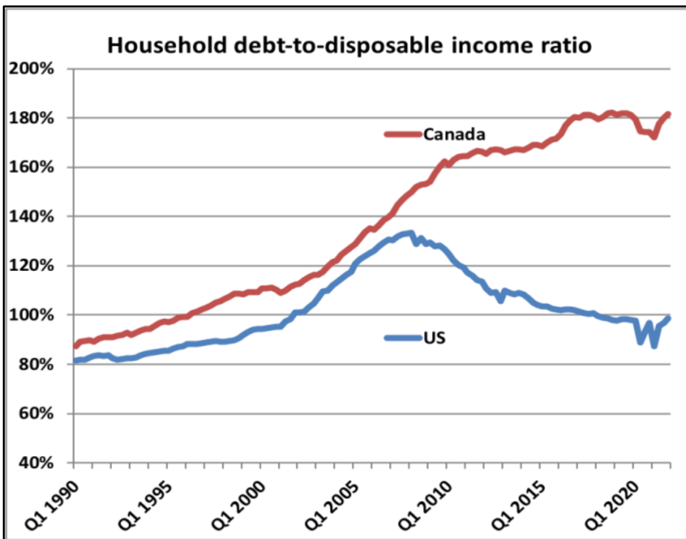


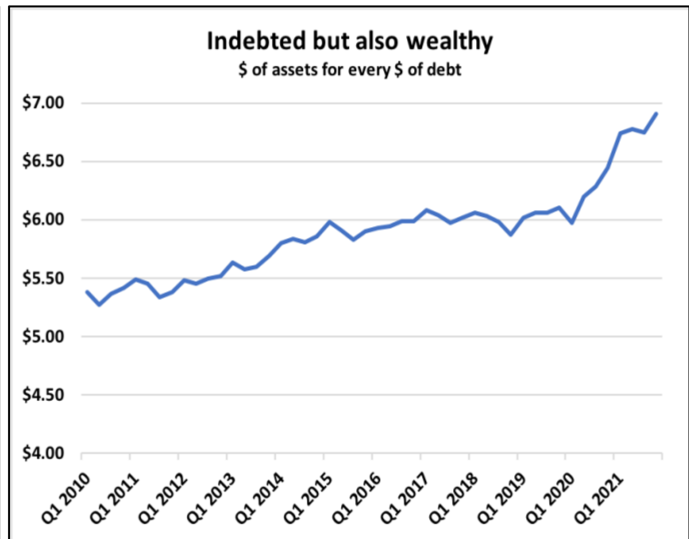
- Household net worth surged by nearly 17% y/y. Real estate hit a record share of household assets. That's good as long as prices remains stable, but it raises the risk of a sharp slowdown in consumer spending if prices fall.



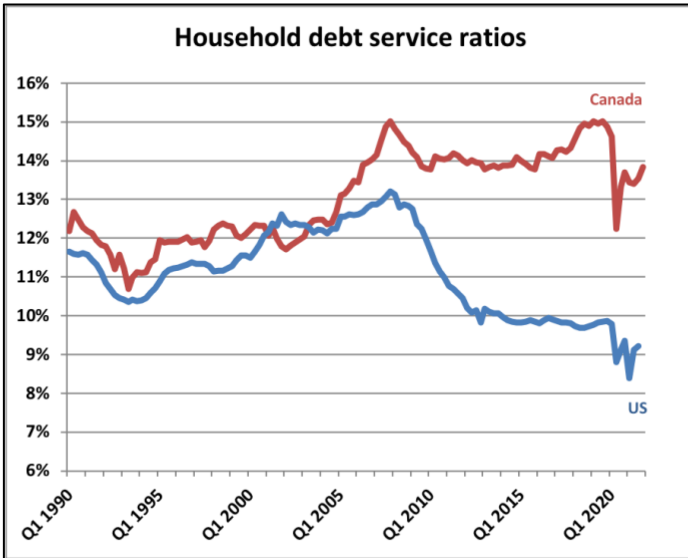


- Debt-to-income ratios ticked up to 180%, but Canadians have nearly $7 in assets for every dollar of debt owed, and that figure keeps rising.



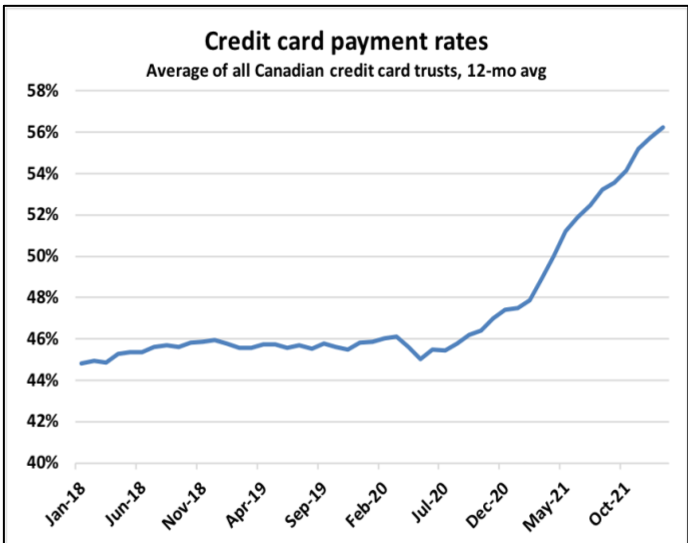


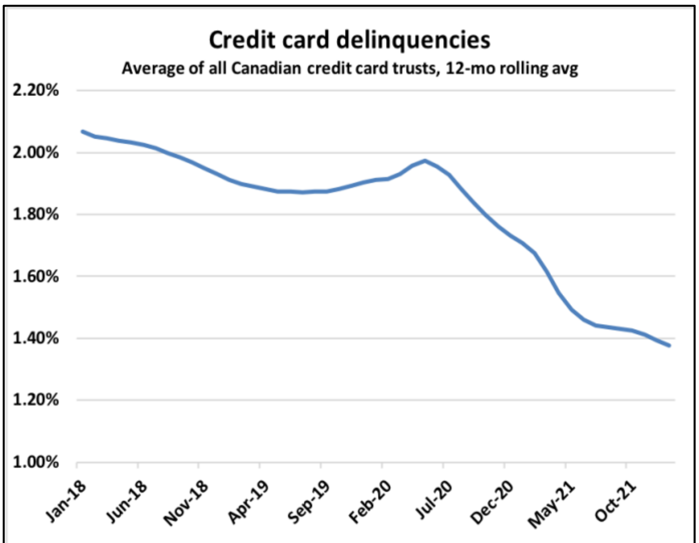
- The debt service ratio ticked up to just under 14% but remains well above pre-pandemic levels (for now!). This is one measure that I'll be watching closely in coming quarters since a rising debt service ratio has a very tight correlation to higher delinquencies down the road.



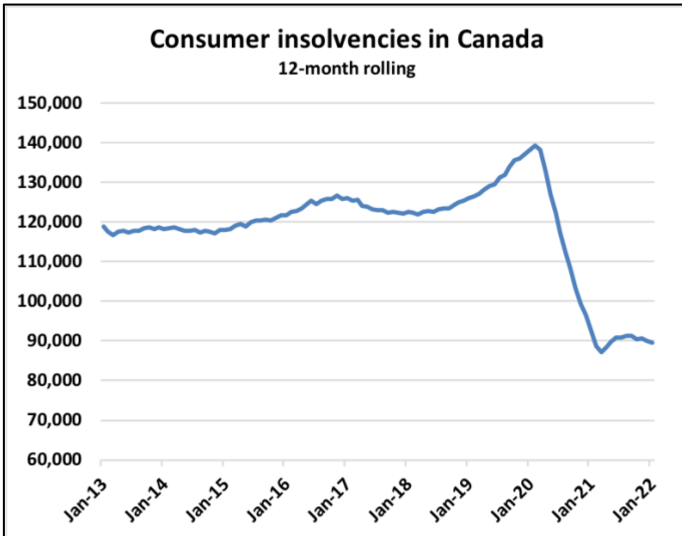
ii) Still no signs of stress among borrowers

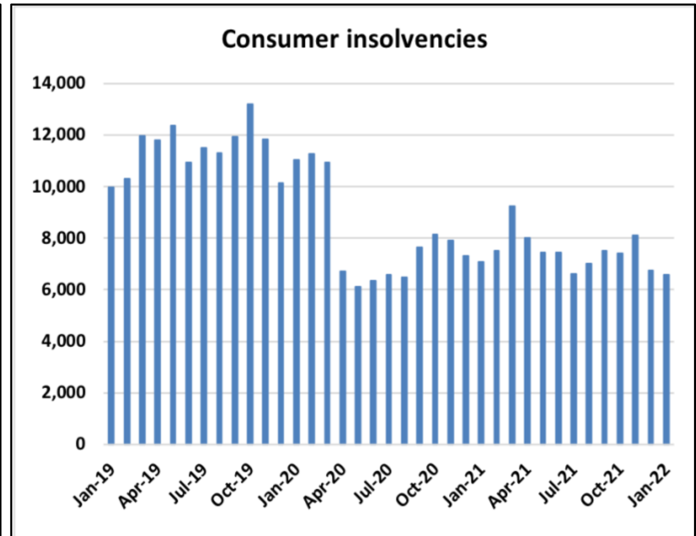
There are still no signs of stress in credit card trust data. Payment rates continue to hit fresh highs while delinquencies are still trending lower. Until this changes materially, there's little risk that we'll see a significant increase in mortgage delinquencies:





Consumer insolvencies fell 4.3% y/y nationally in February, led by a 7% decline in Ontario.

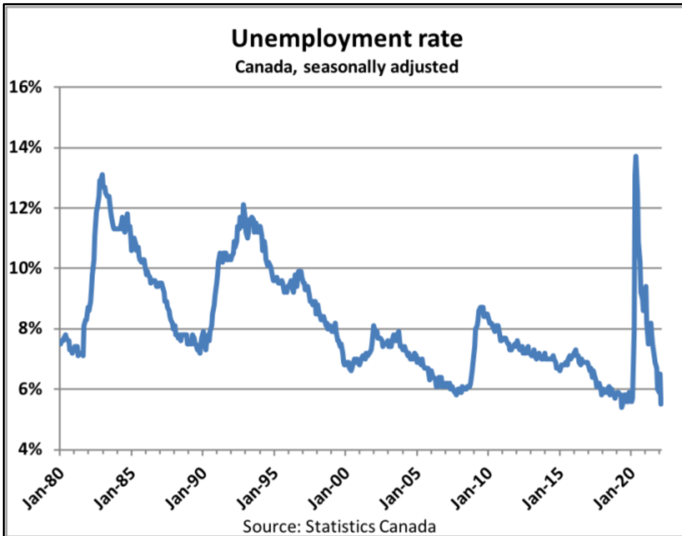




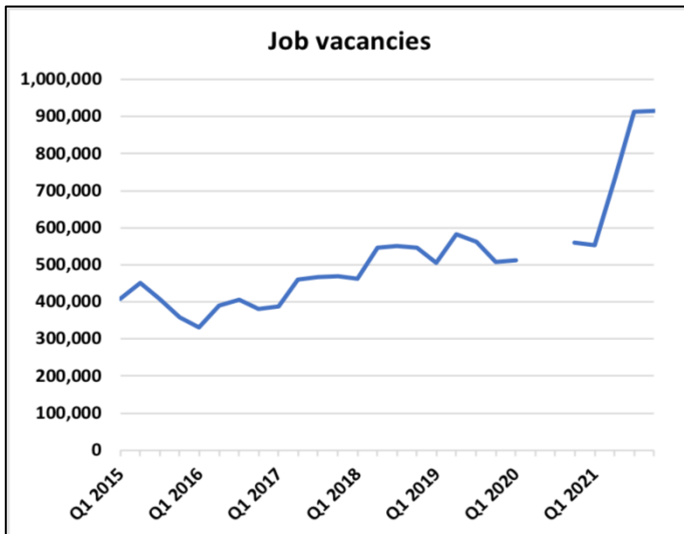
iii) Macro backdrop still looks solid

Canada's job market continues to perform well, adding nearly 340k new positions in February and fully recovering the 200k lost jobs in January amid the Omicron surge.

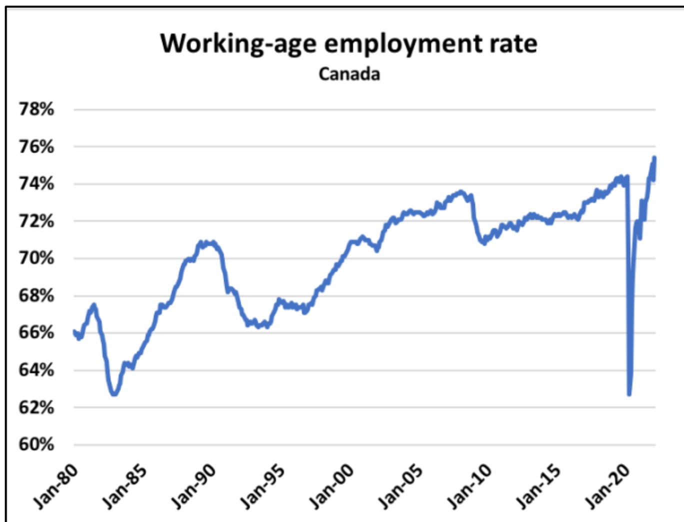
The unemployment rate fell by 1.0% to just 5.5% overall, the second lowest reading on record:



Meanwhile job vacancies jumped again in Q4 to hit over 900,000 across the country:



The working-age employment rate set a fresh all-time high of 75.4% in February which again begs the question of where the workers will come from to fill these vacancies.

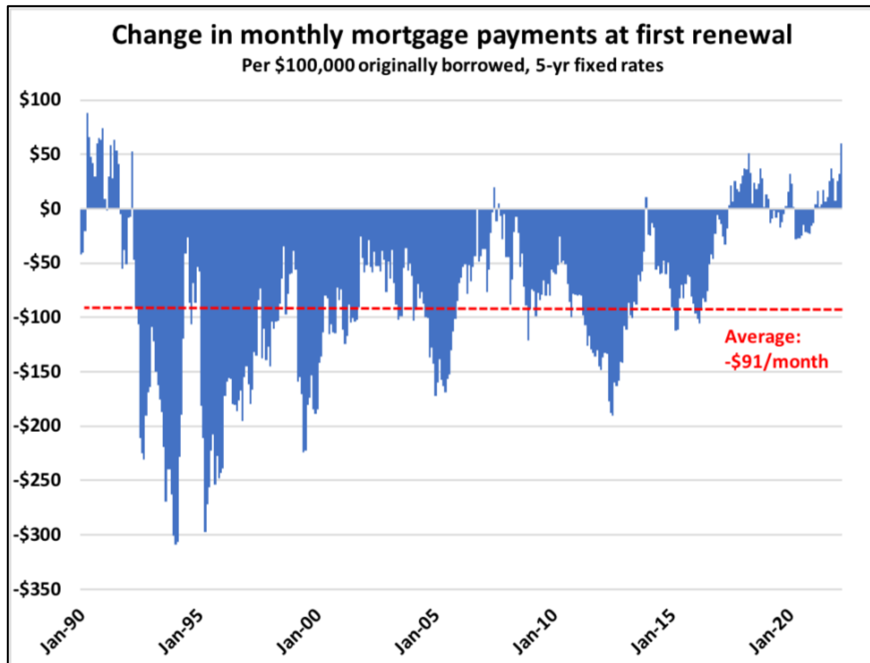


A sharp increase in wage growth this year still looks likely and will cushion some of the impact of rising rates. Already we're beginning to see it in wages offered on new positions according to Stats Canada:

> […] According to results from the Canadian Survey on Business Conditions conducted from October to early November 2021, 25.1% of businesses reported having a plan to increase wages offered to new employees to address obstacles related to hiring and recruitment.
>
> The results from the Job Vacancy and Wage Survey show that overall, average offered hourly wages increased 1.8% (0.8 percentage points more than the increase in the Consumer Price Index [CPI]) from the third to the fourth quarter of 2021 and were up 5.5% (on par with the CPI) since the fourth quarter of 2019.

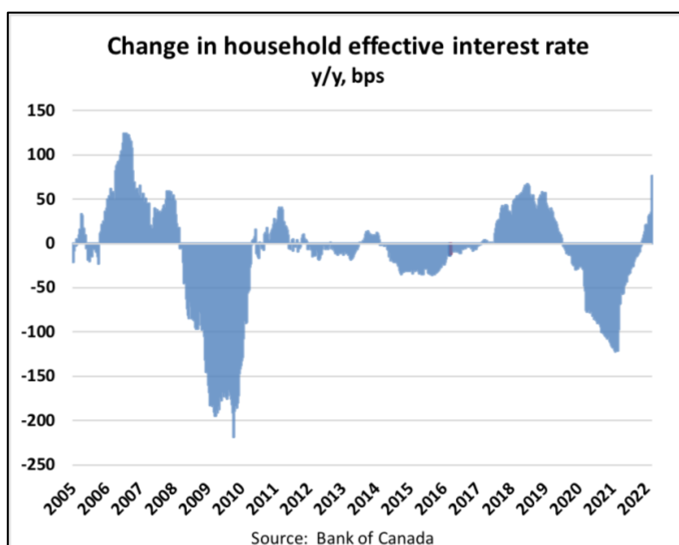
iv) BUT….borrowers are beginning to feel the pinch of rising rates

The mortgage renewal gap has hit the highest level since the early 1990s. This metric measures the change in monthly payments on fixed rate mortgages at first renewal for every $100,000 originally borrowed. The latest reading puts the gap at $60, which means a borrower who took out a $400,000 fixed rate mortgage in March 2017 is facing an increase in payments of $240 per month if they opt for the same term today:

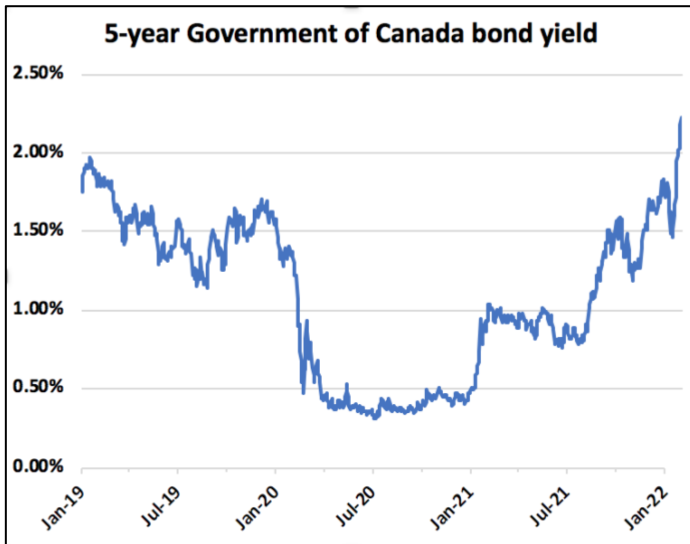


This is not a perfect measure since borrowers can potentially re-extend amortization or switch to variable rates (current variable rates are still roughly 80bps below where fixed rates were 5 years ago). Still, it's a good indicator of general payment trends at renewal.

Further to that point, the household effective interest rate (the weighted average rate paid across all mortgage and consumer debt) is now seeing the steepest annual increase since 2005, and this trend may get considerably worse from here.

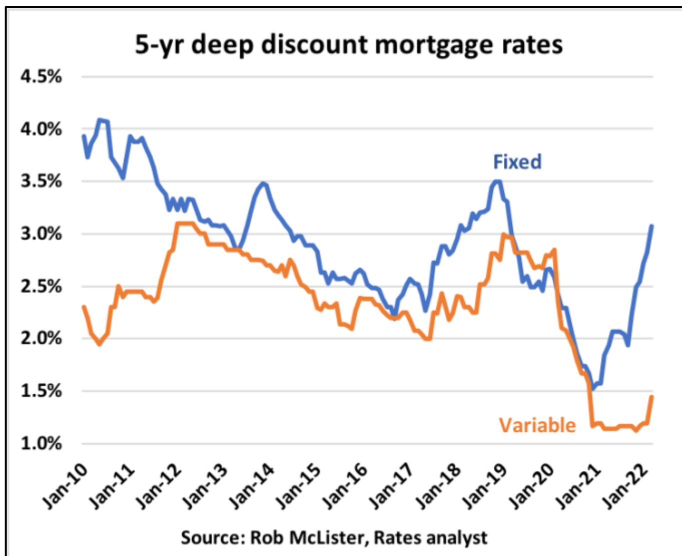


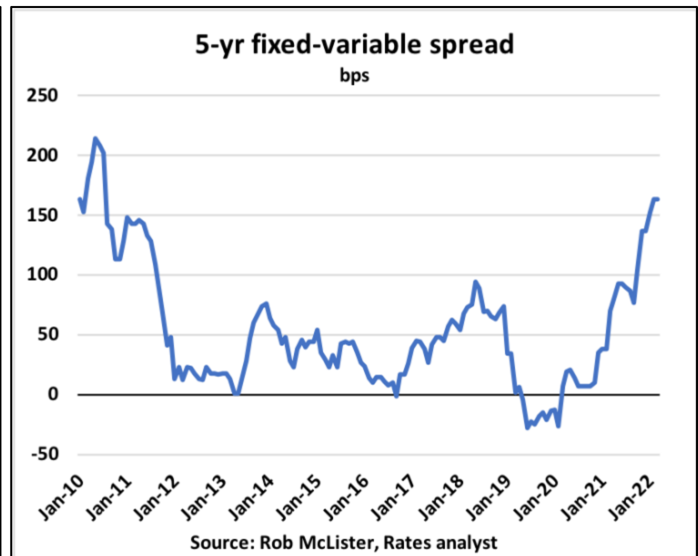
5-year bond yields are surging and have now seen the sharpest 1-month increase in over 20 years!



That's flowing through to fixed rate mortgages, which are now seeing rates rise almost daily.

The best discounted 5-yr fixed mortgage rate available today is 3.07%, up 113bps from the September 2021 lows. The average rate is closer to 3.4%, up 130 bps off the lows. The best discounted variable is 1.44% with most big banks closer to 1.95%. That still leaves fixed rates at a substantial premium of roughly 160bps over variable:

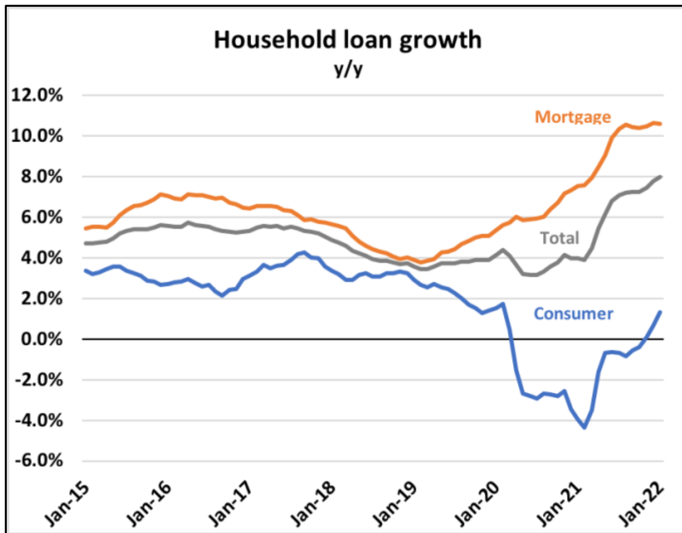


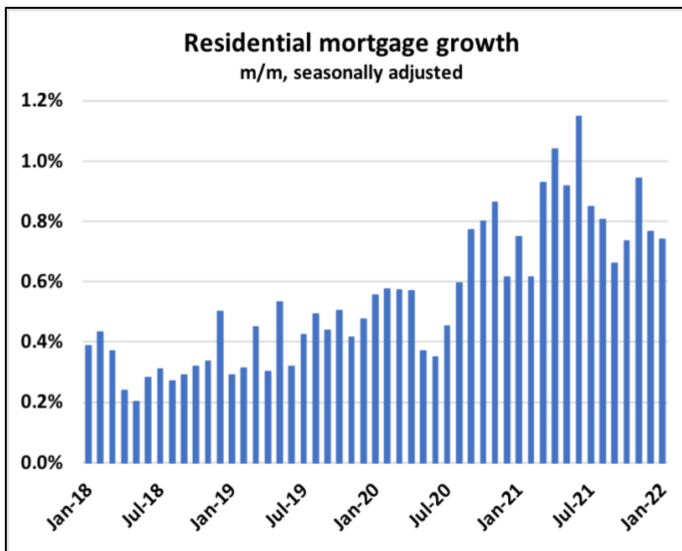


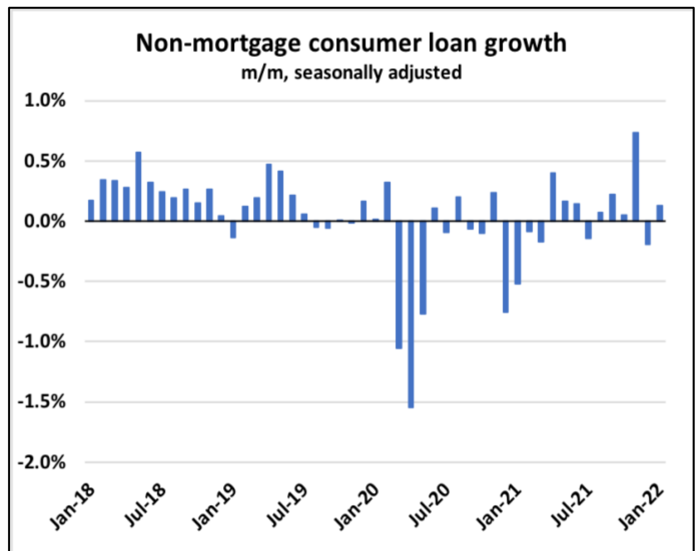
6) Mortgage market update: Variable accounts for 60% of new mortgages

i) Household credit growth hits highest since 2009

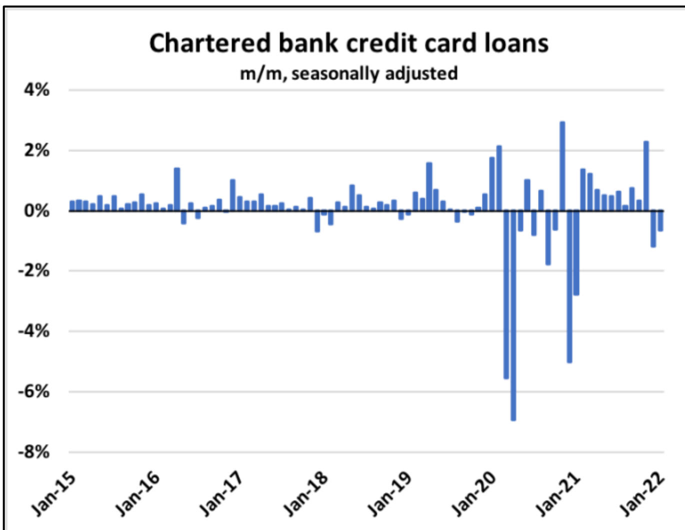
Household loan growth hit 8% y/y in January, the highest clip since 2009. Mortgage growth was 10.6% y/y (+0.7% m/m) while non-mortgage credit rose by 1.6% y/y (0.1% m/m):



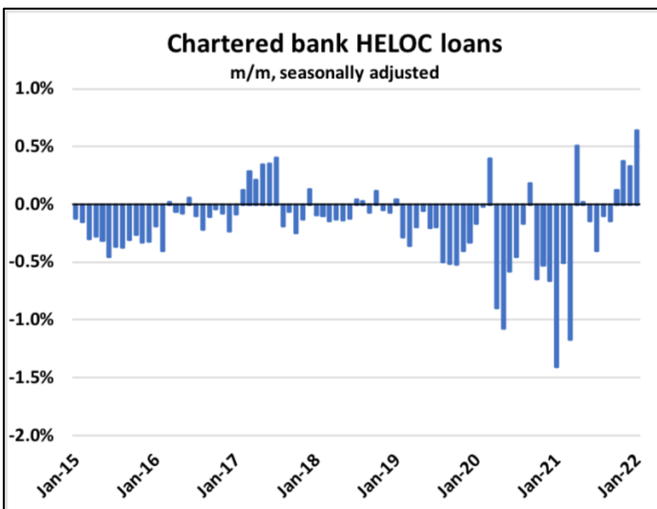




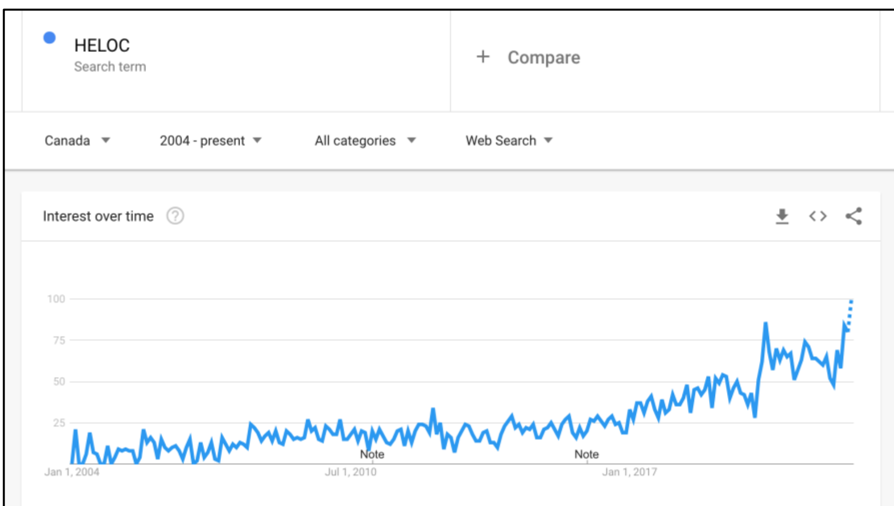
Consumer credit has been constrained by weak growth in card balances which have now declined for two consecutive months for the first time in a year:



HELOC balances continue to grow and were up 0.6% m/m in January, the largest monthly increase since 2012.

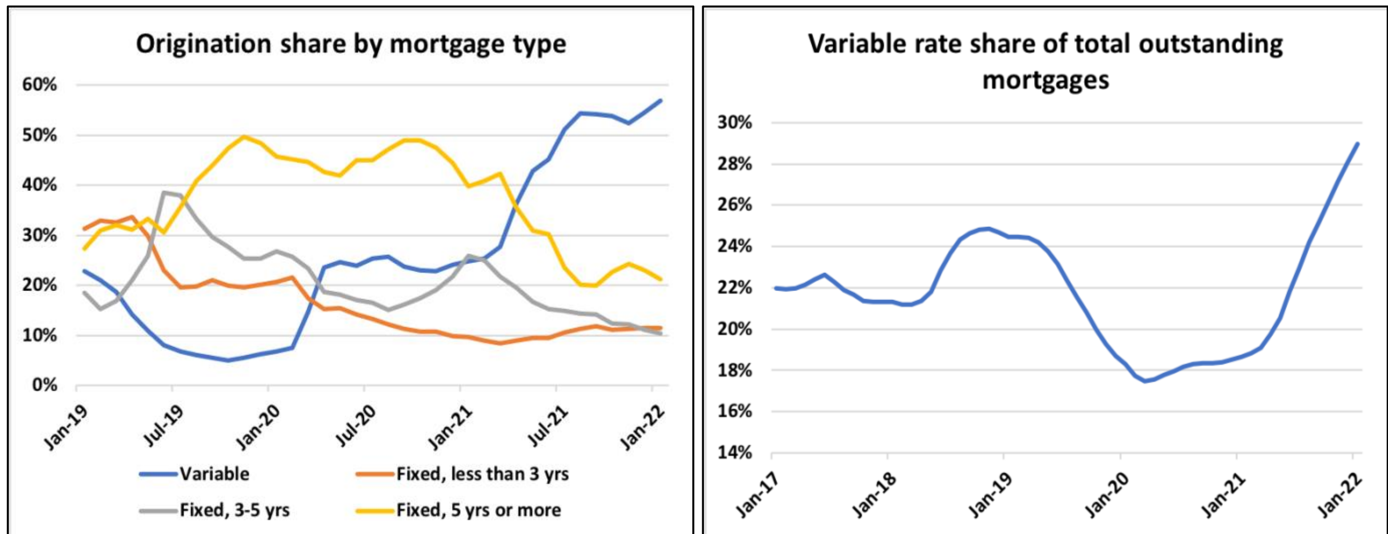


That trend may just be getting started. The typical home has risen by $200,000 in the past year, and average owner equity is at record highs, so it's perhaps not surprising that Google searches for the term "HELOC" in Canada are trending to record highs:



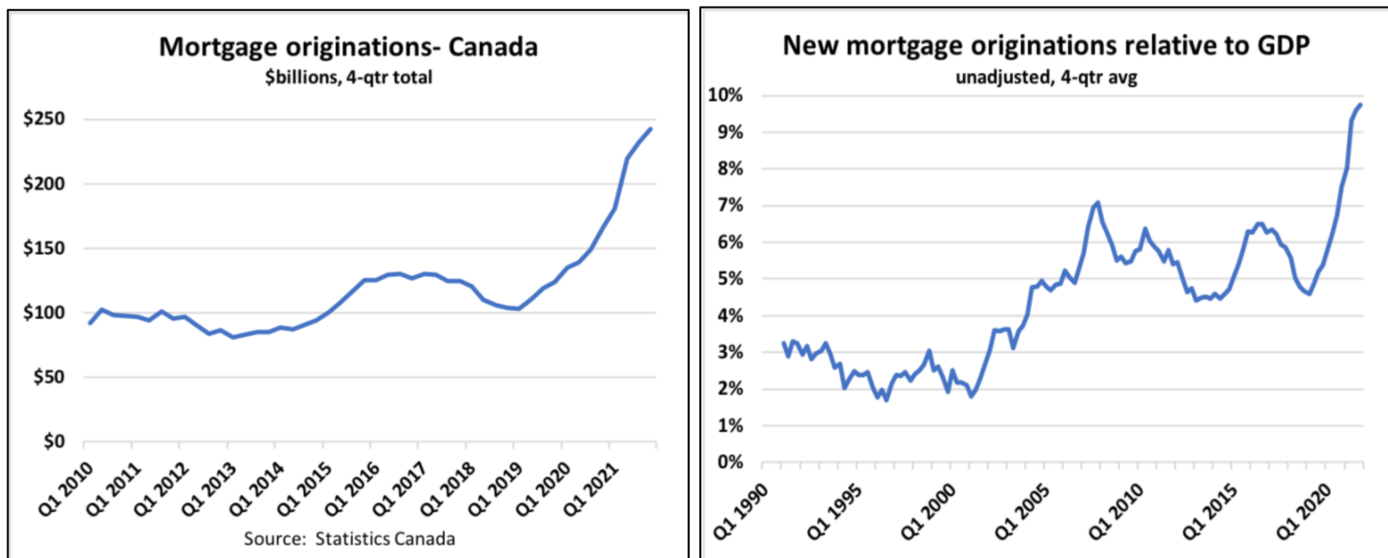
ii) Surge in demand for variable rate products

The popularity of variable rate products continues to rise even with the threat of further rate hikes. Variable originations surged 97% y/y in January. They accounted for 57% of new mortgages and are now nearly 30% of all mortgage balances outstanding.



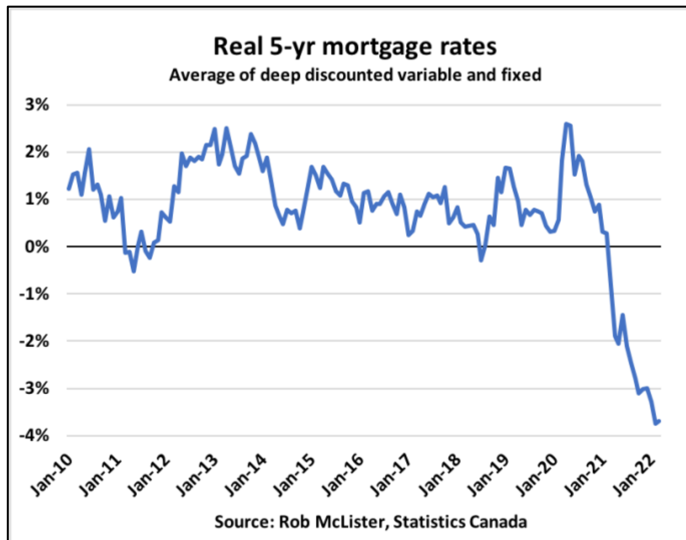
iii) Originations hit record in Q4

The latest data from Stats Canada suggests that mortgage originations (including purchase, renewal, and refinancing) rose 8% q/q seasonally adjusted in Q4 and were up 19% y/y. They now sit at the equivalent of 9.7% of GDP over the past 4 quarters, a record by a wide margin.



iv) Real rates still deeply negative

Even with the recent runup, mortgage rates remain way below the rate of inflation..



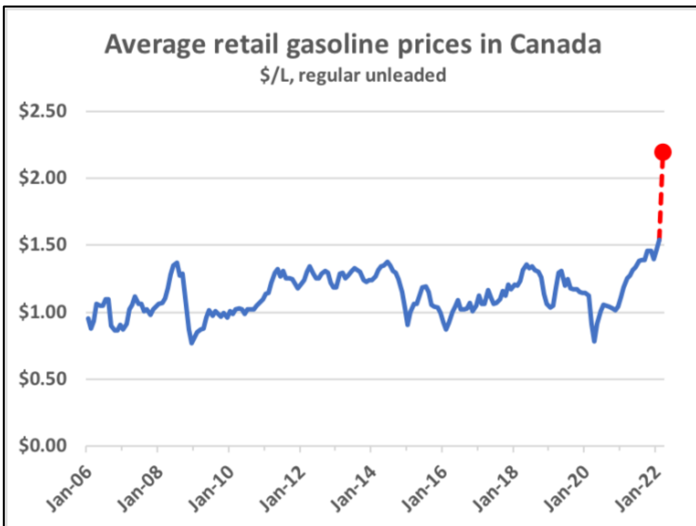
7) Monitoring key risks

i) Russia/Ukraine conflict could create food security issues

I'm going to set aside the risk of nuclear escalation for now. It's sad and more than a little unnerving that this is no longer a near-zero probability (although it's still exceptionally unlikely), but I just have no ability to quantify what that sort of outcome could mean. So for now I'll stick to what I think are the primary impacts of the war on us here in Canada….namely a sharp increase in fuel and food costs.

The potential loss of 3 million barrels per day of Russian crude exports is a major risk to global energy markets, particularly given the magnitude of underinvestment in global energy infrastructure over the past 5 years which will limit the ability of other producing nations to rapidly offset to loss of these barrels.

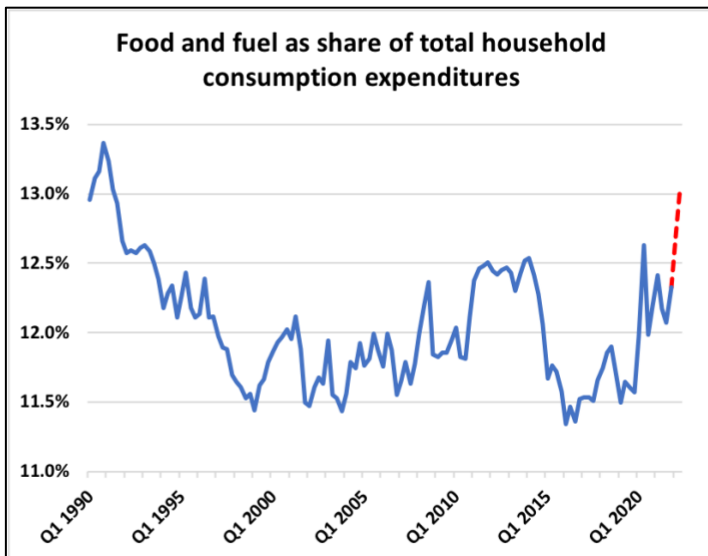
At this point it looks much more likely that oil pushes to $150 or even $200 per barrel than a retracement back to $60. That could mean record prices at the pumps when we hit the key driving season this summer. Even $125 oil would push gasoline prices to a record of roughly $2.25/liter, and I think it's very likely we get there within a couple months.



The other, potentially bigger issue relates to food security. Russia and Ukraine are among the largest producers and exporters of critical agricultural commodities. The disruption in exports and a potential complete loss of the spring planting season in Ukraine represent an enormous shock to global food supplies. The price of corn and wheat have more than doubled since 2020 and risk going higher still:

We're also seeing a massive increase in fertilizer prices, in part due to a shortage of natural gas, a key input into nitrogen based fertilizer production. The CRU Fertilizer Price Index has risen by 200% in the past year alone. We'll almost certainly see lower fertilizer use by farmers this year which risks lower crop yields and a further tightening of global grain balances.

As it relates to Canadian households, we're about to see the highest share of total expenditures on food and fuel since the early 1990s….and that means fewer dollars left to be spent in other areas:



What we're seeing in food and energy prices may be the equivalent of another 50-100bp tightening by the Bank of Canada in terms of the impact on household finances.

This is an inconvenience for Canadians, but it will be a crisis in the third world, and I fear we'll see social unrest in many parts of the world later this year.

ii) Mortgage regulation changes

I still think it's very likely that we see a tightening of financing on investment and recreational properties, with the most likely outcome being a minimum down payment of 30%. Less likely but very much on the table would be a limitation on the ability to use borrowed funds as down payment….ie the death of the BRRR model

I testified at the Standing Committee on Finance this week where several members asked questions related to this exact topic. It's clearly something being discussed, and I'd expect to see an announcement in the next couple months.

Regards,
Ben

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