The Edge Report

November 2022

Hyperlinks:

Key takeaways:

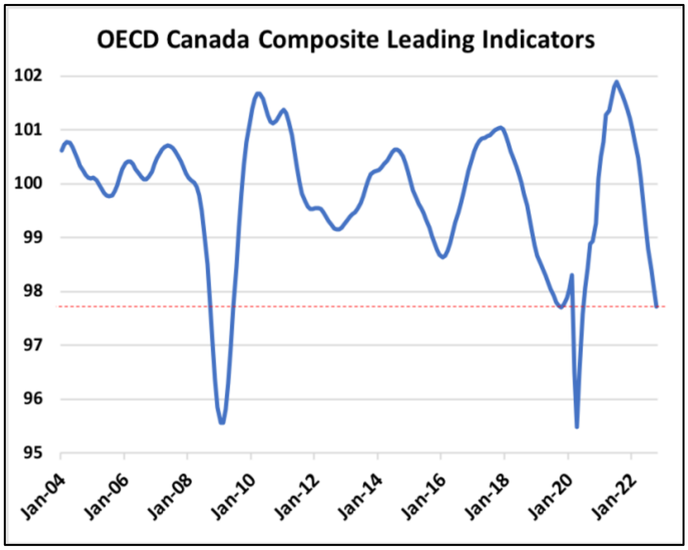
- The risk of recession in 2023 is very high and rising.
- Fixed mortgage rates have likely peaked even if the Bank of Canada hikes a couple more times.
- Home sales remain depressed but have likely bottomed.
- All eyes should now be on resale supply, particularly as we get closer to the spring.
- House prices will likely grind sideways over the winter before we get a more definitive move early next year.
- Population growth remains exceptionally strong though it may have peaked in the near-term.
- It may not be evident now, but we're still not building enough housing. That likely sets the stage for the next supply crisis several years out.
- Stress among consumers is rising quickly but from a very low base.
- Forward-looking indicators of mortgage stress are beginning to mount, and we should expect to see a material increase in mortgage delinquencies next year.

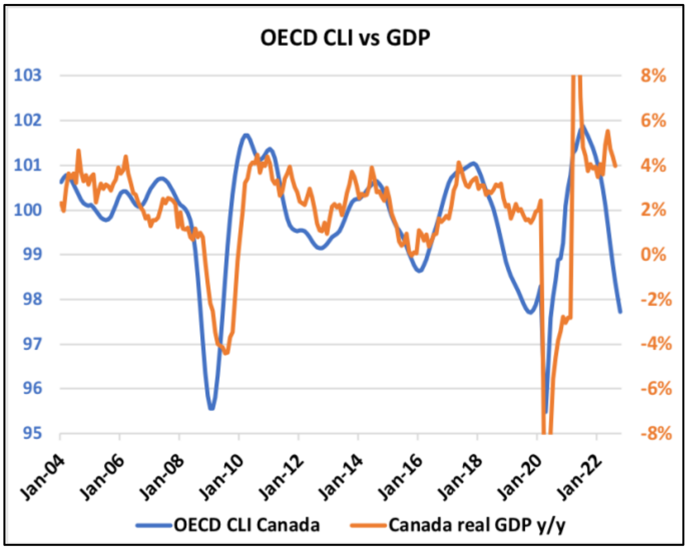
1) Mounting recession risks put downward pressure on rates

i) Big GDP miss on deck?

We may have seen a surprisingly strong jobs report earlier this month (+108k jobs created vs 10k expected) but make no mistake, recessions risks are growing.

Consider the OECD's Composite Leading Indicators which predict economic activity 1-2 quarters out. They have fallen to levels seen in early 2020 and in 2008-2009. It's looking increasingly likely that Canada is facing not just a recession but potentially a very steep one at that:

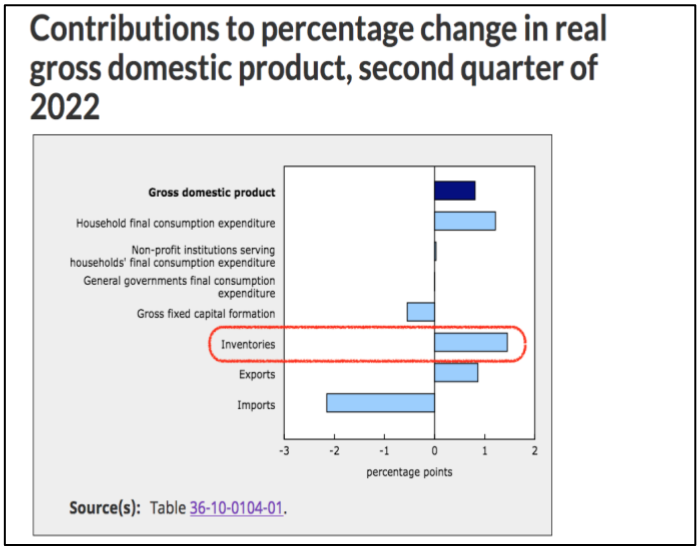


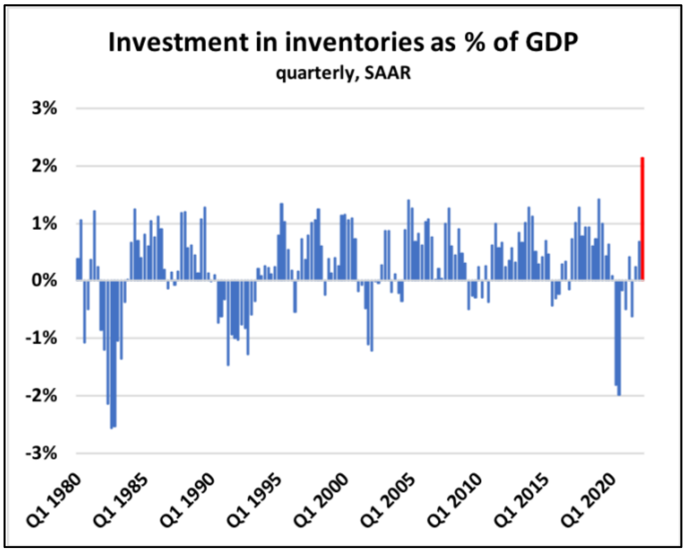


Next week we'll be getting the Q3 GDP report. Markets are expecting a roughly 1% annualized growth rate, which is probably a bit optimistic. But the big concerns is for Q4 and into 2023.

This will be a bit technical and in the weeds, so feel free to jump ahead for housing-related commentary, but I think it's worth understanding some important dynamics.

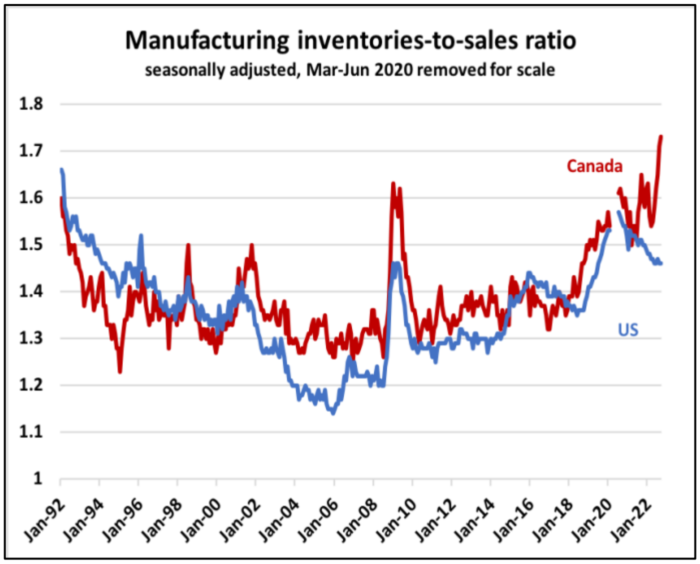
Q2 GDP surprised to the upside, coming in at 3.3% annualized. BUT, those figures were helped massively by a bump in household consumption and the largest investment in inventories on record. <u>Absent the latter, we would have been facing a 5% annualized contraction on the quarter:</u>

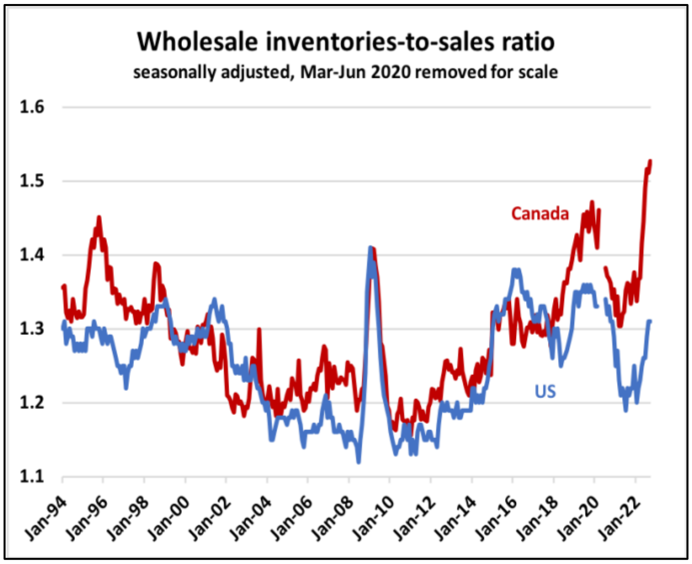




When businesses build inventories, it's positive in the GDP accounts. But over time, inventories net to zero. In some quarters they build, others they draw.

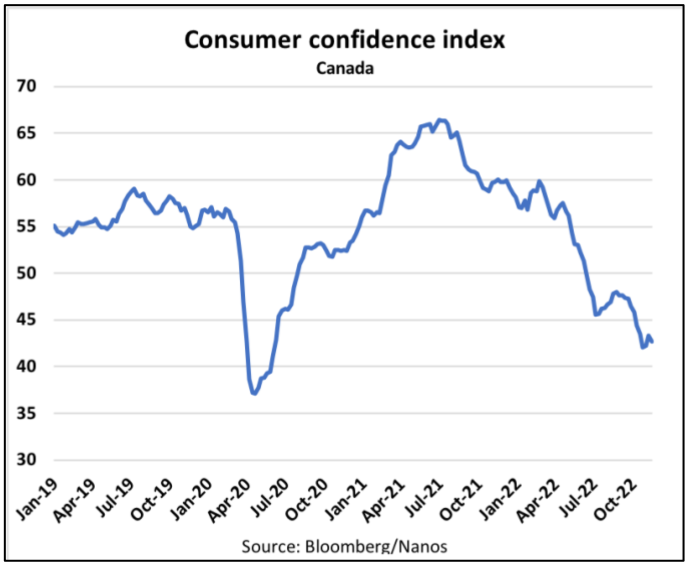
This is important since the inventory situation in Canada is getting a bit extreme, not only compared to anything we've seen in the past, but also compared to our neighbors to the south. Shown below is the inventories-to-sales ratios for manufacturers and wholesalers (the middle-men between manufacturers and retailers). In both cases, we're sitting on record amounts of inventory relative to underlying demand which means at some point (and likely very soon) these will be drawn down.

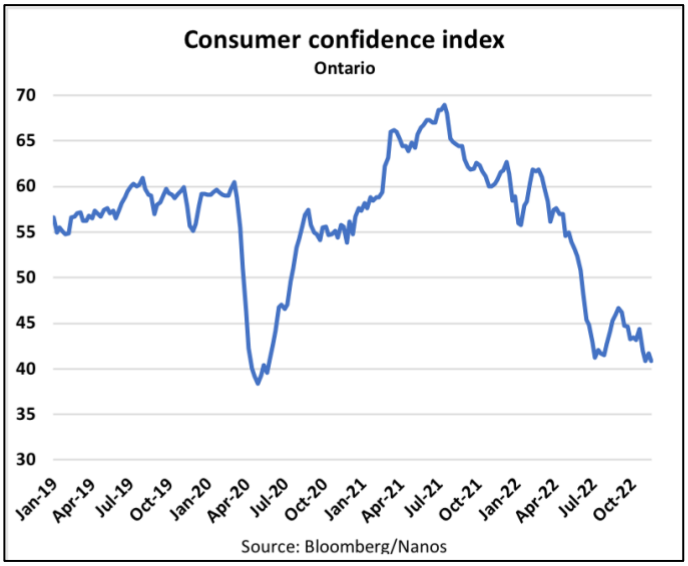




At the same time, household consumption and residential investment, which have provided the lion's share of GDP growth coming out of the COVID recession, are under serious pressure.

Canadian consumer confidence remains stunningly weak, notably in Ontario where it continues to bleed and is now only marginally above the pandemic low. That's not a good read-through to household consumption:





Real estate expectations also remain under pressure but have ticked up marginally in the past couple weeks:

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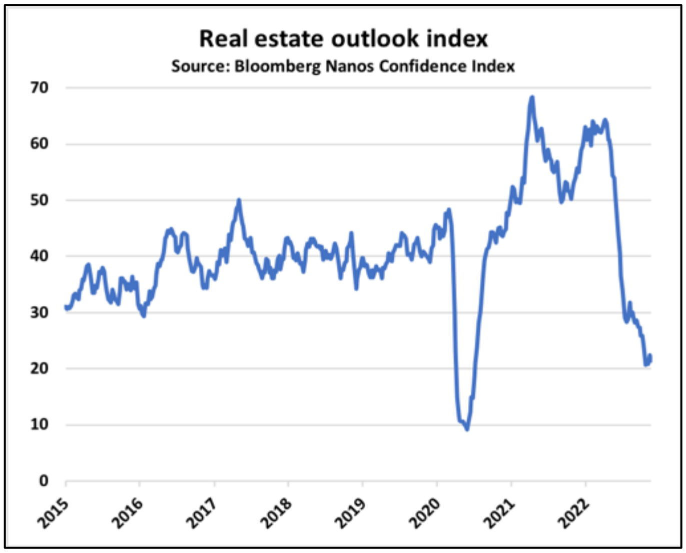


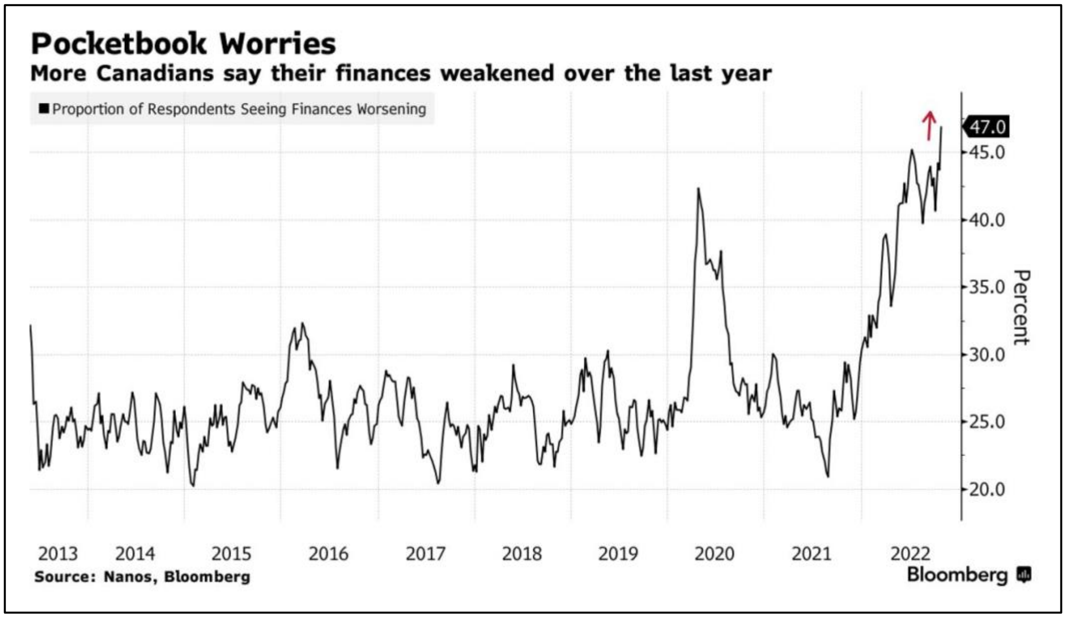
Importantly, we're starting to see weakness migrating from future expectations into current measures of personal finances. In other words, it's no longer about concerns around the future but rather a current deterioration in finances. Consider:

Canadians Have Never Felt Worse About Their Finances, Poll Shows *-Bloomberg*[1]

Canadians say their personal finances haven't been this bad in more than a decade, as they cope with falling prices for homes and rising prices for everything else.

In weekly polling by Nanos Research for Bloomberg News, 47% of respondents said their finances have worsened over the past year.

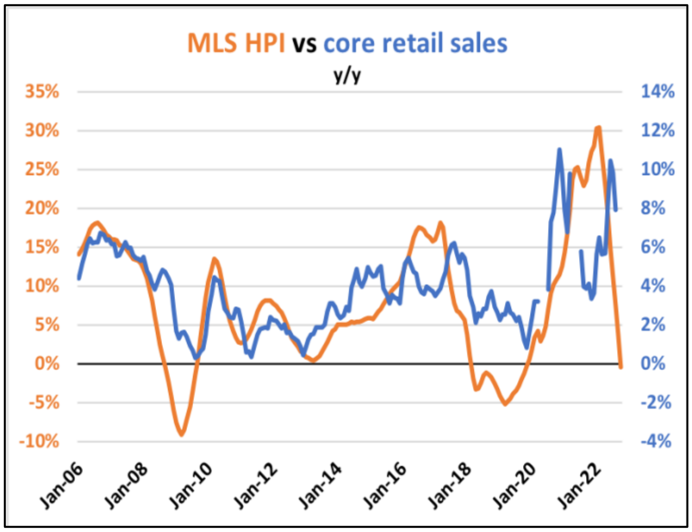
That's the highest-ever reading for this question in surveys going back to 2008, surpassing the depths of the pandemic and the global financial crisis. Only 13% said their finances have improved.



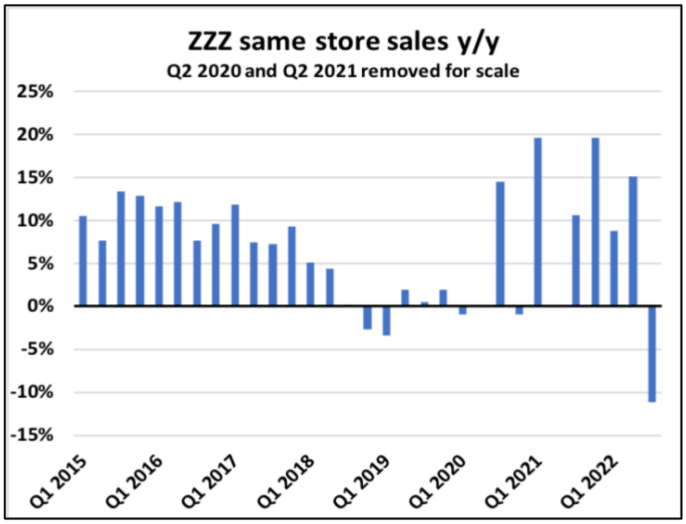
[1] https://www.bloomberg.com/news/articles/2022-10-31/canadians-have-never-felt-worse-about-their-finances-poll-shows

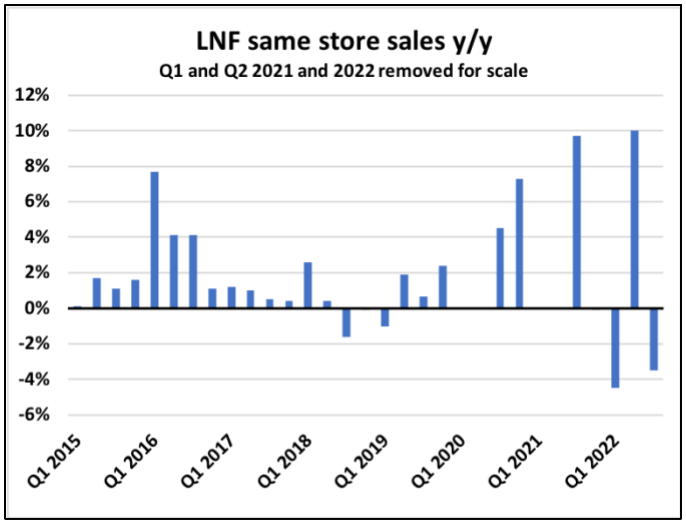
Between falling confidence and declining house prices (more on that below), it's not looking great for consumer spending over the next couple quarters.

Falling house prices act as a drag on consumption via lower wealth effect spending (ie people spend more when they feel wealthier and vice versa). The MLS House Price Index is now negative on a y/y basis for the first time since 2019, which is notable given its history of leading the trend in core retail sales:

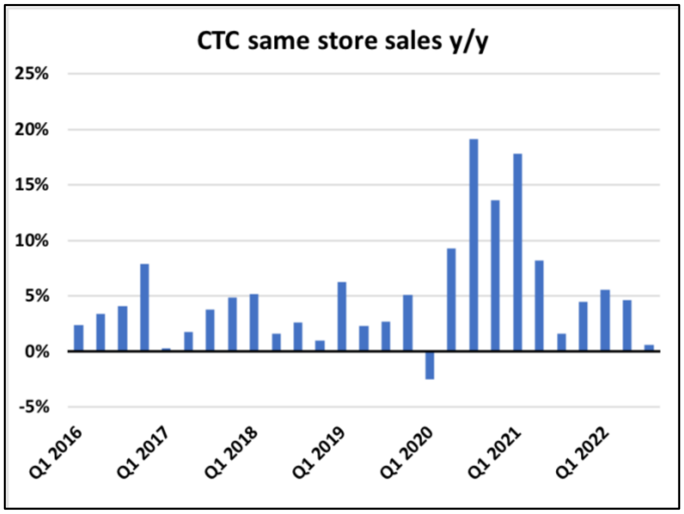


This is not a hypothetical either. Retail sales fell 1.3% in Q3, the steepest non-lockdown related decline in 5 years. And we're also seeing weakness in same store sales at some of the more discretionary-focused retailers. Consider the latest from Sleep Country and Leon's Furniture which both reported last week:





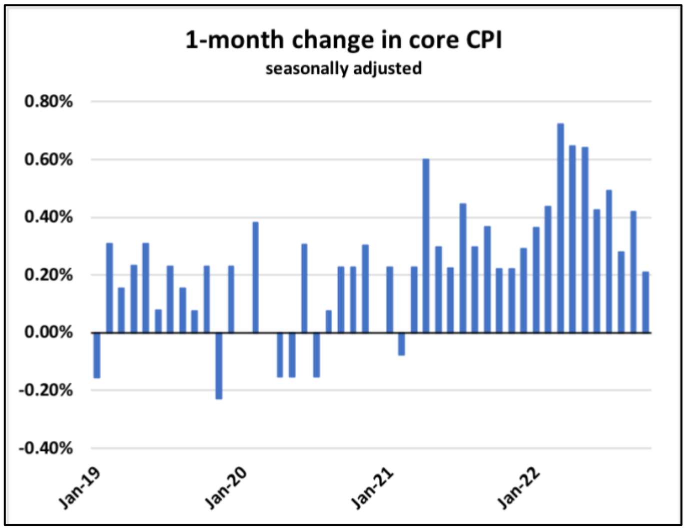
Over at Canadian Tire, same store sales are still positive y/y but are showing the weakest growth since 2017 (notwithstanding early 2020):



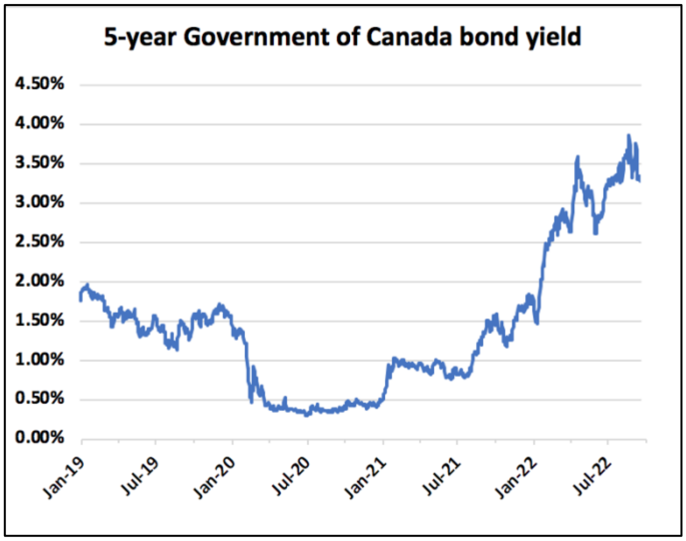
ii) Weak core CPI print brings bond yield relief

Take that weak macro outlook and then throw in a surprisingly weak CPI print and you get a recipe for a violent reversal in bond yields.

Yes, headline inflation came in at 6.9% y/y in October (in line with expectations and unchanged from September) but the real story is in the seasonally adjusted core CPI which registered just a 0.2% monthly increase…the lowest since early 2021:



And since this is the main focus of the Bank of Canada, markets quickly priced in a softer outlook for interest rates. The key 5-yr bond yield plunged 50bps in basically a straight line:



That should bring some relief to fixed mortgage rates in coming weeks if rates hold here, and I think there's a reasonable case to be made that we may have seen the highs in bond yields for a while.

All that to say this: We're now at the point where the conversation should shift from how high rates will go to how deep the coming recession will be.

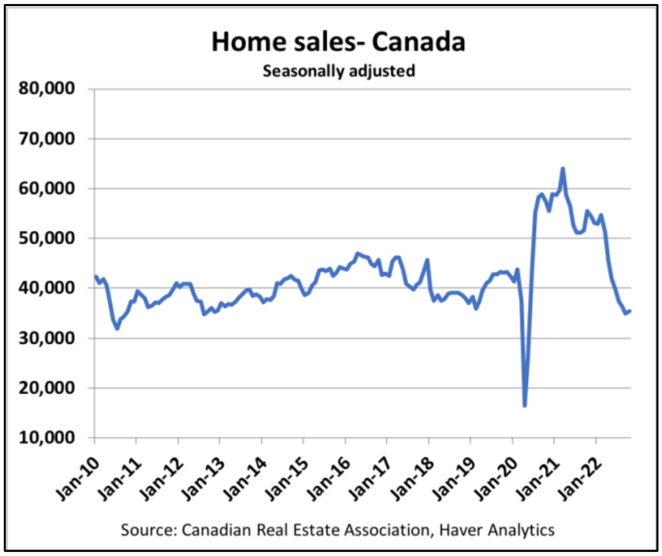
2) Takeaway from October home sales: Sales and inventory rise, prices grind lower

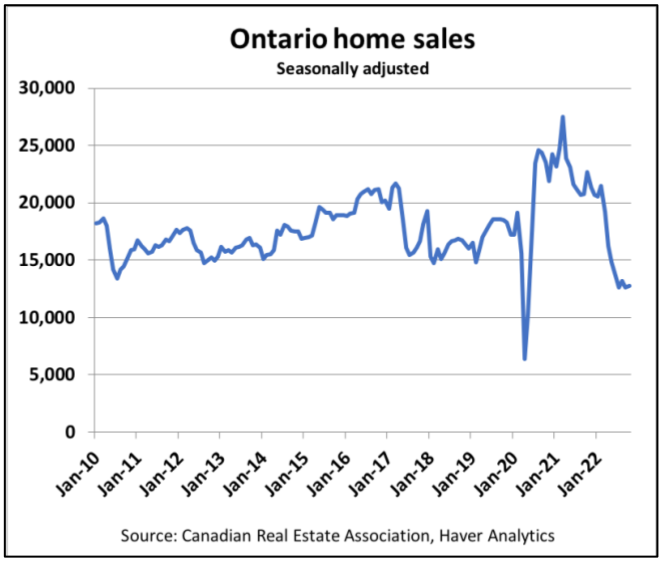
The key data from last month is summarized below.

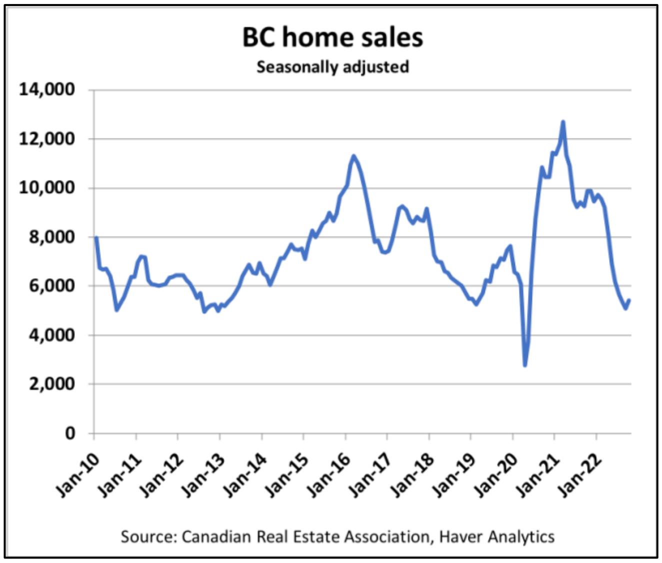
	Sales		New listings		Active inventory		House prices (HPI for Canada, average for provinces)	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	-36.3%	+1.1%	-1.6%	+2.5%	+33.1%	+2.3%	-0.4%	-1.2%
BC	-45.4%	+5.8%	-0.9%	+4.7%	+51.8%	+4.3%	-3.6%	-1.4%
AB	-20.1%	+2.2%	-6.1%	+0.4%	-7.0%	-1.9%	+2.0%	+0.1%
ON	-43.7%	+1.0%	-0.3%	+3.4%	+106.1%	+3.3%	-7.9%	-0.5%
QC	-29.8%	-2.4%	+3.1%	-1.4%	+31.9	+6.2%	+1.4%	-0.1%

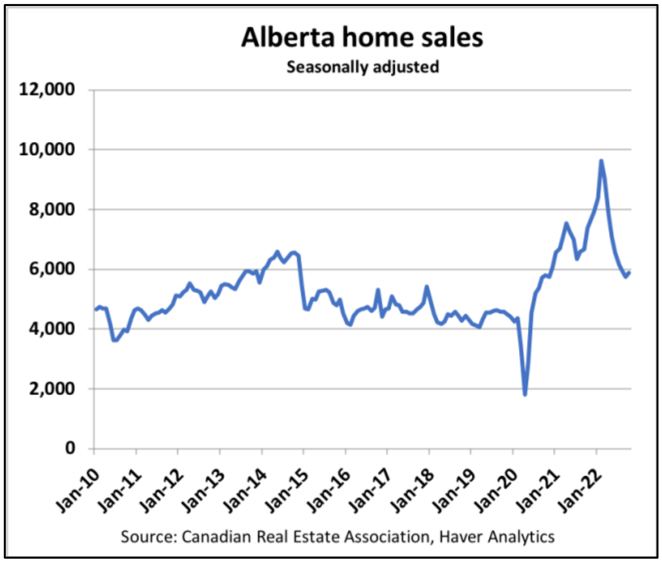
i) Sales rise in October

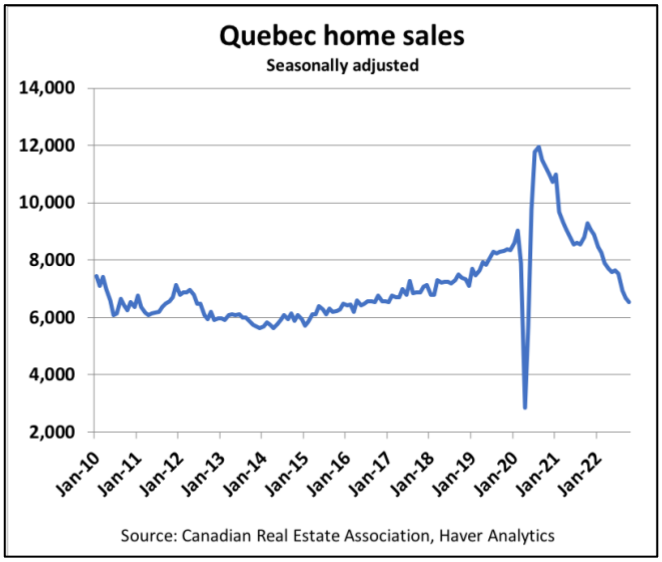
Canadian home sales ticked up 1.1% m/m in October, the first monthly increase since February. That still leaves sales down a massive 36% compared to last year at this time:









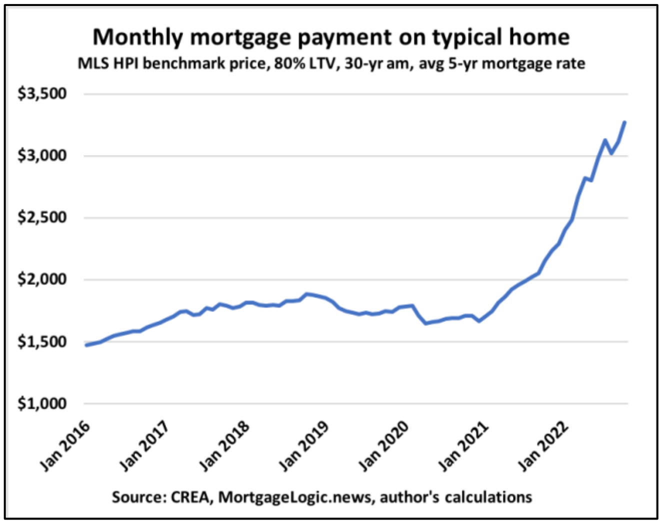


ii) Have sales bottomed?

Notwithstanding a severe economic downturn, there's probably not a whole lot further that sales can fall from here given record population growth (700,000 in the past year compared to 944,000 in the US….a country with 9x the population). Already key provinces like Ontario are seeing demand that is effectively at 1990s levels. It's simply not sustainable over the longer term.

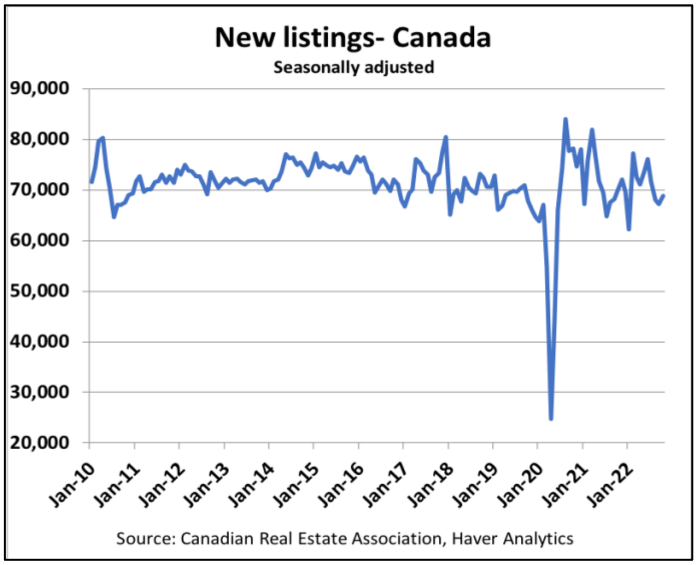
IF we can avoid a severe recession, and IF we get some stability in rates as the Bank of Canada nears the end of the current tightening cycle, we should see demand begin to creep back into the market. There are certainly some well qualified buyers who are simply waiting for clarity on rates before making a move.

That said, it's also difficult to envision a strong and sustained rebound in resale demand back to anywhere close to peak levels until severe affordability constraints begin to ease. Factoring in the latest data, mortgage payments required to purchase a home at prevailing prices and interest rates are now nearly double what they were in late 2020:

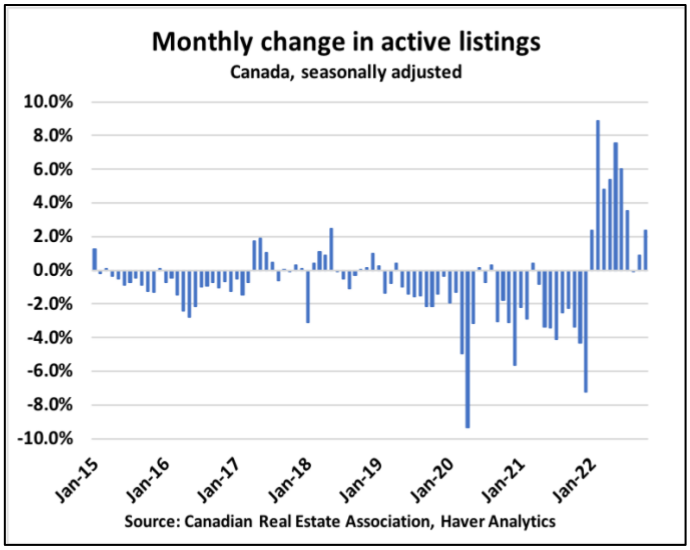


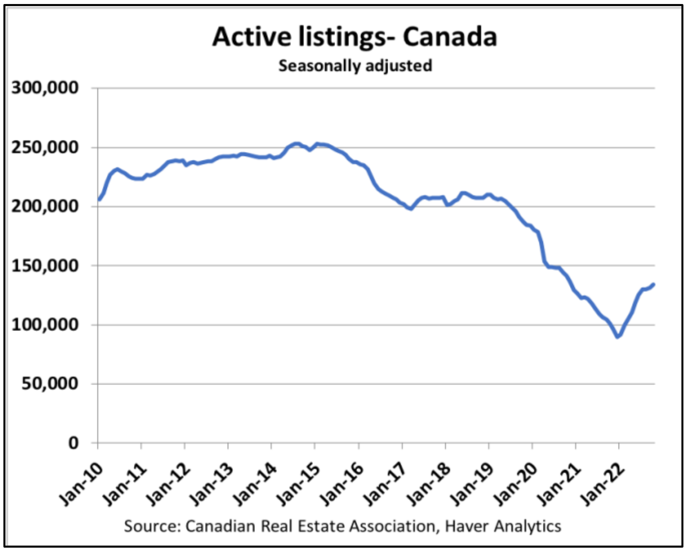
iii) Supply jumps

New listings ticked up 2.5% m/m in October lead by BC (+4.7%) and ON (+3.4%).

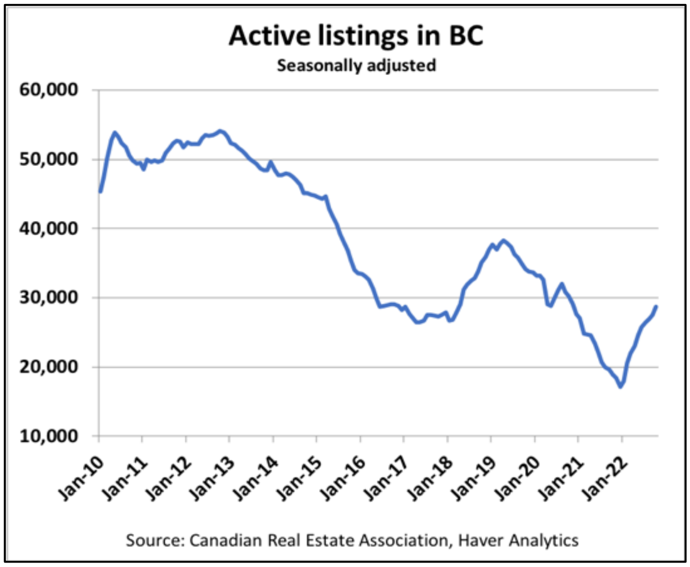


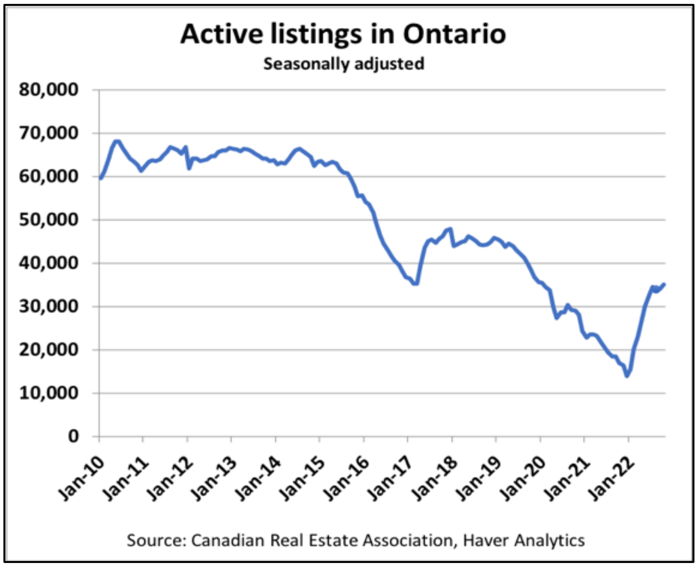
Perhaps more importantly, active inventory levels also rose 2.3% m/m (seasonally adjusted), the largest increase since July. That puts supply up 33% y/y nationally and up a whopping 106% in Ontario.

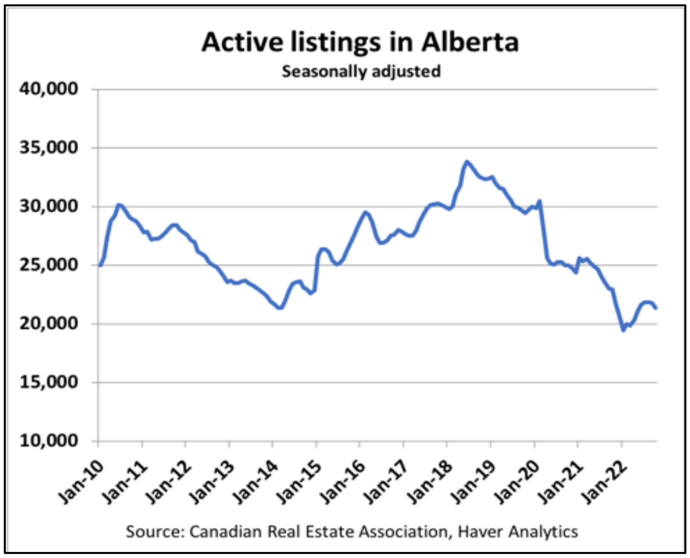


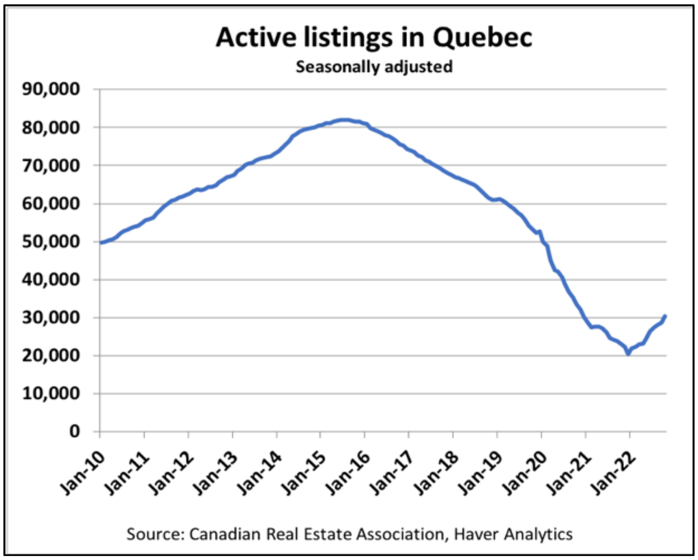


But the trend varies widely by province, and it should be noted that resale supply actually fell in Alberta where it remains basically at 15-yr lows:



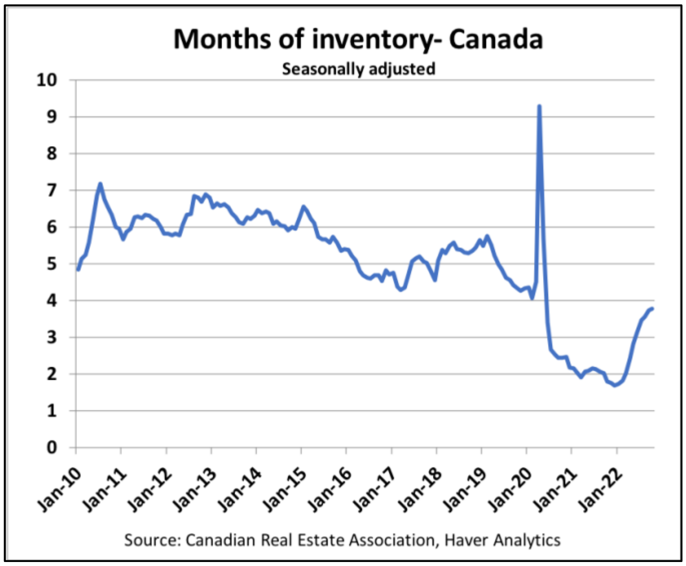




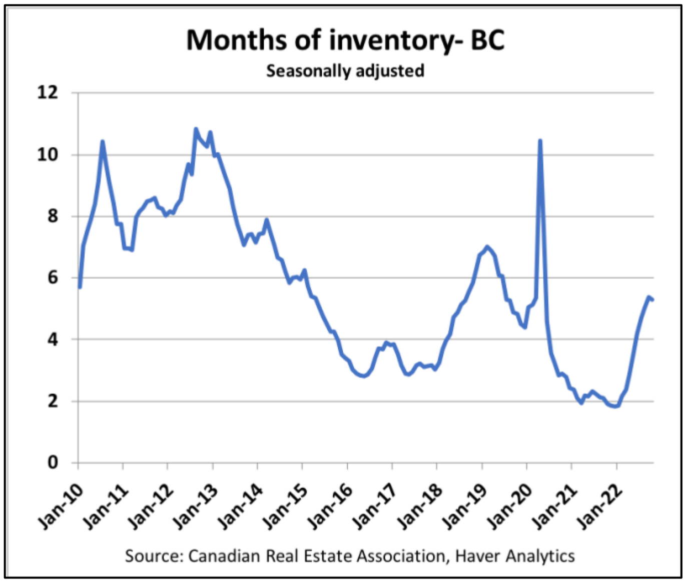


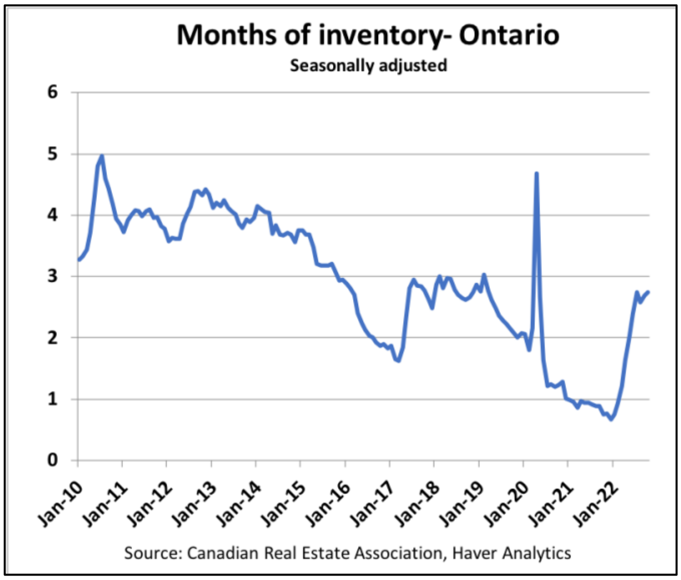
iv) Market still well-balanced

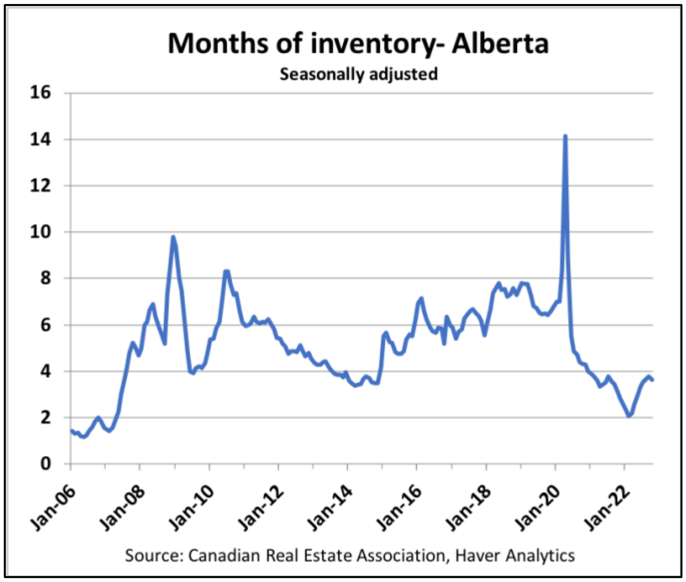
Months of inventory are still a relatively-thin 3.8 nationally. That's up sharply from the dead lows of 1.7, but it's still a long ways from a "normal" market of 5-6.

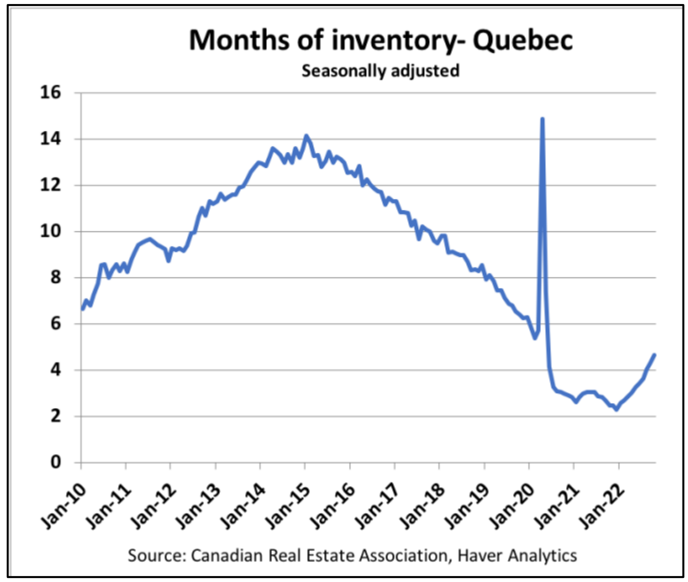


We see the same trend in most provinces: MOI is up, but far from normal levels.



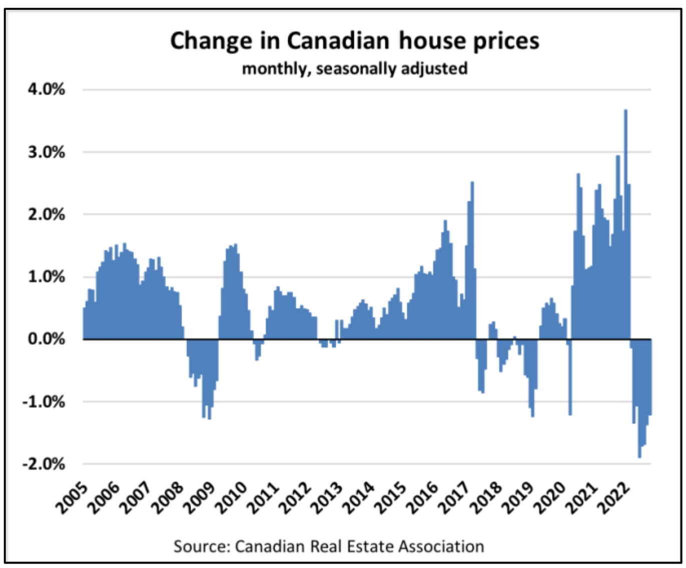


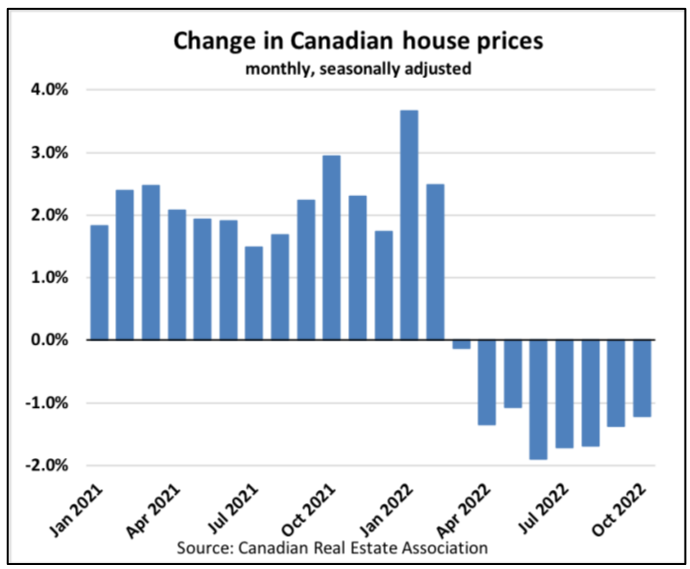




v) House price declines beginning to moderate

House prices were down another 1.2% m/m, a monthly decline larger than anything seen during the Financial Crisis. But if we zoom in, it's clear that the pace of decline is moderating...a trend that will likely continue until the spring.

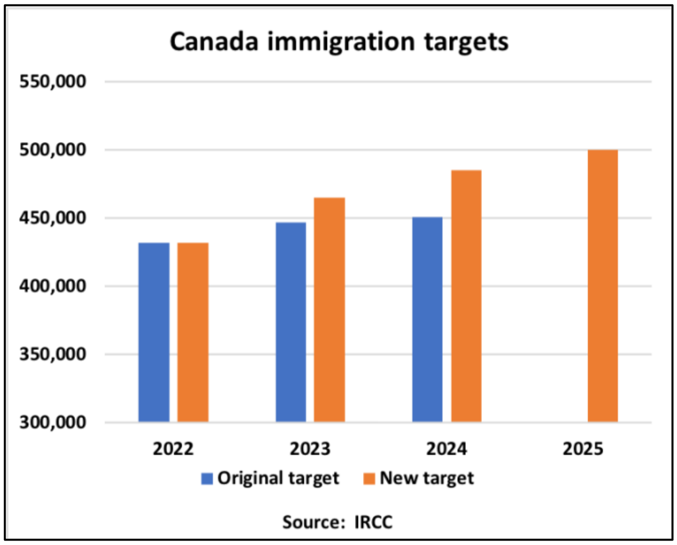




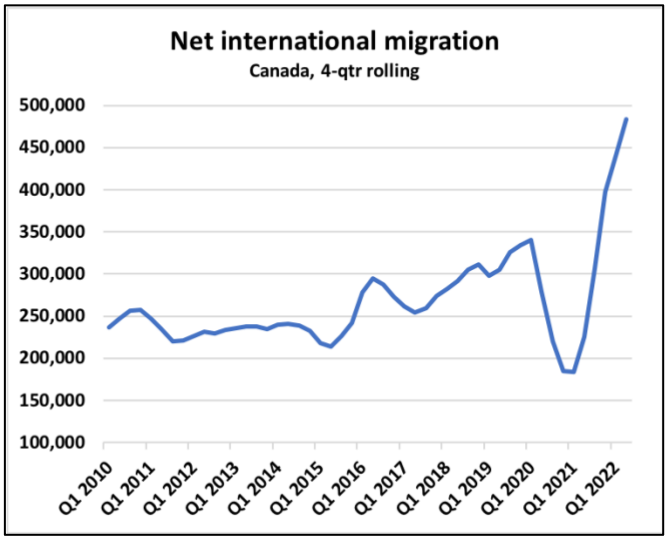
3) Supply and demand: New immigration targets, but is growth already peaking?

i) New immigration targets

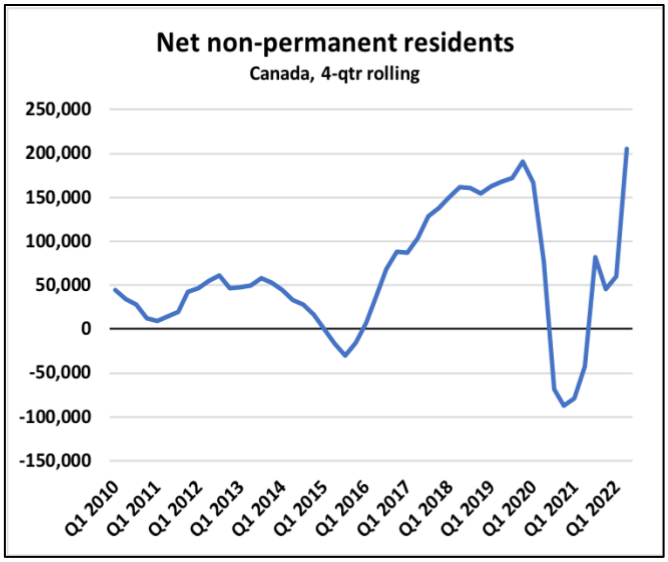
The feds have significantly raised immigration targets for 2023-2025 as shown in the chart below. The high end of the target range for 2025 is now just under 500,000.



Keep in mind, we're already basically there. Net immigration is already at 485,000 over the past 4 quarters compared to a 2022 full-year target of 430,000…which makes this announcement feel suspiciously like the government had an "oh shit" moment when reviewing admission numbers and had to find a way to justify them.

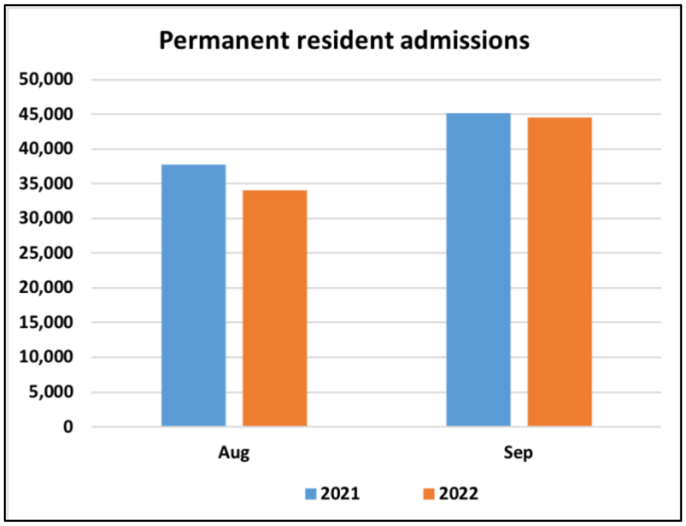


Also bear in mind, these targets don't capture the highly volatile non-permanent residents which have added another 200,000 to the population over the past year:



ii) Is population growth already peaking?

Since we're already basically at the 2025 targets, it would make sense that we would start to see permanent resident admissions begin to slow, and that's exactly what we're seeing. August and September saw lower levels of admissions relative to last year…the first decline since early 2021:

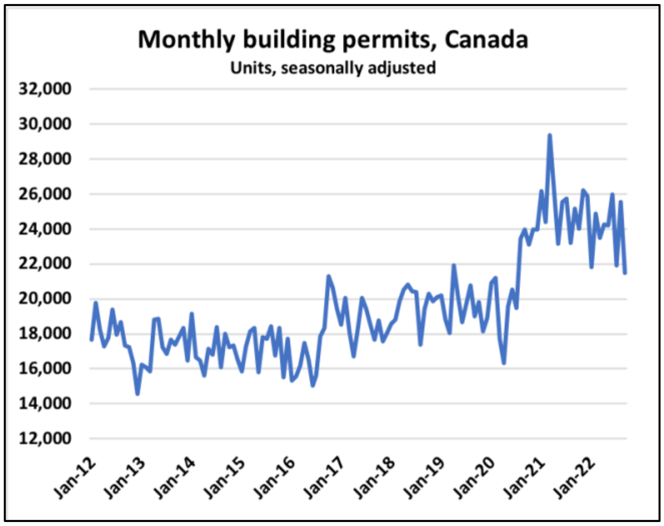


If we also see non-permanent resident admissions stabilize at more normal levels, there's a case to be made that population growth has likely peaked for a while.

iii) Building permits plunge

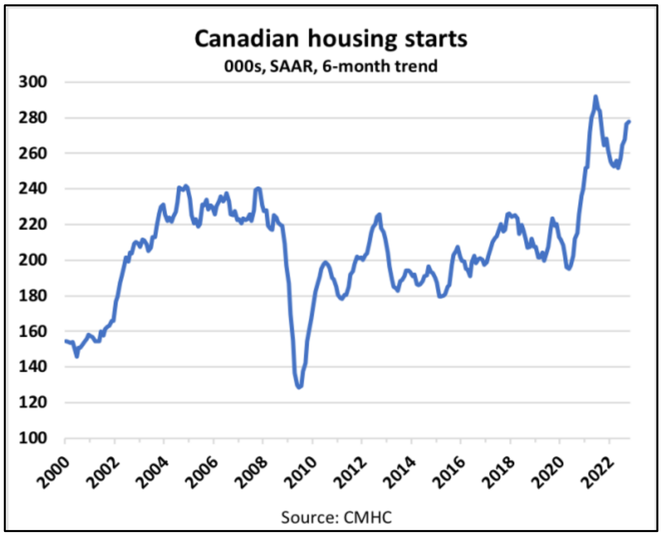
Residential building permits fell16% m/m in unit terms in September, the 2nd largest monthly decline since data became available in 2011. Ontario saw permits plunge 24% m/m.

This comes on the heels of a monster 16.5% build in August on the back of record apartment permits, so some of this is simply giving back those gains. Still, it was the lowest number of permits granted since early 2020 and likely an early sign of an impending construction slowdown:

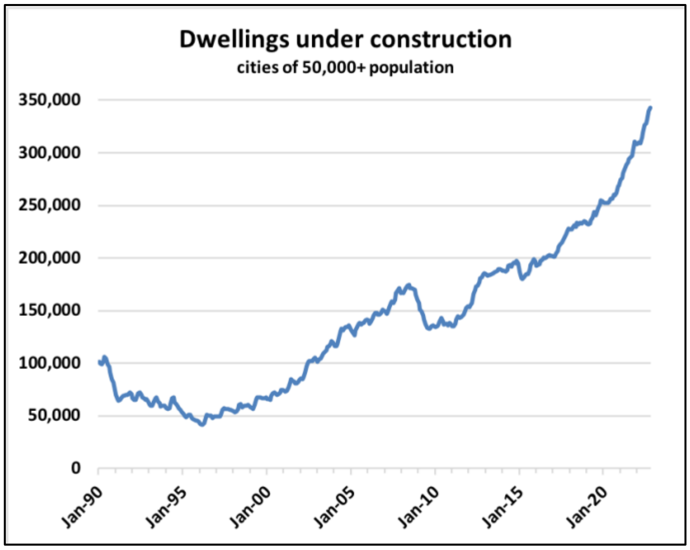


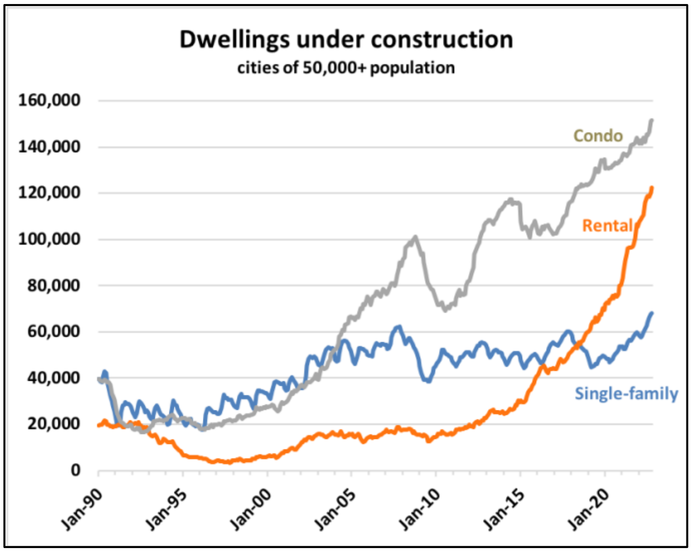
iv) Housing starts slide in October

Housing starts slipped 10.6% m/m in October, the largest monthly decline since December 2021, but the 6-month trend is still running at a very elevated 278k SAAR:

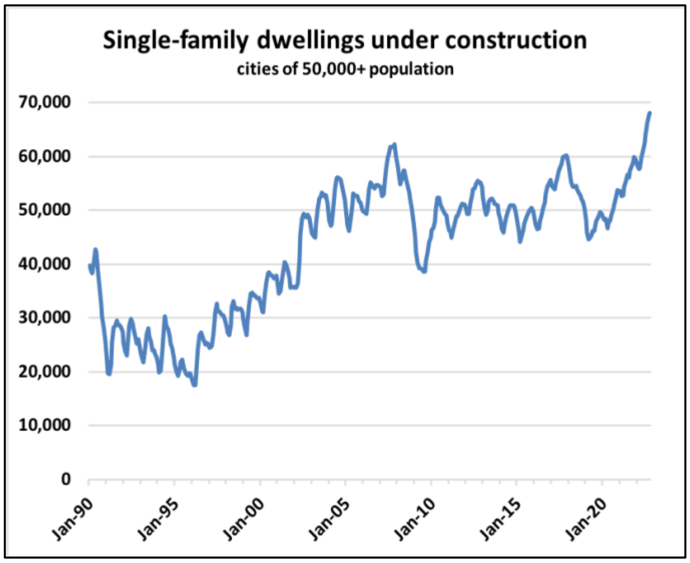


Meanwhile the number of dwellings under construction hit a fresh record high with big increases across all segments:





Zooming in on the single-family segment, it looks like we'll see an unusually large amount of new supply coming online in the next few months given the relatively short construction timeline. Not ideal timing given resale market trends:

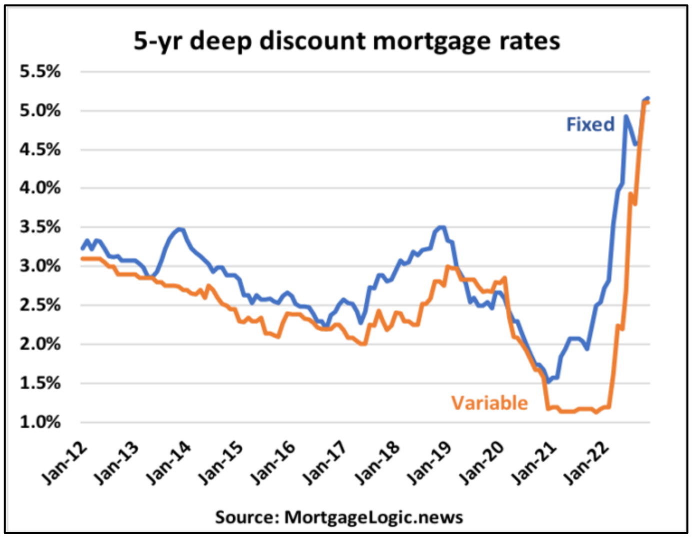


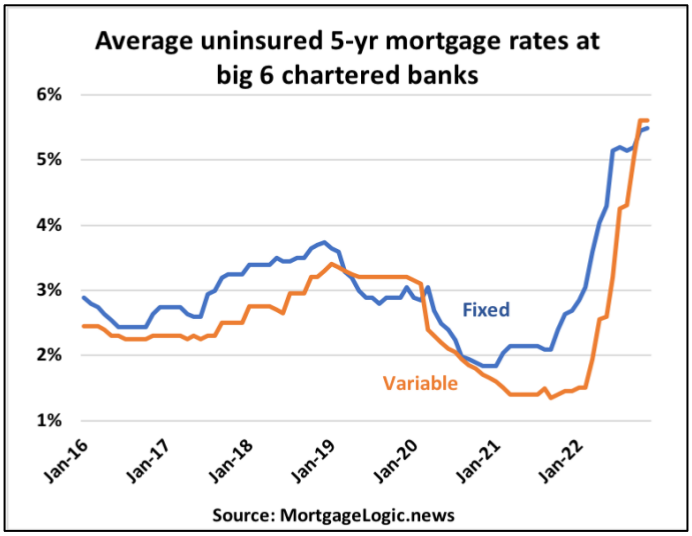
Completions will remain very high for the remainder of the year and right through 2023 which is going to make for some interesting dynamics given the financing constraints facing these buyers at completion. But we're likely to see a steep drop in construction activity in coming months. While this will exacerbate the growing weakness in the broader economy, it will also sow the seeds for the next supply crisis several years down the road.

4) Mortgage rates update: Borrowers keep betting against the Bank of Canada

i) Mortgage rates up slightly

Deep discounted mortgage rates were up roughly 5bps last week:

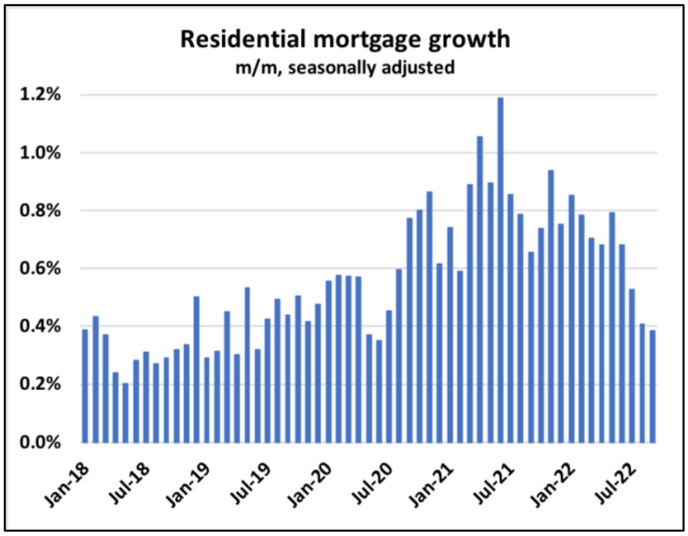


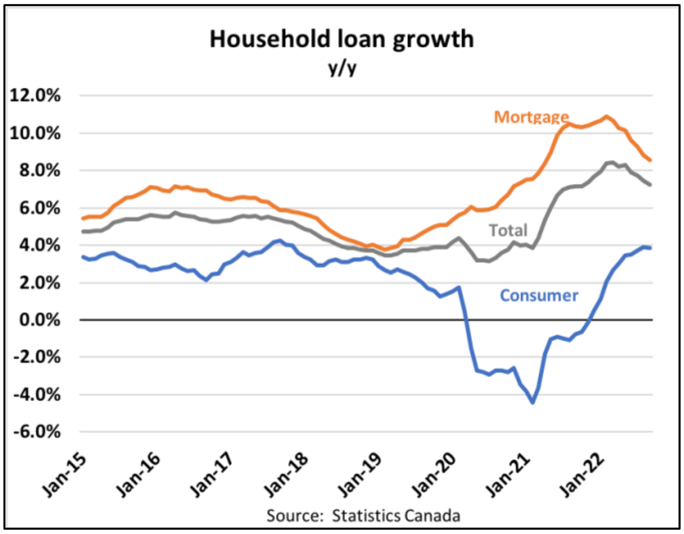


<u>But with Canadian 5-year swaps plunging from 4.3% to currently closer to 3.7%, we should expect to see downward pressure on fixed rates in the near term</u>.

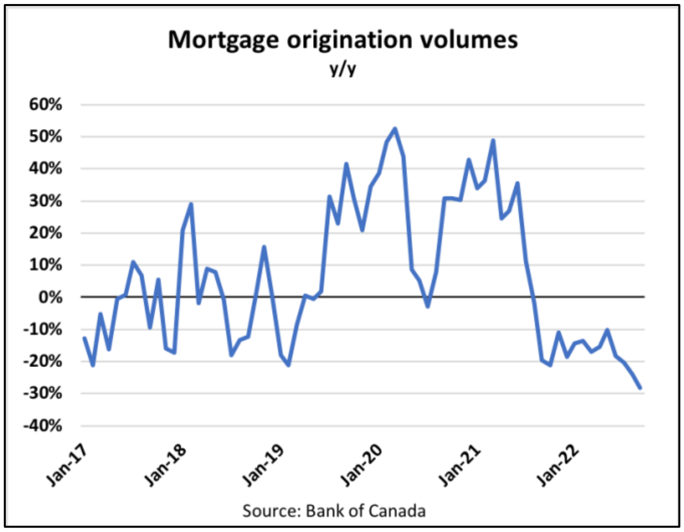
ii) Mortgage growth slumps

Outstanding mortgage balances ticked up just 0.38% in September (seasonally adjusted) and were up 8.5% y/y.



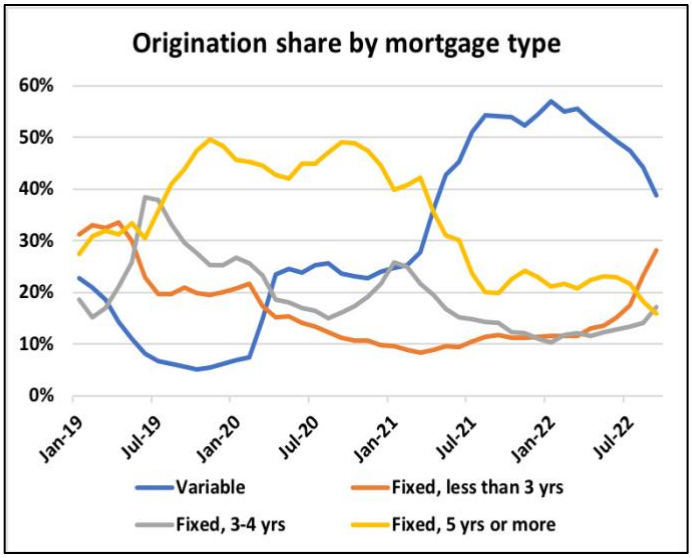


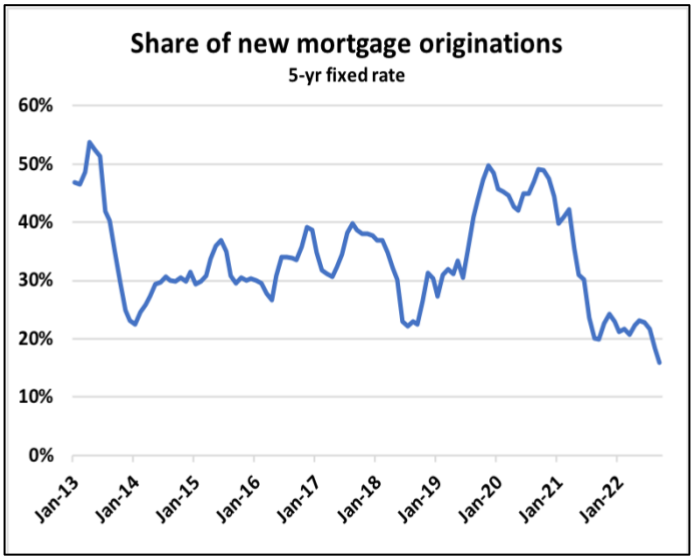
There's reason to think mortgage growth will slow further from here. Originations were down 28% y/y in September, a decline far larger than anything seen post-B20 when annual growth ultimately settled in the 4% range.



iii) 5-yr fixed rate popularity plunges as borrowers continue to bet against Bank of Canada

Canadian borrowers are betting that high interest rates are not going to last. The latest data this week shows that variable and short-term fixed rate mortgages (ie less than 2 years) accounted for a record 67% of new originations in September. At the same time, 5-yr fixed rate mortgages accounted for a record low of just 15% of new originations:

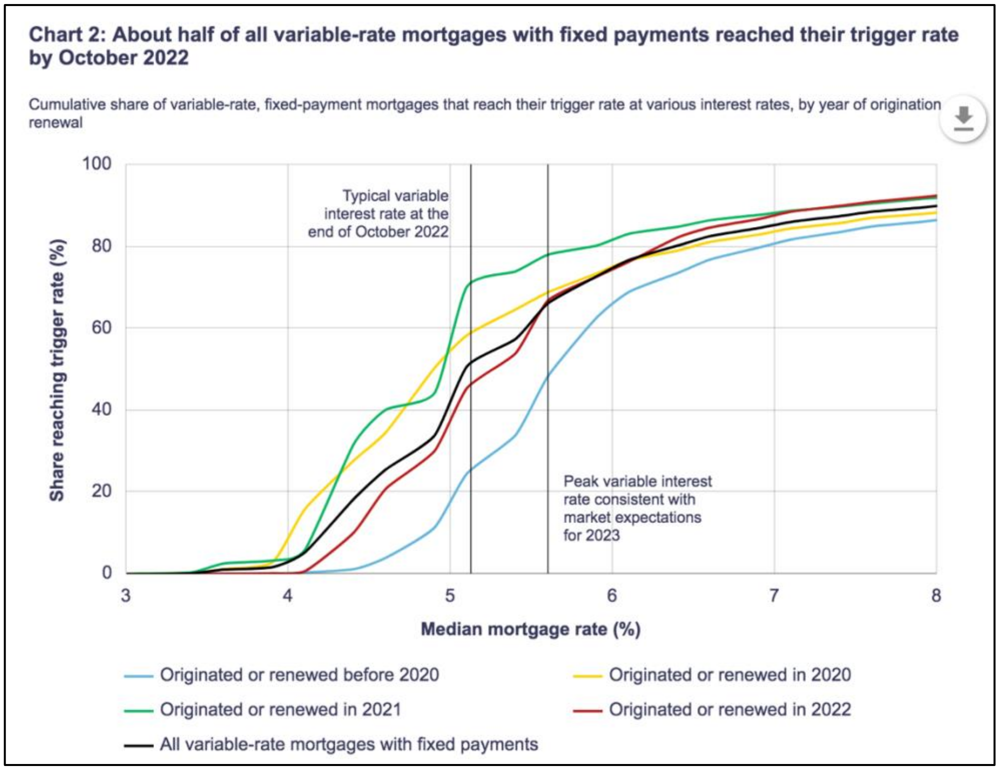




This will help consumers if in fact rates come down later in 2023, but if not, it sets up for even greater financial stress in the future.

iv) Half of variable rate mortgages have hit their "trigger rate"

Interesting new data from the Bank of Canada. By their estimates, roughly 70% of static payment variable rate mortgages originated in 2021 and half of all outstanding variable rate mortgages have hit their trigger rate.



v) More signs of tightening in non-prime credit

Private lenders have been an increasingly important source of marginal liquidity for subprime borrowers over the past decade. But things are changing. From Bloomberg last week:

> **Mortgage Fund Says Payout Freeze Is 'Prudent' Amid Volatility[2]**
>
> Lender Romspen Investment Corp. needs more time to assess the state of the real estate market before it resumes letting investors withdraw money from its flagship mortgage fund, an executive said.
>
> "You have to take prudent action to protect the fund," Managing Partner Derek Jenkin said in an interview. The Toronto-based firm told investors this week it will temporarily defer redemptions in the Romspen Mortgage Investment Fund until there's "more clarity" about when borrowers will be able to repay loans or assets can be sold to free up cash. Romspen's business is secured lending against real estate, including construction.

And the Globe and Mail this week:

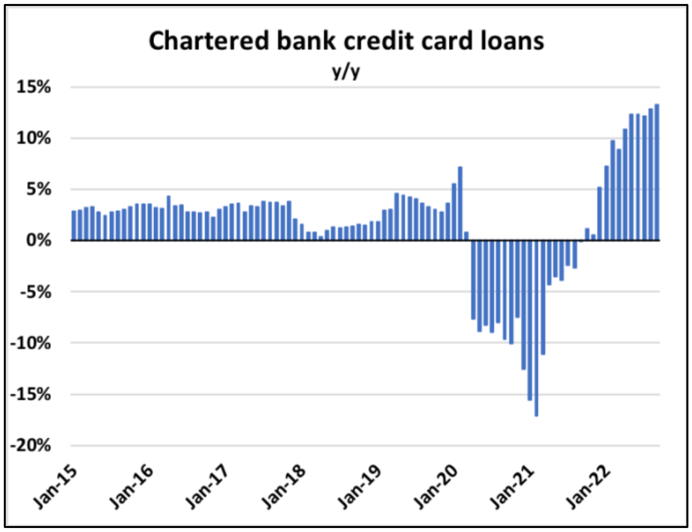
> **Private mortgage lenders raise qualification standards, reducing options for weakest borrowers[3]**
>
> Private mortgage lenders are having a harder time accessing capital and are making it more difficult for borrowers to get a loan, choking off a major source of funds for those unable to qualify at a Canadian bank.
>
> […] Subprime lenders used to lend up to 90 per cent of the value of the home. Now, many private lenders are only willing to lend up to 75 per cent of the property's value…

[2] https://www.bloomberg.com/news/articles/2022-11-11/mortgage-fund-says-payout-freeze-is-prudent-amid-volatility
[3] https://www.theglobeandmail.com/business/article-private-mortgage-lenders-raise-qualifications/

5) Consumer check: More signs of stress building

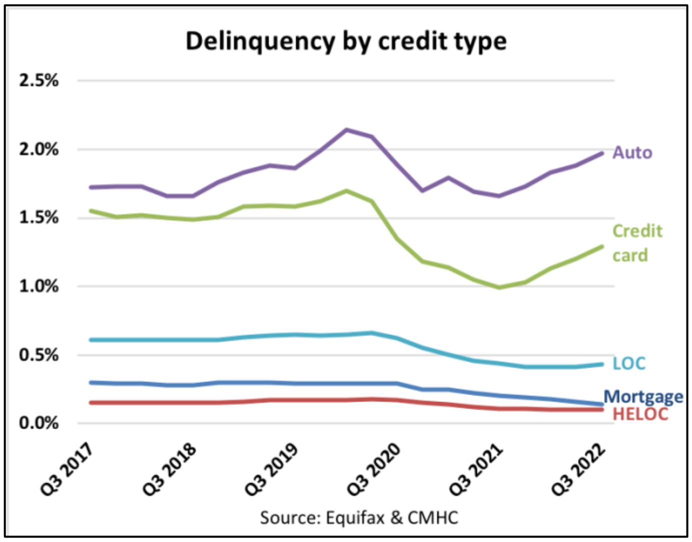
i) Consumers pile on credit card debt again in Sept

The latest household credit data shows another big jump in credit card borrowing, up 1.2% m/m seasonally adjusted in September. That puts the annual growth rate in credit card loans at north of 13%!



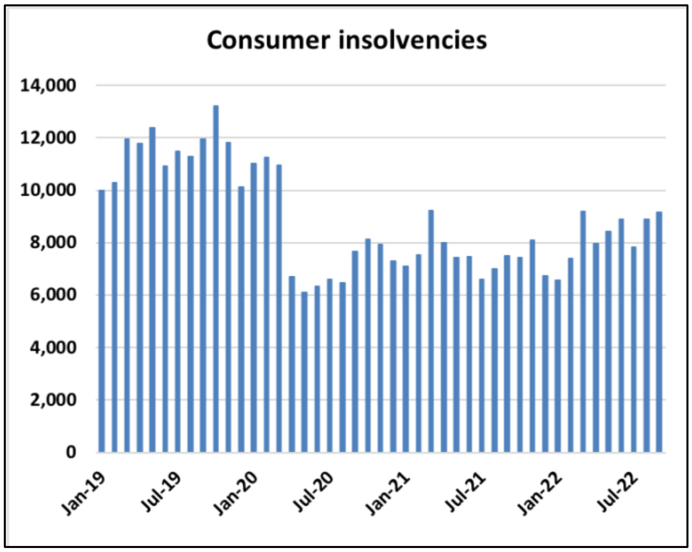
ii) Auto and credit card delinquencies rise

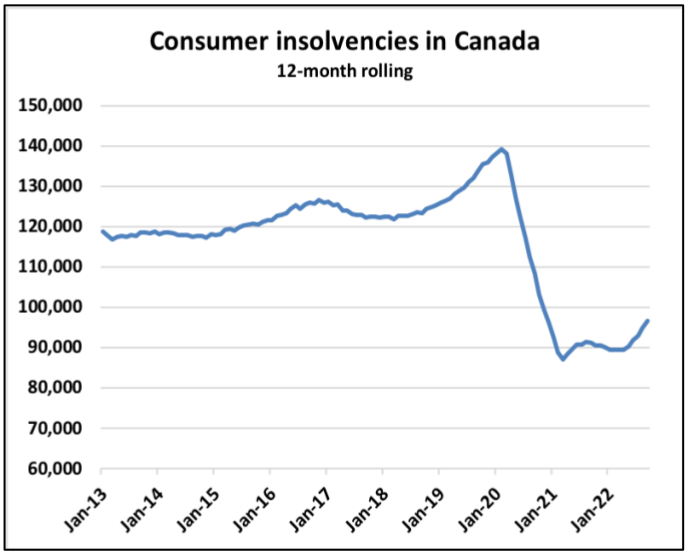
New data from CMHC and Equifax show rising delinquencies in credit cards and autos while mortgages and HELOCs are still low and stable. But since credit cards are forward-looking indicators, we can reasonably expect to begin seeing deterioration in mortgage delinquency trends early next year.



iii) Consumer insolvencies jump 22% y/y

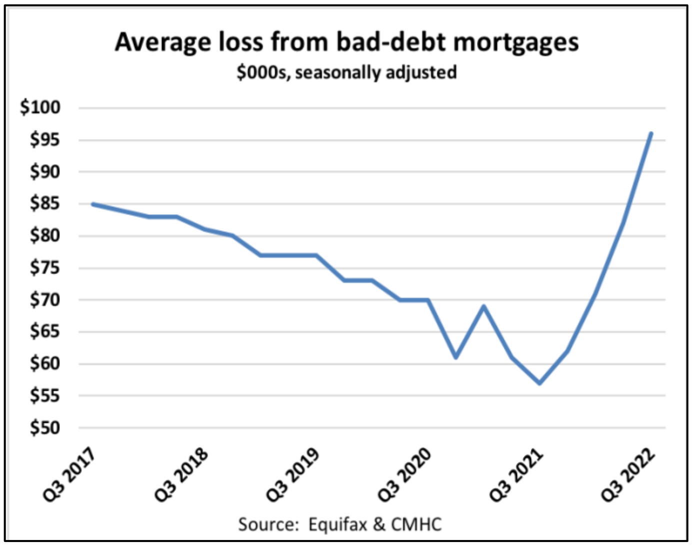
Bankruptcy and proposal filings jumped 22% y/y in September led by a 34% increase in BC and a 29% jump in Ontario. We're still well below 2019 levels for now, but the trend is definitively to the upside:





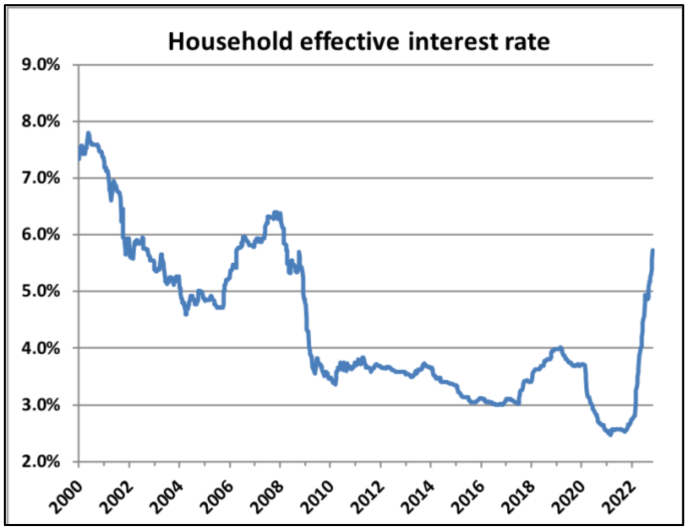
iv) Average loss on bad mortgages spikes

CMHC and Equifax have released the latest consumer and credit trends tables for Q3. Among the interesting takeaways is the sizable increase in average losses on mortgages. Granted, the overall share of delinquencies remains near record lows, and those that actually experience losses is even lower, but still it speaks to mounting risk in the mortgage landscape.



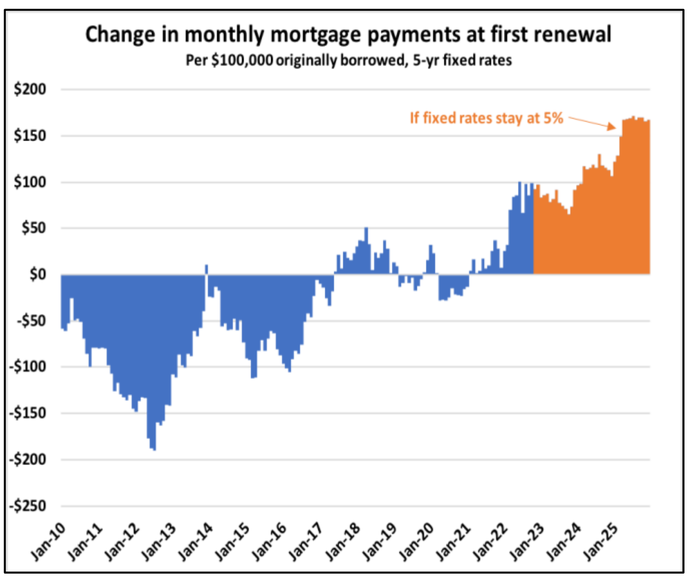
v) Effective interest rate at 13-yr highs

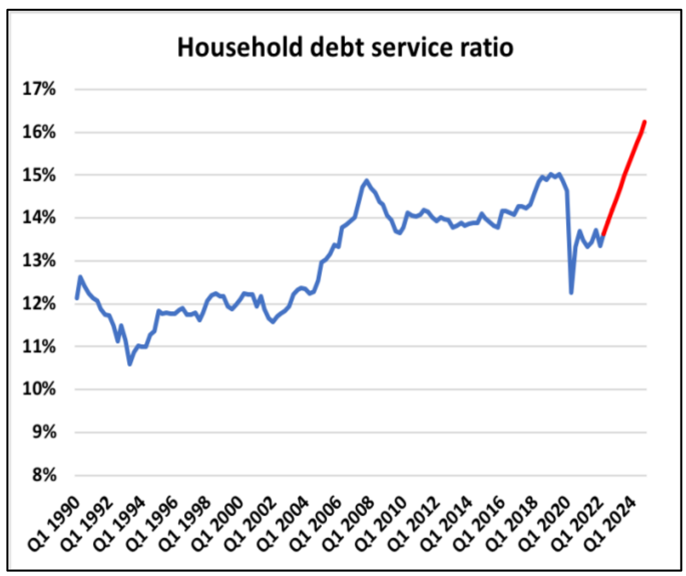
Households are only beginning to feel the impact of rising interest rates. The household effective interest rate is now 5.7%, up from 2.6% just one year ago. Note that this is a hypothetical interest rate that households would pay if all fixed rate debt reset to current levels. So the actual rate paid by households will migrate to this level over time:



BMO expects that roughly $271 billion of fixed-rate mortgages will renew next year, $294 billion in 2024 and $328 billion in 2025.

If we hold fixed rates at current levels, by late 2024 fixed rate borrowers will be looking at a payment shock of nearly $170 per month for every $100k originally borrowed…and we'll see by far the highest debt service ratio on record (and that's even with 6% annual disposable income growth in the model which may prove to be a generous assumption if we do hit a recession next year):



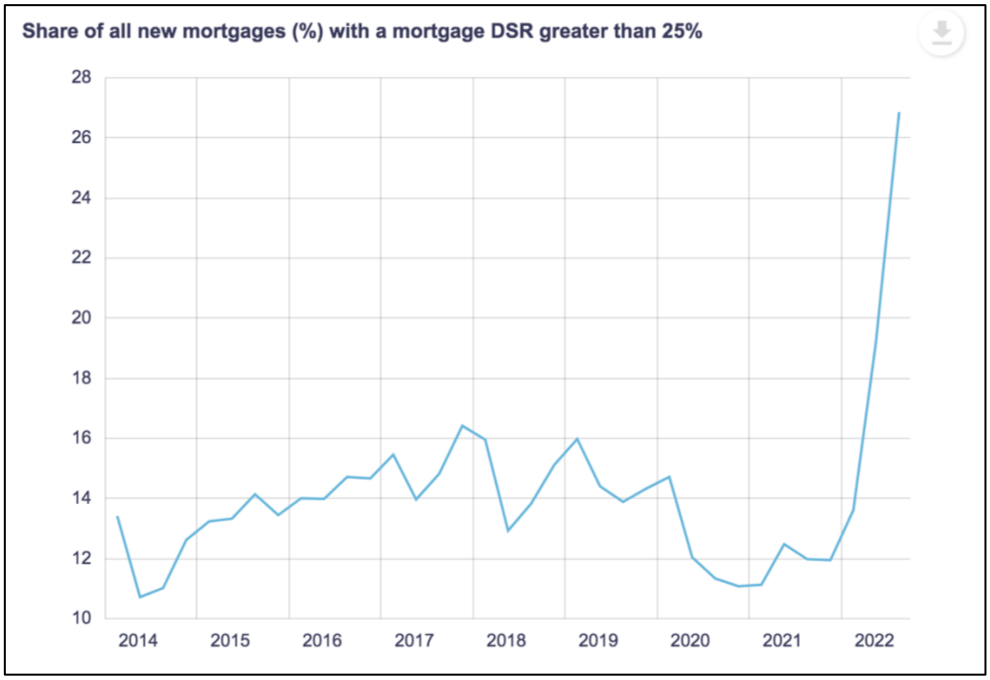


vi) High DSR mortgages spike

New data from the Bank of Canada shows that the share of new mortgages with a “high” debt service ratio of greater than 25% has surged in 2022.

From their publication:

> All else being equal, a household that spends a large portion of its income on mortgage payments may be more vulnerable to financial stress—it may be more likely to fall behind on debt payments if a negative income shock or a rise in mortgage interest rates were to occur. The Bank uses the share of new mortgages with a mortgage DSR greater than 25% to identify the most vulnerable households.



Thanks for reading. As always, feedback is welcome. If you have any tips on interesting happenings in the mortgage and housing markets, please reach out.

Have a great week.

Ben