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The Edge Report

December 2022

Compliments of: TheMortgageGuyNiagara.com

Hyperlinks:

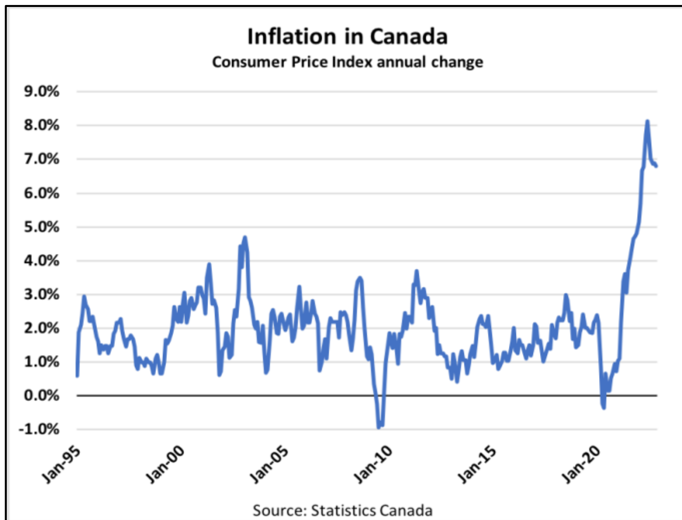
1) **Sticky inflation frustrates the BoC even as they signal a pause**
2) **November home sales: Inventory back on the rise, prices grind lower**
3) **Supply and demand: ANOTHER record for population growth**
4) **Mortgage rates update: Fixed rates drift lower, mortgage growth tumbles**
5) **Consumer check: Debt service ratios jump, housing weighs on net worth**

Key takeaways:

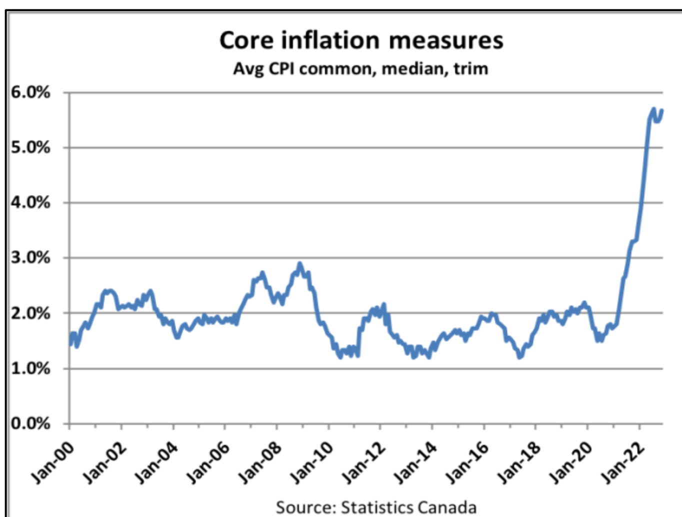
- Inflation is proving "stickier" than expected, but the Bank of Canada clearly *wants* to find reason to pause.
- The odds of a recession in 2023 continue to mount.
- Home sales are weak but likely bottoming even with an affordability crisis.
- All eyes should be on supply, which is rising again.
- Population growth set a record in Q4 by a wide margin but developers are already pulling back, which sets up a supply crisis down the road.
- Falling real estate is weighing on consumer balance sheets, and that's bad news for spending going forward.
- Credit stress is rising, but still nowhere near stressed levels. That will change in 2023 as rates work through the system and the froth comes off the labour market.

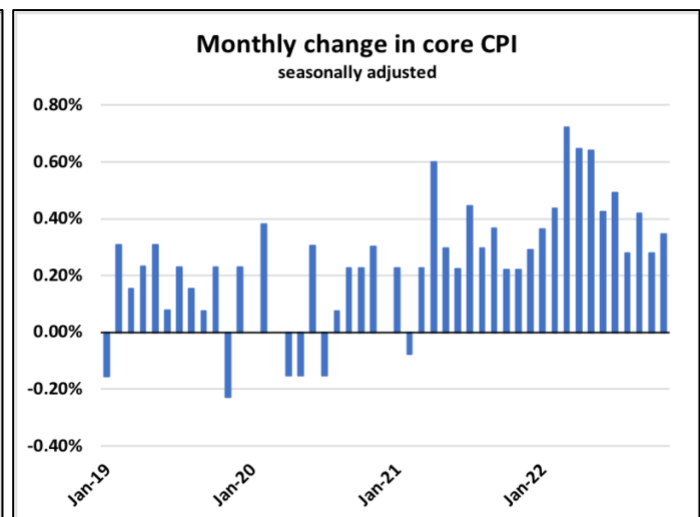
1) Sticky inflation frustrates the BoC even as they signal a pause

This morning's inflation print for November came in a bit hotter than expected with headline running at 6.8% y/y against a consensus forecast of 6.7%:



But much more important is the trend in core inflation which still remains at the highs of 5.7% and saw a stronger than expected 0.4% seasonally adjusted increase in November:



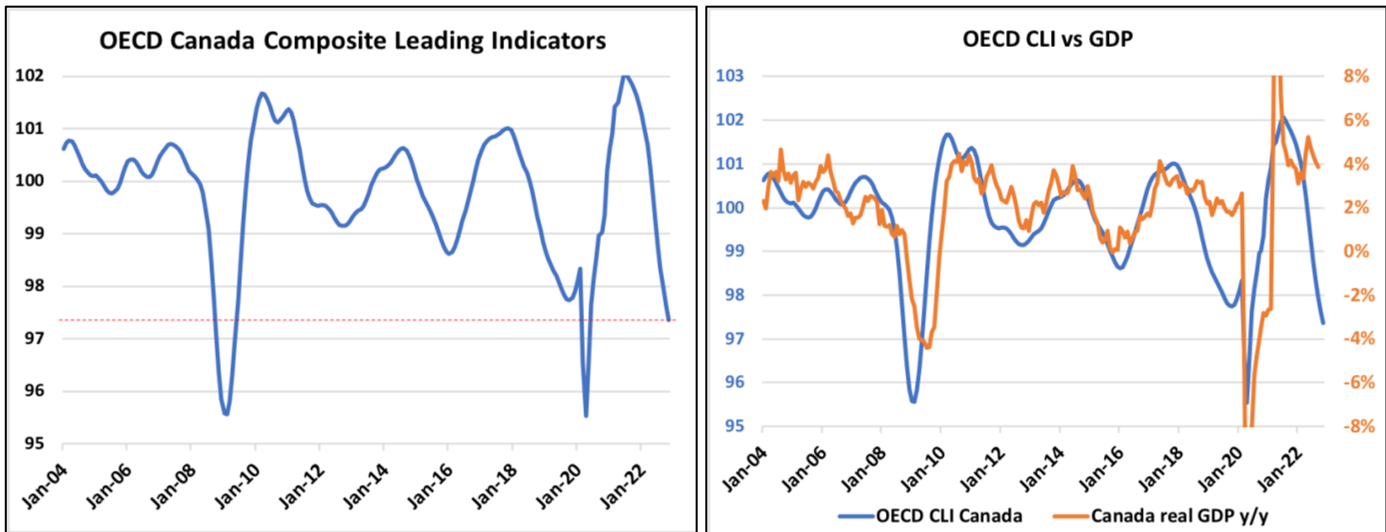


It's not a disastrously strong reading, but it will no doubt frustrate Tiff and his team, who I believe WANT to lay the groundwork for a pause early next year. Consider the comments from his speech last week:

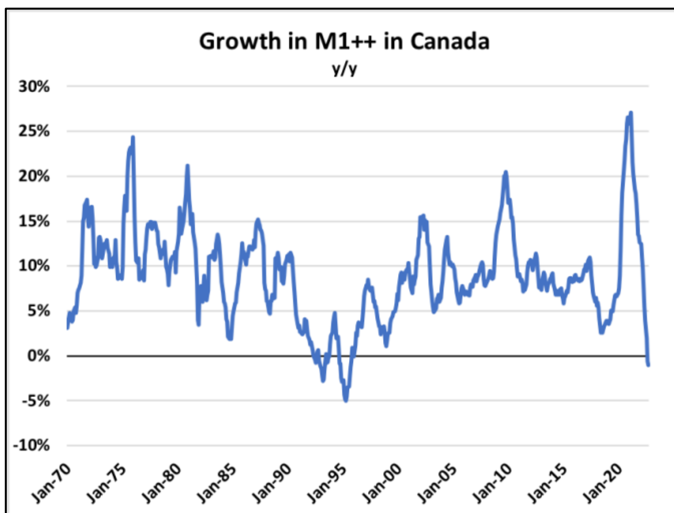
> […] At last week's decision to raise the policy rate by 50 basis points we indicated that, looking ahead, we will be considering **whether** there is a need to increase the policy rate further. This means that decisions to raise the rate or to pause and assess the impact of past rate increases will depend on incoming data and our judgments about the outlook for inflation.
>
> We are trying to balance the **risks of over**- and under-tightening monetary policy.

Quite a shift in tone. It's the first acknowledgement that there are risks to over-tightening in this current cycle which makes sense when we look at forward indicators of economic activity.

Consider the OECD's Composite Leading Indicators, which continue to signal not just a "run of the mill" recession but potentially a very deep downturn. They fell another 0.3 points in November. Outside of 3 months in early 2020 and 8 months in the midst of the Financial Crisis, this is the lowest reading since at least 2004:



Further, growth in the money supply is now negative for the first time since the mid-1990s. Shown below is M1++, a measure of liquid/readily accessible base money like chequable and notice deposits. Consumer and businesses are seeing shrinking liquidity:



The BoC knows they have to tread lightly, even with inflation proving "stickier" than expected. A slowdown is coming, and the full impact of rising rates have yet to be felt.

I want to highlight one other comment that I think is immensely important and squares with my own outlook. From Tiff's speech:

> […] Over the long term, it seems likely that we won't have the same disinflationary forces that we've had for the past 30 years. These potential developments could make it harder to bring inflation back to the 2% target and keep it there. But how much harder is very difficult to say.

This is key. There's reason to think that inflation will not settle back to the 1-2% band we've been used to and may instead settle in the 3-4% range based on de-globalization, demographics, and higher energy costs. If true, it implies a structurally higher overnight rate and mortgage rates that may settle in the 4-5% range longer term.
As I said previously, we may not see 1-2% mortgages again for a generation.

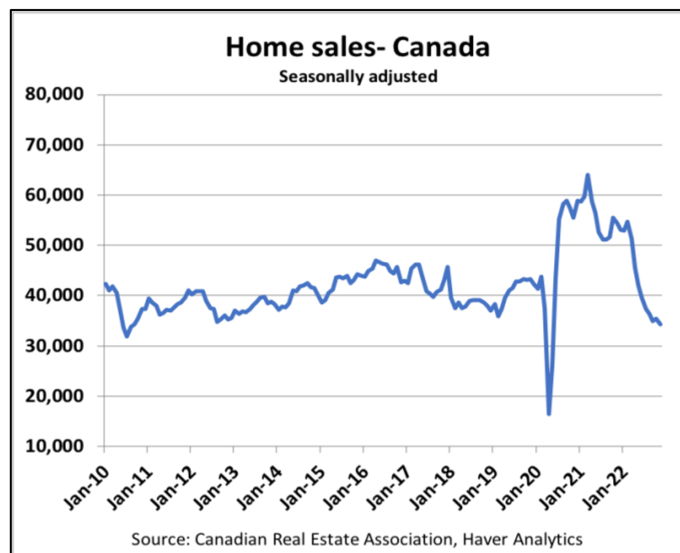
2) November home sales: Inventory back on the rise, prices grind lower

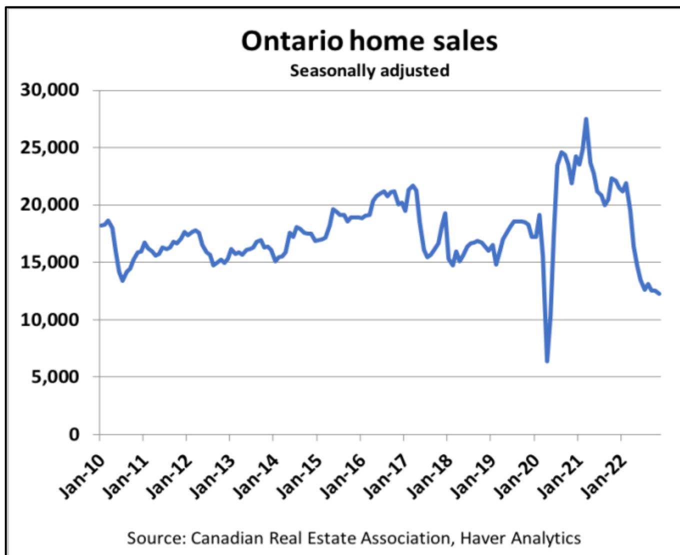
The key data from last month is summarized below.

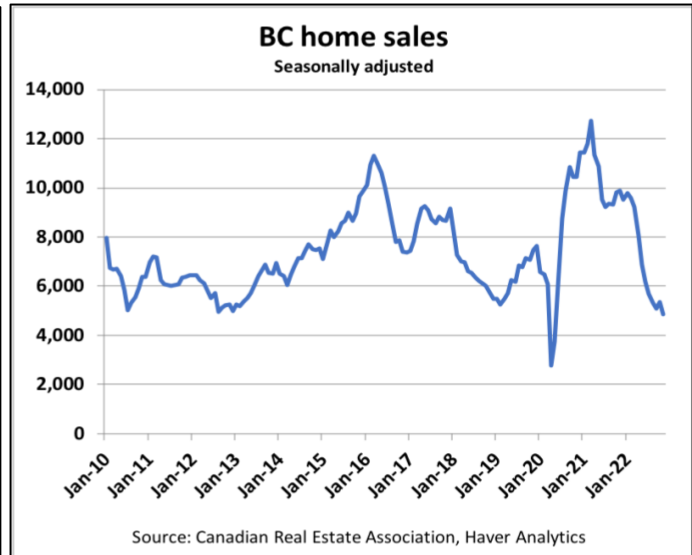
	Sales		New listings		Active inventory		House prices (HPI for Canada, average for provinces)	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	-39.1%	-3.3%	-6.5%	-1.3%	+43.6%	+3.9%	-4.2%	-1.4%
BC	-51.0%	-9.5%	-14.6%	-7.4%	+63.0%	+4.7%	-8.6%	-2.5%
AB	-27.9%	-3.8%	-8.0%	-2.2%	-4.8%	-1.8%	-1.0%	-0.8%
ON	-44.5%	-1.9%	-3.4%	+1.8%	+133.9%	+8.8%	-9.6%	+0.1%
QC	-31.5%	-2.8%	+4.5%	-1.5%	+39.6	+4.2%	+1.2%	+0.4%

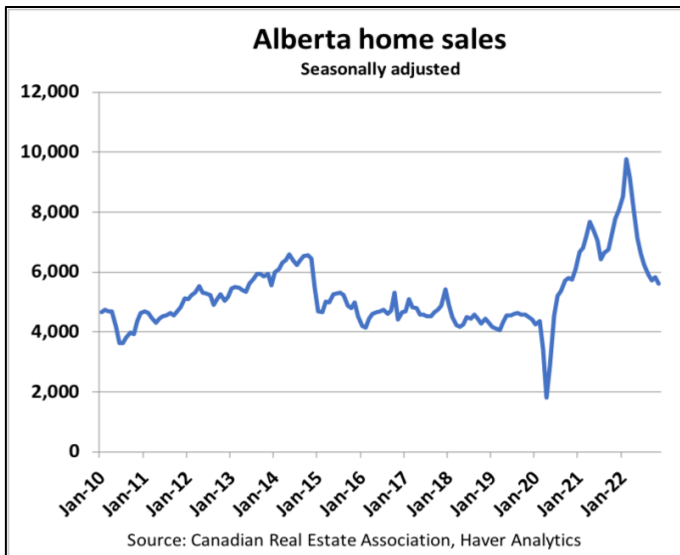
i) Sales back under pressure in November

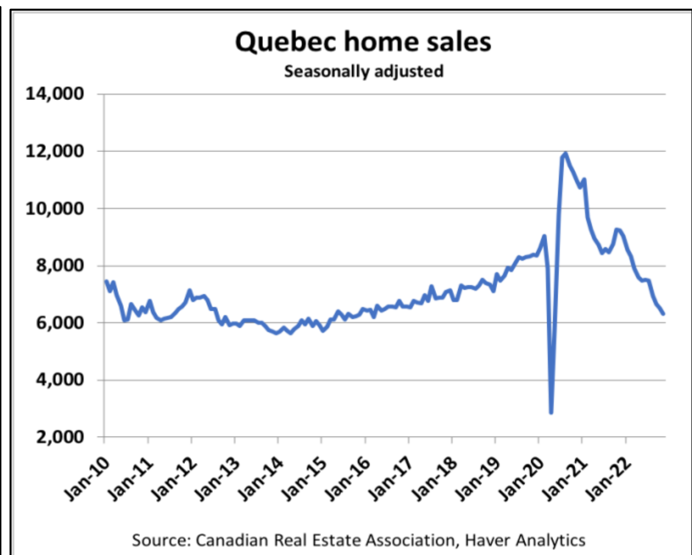
Canadian home sales slumped 3.3% seasonally adjusted in November, dragged lower by a 9.5% drubbing in BC where sales are now 51% lower than they were one year ago:









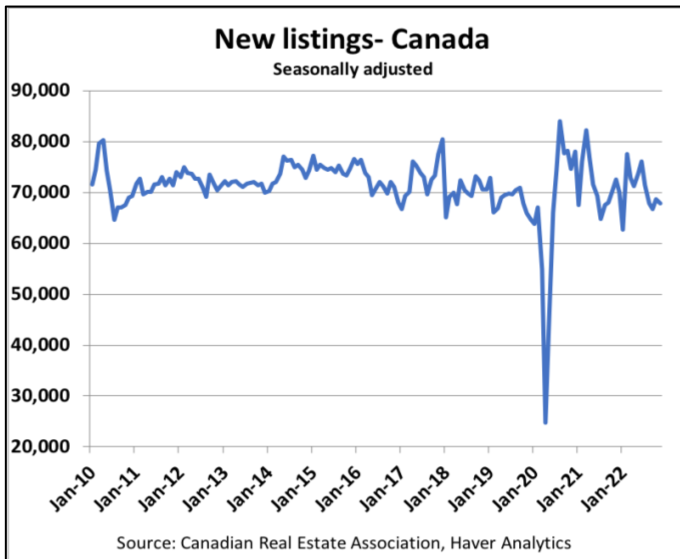


I'm less concerned about sales than I am about inventory trends. It's fairly clear to me that sales can't fall a whole lot further outside of a major economic shock. They're already at 1990s levels in Ontario. I think it's very likely that we see sales levels improve come the spring if we get some interest rate stability.

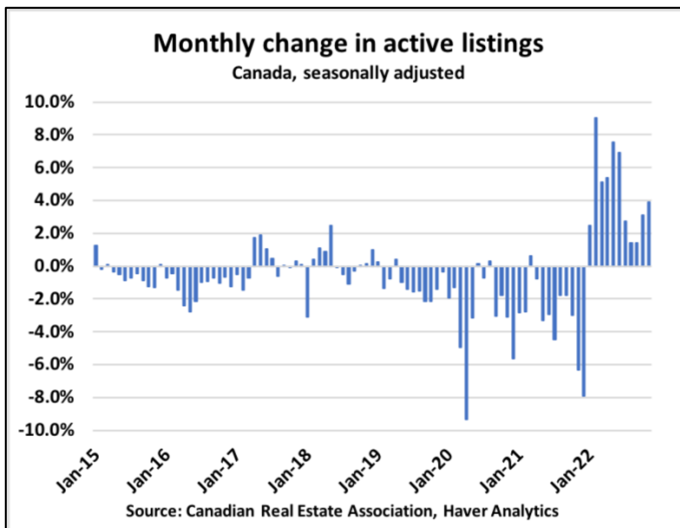
What's much less clear is how inventory trends will shape up. I think it's very likely that we see a strong supply response which could keep pressure on prices for a while still.

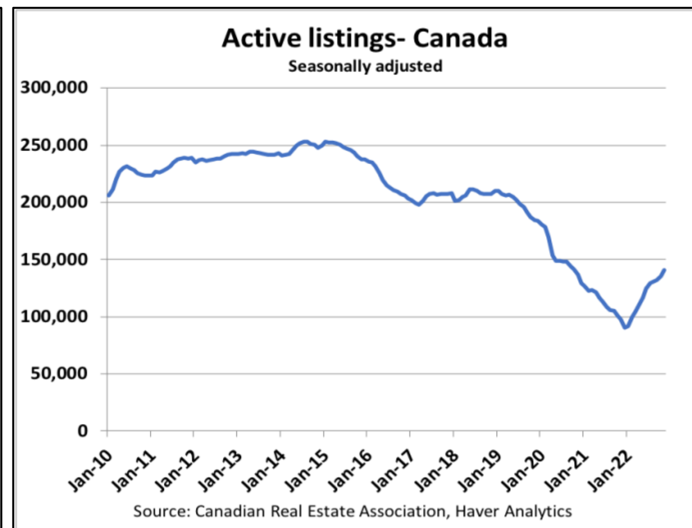
ii) Inventory on the rise

New listings fell 1.3% nationally last month and remain roughly 5% below normal levels from the past decade. And in non-seasonally adjusted terms, it was the lowest November for new listings since 2010:



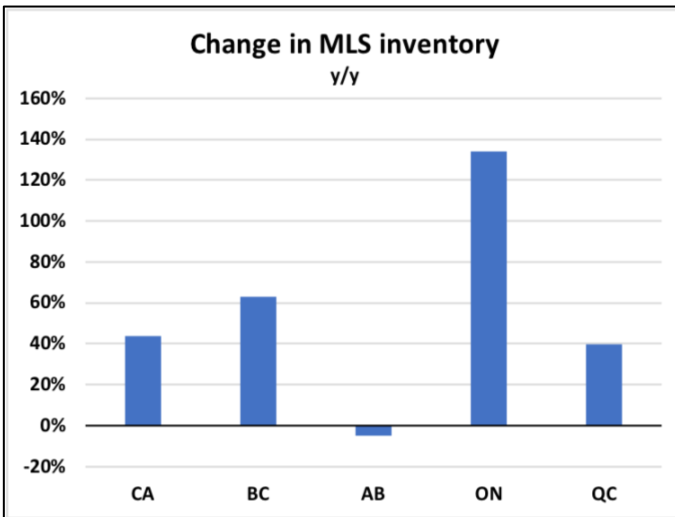
Inventory is building once again. Active listings nationally ticked up 4% in seasonally adjusted terms in November, the largest monthly increase since June.

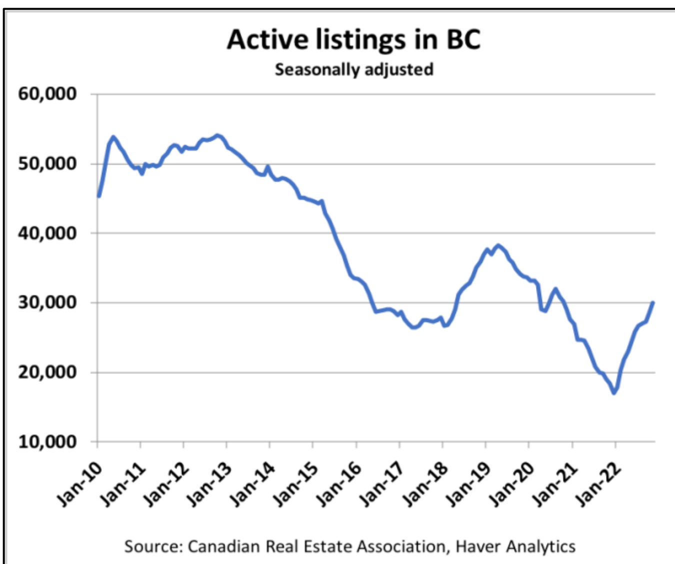


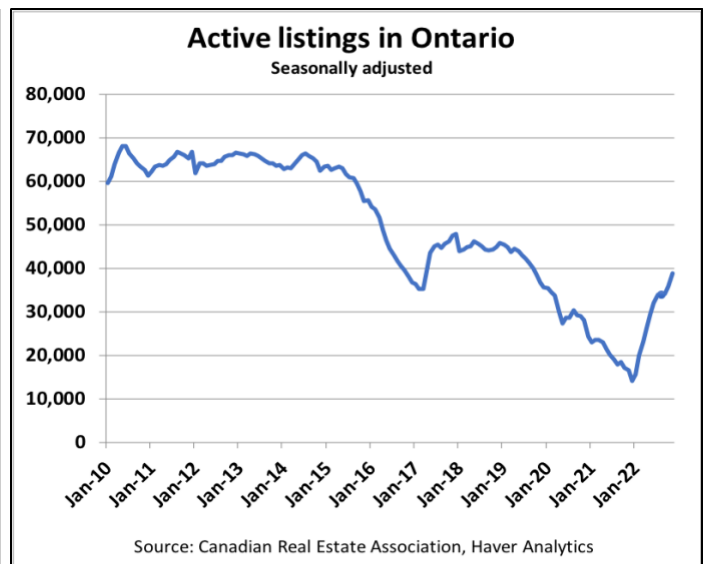


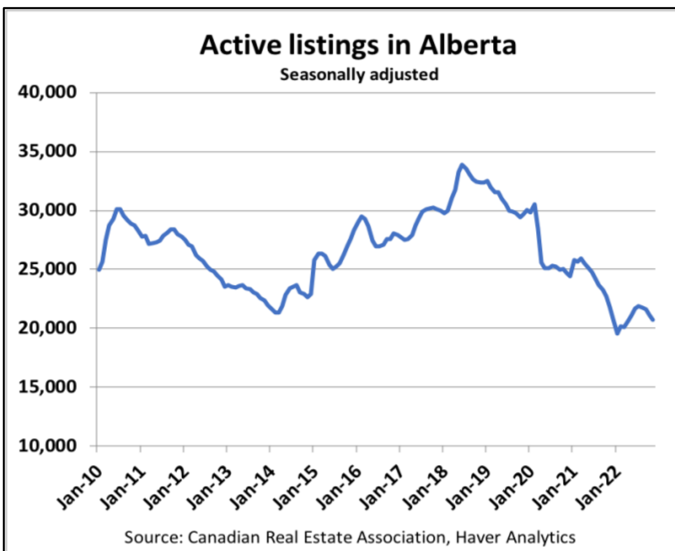
There are now 44% more homes for sale nationally than at this time last year….but still almost 50% less than “normal” levels.

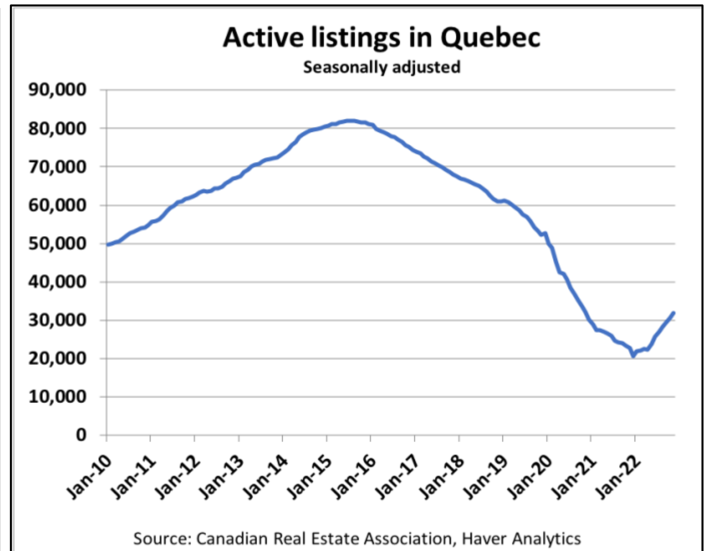
There are significant regional differences in inventory levels. Ontario and BC lead the charge at +134% and +63% respectively while Alberta still has 5% fewer listings than one year ago:


Change in MLS inventory
y/y
160%
140%
120%
100%
80%
60%
40%
20%
0%
-20%
CA
BC
AB
ON
QC


Active listings in BC
Seasonally adjusted
60,000
50,000
40,000
30,000
20,000
10,000
Jan-10
Jan-11
Jan-12
Jan-13
Jan-14
Jan-15
Jan-16
Jan-17
Jan-18
Jan-19
Jan-20
Jan-21
Jan-22
Source: Canadian Real Estate Association, Haver Analytics


Active listings in Ontario
Seasonally adjusted
80,000
70,000
60,000
50,000
40,000
30,000
20,000
10,000
0
Jan-10
Jan-11
Jan-12
Jan-13
Jan-14
Jan-15
Jan-16
Jan-17
Jan-18
Jan-19
Jan-20
Jan-21
Jan-22
Source: Canadian Real Estate Association, Haver Analytics


Active listings in Alberta
Seasonally adjusted
40,000
35,000
30,000
25,000
20,000
15,000
10,000
Jan-10
Jan-11
Jan-12
Jan-13
Jan-14
Jan-15
Jan-16
Jan-17
Jan-18
Jan-19
Jan-20
Jan-21
Jan-22
Source: Canadian Real Estate Association, Haver Analytics

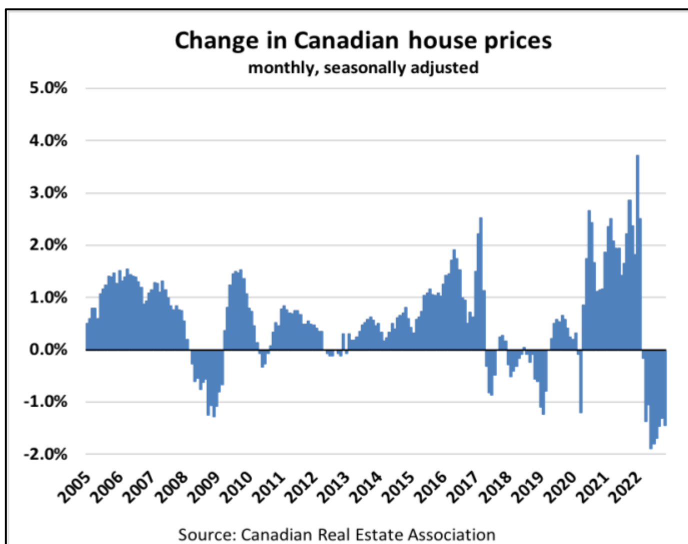

Active listings in Quebec
Seasonally adjusted
90,000
80,000
70,000
60,000
50,000
40,000
30,000
20,000
10,000
0
Jan-10
Jan-11
Jan-12
Jan-13
Jan-14
Jan-15
Jan-16
Jan-17
Jan-18
Jan-19
Jan-20
Jan-21
Jan-22
Source: Canadian Real Estate Association, Haver Analytics

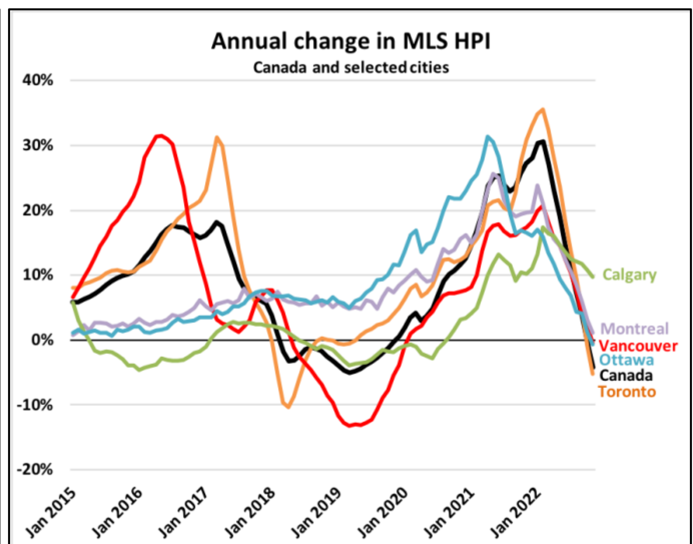
iii) Months of inventory above 4 for the first time since mid-2020

Months of inventory remain below the long-term average of 5.5, but they did rise above 4 for the first time since mid-2020 last month:

iv) House price declines continue

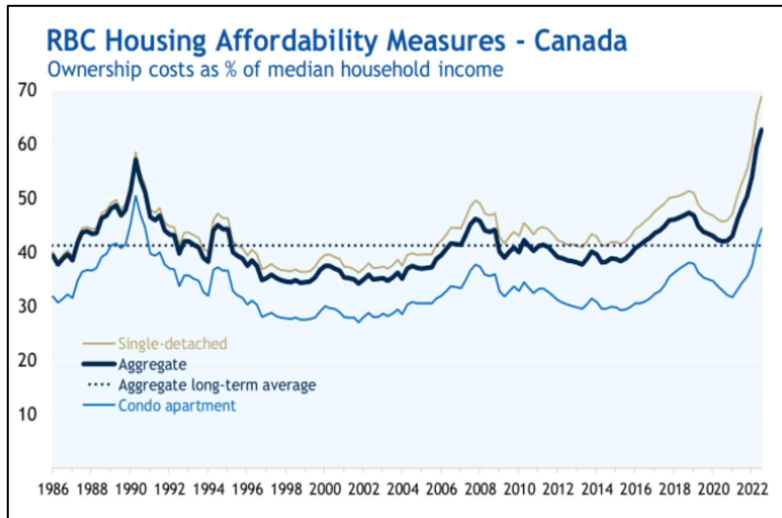
The MLS House Price Index posted another 1.4% seasonally adjusted decline in November, bringing the cumulative drop from peak to nearly 12%. It also pushed y/y prices negative for the first time since 2019, though here too we see significant regional differences with Calgary well ahead of the rest of the pack at +10% y/y:



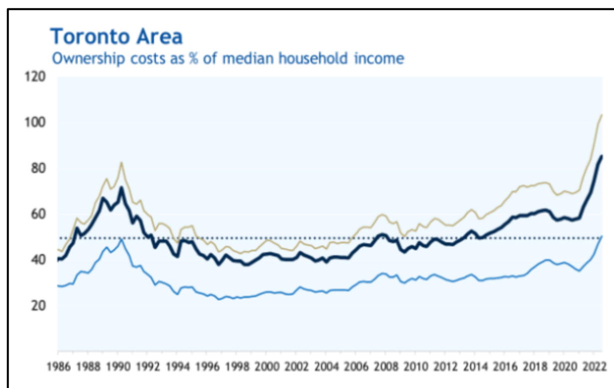


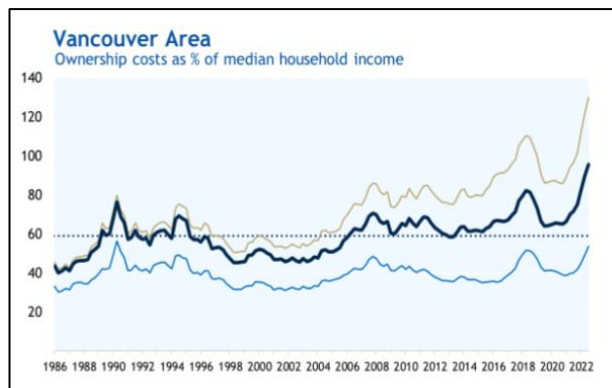
v) "Dreadful" affordability

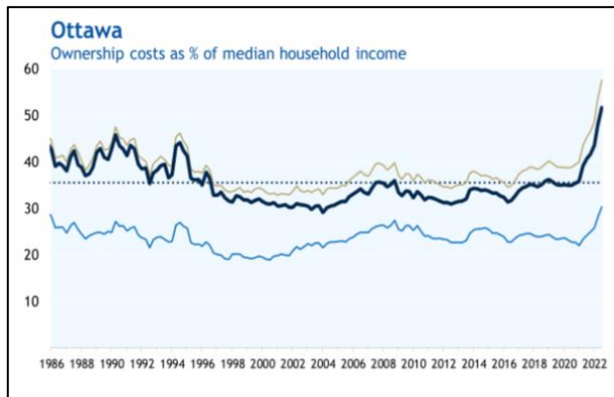
That's the conclusion of RBC's latest housing affordability report[1]. Ownership costs as a share of median income have surged to the highest on record nationally:

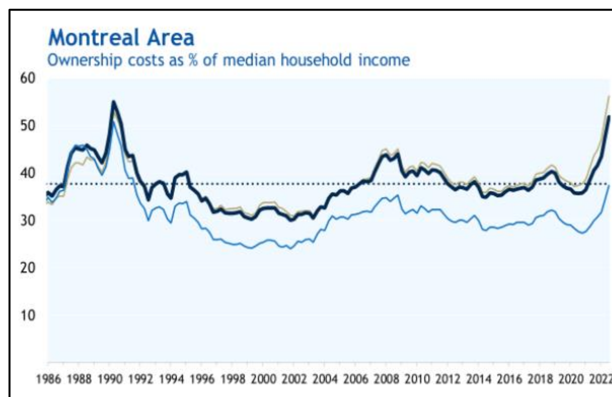


But here too the regional differences are dramatic. No one is shocked at deteriorating affordability in Toronto and Vancouver, <u>but it's worth noting that Calgary is only now just barely back to long-term affordability norms, and it's still way below average for condos…all the more reason to think Calgary is in the early days of outperformance.</u>

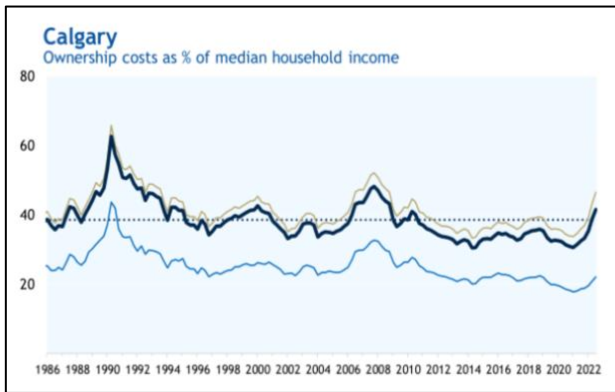








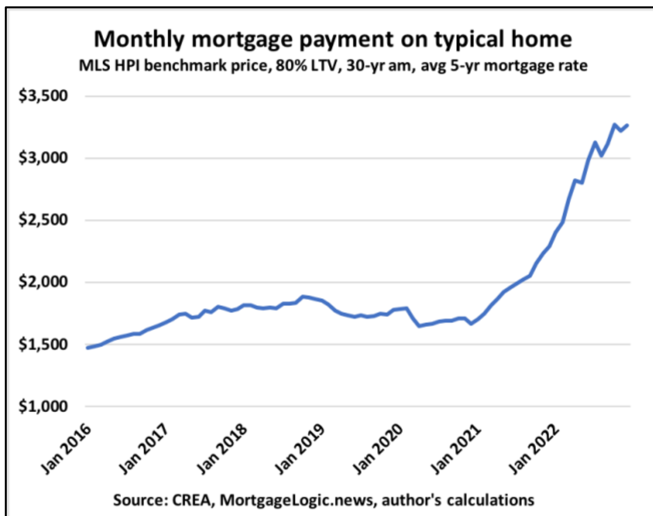
[1] https://royal-bank-of-canada-2124.docs.contently.com/v/homebuyer-blues-dreadful-affordability-gets-worse-in-canada



There is some good news from RBC. They expect affordability to begin improving early next year:

> Price correction should soon bring relief to buyers: The low point for affordability is likely close at hand. Widespread price declines—especially in Ontario and BC—should help lower ownership costs once interest rates stabilize. We expect benchmark prices to fall 14% nationwide from the peak by next spring.

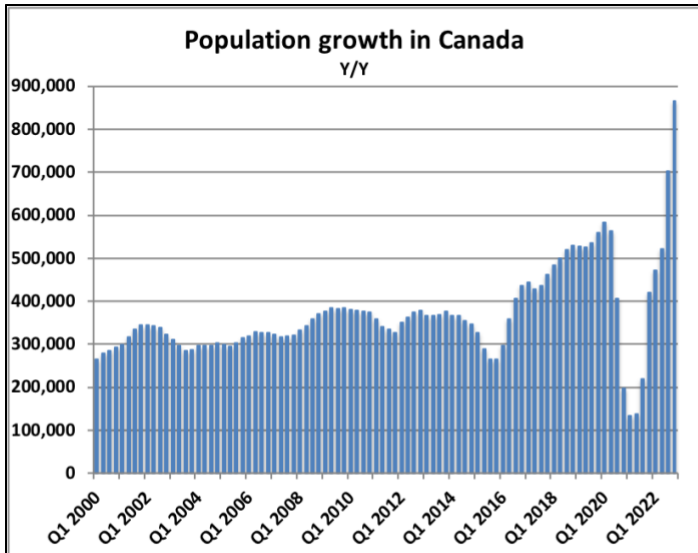
My own calculations put the monthly payments required to carry a mortgage on a typical home at today's prices at just under $3,300…up 43% from one year ago. Until this changes, it's hard to envision demand returning to anywhere close to early 2022 levels:

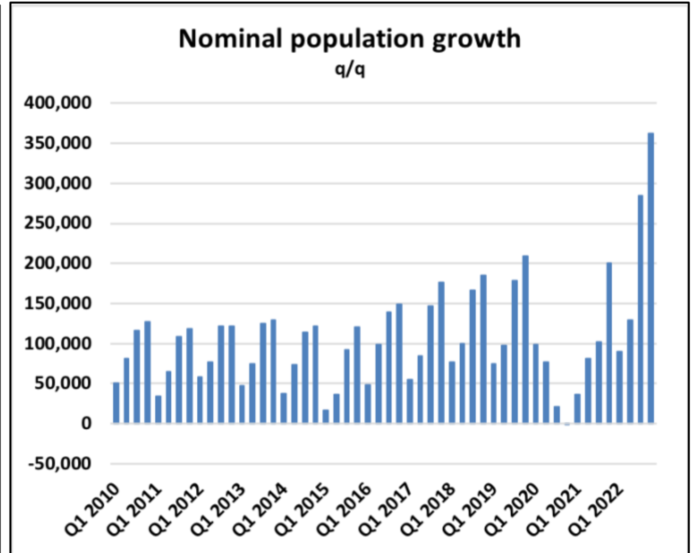


3) Supply and demand: ANOTHER record for population growth

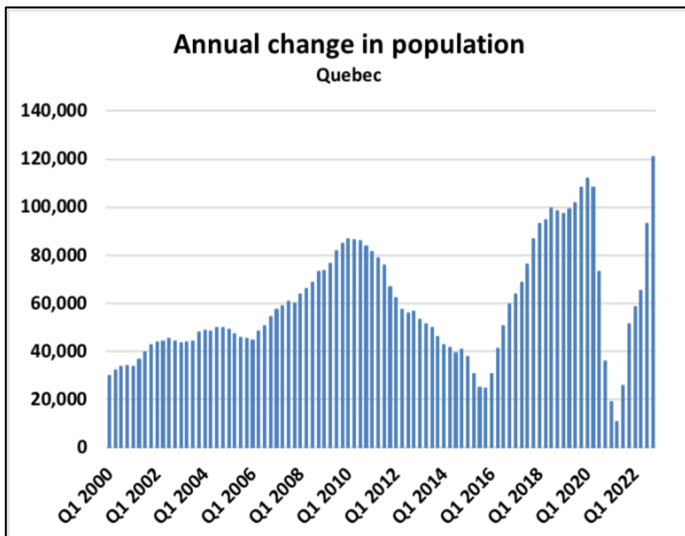
i) INSANE population growth

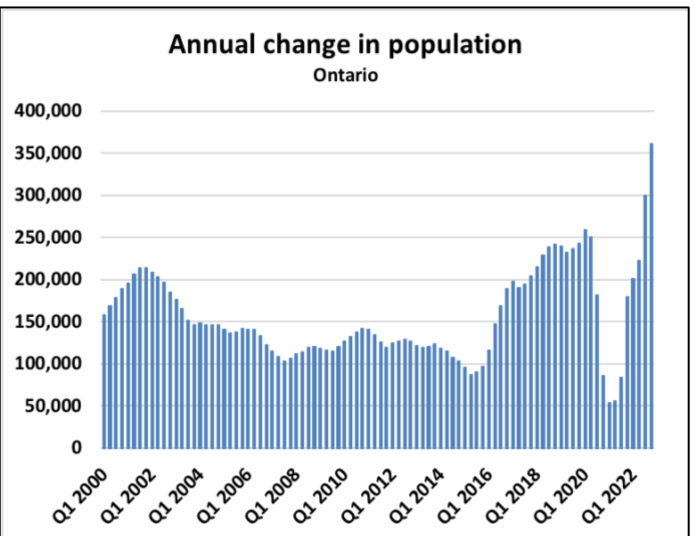
All eyes were on the CPI print this morning but the real fireworks were in the quarterly population estimates. Just LOOK at these charts….865,000 y/y growth and 360,000 in the past 3 months alone! Unprecedented is the right word!

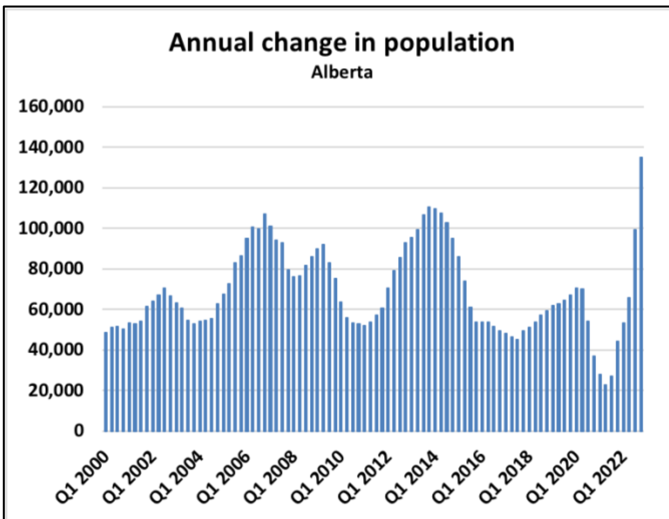


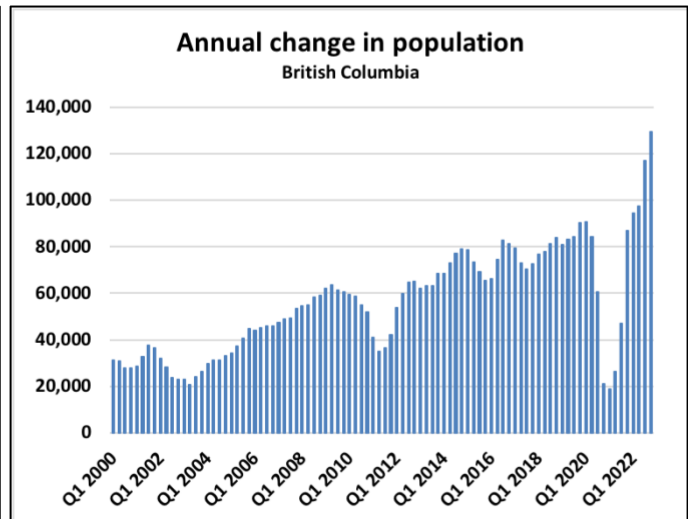


EVERY province set a new record for population growth last quarter:





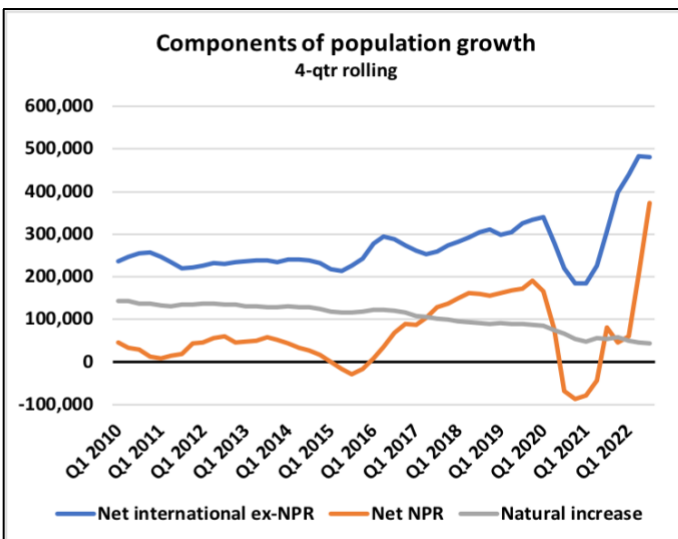


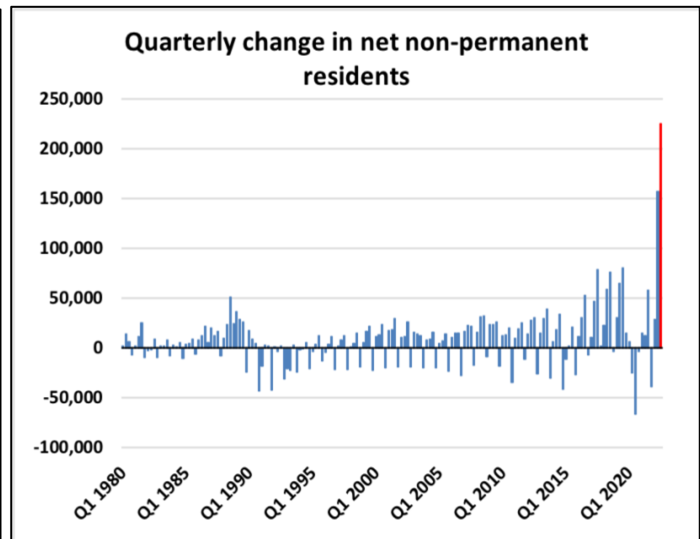


It's pretty hard to overstate how supportive this will be to housing over the longer term if these trends are sustained. As to what drove this boom, we turn to Stats Canada:

> […] the record population growth in the third quarter of 2022 was mainly driven by an increase of 225,198 non-permanent residents (NPRs).

As a refresher, NPRs include international students, work permit holders, and refugees. Note in the chart below that net international migration (ie immigration) actually flattened out. All the gains were in the non-permanent resident (segment which saw by far the largest influx on record.





Again, from Stats Canada:

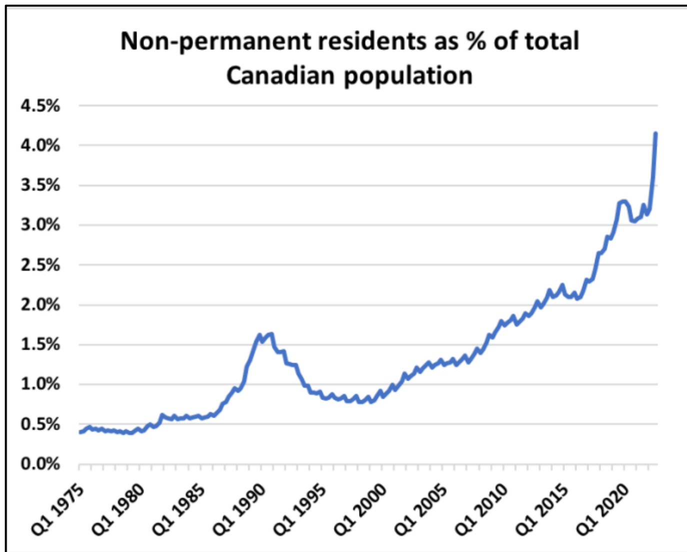
> […] The increase of NPRs in the third quarter of 2022 was larger than any full-year increase since 1971 (when data on NPRs became available). This increase was driven by work permit holders, but all types of NPRs increased, and Canada continued welcoming people fleeing the Russian invasion of Ukraine.

Two points on this:

i) One might wonder if this is a deliberate attempt to suppress what has been a notable uptick in wages (and therefore inflation) by bringing in piles of cheap foreign workers rather than have businesses compete for existing labour.

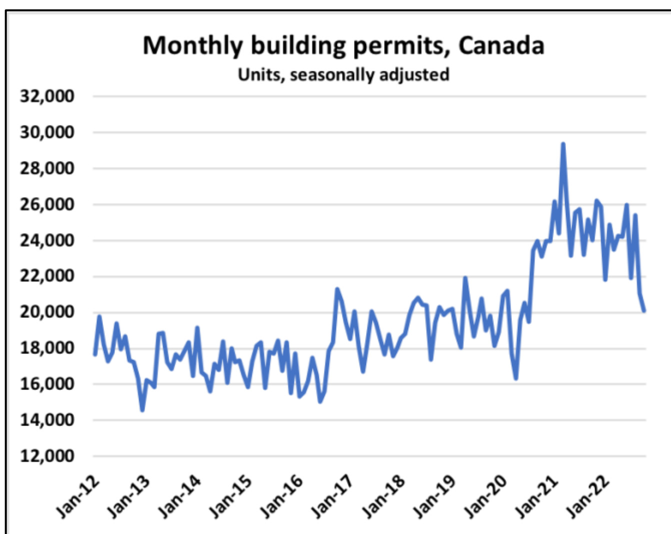
ii) This creates a vulnerability that few recognize. We bring in foreign labour when the job market is tight, but they often go home when the labour market turns. This was true in 2015, 2020, and most significantly in the early 1990s (see below). What this does is create a hyper-cyclical rental market where rental demand surges when we bring in temporary workers but unexpectedly weakens as the economy rolls over and those same workers leave.

That's potentially an issue when we have a record 4.1% of the total Canadian population in this highly volatile bucket. Something to watch if we do head into recession next year where we may suddenly find ourselves with surplus of workers:



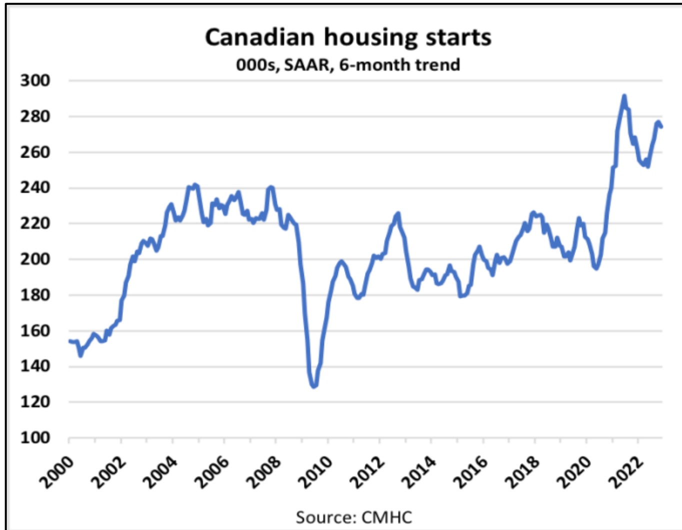
ii) Building permits plunge

At the same time that population is surging to new records, developers are pulling back. Building permits fell 4.6% seasonally adjusted in November after plunging 17% the month prior. It's the steepest 2-month decline in over a decade, and it doesn't bode well for the future supply growth that will be needed to house all the newcomers:



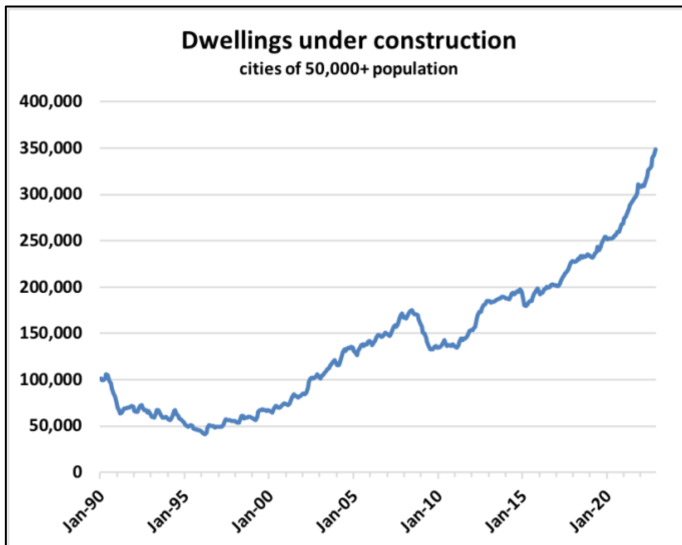
iii) Housing starts flat in November

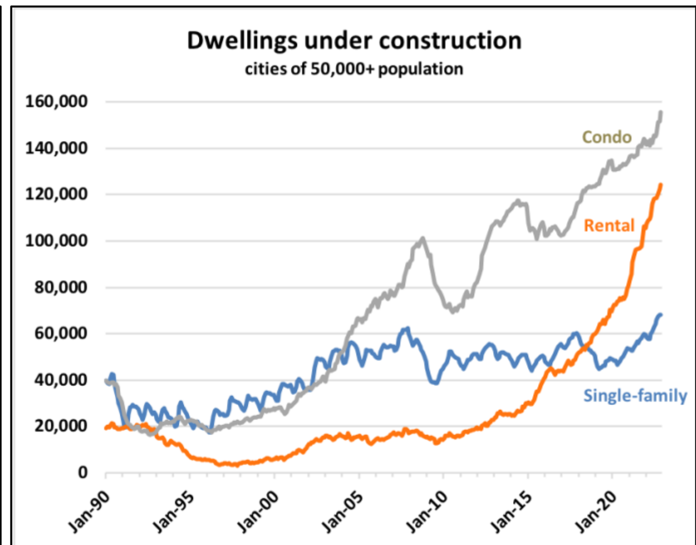
Canadian housing starts were flat in November at 264,000 annualized and are still at nearly 275k average over the past 6 months:



Starts lag building permits by about 6 months, so expect a steep slowdown early in 2023.

As for the new housing pipeline, dwellings under construction rose 1.8% m/m to hit 350,000 in larger cities in November. All 3 segments hit new record highs including condos which rose 2.7% on the month:



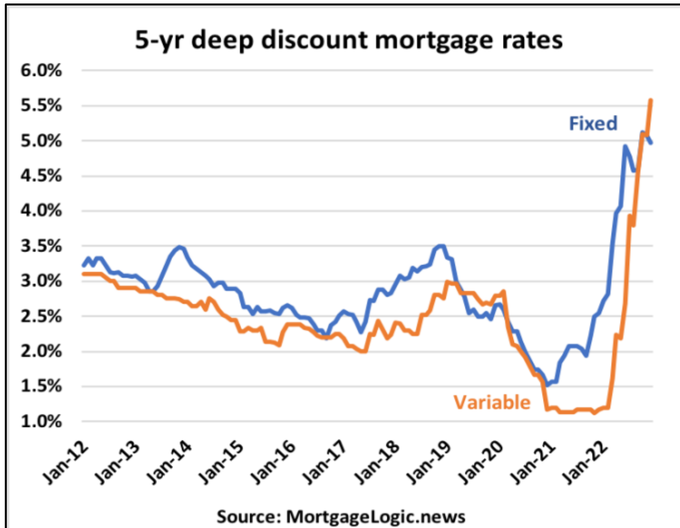


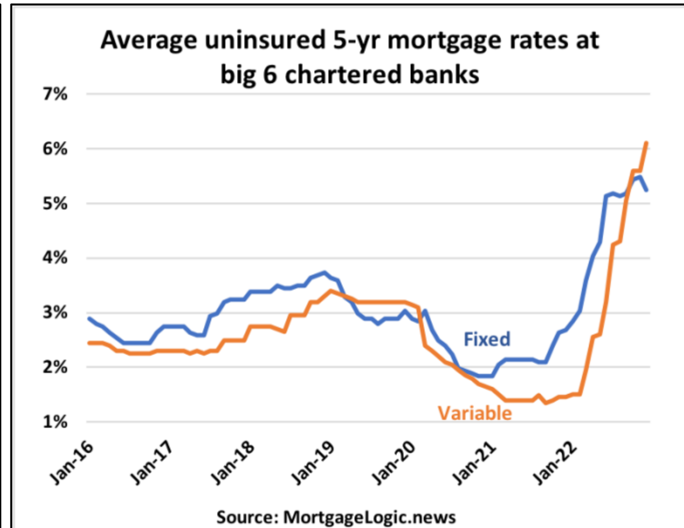
The takeaway is this: There's a pile of housing under construction which will keep the market well supplied into 2023, but the flow of new construction projects will slow sharply. And it the feds really are committed to these population targets, there's no way to avoid a severe supply crisis at some point down the road.

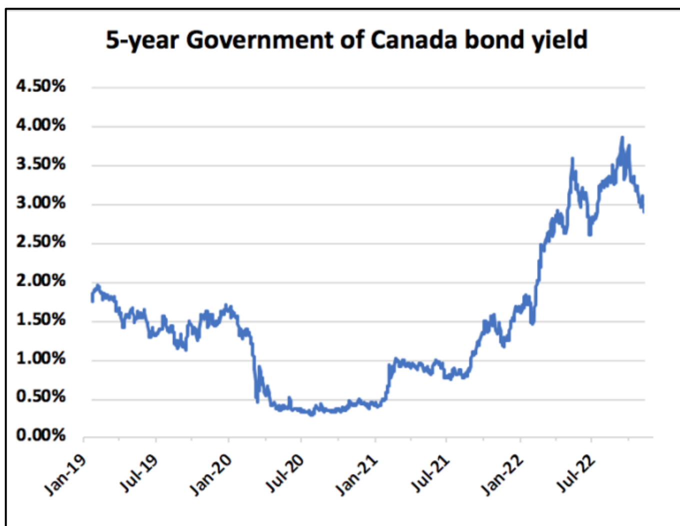
4) Mortgage rates update: Fixed rates drift lower, mortgage growth tumbles

i) Rates drift lower

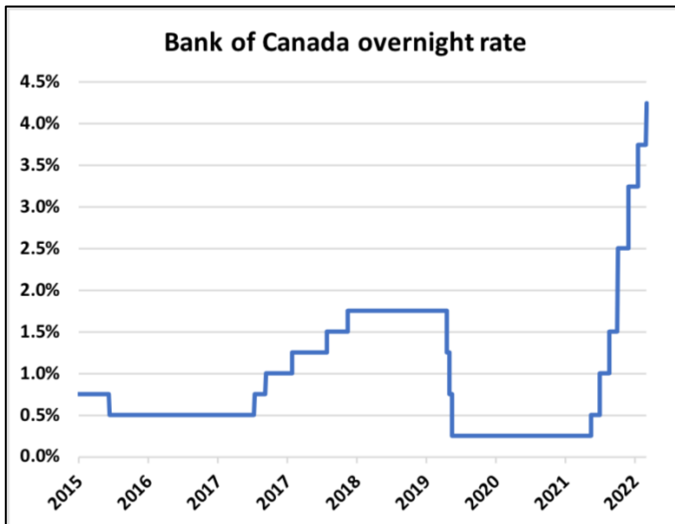
Fixed mortgage rates continue to drift lower, dragged down by 5-yr bond yields that have fallen by nearly 90bps over the past couple months. I suspect we'll see further downward pressure on fixed rates over the next couple weeks:

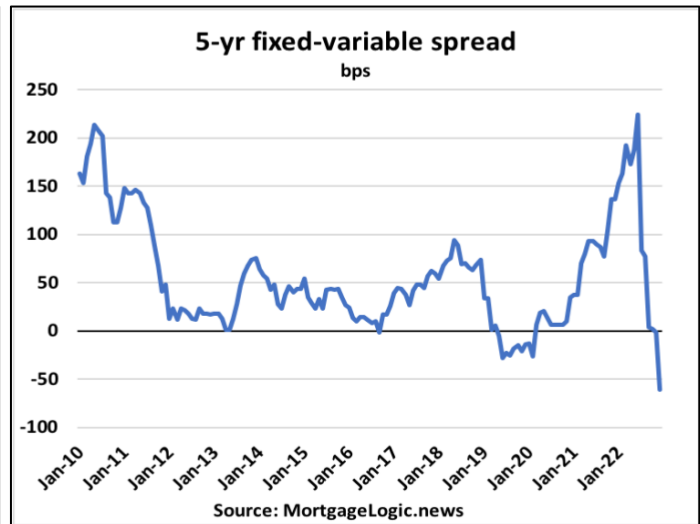






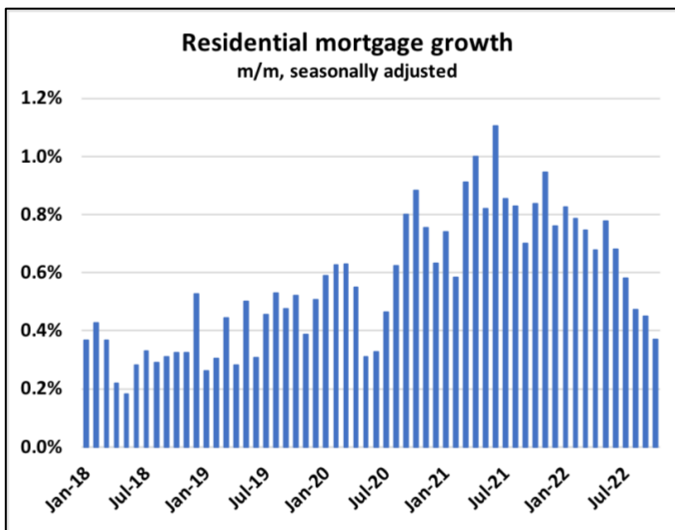
Variable rates moved higher with the latest 50bp rate hike from the Bank of Canada on December 7 and are now priced nearly 60bps above 5-yr fixed rates:

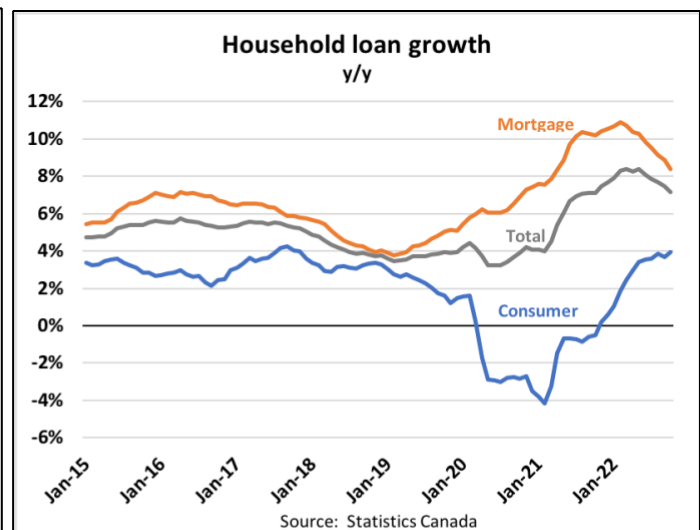




ii) Mortgage growth slumps

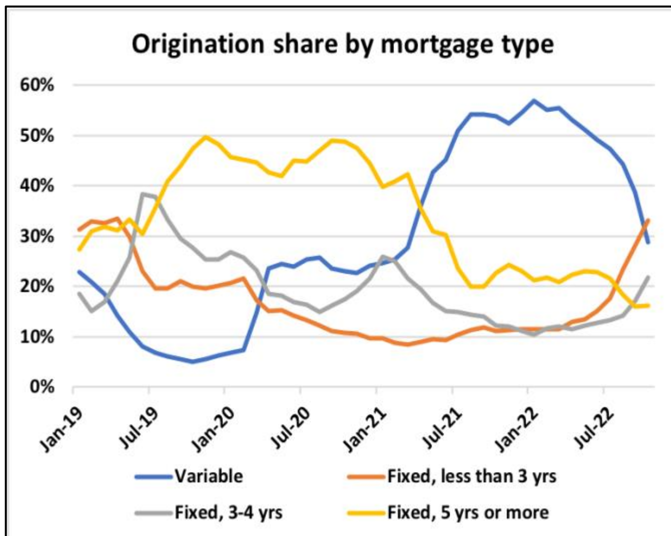
Residential mortgage growth slowed again in October, posting the weakest increase since June 2020. Mortgage debt is still 8% higher than one year ago, but slowing quickly. I expect we'll see sub-4% growth in 2023 based on origination trends, which were running nearly 30% below 2022 levels in October:





iii) Borrowers still betting on Bank of Canada pivot

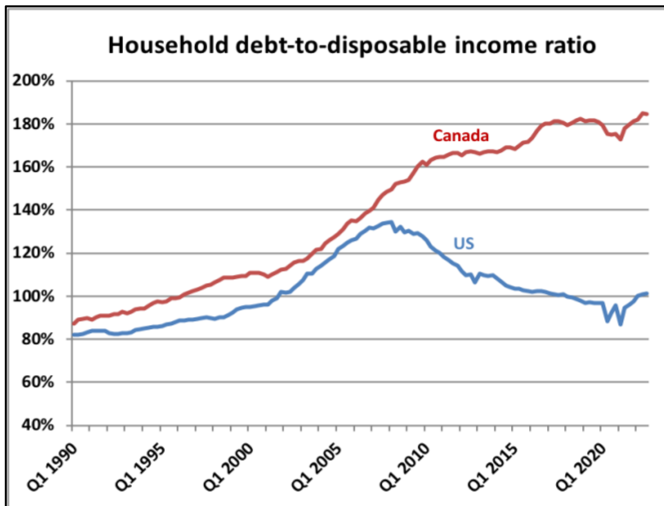
For the first time since early 2021, variable rate mortgages are not the most popular term for new borrowers. That crown has been claimed by short-term (1-2 yr) fixed rate mortgages which accounted for nearly 35% of new borrowing in October. Meanwhile 5-yr fixed terms remain near historic lows at just 15% of originations:



5) Consumer check: Debt service ratios jump, housing weighs on net worth

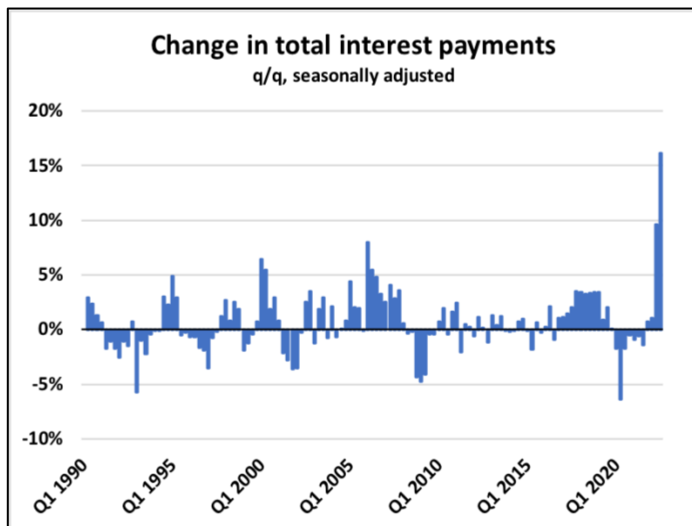
i) Debt-to-income ratios at record high in Q3

Canadian household debt-to-disposable income ratio held steady at a record 185% in Q3:

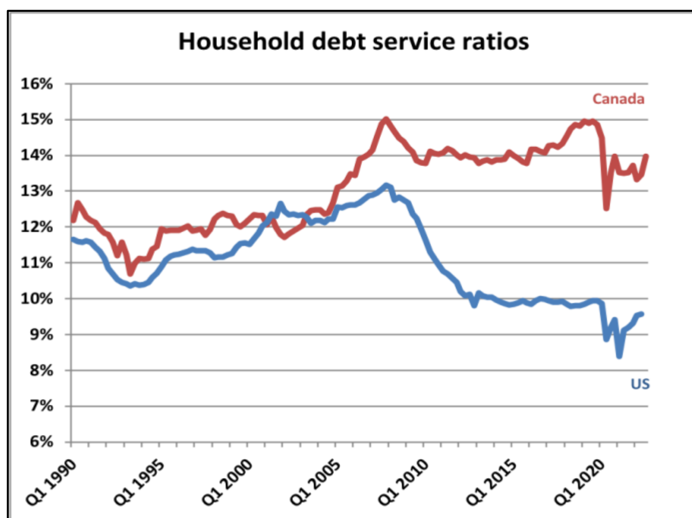


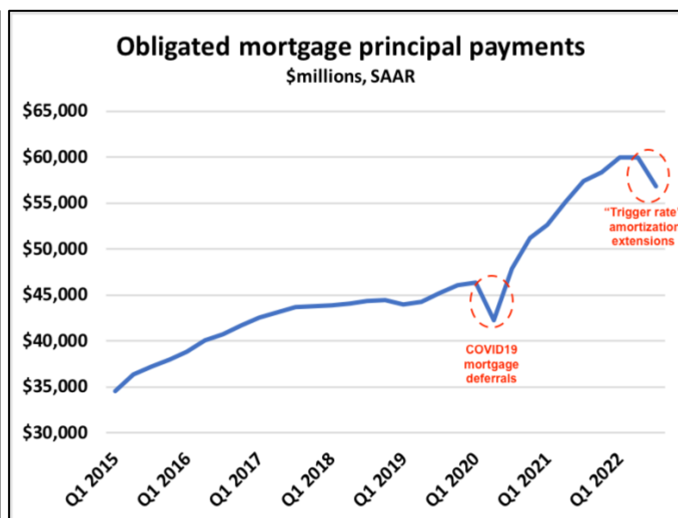
ii) Interest payments post record increase

Household interest payments jumped 17% in the third quarter, the largest increase on record. Mortgage interest expenses hit 4% of aggregate disposable income for the first time since 2009.



The household debt service ratio jumped 50bps q/q, the second largest quarterly increase since at least 1990. And it would have been much higher were it not for a steep decline in principal repayments as banks extended amortizations to soften the impact of borrowers hitting their "trigger rates". For context, the decline in principal payments last quarter was nearly as large as the COVID19 mortgage deferrals in Q2 2020:





Of course that sets up for nasty payment shocks down the road when these mortgages renew and revert back to the original amortization schedule. An interesting expose below from CTV News[2]:

Canadians 'terrified' in face of higher interest rates upon renewal

After seven interest rate hikes implemented by the Bank of Canada in 2022, Anita Gupta says she won't be able to afford her home payments by the time her fixed-rate mortgage comes up for renewal in March.

As a result, Gupta said she has no choice but to sell her home.

"We don't stand a chance … we're packing right now," Gupta told CTVNews.ca in a telephone interview on Thursday. "It's going to be extremely difficult to renew because the interest rate is going to be twice as much."

[2] https://www.ctvnews.ca/business/canadians-with-fixed-rate-mortgages-terrified-in-face-of-higher-interest-rates-upon-renewal-1.6191490

[…] This is the case for Syed Mubarak and his wife, who renewed their fixed-rate mortgage earlier this month. In 2021, the couple secured a one-year mortgage from a B lender at 2.2 per cent interest. Since renewing, the couple's monthly mortgage payments for their Newmarket, Ont., home have risen to approximately $6,500 from $4,000, and they now pay 6.2 per cent in interest.

[…] Mahmood and his wife purchased their home in Cochrane, Alta., in 2018 with a five-year fixed-rate mortgage from an A lender at 3.29 per cent. Mortgage rates currently offered by lenders, however, are around the six-per-cent mark, he said. This would take his monthly payments from $1,985 to about $2,500.

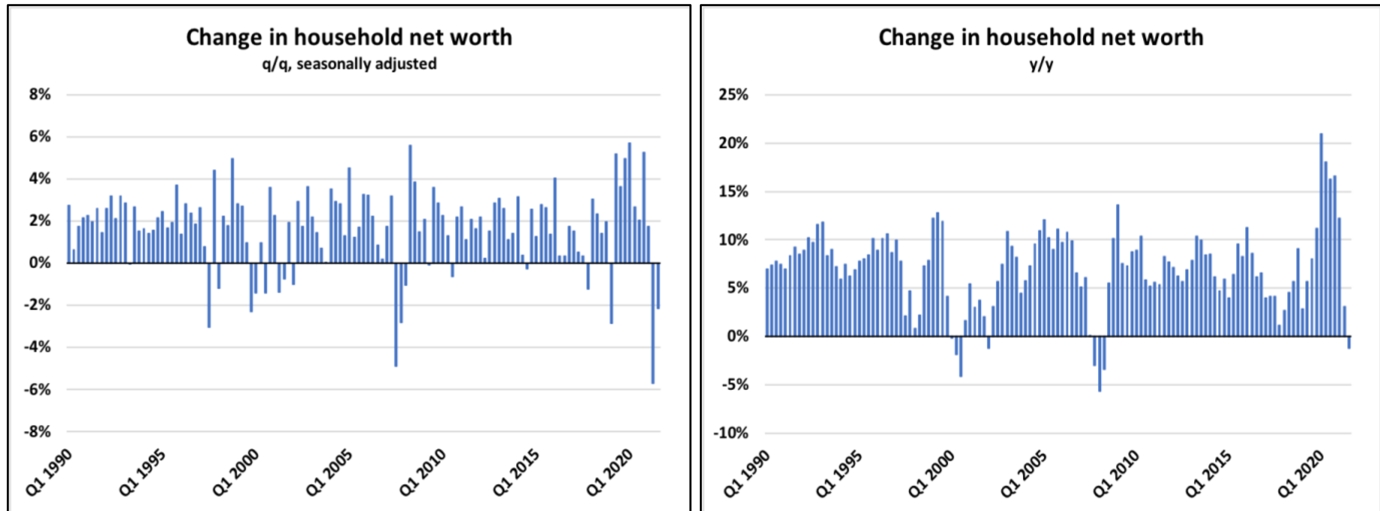
"We're barely affording our mortgage as it is," he told CTVNews.ca

[…] Mehdi Amiri is in a similar position. His bank called on Dec. 5 to notify him of his mortgage renewal in May, and offer him the chance to secure a new rate in advance. However, renewing his mortgage now would result in a $1,200 increase in monthly payments for a five-year fixed-rate agreement from the A lender, he said.

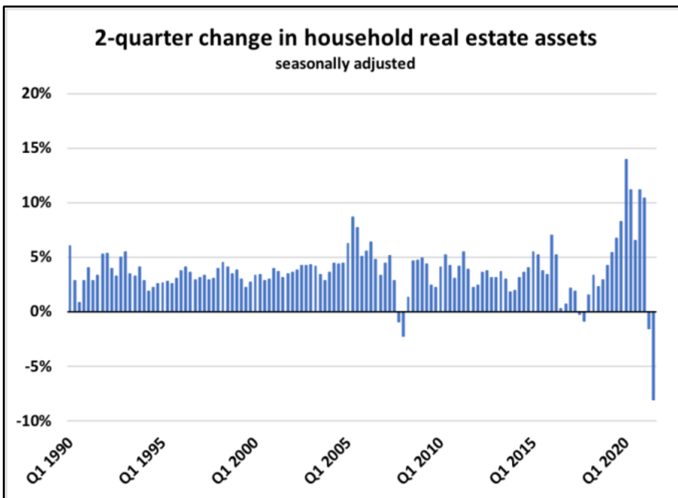
"I was shocked," the 36-year-old told CTVNews.ca in a telephone interview on Sunday

iii) Net worth dragged down by falling real estate

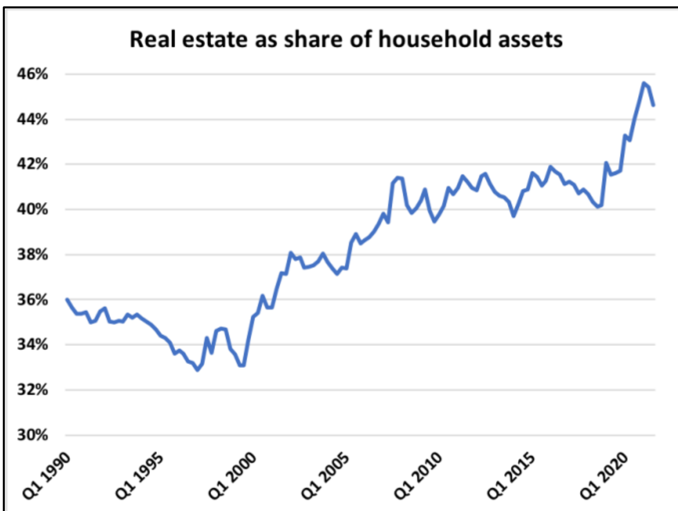
Canadian households saw their net worth contract 2.1% last quarter, and it's now negative on a y/y basis for the first time since 2009, and that has serious implications for big ticket expenditures going forward. It's simply a fact that people spend less when their net worth falls:

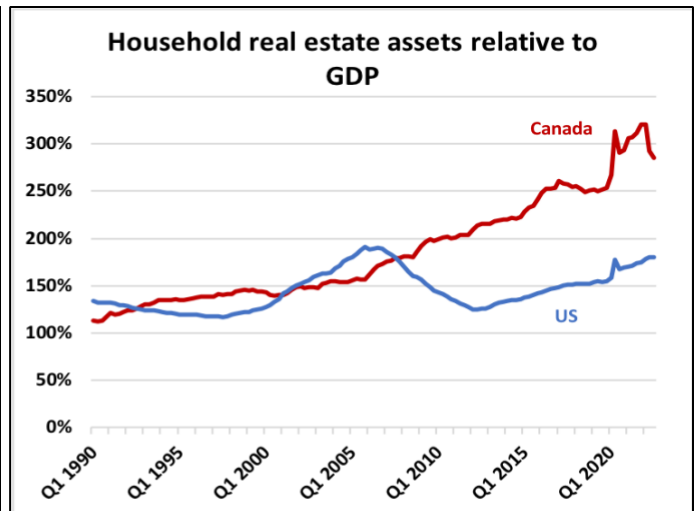


Real estate assets plunged a further 3.3% q/q bringing the 2-quarter change from peak to -8%...by far the steepest such decline on record:

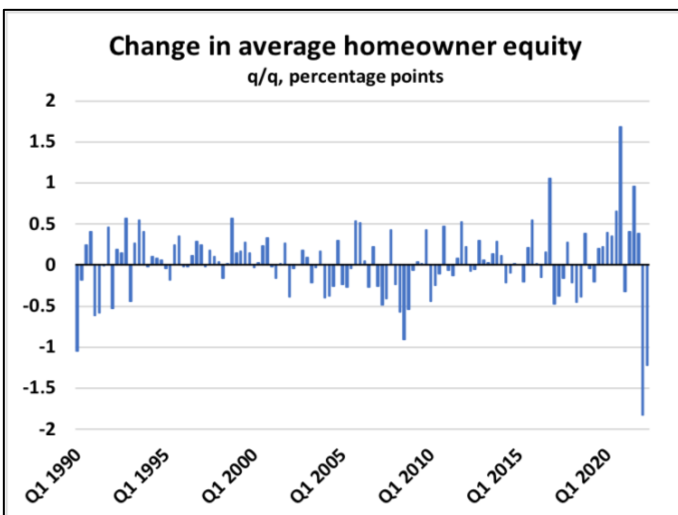


Real estate still represents a near record share of household assets, which will serve to amplify the impact on consumption going forward. And in terms of further potential downside, consider that that housing assets are still nearly 300% of GDP, only marginally off the all-time highs and nearly double the levels in the US:



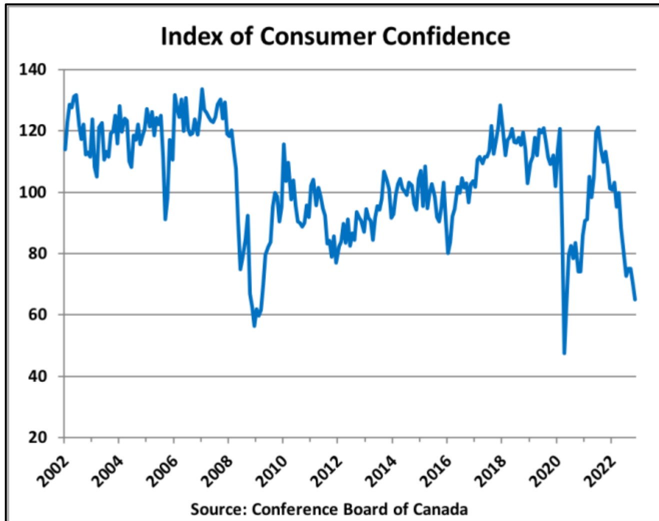


Average homeowner equity levels are still healthy but have posted the two largest quarterly declines on record:



iv) Sentiment hammered

When your net worth declines and newspapers are filled with headlines about a looming recession, it's hard to feel optimistic. Not surprisingly, the Conference Board's measure of consumer confidence plunged 5.3 points in November. Outside of 2 months at the onset of the pandemic and 5 months during the depths of the Financial Crisis, this is the lowest level for consumer confidence in at least 20 years:

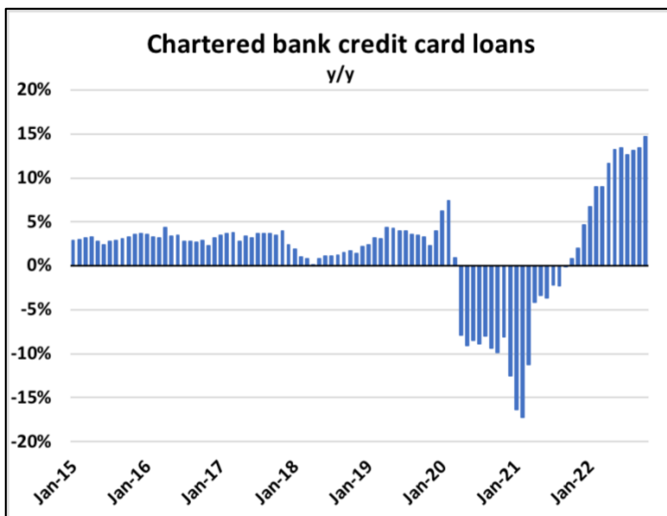


vi) Consumers pile on credit card debt

From Statistics Canada this week:

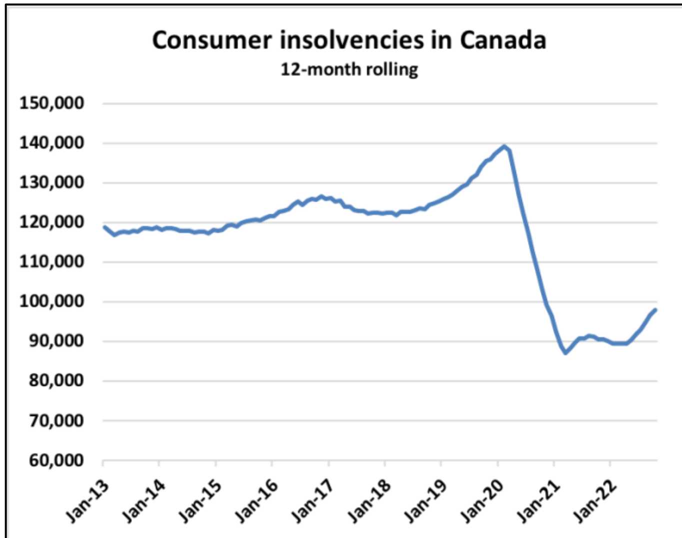
> Faced with inflationary pressures, households continued to increase their reliance on credit cards relative to other forms of non-mortgage debt in October. More than two-thirds of the $2.2 billion (+0.3%) increase in non-mortgage loans in October was in the form of credit card debt with chartered banks.

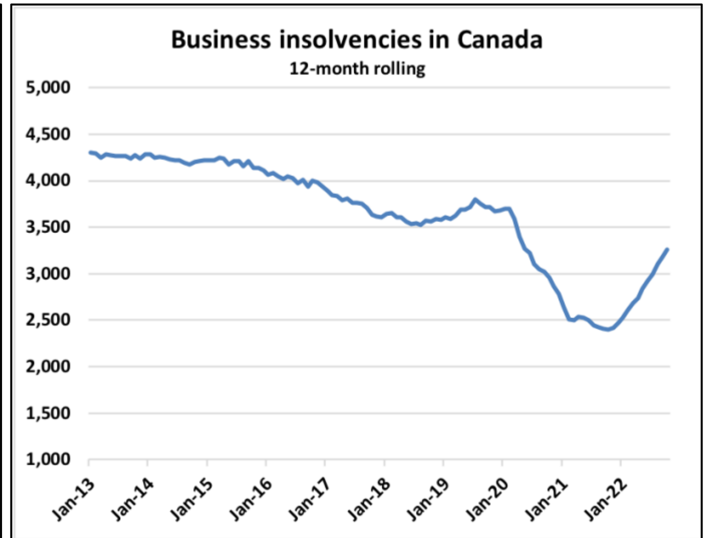
Yikes! That's not a good read into the state of the Canadian consumer or the durability of current spending trends. In fact, the annual growth in credit card loans at chartered banks is currently the highest since in a decade:



vii) Consumer insolvencies up 19% y/y

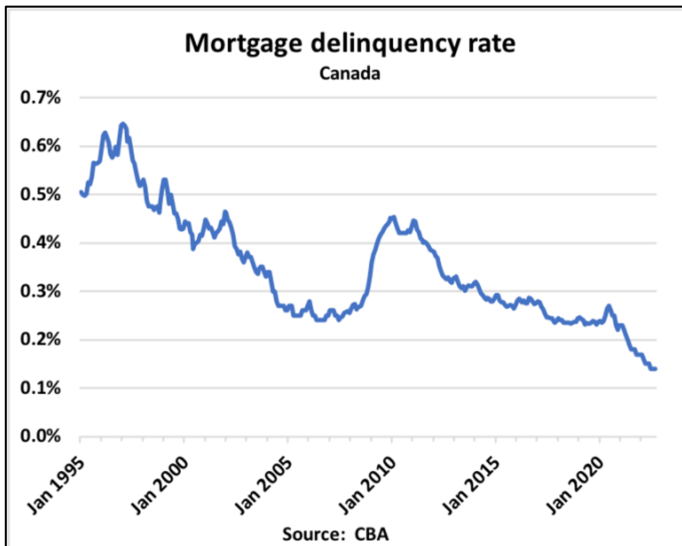
Bankruptcy and proposal filings jumped 19% y/y in October led by a 32% increase in BC. We're still well below 2019 levels for now, but the trend is definitively to the upside. The real action is in business insolvencies which rose 32% and are trending up much more rapidly than for consumers.





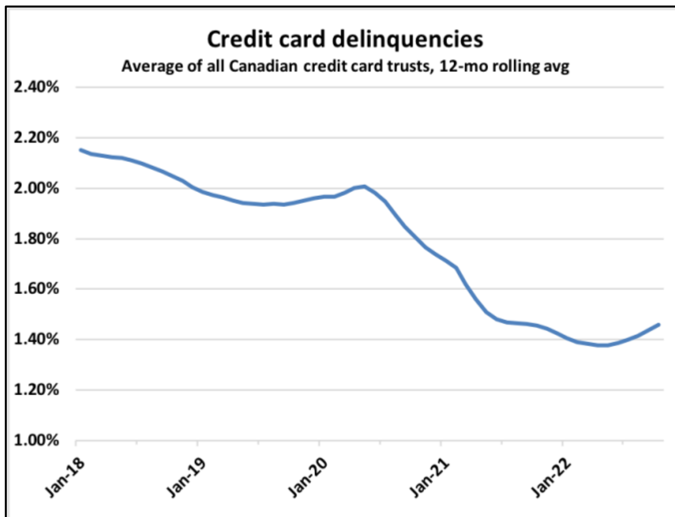
viii) Mortgage delinquencies still at the lows….sort of

Official mortgage delinquency data shows that just 0.14% of Canadians are behind on their mortgage. That's a record low:



The problem is that this data lags so badly that it's nearly useless as a forecasting tool. For starters, this is data as of September. That's stale to begin with, but because of bank reporting requirements, some mortgages aren't reported as delinquent until they are 180 days late. So in other words, this data captures people who stopped making payments as far back as March.

A much better gauge of credit stress is credit card delinquencies which report monthly. Here we see a definite upward trend, albeit with a long ways to go to get back to normal levels.



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

Have a great week, and all the best of the holidays!

Ben