The Edge Report

January 2022

Compliments of: TheMortgageGuyNiagara.com

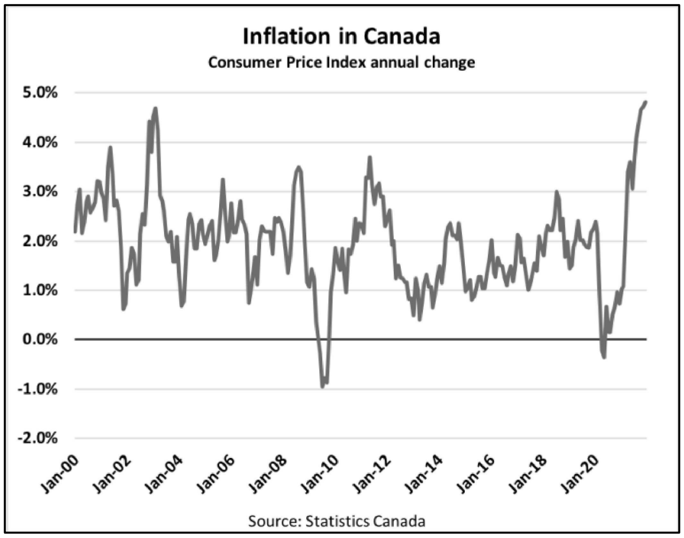
Hyperlinks:

1) Interest rates set to move as inflation expectations jump

We start this month's note with a look at some important developments on the inflation front since rates and inflation remain the biggest risk to this market currently.

The key takeaway is this: I now think there's a very good chance that we'll see the Bank of Canada hike rates by 25bps TOMORROW, and I'm now thinking we may be looking at 3-4 hikes this year as opposed to the 2-3 I had anticipated previously.

So why the change? Yes, headline inflation is up a tad from last month and is running at 30-year highs, but that was largely expected. No big surprise here:



What has changed are expectations of future inflation on the part of consumers and businesses, and this is a bigger deal than most people realize.

To understand why, we need to remember that inflation has a BEVAVIOURAL component to it. It's not entirely about how much money is being created or about supply chain issues.

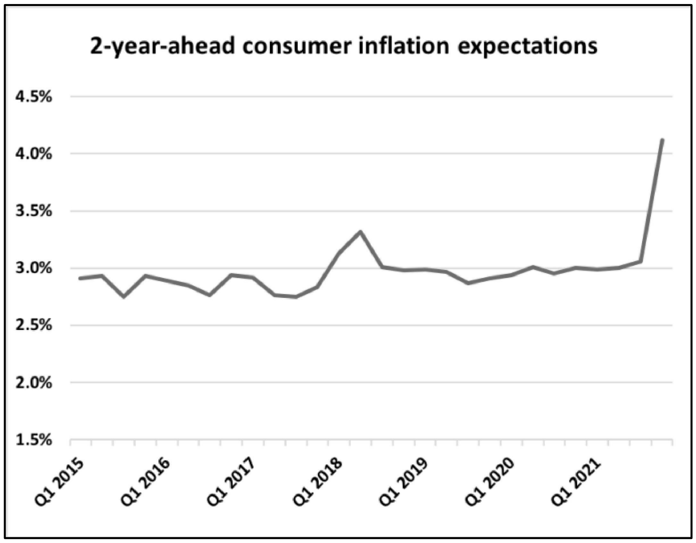
The Bank of Canada not only wants inflation in the 1-3% range, they want people's EXPECTATIONS of future inflation to remain anchored in that same range since people's expectations of future inflation impacts their spending patterns today.

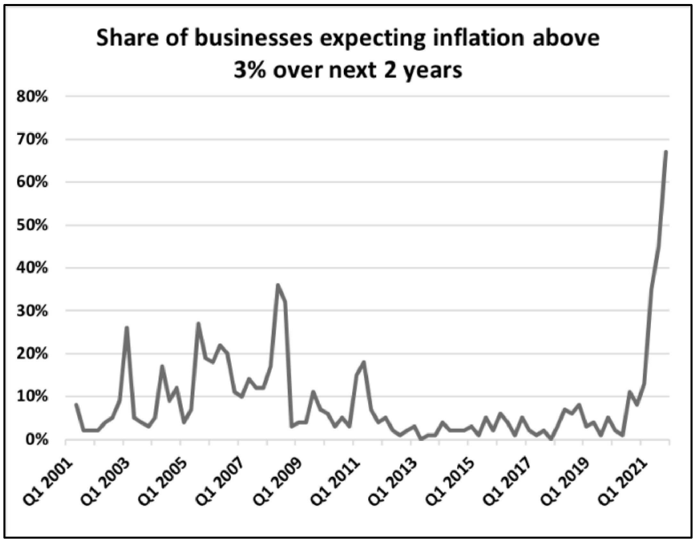
As an example, consider how someone might view their savings differently if they think inflation will be at 2% compared to 20%. To make it really concrete, let's say someone is saving to build a new deck in 2 years. If that person expects the price of the deck (including material and labor) to cost 2% more each year, they will probably be content to leave their savings in the bank and keep adding to it until they reach their goal.

But that same person will act very differently if they suddenly expect the price of that deck to rise 20% per year. They are much more likely to spend their savings today and may even borrow money to "lock in" that price before it rises further.

When you multiply this across an economy, it risks creating a self-fulfilling feedback loop whereby people spend more because they THINK prices will be higher later, and this creates more demand…which leads to higher prices…which in turn which creates fear of even more price increases…which pulls forward even more spending. Rinse and repeat. It's a potentially nasty cycle and one that every central bank fears since the only way to break it is to hike rates until the point where the economy tips into a recession.

Now let's look at survey data released this week by the Bank of Canada. Below left is a chart showing where consumers think inflation will be in 2 years. Below right is a similar chart showing the share of businesses expecting inflation to run above 3% over the next 2 years:





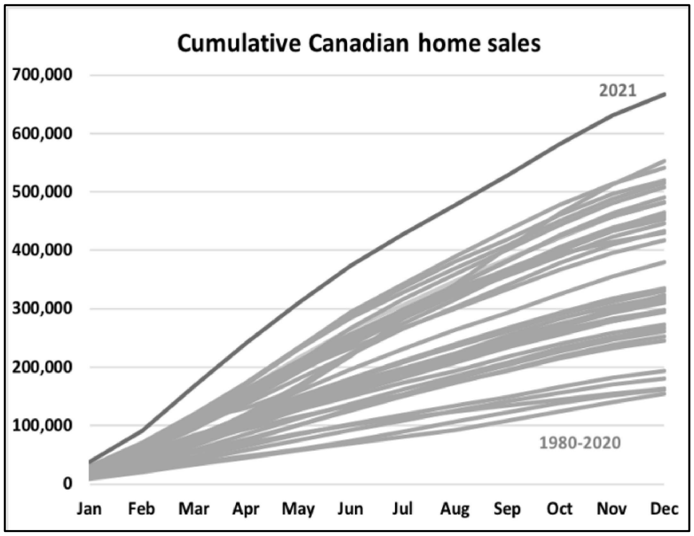
Until now, inflation expectations among consumers and businesses had been relatively "anchored" beyond the next year, which tells us that most people bought into the "transitory"/temporary inflation narrative. But that changed with the data released this week. And if you're the Bank of Canada, this puts you in a very difficult spot. You may be absolutely convinced that inflation is transitory, but if consumers and businesses disagree, their spending patterns can create a more permanent inflation.

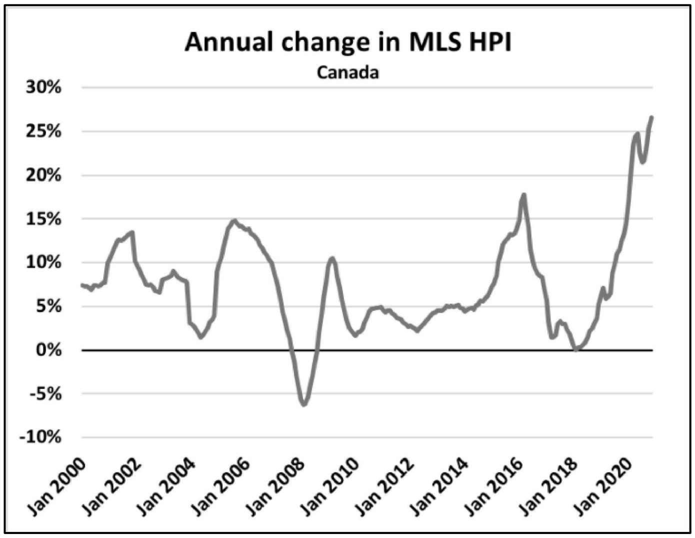
This is a big deal, and the Bank of Canada is going to want to get ahead of this. To be clear, I still don't think we'll see the 6 hikes that markets are expecting in 2022, but I am expecting a bit more upward bias on interest rates than I was previously.

2) National home sales update

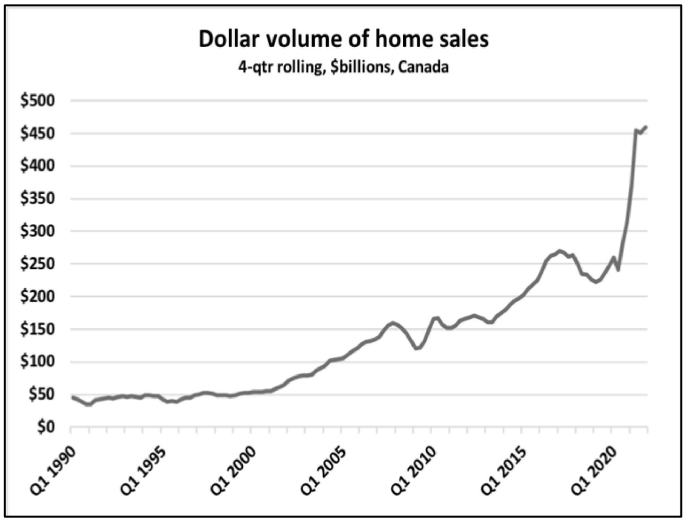
i) Just when you thought things couldn't get any crazier…

…we learned last week that final 2021 home sales eclipsed the prior annual record by 20% (!) while house price appreciation hit a record high of 26.6% y/y in December:

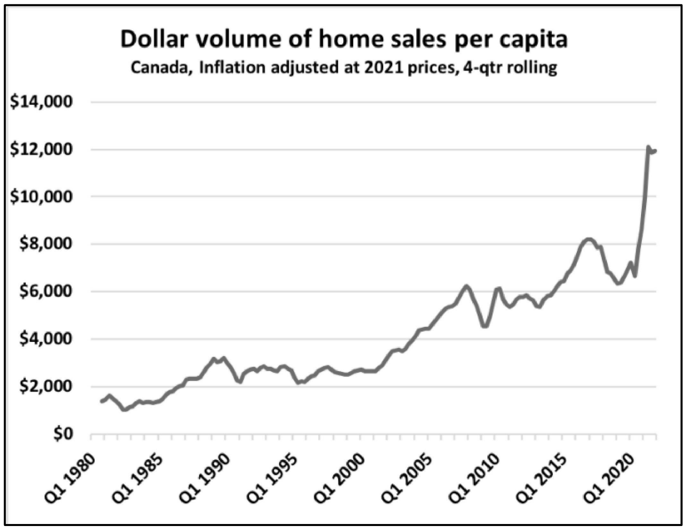




When you combine prices with transactions, you end up with a massive record for the dollar volume of homes sold. We've now seen $460B in home sales in the past year alone. And since real estate and mortgage commissions are directly related to sales volumes (and the mortgage debt needed to finance these purchases), this tells us just how good a year it was for folks in those industries:



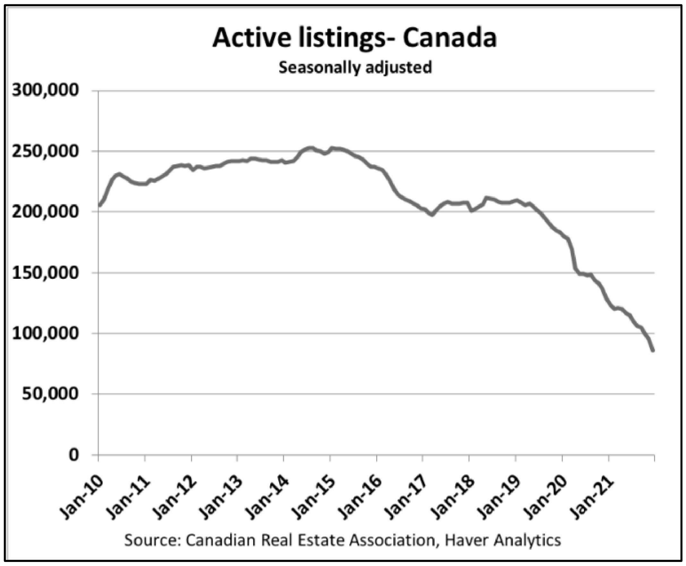
Now let's look at that same chart on a per capita basis to account for population growth, and let's adjust the numbers to account for inflation so we can compare over time. When we do that, we see that every man, woman, and child in Canada bought the equivalent of $12,000 worth of real estate in the past year. It's never EVER been anywhere close to that, even accounting for inflation. In fact, it's 50% higher that the peak in 2016 which warranted significant policy interventions in the form of B20 and foreign buyer taxes:



Two things we can take away from this chart:

- You have to think that policy makers will respond to this absurd level of demand.
- It should help us think about what to expect in 2022. As they say, trees don't grow to the sky. Expectations should reflect the reality that it's going to be very difficult to grow sales volumes (and hence commissions) off these numbers, particularly with rate hikes and mortgage tightening on the horizon.

While demand remains impressive, the real story is still the supply side. Active listings posted a seasonally adjusted 9.9% monthly drop in December, the steepest 1-month decline on record. There are now fewer than 90,000 listings across the country, a 33% decline from last year and a 54% drop since the start of the pandemic. The decline has been simply relentless. Months of inventory are now at a record low of just 1.6, and since there's a direct correlation between falling months of inventory and accelerating price trends several months out, there's a good chance that we may still see new price appreciation records in coming months:



I have to reemphasize this point: A balanced market is closer to 5-6 months of inventory, which implies that in order to get back to a more normal state, inventory needs to more than triple or sales have to fall by 2/3 (or some combination of the two).

The table below shows the important monthly data for Canada and some select provinces. I would again draw your eyes to the absurd trend in active inventory:

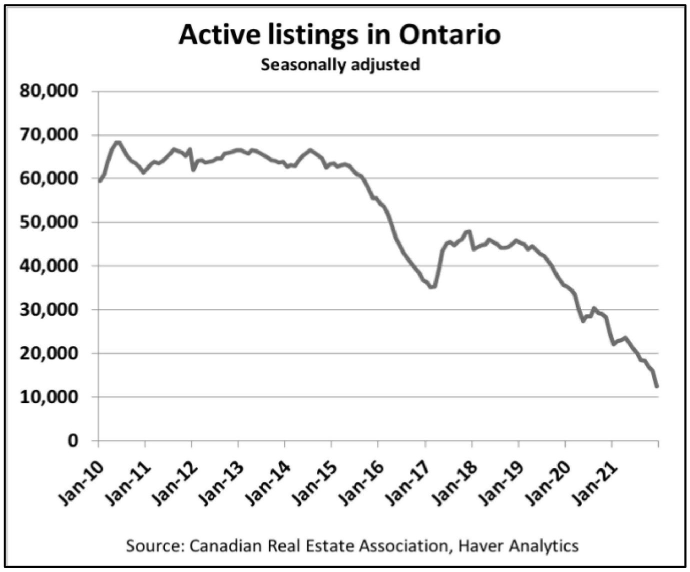
	Sales		New listings		Active inventory		Average prices	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	-7.6%	+0.2%	-12.0%	-3.2%	-33.4%	-9.9%	+17.9%	+1.5%
BC	-15.8%	-2.4%	-15.6%	-3.9%	-40.4%	-6.7%	+22.5%	+2.4%
AB	+30.3%	+5.0%	+1.3%	-0.4%	-21.9%	-5.7%	+7.5%	-0.6%
ON	-10.3%	+1.1%	-9.0%	+2.9%	-48.7%	-22.4%	+23.0%	+1.9%
QC	-16.0%	0.0%	-26.6%	-19.8%	-29.4%	-10.7%	+17.9%	+1.4%

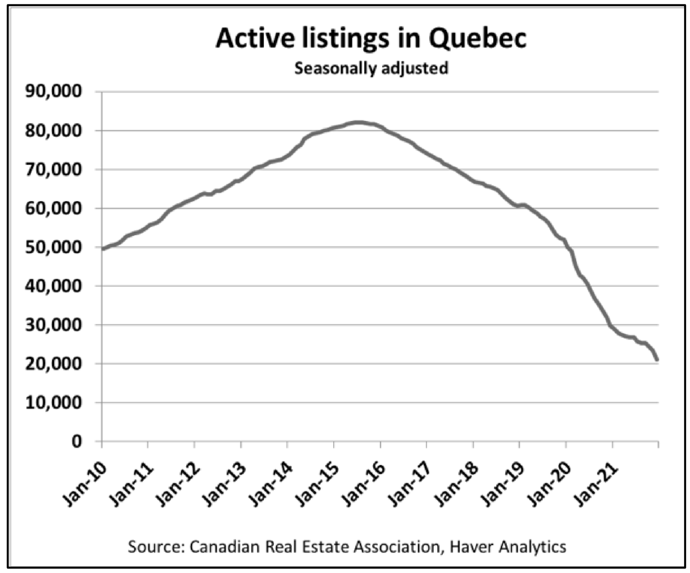
ii) Inventory shortages visualized

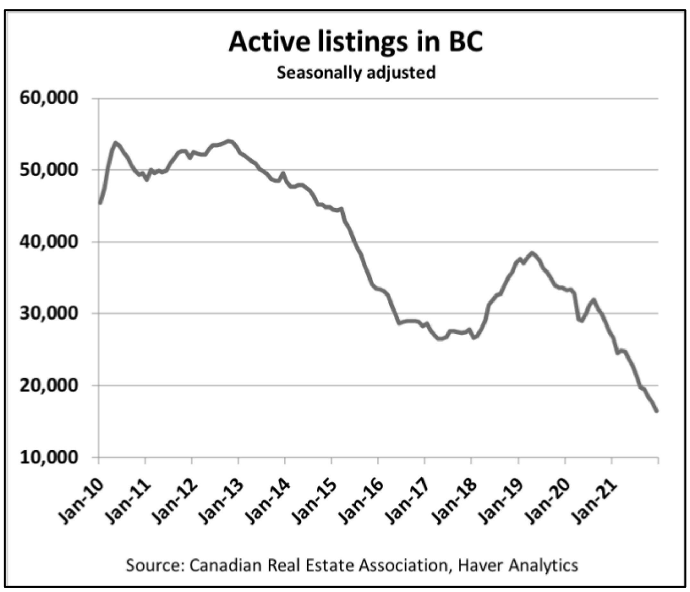
It's perhaps worth stopping here for a moment and zooming in on active inventory across provinces since these charts truly are jaw-dropping. You have the y/y change in inventory in the table above, but now consider the change in inventory from the 2010-2015 average:

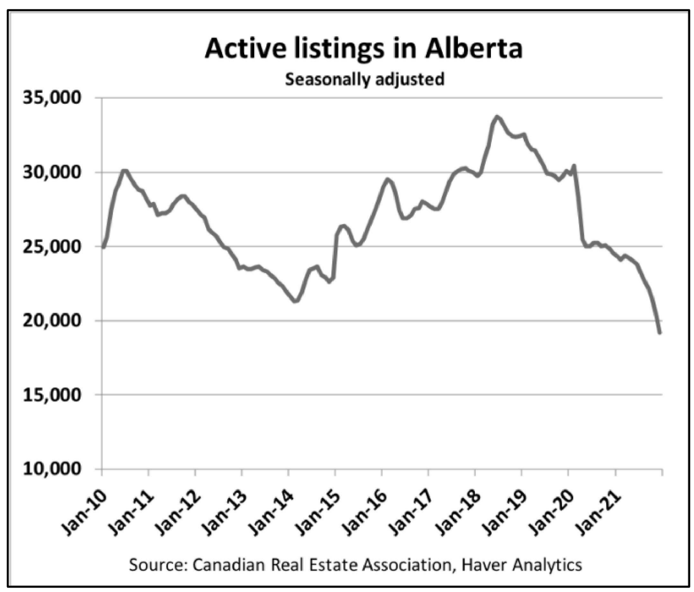
Ontario:	-80% (**NOT a typo!**)
Quebec:	-69%
BC:	-66%
Alberta:	-25%

Here's how that looks in chart form:









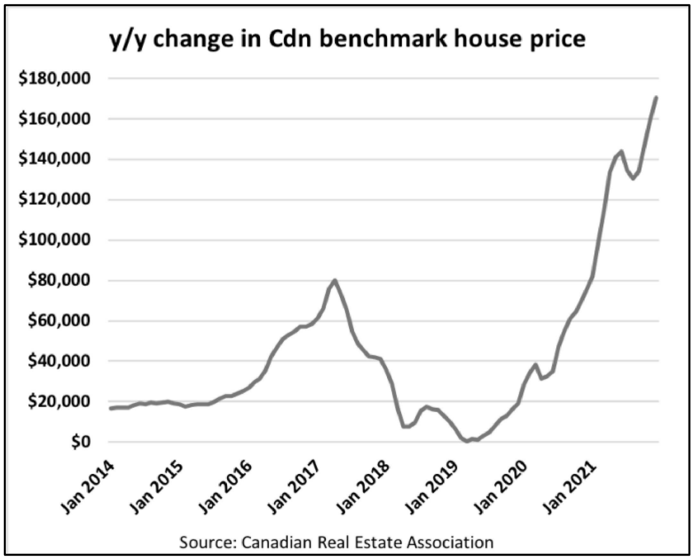
There's no other way to put it: This is a what a crisis looks like.

This is the number one trend to watch. Until these charts hit some sort of bottom and inventory levels begin to rise meaningfully, there's just no end in sight to these crazy prices.

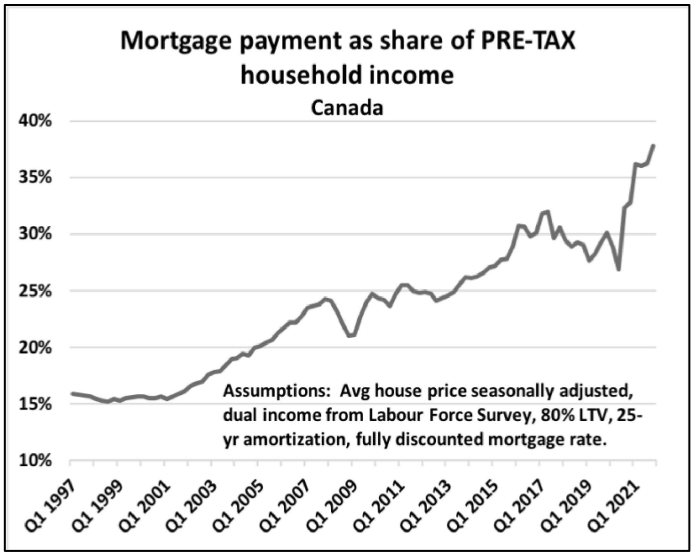
iii) Thoughts on "housing nomads" and who benefits from deteriorating affordability

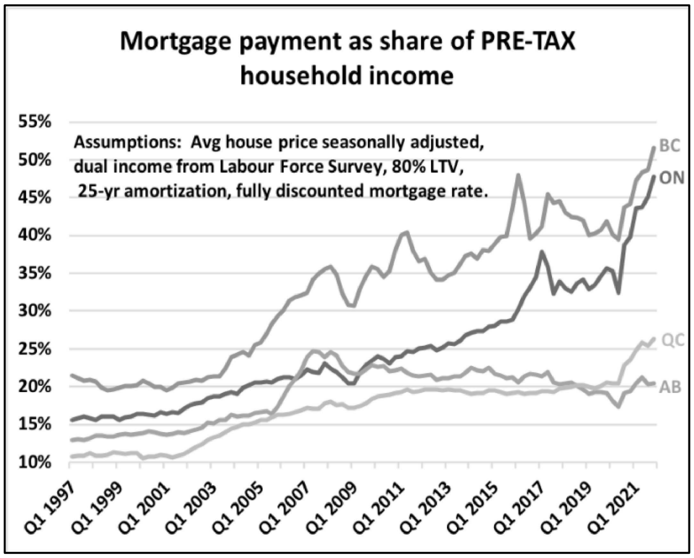
The price gains are also getting just silly. I'll be the first one to point to the absurd imbalance in supply and demand across the country as a fundamental underpinning, but eventually we're going to run up against real constraints related to the ability of prospective buyers to sustain these prices. Consider that the typical house in Canada has risen by $170,000 in the past year alone, and it's closer to $200,000 for single-family homes.

To "earn" $170,000 in pre-tax income, you'd need to earn just shy of $300,000 in most provinces…which is top 1% level income. Just think about the absurdity of that stat.

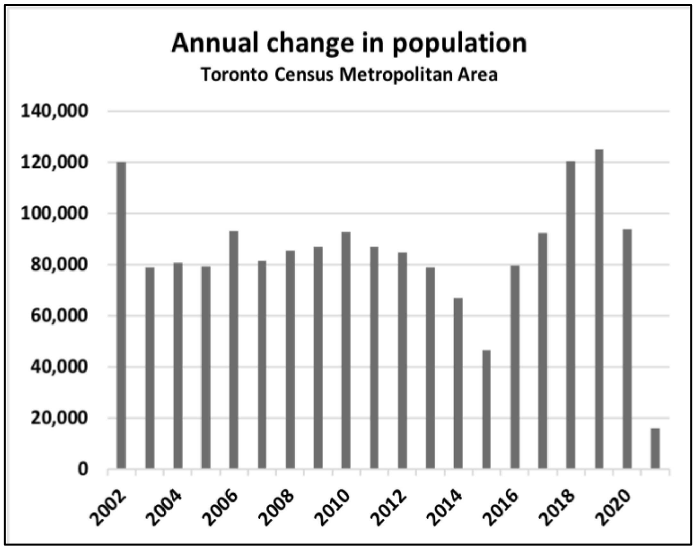


I've updated the affordability metrics to include the Q4 data. Affordability pressures are intense right now and only getting worse…and that's particularly true in Ontario and BC. We're now looking at some of the highest carrying costs relative to income that we've ever seen:

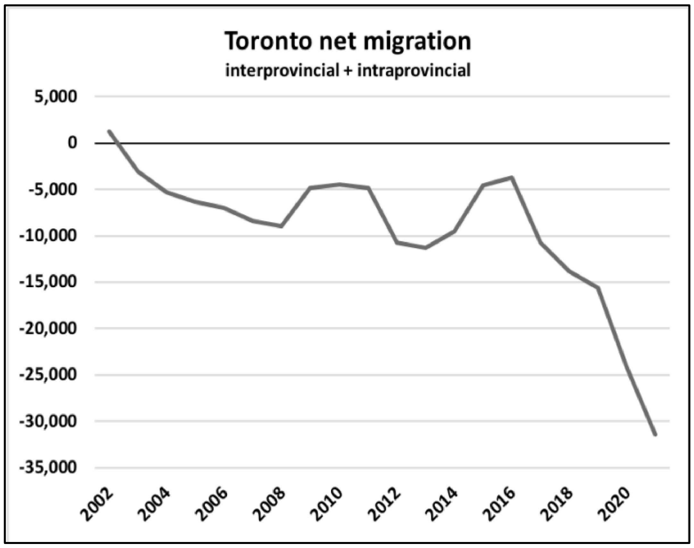




Last week Stats Canada released final 2021 population estimates. The numbers for the Toronto Census Metropolitan Area are quite striking. While the population overall continues to grow, it showed a dramatic deceleration relative to previous years:



Yes, the border closures and reduced immigration were a major factor, but just as important is the growing exodus of residents out of the region. Net migration from Toronto to other parts of Ontario (intraprovincial) and other provinces (interprovincial) was -31,000 in 2021…and that trend is accelerating:

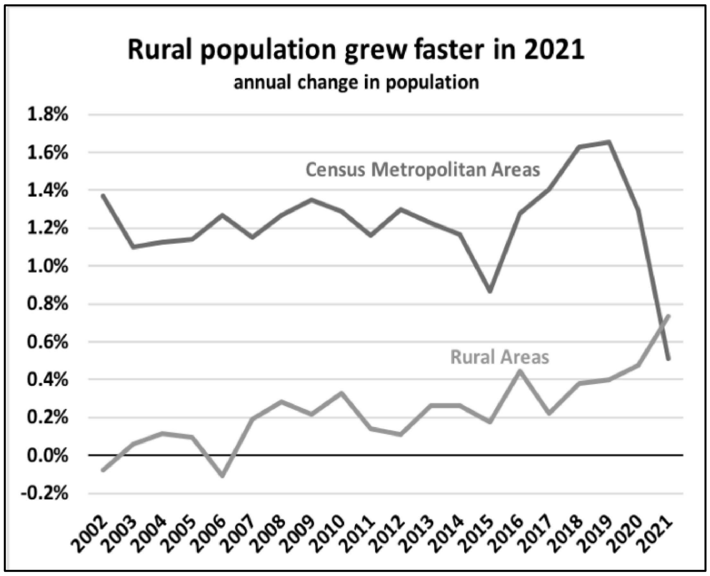


One has to think that at least part of this trend is due to house prices that just keep pushing the boundaries of affordability.

With prospective buyers increasingly priced out of big cities in Ontario and BC, it’s worth considering what areas or property types may benefit from “housing nomads” seeking more affordable housing options. Here are 5:

- **Rural areas, particularly in Ontario and BC**

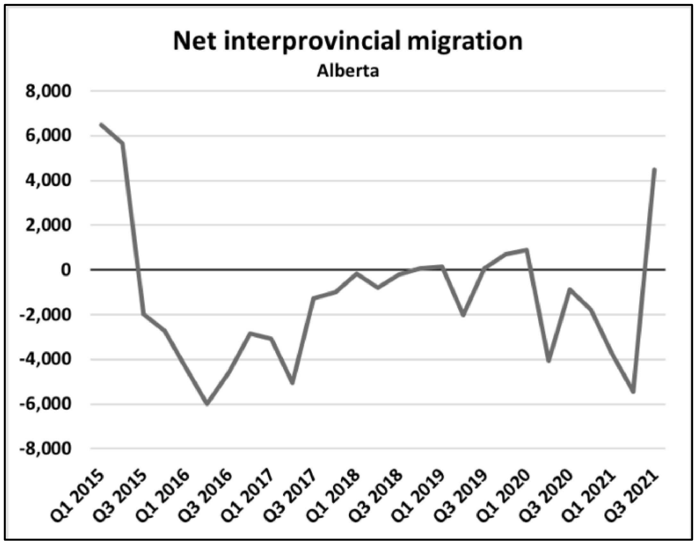
  Work from home is a potential game changer, particularly when coupled with increasing access to high speed internet in rural areas. It's perhaps not surprising that these areas saw stronger population growth in 2021 than major urban areas for the first time in at least 20 years…and likely much longer:



- **All of Alberta**

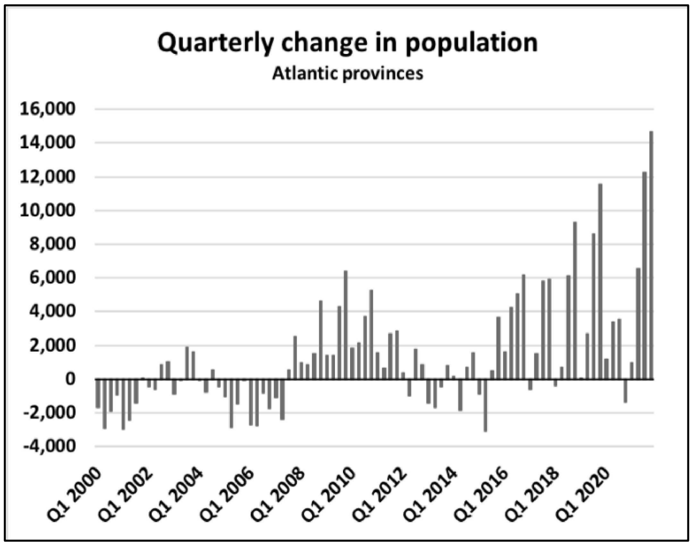
  You can still buy a home in many parts of the province for about the same price as you could in 2007 in spite of much lower rates and much higher incomes. That means affordability has improved dramatically in that time. It's crazy to think that as recently as 2007, house prices were LESS affordable in Alberta than in Ontario.

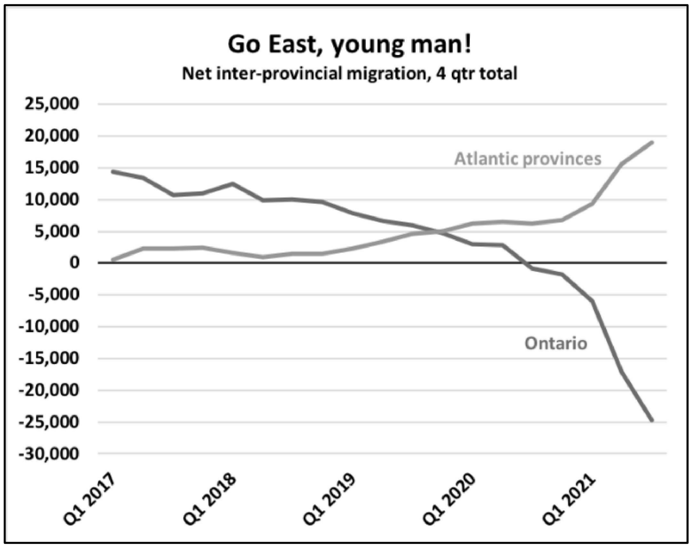
  With the improving economic backdrop, it's not surprising that Alberta is now seeing positive net interprovincial migration (ie more people coming from other provinces than leaving) for the first time since oil crashed in 2015. I expect this trend will accelerate in coming quarters:



- **Atlantic Canada**

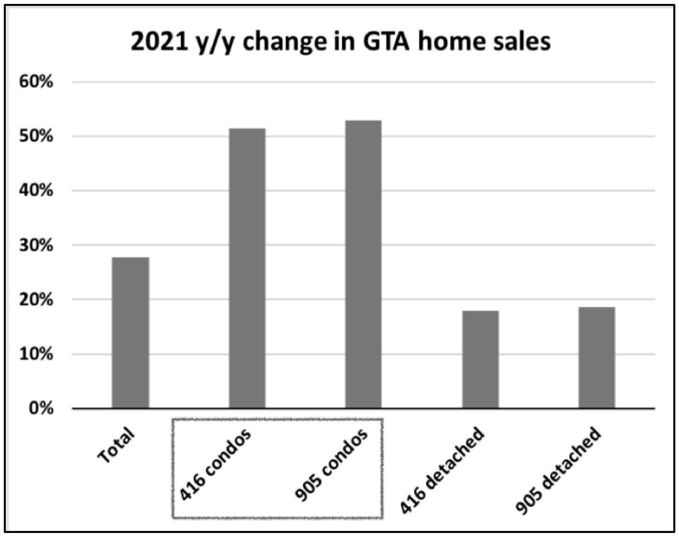
  Population growth just hit the highest in at least 50 years in Atlantic Canada. What's driving it? Primarily strong interprovincial flows. Atlantic Canada is clearly benefiting at Ontario's expense:





- **Condos….for now**

With sky-high single-family prices, the only option to get on the property ladder in some bigger cities is via the condo market. It's no surprise that this segment led the sales gains in major metros in 2021.

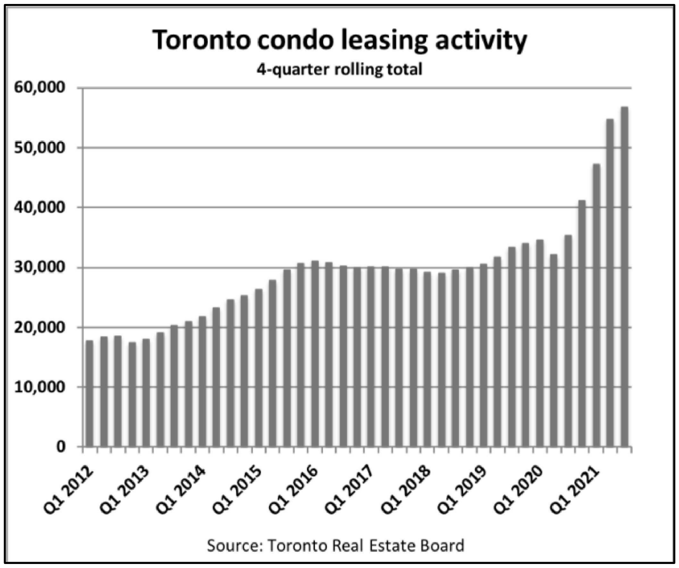


But even condo prices are surging….up 8% in the past 3 months alone! There was a time when that was a great return for the entire year. Now it's what you get in a single quarter.

The problem is that condo prices have run so far that they are now at the same level that single-family prices were in early 2019…and single-family homes were far from affordable back then. How much further can condo prices run before bumping up against their own affordability constraints?

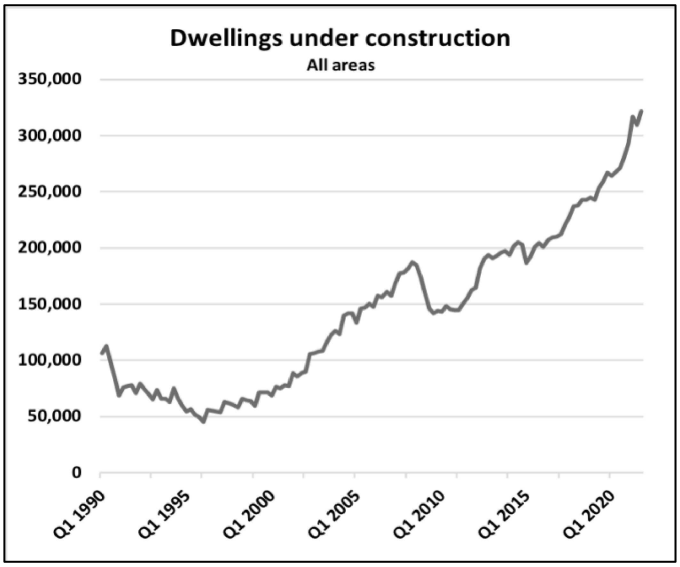
- **The rental market**

  Strong population growth and deteriorating affordability mean we should expect to see strong leasing activity continue through the year. Toronto condo leasing activity is shown below as an example. Notwithstanding what may be a bit of a supply glut in coming years in certain parts of the country (more on that below), we can't ignore the reality that as affordability deteriorates, it provides a natural tailwind to rental demand.

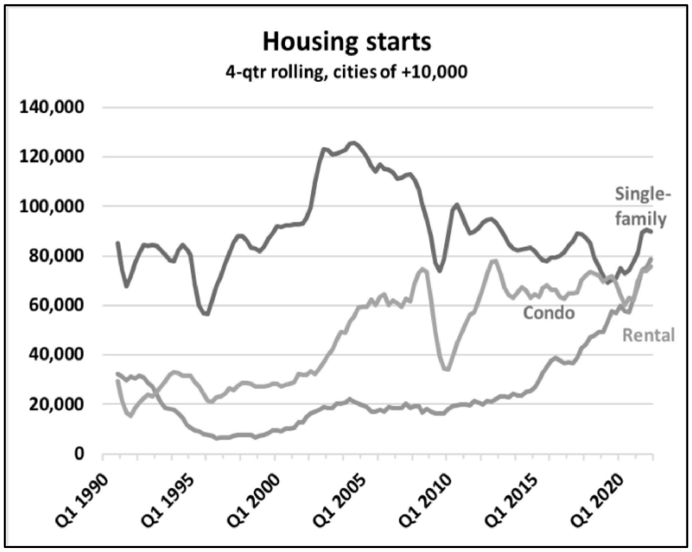


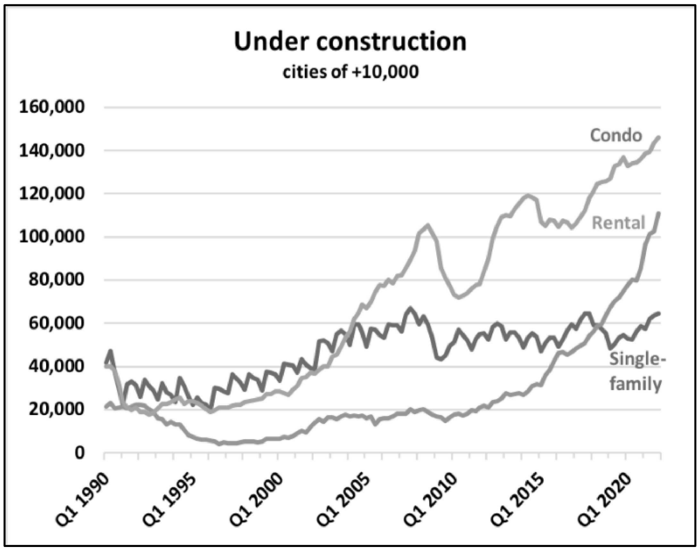
3) Supply/demand deep-dive: Housing starts pull back even as rental construction surges

Housing starts pulled back sharply in December to hit 236,000 on an annualized basis after reaching over 300,000 in November. The 6-month trend is 260,000 annualized, which is still well above "normal" levels over the past 2 decades. Dwellings under construction surged to a fresh record of 322,000 nationally in Q4:



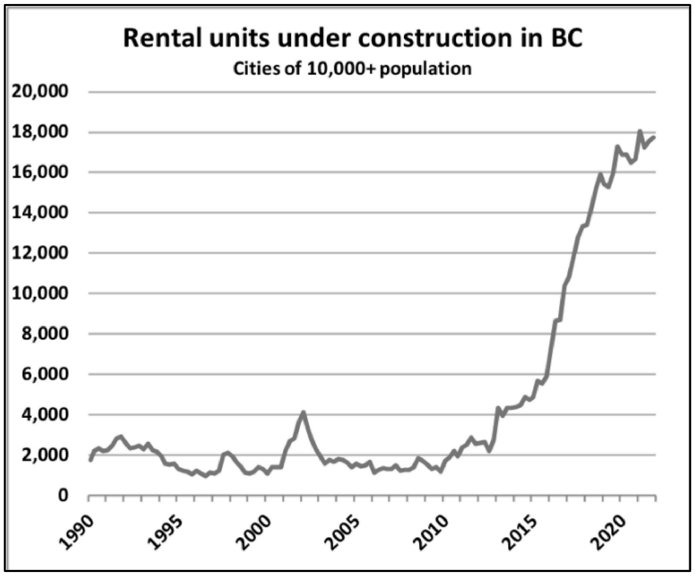
But again, the devil is in the details. When we deconstruct starts and dwellings under construction into three buckets, we can see that single-family starts are rolling over and it's the rental construction boom that continues to account for much of the strength in starts. The same is true for dwellings under construction:

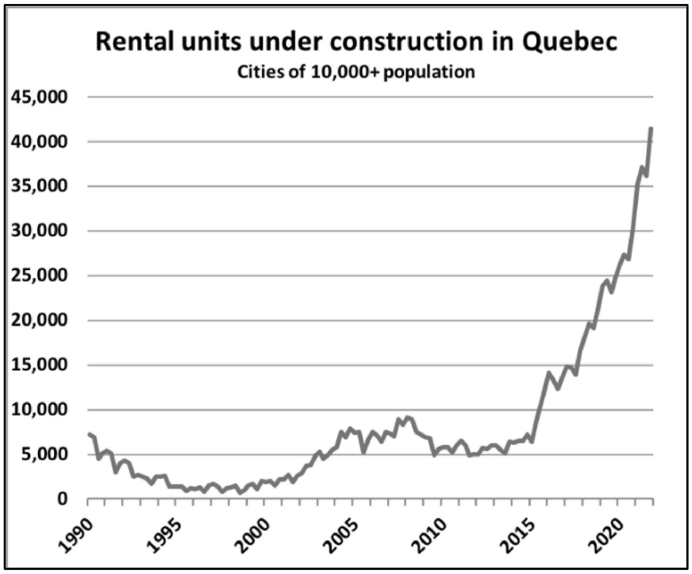


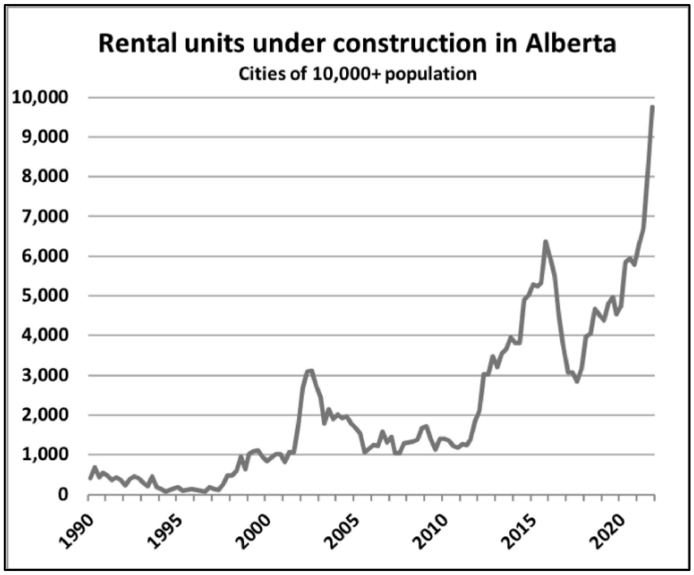


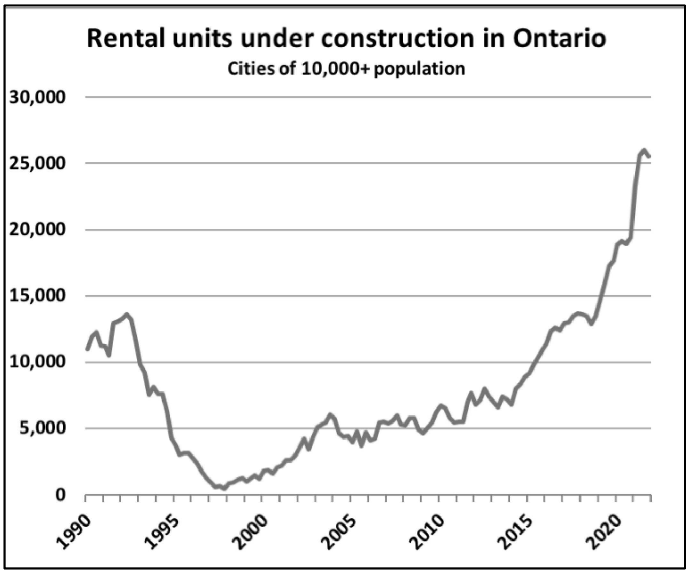
There's still nothing in this data that suggests that we'll see a surge in supply in the chronically under-supplied single-family segment, which is what is desperately needed to bring balance to the resale market.

I do think there's a chance that we're overbuilding on the rental front, at least in certain pockets. When we look across select provinces, BC and Quebec really stand out in terms of current construction activity relative to 30-year norms:







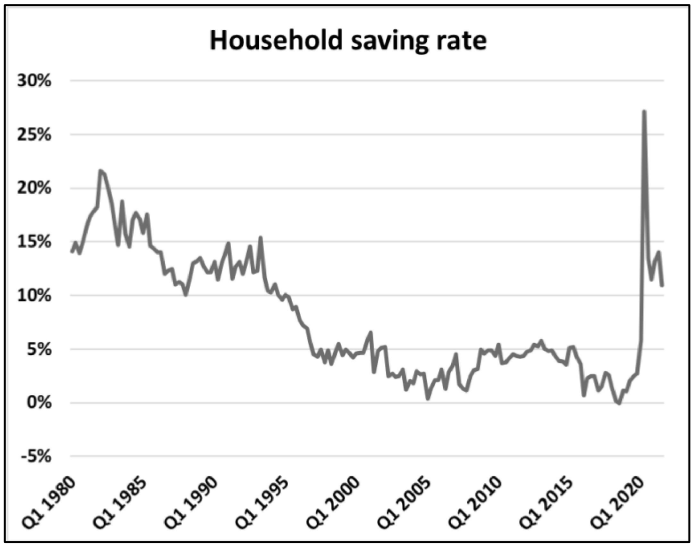


It’s something to be mindful of if you have clients pushing aggressively into rentals in these areas.

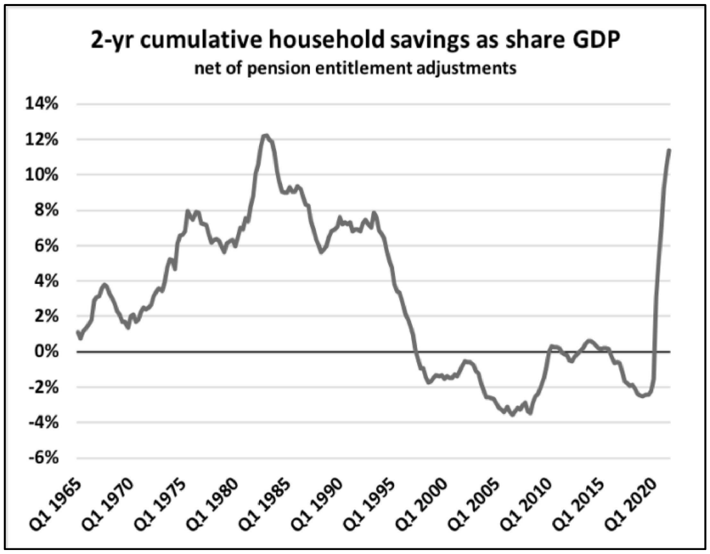
4) Household credit update: Consumers starting to tap credit cards again as savings slow

i) More signs that savings glut is fading

The Canadian consumer remains in very good shape, in no small part due to massive savings accumulated during the pandemic. As of Q3 2021, the savings rate was still in double digits (it was ZERO as of 2019) while households had accumulated $280B in excess savings since the start of 2020.



To contextualize that number, I’ve calculated cumulative 2-yr rolling savings and compared it to GDP over time. What we find is that households are sitting on the largest amount of accumulated savings since the early 1980s:

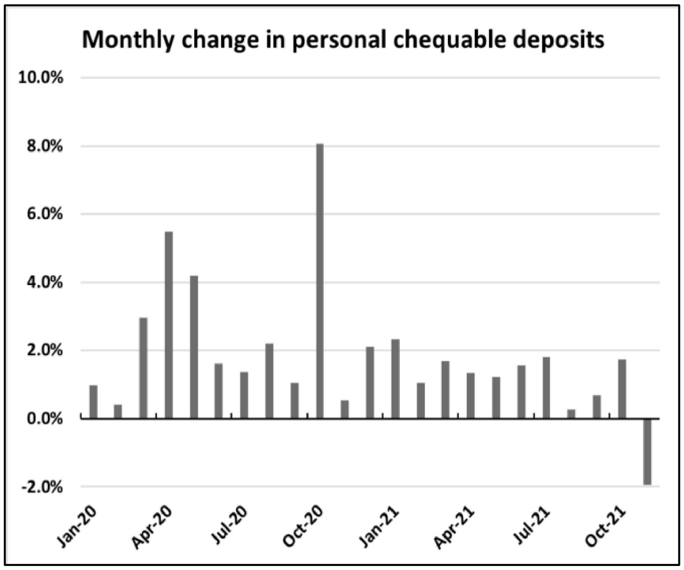


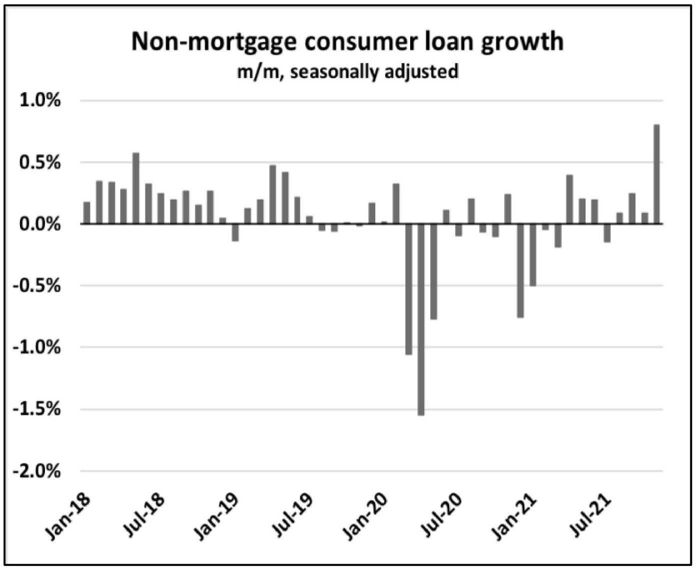
A number of dynamics have contributed to this trend: Solid wage growth, massive government transfers through income support programs, lower spending during the pandemic due to lock downs, lower interest rates, etc.

Assuming this doesn't get eaten away by inflation and rising rates, it represents potential rocket fuel for the economy if we ever get back to "normal".

But all that said, we're now starting to see signs that this trend of high savings is normalizing. How do we know that?

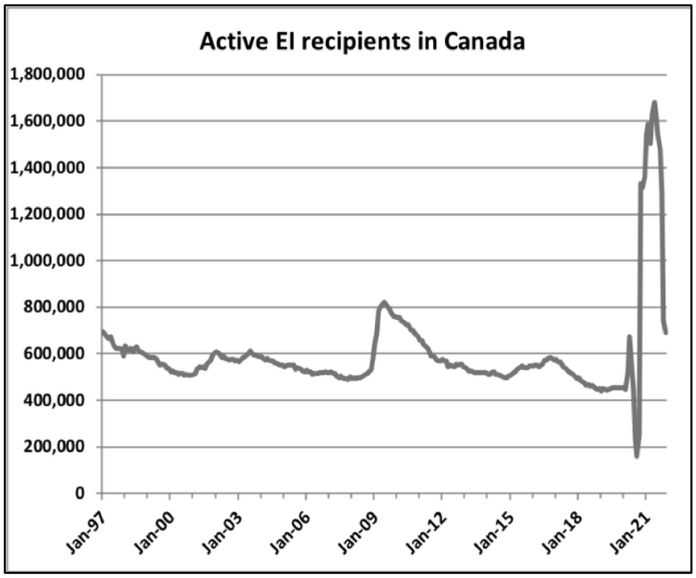
First off, deposits at chartered banks just posted the largest monthly decline since 2012, which is a sign that consumers have gone from saving to dis-saving. At the same time, non-mortgage consumer loan balances at chartered banks jumped by 0.8% in one month, the largest increase since 2013. And that was led by a 2.3% monthly increase in credit card balances….the second largest such increase in the past decade. Consumers who have excess cash don't tend to ramp up credit card balances, so these two data points suggest that the tide may be turning:



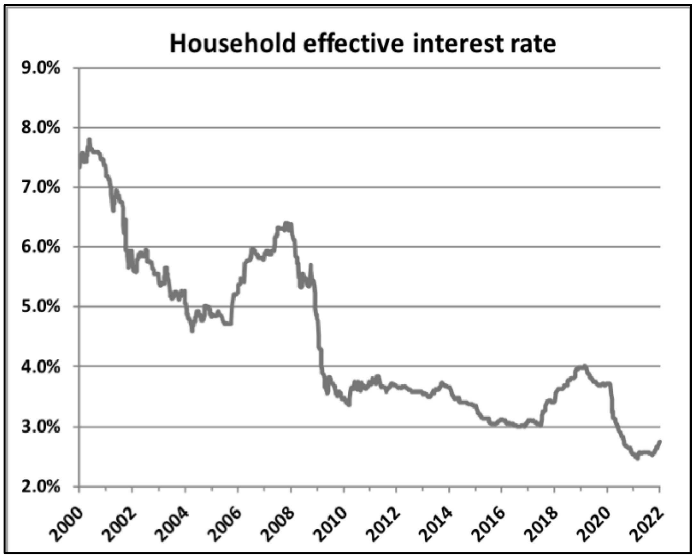


What's behind this trend? If I were to guess, I would point to 2 dynamics:

- The end of key income support programs. The number of Canadians receiving Employment Insurance (either traditional or programs like the Canada Recovery Benefit) has fallen by nearly 1 MILLION in just 4 months.



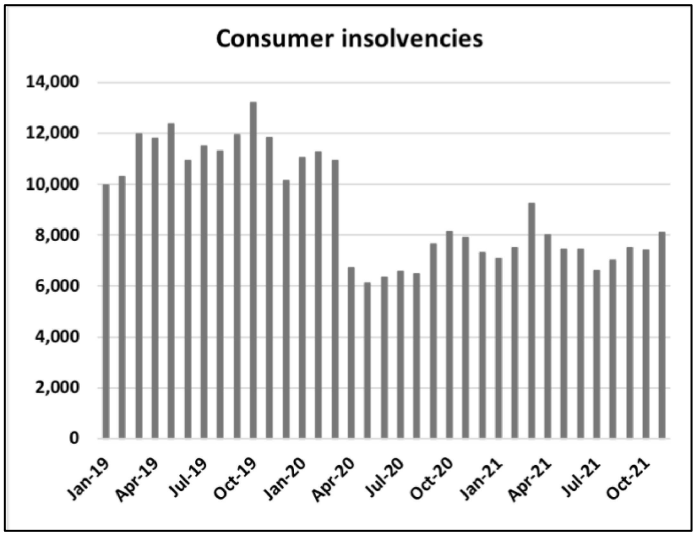
- Rising interest rates. The Bank of Canada may not have moved rates yet, but already the average interest rate paid by Canadians across all credit products has risen by almost 25 bps since October in part due to rising rates on fixed mortgages and other consumer loans:

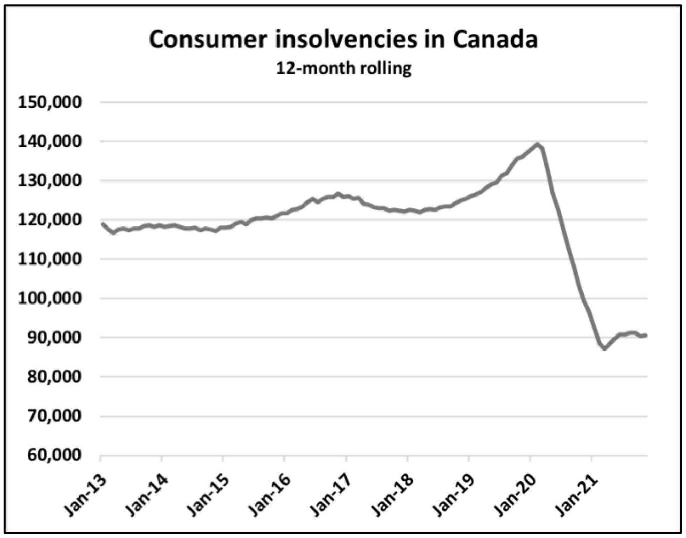


ii) Why should we care about falling savings anyway?

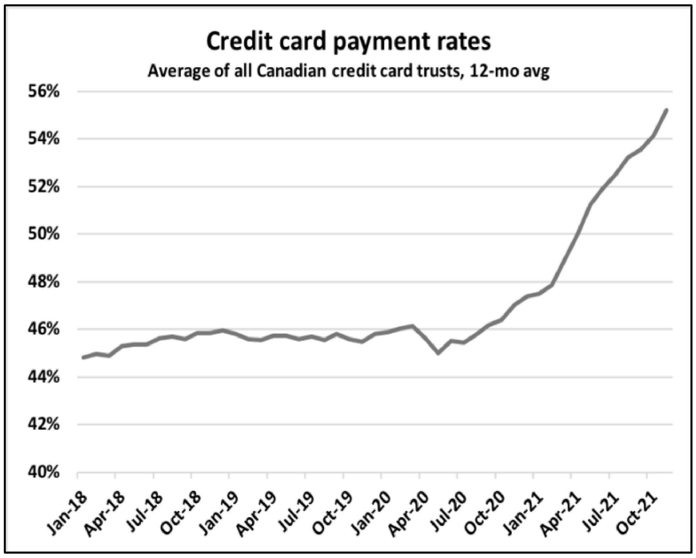
The reason we should care about the trend in household savings is that I think it is the main driver of one of the more surprising dynamics to come out of the pandemic, namely the massive decline in consumer insolvencies.

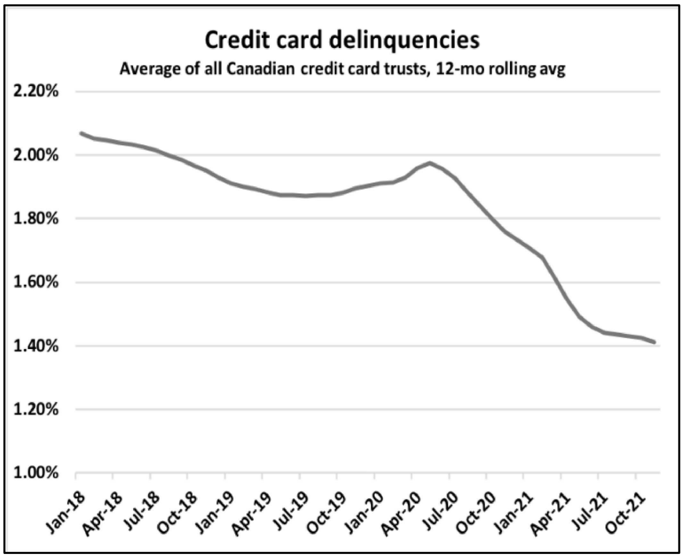
Think about it: We had by far the biggest economic shock of our lifetimes, and yet the number of people declaring bankruptcy or filing proposals (a restructuring of unsecured debt) FELL by 40% and remains at those levels. Who saw that one coming? If households are saving cash at unprecedented rates, it stands to reason that they're not falling behind on their debts:





At present there are no signs of stress in consumer credit….and I mean NONE. Payment rates on credit cards are as high as they've ever been (think of this measure as the share of households that pay off their entire balance every month…t's a bit more nuanced than that, but that's the right idea) while delinquencies are as low as they've ever been.





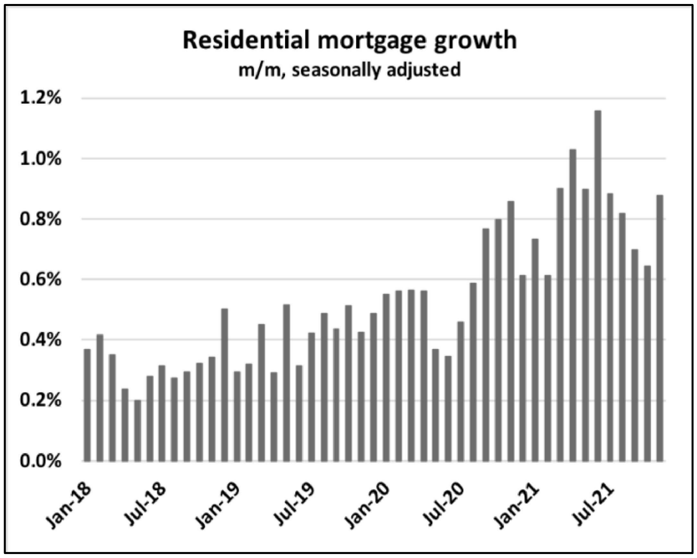
Again, I ignore the widely followed mortgage delinquency data. It lags so badly that's there's no predictive value to it. We only just got the September data, but since lenders don't report delinquencies until borrowers are 90-180 days delinquent, it means the September data captures people who missed payments as far back as March. Useless!

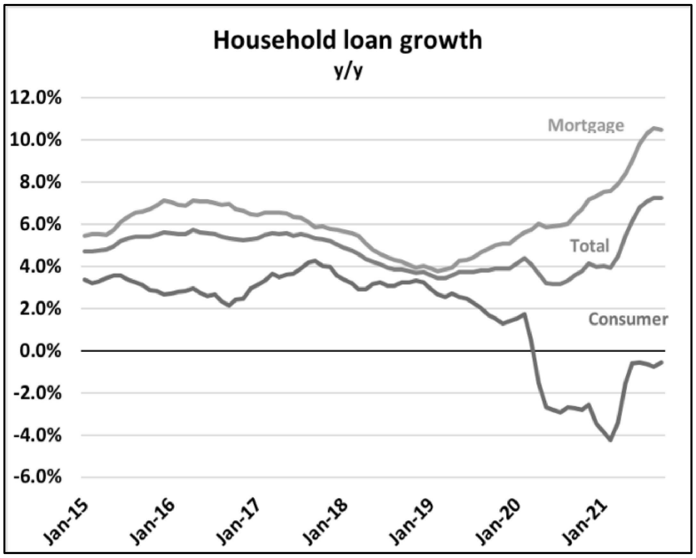
Credit card trusts report in real time. We already have December data for many of them. And since most people won't default on a mortgage before missing a credit card payment, this is a fantastic forward-looking indicator.

The takeaway is this: Households are in fantastic shape right now, but this is probably as good as we'll ever see it in our lifetimes. Savings are slowing, and we have interest rate hikes on the horizon. I expect we'll see credit card data start to inflect within the next couple months, with insolvencies bottoming shortly after, and likely an uptick in mortgage arrears by mid-year. We have a long ways to go to get back to "normal" levels.

5) Mortgage market update: Nearly 40% of mortgages set see higher rates in 2022

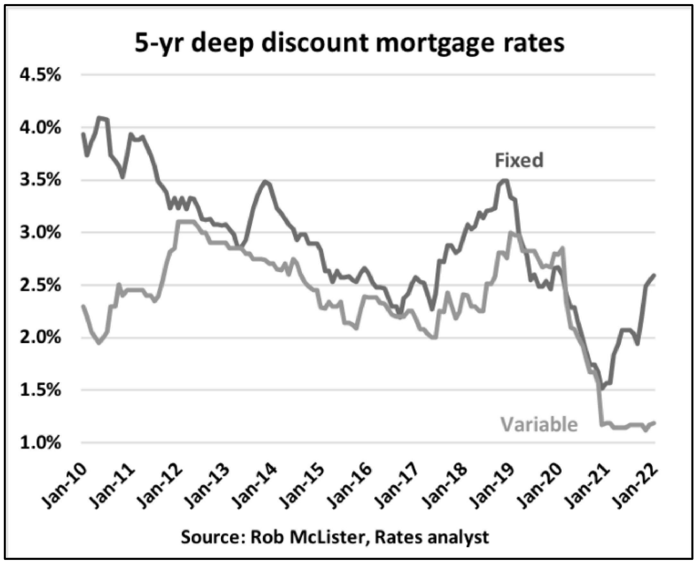
Mortgage credit growth ticked up in November, up 0.9% m/m and nearly 11% y/y:

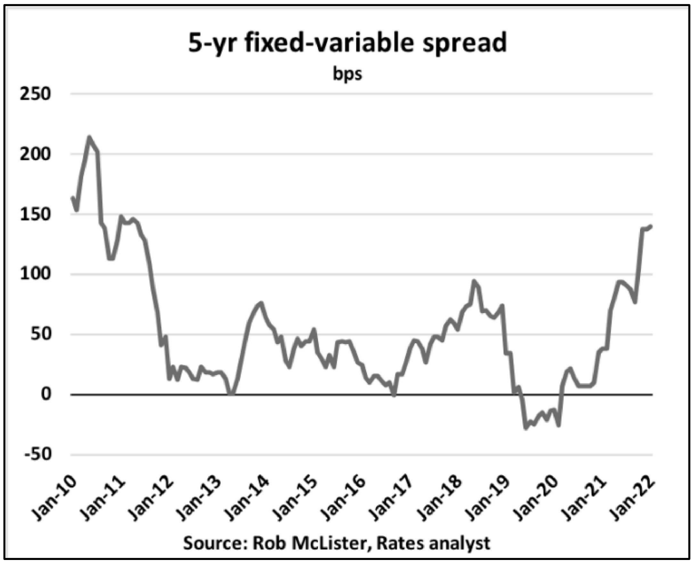




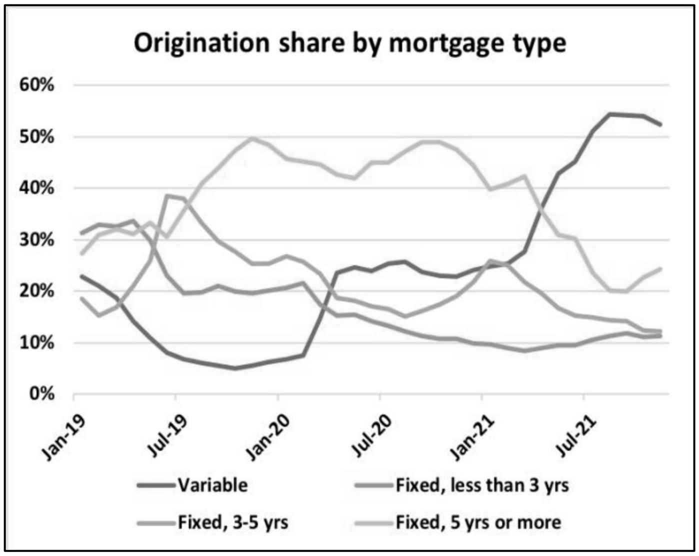
The best discounted 5-yr fixed mortgage rate is now just under 2.6%, up 110bps from the lows 1 year ago. <u>For chartered banks, the discounted fixed rate now averages 2.84%, up 75bps from September</u>. There may be more movement to come based on the 90bps increase in 5-yr bond yields over the past 4 months.

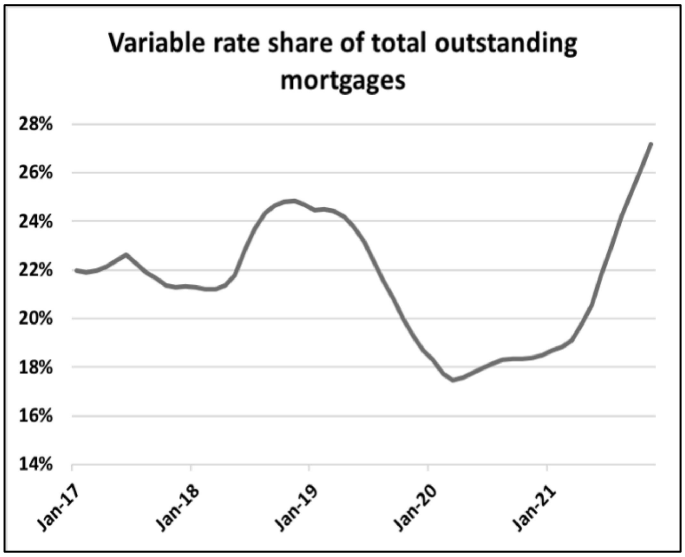
Meanwhile variable rates remain near record lows with the gap between the two now close to 150bps:





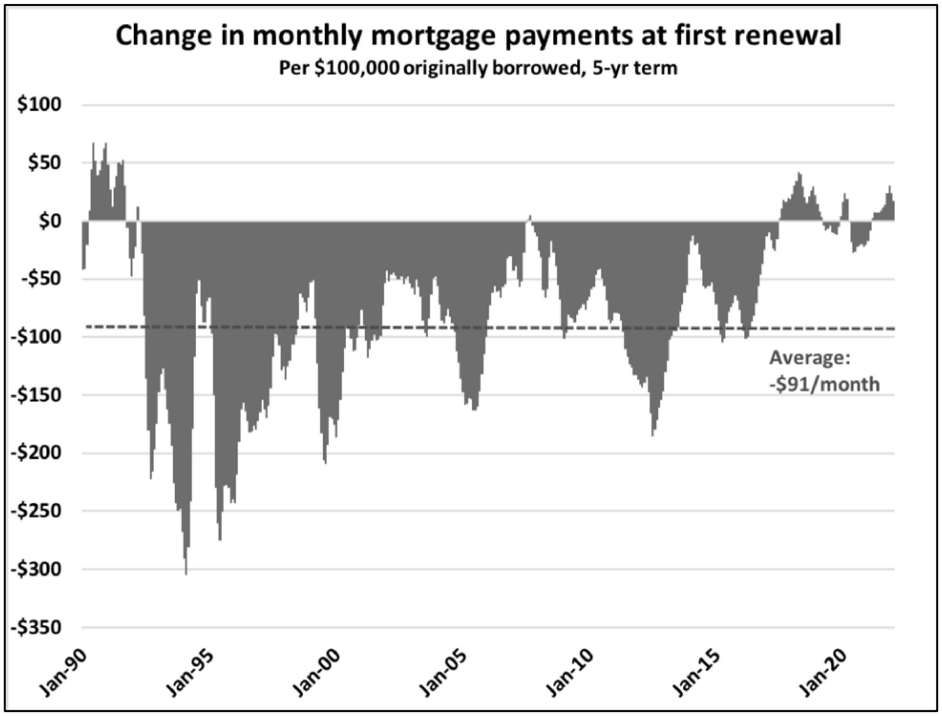
As a result, variable originations continue to surge, up 105% y/y in November compared to a 55% y/y decline in the standard 5-yr fixed segment. Floating rate mortgages now account for over half of all NEW mortgages and nearly 28% of total outstanding mortgage debt….not an ideal situation as we head into a Bank of Canada tightening cycle.





By my estimates, roughly 1/3 of variable rate mortgages have fixed payments that reset at renewal. Only the effective amortization changes. Still, that leaves just shy of 20% of variable rate mortgages that will reset higher as soon as the Bank of Canada begins to raise rates. Now throw in the normal run rate of renewals on fixed rate products, and it means we have about 37% of all mortgages in the country set to renew at higher rates in 2022.

And make no mistake, rates will be higher. Even for people with 5-yr fixed rate mortgages, they will be renewing at rates that are currently above where they were at origination. For the average person renewing a 5-yr term this month, the change in payments if they again opt for a fixed rate term equates to $16 per month for every 100,000 originally borrowed.

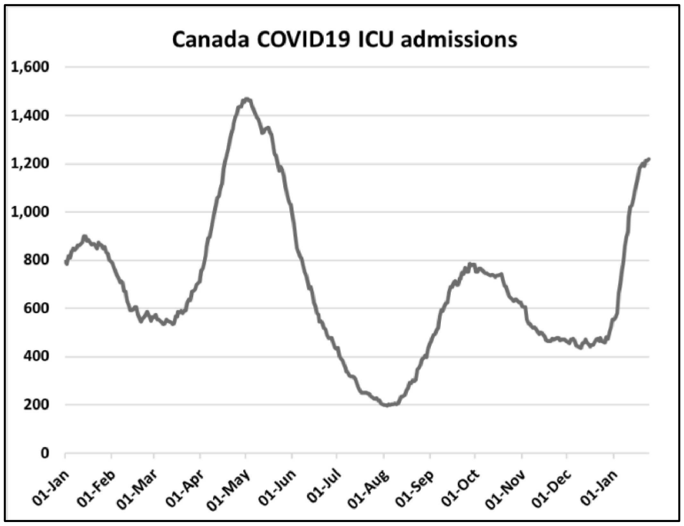


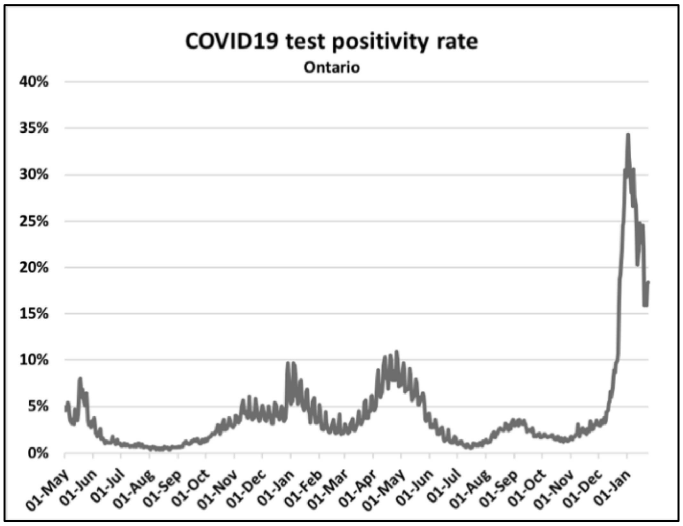
6) Monitoring key risks

i) Signs that Omicron wave has likely peaked

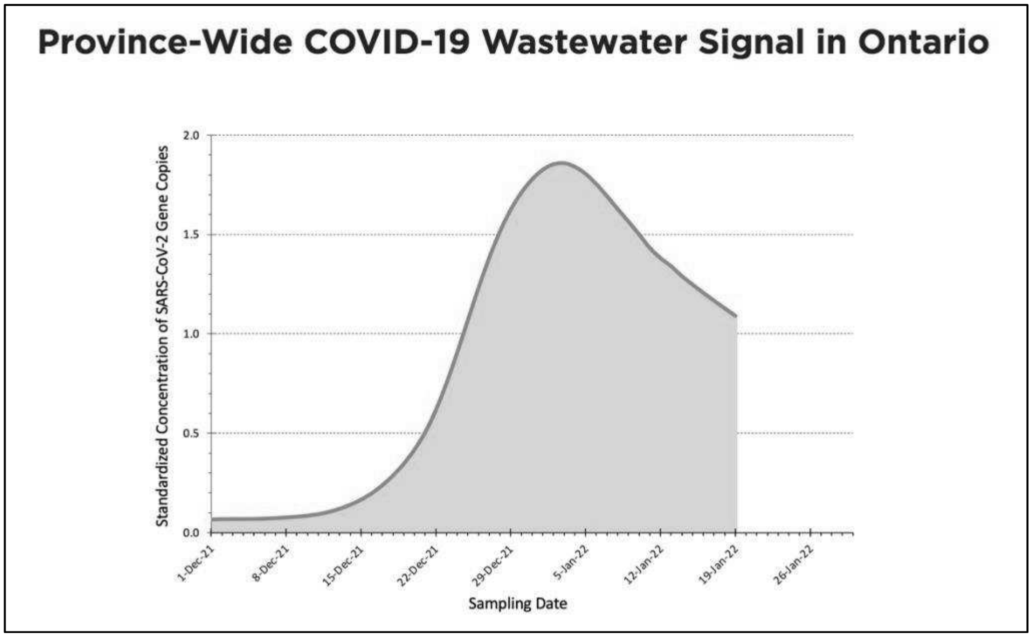
There's plenty of reason for optimism in the latest COVID data. Yes, the absolute numbers are still terrible, but there's mounting evidence that we've likely already seen the peak.

It's hard to read too much into case numbers since PCR tests are in short supply. But we can see that ICU admissions attributable to COVID are showing signs of topping out. Further, test positivity rates in Ontario have fallen sharply from in recent weeks. It's not a perfect measure because of limited testing, but it has been a very good leading indicator in every other wave:



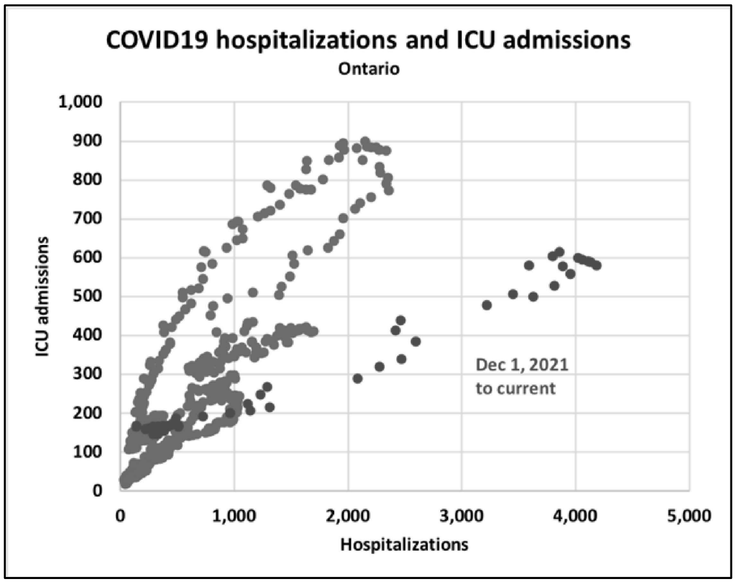


But the most compelling evidence is the declining viral load in wastewater in Ontario. This is not reliant on PCR testing, but rather tests for shed viruses in waste water (ie sewage). It's not a pretty thought but it's probably the best signal we have right now:



My entirely unqualified opinion is we've very likely peaked for this wave, and if there's a surprise in store, it's more likely to be a dramatic DECLINE in cases, hospitalizations, and ICU admissions over the next month rather than a renewed surge.

One final note: Omicron continues to be far more contagious but less virulent than prior strains. The normal relationship between hosptializations and ICU admissions from prior waves has broken down with Omicron. That's a good thing!



ii) More signs that regulators are set to cool demand

I continue to expect that we'll see regulators and policy makers address excesses in the housing market via two main channels:

- Demand reduction (VERY likely that we'll see this by the spring)
    - Higher down payment on rental/recreational properties (extremely likely…80% chance)
    - More regulations around source of down payments on second properties…ie buyers can't tap equity in another property (less likely….40% chance)
    - Possible amendment of B20 to include hard debt-income limits (less likely but still being discussed….20% chance)

- Wealth redistribution (much less likely but potentially more impactful)
    - Tax on "luxury" homes (less likely…20% chance)
    - Capital gains tax on principal residence (extremely unlikely….political suicide….5% chance)

Note the two headlines from the past couple weeks. Completely on point. Housing markets that are as out of control as what we're seeing currently are ripe for policy interventions. They are coming. If you have clients looking to buy investment or recreational properties, they would probably appreciate a "head's up":

Real Estate / Mortgages

CMHC to review down payments on investment properties as part of federal strategy to tackle housing risks

Speculative investing in residential real estate has become an important concern, prompting Canadians to overbid on properties

Stephanie Hughes
Jan 12, 2022 • 1 week ago • 4 minute read • 86 Comments

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REAL ESTATE
7h ago

CMHC-backed report calls for surtax on $1M+ homes

Michelle Zadikian, BNN Bloomberg

Regards,
Ben