The Edge Report

March 2023

Compliments of Steve Dainard, Mortgage Broker
TheMortgageGuyNiagara.com

Hyperlinks:

1) Bond market jitters and recession fears set the stage for lower mortgage rates

2) Home sales perk up, inventory falls in February

3) Supply and demand: More than meets the eye in latest population data

4) Household debt burdens jump in Q4 with more still to come

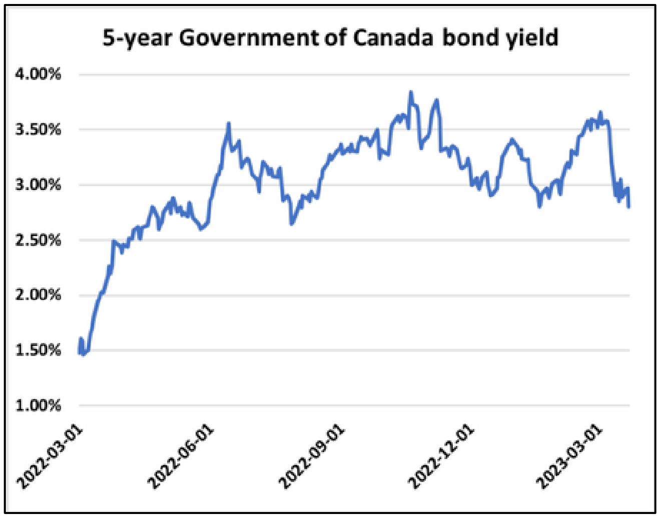
5) Consumer check: Largest increase in insolvencies since 2009

Key takeaways:

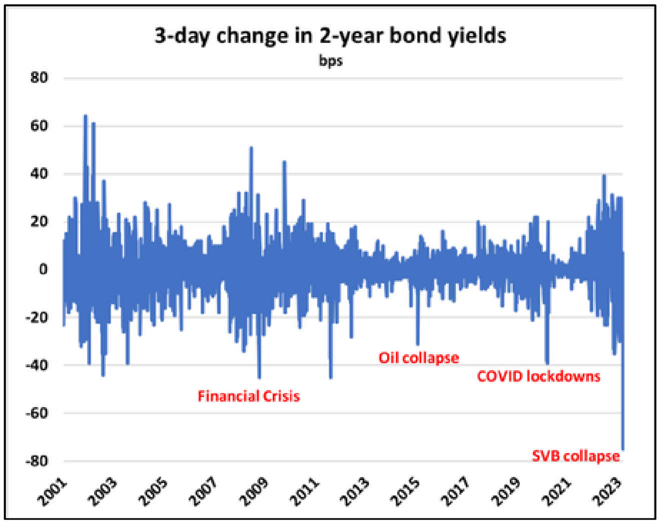
- The Bank of Canada may welcome a modest recession, but a financial crisis is a different beast altogether
- Housing sentiment is improving and it's showing up in an uptick in home sales
- The lack of sellers remains the BIG story in the market right now
- Households are now in deleveraging mode, which makes OSFI's latest B20 proposals look pretty silly We're
- likely seeing a generational low in mortgage delinquencies right now. Expect them to double within a year.

1) Bond market jitters and recession fears set the stage for lower mortgage rates

It's been a roller coaster in bond land of late. Consider the all-important 5-yr Government of Canada bond yield over the past year, and pay particular attention to move over the past 3 weeks on the far right of the graph:



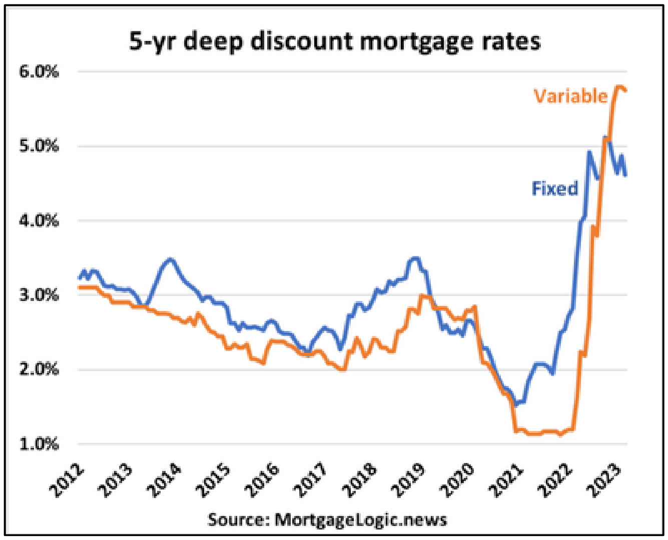
It may not be immediately obvious from that chart, but rates have collapsed over the past few weeks, particularly at the short end of the curve which reflects anticipated moves from the Bank of Canada. For example, in the wake of the Silicon Valley Bank collapse, we saw a historic decline in 2-yr bond yields:



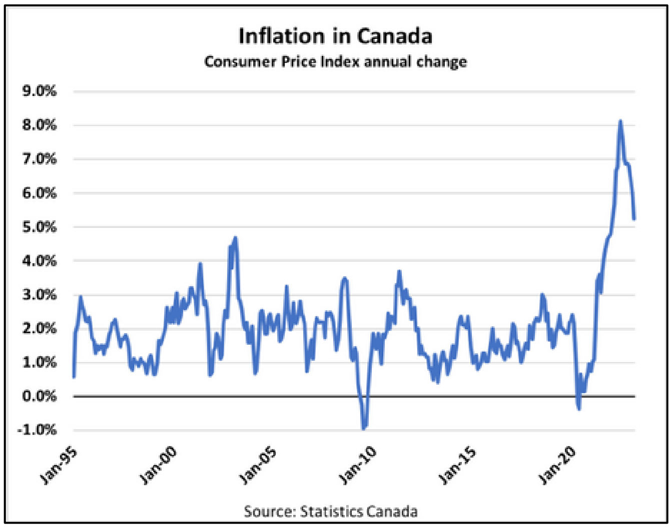
That tells us that markets are now expecting rate cuts earlier than they had previously, which would seem like good news for housing were it not a reflection of a potential credit crisis.

Credit crises are very different beasts than your typical run-of-the-mill recession, which up until two weeks ago looked like the most likely outcome later this year. I've argued previously that the Bank of Canada won't lose any sleep over a recession and a, say, 200bp increase in the unemployment rate (*in fact they WANT that outcome....which is why I still think that even in a recession, rates will not be going back to zero or close to it*). But they care immensely about a banking issue which can quickly metastasize into contagion that becomes very difficult to stem. THAT would force some serious rate cuts very quickly, and that's the potential scenario being priced in at the moment.

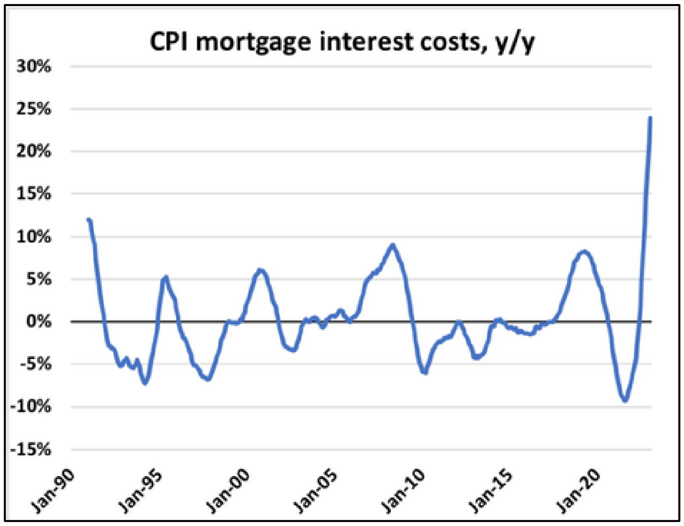
Mortgage rates are indeed back on the decline, with deep discounted fixed rates falling 30bps in the past week alone. Good news has been pretty sparse for the real estate and mortgage industries of late, so take a win where you can get it, but let's be mindful that this rate decline comes with some potentially serious baggage attached.



On the inflation front, headline CPI slowed to 5.2% in February, below consensus of 5.4% y/y. That's the good news. But unfortunately core inflation remains sticky at just under 5% and it was up 0.35% on the month which on an annualized basis puts it still well above the Bank's 1-3% target band.



Now here's where things get weird. Mortgage interest costs are a component of CPI, and that index is surging...up almost 25% y/y. That means that of the headline 5.2% inflation rate, 0.7 percentage points were just from rising mortgage rates. The Bank of Canada is now creating the inflation they're trying to fight. Go figure!



The key data from last month is summarized below. Of note is the steep decline in new listings and active inventory:

2) Home sales perk up, inventory falls in February

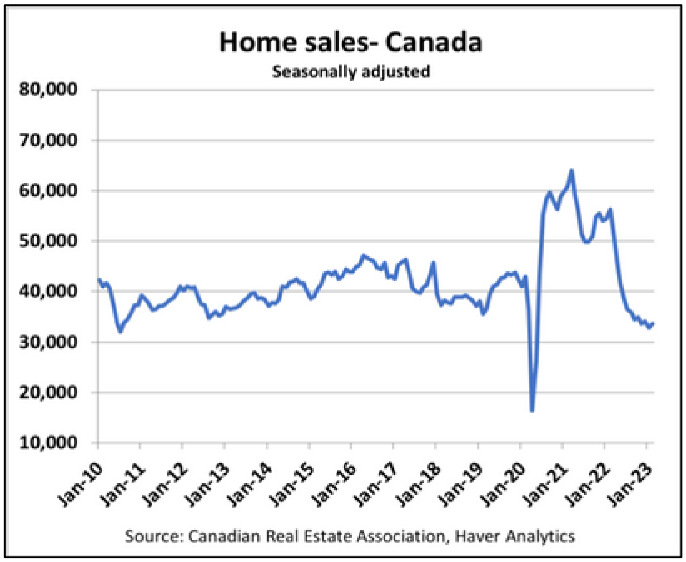
	Sales		New listings		Active inventory		House prices (HPI for Canada, average for provinces)	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	-40.2%	+2.3%	-27.0%	-7.9%	+37.1%	-1.4%	-15.8%	-1.1%
BC	-46.9%	+6.9%	-35.5%	-5.7%	+37.8%	-1.7%	-15.1%	+2.9%
AB	-45.5%	-0.4%	-30.9%	-2.2%	+0.3%	-0.3%	-10.8%	-0.6%
ON	-43.7%	+2.6%	-30.8%	-15.9%	+80.6%	-4.9%	-20.9%	+0.3%
QC	-29.6%	+1.9%	-8.6%	+0.5%	+50.0	+3.0%	-6.3%	+0.5%

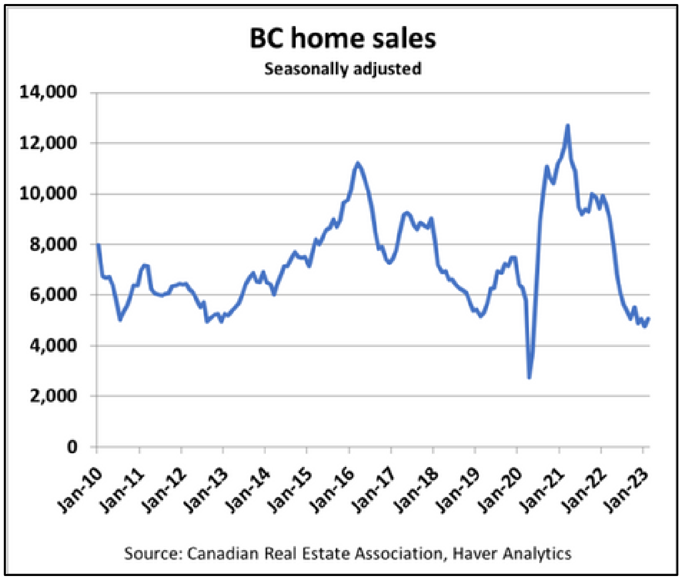
Key takeaways:

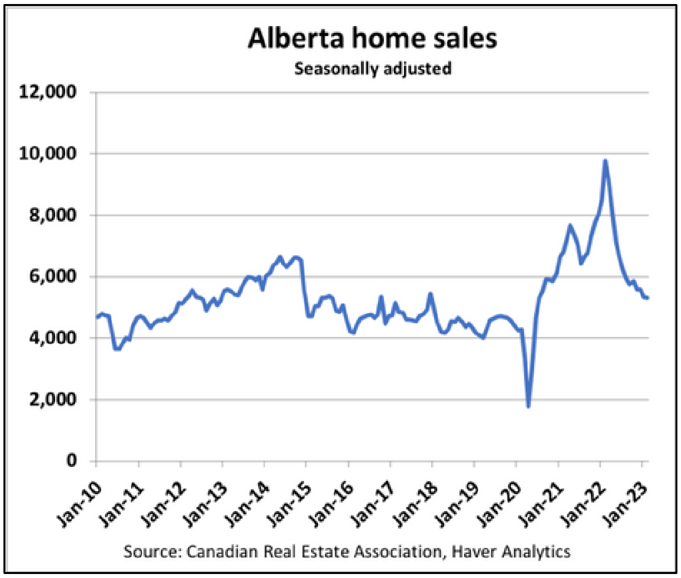
i) Home sales tick up in February

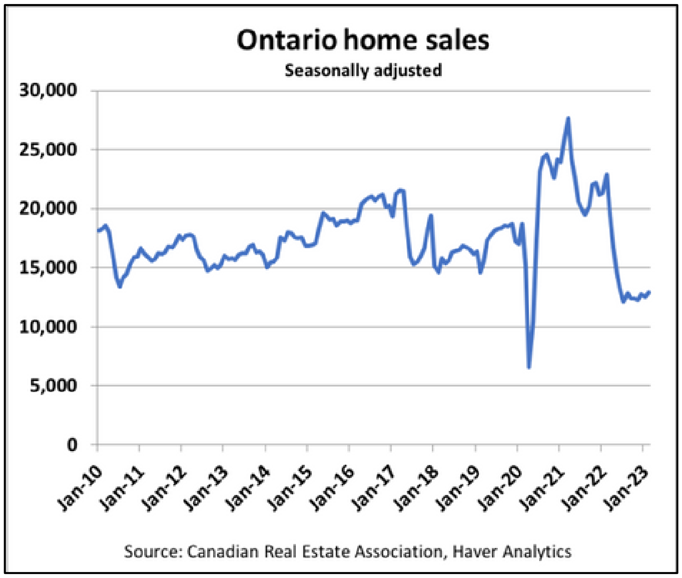
Seasonally adjusted home sales rose 2.3% m/m in February led by BC (+6.9% m/m) and Ontario (+2.6%). This partially offset a downwardly-revised 3.7% decline in January.

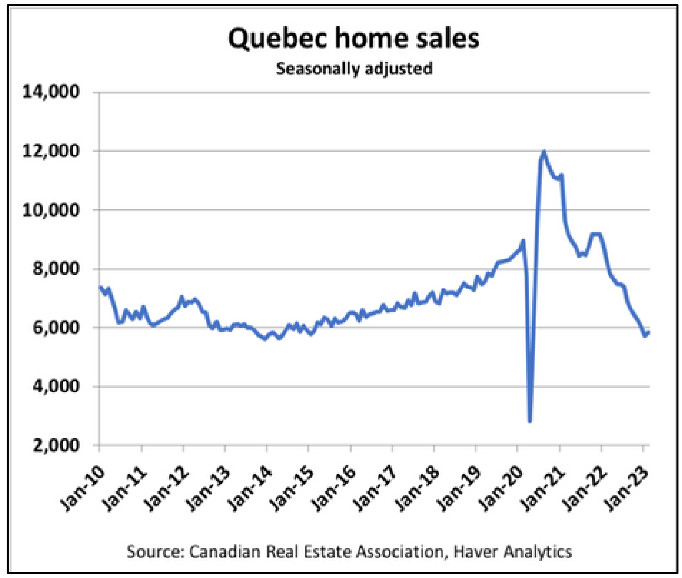
Still, that leaves unit sales down 40% y/y and 48% off the peak. It's even worse in dollar volume terms at -51.9% y/y...not a great readthrough to ownership transfer costs in the economic accounts.









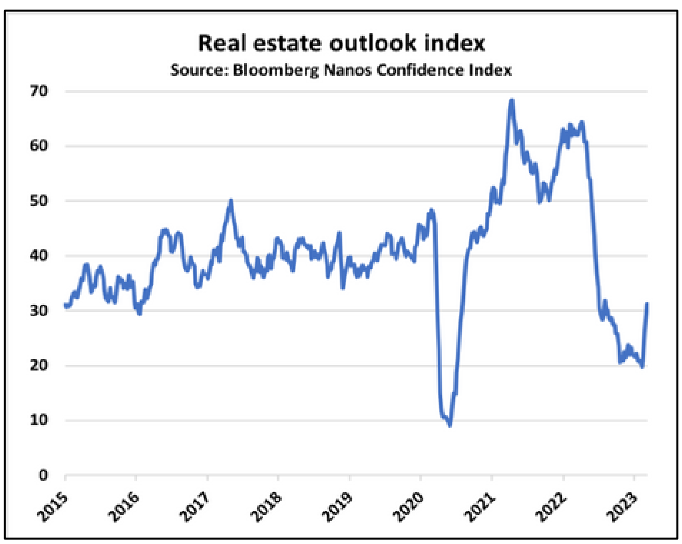


I continue to expect sales to bounce a minimum 20% off the seasonally adjusted lows this spring, and it may be even bigger than that based on these trends.

ii) Sentiment is improving

The real estate outlook component of the Bloomberg Nanos Confidence Index has seen a remarkable improvement off the lows over the past 4 weeks. We've now seen the sharpest 4-week uptick in real estate sentiment since coming out of the pandemic lockdowns.

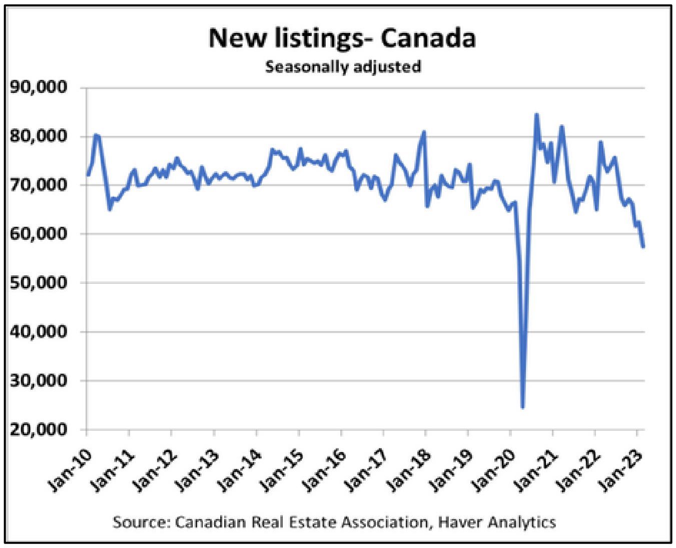
This will be something to watch this spring. Inventory is still tight. A sustained rebound in sales could very quickly reignite animal spirits:



iii) Still no sellers…

This remains THE…BIG…STORY.

New listings plunged 7.9% m/m in February. Outside of 3 months during the COVID lockdowns, this is the lowest level of seasonally adjusted new listings since 2004!

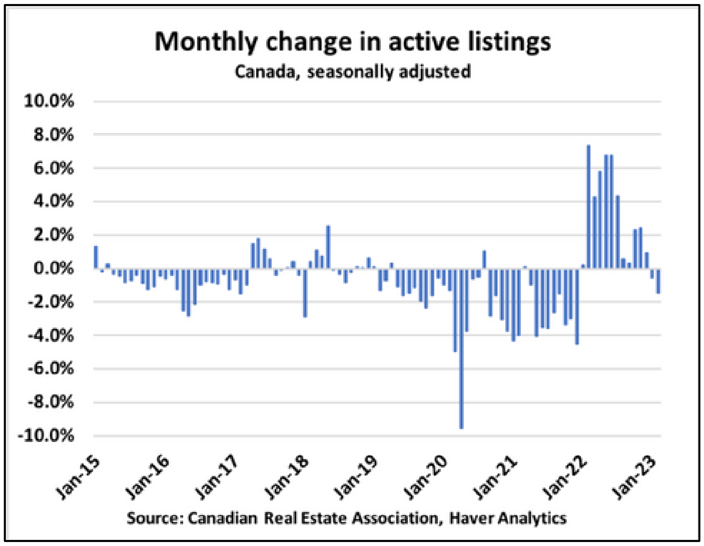


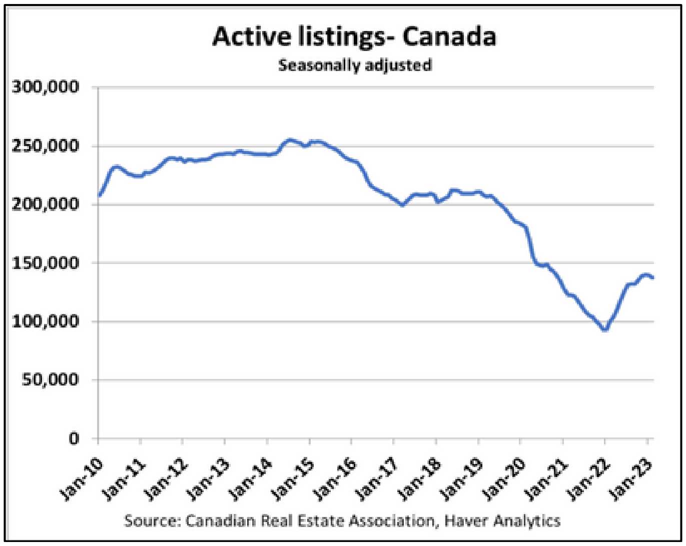
My base case has been that we would see rising sales AND a sharp increase in new listings heading into the spring selling season, but so far we're only seeing the former. Sales typically rise sharply from March to May, so the next 10 weeks will be crucial. If we don't see a strong supply response going forward, the market could tighten significantly.

On that point, the sales-to-new listings ratio improved to a 10-month high in February:

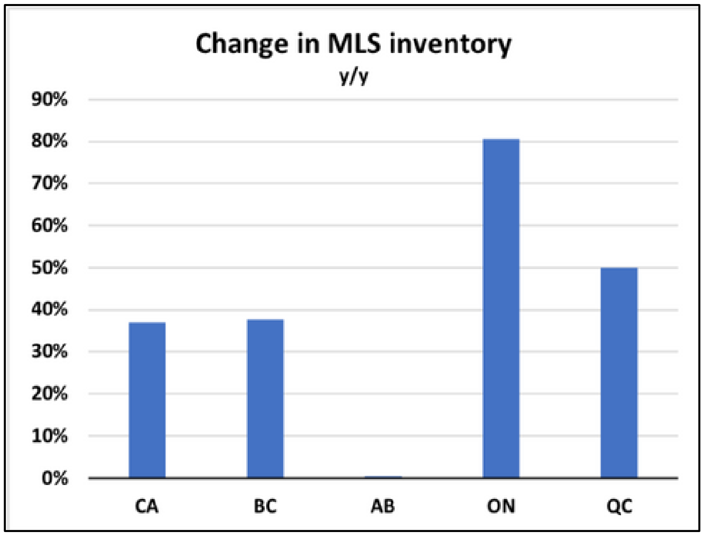
iv) Inventory back on the decline

With fewer new listings coming to market, active inventory at month end declined 1.4% m/m in February, the second consecutive monthly decline and the largest since late 2021. The decline was led by a 4.9% drop in listings in Ontario which also saw a 3.8% decline in January.

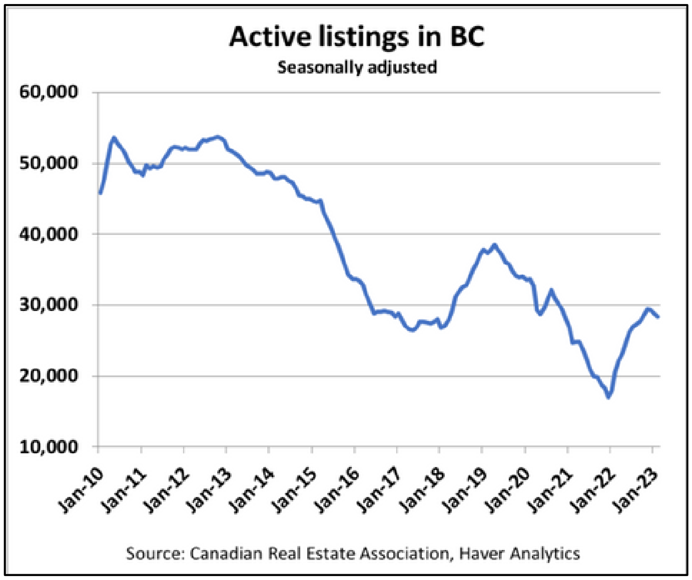


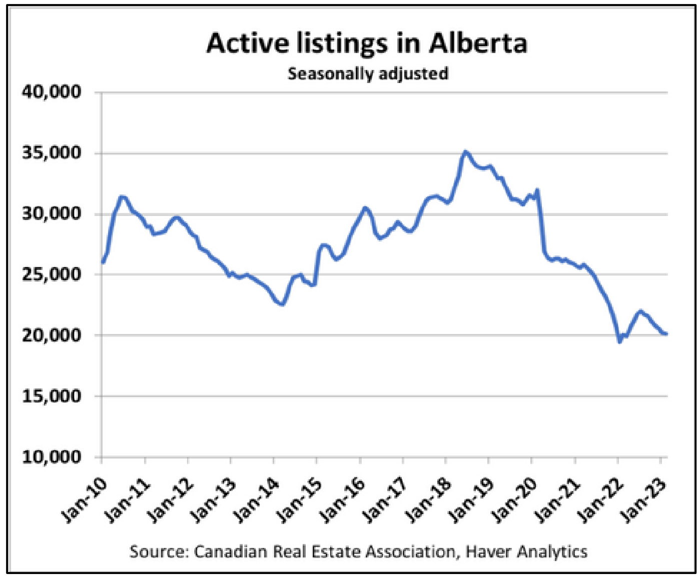


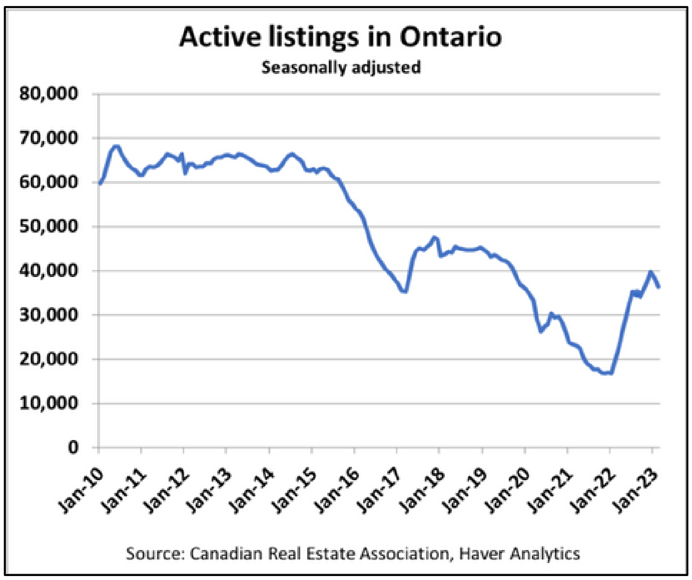
We continue to see sharp regional differences, with inventory in Alberta effectively flat y/y compared to an 80% jump in Ontario, but the story across the country remains the same: We're a YEAR into this downturn and inventory is still not back to "normal" levels!

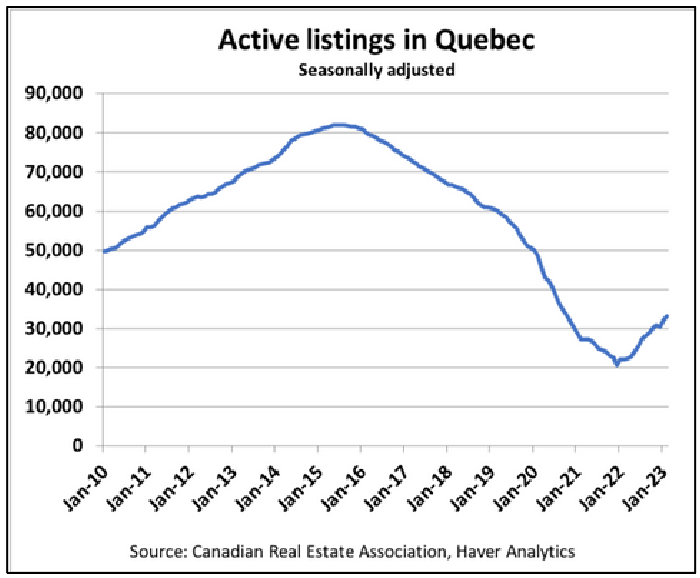


One more point on Alberta. Note in the chart below that inventory levels are basically back to decade lows. That province continues to see significant tail winds, and think we're still in the early days of relative outperformance.



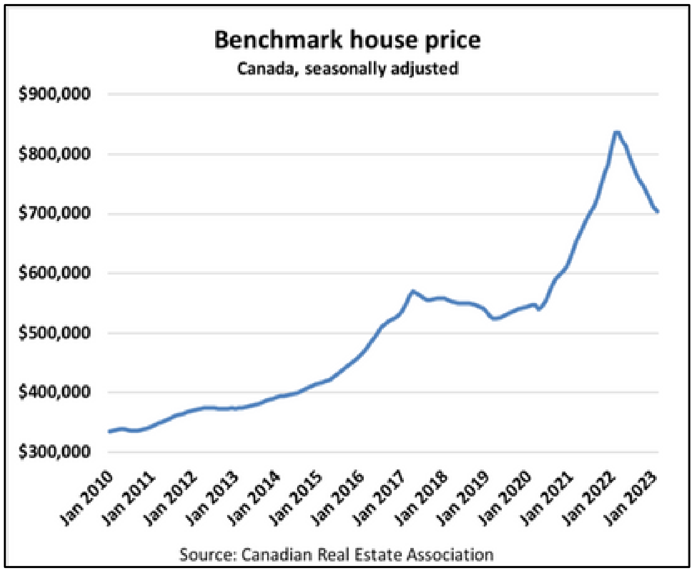


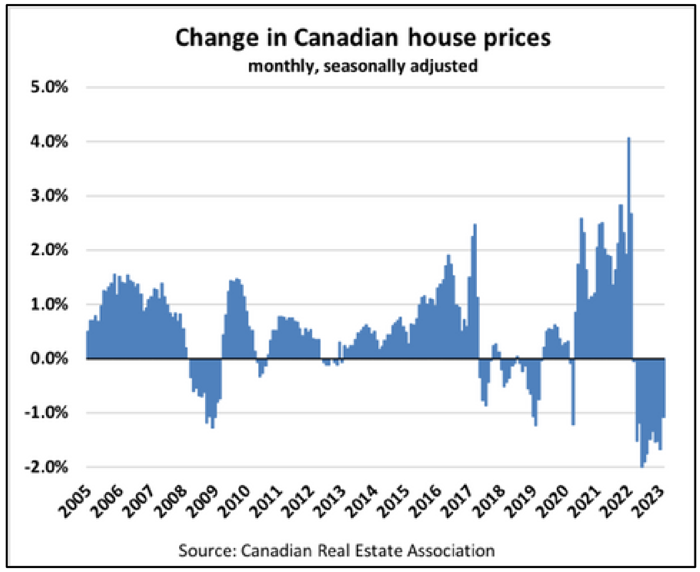


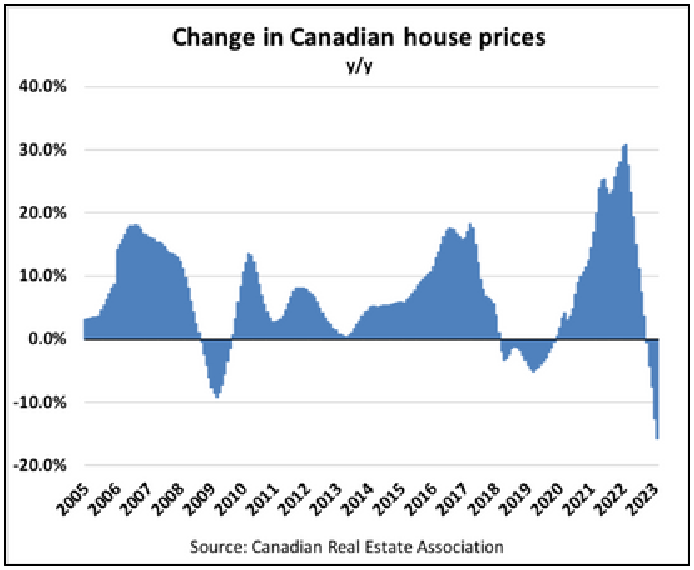


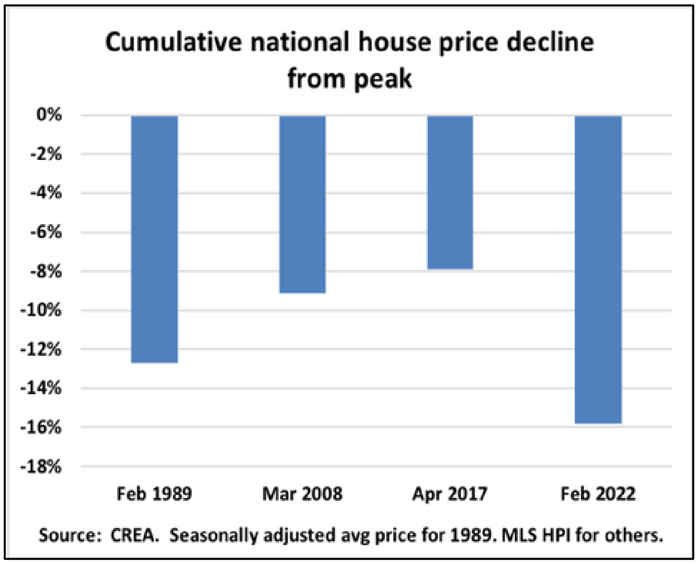
v) Price declines continue

Seasonally adjusted resale prices declined another 1.1% m/m in February and were down 15.8% or $131,000 relative to last year…nearly double the peak annual percentage decline seen during the Financial Crisis.

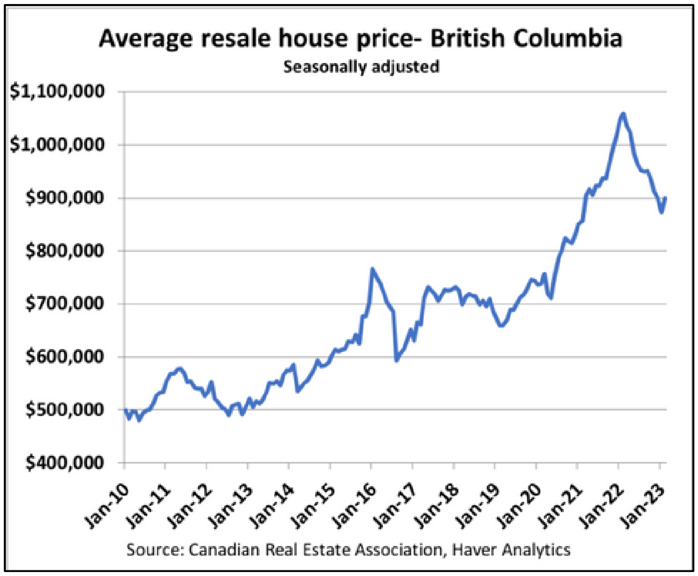


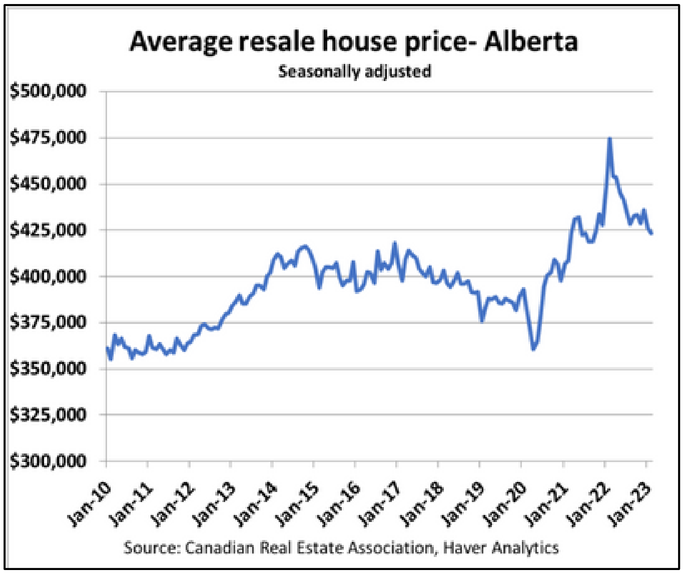


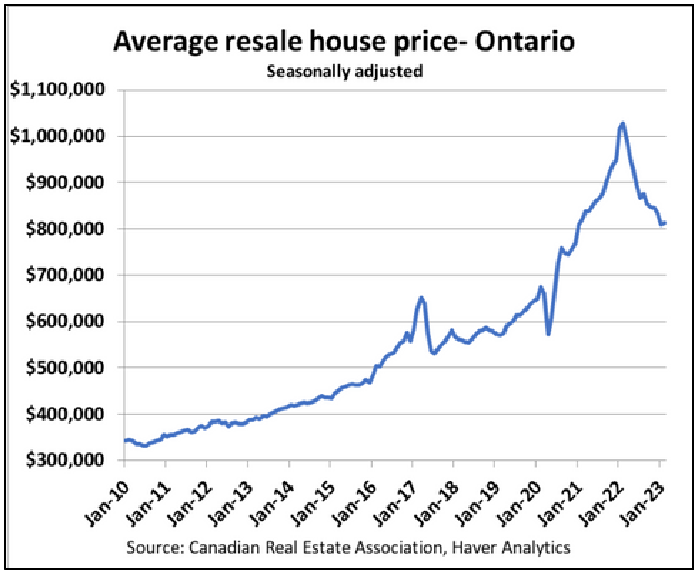


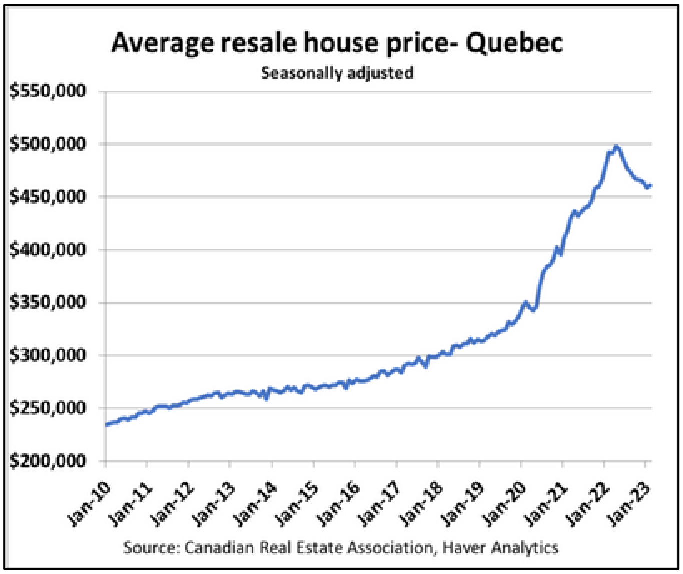


At this point I expect we'll see positive monthly price appreciation either this month or in April based on inventory trends. That could change if we start to see new listings come to market in size, but I'll believe that when I see it.



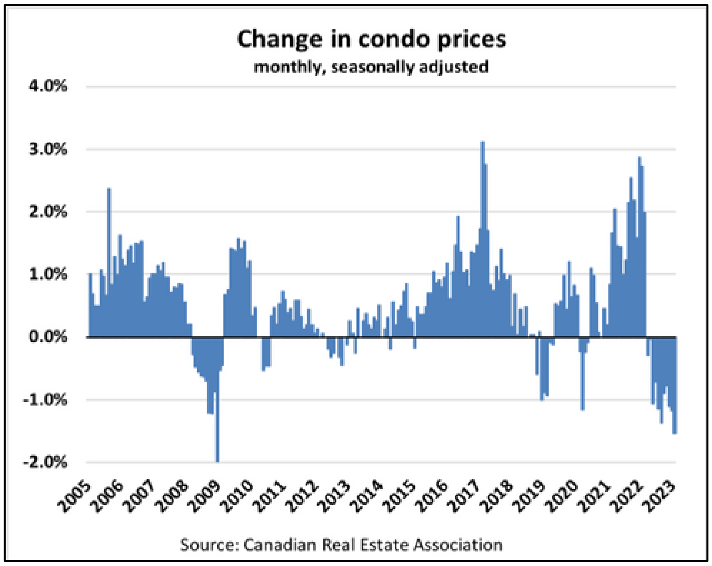




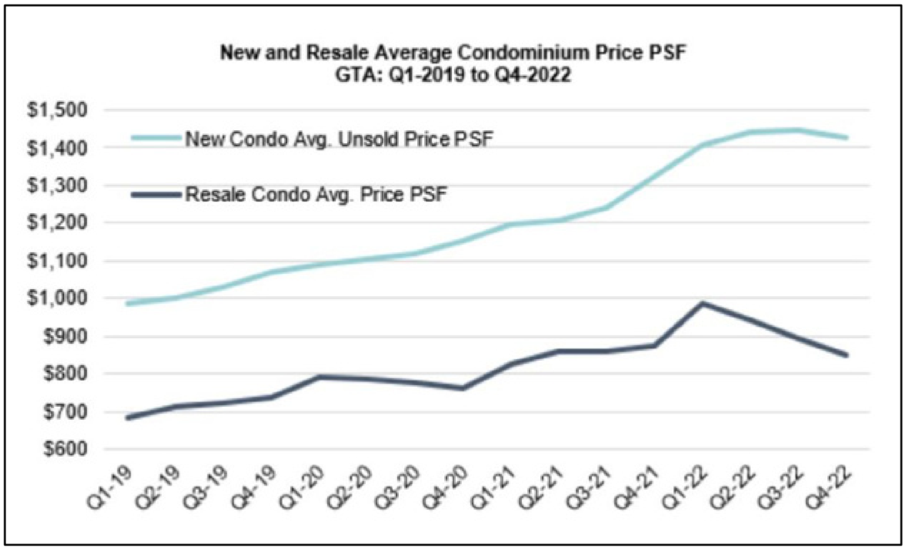


vi) Weakness bleeding into condos

An important dynamic to watch is the disproportionate weakness in the condo segment which saw outsized price declines of 1.5% m/m. That represents the steepest monthly decline since the Financial Crisis and the 2nd steepest on record:



This is a major trend to watch in 2023. The past decade has seen a widening gap in pricing between new and resale units on a psf basis. From Urbanation:



This premium means preconstruction buyers need resale prices to rise during the construction period in order to avoid appraisal deficiencies and capital calls at closing.

Declining resale prices will drive more distressed assignment listings like the one below, as well as mounting issues with financing at closing as we move through the year:


Assignment Sale / GTA pre construction
David Simonetta · 47m ·

Distressed Assignment Sale

$565,000

MCITY 2 CONDO located in Mississauga (Mavis & Burnhamthorpe)

532 sqft bachelor suite 56sqft balcony
5th floor
1 parking
1 locker
North exposure

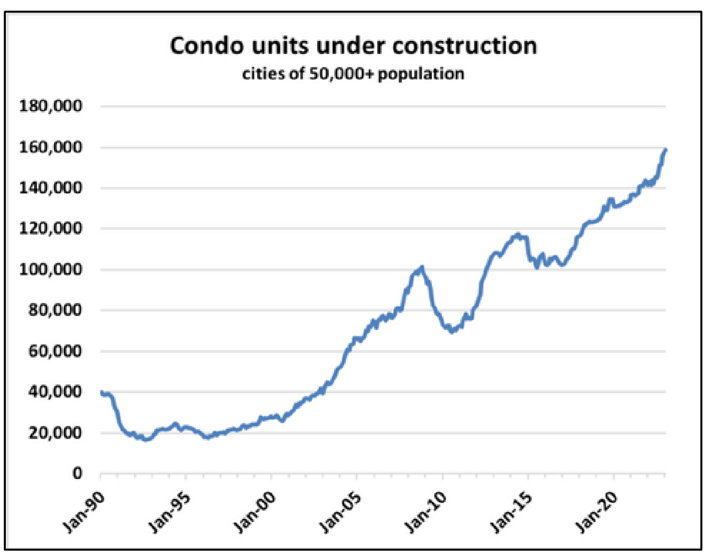
Purchased for $614,900... 10% deposit down $61,490

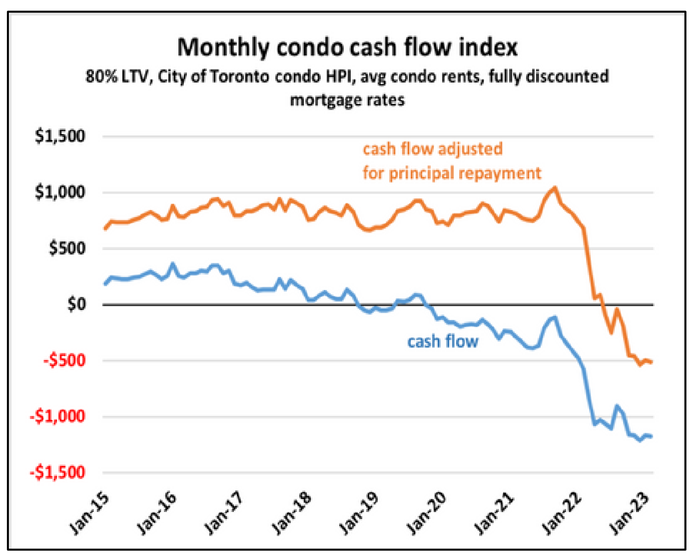
List price: $565,000 (50k below purchase price

Tentative spring 2023

David Simonetta
Iconic Realty
647-309-0933
simonettahomes@gmail.com
@simonettahomes

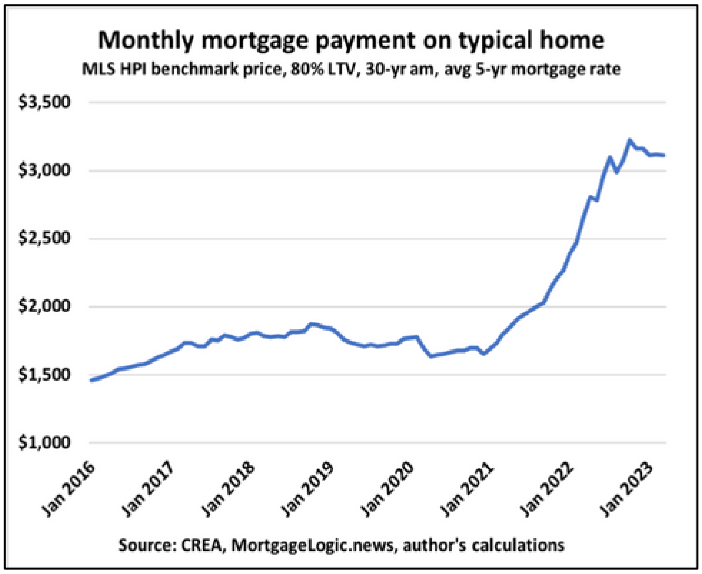
There are over 160,000 condos under construction in larger metros across the country, with 2023 expected to see a record number of new completions. But with rental economics blowing out, who is the natural buyer in a market where up to half of demand came from investors?

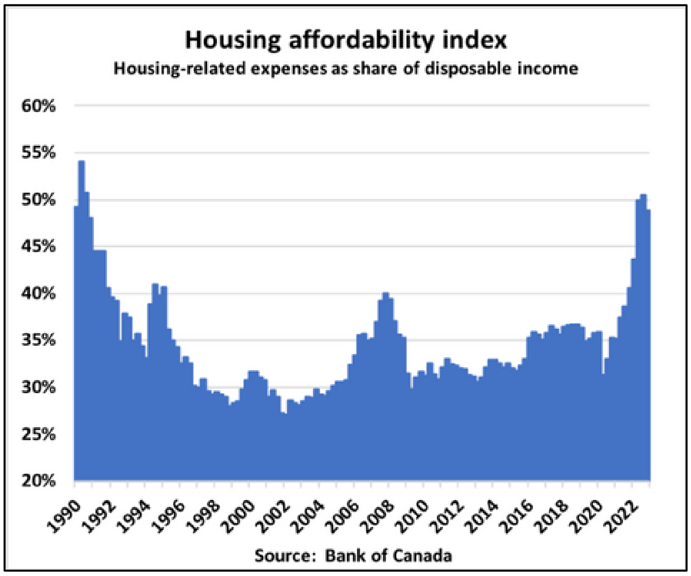




vii) Affordability still dreadful but improving

Affordability remains at crisis levels but is finally beginning to improve. Monthly mortgage payments required to purchase a typical home have flattened out over the past 6 months, during a time where average hourly wages have surged 3.9% nationally (and 5.4% y/y). As a result, the Bank of Canada's housing affordability index improved slightly in Q4 but remains at the highest level in 30 years:





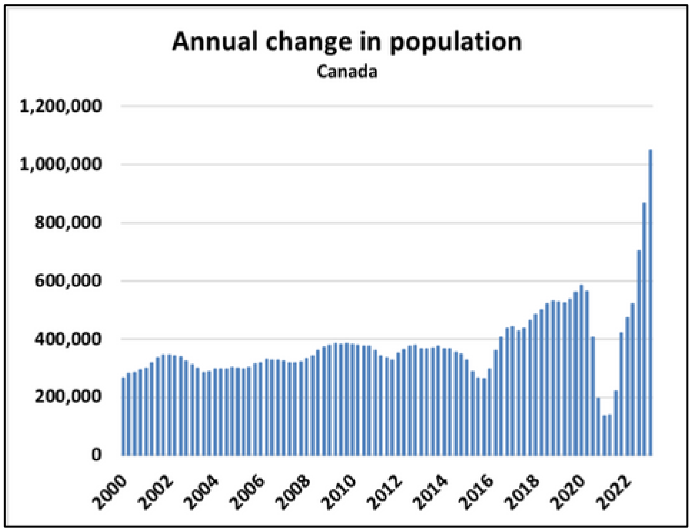
Putting it all together, I think this latest data is very constructive and supportive of the view that the market is stabilizing and set to improve heading into the spring....with the caveat being that a strong flow of new listings could completely upend that dynamic.

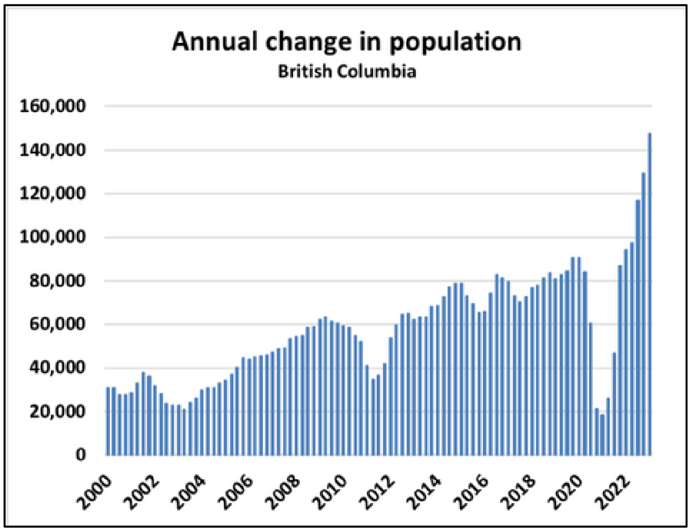
3) Supply and demand: More than meets the eye in latest population data

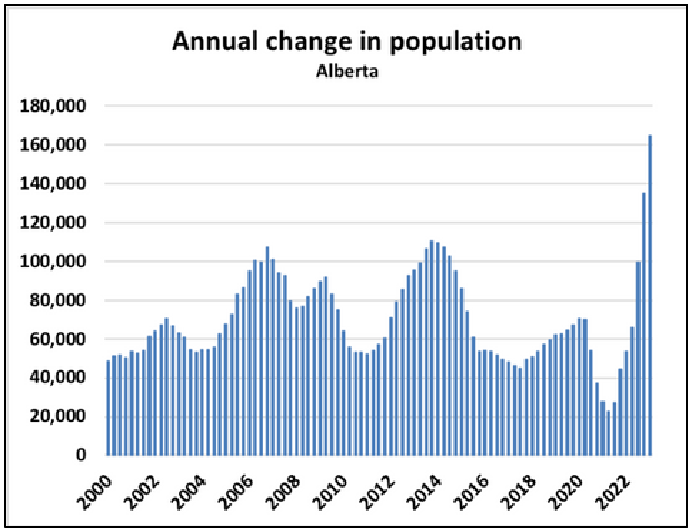
i) Takeaways from latest population data

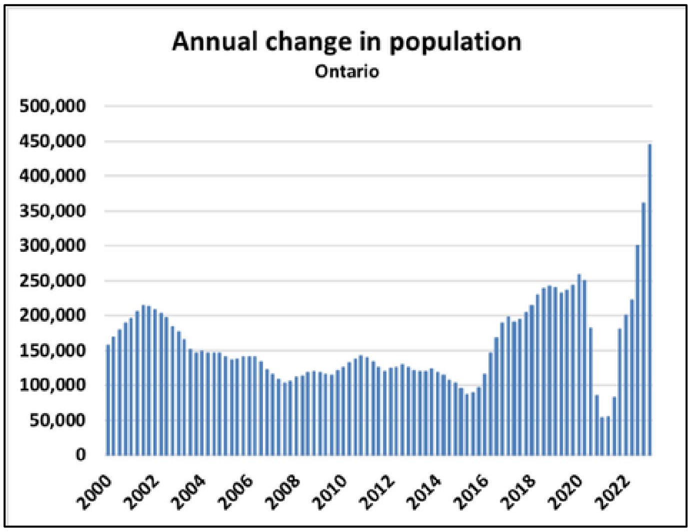
Yet another record

Annual population growth broke the 1 million mark for the first time ever including 274,000 in the past quarter alone. We're now seeing record population growth in every province:



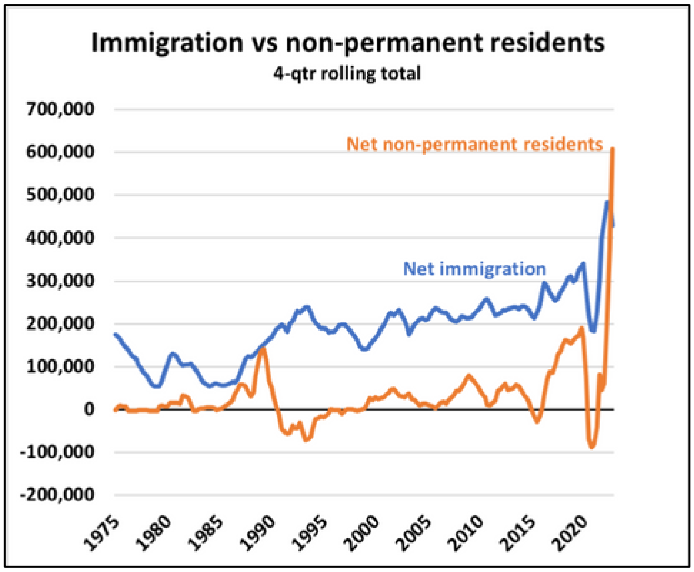




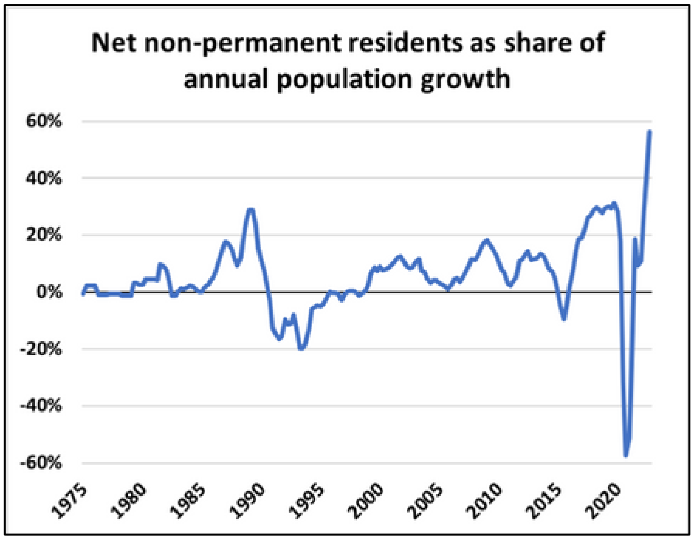


Non-permanent residents surge in Q4

Canada added nearly 200,000 net non-permanent residents (NPRs) in Q4 bringing the annual total to over 600,000. That means that for the first time ever, we've seen NPRs outpace traditional net immigration (ie PERMANENT residents). The last time it was remotely close was 1989 just ahead of that housing downturn. Of note, the growth rate in net immigration actually slowed in Q4.

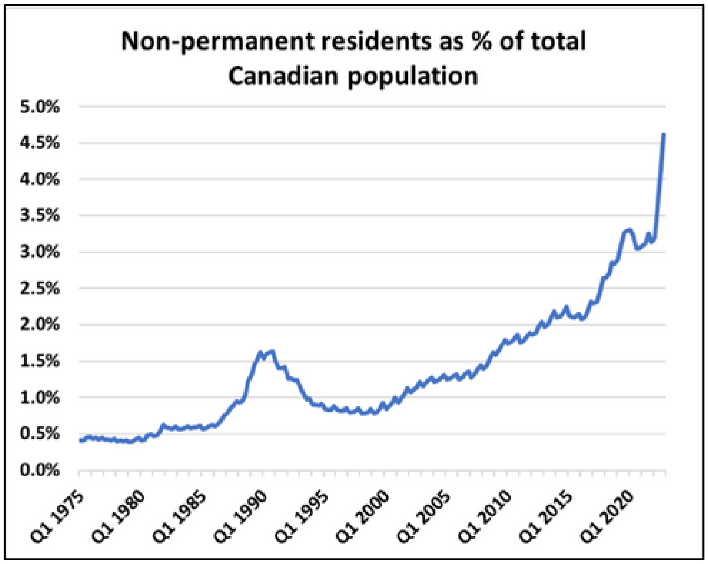


It also means that non-permanent residents accounted for an unprecedented 60% of total population growth over the past year...double any other period on record:



The skew here is towards temporary workers who were brought in to help bridge the gap in the labour market. But this raises an idiosyncratic risk that few people appreciate. Canadian population growth is now HIGHLY PROCYCLICAL and tethered to the strength of the labour market. In other words, low unemployment is driving population growth, but the opposite will also be true: We won't need 2 MILLION non-permanent residents in the country if the unemployment rate starts to rise.

This cohort sees outflows in every recession, with the most nasty being the early 90s when it was cut in half. Back then NPRs comprised 1.5% of the total Canadian population. Today it's triple that.



What this means is very simple: If we hit a recession later this year or early 2024, people will be surprised at how quickly headline population growth slows. And that will probably be a good thing. While I'm all for robust immigration, it's REALLY hard to accept that population growth at over a million a year won't have some tremendously negative externalities.

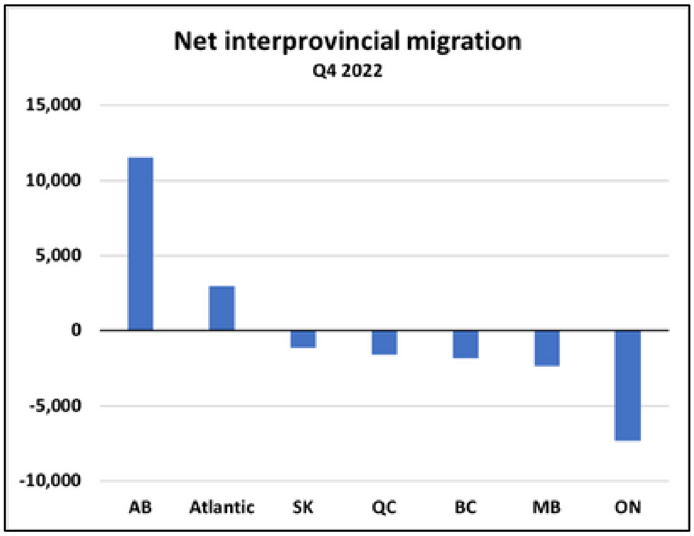
Ontarians flee to Alberta and Atlantic Canada

It's always interesting to see population flows WITHIN the country. Here we look at net interprovincial migration, which is simply the number of people coming to a province from other provinces minus those who are leaving.

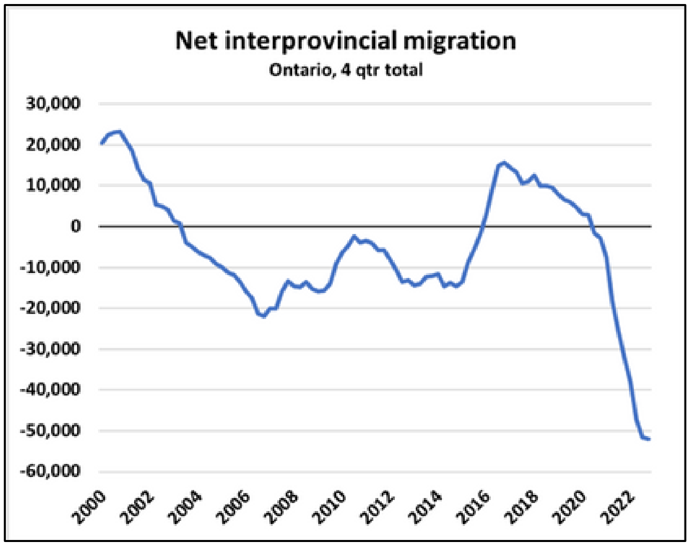
The Q4 numbers are telling and reinforce a theme I've highlighted many times: The cure to low prices is low prices.

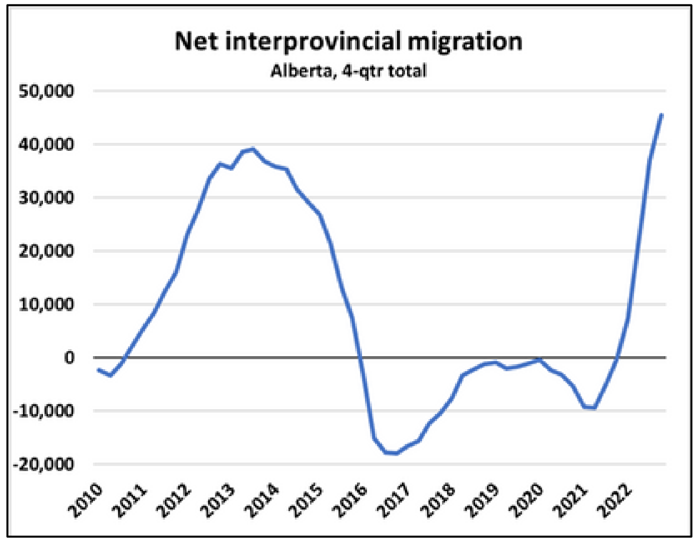
There comes a point where the "arbitrage" offered by absurdly affordable housing (relatively speaking) in Alberta and the Atlantic provinces becomes very compelling for young people in, say, Toronto and Vancouver.

The latest data speaks for itself: Massive net flows into Alberta (nearly 12,000 in Q4 alone) with monster outflows from Ontario.



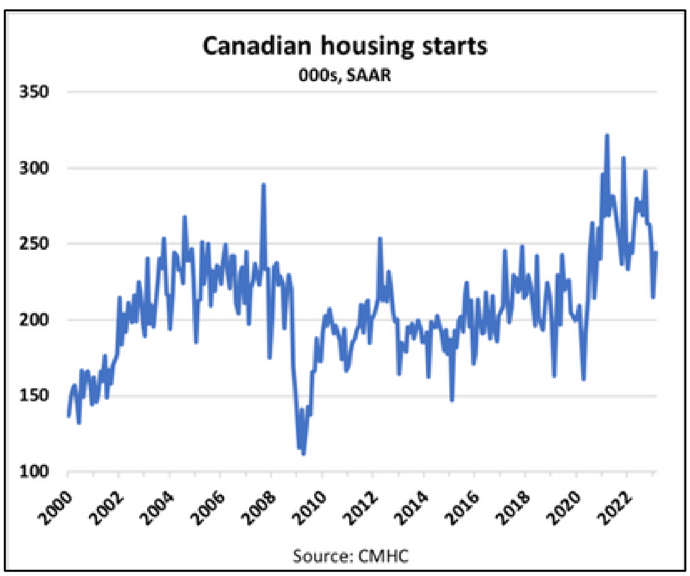
In fact, we've now seen net outflows of 50,000 Ontarians over the past year while Alberta is seeing net inflows of nearly the same magnitude:



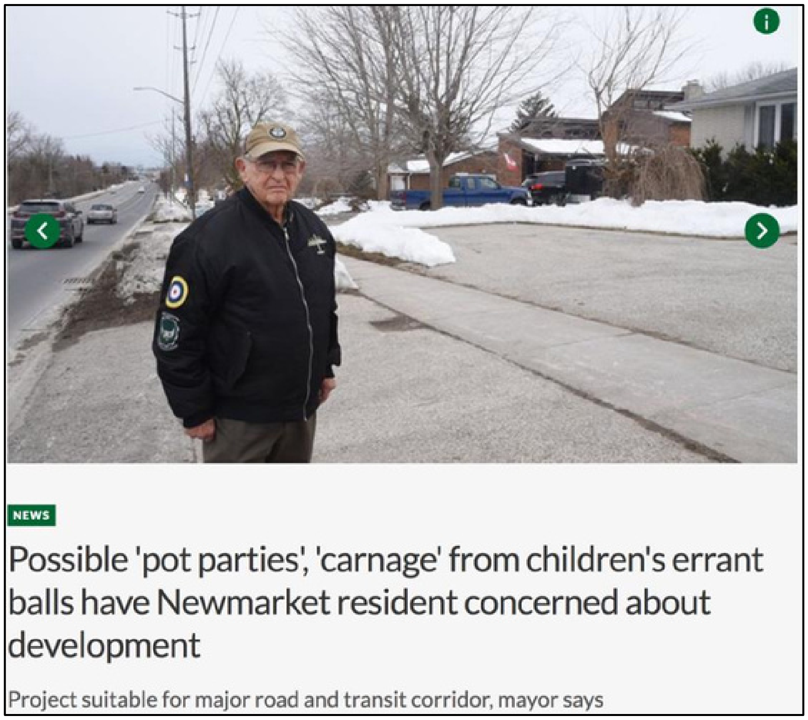


ii) Housing starts bounce, but where are the completions?

Housing starts ticked up to 244,000 on an annualized basis in February, up from 215k previously. That's pitifully low in the context of population growth of over a million.



It's hard to see how we'll ever build enough to accommodate robust population growth, particularly with growing NIMBY (not in my backyard) sentiment. Consider this absurd article about residents opposing a townhouse development out of fear of "possible pot parties" and "carnage" from "errant balls":

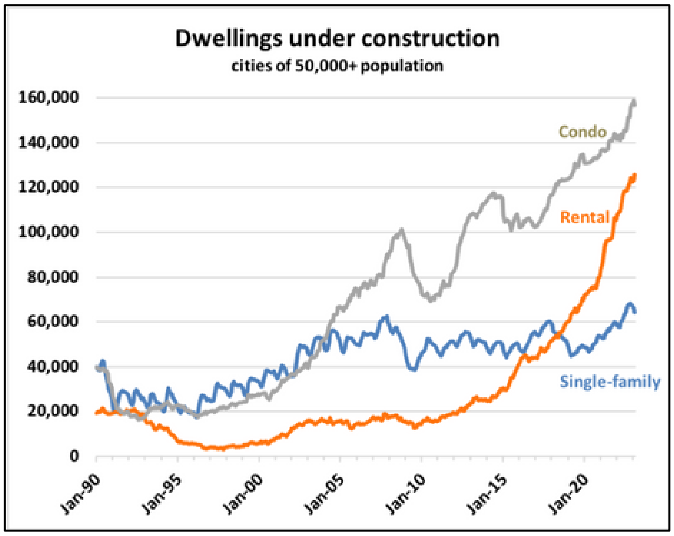


Quote:

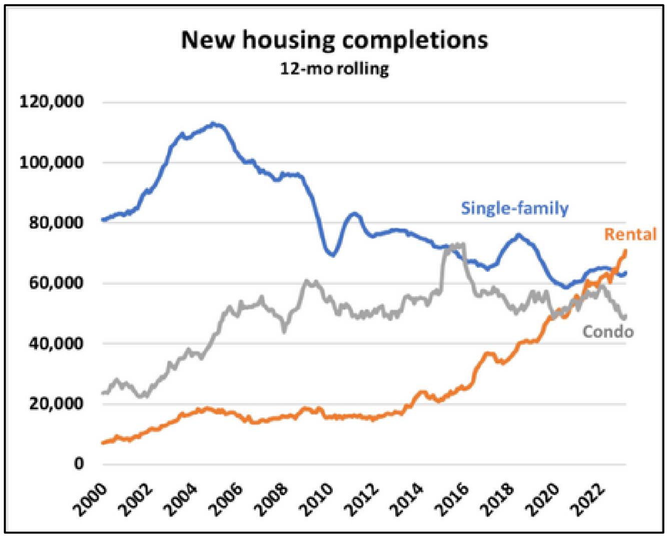
“I can just imagine, as I sit on my front veranda, the sound of screeching brakes and the crashing of metal, followed by sirens as these baseballs, soccer balls or whatever manage to find their way from the terraces to the unsuspecting windshields of passing motorists.”

This is the sort of shit developers are facing. The whole system needs an overhaul. Until it changes, housing supply will remain challenged over the longer term.

Now that’s over the LONG term. In the next year there’s a good chance that we’ll see ample new supply, particularly in the condo segment where dwellings under construction are sky-high and new completions this year are projected to smash records.



But so far that hasn't been the case yet. Completions have been downright tepid outside of rentals. Consider, over the past 3 months new completions were up 6.7% y/y overall but primarily due to a 23.4% y/y jump in the rental segment while condos were DOWN 7.4%:



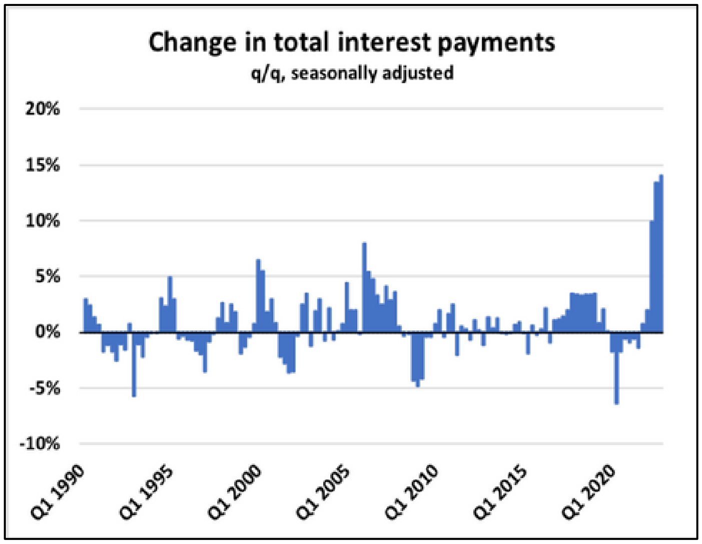
This helps explain why inventory growth has been so benign in the condo space. That may change if projections of record completions prove out.

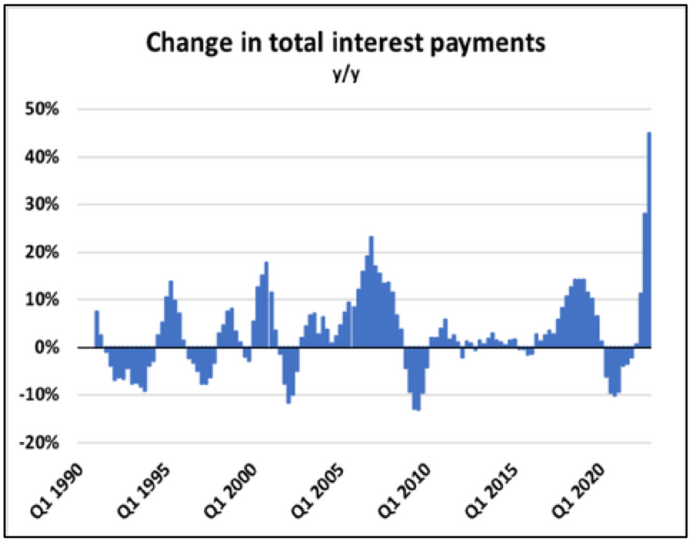
4) Household debt burdens jump in Q4 with more still to come

There's been a pile of borrowing-related data points over the past month. Some of the key takeaways:

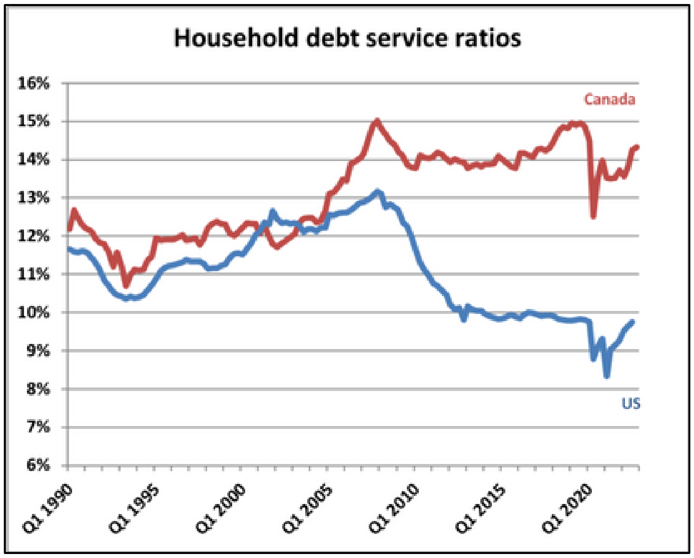
i) Household debt burdens jump in Q4

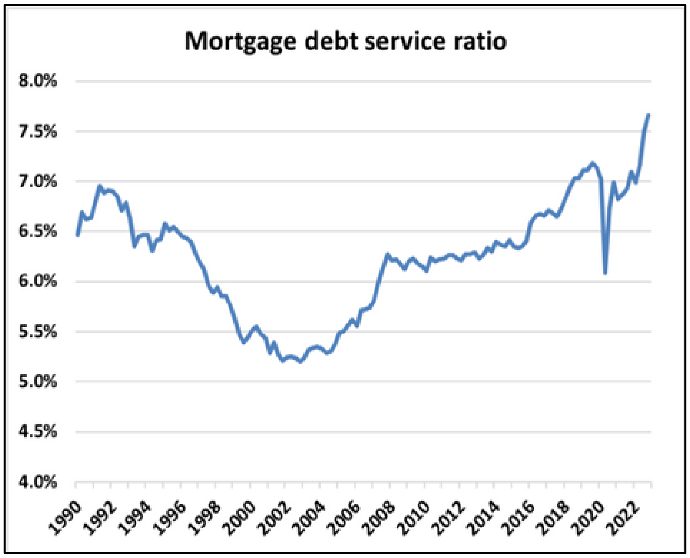
Household interest payments spiked in the fourth quarter, rising a record 14.1% q/q and 45% y/y:





That pushed the debt service ratio to 14.3% from 14.2% previously while the mortgage debt servicing component rose to a record high:

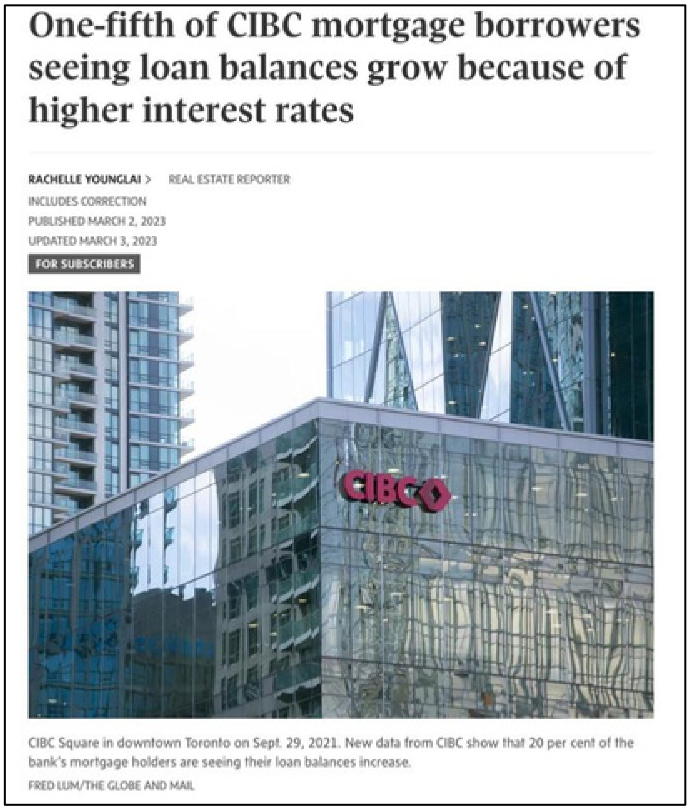




ii) It could have been worse!

It could have been much worse were it not for a drastic drop in principal repayments, the result of amortization extensions from static payment variable rate mortgages.

We now have the likes of CIBC with 1/5 of their mortgage book seeing negative amortization, something that was unthinkable just one year ago:



One-fifth of CIBC mortgage borrowers seeing loan balances grow because of higher interest rates

RACHELLE YOUNGLAI > REAL ESTATE REPORTER
INCLUDES CORRECTION
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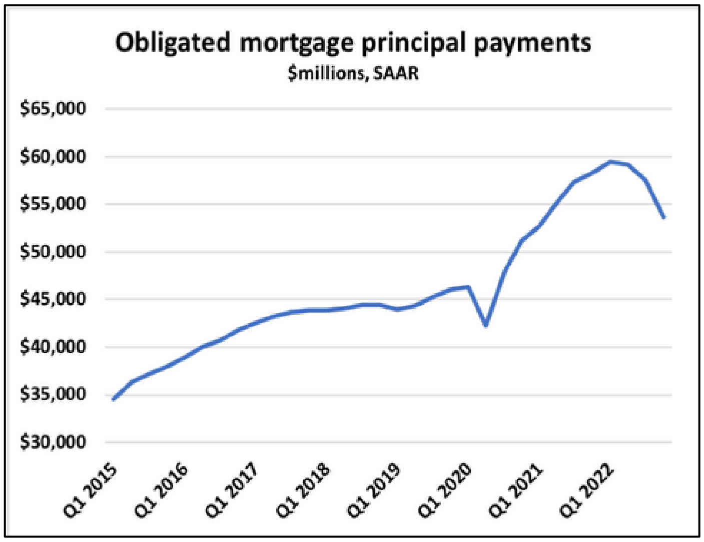
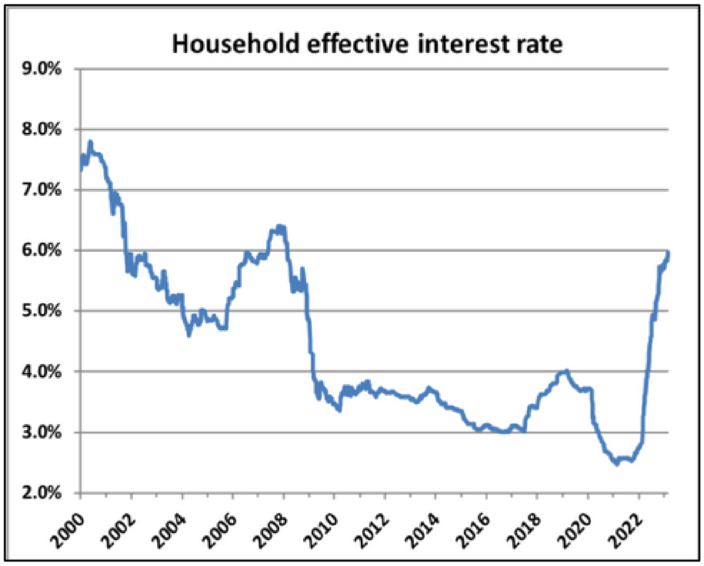
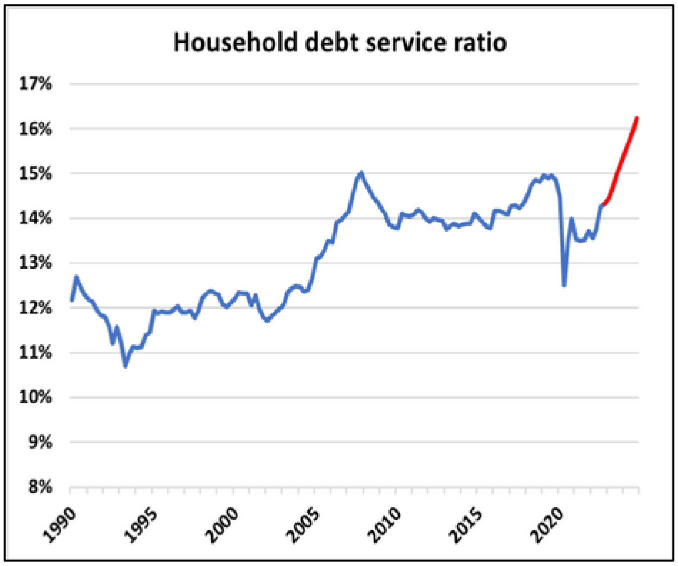
CIBC Square in downtown Toronto on Sept. 29, 2021. New data from CIBC show that 20 per cent of the bank's mortgage holders are seeing their loan balances increase.
FRED LUM/THE GLOBE AND MAIL

This is not a small thing. Principal repayment fell 5.3% in the fourth quarter, equivalent to the quarterly drop registered in Q2 2020 when mortgage deferrals surged during COVID...and it's the largest decline since the mid-1990s:



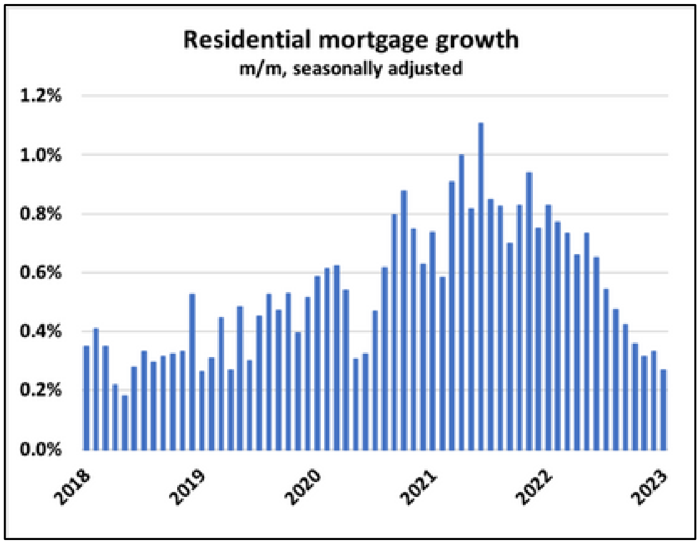
But payments delayed today simply mean accelerated payments in the future. The piper has to be paid. When I model out this dynamic and account for interest rates (the household effective rate is now just a couple bps from 6%), I get a debt service ratio that hits a record high later this year or early 2024 depending on wage growth. Either way, there's more pain to come for Canadian households unless we see a drastic decline in rates this year:

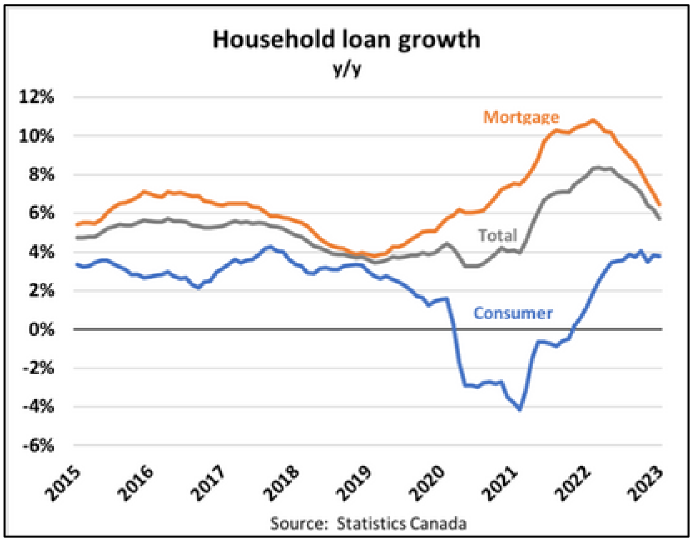




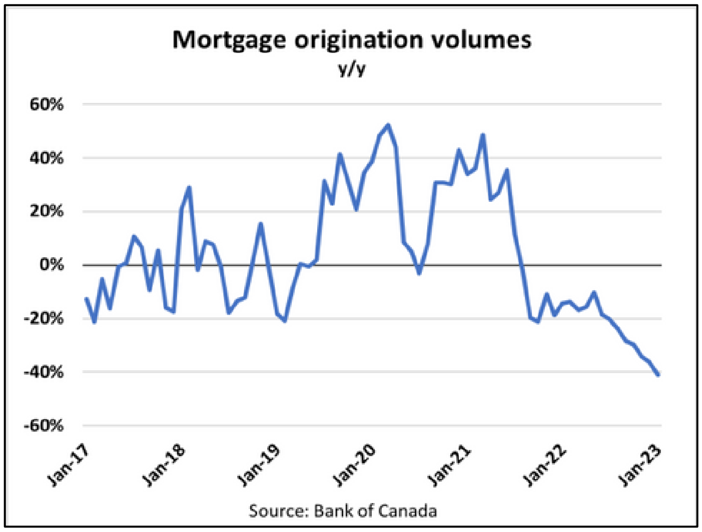
iii) Mortgage growth tumbles

Mortgage growth slowed to just 0.3% m/m in January, the weakest monthly growth rate since 2018. And on a y/y basis, mortgage growth is just 6.4%....which may sound like a lot, but let's remember that household disposable income growth was up 8.5% y/y in Q4.

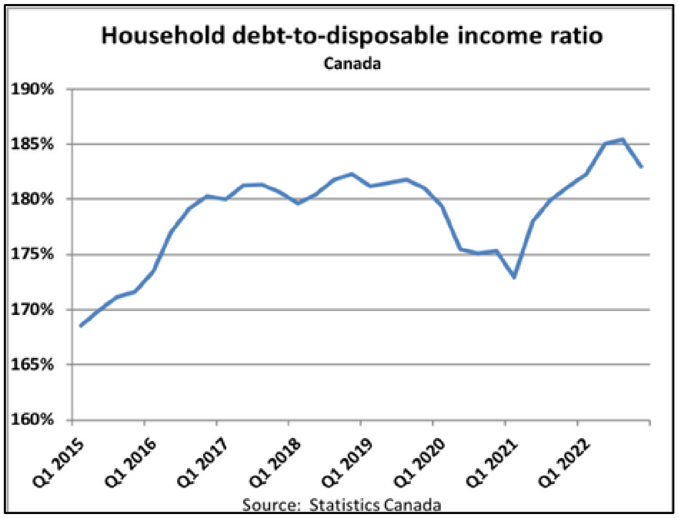




Mortgage originations in January plunged 41% y/y, a decline that is already twice as large as anything seen after the implementation of the original B20. At this rate, we'll see annual domestic mortgage growth fall well below the 2019 lows of 3.8% later this year:



With loan growth now well below wage growth, Canadians are effectively in deleveraging mode, and that has ramifications for consumer spending and bank profit growth. In Q4, the household debt-to-disposable income ratio fell to 183% from 185% previously. Outside of Q2 2020, that represents the largest quarterly decline since at least 1990.

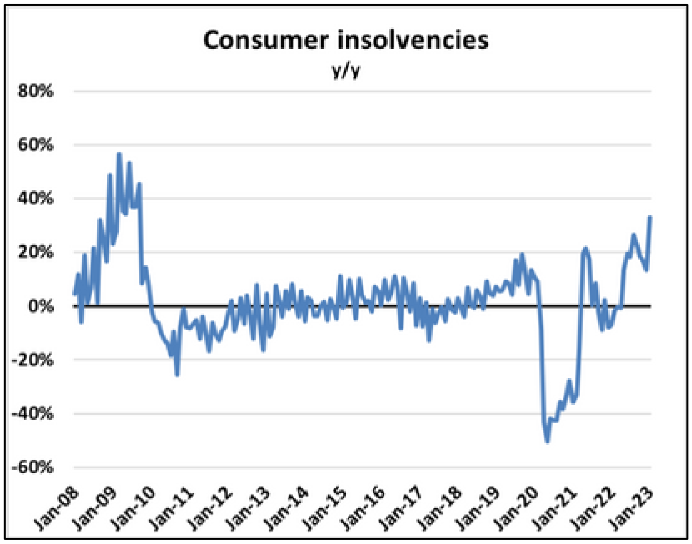


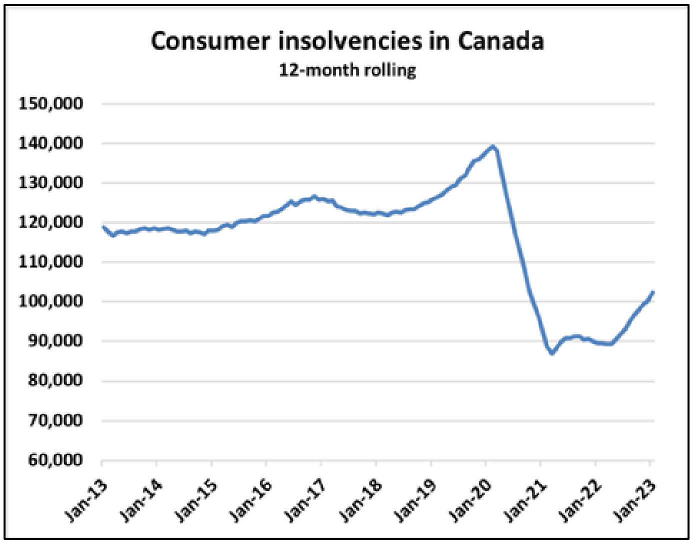
All of this begs the question of just what OSFI is hoping to achieve in their proposed tightening of B20 guidelines. With the benefit of hindsight it's clear that the stress test was a brilliant piece of macroprudential legislation, but what's to be gained now by crimping mortgage growth when it's already running negative in real terms and well below wage growth? It makes no sense, but I suspect I'm preaching to the choir here.

5) Consumer check: Largest increase in insolvencies since 2009

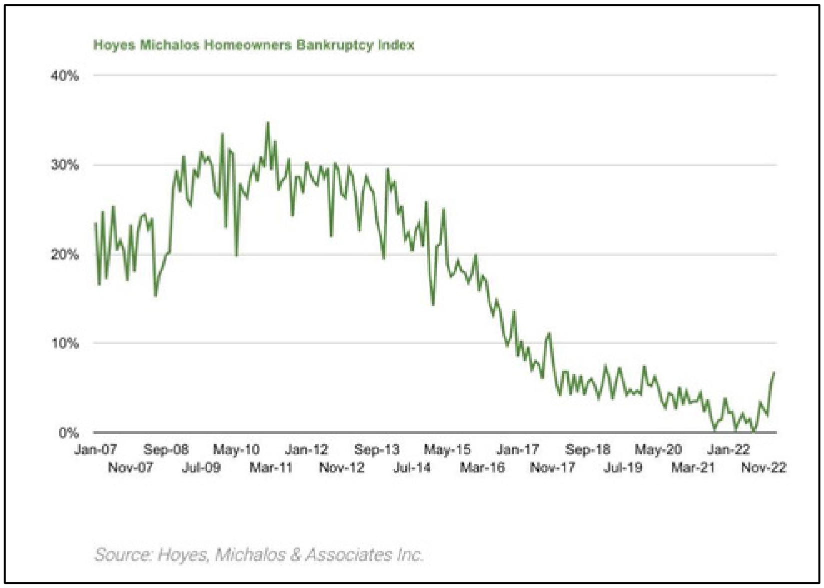
i) Consumer insolvencies jump 33% y/y

Consumer insolvencies surged 33% y/y nationally in January (+39% in ON and BC, +42% in AB). That represents the steepest y/y increase since 2009. Notably, the dollar volume of liabilities in those filings was up 47% y/y in part due to a rising share of homeowner filings where debt levels tend to be much larger.



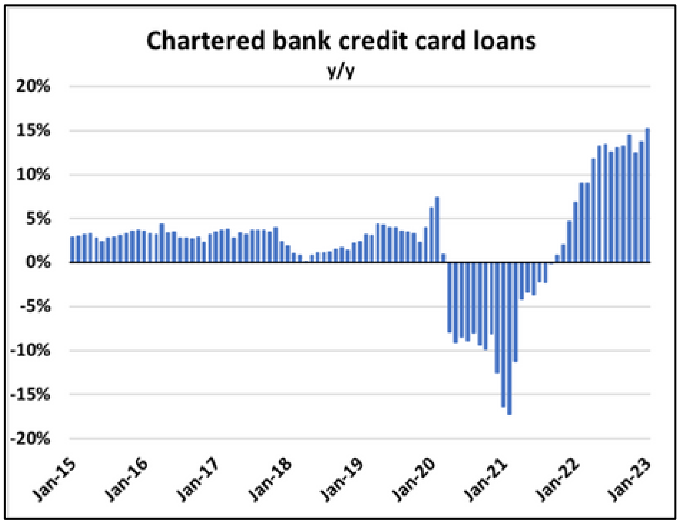


While mortgages continue to perform well at the big banks, insolvency trustees are reporting a rising share of filings from homeowners. Consider the Hoyes Michalos Homeowners Bankruptcy Index which jumped to a 3-year high last month:



ii) Credit card borrowing surges

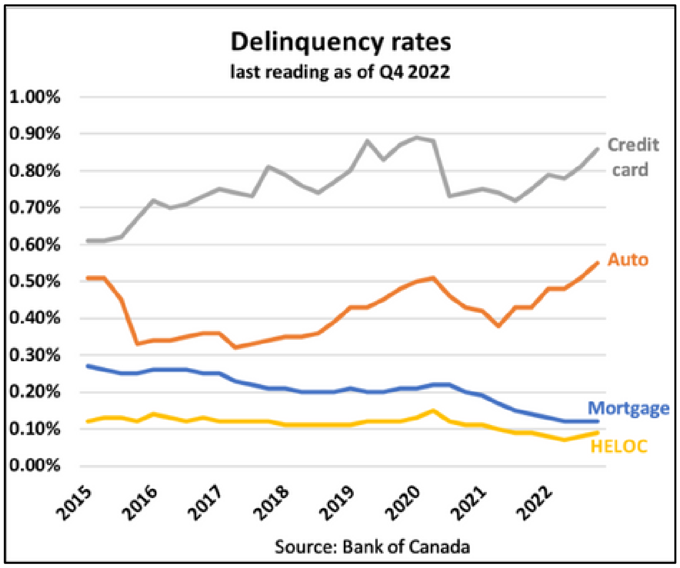
Growth in credit card borrowing is now outpacing mortgage growth by a factor of nearly 3! Over the past three months, credit card balances have grown 2.5% while mortgages have grown just 0.8%. That puts credit card growth over the past year at north of 15%.



I have to assume that a non-trivial portion of this growth is from people either just trying to make ends meet or trying to sustain consumption in the face of rising rates....neither of which is a great read-through to the state of the Canadian consumer:

iii) Credit card and auto delinquencies rise in Q4, mortgages stable

The latest data from the Bank of Canada shows auto and card delinquencies on the rise in Q4 while mortgages held steady at a record low of just 0.12% (compared to a long-term average of 0.35%).

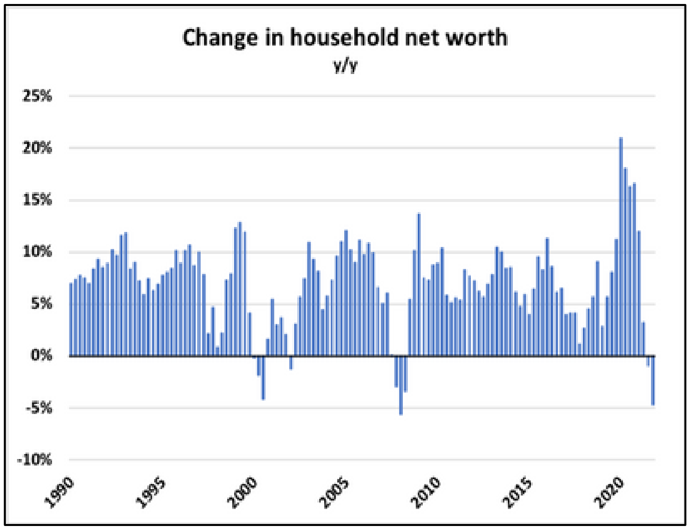


Mortgage delinquencies take a long time to show up in official data. I suspect we're seeing generational lows in delinquencies right now. I expect delinquencies will more than double by this point next year, and we won't see these levels again for many, many years. A doubling in delinquencies may sound like a lot, but it would leave delinquencies at only 2/3 of the long-term norm. Not exactly a stretch when it's framed that way.

iv) Net worth on the decline

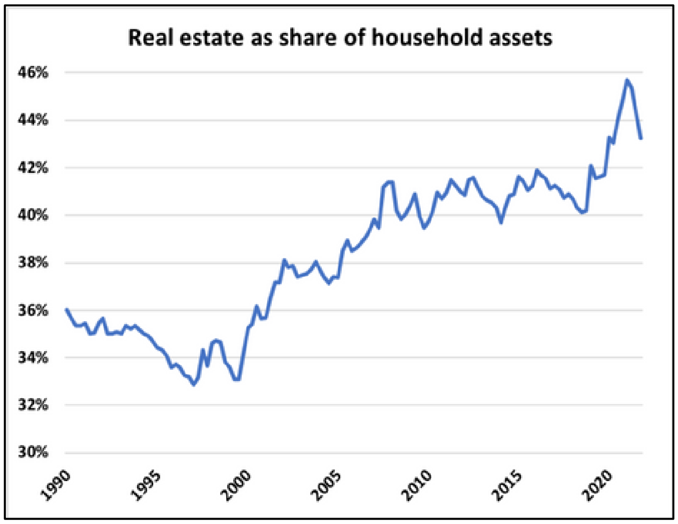
Rising asset values are good for consumer spending and also good for credit performance. After all, people have options to avoid default when they have ample assets on the other side of the ledger.

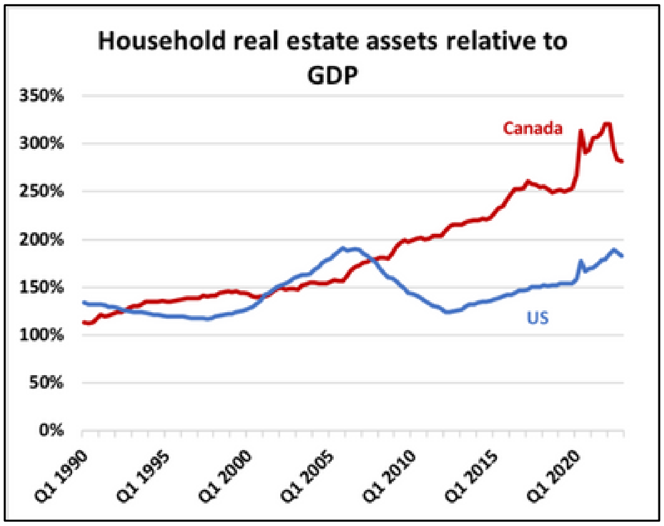
That makes the trend in household net worth a bit of a concern. After falling a cumulative 5.6% over the prior two quarters, household net worth inched up 1.2% in Q4. Still, that leaves net worth down 5% y/y, the steepest decline since the Financial Crisis:



Real estate assets declined 1.3% in Q4 but still represent a near record of total assets, leaving households vulnerable to a continued decline in prices should that materialize.

For perspective, real estate assets on household balance sheets represent 280% of GDP, barely off the all-time highs and way above the US peak in 2005. I struggle to articulate a fundamental reason why Canada should sustain such a high level relative to our US peers:





Regards,

Ben