

SPOTLIGHT ON HOUSING

Faster-Rising Interest Rates Set to Shake Up the Housing Sector

By H el ene B egin, Senior Economist

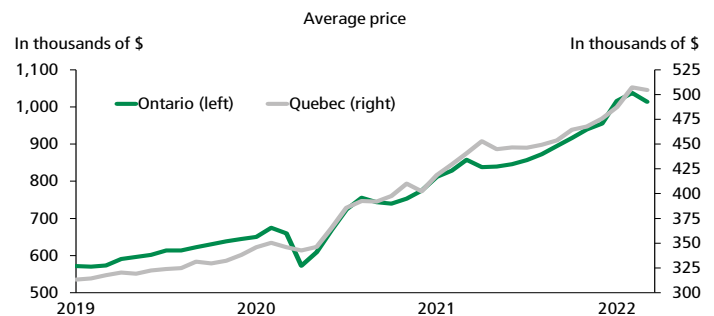
Although runaway real estate prices continue to cause concern, there is light at the end of the tunnel. The rise in mortgage rates, which will be more important than projected a few months ago, will help cool down the resale market. Lower demand from first-time buyers, who generally have more limited budgets, will gradually ease price pressure. Overbidding is expected to eventually recede, helping prices stabilize somewhat by the end of the year. Prices could even drop next year in Quebec and Ontario as households feel a bigger pinch from interest rate hikes. Housing starts will also reflect lower demand, but construction of rental apartments should continue at a good clip. While it may seem hard to imagine now, the residential real estate boom will soon give way to a lull.

Almost past the Boiling Point

In the first quarter of this year, the average sale price for an existing home rose to almost \$500,000 in Quebec. That's an annual increase of more than 15% that has held since mid-2021, tipping past 20% in the first few quarters of the pandemic. Major metropolitan areas saw prices spike in the first quarter (table 1). It was the same story in Ontario, where the annual increase in average prices was 10%–30% in major markets. The average price topped \$1 million in the first quarter, a 22.0% year-on-year gain (graph 1). Although prices are up significantly compared to a year ago, month-on-month increases seem to be weakening in both provinces—perhaps an early sign that the frenzy is dying down.

Still, the market remains tight for several reasons. First, demand has stayed strong, with many buyers rushing to close before

GRAPH 1
Existing home prices were up sharply in early 2022



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

mortgage rates go any higher. Many borrowers with low-interest loan approvals (guaranteed for a few months) moved quickly. And with inventory levels at an all-time low, there are nowhere near enough properties for sale. The decline in sales that started last year in Quebec and Ontario doesn't necessarily mean a downward trend in buyer demand, but rather a lack of supply.

As a result, price pressure has held steady early this year and could persist for a few more months. 2022 came in like a lion. Prices are expected to increase by more than 10% again this year in Quebec and Ontario, even if they do stabilize somewhat in the second half of the year. Next year, it seems inevitable that prices will fall in both provinces (graph 2 on page 2). Lower demand will mean fewer multiple offer situations and an end to the overbidding that's been happening almost everywhere. Sales prices are expected to come back toward properties' real

TABLE 1
Average price of an existing home in major urban centres

CMA	Q1 2022	
	Level in \$	Annual variation in %
Gatineau	481,144	27.1
Montreal	615,650	15.2
Saguenay	252,547	13.7
Sherbrooke	392,175	12.7
Trois-Rivi�eres	288,305	27.0
Quebec	359,422	15.2
All of Quebec	493,249	16.4

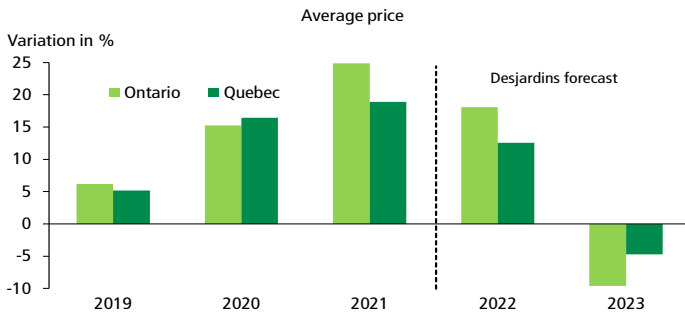
CMA: Census metropolitan area

Sources: Canadian Real Estate Association and Desjardins, Economic Studies

NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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GRAPH 2
Existing home prices are expected to fall in 2023



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

value, i.e., lower than the peak prices we saw at the height of the frenzy. Some parts of Quebec will be hit hard, including the Island of Montreal and neighbouring areas as well as parts of the Eastern Townships that saw more overbidding. Most other markets won't see price declines next year. In Ontario, many urban areas will be vulnerable to falling prices in 2023. A number of factors will lower housing demand, although in the short term we don't expect much change in inventory.

Fewer First-Time Buyers

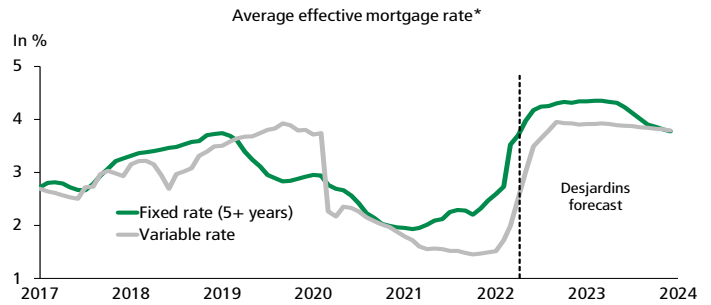
Rising borrowing costs will slowly pare down the number of potential buyers, especially younger buyers who will be harder hit by eroding affordability. Last year, first-time buyers accounted for nearly half of residential sales in Canada. This group will be less active, marking a turning point for the resale market. According to its latest budget, the federal government will introduce a tax-free First Home Savings Account and double the home buyers' tax credit. Buyers will be able to contribute up to \$8,000 per year, with an overall cap of \$40,000. This measure won't take effect until 2023, so it may take some time to have an impact on the market. In the short term, home ownership could be a big reach for many. The fact that first-time buyers will be less active will inevitably ease price pressure since there are more of them than experienced home buyers and investors (box on page 3). Prices are expected to fall next year as households feel a bigger pinch from interest rate hikes. This time, it won't be a soft landing—though it won't be so hard it triggers a serious price correction. Everything will hinge on the biggest risk, which is how far and how quickly borrowing costs rise.

How High Will Mortgage Rates Go?

It's hard to imagine a lull in the resale market after the pandemic-driven overheating we've seen. However, higher interest rates will make the difference. Fixed mortgage rates started to inch up last fall in response to investor inflation expectations on the bond market. Rates have risen higher of late and will continue to over the coming quarters. Effective rates on mortgages with a term of five years or more will likely exceed 4% soon, which is around double the prevailing rate at the height of the pandemic

(graph 3). Given today's high housing prices, this will limit the number of new buyers on the market. Existing homeowners will feel the effect when their mortgage matures if there's a big difference between their initial rate and the rate available at renewal.

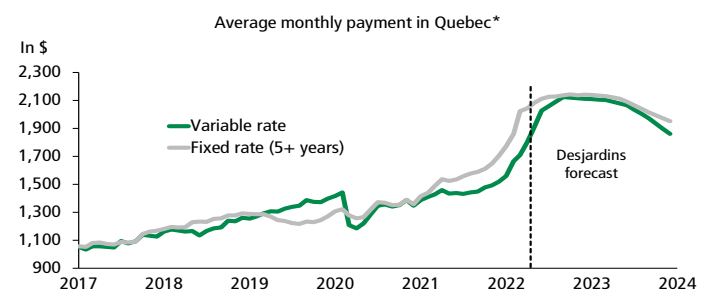
GRAPH 3
Mortgage rates are increasing rapidly in Canada



* Weighted for advances. Sources: Bank of Canada and Desjardins, Economic Studies

Variable mortgage rates will soar and are expected to be close to 4% by the end of 2022 as the Bank of Canada (BoC) quickly raises its key interest rate. In Canada, inflation hit 6.7% in March, a level not seen since the early 1990s. The BoC will therefore have to respond more forcefully. It began raising rates in March with a 25-point hike, followed by a 50-point increase on April 13. The BoC's overnight rate began the year at a low of 0.25% and is now expected to end the year above 2%. Variable mortgage rates reflect each uptick in interest rates, but monthly payments remain the same for many borrowers. However, more of their payments are applied to interest and less to repaying the principal. As such, they'll need to refinance more of their mortgage at renewal. Rising fixed and variable rates will be felt by current homeowners, but even more so by first-time buyers who will be facing much larger monthly payments (graph 4).

GRAPH 4
Monthly payments are rising on new mortgages



* Based on a home purchased at the average price with a 20% down payment and a 25-year amortization. Sources: Bank of Canada, Canadian Real Estate Association and Desjardins, Economic Studies

BOX

Investors in the Government’s Crosshairs

Investors have been exacerbating the price surge since the start of the pandemic, but that could change next year. Investors were counting on properties appreciating fast so they could sell them for a profit. Once prices stabilize and start to fall after, investor perceptions could sour. Investors could then be tempted to sell some of their properties and cash out the gains they’ve made over the past few years. In Toronto, a quarter of all homes belong to investors who own multiple properties. Starting January 1, 2023, the federal government will change the tax rules for anyone selling real estate that they’ve owned for less than 12 months, whether for personal or rental use. Instead of being treated as a capital gain and taxable at 50%, it will be considered business income and taxed at 100%. This won’t change anything for professional flippers, but it will make a difference for private buyers.

In addition, the federal government will bar foreigners from buying property for two years. Most real estate investors are Canadian, however, and non-residents have only a marginal influence on the market. In Ontario, the tax levied on foreign investors who buy residential property recently rose from 15% to 20% and its application, previously limited to the Golden Horseshoe region, was expanded across the province. It remains to be seen whether these measures will affect the number of residential real estate investors in the market. But we do know the end of fast-rising prices could curb enthusiasm for speculative buying and, in turn, housing demand.

More households could have trouble qualifying because of the federal government mortgage stress test. Borrowers must now qualify using either the rate offered by their lender plus 2% or 5.25%, whichever is higher. Since mortgage rates are going up, the minimum qualifying rate could be more than 5.25%.

High household debt makes homeowners more vulnerable to rising interest rates than they were in past cycles. However, record low unemployment of 4.1% in Quebec and 5.3% in Ontario, as well as high savings rates, are mitigating downside risks to the housing market (graph 5). Many households have a bigger financial cushion post-pandemic and will be able to make higher mortgage payments by dipping into their savings. Still, some borrowers have less leeway and could have trouble paying off their debt.

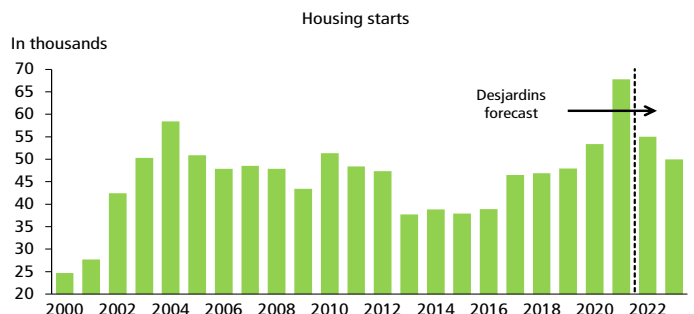
will mean less activity after a big 2021 (graph 6). Housing starts are down sharply in urban centres of all sizes in Quebec. And yet the decline is more pronounced in small towns of fewer than 50,000 inhabitants. Last year, these towns saw a housing boom as the pandemic drove many households out of main centres.

TABLE 2
Single-family housing starts have already dropped

CMA	Q1 2022	
	Number	Annual variation in %
Gatineau	129	-1.5
Montreal	330	-46.6
Quebec	217	-24.9
Saguenay	45	36.4
Sherbrooke	82	-33.9
Trois-Rivières	31	-26.2
Province (centres with 10,000+ inhabitants)	1,091	-36.9

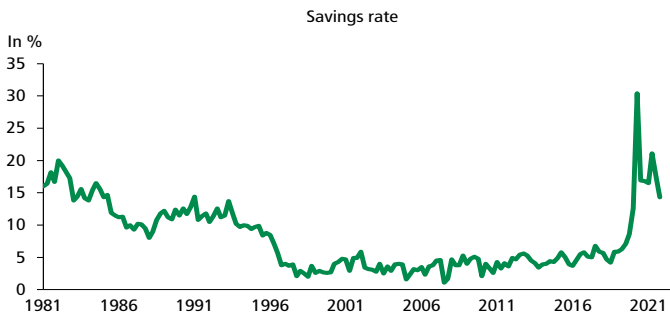
CMA: Census metropolitan area
Sources: Canada Mortgage and Housing Corporation and Desjardins and Desjardins, Economic Studies

GRAPH 6
Housing starts are expected to return to more “normal” levels in Quebec



Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

GRAPH 5
The savings rate among Quebecers remains historically high



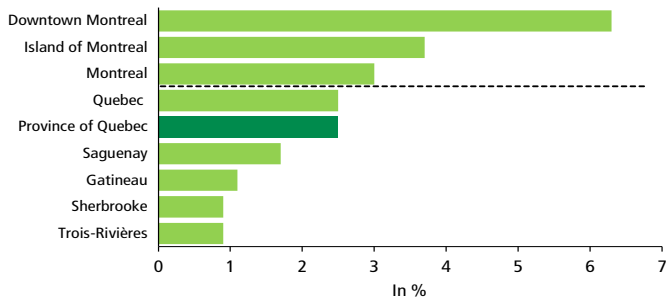
Sources: Institut de la statistique du Québec and Desjardins, Economic Studies

New Construction Falters

Despite the severe housing shortage, housing starts slowed in the first quarter of this year (table 2). Higher building costs, supply problems, and the scarcity and cost of land in urban areas

Now, rising interest rates will accelerate the decline in housing starts, which could be down nearly 40% this year (table 3 on page 5). Rental housing starts, on the other hand, should stay on pace. Low vacancy rates in most Quebec and Ontario markets (graph 7), along with higher barriers to ownership and more immigration, will increase demand for rental housing.

GRAPH 7
2021 rental apartment vacancy rates by CMA



CMA: Census metropolitan area
 Sources: Canada Mortgage and Housing Corporation and Desjardins, Economic Studies

In a [study](#) (in French only) published in April, the APCHQ (Quebec home builders’ association) estimated that the province needs another 15,000 private rental apartments and 37,000 social housing units right now. An injection of public funds to build additional housing should kickstart new rental projects. But given the construction timelines on large projects, the housing shortage for more vulnerable households could persist for some time to come.

TABLE 3
Quebec housing market outlook 2022–2023

	2019	2020	2021	2022f	2023f
New housing market					
New construction (\$B)	11.7	13.0	17.7	16.0	14.5
Annual variation (%)	-1.9	10.7	36.4	-9.8	-9.4
Housing starts	47,967	53,364	67,810	55,000	50,000
Annual variation (%)	2.3	11.3	27.1	-18.9	-9.1
House	13,742	15,502	21,091	12,000	9,000
Annual variation (%)	-8.2	12.8	36.1	-43.1	-25.0
Single-detached	8,989	10,437	14,826.0	---	---
Annual variation (%)	-10.6	16.1	42.1	---	---
Semi-detached	2,966	3,457	4,175.0	---	---
Annual variation (%)	-1.0	16.6	20.8	---	---
Row housing unit	1,787	1,608	2,090.0	---	---
Annual variation (%)	-6.6	-10.0	30.0	---	---
Apartment	34,225	37,862	46,719	43,000	41,000
Annual variation (%)	7.3	10.6	23.4	-8.0	-4.7
Condo ¹	8,172	7,222	8,032	7,000	5,500
Annual variation (%)	-17.1	-11.6	11.2	-12.8	-21.4
Rental ¹	24,861	28,709	35,659	35,500	35,000
Annual variation (%)	21.3	15.5	24.2	-0.4	-1.4
Conventional rental ²	21,536	26,554	33,049	33,000	32,700
Annual variation (%)	28.6	23.3	24.5	-0.1	-0.9
Retirement home ²	3,159	2,017	2,567	2,500	2,300
Annual variation (%)	-11.4	-36.2	27.3	-2.6	-8.0
Resale market					
Unit sales	96,636	112,176	110,121	93,434	75,054
Annual variation (%)	11.8	16.1	-1.8	-15.2	-19.7
Weighted average price (\$k)	324	377	448	504	481
Annual variation (%)	5.2	16.4	18.9	12.6	-4.7
Sales volume (\$B)	30.5	40.0	46.8	47.1	36.1
Annual variation (%)	15.9	31.1	17.1	0.6	-23.5
Other indicators					
Vacancy rate for rental units ³ (%)	1.8	2.5	2.5	1.8	1.5
Average rent ³ (\$)	800	844	873	915	965
Annual variation (%)	5.1	3.8	3.6	4.8	5.5
Renovation spending ⁴ (\$B)	14.2	14.2	19.9	22.0	20.0
Annual variation (%)	3.9	0.1	40.1	10.4	-9.1

f: forecasts; ¹ Urban centres with populations of 10,000 and over, the total is slightly below the total for provincial apartments shown above; ² Included in rental units; ³ Three units or more, biannual survey of the fall; ⁴ Maintenance and repair expenditures are excluded.

Sources: Canada Mortgage and Housing Corporation, Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies