ECONOMIC VIEWPOINT

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ANALYST FORECAST AWARDS
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#1 BEST OVERALL FORECASTER – CANADA

Canada's Housing Market Correction Has Begun. Is It a Good or a Bad Thing?

By Jimmy Jean, Vice-President, Chief Economist and Strategist

In a recent *Economic Viewpoint*, we argued that the Canadian housing market is in the very early stages of a meaningful rebalancing. The natural instinct is to interpret this as a negative. After all, Canadian households' long-term finances inexorably revolve around the wealth they accumulate in the value of their homes over time. Yet the severe housing market imbalance in recent years encouraged risky buying, eroded affordability and exacerbated inequality in Canada. From that perspective, a real estate cooldown could be construed as reassuring news. So which is it?

Breaking the Mindset

In our latest *Economic Viewpoint*, we shared our updated outlook for the Canadian housing market. Affordability is central in our framework, and we believe the combination of rapid appreciation and higher interest rates has pushed affordability to the limit.

However, the price correction we expect won't just mean lower affordability. It will also force buyers and sellers to shift their expectations and behaviours. As recently as February, nearly two-thirds of Canadians expected home values to keep rising even though the average price had already increased by 50% since December 2019.

The Bank of Canada has often described this mindset as "extrapolative expectations." It's the assumption that real estate will always appreciate. When this belief becomes entrenched, it can cause prices to increase exponentially. This in turn leads to bidding wars across housing markets.

Now that some markets have reached a turning point in housing prices, this mindset will be turned on its head. Other local markets will join the fray, as relentless rate hikes continue to erode affordability. Where this is happening, fear of missing out may turn into fear of overpaying or ending up underwater. This concern will be particularly prevalent among those who have little equity to begin with. A significant proportion of new mortgages in the last two years was extended to borrowers with low equity.

Those buying a home to live in may not be the only ones spooked. Many investor-owners were counting on continuing capital gains to offset the net negative cash flows they were incurring. Add to that the various policy measures recently introduced to limit speculative buying, and it's clear the days of maxing out a HELOC to buy a condo are over.

And as buyers lose their appetite, sales-to-listing ratios will continue to fall. This is already happening in the Greater Toronto Area (GTA). In January of this year, the sales-to-listing ratio was 87.6%, making it the best month for sellers aside from January 2021. Just three months later, the ratio had plummeted to 45.2%. Further weakness in sales along with upward pressure on listings should send the GTA into a buyer's market for the first time since the 2008–2009 financial crisis (graph 1 on page 2).

Vancouver appears to be on the verge of a balanced market. And while conditions have still been very tight this spring in Quebec, Alberta, Manitoba and the Atlantic provinces, we expect to see some meaningful moderation there as well.

Rather than going away, the fear of missing out may actually take hold in sellers. With most provinces in a seller's market the last few years, bidding wars have become common in a broader set of Canadian cities. By contrast, during the last decade, bidding wars were most prevalent in Vancouver and Toronto, while homes would typically sell at or below asking in balanced markets elsewhere.

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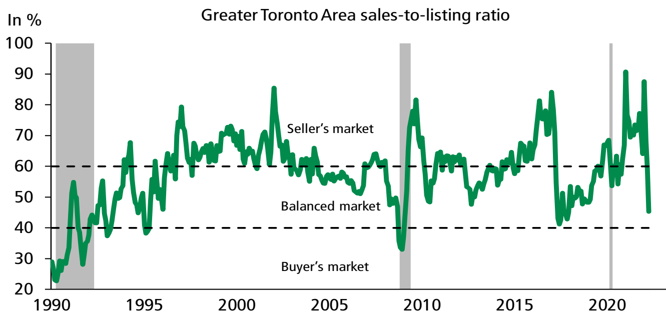
GRAPH 1
Toronto could soon tip into a buyer's market



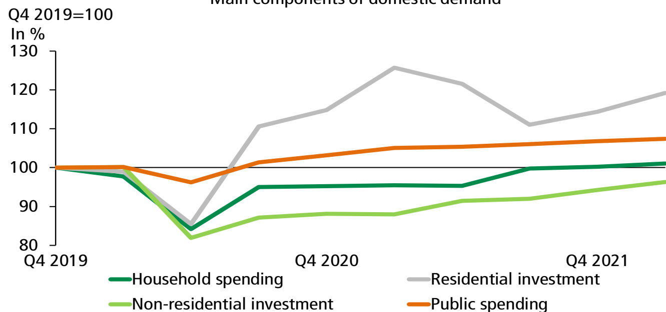
April 2022 data
Sources: Statistics Canada and Desjardins, Economic Studies

The transition away from a seller's market will fundamentally change sellers' psychology and promote sustained depreciation. Owners of single-family homes looking to downsize or move to cheaper areas may have opted to ride the wave a bit longer than they would have otherwise. Once it's clear the market has turned, we'll likely see a "last-call" effect, and some of these owners will list. This will tip local markets further into either balanced or buyer's market territory.

Bracing for the Biggest Housing Drag On GDP since the Financial Crisis

The nascent housing slowdown is a key reason we expect Canada's economic growth to weaken significantly in the second half of this year and into next. Residential investment accounts for about 10% of Canadian GDP. That figure has increased steadily over the years. It reflects high levels of homebuilding activity and real estate transactions, as well as spending on renovations. Since the pandemic began, loose monetary policy and remote work have so super-charged the housing market that it recovered almost immediately from the shock. Even today, residential investment is still the top-performing component of domestic demand (graph 2).

GRAPH 2
Unlike other components of private domestic demand, residential investment rebounded almost immediately

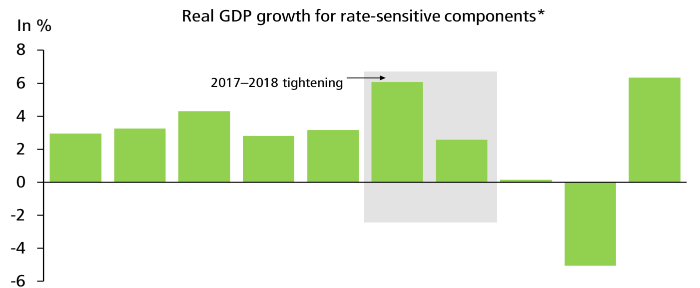


Sources: Statistics Canada and Desjardins, Economic Studies

During the pandemic, it was to Canada's advantage that the most rate-sensitive segment of the economy had a large GDP footprint. As the Bank of Canada brought the overnight rate to its lower bound and rolled out quantitative easing, the economy responded more swiftly than it would have otherwise.

But it cuts both ways. Now that inflation has veered out of control and the Bank of Canada has had to take aggressive action to get rates back to neutral, housing's prominence in Canada's economy will likely mean a significant slowdown. Even when the BoC normalized policy much more cautiously in 2017 and 2018, GDP categories most sensitive to rate hikes responded meaningfully (graph 3).

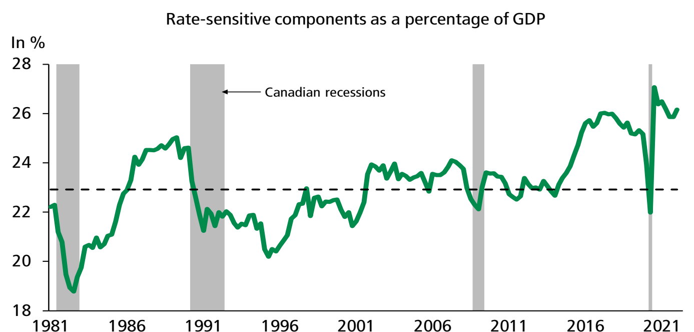
GRAPH 3
Rate-sensitive components of GDP reacted as expected during the last tightening cycle



*Includes transfer costs, new construction, renovations, dwelling repair, furniture and appliances, and purchases of vehicles
Sources: Refinitiv and Desjardins, Economic Studies

There's little reason to expect a more forgiving outcome now that rate-sensitive components play an even bigger role in GDP (graph 4). Take residential investment. It accounted for only 7.7% of nominal GDP at the start of the last rate normalization cycle. That figure is now 10%.

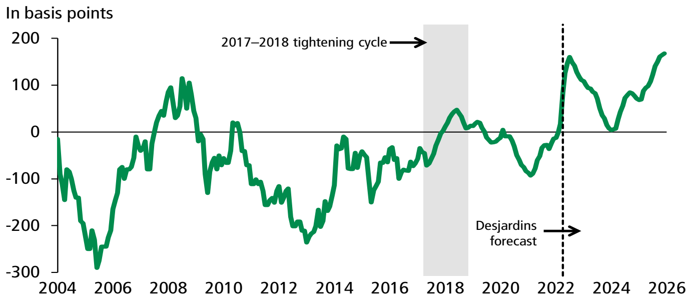
GRAPH 4
Rate-sensitive components now have a larger footprint



Sources: Statistics Canada and Desjardins, Economic Studies

Our mortgage forecast sees a bigger rate adjustment for borrowers renewing fixed mortgages than similarly situated borrowers in 2017 and 2018 (graph 5 on page 3). In addition, a

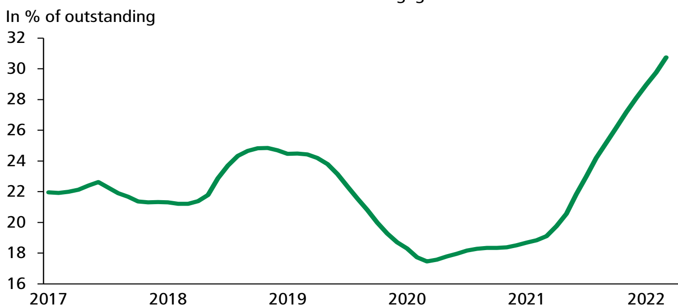
GRAPH 5
Mortgage rates will rise more at refinancing than they did in the last tightening cycle
Five-year rate change on mortgages with terms of 5 or more years



Sources: Bank of Canada and Desjardins, Economic Studies

historically high percentage of borrowers now have variable-rate mortgages (graph 6). The mortgage debt service ratio of Canadian households is already 0.3 percentage points higher than it was at the start of the last rate normalization cycle. As rates rise, we expect that ratio to hit new highs.

GRAPH 6
Over 30% of outstanding mortgages now have a variable rate

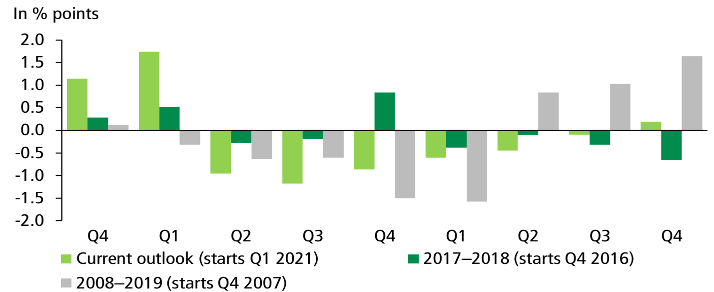


Sources: Statistics Canada and Desjardins, Economic Studies

As a result, we expect housing to be a bigger drag on GDP growth than it was in 2017–2018. Headwinds from residential investment could be the strongest they've been since the 2008–2009 financial crisis, although we don't think they'll reach that magnitude (graph 7).

However, this drag is needed to alleviate domestic inflationary pressures. After the BoC lifted its overnight rate to 1.75% in the second half of 2018, headline inflation fell all the way to 1.4% in January 2019. Other factors weakened Canadian growth at the time as well, such as growing global trade tensions and transportation bottlenecks in the domestic oil and gas sector. But housing was a big part of the story, and the BoC was concerned about mutually reinforcing declines in home prices, sales and construction. Because such declines could exacerbate disinflation, the BoC paused rate hikes earlier than planned.

GRAPH 7
The magnitude of the real estate slowdown should be somewhere between those of the previous two episodes
Residential investment – Contribution to real GDP growth



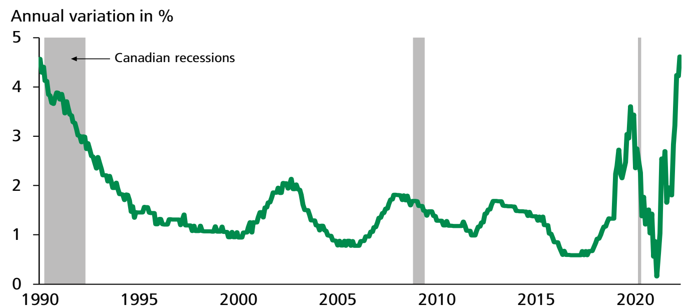
Sources: Statistics Canada and Desjardins, Economic Studies

By contrast, because of today's overheating, the BoC believes a moderate housing cooldown would be more consistent with its inflation objective. But there are still valid reasons to expect a more cautious rate hike tack once we're in the neutral range. The BoC has spent the better part of a decade warning that housing-related vulnerabilities were the biggest downside risks facing the Canadian economy. The BoC is rightfully focused on tackling excessive inflation at present. But given the central role housing plays in financial stability, it can't ignore these risks altogether. The Financial System Review released by the BoC in June was clear about the fact that rate hikes won't be entirely painless.

A Game of Affordability Whack-a-Mole?

Less demand for homeownership doesn't mean less demand for housing. Low affordability on the ownership side creates pressure on the rental side. The consumer price index for rent is growing at its fastest pace since 1990 (graph 8). And the index includes all rents, not just new leases. In April, some rental listing sites reported year-over-year increases of 9% for single-family rental homes, evidence of still acute supply-demand imbalances for certain types of housing units.

GRAPH 8
Rents are soaring as pressures build again in the rental space



Sources: Statistics Canada and Desjardins, Economic Studies

So if home prices cool down as expected, housing affordability won't necessarily improve across the board. Once homes become somewhat affordable, more renters will be looking to buy again, reducing upward pressure on rent. But for now, rental affordability is likely to get worse before it gets better. This adds to a long list of living expenses that have gone up lately and will continue eating away at the savings households accumulated during the pandemic.

A Few Reasons to Celebrate

Shelter is a basic human need, so framing housing depreciation as welcome news is always touchy. That's especially true when housing is the biggest financial asset individuals typically possess. However, excess in any market is undesirable.

The trends over the last two years were both unsustainable and unhealthy. Buyers competing against each other felt compelled to submit bids well above asking prices. Some even bought sight unseen. In some markets, home inspection contingencies disappeared from offers. This effectively increased prices for buyers by shifting the cost of repairing any home defects to them. And many first-time homebuyers turned to the Bank of Mom and Dad to afford swelling down payments, something previous generations didn't have to do to the same extent.

From this perspective, it will be good to see home prices return to levels more aligned with supply and demand, household formation, incomes, and job market conditions like commutes.

However, our base case scenario is for these fundamentals to remain healthy overall. We therefore expect that by the end of 2023, home values will still be nearly 30% higher than at the end of 2019. In addition, recent history has shown that the Canadian housing market tends to be resilient to various shocks. Increasingly strict mortgage standards in the 2010s caused housing markets to bend, but not break.

Moreover, our baseline forecast assumes that the BoC won't lift rates into restrictive territory and the economy will slow enough in 2023 for the BoC to loosen policy a bit. While we believe that housing will be facing the strongest headwinds since the 2008–2009 crisis, these supportive factors should make rebalancing manageable overall, with the housing market finding its footing again by the end of next year.

Only a Small Win for Affordability

Canada has one of the fastest growing populations of any developed country, and the federal government has said it wants to welcome 1.3 million newcomers by 2024. But with housing already in short supply, additional demand will put further stress on affordability. This will be the case especially in the rental segment, as newcomers typically rent for three years before purchasing their first home in Canada.

Canada is counting on immigration to provide the critical human capital it needs, so solving the housing supply problem is paramount. This means deploying more public and private capital into affordable, family-oriented, energy-efficient housing. This is true in major cities, but also in some smaller urban centres, some of which struggle more than larger cities to appeal to immigrants. Having high-quality, affordable housing would be a major selling point for these communities and help local employers attract workers.

Many policy initiatives have been put forward, but the question remains: will they move the needle and by how much? The federal government announced a Housing Accelerator Fund aimed at building 100,000 units over five years. But that amounts to just 20,000 units per year. It also announced funding for 6,000 affordable housing units over two years. And while the last federal budget mentioned 4,300 units for the vulnerable and 6,000 co-op units, funding for these programs was already included in prior initiatives. By some accounts, Canada will need to double its current pace of homebuilding over the next decade to meet housing needs. But by our estimate, the latest budget measures would close less than 20% of the annual gap, and only in the next few years.

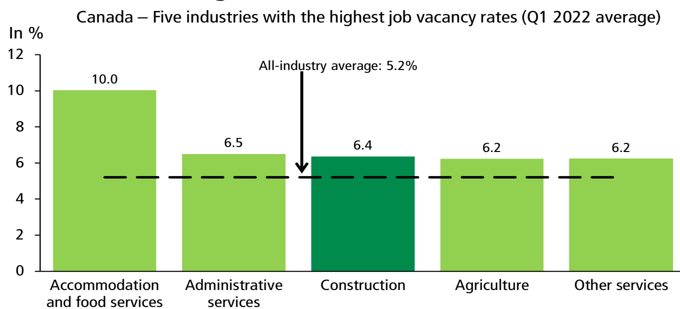
That means public and private sector initiatives would need to ramp up significantly to fundamentally improve affordability. Matching housing supply with current needs will be critical. In places like Ontario, measures could be taken to allow construction of buildings in the so-called "missing middle," which includes townhouses and small apartment buildings. In Quebec, the government will need to provide adequate funding to meet previously established social housing targets. It could also enhance tax incentives to make it economically viable for the private sector and housing co-ops to undertake affordable rental housing projects.

Efforts should also be made everywhere to fast-track the conversion of underutilized commercial space to residential and mixed-use housing, encourage construction of secondary suites and multi-tenant housing, raise density limits around public transit stations and in neighbourhoods where schools are over capacity, and institute more permissive land use planning and approval processes.

When the market was red hot, there was an urgent need to build new housing. But residential investment is highly cyclical and sensitive to interest rates. The longer lag between housing starts and completions since the beginning of the pandemic should help mitigate supply challenges in the near term as the pipeline of projects to be delivered remains well stocked. However, governments should still redouble their efforts to ensure homebuilders remain engaged, even as the sales outlook turns less favourable over the next few quarters.

Specifically, policies to tackle labour shortages in the construction industry could pay off. At the start of the year, the construction industry had the third highest job vacancy rate in Canada (graph 9). And construction workers will be in high demand globally in the coming years. They'll be needed on capital projects aimed at decarbonizing the economy, enhancing supply chain resilience and building critical public infrastructure.

GRAPH 9
The construction industry is among the sectors seeing the most acute labour shortages



Sources: Statistics Canada and Desjardins, Economic Studies

As a result, homebuilders will be competing with many other industries to hire construction workers. Rising labour and material costs are already a profitability headwind for homebuilders. Absent some improvement in labour availability, increasing the housing supply will remain a challenge.

Conclusion

Canadian housing is coming out of two years of torrid activity. Some might even say it's a bubble market. As the market cools, we can expect to see more rational expectations, less erosion of affordability, and yes, slower growth—all healthy side effects. Absent a recession, rebalancing should be manageable from a macro or financial system perspective. But that doesn't fix the supply issues. Lack of supply will be one of Canada's major economic challenges for years to come, and we'll continue to need a multi-pronged approach to address it.