Housing Market Digest

Canada, January 2023

That Time When I Was Right About Something

Recent events have reminded me of a report that I wrote in 2014 - *"How to Dissect a Housing Bubble"*. It's the second last item on this page: https://www.wdunning.com/recent-reports. It got a lot of attention: at the time there was a lot of commentary that Canadian housing was in a bubble and a price collapse was inevitable. What got attention was my conclusion that, to the contrary, at that time there was room for prices to be 20-25% higher. But, more important than the conclusion was the argument I used to get there. The bubble arguments that people were making were often about ratios – the ratios of prices to rents or incomes, or inflation-adjusted ("real") prices. My argument was that what matters isn't those ratios, but the cost of housing as ownership versus renting. On that basis, prices had not fully incorporated the interest rates that existed, and therefore there was room for further price growth.

For some reason, people keep repeating the mistake of looking at the price ratios, and not the monthly costs. There was another wave of that during December and January.

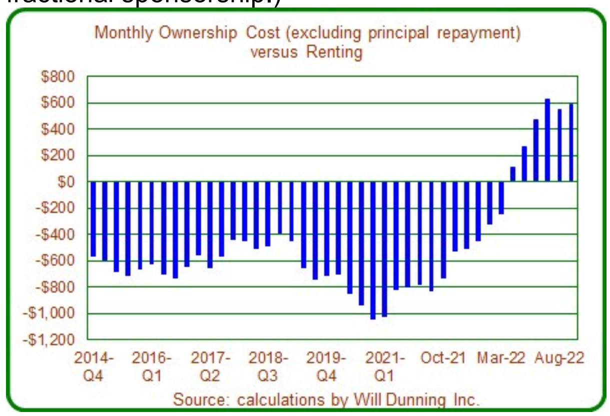
I have occasionally updated the calculations (including the fourth item on the Recent Reports page). That analysis tells me that most of the time, home prices in Canada have been below the levels consistent with interest rates (this amply explains why there is so much interest in home ownership). Despite all of the bubble commentary, Canadian housing markets have not satisfied a definition of a bubble, because pricing has been explicable, based on an economic fundamental.

Another way to put this: a long downtrend for interest rates created space in which house prices could rise and still be affordable. But, it was not inevitable that the affordability space must be filled. The space was filled because we haven't produced enough housing to meet the needs of our growing population.

As I have recently commented, that favourable affordability situation has been disrupted since mid-2021, and we did experience a short-lived bubble. Prices are now more-or-less back to where they were at mid-2021 (the bubble has been reversed). Current pricing is consistent with the interest rates we had at that time, but do not (yet) reflect the interest rates we have now. I wouldn't call where we are today a bubble – I call it an enormous mistake by the Bank of Canada.

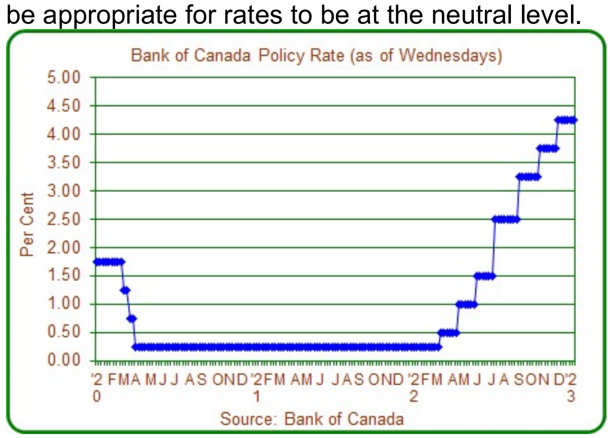
Being an economist means being wrong a lot of the time. On the bubble issue, I have been correct. I find it quite frustrating and disappointing that people, organizations, and media channels who have large audiences keep rediscovering the bad arguments.

Here is the most recent version of the key graphic. It uses data up to September. I might do an update in March. Is anyone interested in sponsoring that research? (I will consider fractional sponsorship.)



Interest Rates

Last month, I commented that it takes time for changes in interest rates to have economic effects. At this time, economic conditions reflect the below-neutral interest rates that existed during the first half of 2022. It was only during the fall that Canadian interest rates passed the neutral level estimated by the Bank of Canada (2.5% for its "policy rate", the Overnight Rate). Current rates will weigh increasingly on the economy as this year progresses. I fear that during the second half, the economy will be in dire shape. Given the economic conditions that exist in Canada, it would be appropriate for rates to be at the neutral level.



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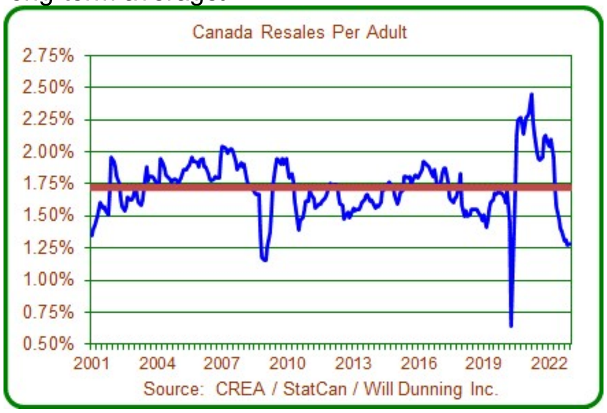
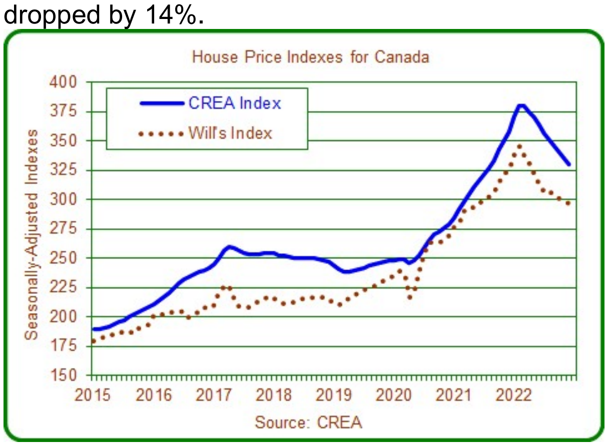
Resale Market

The sales rate increased by a tiny amount in December, to an annualized rate of 411,100. On a population-adjusted basis, this is 25% below the long-term average.



The various indexes that are available indicate that prices continue to erode gradually. Compared to the peak last February, CREA's price index is down by 13% and my alternative index has dropped by 14%.



As I commented earlier, the economy is not yet showing the effects of higher interest rates. There is a lot of downside risk for sales and pricing. It isn't guaranteed that there will be further reductions, but of they do occur, the "negative wealth effect" could start a dangerous feedback loop with the broader economy.

Employment

Statistics Canada reported a very large rise in employment for December (104,000 versus November, a rise of 0.5% in just one month). This superficially supports a narrative that the Canadian economy is too strong and might encourage the Bank of Canada to further raise interest rates. I'm looking at this new datapoint cautiously. I see two issues.

1. As I have commented many times, the data is from a sample survey and therefore can be inaccurate (due to changes in the sample, rather than to real changes). When there is a large change for employment, I look to see if there is a corresponding move for the labour force, and there was this time – it rose by 91,200. Statistics Canada does internal analysis of the effects of "sample rotation", but they don't publicize the findings. They really should be more open about this.
2. People are counted as employed if they have a job but aren't actually working (due to illness, vacation, or other reasons). StatsCan says that during December, "8.1% of employees were absent due to illness or disability, up from 6.8% in November. This was higher than the pre-pandemic average of 6.9% recorded in the month of December from 2017 to 2019 (not seasonally adjusted)". Because absences from work remain elevated during this continuing Covid period, I think that hours worked (per adult) might now be the best available measure of the employment situation. By this measure, actual employment is about 1% lower than in 2019.

How to Reach Will Dunning Inc.

Email: wdunning@sympatico.ca
Web site: www.wdunning.com
Twitter: @LooseCannonEcon

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