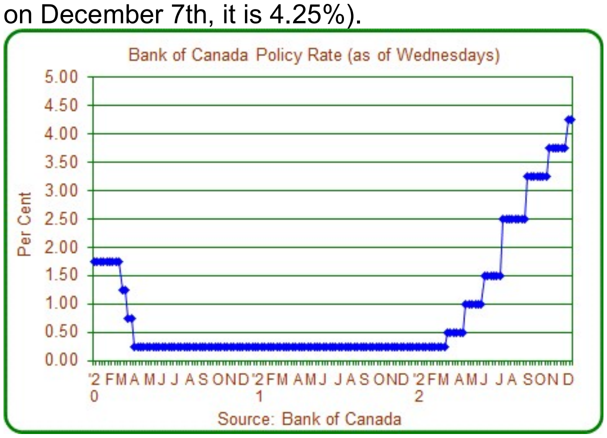
Housing Market Digest

Canada, December 2022

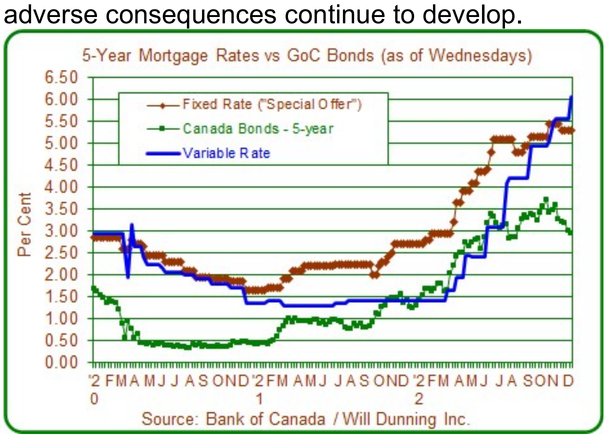
Interest Rates and the Economy

It takes time for changes in interest rates to have economic effects. During the past 4 decades I have seen various commentary (from the Bank of Canada, and before that, the Economic Council of Canada) that it takes a half year for the effects to begin. My forecasting models (for whatever they're worth) suggest that the effects occur mostly in the second year.

The Bank of Canada says the neutral policy rate is in the range of 2-3%. A half year ago, the "policy rate" (the "target for the overnight rate"), had only recently passed the neutral levels. But, in the second half of the year, multiple increases moved it to far above the neutral level - with the increase on December 7th, it is 4.25%).



In the housing market, I calculate that the neutral mortgage interest rate is in the area of 2.6%. Current rates are very far above that, and the adverse consequences continue to develop.



At this time, economic conditions reflect the below-neutral interest rates that existed during the first half of this year. During the first half of next year, the consequences of above-neutral rates will begin to gradually unfold. I fear that during the second half of 2023, the economy will be in dire shape.

The Bank of Canada says that future policy decisions will be data-determined. Does this mean that they are driving by looking in the rear-view mirror? The greatest risk to our economy is that the BoC will be too late to change direction.

With the December 7th rate announcement, the BoC signalled that it may be close to the end of raising rates. But, Canada is now much more interest-rate-sensitive than the US, because of our much higher debt levels and the fact that the term-structure of our debt is much shorter (in the US, mortgages are long-term – 25 or 30 years, at fixed rates. Our mortgages are short- and medium-term, or variable rates). Interest rate resets will have a much larger effect in Canada than in the US. It has been a mistake for the BoC to essentially match rises seen in the US, as this will cause our economy to be much worse than the US.

So, the question at this time shouldn't be "will there be further rate increases in Canada?" Instead, it should be "will the BoC reduce rates in time, and by a large enough amount, to avert an economic catastrophe?"

Something else to watch: current events in China may cause more disruptions to supply, and this might result in further inflationary pressures. Will the Bank of Canada view that as requiring further rises in interest rates? Or, will they admit that the 1980s model of reducing inflation by crushing the economy will not work in this environment?

The most important way to end this global inflation is to end the global health emergency. Since that is probably beyond the capabilities of the central banks, the second-best course of action is to be patient. They did that for a while. Unfortunately, when it became clear at mid-2021 that a small increase (say, 0.75, and maybe another 0.50 six months later) was needed, they demurred. They waited too long, and since then have over-compensated, and been drastically impatient.

This is "Chekhov's Monetary Policy": if you give central bankers the ability to influence interest rates, eventually they will all agree that they should shoot the economy.

As can be seen in the chart to the left, bond yields have retreated during the past month, but rates for 5-year fixed rate mortgages have not yet followed. The spread (mortgage rates versus bond yields has gotten to be unusually large (currently 2.35, but it should be more like 1.5-1.75 points).

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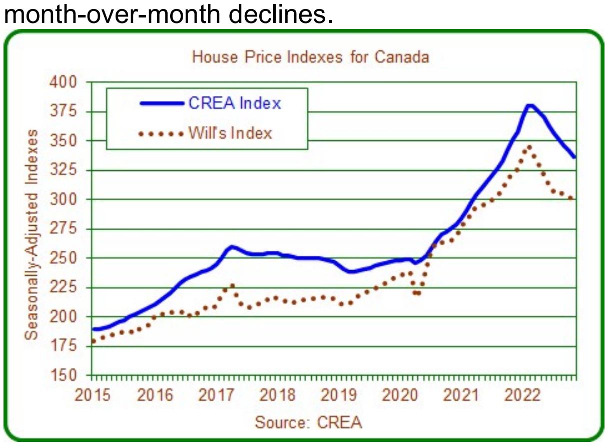
Mortgage rates should fall, but "should" does not always equal "will". Even if rates fall by 0.50-0.75 point in the coming weeks, they will still be exceptionally high, and I expect that sales would remain very weak.

Resale Market

The sales rate fell a bit more in November, to a rate of 406,600. On a population-adjusted basis, this is 26% below the long-term average. November figures are about 50% below average in BC and Ontario, but less-bad elsewhere.

The various price indexes that are available indicate that prices are lower than a year ago (for example by 4% for CREA's index and 7% for my alternative index). The details in the most-recent data differ slightly, as CREA is showing larger month-over-month declines.



I argue that until mid-2021, prices were consistent with the interest rates that we had, but then there was excessive, unjustifiable growth (if you are looking for a housing bubble, I can see one that started in the fall of 2021). Prices have now reversed that excess growth.

Pricing we have now is consistent with the interest rates we had a year ago: it does not reflect the interest rates we have now. I see a lot of downside risk. I can calculate that to be consistent with current interest rates, prices would need to fall by 40-50%. I'm not predicting that will happen, because if it does it would be economically devastating. I'm saying, yet again, that the Bank of Canada needs to reverse direction really soon.

Employment

Last month (in the Toronto edition of this report), I commented that I currently think the most useful economic statistic is average hours worked per adult. That data is currently more-or-less flat, but at a level that is slightly lower than before Covid. I take three things away from this data:

1. The percent of people who are counted as employed has recently been very high, but the actual amount of paid work is not unusual (and has been reduced slightly - this is in part due to impacts of Covid).
2. Inflation is not being caused by an excess of employment, and the Bank of Canada does not need to cause job losses (they are clearly saying that they think employment is too high).
3. And, to repeat myself, we are not yet seeing the effects of interest rates - I expect a considerable weakening during 2023.

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