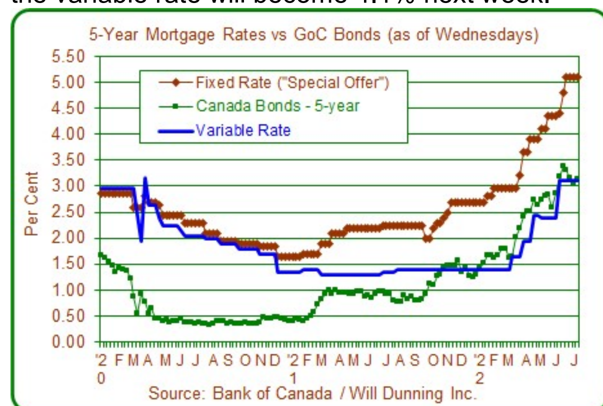
Housing Market Digest

Greater Toronto Area, July 2022

Interest Rates

In the June edition for Canada, I updated my research on the comparative costs of owning versus renting. Using that data, I calculate that the "neutral" mortgage interest rate (as of May) is 2.6%. The current typical 5-year fixed-rate (exceeding 5%) is far above that. Typical variable rates had been below the neutral level until the June increase for the Bank of Canada's Overnight Rate. With the further rise on July 13, in this chart the variable rate will become 4.1% next week.



With these sharp rises for fixed and variable rates, the rise in mortgage costs is depressive enough to cause a substantial housing-led recession. I expect that evidence of the recession will begin to materialize late this year. Housing market data shows that this process has started.

I believe that it would be healthy to reverse the excessive price growth that occurred after mid-2021 (meaning a further drop of about 5% from the June levels). Price drops that are deeper than that could result in a "negative wealth effect" that sharply hurts consumer confidence, causing a severe recession. Also, housing starts would plunge, ultimately worsening the supply shortages.

In an additional analysis of my database on ownership costs and rents, I calculate that if interest rates were to remain at the level seen in May (4.23% for 5-year fixed rates), Canadian home prices would need to fall by 38% (from the May level) to restore the average owning-versus-renting cost comparison. If that happened, it would bring prices back to about the same level as at the start of 2016. That might not seem so bad, but it would mean that more than 4 million Canadian home owners (at least 40% of all home owners) would have home values less than they paid. This would result in a large hit to consumer confidence and the economy.

Current interest rates are even higher than in May, implying even larger consequences for housing prices. At a 5% rate, prices would need to fall by 48% from the May level to restore a normal relationship between rents and ownership costs.

I'm not predicting that prices will fall by those amounts. My expectation is that next spring we will see some combination of: home prices will fall somewhat from current levels and mortgage interest rates will retreat somewhat. In consequence, ownership affordability will be less bad than it is today, but it will still be substantially worse than previously. The economy will be weaker. With this combination, housing activity (resales, pre-construction new home sales, and housing starts) will be sub-par by considerable amounts. Reduced new homes activity will further worsen our long-term supply issues.

If you didn't see the June edition of this report, I suggest that you look at it, for the discussion of "The Boom", which ended in 1990 and caused a strong downward interaction between falling house prices and a severe, long-lasting recession.

Employment

Statistics Canada reports that employment fell by an estimated 43,000 in June (for all of Canada). It's too soon for interest rates to cause that, and this looks to me like one of the occasional "artifacts" that can result from "sample rotation". The fingerprint in this data is that the labour force fell by a large amount (almost 100,000, which is unlikely to be real). Alternatively, it might be that a very large number of people decided to retire during the month.

I expect that the housing-led recession will start to show in the employment data late this year. But, the data that is most-watched by the Bank of Canada will arrive later, and so it might take longer for them to change direction. If my expectations are realistic, by that time there will be a lot of downward momentum in the economy.

Resale Market

Sales continue to slow. For June, the annualized sales rate in the GTA was 70,900.

I expect that a lot of recent sales were dependent on pre-approved, guaranteed rates from a few months ago. A pre-approval from late April might have a 5-year fixed rate in the area of 3.25-3.5%.

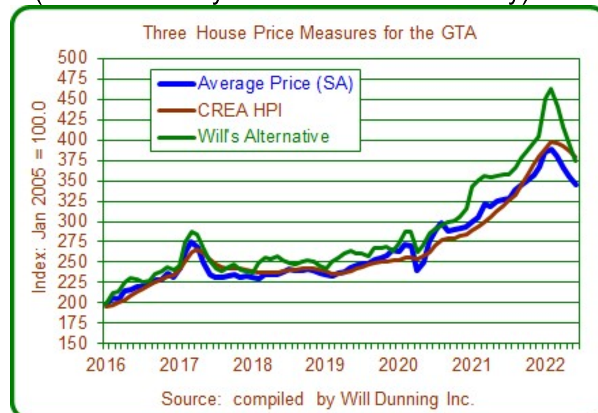
Those will expire in the coming weeks, and then the May pre-approvals at 4-4.5% will expire during August. In consequence, I expect that there will be a further slowing of sales during July and August, and then during September/October we'll find out what the market can be at a 5% interest rate.

On a population-adjusted basis June sales were 34% below the long-term average. For all of Canada, June sales were not as soft, at 12% below the population-adjusted average.

The sales-to-new listings ratio is also trending downwards. For June, it was 44%, versus the 52% threshold for a balanced market.

Prices are clearly falling, but there is uncertainty about the speed. The next chart shows three measures of prices.

- As I've commented previously, indexes like CREA's House Price Index are slow to respond at turning points. It shows prices down by 2.0% in June versus May, and by 4.8% since the peak in February.
- The average price shows a larger drop than the HPI (3.0% versus May and 11% since February). However, the monthly figures are affected by changes in composition (notably, changing shares for singles and apartments) and at this moment, the average might be understating changes.
- My alternative price index shows a larger drop (5% versus May and 19% since February).



Other News

In the Canada edition (for July) I have some thoughts about a recent CMHC report. CMHC concluded that by 2030 Canada needs 3.5 million more dwellings, in addition to the production that we would normally expect (2.3 million). In 2030 there would be more than 22 million dwellings (versus 16.3 million in 2021). I conclude that this would be 10-15% more dwellings than we really need. The result would be to transition from a situation of damaging shortages, to damaging surpluses that would have consequences for the economy and financial system.

Something else - here is a link to a paper that I found really helpful: a great summary of the current state of Covid, as well as long Covid, and what this all means for public health strategies. It's a bit long, but I think it's worth the effort. https://thetyee.ca/Analysis/2022/07/04/Get-Ready-Forever-Plague/?utm_source=twitter&utm_medium=social&utm_content=070422-3&utm_campaign=editorial

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