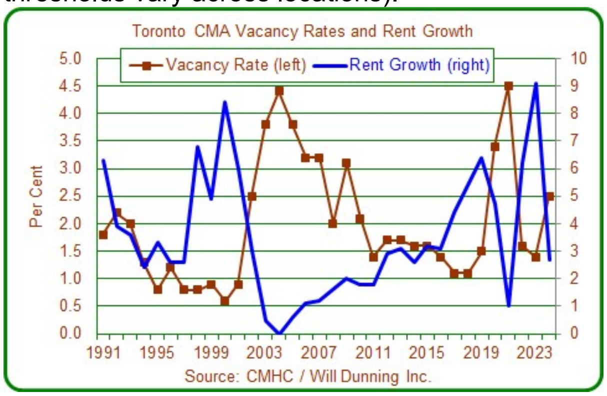
Rental Housing Market Digest

Toronto CMA, 2024

Surprising Results

CMHC released the results from its annual survey on December 17th (the data is for October) I was surprised, that the vacancy rate rose quite sharply, to 2.5% from 1.4% a year earlier. Also, rent growth slowed quite sharply, to 2.7% (on a constant sample basis). The 2024 vacancy rate is at about the balanced market level (my estimates of the thresholds vary across locations).



CMHC estimates that the turnover rate was extremely low at just 6.4% and that on turnover the average rent increase was 40.7% (I'm skeptical, but I don't have any alternative data).

The large amount of change seen in the rental market confirms once again that once-per-year data is inadequate and CMHC should do this survey quarterly.

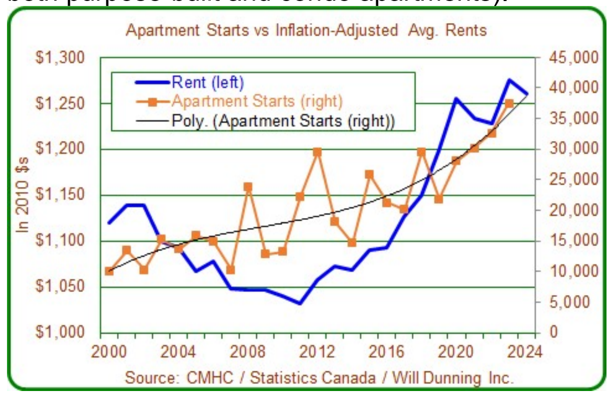
CMHC's reporting can be found on this page: https://www.cmhc-schl.gc.ca/professionals/housing-markets-data-and-research/market-reports/rental-market-reports-major-centres

I understand the 2024 results in several ways.

Rents are Unsustainably High

In developing my forecasting system, I have found repeatedly, and in multiple locations, that the two most important drivers of new rental supply are interest rates and rents (in inflation-adjusted dollars). The vacancy rate doesn't seem to matter, at least directly. (But, low vacancy rates result in rent growth, indirectly affecting construction.)

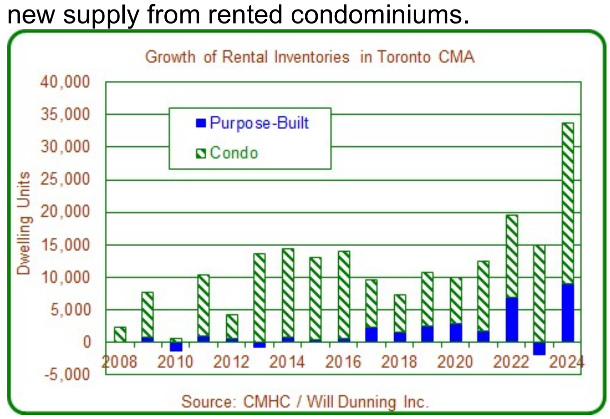
In this chart, I used the CMHC data to calculate average rents for apartments that were added to the purpose-built rental inventory prior to 2000, and converted to inflation-adjusted dollars. This chart shows that growth in inflation-adjusted rents has influenced apartment starts (the data includes both purpose-built and condo apartments).



Years ago, I concluded that since about 1990, the natural source of new rental housing in Canada has been investment by individuals (with a smaller contribution from privately-owned companies). Individuals can decide to invest at lower rents than can large organizations (like publicly-traded companies and investment funds) because individuals can and will give more consideration to growth in the values of the properties, and they can look at the cost of finance as the interest part of mortgage payments, not the total payment.

A corollary to this is that if there is a significant amount of construction of "purpose-built rentals" it means that rents are higher than they need to be.

The 2024 survey results are consistent with my theory: in addition to the large amount of purpose-built supply that became available during the 2024 survey year, there was an even larger amount of new supply from rented condominiums.



Growth in the total rental inventory during the year, at the rents that were expected by the suppliers, exceeded what the market could absorb.

My Model for Vacancies Has Been Disrupted

Modeling over many years have convinced me that the two factors that matter for vacancies are growth of employment (which determines how many people can be active in the market) versus total completions of housing. Completions of rentals didn't seem to matter, what matters is total supply. For 2024, the supply of rented condos and purpose-built rentals mattered, because the new supply wasn't affordable by enough people.

The Hog Cycle

I learned about this in my first economics class:

- When prices are low, new supply is reduced.
- That results in future shortages, which,
- Results in price increases, which
- Increases supply, which
- Reduces prices,
- Etc.

This model (which is sometimes called the corn cycle) is useful in understanding what's happening in the Toronto rental market.

In agriculture, each under-supply and over-supply phase lasts one year. In the rental market, the phases are much longer, because of the long production cycles. In the Toronto CMA this over-supply phase will take some time (probably another two or three years) to complete: there is currently a very large supply under construction, which will result in very high volumes of new completions (similar to the volume for 2024), and the investors had very high expectations about achievable rents.

What is especially surprising at present is that the volume of new starts of apartments hasn't fallen by very much, despite the very sharp increase in interest rates and the very sharp drop in pre-construction sales of new condominiums. There are at least two reasons for this:

- Starts that result from commitments that were made when interest rates were much lower.
- Inflation-adjusted rents are still very high, resulting in optimistic expectations about financial viability.

During the coming two to three years, the accretion of additional excess rental supply will result in a market adjustment, including further growth of vacancies and lower rental achievement. Financial outcomes for the investors will become increasingly disappointing (unless there is a very large further reduction in interest rates, which I can't expect).

Impacts on Tenants (and Landlords)

Disclosure: I own some shares in two REITs that have residential rental properties.

Given current rent levels, it is now extremely difficult for tenants to move, especially for anyone who moved-in three or more years ago (to give up their much-lower controlled rents). On the other hand, for tenants who moved in more recently or are in non-controlled buildings, there will be increasing incentive to move out (or for their landlords to reduce their rents).

The owners of older buildings will continue to be able to take advantage of tenant departures to raise market rents (but the volumes of those departures will remain quite low).

Finally, an argument that some of you will despise: I believe that the new building exemption from rent controls must be abolished. In addition to providing a reasonable amount of consumer protection against exploitative behaviour, it might actually help the property owners attract and retain tenants.

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