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Canada Housing Market: Slower Price Growth

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INTRODUCTION

The COVID-19 pandemic drove massive activity in the Canadian housing market. The drop in interest rates, combined with historic fiscal support, encouraged many Canadians to upgrade their lodgings. As a result, almost all indicators of housing market activity shot through the roof. The increase in borrowing, spending and investment linked to housing helped stave off worse macroeconomic outcomes during the depths of the ensuing recession.

The housing market is now showing signs of returning to earth. House price appreciation notched its slowest pace in seven months in September. Building permits and housing starts appear to have peaked in March, with the last five months of data showing a noticeable slowdown. Further, prices for raw materials are responding to normalizing demand. The second-quarter GDP report showed a sharp drop-off in commissions and fees related to sales activity. This is consistent with Canadian Real Estate Association data showing a 15% year-over-year contraction in overall transactions.

The rapid elevation of prices has put the cost of a home out of reach for many potential buyers. With the Bank of Canada now tapering its asset purchases, interest rates are poised to rise. We expect that the bank's quantitative easing program will end in early 2022. The bank will begin hiking its target for the policy rate at the start of 2023. Because of the gradual evolution of the policy environment, we expect that households will be able to adjust to the increase in debt-service obligations. However, given that Canadians' high debt loads make them relatively more sensitive to changes in interest rates, house price appreciation is likely to reach a near standstill in late 2022. The baseline forecast projects that house price appreciation will slow considerably through 2022 and into 2023.

Canada Housing Market: Slower Price Growth

BY ABHILASHA SINGH

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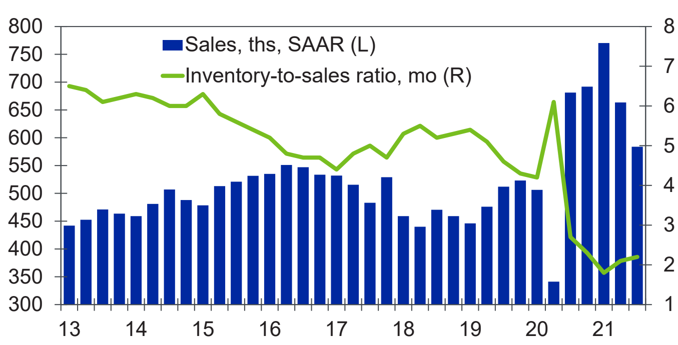
Recent Performance

Across the board, real estate market data appear to show that the Canadian housing market has hit a ceiling. According to the CREA, existing-home sales fell for the fifth straight month in August. At 587,000 annualized units, sales are down 27.5% from the peak reached in March, but overall, the level of activity remains elevated compared with historical averages. The housing markets remain ultra-tight with about two months of supply, as new listings have fallen along with sales (see Chart 1).

Chart 1: Resale Market Loses Traction



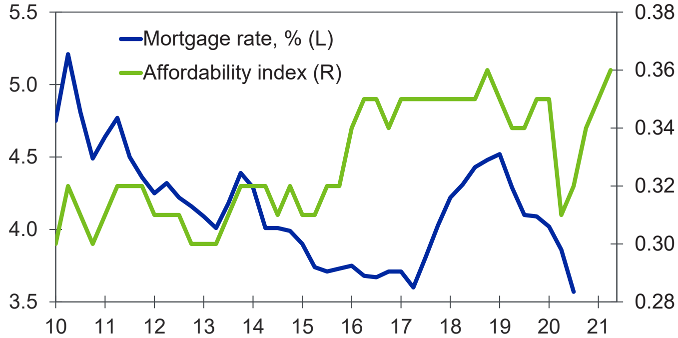
Sources: CREA, Moody's Analytics

Tight conditions remain across most of the country, but some variability is starting to show up again. Sales in Ottawa, Toronto and Montreal have fallen significantly over the past few months amid low inventories and are now closer to pre-COVID-19 levels. While tight supply is a growing constraint in Vancouver, sales remain slightly above their year-ago levels and well above pre-pandemic levels. Sales in Calgary and Edmonton have slowed from the record-setting pace seen earlier this year but are up year over year.

The runup in house prices has decreased affordability despite still-low rates and an enormous trove of consumer savings (see Chart 2). Now, house price appreciation is slowing. The RPS 13 metro-area composite index climbed 0.3% in August—the smallest appreciation since late 2019. Monthly gains have eased, but the tight market conditions still support upward momentum. Though house prices are still appreciating by more than 10% on a year-ago basis, the pace of appreciation seems to have peaked in May.

The slowdown is even more evident when examining house price dynamics in the six months between March and September, as shown in Charts 3 and 4. In March, most metro areas had current annualized house price growth that equaled or exceeded year-over-year growth. By September, only Regina fit that category, while year-over-year house

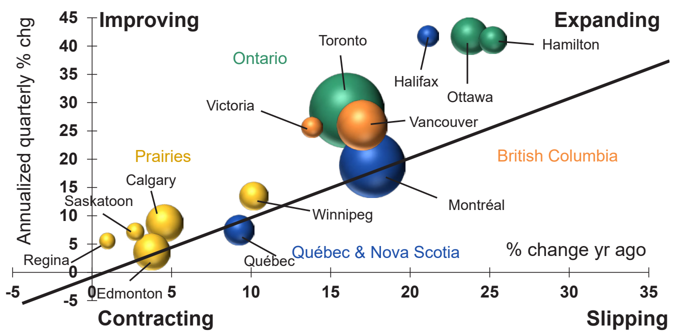
Chart 2: Low Rates yet Affordability Down



Sources: CMHC, Bank of Canada, Moody's Analytics

Chart 3: Good HPI Growth Early in Year…

Composite index, 1-yr vs. 1-qtr performance, 3-mo MA, Feb 2021

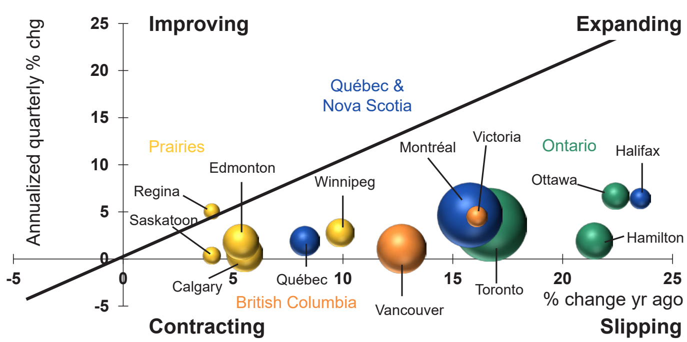


Sources: RPS, Moody's Analytics

Note: Bubble size indicates # of households

Chart 4:…But Has Started to Slow

Composite index, 1-yr vs. 1-qtr performance, 3-mo MA, Aug 2021



Sources: RPS, Moody's Analytics

Note: Bubble size indicates # of households

price growth has been weaker in Vancouver, Montréal and Hamilton. The Prairies metro areas, which still had flat or falling prices in early 2020, have now recorded nearly a year of modest house price growth thanks to low interest rates.

The effects of housing's slowdown are already evident in economic growth. The surge in spending on housing masked anemic weakness in other categories of investment spending during the downturn. In the second quarter, total fixed investment weakened drastically, helping contribute to the poor GDP reading. Investment in residential structures was to blame, falling 12.4%. Ownership transfer costs—the fees associated with buying a home—plummeted 54%, and this is consistent with falling sales activity.

Further evidence of a cooling in Canada's still-strong housing market, housing starts fell for the fourth straight month in September. Since hitting an annualized pace of 284,587 in May, monthly starts have fallen by a cumulative 11.7%. Permitting data, which lead starts, signal further cooling in the next few months, but overall, the pace of building in Canada remains elevated compared with historical averages thanks to low interest rates.

Over the past year, the total value of permits increased 9.7%, with a 24.9% gain on the single-family side and a 1.9% decrease on the multifamily side. Though the pace of new building intentions has slowed noticeably, it remains elevated. Residential permitting contracted 8.3% from the prior month in July, but the performances across property types diverged sharply. The pace of new multifamily construction is now close to its pre-COVID-19 rate. In contrast, the rate of new single-family projects, which had been the primary driver of the previous boom, has slowed but remains elevated.

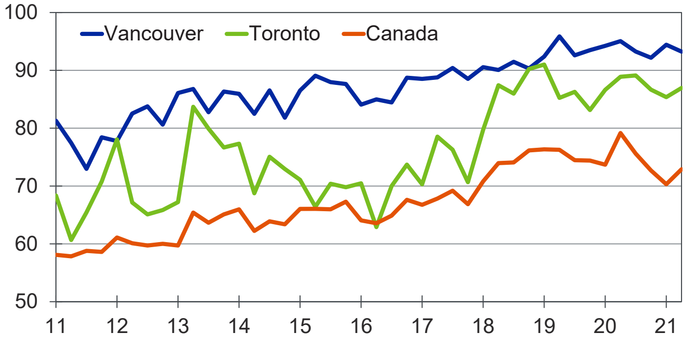
Ontario accounted for more than half of the national decline, with total residential permitting in the province falling 27% since March. Next in line was Québec, accounting for almost one-fifth of the national decline, with permitting in the province falling 22% from its peak. Atlantic provinces recorded the largest percentage decline in permitting with a cumulative drop of 26%.

Further, prices for raw materials are responding to normalizing demand. Softwood lumber prices—which have been on a tear because of high demand from construction—dropped 23% in July alone.

> *"While the pace of home value growth has slowed, the RPS National House Price Index shows ongoing strength in the vast majority of markets across the country. In the past, we have seen individual cities or even regions dominating our national statistics; what we have seen recently is a fully national housing market expansion in both value and number of sales," said Joel Bates, president of RPS.*

Chart 5: Housing Imbalance

Share of multifamily permits, %



Sources: CMHC, Moody's Analytics

Chart 6: Help Is on the Way

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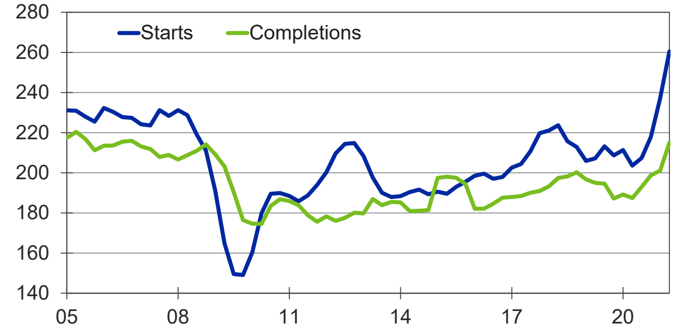


Sources: CMHC, Moody's Analytics

Help on the way

Over the last decade, the nation's share of single detached housing units steadily declined while multifamily units were on the rise. The growing popularity of multifamily units has been even more prevalent in urban centers given strong population growth and limited space. The share of residential permits issued in Vancouver and Toronto has been overwhelmingly weighted toward multifamily units, with them making up more than 90% of permits issued. This sheds light on why single-family housing inventory had been so low (see Chart 5).

In 2020, the pandemic put a premium on space. High-income households were able to make the most of ultra-low mortgage rates stemming from an unprecedented era of expansionary fiscal and monetary policy. Demand for single-family units surged, outstripping supply, and put strong upward pressure on prices.

The rise in prices during the pandemic has caused housing to become less affordable across most markets even with low mortgage interest rates and an enormous trove of consumer savings. Ultra-low interest rates provide some relief in the near term, but a rate increase will put monthly mortgage payments out of the range of many aspiring first-time homebuyers.

Additional supply in the form of new construction should provide more long-lasting relief. With prices at record highs and elevated buyer demand, there is no shortage of builders' willingness to construct new homes.

Housing starts have been elevated throughout the pandemic at unseen levels (see Chart 6). As a result, completions are rising, but all that construction activity has yet to significantly boost supply. The lag in completions reflects the various pandemic-related disruptions as well as the time taken to complete a unit, depending on the property type. Completions will rise through next year as builders complete units started before and during the pandemic.

The baseline forecast

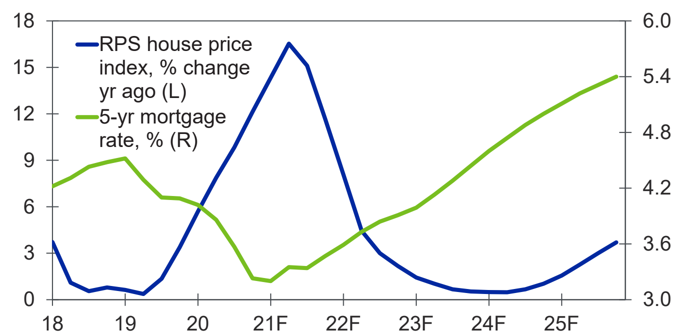
The demand side of the market is becoming exhausted. The COVID-19 crisis pushed many Canadians into new homes, with low interest rates and a wash of fiscal support encouraging high demand. Beyond the rock-bottom borrowing costs, pandemic-induced shifts in preferences sent potential buyers flocking in search of larger homes. However, with the advent of widespread vaccination and the normalization of public health conditions, this dynamic appears to be nearly played out.

Now, house price appreciation is slowing. Year-ago increases in new-house prices reached their peak in May. With the central bank now tapering its asset purchases, interest rates are poised to rise. We expect that the bank's quantitative easing program will end in early 2022, but policymakers will then allow assets to mature off the balance sheet rather than engage in a full pivot of selling off securities. The program's conclusion will mark the first inflection point for interest rates.

Next, the bank will begin hiking its target for the policy rate at the start of 2023. Since the May forecast, we have moved forward the timing of this rate hike slightly, bringing it ahead one quarter. Because of the gradual evolution of the policy environment, we expect that households will be able to adjust to the increase in debt-service obligations. However, given that Canadians' high debt loads make them relatively more sensitive to changes in interest rates, house price appreciation is likely to reach a near standstill in late 2022 but avoid any significant contractions (see Chart 7). The baseline forecast projects that house price appreciation will slow considerably through 2022 and into 2023.

However, Canada's high population growth relative to other industrialized nations supports an upbeat long-run outlook. A more robust pace of price appreciation should re-

Chart 7: Mortgage Rates Will Drag Prices



Sources: Bank of Canada, RPS, Moody's Analytics turn in late 2023 as heightened immigration and a nearly healed labour market re-energize wage and salary growth. The revival of in-office work, indoor dining, and large social gatherings will bring back demand to the urban core.

The regional forecast

The macroeconomic forecast implies a deceleration of national house price growth as higher mortgage rates kick in. Some of the undervalued housing markets, especially in Alberta and Saskatchewan, will do better despite weaker economic fundamentals precisely because they have retained better affordability, while Montréal will see a house price correction for at least the next year.

Table 1 presents the dynamics of the short-term forecast for single-family home markets. The first column shows the rate of over- or undervaluation for all metro areas. In geographies with highly overvalued housing, house price growth would normally start to slow because of a combination of reduced affordability, excess construction, and a possible decline in mortgage debt performance leading to distress sales. Highly undervalued metro areas are likely to see a wave of opportunistic purchases, either to flip dwellings or to make them available on the rental market, with resulting appreciation as such purchases start to act on a limited supply of homes.

Toronto and most of the metro areas in the surrounding Golden Horseshoe region suffer from overvaluation. However, their house prices have also shown less sensitivity to overvaluation in the historical data since 2005, so they will likely experience less downward price pressure.

British Columbia housing markets are overvalued, not just for Vancouver but for the other three metro areas as well. Given their overvaluation, the British Columbia metro areas will continue to have downward pull on their house prices due to reduced affordability.

By contrast, overvaluation is not a problem in the Prairie regions. In fact, the Calgary, Edmonton and Saskatoon metro areas are all seriously undervalued despite recent price increases.

Québec presents important contrasts. Montréal is the only metro area in Québec not in the “correctly valued” range of plus or minus 10% and will continue to experience a downward pull on its house prices due to reduced affordability. House prices in Montréal have also shown greater sensitivity to overvaluation in the historical data since 2005, so they will likely experience more downward price pressure compared with Toronto or Vancouver.

The second column of Table 1 shows house price appreciation in the third quarter of 2021, an important consideration given that pricing inertia tends to carry over part of this appreciation into the subsequent three to four quarters. The strongest appreciation rates are for smaller Ontario metro areas, including Brantford, Kitchener, Kingston, London, Windsor and Oshawa, as well as Moncton in New Brunswick and Halifax in Nova Scotia. Depreciating metro areas include Regina and Edmonton, as well as Saguenay in Québec.

The third column of Table 1 shows average forecast appreciation over the next four quarters, which tends to be significantly influenced by house price growth in the last historical quarter. Of the large metro areas, only Montréal will have a house price correction, with others such as Toronto and Vancouver having slight appreciation at best. House price appreciation will strengthen in the Prairies, advancing at the fastest rate along with Newfoundland and Labrador. This reflects affordability conditions that are solid by historical standards.

The fourth column shows house price growth from the fourth quarter of 2021 to the third quarter of 2023, when persistence effects from the last quarter of history have faded out and house prices respond mainly to valuation and to changes in mortgage rates. In line with slowing national appreciation, most of the metro areas in Ontario will undergo slight depreciation. The British Columbia metro areas will revert to flat prices to slight appreciation. Montréal will continue to correct downward, hamstrung by overvalued prices. House price appreciation will strengthen in the Prairies, advancing at the fastest rate along with Newfoundland and Labrador.

Risks

The main risk to the residential real estate market is a larger-than-expected increase in mortgage interest rates. Higher inflation expectations would likely be the main catalyst for a greater-than-anticipated increase. The resulting decline in affordability would place downward pressure on home sales and limit future house price appreciation.

Downside risks include supply-side constraints, which will drive up prices in the short term and could cause frustrated buyers to sour on the prospects of homeownership.

The Delta variant is also likely to slow the market further. Though the pandemic initially juiced up the market, the new variant will not contribute to this trend. Canadians who were encouraged to buy by being locked in their homes have already done so. The slightly less optimistic labour market outlook resulting from the variant will have a negative impact on demand, though not enough to significantly derail the market.

Expanded work-from-home options have fueled increased housing demand and higher prices in suburban districts. As public health measures improve, city living should become desirable again, leading more people to return to offices and schools—causing upward pressure on prices in these areas and reviving the rental market. Although the sustainability of these trends is uncertain and hard to predict, their impact on housing markets, and housing forecasts by extension, could be profound.

Table 1: Canada Subnational Forecast, Composite House Price

	% deviation from trend price, 2021Q2	% change annualized, 2021Q3	% avg annualized house price growth, 2021Q4-2022Q3	% avg annualized house price growth, 2021Q4-2023Q3
Canada		5.33	1.42	0.63
Avg across metro areas	22.59	6.88	2.62	1.38
Alberta	-19.75	-0.01	7.84	9.34
Calgary, census metropolitan area	-30.92	0.11	7.61	9.03
Edmonton, census metropolitan area	-29.87	-0.15	8.15	9.77
British Columbia	-2.93	3.96	1.95	1.84
Abbotsford, census metropolitan area	35.84	14.02	2.68	-0.12
Kelowna, census metropolitan area	3.31	9.60	9.03	8.33
Vancouver, census metropolitan area	22.95	2.74	1.17	1.32
Victoria, census metropolitan area	15.86	7.18	4.29	3.45
Manitoba	-3.86	0.06	2.73	3.65
Winnipeg, census metropolitan area	-5.86	0.06	2.73	3.65
New Brunswick	-1.80	9.54	5.39	3.05
Moncton, census metropolitan area	-9.99	16.27	9.85	6.20
Saint John, census metropolitan area	0.75	2.70	0.46	-0.54
Newfoundland and Labrador	-10.28	0.39	6.22	6.32
St. John’s, census metropolitan area	-21.06	0.39	6.22	6.32
Nova Scotia	15.30	13.35	0.85	-2.94
Halifax, census metropolitan area	5.41	13.35	0.85	-2.94
Ontario	16.89	7.58	1.26	-0.27
Barrie, census metropolitan area	47.38	10.56	2.01	-0.20
Brantford, census metropolitan area	59.18	13.54	2.51	-0.42
Greater Sudbury, census metropolitan area	26.31	5.49	-0.30	-1.64
Guelph, census metropolitan area	53.53	8.59	0.65	-1.34
Hamilton, census metropolitan area	73.12	6.06	-1.38	-3.12
Kingston, census metropolitan area	36.98	11.19	2.07	-0.30
Kitchener, census metropolitan area	38.54	14.32	3.71	0.87
London, census metropolitan area	61.77	12.47	1.99	-0.79
Ottawa-Gatineau, census metropolitan area	57.47	10.24	1.94	-0.10
Oshawa, census metropolitan area	21.35	14.13	3.99	1.28
Peterborough, census metropolitan area	79.65	10.83	0.52	-2.17
St. Catharines-Niagara, census metropolitan area	90.80	8.79	-0.49	-2.90
Thunder Bay, census metropolitan area	15.77	2.31	-1.92	-2.68
Toronto, census metropolitan area	39.53	5.25	0.86	-0.05
Windsor, census metropolitan area	77.45	20.91	5.08	0.65
Prince Edward Island	25.16	-8.26	-9.63	-8.07
Quebec	14.33	4.31	-3.98	-5.37
Montreal, census metropolitan area	24.96	5.37	-5.29	-7.21
Quebec, census metropolitan area	-3.57	-0.19	2.40	3.00
Saguenay, census metropolitan area	0.95	-5.48	-0.91	0.88
Sherbrooke, census metropolitan area	0.80	5.03	2.80	1.87
Trois-Rivieres, census metropolitan area	5.86	0.69	-0.31	-0.29
Saskatchewan	-16.01	0.64	7.16	8.21
Regina, census metropolitan area	-17.12	-1.58	4.88	6.02
Saskatoon, census metropolitan area	-31.78	2.21	8.75	9.70

Sources: RPS, Moody's Analytics

About the Author

Abhilasha Singh is an economist at Moody's Analytics, where she leads model development, validation, and forecasting for global subnational economies. She is responsible for coverage of emerging markets as well as U.S. and metropolitan area economies. She is also a regular contributor to Economic View. Abhilasha completed her PhD in economics at the University of Houston, where she taught microeconomics. She holds a master's degree in finance from Pune University in India.

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RPS Real Property Solutions is a leading Canadian provider of outsourced appraisal management, mortgage-related services, and real estate business intelligence to financial institutions, real estate professionals, and consumers. The company's expertise in network management and real estate valuation, together with its innovative technologies and services, has established RPS as the trusted source for residential real estate valuation services.

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The RPS – Moody's Analytics House Price Forecasts are based on fully specified regional econometric models that account for both housing supply-demand dynamics and long-term influences on house prices such as unemployment and changes in mortgage rates. Updated monthly and providing a 10-year forward-time horizon, the forecasts are available for the nation overall, its 10 provinces and for 33 metropolitan areas, and cover three property style categories, comprising single-family detached, condominium apartments and aggregate, in a number of scenarios: a baseline house price scenario, reflecting the most likely outcome, and six alternative scenarios.

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