Economic Commentary

January 11 2022

central 1 Economics

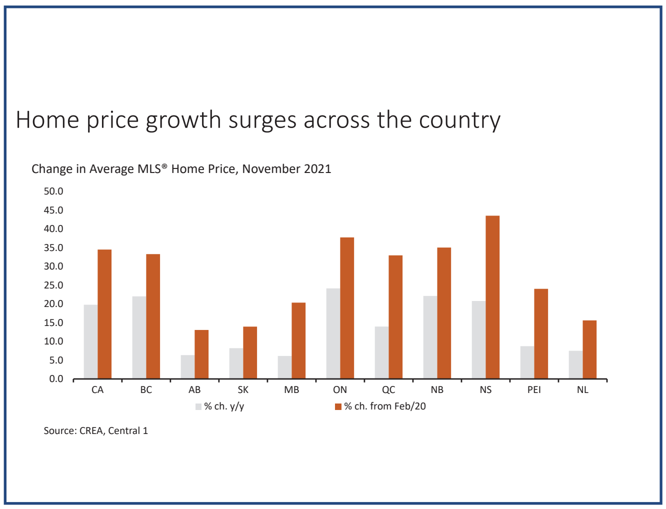
Key trends for Canada's Housing Market in 2021 and a Look Ahead

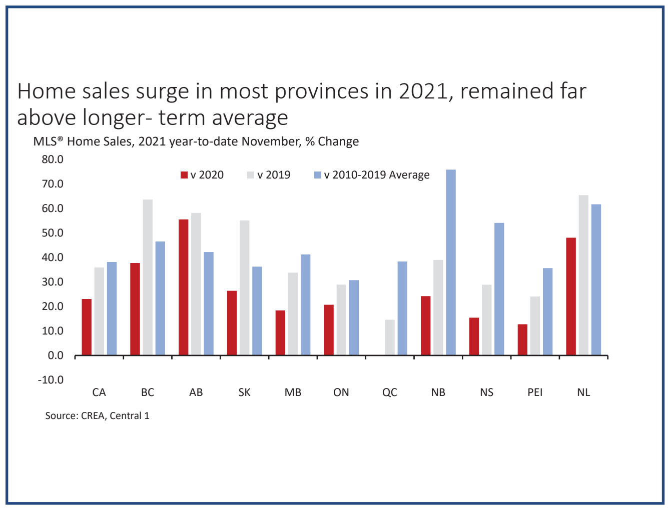
The housing market is likely to be the key story again for 2022 following blockbuster price growth through the pandemic that only intensified near the end of 2021 after a short-lived lull period over the summer. While a robust housing market has positively contributed to economic activity in the country, the rapid ascension of home prices has crushed affordability in regions large and small. This note examines key trends observed in 2021 and themes for the year ahead that are expected to curtail home sales and slow, but not derail rising prices.

Housing affordability crushed by soaring prices

The big story of 2021 was skyrocketing home values across the country. While ebbing and flowing through the year, the average price of homes sold (based on MLS® records) in Canada raced ahead to $719,100 by November, a gain of $100,000 (or 16 per cent) from December of 2020. Since the onset of the pandemic, the average price increased by $185,000 or 35 per cent with most provinces experiencing substantial gains as demand ran far ahead of supply across the country. Home sales have decelerated from the Spring peak but still exceeded pre-pandemic levels by 20 per cent in November

Price momentum in the Prairie provinces were comparatively tame and lagged the rest of the country, but still averaged near 15 per cent as economic conditions were hampered by structural weakness in the energy sector.





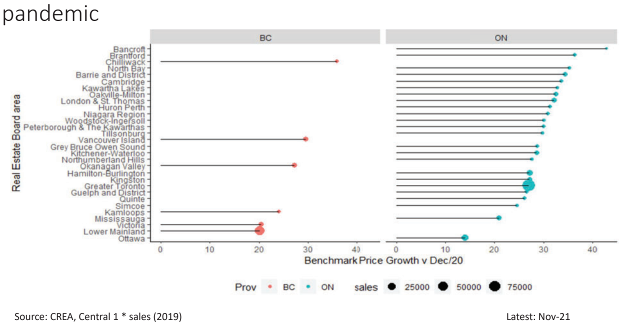
The race for space seen in 2020 continued as households hunkered down at home due to the health crisis and ongoing requirements for many employees to work from home. The latter specifically also reduced, at least temporarily, the importance of workplace proximity. Down payments were buoyed by excess savings by higher income households.

These factors contributed to soaring demand and prices for detached homes. As of November, the CREA MLS® benchmark price index for single- family homes came in 25 per cent above December 2020 and 44 per cent above February 2020 levels. The latter outpaced a 37 per cent increase for all unit types. Apartment prices also ripped higher but were considerably less at 21 per cent.

With detached homes in Canada's metro areas increasingly a luxury product, remote and hybrid work options allowed demand to cascade well outside the large metro areas into more affordable suburbs and bedroom communities, and even further into small-to-medium markets. Moreover, individuals working remotely brought both their higher urban incomes and potential equity gains from a pricier housing market to areas that by comparison were bargains, driving up in these markets. New home supply was unable to adapt to the influx of demand.

Benchmark home prices are not computed for many small urban and rural areas, but available benchmark MLS(R) shows smaller markets outperforming metro markets through 2021 in both B.C. and Ontario a pattern that likely repeated across the country. Specifically, growth outperformed in Bancroft, Brantford, North Bay and Barrie in Ontario, and Chilliwack and the broader Vancouver Island market outside Victoria.

Broad price gains, but smaller regions lead growth during pandemic



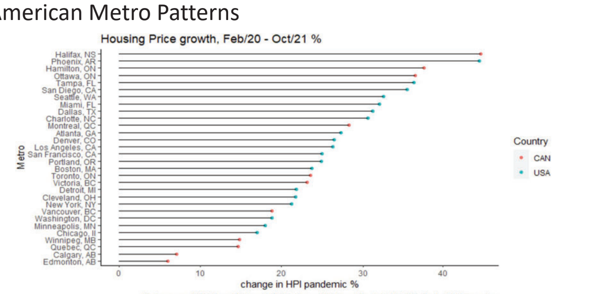
Looking over the period from February 2020 onwards, B.C. price growth was particularly robust in Chilliwack, Vancouver Island (excluding Victoria) and Okanagan which all recorded growth of about 40 per cent during the pandemic. In Ontario, London, Brantford, Kawartha Lakes and Cambridge are up 60 per cent, Hamilton up 50 per cent, were a handful of highlights. Robust growth in home prices reflect a long- term bet by buyers that hybrid work models will continue which has allowed households to seek more affordable markets and inability of local housing markets to quickly adapt to higher demand through immediate construction.

Is Canada's market special?

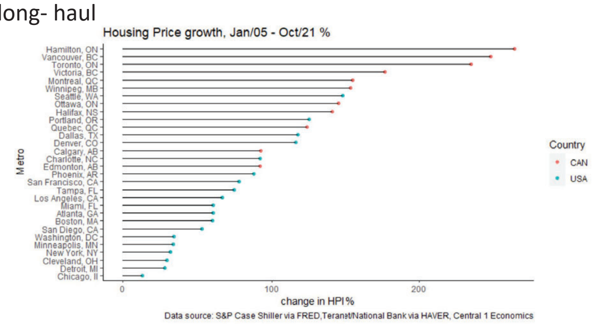
Canadian price growth over the period has been spectacular but not out of line within a broader North American context. Not to be confused with the average MLS® price, influenced by composition of sales, the Teranet/ National Bank repeat sales price index was up 24 per cent from February 2020 with a similar gain in the U.S. S&P Case-Shiller repeat sales index (26 per cent). Broad pandemic drivers of low mortgage rates, high savings rates and rotation of preferences towards homeownership due to remote work has underpinned these gains.

A big caveat is that Canada never saw a bust in the housing market during the mid- 2000s and has run far ahead on a trend basis. The Canadian index is up nearly 200 per cent from 2005 compared to a 50 per cent increase in the U.S. This divergence adds a layer of risk to the Canadian market.

Canada Pandemic housing price growth in line with North American Metro Patterns

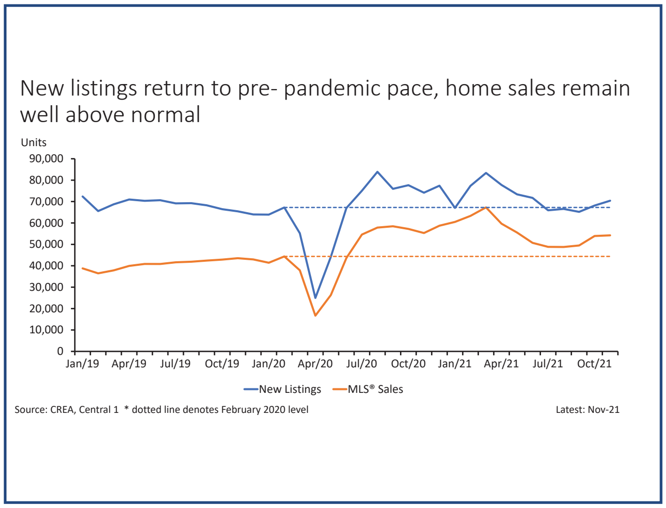


Northern exposure: Canadian prices lead since over the long- haul



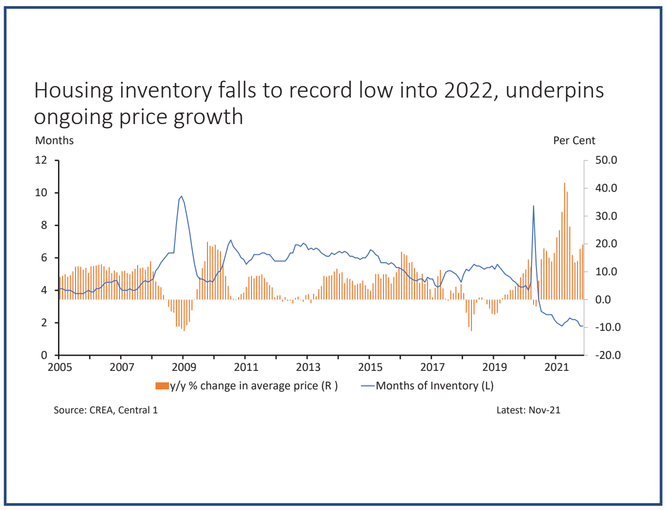
Supply, supply, supply flusters buyers, amplifies price growth

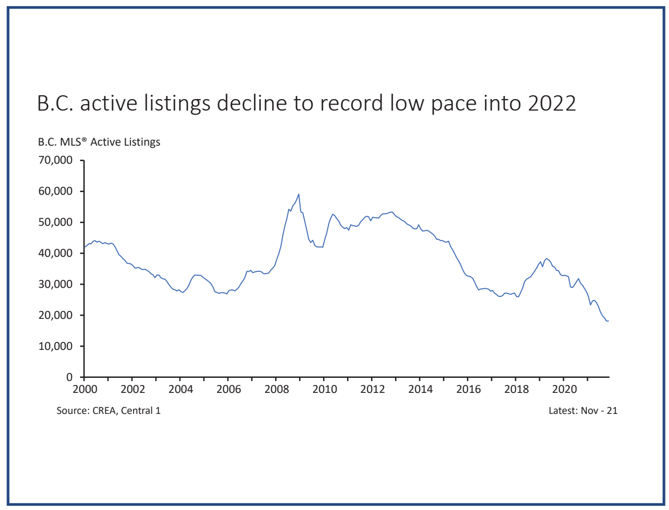
Rapid home prices have largely reflected robust housing demand which has outpaced new listing supply and depleted inventories to record low levels in many markets. This has further amplified pricing pressures as flustered buyers have responded by engaging in intense bidding wars to secure properties.



A measure of this discrepancy is months of inventory (MOI), representing the time it would take to deplete inventory levels at current sales. Nationally, MOI has fallen to a record low of under two months compared to an historic average of nearly four months. Estimates have been dragged sharply lower in Ontario with less than one month of inventory, while B.C. sits at near two months albeit with sharp regional deviations. Active listings are not readily available for all regions, but B.C. for example has seen listings decline to a record low of about 18,000 units.

The rapid drawdown of inventory and tight market conditions points to robust price growth through the first half of 2022. A rebalancing of market conditions requires a combination of elevated new listings and a normalization or more significant decline in home sales. We anticipate the latter to result from affordability erosion as prices continue to rise and a general normalization of sales flow. New home construction while helpful for long-term supply does little to improve current conditions given lengthy construction times as it takes months or even years for project to come online.





Home sales to ratchet back, home prices to slow

Following a momentous year for the housing market and further price acceleration to cap it off, a step back in homes sales volume is expected but prices will continue at a brisk pace before slowing by mid- year. Inventories are expected to rebound modestly but remain lower than normal. This is likely to be driven by a number of factors.

Normalization of sales

The pandemic has driven much higher than normal sales flow for reasons already noted. Flow of sales should naturally revert to previous averages as some of these drivers wane such as urban exodus and pull-forward of future sales also bites into future activity. The fact is that stronger than normal demand emerged during a period of weaker population will likely mean reversion to a period of normalized sales. MLS® home sales are forecast to decline about 5 – 10 per cent on an annual basis. Provided listings flow remains steady, inventory adjust higher.

Borrowing conditions to tighten

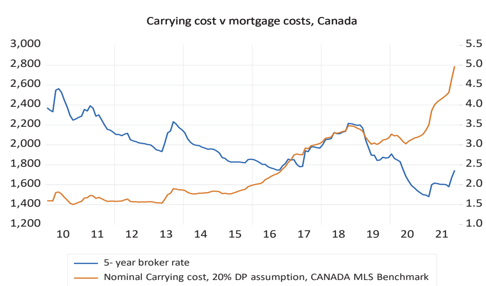
Higher mortgage rates will also dampen demand, reflecting higher bond yields and short- term rates. Contract rates have already increased and modest upside is expected. According to Central 1's Broker Rate Survey, the 5- year fixed rate fell from 2.7 per cent at the end of 2019 to a low of 1.7 per cent in early 2021, providing an offset to rising home prices and window to re-finance for owners. Levels have returned to about 2.4 per cent although variable rates remain significantly lower. We anticipate a highwater mark for 5-year rates near three per cent in 2022/23.

For existing homeowners, rising rates will be negligible for refinancing as renewal rates will likely be consistent or lower than current rate obligations.

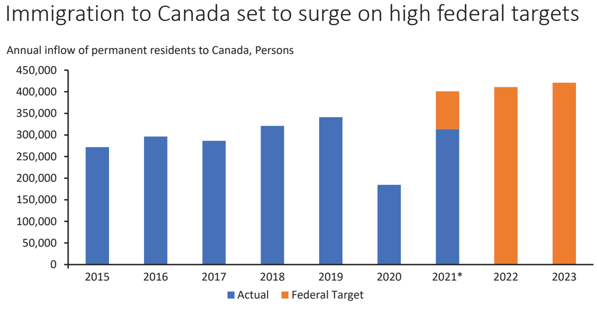
Prospective home buyers already reeling from the rapid ascension in home values and increased rates will further stress incomes as carrying costs capture the entirety of price gains with reversion of contract mortgage rates to pre- pandemic levels. The actual impact on carrying costs depends on the extent that down payments increased with higher savings and family gifts. However, purchasing power is already constrained by the mortgage stress test rate of 5.25 per cent (or contract +2 per cent, whichever is higher), suggesting buyers are working with cushion in their bids. The qualifying rate is unlikely to change significantly given contract rates below three per cent, although buyers may still adjust to higher realized rates by cutting price points, shift to multi-family units or reduction in other expenses. Buyers will need to rely on wage increases and gifting to lift purchasing power and to jump a more stringent down payment hurdle given rising home values.

Affordability erosion will likely slow sales flow and price growth as inventory rise. That said, this is unlikely to trigger a price contraction as demand will flow back in with any affordability improvements.

Canadian housing affordability decimated by pandemic price surge, mortgage rates on the rise



Immigration to Canada set to surge on high federal targets



Government measures to stem demand

Further constraining demand is the likelihood of government measures to temper demand. The federal government mandate letter related to housing suggests a likelihood of higher down payment requirements for investment properties, a temporary ban on foreign buyers of non-recreational property, prevention of renovictions, and policies to curb profits on investment properties. That said, any measures are unlikely to be immediate[1].

Rising population to remain supportive

Despite expectation of further affordability erosion and short- term drag on demand, elevated population growth is expected to underpin longer- term demand. On a calendar year basis, Canada added more than 400,000 permanent residents in 2021, according to government statistics, despite borders remaining closed. This compared to 185,000 in 2020 and 340,000 in 2019. While newcomers were already in the country and transitioned from non-permanent residency status, this continues to lift housing demand. Federal PR intake targets 411,000 persons in 2022 and 421,000 in 2023 suggesting a strong pick up of inflows from abroad over the next two years. Federal targets are geared towards increasing the

1 Minister of Housing and Diversity and Inclusion Mandate Letter, https://pm.gc.ca/en/mandate-letters/2021/12/16/minister-housing-and-diversity-and-inclusion-mandate-letter

flow of highly- skilled immigrants and will continue to put strong demand pressure on the homeownership market, specifically in the largest urban areas where most immigrants settle.

Strength in population growth suggests the way out of the current housing crisis over the long term can only be solved with increased new housing supply.

Takeaways

Canada's housing market has experienced explosive growth over the course of the pandemic due to strong demand which has led to an unprecedented contraction in available housing inventory in the market and massive home price growth effecting markets across the country. That said, price appreciation has aligned with broader price growth in the U.S. and other markets.

This imbalance is expected to ease as sales slow due to affordability erosion; natural normalization of sales activity; and government measures. However, still low inventory likely fuels robust price appreciation through mid-2022 before slowing growth thereafter as inventories respond to easing demand. Average annual price growth of 5-10 per cent for 2022 would not surprise, but a sideways move in future years would not surprise.
Ongoing affordability erosion will further stress buying activity, and rotate sales towards lower price multi-family housing stock, inventory contingent.

In coming years, affordability is expected to remain stressed as high levels of immigration support robust demand. A long- term rebalancing of housing market conditions requires significant increases in new home construction and particularly construction of "missing middle" housing such as semis and townhomes which caters to families.

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