Economic Commentary

May 3 2022

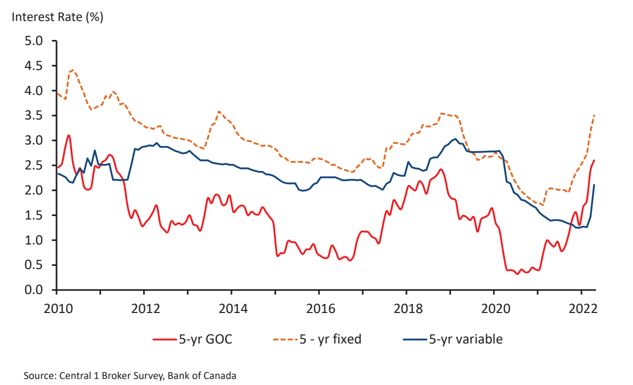
central 1 Economics

A modest housing “correction” ahead

After unprecedented pandemic gains the housing market is set for a modest correction as higher borrowing costs shakes the market. Rates that collapsed during the pandemic have reverted quickly amidst multi-decade high infl ation of nearly seven per cent and strong economic conditions. Key benchmark bond yields have risen sharply with 5- and 10- year GOCs near 2.8 per cent, marking a doubling since early 2022, with gains in short-yields even more striking. The Bank of Canada’s has hiked its policy rate to 1.0 per cent and looks to normalize rates at a rapid pace to 2.5 per cent by early 2023, with risks of overshoot.

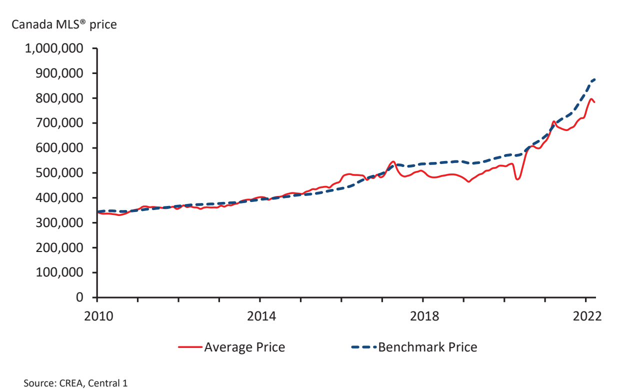
Prospective buyers are navigating a substantial shift in the mortgage environment and quick succession in policy rates hikes means little room hide in the variable bunker. Fixed 5-year rates have climbed to 3.6 per cent according to our Central 1 broker rate survey from 1.7 per cent at the pandemic low and anticipated to rise to a range of 4-4.5 per cent. The estimated variable rate according to our survey has climbed to near 2 per cent but are set to rise sharply with further Bank of Canada hikes. Consumers have already shown significant rate sensitivity during the pandemic shifting to variable mortgages due to the rate differential.

Rising interest rates upend the housing market boom

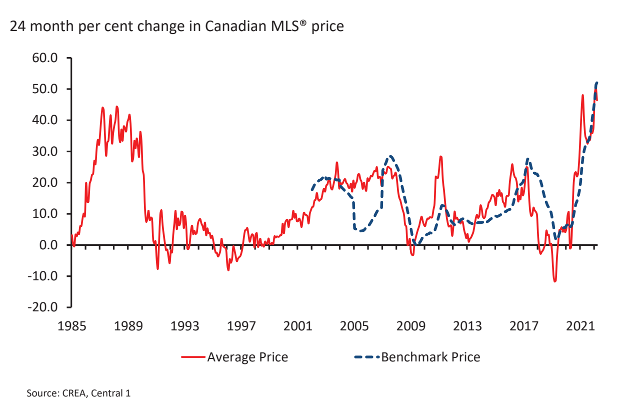


While current rates are still low relative to historic patterns and real rates are deeply negative, the affordability crunch has intensified. The pandemic ushered in a historic wave of purchasing driven by low rates and pandemic shifts in the demand driving demand in urban and rural markets. Work from home has supported the shift to the latter and suburban market demand. Normalization of interest rates coincides with home values that have soared. Benchmark home values surged over the period with the Canadian benchmark up 50 per cent over the past 24- months, the strongest two-year gain going back to the late 1980s. A similar pattern is observed in the average values. Patterns differ among provinces, with and suburban and small urban/rural markets have led growth.

Canadian values surge during pandemic

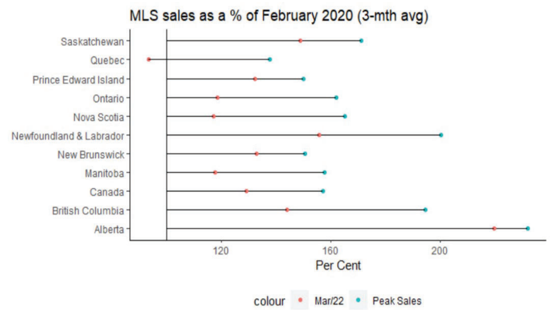


Historic price momentum observed



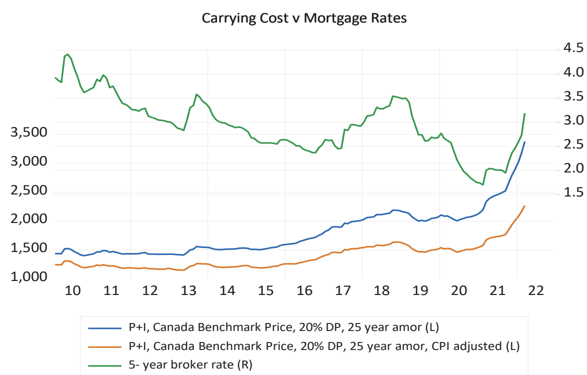
That said, the housing party is over. Catalyzed by this rapid change in mortgage market conditions, we anticipate both sales to normalize swiftly and price levels to decline in coming quarters. The most recent MLS® sales data still shows above normal demand across Canada in March with national home sales 30 per cent above pre- pandemic levels, albeit with varying patterns. Alberta sales are still more than double, while B.C. sits 44 per cent higher. Ontario is a more modest 18 per cent while Quebec has eased below pre-pandemic sales.

Excess demand for housing persists



Source: CREA, Central 1

Housing affordability already stressed by pandemic, to worsen



Current purchasers are internalizing the double-whammy of higher interest rates and record home prices, while at the same time, grappling with broader challenges of inflationary pressure affecting households. Wage growth has been insufficient to offset these pressures.

Our calculation of carrying costs under a 5- year fixed rate while initially improving during the pandemic has increased by more than a third. This is illustrative as buyers have adapted by increased use of lower variable rate products, allocating pandemic savings for larger down payments, and tapping intergenerational wealth from the bank of mom and dad. The share of variable rate mortgages increased from about six per cent of new mortgage volume in 2019 to over 20 per cent early in the pandemic and to above 50 per cent in early 2022. CIBC estimates pointed to 30 per cent of first- time homebuyers receiving a gift averaging above $80k, with move-up buyers receiving $128k[1]. Larger urban areas exhibit larger gifts.

What's next?

There are early signs that recent hikes to fixed rate mortgage rates have already slowed sales; a trend we expect to accelerate during the remainder of Q2 and through Q3 as rate holds expire and variable rates increase. For prospective buyers choosing fixed rate mortgages, purchasing power has already been reduced by a higher qualifying rate (stress test) although variable products provide temporary relief. More broadly, increased mortgage carrying costs will reduce demand as more households are priced out of the market and others shift toward lower priced homes. Moreover, we think pent up demand has also been exhausted and buyer sentiment is turning against the housing market and will amplify the slowdown. Broader factors including an equity market pullback and higher inflation among a broad range of goods further factor into consumer weakness.

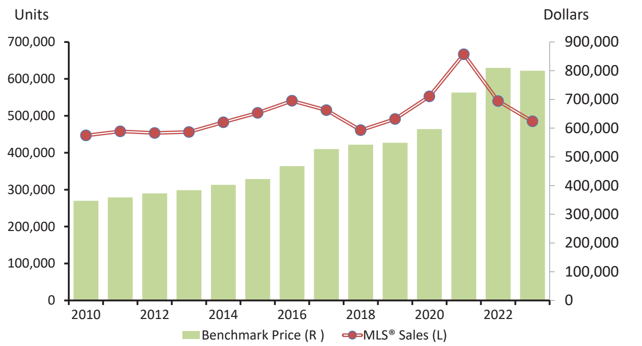
While the path of sales and prices is uncertain, we anticipate a pattern in line with 2017/18 and the mid-1990s when rising interest rates triggered sales declined over multiple years. That said, this decline is expected to dwarf those declines due to record pandemic sales. **Seasonally- adjusted MLS(R) sales are forecast to fall 20 per cent in the second quarter and 12 per cent in Q3.** This would bring sales flow back to pre-pandemic levels and we expect levels to grind lower before stabilizing in Q4. Annual sales are forecast to contract 19 per cent this year and 10 per cent in 2023.

1 CIBC, Economics in Focus, Gifting for a Downpayment – Perspective, October 2021

Deterioration in sales will by extension soften what have been excessively tight market conditions during the pandemic. Low listings inventory has been a key driver of home price acceleration, but it should be recognized that dwindling active listings reflected excess sales activity and demand. As sales decline, inventories will rebound rather quickly shifting the housing market well into balanced conditions. Market sentiment is expected to play a role in swinging the pendulum negotiating power to buyers.

We have noted for some time that housing prices overshot during the pandemic amidst the buyer frenzy and increased speculative demand. The benchmark price rose $300k over the past 24 months (52 percent) which was by far a the strongest two- year gain since the late 1980s. Prior to the pandemic, it took nearly a decade for the average and benchmark prices to record a 50 per cent increase.

Small business confidence improved in both short-term and long-term outlooks in B.C.



Source: CREA, Central 1

Declining sales and upward pressure on supply to cool conditions and c**ontribute to a decline in values of up to 10 per cent on peak to trough basis,** a modest retracement of benchmark prices to late Q4 2021 levels and potentially lower as investors reduce holding and exit the market. That said, prices remain well above pre-pandemic levels with downside momentum limited by still strong underlying demand from higher immigration while the inflationary backdrop suggests further upward momentum in wages in coming quarters which will support purchasing power. **On an annual basis, the benchmark price remains up nearly 10 per cent given and the average prices is up five per cent due to the run up through 2021 and into 2022. Home prices are anticipated to remain flat through 2023.**

Housing scarcity is a factor supporting home values, observed in the flurry of home buyers flooding the market during the pandemic despite soaring prices while rental market vacancy rates have remained tight. Core urban markets which have relatively “underperformed” during the pandemic should retain strength as condominium demand improves with the affordability hit and greater return of employees to offices. Greater risk is likely for suburban and smaller urban/rural markets which have experienced the bulk of the price appreciation.

The reversal in the high-flying housing market is expected to be orderly. The rapid price growth during the pandemic have largely reflected paper gains for the vast majority of homeowners and a decline will be of little concern. That said, there will be immediate challenges as higher mortgage rates stress finances of variable rate mortgage holders, while those already locked into purchases may be surprised by lower-than-expected appraisal values creating difficulties in closing.

For the broader economy, we expect a slowdown in housing- related growth including the finance and real estate sectors, and weaker ancillary spending on renovations and retail purchases.

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