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Canada Housing Market: Tight Supply, Higher Costs Ahead

Prepared by

Abhilasha Singh
Abhilasha.Singh@moodys.com
Economist

Contact Us

Email
help@economy.com

U.S./Canada
+1.866.275.3266

EMEA
+44.20.7772.5454 (London)
+420.224.222.929 (Prague)

Asia/Pacific
+852.3551.3077

All Others
+1.610.235.5299

Web
www.economy.com
www.moodysanalytics.com

INTRODUCTION

The Canadian housing market continues to weather the storm from the COVID-19 pandemic much better than originally expected at the start of the crisis. Unemployment remains significantly elevated and a new wave of COVID-19 in the fall has swept across the world. Several businesses are struggling to survive in the wake of the global pandemic and public health restrictions.

Nevertheless, the single-family home market has flourished. Record low mortgage rates and the work-from-anywhere phenomenon have juiced up house prices. However, weakness is evident in the condo apartment market. Condo apartment prices have started to decline in Toronto and have leveled off in Vancouver and Montréal over the past three to four months.

The story has not changed in the first quarter of 2021. The housing market started 2021 with a bang. Existing-home sales rose to a record high. Supply-side conditions remain exceedingly tight with existing-home inventories declining as homebuyers clamor for additional properties.

Though house prices are still rising at a fast pace, the pace of appreciation has slowed recently. Mortgage rates are starting to rise, but homebuilders continue to plow full steam ahead. Single-family housing construction is soaring to high levels.

However, the housing market will confront a multitude of headwinds such as higher mortgage rates and a persistently higher unemployment rate. We expect price growth to moderate late this year as a result.

Canada Housing Market: Tight Supply, Higher Costs Ahead

BY ABHILASHA SINGH

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Recent Performance

The housing market has been one of the bright spots in the Canadian economy. The RPS 13-metro area transaction-weighted composite house price index rose 8.4% over the course of 2020—its fastest rate since mid-2017—despite the deterioration of economic conditions.

Though house prices are still rising at a fast clip, house price appreciation has moderated, according to the latest data from RPS. In January, the RPS composite house price index rose 0.4% from the previous month and advanced 11.3% year over year. This is a strong year-over-year increase from a historical perspective, but it is the fourth consecutive month in which the index rose less than the month before.

Likewise, existing-home sales rocketed to 783,636 annualized units in February—a whopping 39% above the year-ago levels, according to the latest report from the Canadian Real Estate Association. Home resales growth has been primarily driven by single-family detached homes as opposed to condominiums, which supports the notion that the pandemic is driving more buyers to the suburbs and unshared property spaces.

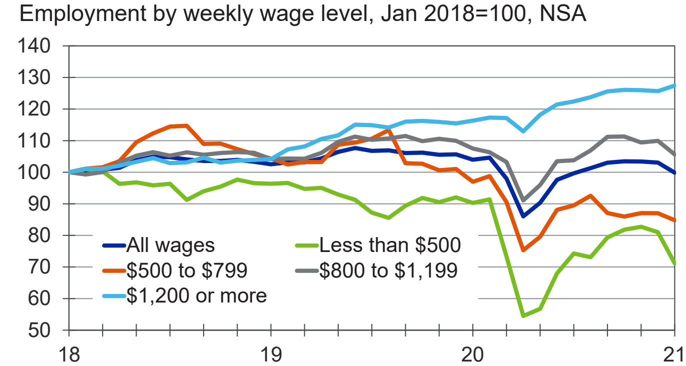
The strength in the housing market reflects a multitude of supply- and demand-side factors.

On the demand side, the pandemic has shifted preferences. With expanded telework options, demand for housing outside of crowded city centers has surged as many formerly office-bound workers have abandoned apartments in and around high-rent, high-tax central business districts for homes in relatively low-cost suburbs and nearby smaller metro areas.

Bolstering Canadians' ability to satisfy their newfound preferences, fiscal stimulus programs have boosted disposable income through a multitude of income-assistance programs. Furthermore, Canadians higher up on the income scale—those more likely to purchase homes—have had healthier financial outcomes during the pandemic. Employment in higher-income professions has more than recovered pandemic losses while employment

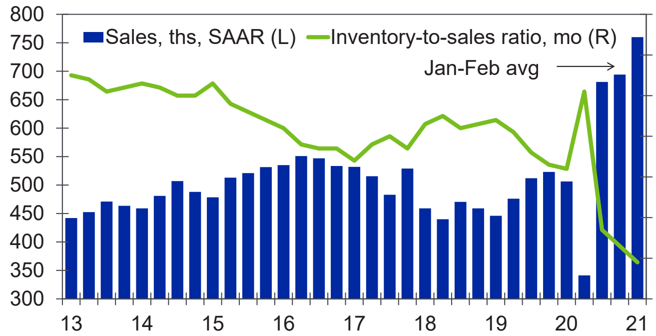
Chart 1: High-Wage Earners Barely Hit

Employment by weekly wage level, Jan 2018=100, NSA



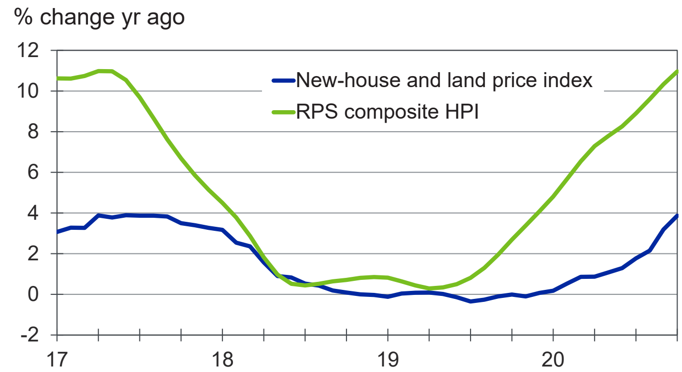
Sources: Statistics Canada, Moody's Analytics

Chart 2: Sales Soar, Market Tightening…



Sources: CREA, Moody's Analytics

Chart 3: …Pushing House Prices Upward



Sources: RPS, Moody's Analytics

in lower-income industries remains down more than 10% (see Chart 1).

In addition, the five-year conventional mortgage rate dropped to 3.5% in September, its lowest rate on record going back to 1951. Though mortgage rates ticked up slightly in January, they continue to hover near all-time lows, bolstering buyers.

Supply-side conditions also remain exceedingly tight. The inventory of existing homes remains slim. Resale activity rebounded from the lows in April and new listings coming onto the market did not keep pace with demand. At the current sales pace, the available inventory amounts to a 1.8-month supply of existing homes, the lowest on record. Consequently, sellers remain firmly in control of the market and have been able to hike prices despite the recent economic downturn (see Charts 2 and 3).

Conditions are no different in the new-home market. The number of completed and unabsorbed new homes is at the lowest level since late 2007. Builders are hampered by supply-chain issues brought on by the pandemic and public health restrictions. Also, input costs are rising, particularly for lumber. Meanwhile, mortgage deferrals and an eviction moratorium are preventing homeowners from having to deleverage.

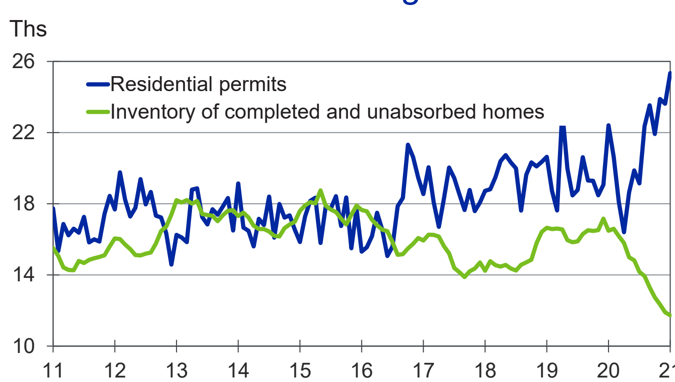
High absorption of new homes—particularly single-family homes—is pushing up new-home prices. The national new-house and land price index rose by 1.8% in January on a month-ago basis and by 7% year over year. Elevated house prices are motivating builders to push ahead with new construction at a record pace. In January, the total value of residential building permits surged 21% over the past year to C$7.1 billion, the highest monthly tally on record (see Chart 4).

Though house prices surged to record levels in 2020, housing was more affordable than at any time during the previous five years (see Chart 5). The affordability index, which measures the mortgage cost of a median-priced home relative to median family income, has since dropped below its pre-pandemic level. Rising interest rates will erode affordability over the next year, but this erosion will be countered by an increase in employment and wages. As a result, housing affordability will rise in 2021 but will remain below pre-pandemic levels.

Slowest growth in Prairies

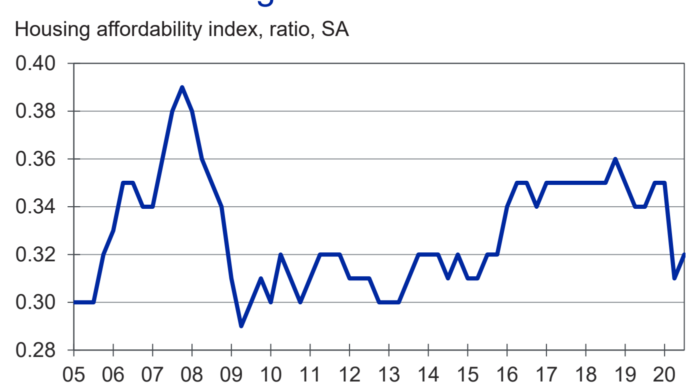
Though house prices are rising at their fastest rate since 2017, this speedy pace is not consistent across regions and will likely stay that way. Table 1 shows a comparison of year-over-year house price appreciation for Canada's metro areas for January 2020, just before the global pandemic, and January 2021. The RPS composite house price index is used to allow for the broadest possible coverage of the housing market. Of the six largest metro areas, Vancouver has had the largest house price appreciation, followed by Montréal, which has one of the tightest

Chart 4: New Homes Surge Ahead



Sources: Statistics Canada, CMHC, Moody's Analytics

Chart 5: Housing Is More Affordable



Sources: Bank of Canada, Moody's Analytics

Table 1: Composite House Price Index Appreciation, 2020 and 2021

	Jan 2020, % change yr ago	Jan 2021, % change yr ago	Difference
Canada	**4.9**	**11.3**	**6.4**
Alberta	**-1.1**	**2.1**	**3.2**
Calgary, census metropolitan area	-1.3	3.0	4.3
Edmonton, census metropolitan area	-0.9	2.1	3.0
British Columbia	**0.9**	**11.3**	**10.4**
Abbotsford, census metropolitan area	1.3	14.4	13.1
Kelowna, census metropolitan area	3.1	8.8	5.7
Vancouver, census metropolitan area	-0.1	12.7	12.8
Victoria, census metropolitan area	2.4	6.3	3.9
Manitoba	**1.9**	**6.4**	**4.5**
Winnipeg, census metropolitan area	1.6	6.9	5.2
New Brunswick	**0.2**	**4.4**	**4.3**
Moncton, census metropolitan area	-4.2	6.6	10.8
Saint John, census metropolitan area	-3.2	3.4	6.6
Newfoundland and Labrador	**1.6**	**2.3**	**0.8**
St. John's, census metropolitan area	-0.8	2.1	2.8
Nova Scotia	3.0	11.5	8.5
Halifax, census metropolitan area	3.8	12.1	8.4
Ontario	**7.7**	**12.9**	**5.2**
Barrie, census metropolitan area	5.5	18.7	13.2
Brantford, census metropolitan area	11.1	16.4	5.3
Greater Sudbury, census metropolitan area	8.2	12.1	4.0
Guelph, census metropolitan area	7.5	11.1	3.6
Hamilton, census metropolitan area	7.8	16.4	8.7
Kingston, census metropolitan area	6.5	12.6	6.2
Kitchener, census metropolitan area	9.1	13.7	4.7
London, census metropolitan area	10.0	16.9	6.9
Oshawa, census metropolitan area	4.6	15.2	10.5
Ottawa-Gatineau, census metropolitan area	10.7	16.7	6.0
Peterborough, census metropolitan area	5.7	11.0	5.3
St. Catharines-Niagara, census metropolitan area	9.9	15.8	5.9
Thunder Bay, census metropolitan area	2.9	6.1	3.2
Toronto, census metropolitan area	7.2	10.9	3.7
Windsor, census metropolitan area	11.2	20.1	8.9
Prince Edward Island	**11.1**	**12.6**	**1.5**
Québec	**6.5**	**12.0**	**5.5**
Montréal, census metropolitan area	7.5	12.5	5.0
Québec, census metropolitan area	2.0	5.5	3.5
Saguenay, census metropolitan area	7.9	6.5	-1.5
Sherbrooke, census metropolitan area	7.5	5.8	-1.6
Trois-Rivières, census metropolitan area	2.2	12.7	10.6
Saskatchewan	**0.1**	**0.4**	**0.3**
Regina, census metropolitan area	-1.2	1.0	2.2
Saskatoon, census metropolitan area	1.9	0.5	-1.4

Italicized metro areas are part of the RPS 13-metro area composite index.

Sources: RPS, Moody's Analytics

demand-supply conditions. Home sales fell in February despite higher condo sales as many buyers were out of luck because of depleting inventories.

House prices in the Toronto metro area rose by about 10% on a year-ago basis throughout the COVID-19 crisis, and home resales jumped 8% in 2020, largely because of strong sales of low-rise homes. The housing markets were mixed in the Atlantic metro areas. House prices barely increased in Saint John's while prices were up by more than 12% year over year in Prince Edward Island and Halifax.

Strong demand in the fourth quarter also resulted in price stability in Canada's energy provinces. In Calgary and Edmonton, previously plentiful inventories have come down considerably and prices are now rising, after declining during much of the past five years.

Smaller metro areas such as Barrie, London, Hamilton, Ottawa, Windsor near Toronto, and Abbotsford near Vancouver had fairly large price appreciation, which supports the notion that the pandemic is driving more buyers to the suburbs and unshared property spaces.

While rising house prices were somewhat disconnected with the employment and economic outcomes during the pandemic across regions, the change in home values was closely associated with the take-up rate of mortgage deferrals.

That is, markets with higher take-up rates of mortgage deferrals were more likely to see weaker price appreciation (see Chart 6). For example, Calgary, Edmonton, Regina and Saskatoon had much higher take-up rates of mortgage deferrals in July 2020 and were among the metro areas with the weakest house price appreciation. Meanwhile, Toronto, Vancouver and Montréal had lower take-up rates and experienced strong house price appreciation.

Condos struggle

The market for condo apartments is usually overshadowed by the single-family market, but there is reason to be cautious for real estate investors in some condo apartment markets (see Chart 7). Condo apartment price growth has slowed to just 2.6% year over year, or a record 9.6 percentage points below the growth in single-detached homes—the widest gap on record. The condo apartment market is being impacted by changing preferences of homebuyers, together with lower immigration and the impact of the pandemic on the labour market, especially for younger workers.

The pace of price appreciation for condo apartments has slowed in Vancouver and Montréal in the last few months. Condo apartment prices in Toronto fell in the last quarter of 2020 as condo listings have surged—bringing some balance to the metro area's condo market in 2020. At the current sales pace, the available inventory amounts to a two-month supply, up from a 1.3-month supply a year ago.

The demand-supply balance

Even though joblessness in Canada remains elevated in the wake of nationwide COVID-19 lockdowns and restrictions, house prices are increasing. The current dynamic is unlikely to subside in the short run.

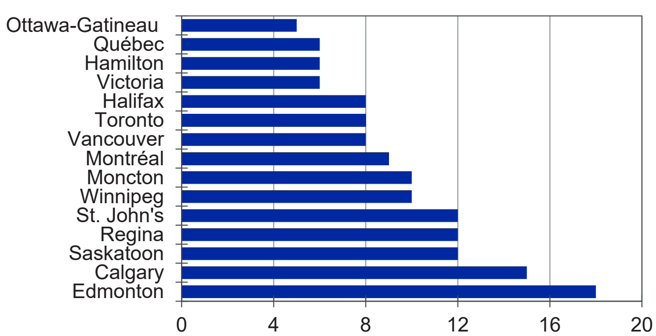
New cases of COVID-19 have eased from January's highs, but the slow pace of vaccine distribution suggests that immediate relief is not imminent. The prolonged duration of the crisis suggests that some of the shift in consumer and business behavior will linger for some time. However, the conditions that have resulted in rapid house price appreciation are unlikely to persist throughout the year.

Primarily, house prices are rising because exceptionally low mortgage rates have boosted demand. As interest rates have fallen, a new pool of potential buyers has joined the market. Lower interest rates have also pulled forward demand. Because of the lower interest rates, homebuyers can afford a larger mortgage than they could a year ago. This extra purchasing power encourages demand, but because the supply of housing is essentially fixed in the short term, prices rise.

Prices are also rising because the housing market is in short supply. Home resales are flirting with multidecade highs, pressuring housing supply. In addition, concerns about being exposed to potentially infectious strangers have clipped the supply of occupied homes during the coronavirus pandemic. Though relatively volatile, housing starts averaged 218,948 annualized units in 2020—a three-year high. Thus far, even the recent boom in single-family construction has failed to relieve overall supply-side pressure on the housing market.

Chart 6: Deferral Take-Up High in Prairies

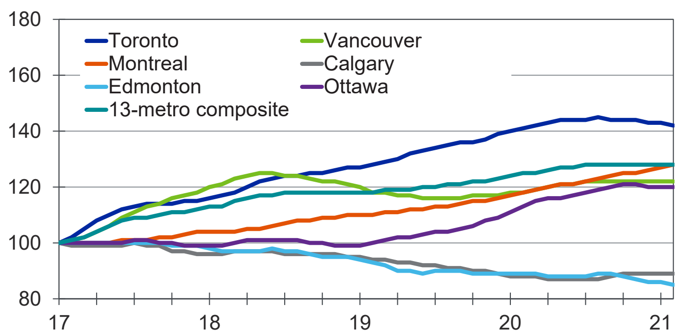
Active deferral, Jul 2020, %



Sources: RPS, Moody's Analytics

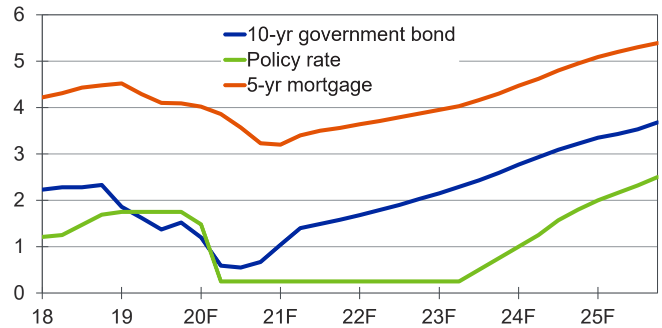
Chart 7: Condo Market Loses Traction

RPS condo apartment prices, Jan 2017=100, SA



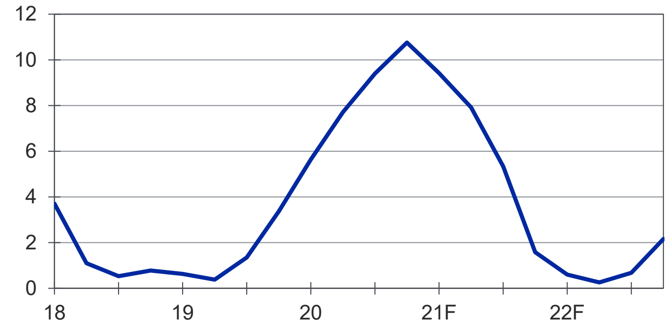
Sources: RPS, Moody's Analytics

Chart 8: Mortgage Rates Will Rise…



Sources: Bank of Canada, Moody's Analytics

Chart 9: …And Will Drag Price Appreciation



Sources: RPS, Moody's Analytics

However, all the factors that aligned in housing's favor last year are set to reverse, spelling trouble for the high-flying market.

Housing demand will moderate from its record pace but remain robust in the coming quarters. Interest rates will rise as the Bank of Canada winds down its asset purchases. Most notably, mortgage rates will pivot and start creeping higher (see Chart 8).

As borrowing costs begin to pick up, the pool of potential buyers will start to dwindle. We anticipate that the pace of housing starts will likely moderate back in line with its pre-pandemic trend by the end of 2021. In addition to interest rates, the persistently high rate of unemployment should weigh on demand.

Supply will increase as the rollout of COVID-19 vaccines encourages more sellers to list their occupied residences. Pent-up supply will be unleashed as homeowners who deferred selling in 2020 out of caution list their properties in 2021 and beyond.

Further supply will come from the expiration of the mortgage payment deferral program, which effectively removed troubled households' need to deleverage. Nearly 10% of mortgages insured by the Canada Mortgage & Housing Corp. were in deferral at the program's peak in July, but that figure has declined closer to 1%. The large number of households that utilized the deferral program raises significant concerns about their ability to handle rising debt-service obligations once interest rates start increasing.

House price appreciation will extend into 2021, although it will cool somewhat from its breakneck pace in 2020 (see Chart 9). Limited supply of existing homes for sale will support strong house price growth early this year, around 8% to 9% year over year. But as housing financing costs increase, demand will moderate and so too will price gains. Year-over-year growth will slow to 1.6% by year's end.

Outlook and risks

Many measures of the housing market's performance over the next year are easy to forecast because the unprecedented events in 2020 have pushed these values to record-shattering levels.

The Bank of Canada will likely hold off on hiking its target for the overnight rate until mid-2023, when the labour market has more fully healed. Mortgage rates are certain to rise in 2021, but the BoC will likely continue shifting its asset purchases toward the longer end of the yield curve to temper the increases in mortgage rates, while leaving the size of its total balance sheet unchanged.

Inventory will rebound from the lowest level on record when existing-home sellers feel comfortable opening their residences to potential buyers. Housing starts will retreat from their elevated levels when rising interest rates and surging inventory dissolve these perfect conditions for homebuilders.

Other elements of the housing market are more difficult to predict because the unprecedented events in 2020 may lead to lasting changes in preferences. Expanded work-from-home options have fueled increased housing demand and higher prices in suburban districts. If expanded telework arrangements are a permanent feature of the labour market, the surge in housing demand could extend to smaller cities and rural areas over the next year.

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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