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Canadian Banks

Canadian housing market outlook: Expert call takeaways

Industry Overview

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Toronto housing market heating-up and so are rates

Last week we hosted John Pasalis, President of Realosophy Realty, to discuss the outlook for the Canadian (specifically Toronto) housing market. The punchline was that the market has begun to reheat, as supply constraints persist while strong jobs/wages/immigration drive demand. The reemergence of buyers was aided by the stabilization in interest rates until the Bank of Canada surprised the markets with a 25bp rate hike last Wednesday. The 5yr govt yield (proxy for mortgage pricing) closed last night at YTD highs of 3.77% or ~100bp above early May levels. *Turn to page 2 for takeaways from the call and see Exhibits 1-7 for housing market trends.*

Immigration critical but adding to housing imbalance

Immigration has been an undisputable force for good for the Canadian economy adding 1%+ in population growth each year which has underpinned economic demand and allowed Canada to outperform its G7 peers. However, the high net worth and high skilled nature of Canada's immigration combined with most immigrants ending-up in Toronto is contributing to an acute housing shortage, worsening affordability, and driving rents higher. Unfortunately, policymakers have been unable to address the supply side constraints that would alleviate some of these pressures. *Exhibit 8-11*

Consumers have yet to feel the pain

Given that most variable rate mortgages are unlikely to see payments reset higher until renewal, the pass through from high debt service costs to consumer pocketbooks has been blunted. Homeowners could see as much as a 50% increase to their mortgage payments at renewal if rates stay at current levels or move higher. This in a backdrop where jobs and wage growth has generally been relatively strong and the consumer is sitting on ~$350bn in excess savings vs. pre-pandemic levels. As a result, it was not surprising to see the BoC hiking interest rates last week. *Exhibits 12-16*

Our view: unhealthy backdrop

Higher for longer interest rates combined with a worsening economic backdrop "stagflation" remains the key downside risk to our outlook. Markets have had a hard time calling peak inflation and inflation related surprises have generally come to the upside with BoC and the Reserve Bank of Australia resuming their rate hike cycle after a brief pause. Mortgage renewals in 2025/26 (origination years: 2020/21) have the potential to significantly squeeze the consumer due to higher debt servicing costs. While credit losses tied to the mortgage portfolio should be relatively low, we worry about slower growth and rising losses across other consumer and commercial loan categories.

Relevant research: Canadian Banks: Earnings & Beyond: Higher for longer taking a toll 04 June 2023

Key Takeaways from the call

#1 Market heating up

The housing market in Toronto (and Canada in general as patterns from Toronto spread across the country) is heating-up. The Toronto market is seeing strong demand and intense competition despite elevated interest rates (4.5% mortgage rates), partially due to the Bank of Canada's (BoC) signaled pause back in February (note that since the call the Bank of Canada hiked overnight rates by 25bp on June 7). Low listings/inventory is currently the largest driver for home prices reversing their decline. House prices and rents have been rising rapidly since 2015, at 11% and 5% per year respectively and 6%/1% annually before 2015.,

#2 Consumer yet to feel the impact from higher rates

With the popularity of the 5-year variable rate mortgage in Canada, many anticipated increased stress on the Canadian consumer. Banks are extending amortization periods for customers who have hit the trigger rate, providing a cushion for elevated payments. As mortgages originated in 2018-2020 begin to renew at today's higher rates, borrowers will begin to see the pressure through their payments resetting higher. Customers have already slowed spending in discretionary areas (entertainment, restaurants), and increased mortgage payments likely to drive a slowdown in spending. Mr. Pasalis estimates a 50% increase in mortgage payments at today's rates upon renewal.

#3 Immigration underpinning strong demand

Immigration has continued to overwhelm the Toronto housing market. With an influx of 1mn+ immigrants over the last 12 months (mostly high net worth and/or high skilled), demand for housing remains elevated and prices continue to climb. This represents a significant increase over the average 20year avg. immigration figure of 350-400k/year.

#4 Pre-construction condos to lose steam

While the market for existing homes remains hot, pre-construction condos should lose steam. Prices for pre-construction condos are around 30-40% above existing home sale prices. The buyers (investors/speculators) are willing to pay the hefty premiums with the expectation of continued home price momentum higher. Pasalis believes an eventual stabilization in the market and flattening in prices will cause the condos that are eventually completed to be worth less than what was originally paid for them.

#5 Rental market rebounding:

Toronto rents have risen (up ~20% YoY in the GTA) after a recent cooling during the winter months. Pasalis notes that customers are being pushed into rentals as home affordability remains at low levels, especially with the influx of immigrants pressuring demand. In some cases, two families will attempt to rent one home due to the intense competition.

#6 Supply correction will help cool the market

Debate continues around the potential "limit" on supply from not being able to build on the Greenbelt. Pasalis argues that the Greenbelt argument is mainly supported by the provincial government while others do not agree, noting that there is available and developable land around the Greenbelt. With a current annual build figure of ~650k homes per year, Pasalis believes this number would have to nearly triple to ~1.5mn to meet demand. Ability to scale up construction quickly remains a challenge.

#7 Government intervention is limited

While the Canadian government has established taxes such as foreign buyer taxes, Pasalis finds these measures to be largely symbolic vs. making a real impact. With the housing market as hot as it is, the Bank of Canada is relatively limited in using their tools (raising interest rates) to cool things down without causing pain elsewhere. Pasalis also mentioned that both political parties are supportive of the immigration policy given the largely positive impact on the Canadian economy. When the population boom decreases, Pasalis expects home prices to subsequently come down.

#8 Buyers locking-in 2-3yr mortgages

As a result of higher interest rates, customers have begun to change their preferences in mortgages. 80% of mortgages originated in Canada during the pandemic were variable (due to the benefit of low interest rates), and with the current rate backdrop, Pasalis is seeing customers flock towards the 2-3yrs fixed rate mortgages. The benefit comes with a discount to the short-term rate, and also doesn't lock in a high rate over a long period of time. Customers are currently seeing an average rate of ~5% on these mortgages.

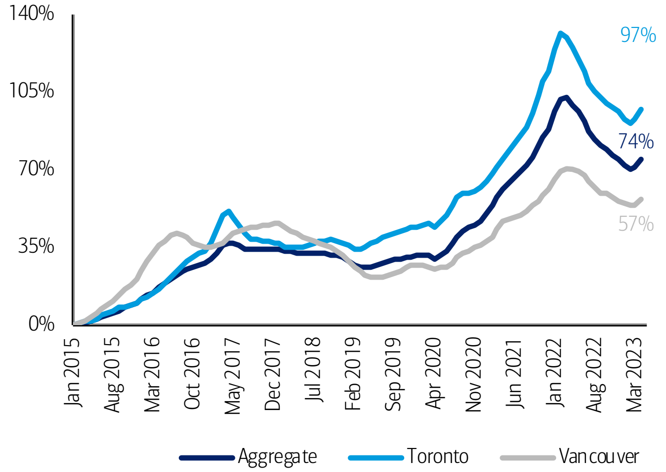
#9 Detached vs. condo is a key differentiator

Demand is intensely concentrated around low rise/detached homes (standard single-family homes) as opposed to condos. Pressure is unlikely to abate soon with average home prices in the GTA floating around ~CAD $1mn, condos around ~$700-800K. Pasalis notes that due to the high demand, customers are having to put down more money upfront, mentioning that a typical down payment would be around $160K. Condos are preferred by investors, especially the pre-construction market where Pasalis says is 80%+ driven by investors.

#10 Banks continue to be prudent

Pasalis noted that borrowing standards have remained tough, giving credibility to the notion that banks are not necessarily changing their risk appetite. LTV ratios for Canadian mortgages have been steadily declining since 2015 (63% on average for uninsured mortgages for the big five banks as of 2Q23), partially because many of the buyers own real estate already.

Exhibit 1: Home prices have begun to reverse their decline recently
Home price appreciation since January 2015



Source: BofA Global Research, CREA
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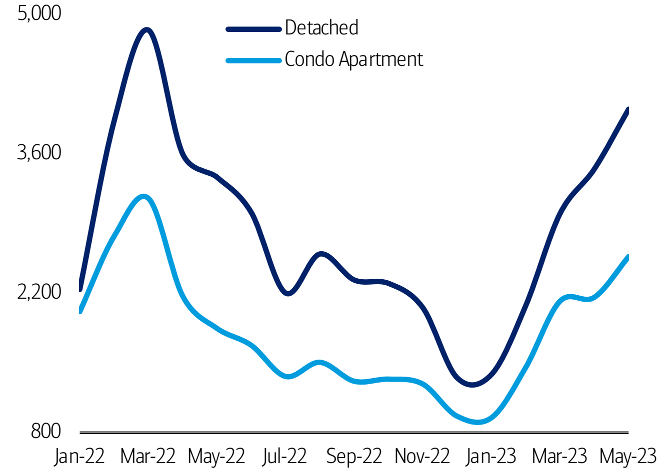
Exhibit 2: Detached home sales -22% YoY YTD, Condos -23% YoY YTD
Detached house sales vs. condo apartment sales



Source: BofA Global Research, TRREB
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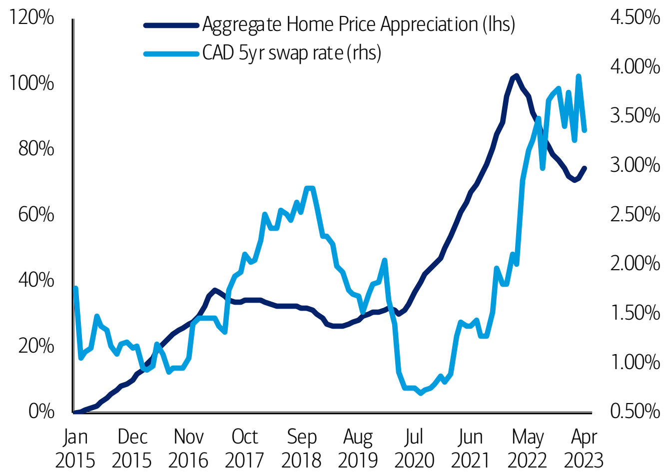
Exhibit 3: 5yr swap rate remains far above '17/18 peak
Home price appreciation vs. 5yr swap rate



Source: BofA Global Research, Bloomberg, CREA
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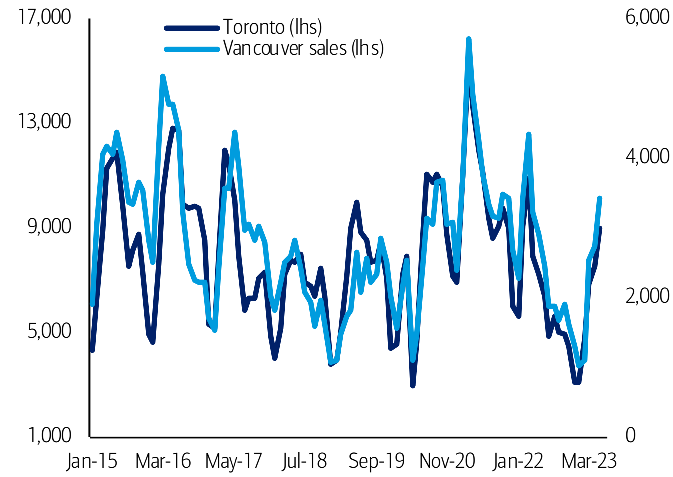
Exhibit 4: Toronto sales – 23% YoY YTD, Vancouver -33% YoY YTD
Toronto and Vancouver housing sales since January 2015



Source: BofA Global Research, TRREB, Vancouver Housing Board
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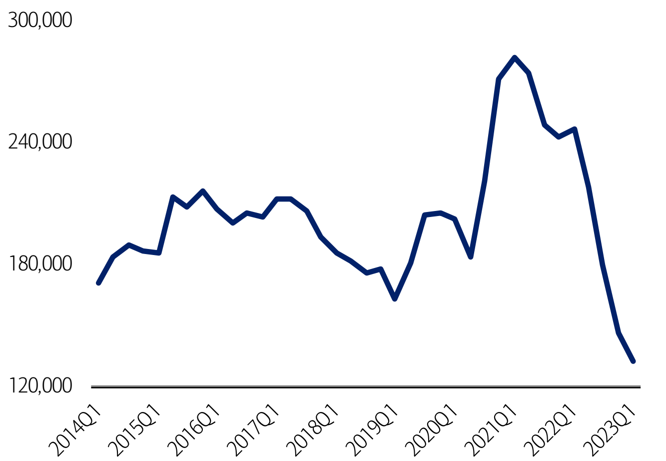
Exhibit 5: Mortgage originations are at a near decade low
Total mortgages originated in Canada



Source: BofA Global Research, Bank of Canada

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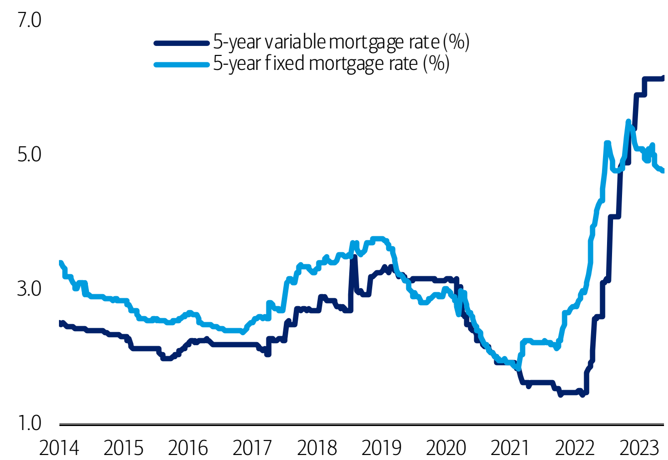
Exhibit 6: Mortgage rates are at a near decade peak
Canadian 5-year variable and 5-year fixed mortgage rate



Source: BofA Global Research, Bank of Canada, Lender Spotlight

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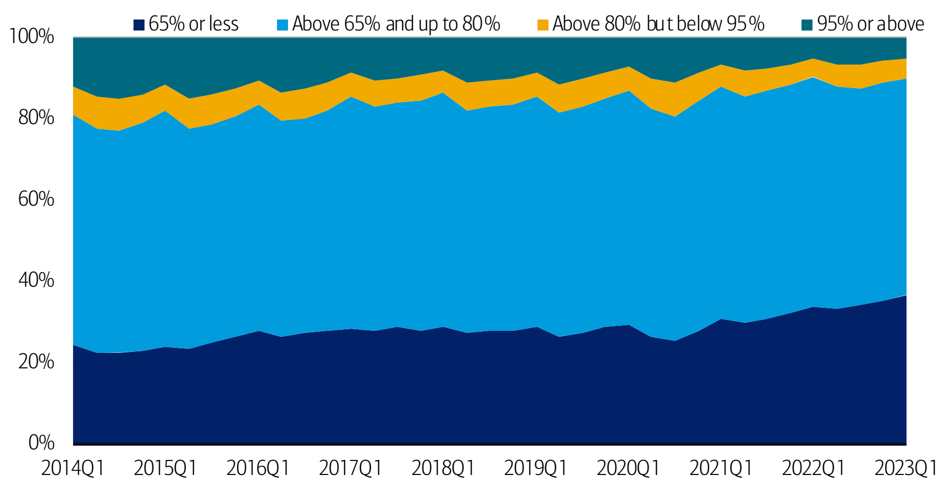
Exhibit 7: Over time, new mortgage LTV ratios have been decreasing
New mortgages by LTV



Source: BofA Global Research, Bank of Canada, TransUnion

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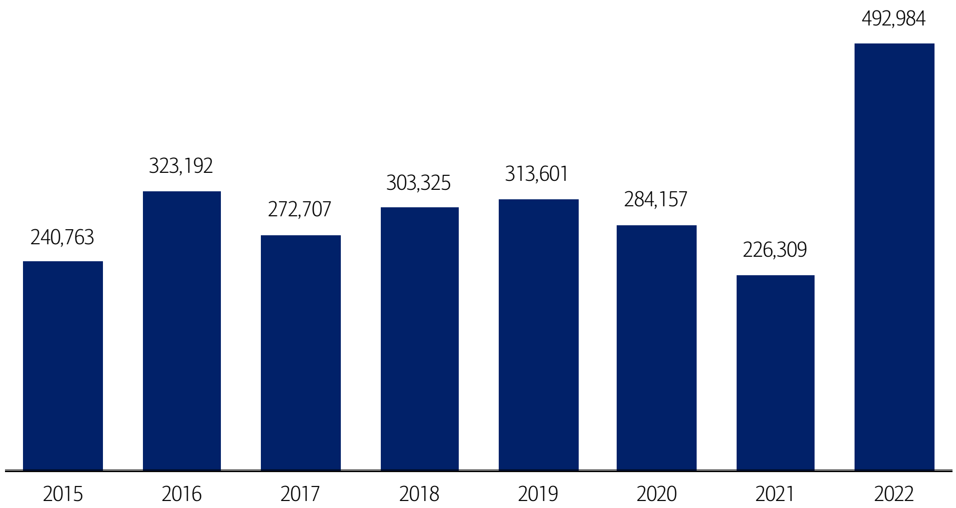
Exhibit 8: Immigration has picked up significantly from pandemic lows
Number of immigrants in Canada per year (from July 1st of previous year to June 30th of listed year)



Source: BofA Global Research, Statista

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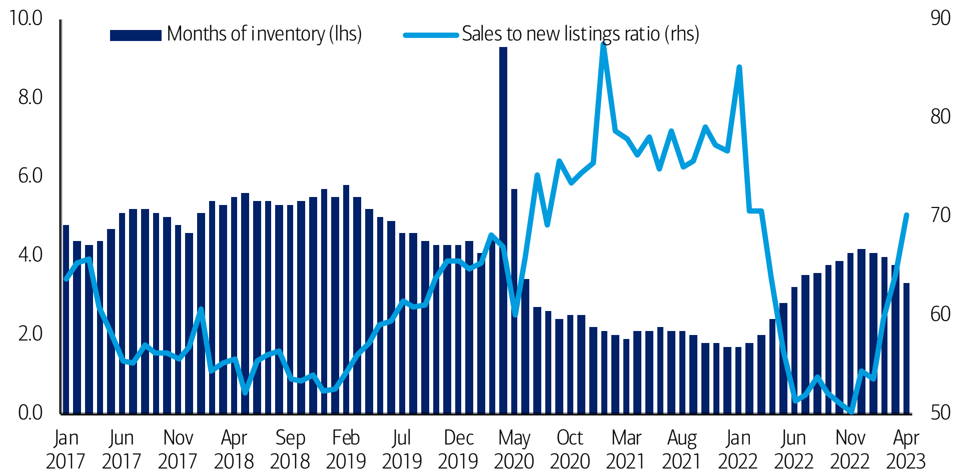
Exhibit 9: Apr. '23 months of inventory at 3.3 – above 1.7 trough, below pre-pandemic avg of 5.0
Canadian real estate market inventory vs. sales to new listings ratio



Source: BofA Global Research, CREA

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Exhibit 10: Expected house price increases are beginning to grow
Expected increase in avg. house prices over the next 12 months (%)

Source: BofA Global Research, Bank of Canada
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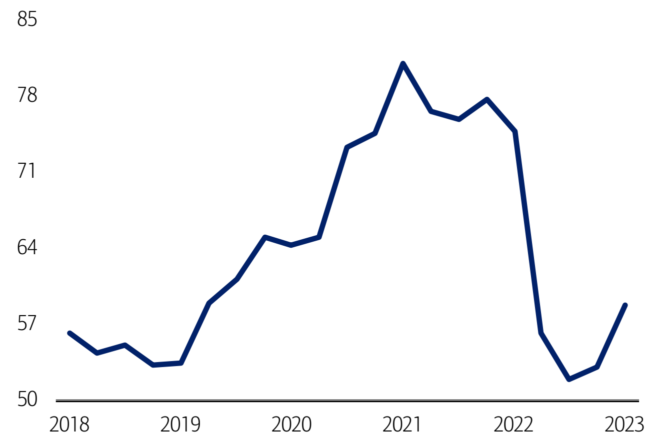
Exhibit 11: A rising sales/new listings ratio implies sellers are favored
Sales to new listings ratio (%)



Source: BofA Global Research, Bank of Canada, CREA
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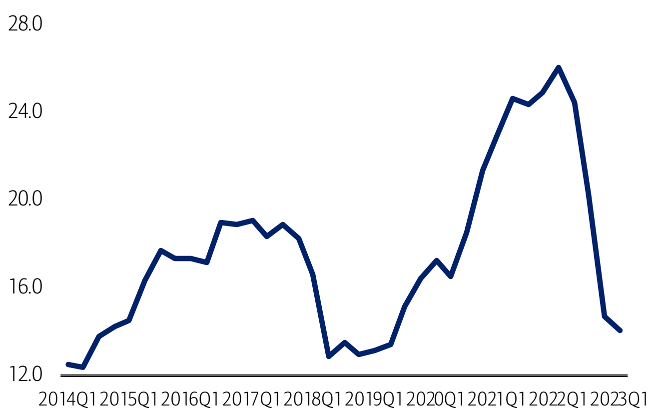
Exhibit 12: Amount of highly vulnerable households by LTI has fallen
% of all mortgages with a loan-to-income ratio above 450%



Source: BofA Global Research, Bank of Canada, TransUnion
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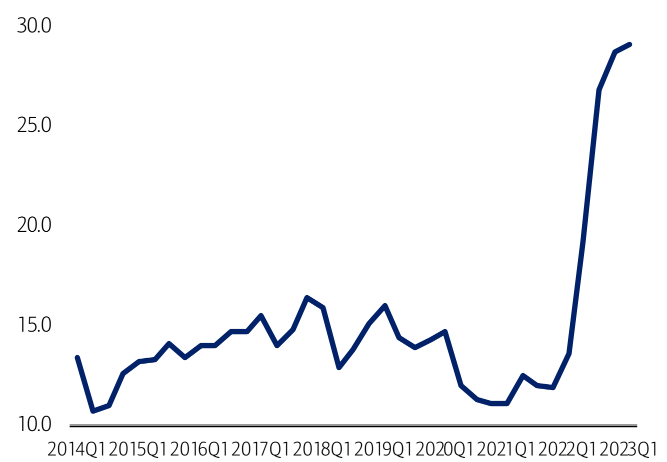
Exhibit 13: More households see >25% of income go to mortgages
Share of new mortgages (%) with a mortgage DSR >25%



Source: BofA Global Research, Bank of Canada, TransUnion
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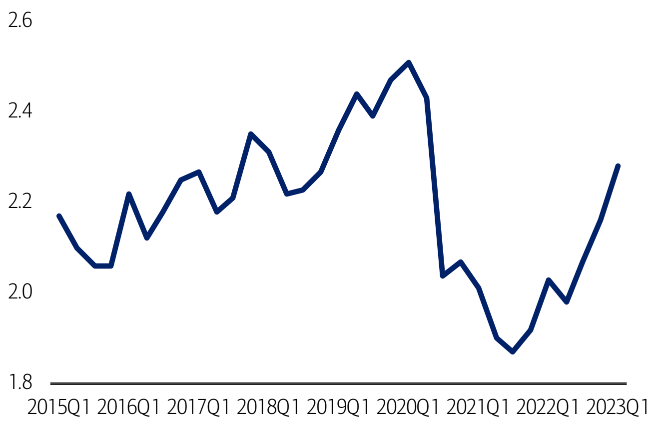
Exhibit 14: Households falling behind on payments continues to rise
Share of indebted households behind on payments for at least 60 days (%)



Source: BofA Global Research, Bank of Canada, TransUnion

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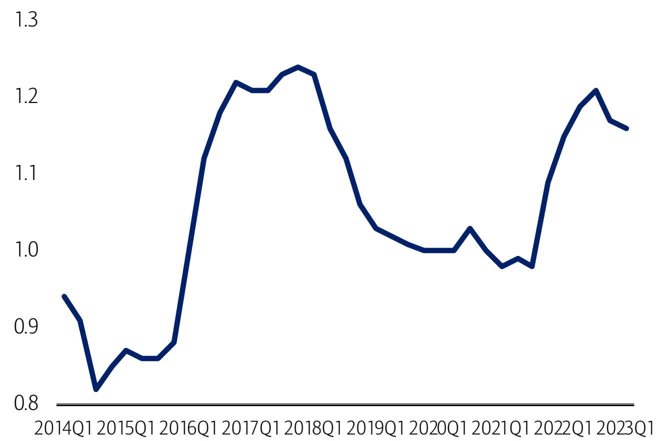
Exhibit 15: Speculation in the market beginning to cool off
Share of homes purchased and then flipped within 6 months (%)



Source: BofA Global Research, Bank of Canada, Teranet

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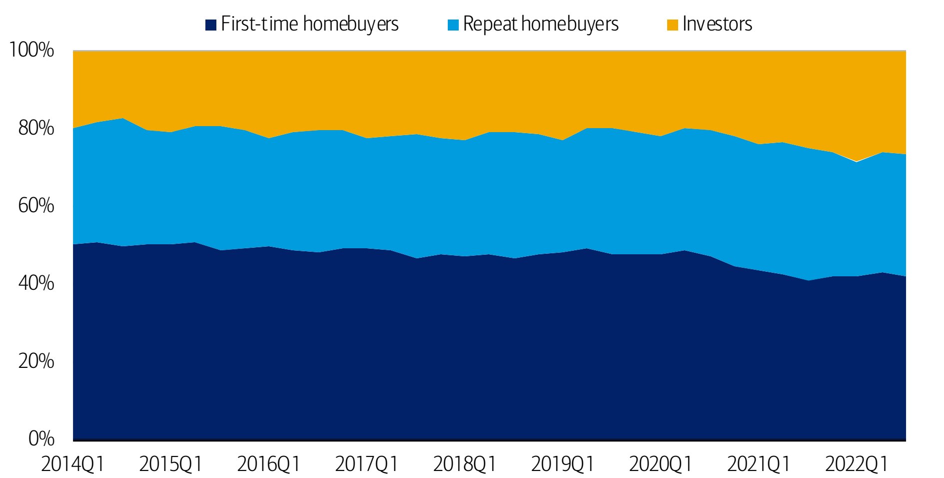
Exhibit 16: First-time homebuyers have lost share as the primary mortgaged homebuyer over time
Share of mortgaged home purchases by type of home buyer (%)



Source: BofA Global Research, Bank of Canada, TransUnion

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Underperform	N/A	≥ 20%

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