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Canada Housing Market Outlook: Housing Market Weathers the Storm, but the Pandemic Will Eventually Take a Toll

INTRODUCTION

Despite sustained weakness in the job market, house prices in June rose 0.9% over the previous month. Fiscal stimulus measures and mortgage deferrals, combined with low interest rates and Canada's strong demographics, have kept Canada's housing market marching ahead throughout the COVID-19 crisis. The housing market's vigor will fade as high unemployment and lower incomes will restrain buyers' return to the market.

House prices are set to fall from their current levels. However, the speed of the drop will vary considerably across provinces. All regions will experience price declines, but the Prairie provinces will register the most sizable peak-to-trough decline.

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BY ABHILASHA SINGH

Despite sustained weakness in the job market, house prices in June rose 0.9% over the previous month. Fiscal stimulus measures and mortgage deferrals, combined with low interest rates and Canada's strong demographics, have kept Canada's housing market marching ahead throughout the COVID-19 crisis. The housing market's vigor will fade as high unemployment and lower incomes will restrain buyers' return to the market. House prices are set to fall from their current levels. However, the speed of the drop will vary considerably across provinces. All regions will experience price declines, but the Prairie provinces will register the most sizable peak-to-trough decline.

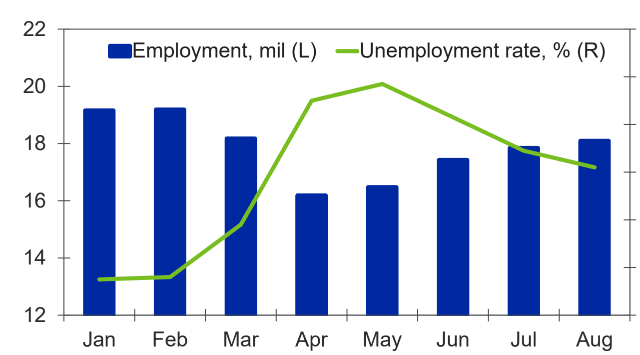
Recent performance

The effort to combat the spread of the COVID-19 outbreak left its mark on the Canadian economy. Canada's GDP contracted at an annualized rate of 38.7% in the second quarter—the worst decline on record. Unemployment soared to 13.7% in May, exceeding the record high of 13.1% from late 1982.

Residential construction came to a standstill in March and April in many parts of the country as lockdown and social distancing orders prohibited workers from entering job sites. Even in areas with few restrictions, demand for new homes collapsed overnight as buyers were cautious because of skyrocketing unemployment, economic uncertainty, and fears of contracting COVID-19. The total value of residential building permits in April was down 22% from February levels while home resales plunged a whopping 57% to 199,176 annualized units in April and newly listed homes declined by 56%.

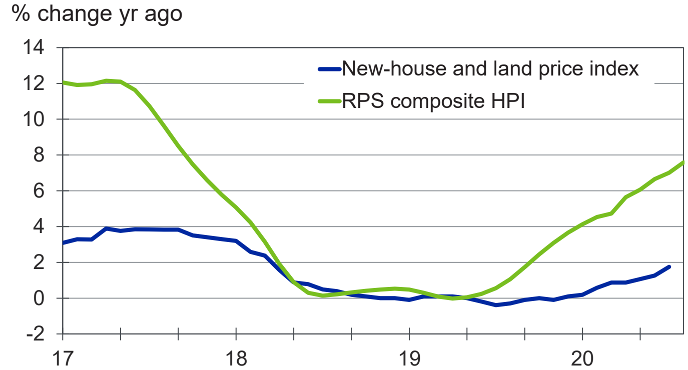
The rate of new COVID-19 cases has edged higher since bottoming out in early July as Canada's economy reopened, but the rate is holding stable at about a fifth

Chart 1: Labor Market Is Weak…



Sources: Statistics Canada, Moody's Analytics

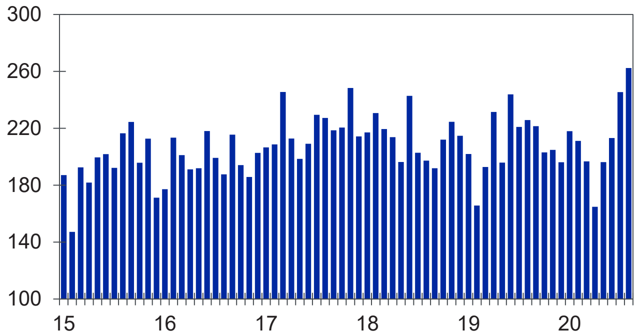
Chart 2: …Yet House Prices Rally



Sources: RPS, Moody's Analytics

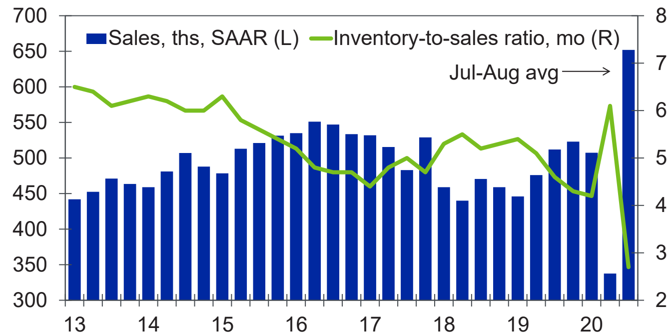
Chart 3: Construction Back to Normal

Housing starts, ths, SAAR



Sources: CMHC, Moody's Analytics

Chart 4: Housing Demand Bounces Back



Sources: CREA, Moody's Analytics

of its early-May peak. The reopenings have spurred job growth, yet employment in August was still lower than February's pre-pandemic high by more than 1 million jobs. Unlike the labor market, which remains in poor shape, the residential real estate market has not just weathered the crisis but thrived (see Charts 1 and 2).

Fiscal support such as unemployment assistance, onetime stimulus checks, and six-month deferrals on mortgage payments for troubled borrowers in the early months of the lockdown has preserved household balance sheets, and demand is rebounding.

Record low interest rates are also stimulating demand. The Bank of Canada has cut its benchmark interest rate for the third time since the pandemic started. The benchmark five-year mortgage rate has fallen from 5.04% in March to 4.79%, translating to greater purchasing power for homebuyers.

Construction activity has returned to pre-pandemic levels (see Chart 3). Annualized housing starts jumped to 262,000 in August from 226,000 a year earlier, marking the fastest pace of homebuilding since 2007. The August increase was primarily driven by multifamily starts, with urban multifamily starts up 27% on a year-ago basis. Urban single-family starts are rising but are still down 12% on year-ago basis.

Multifamily starts are seeing a relatively stronger recovery mainly because projects that were planned before the crisis are continuing given the development and planning costs. Builders have spent too much money on the projects to abandon them. This is particularly true for large multifamily ventures.

Home resales edged higher as provincial economies began to reopen and buyers and sellers became more comfortable transacting under social distancing rules. Home resales surged 26% month over month to an all-time high of 637,000 annualized units in July, largely due to pent-up housing demand during lockdowns (see Chart 4). 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.

New listings rose sharply Canada-wide in July. With demand outstripping supply, inventories have reached a record low of 2.8 months as homeowners who occupy their homes have declined to offer their residence for sale out of concern of being exposed to the coronavirus. The tightening in the housing market is also evident in the Canadian Real Estate Association's sales-to-new-listing ratio, a reliable gauge of price pressure; the ratio jumped to 0.74 in July, one of the highest levels on record for this measure.

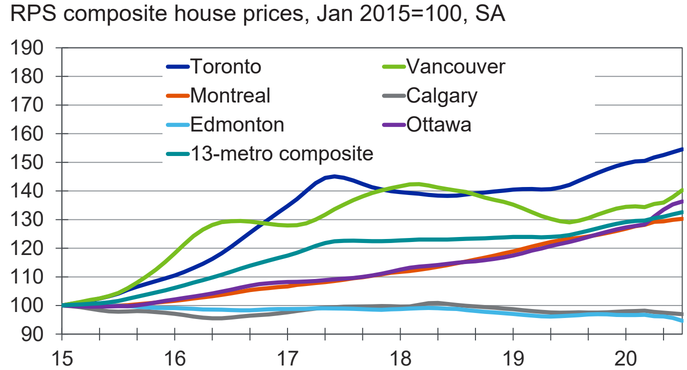
House price trends generally have held up since March despite the plunge in home resale activity as supply fell in tandem. House prices continue to rise with the RPS 13-metro area transaction-weighted composite house price index registering a monthly appreciation of 0.9% in August, boosting the year-over-year pace to 7.6%—the fastest pace since late 2017. High absorption of new homes is pushing up new-house prices. The new-house and land price index rose by 0.4% on a month-ago basis at the national level and by 1.8% year over year.

While house prices have been marching ahead, consumer debt performance has shown some signs of strain. Bankruptcy filings and insolvency proposals have been rising since late 2018. Further, Statistics Canada's mortgage debt service ratio at 6.7% of disposable income in the first quarter of 2020 is still high compared with 6.4% of disposable income in mid-2016.

Meanwhile, the BoC's housing affordability index—the cost of owning a home as a share of a household's disposable income—improved in the second quarter of 2020 after having deteriorated in the three prior quarters. However, the improvement in the

Chart 5: Toronto/Vancouver March Ahead

RPS composite house prices, Jan 2015=100, SA



Sources: RPS, Moody's Analytics

second quarter was mainly because of higher disposable incomes and lower mortgage rates which more than offset the increase in house prices.

Regional disparity

House price appreciation remains regionally asymmetric and will likely stay that way. Chart 5 shows the asymmetry of RPS transactions-weighted composite indexes for the six largest metro areas and the RPS 13-metro area composite index. House price dynamics have not changed much over the past six months. Montréal and Ottawa still show steady appreciation, while Calgary and Edmonton have been pulling down on the 13-metro area composite index. The national composite house price index is heavily influenced by sales in Toronto and Vancouver—two of Canada's most active and expensive housing markets. The indexes for Toronto and Vancouver recorded the largest 10-year price appreciation despite their policy-induced slowdown in 2017-2018 and have been gaining traction since mid-2019.

No province or metro area was immune to the historically sharp downturn, but the performance of the housing market is divergent. Provinces dependent on the energy sector—notably Alberta and Saskatchewan—were already dealing with soft market conditions. New single-family homes show dangerous signs of excess supply in Calgary and Edmonton. The share of first mortgages in arrears is also much higher for the Prairies than for Canada while housing starts are almost one-third below their year-ago levels, mainly due to elevated inventories of unsold new units in Alberta. And now they have been hit by the double whammy of COVID-19 and lower oil prices. Transaction-weighted composite house prices declined in Calgary by 0.6% and in Edmonton by 2.1% in August, reflecting the uncertainty in the energy sector.

In a stark contrast to the Prairies, the housing market is tight in Ontario. According to the Canadian Real Estate Association, several Ontario markets shifted from months of inventory to weeks of inventory in July. The recovery in residential starts has been striking in Ontario, mostly driven by multifamily construction.

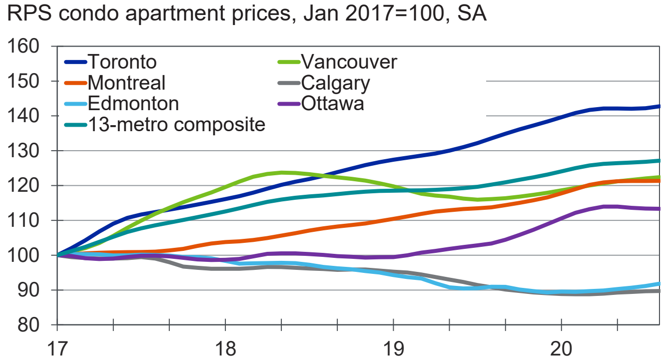
As per the Toronto Regional Real Estate Board's latest report, home resales jumped 40.3% from a year ago, largely because of strong sales of low-rise homes while new and active listings were up on a year-ago-basis. House prices in the Toronto metro area rose by about 10% on a year-ago basis throughout the COVID-19 crisis.

Ottawa and Montreal have had the hottest housing markets in Canada for the last few years. Market conditions are extremely tight because of robust sales activity and low inventories. House prices in Ottawa are up by about 12% on a year-over-year basis while Montreal house prices are up by 7.5%. New-home markets in Toronto, Ottawa and Montreal remain relatively tight and have not seen any increase in unabsorbed inventory.

In contrast, the pace of price appreciation for condo apartments in Toronto, Ottawa and Montreal slowed in the last few months (see Chart 6). The recent softness in the rental market in these three markets is in part due to weaker immigration.

Chart 6: Condo Market Plateaus

RPS condo apartment prices, Jan 2017=100, SA



Sources: RPS, Moody's Analytics

Vancouver continues to have the lowest affordability in the nation, followed by Victoria and Toronto. Though affordability is still a concern for these metro areas, it is no longer deteriorating. House prices in Vancouver have been rising since last summer and are now above their year-ago levels thanks to tight market conditions. According to the Real Estate Board of Greater Vancouver, home resales jumped 37% from a year ago while inventories are slightly above 4 months—well below their 10-year average.

The housing markets were mixed in the Atlantic metro areas. House prices in Saint John and St. John's declined at an increasing pace while the pace of appreciation strengthened in Moncton and Halifax. Housing starts in the Atlantic provinces slowed in August but were at a solid level by historical standards.

Policymakers' response

Though Canada's public health measures took a toll on the economy, they have been proving effective at minimizing the number of new coronavirus infections, even as restrictions on social activities were relaxed. For now, the trend in the daily number of new infections is holding below 500, about a quarter of its late-April/early-May peak and barely above its late-June shutdown-induced low.

The BoC is deploying extraordinary measures to maintain the normal functioning of credit markets and stimulate economic activity, far surpassing the steps taken in 2008.

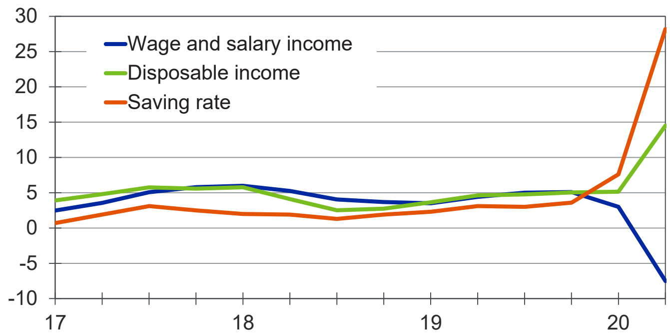
In total, the bank's balance sheet has swelled from C$120 billion to nearly C$550 billion, a nearly fivefold increase. Policymakers will not start raising rates until the recovery is well underway. This suggests that a move will not come before 2023.

In addition, Canada's largest banks and many other lenders have announced that borrowers struggling because of the COVID-19 crisis will be able to defer their mortgage payments for up to six months. And the Office of the Superintendent of Financial Institutions has suspended a change to its mortgage stress test that could have lowered the benchmark used to determine the minimum qualifying rate for borrowers with down payments of more than 20%.

Last, the government has extended the Canada Emergency Response Benefit payments to the end of 2020. A massive and mounting monetary and fiscal policy response is helping many households navigate the storm; despite an approximately 9% decline in compensation of employees—wage and salary income—disposable income surged nearly 11% in the second quarter (see Chart 7).

Chart 7: Stimulus Drives Disposable Income

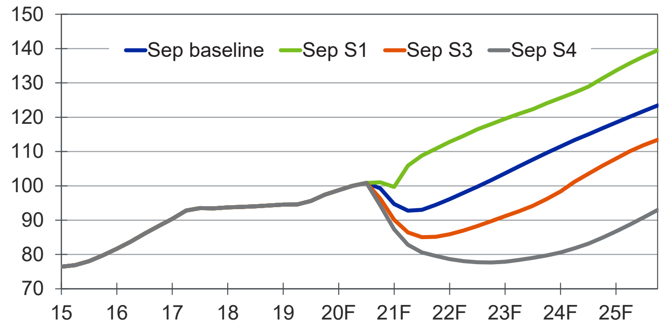
% change yr ago



Sources: Statistics Canada, Moody's Analytics

Chart 8: Housing Won't Escape Unharmed

RPS house price, by forecast vintage, 2020Q2=100



Sources: RPS, Moody's Analytics

Housing outlook

The fiscal stimulus measures and mortgage deferrals combined with low interest rates and Canada's strong demographics have kept Canada's housing market marching ahead throughout the COVID-19 crisis.

Moody's Analytics expects that the short-lived burst of growth in the third quarter will produce too few job gains to meaningfully reduce unemployment. Joblessness will still slightly exceed 9% by year's end.

The recovery is expected to lose momentum through the first half of 2021 as the U.S. economy stalls, the boost from stimulus fades, and credit problems crop up. Growth will regain momentum in the second half of 2021 as positive vaccine developments boost confidence and lockdown restrictions ease.

The housing market will no longer be able to escape the poor condition of the labor market as vacancy and delinquency rates rise in 2021. High unemployment and lower income will restrain buyers' return to the market. So will affordability issues in Vancouver and Toronto. Further, slower in-migration flows to Canada due to COVID-19 disruptions will weigh on housing demand. Not even lower interest rates will be enough to save the housing market.

Moody's Analytics expects Canadian house prices to suffer a peak-to-trough decline of about 7% under our September baseline scenario (see Chart 8). Building permits softened in July, portending some easing in the pace of homebuilding in the near term. Housing starts are forecast to decline to 151,000 annualized units by the third quarter of 2021, compared with 206,000 in the first quarter of 2020.

Fortunately, the declines will be brief and the restoration of robust job growth in 2022 along with Canada's strong demographics will put a floor under the housing market which mitigates the degree of the declines. Table 1 provides current Moody's Analytics macroeconomic and house price forecasts for Canada.

House prices are set to fall from their current levels nationally. However, the speed of the drop and recovery will vary considerably across provinces. The Prairie provinces are the most vulnerable (see Chart 9). The collapse in oil prices will only deepen and prolong the economic hardship for the oil-producing provinces. The impact on the Calgary and Edmonton housing markets will last longer than for the rest of the nation.

Housing affordability is still a big issue in Vancouver and Toronto, but the COVID-19 pandemic and economic turmoil will draw more attention to it in the near term. House prices continue to rise in both metro areas. However, the pace of appreciation has slowed in the condo apartment market. Rental vacancy rates will rise in Toronto and Vancouver as an increased supply of rental units coincides with a fall in demand due to disruption of migration to Canada.

Table 1: Canada Housing Market, History and Baseline Forecast

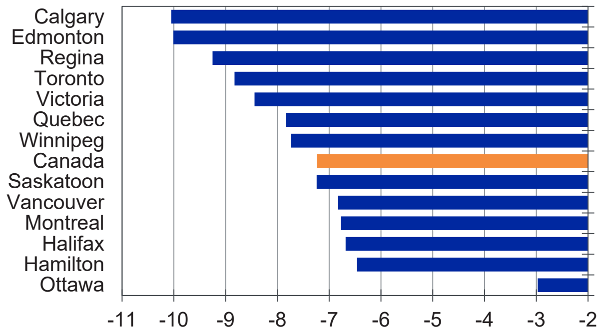
	Most recent, Q2*	2018	2019	2020	2021	2022	2023	2024	2025
Detached single-family house price index, % change	7.08	1.50	1.42	5.65	-6.72	4.64	7.49	6.73	5.78
Condo apartment price index, % change	6.18	9.13	3.32	4.75	-6.52	3.67	6.25	5.65	4.82
Composite house price index, % change	7.11	2.22	1.44	4.25	-10.2	4.18	8.29	7.74	6.09
Real per capita disposable income, % change	12.43	0.62	1.33	4.33	-2.09	1.73	1.1	0.87	1.19
Unemployment rate, %	13	5.83	5.67	9.65	8.56	7.5	6.87	6.7	6.68
Avg mortgage rate, 5-yr, %	3.86	4.36	4.25	3.64	3.31	3.91	4.58	5.23	5.61
Housing starts, ths	192.67	214.16	208.55	208.26	162.98	181.93	191.63	171.27	161.53
% change	-11.77	-2.92	-2.62	-0.14	-21.74	11.62	5.33	-10.63	-5.69
Ratio, median dwelling price/median family income	8.64	8.02	7.93	8.41	7.44	7.5	7.82	8.18	8.43
Ratio, outstanding mortgage debt/disp. income	1.04	1.16	1.15	1.11	1.09	1.02	0.98	0.96	0.94

*yr over yr

Sources: RPS, Statistics Canada, CMHC, Moody's Analytics

Chart 9: Downturn Will Be Uneven

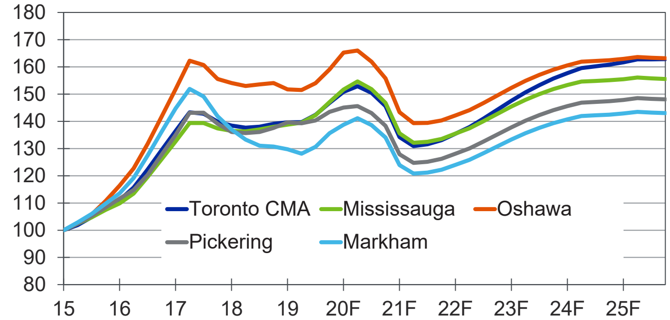
RPS HPI, forecast peak-to-trough decline, %, Sep vintage



Sources: RPS, Moody's Analytics

Chart 10: Disparity Within Toronto Metro

RPS composite house prices, Jan 2015=100, SA



Sources: RPS, Moody's Analytics

We expect greater resilience in lower-density markets outside Canada's large urban cores. The pandemic has boosted demand for properties offering more space for working from home and fewer shared areas with neighbors. Smaller markets where such properties are more affordable will particularly benefit from this trend. Trends may diverge even within urban cores, where the condo segment's prospects could be adversely affected by a drop in immigration. In Chart 10, we see the asymmetry in the forecasts across different subdivisions of the Toronto metro area. House prices in Oshawa rose at a faster pace because of higher house prices and lack of space in areas such as Mississauga, and we expect the trend to continue. Overall, Moody's Analytics expects that housing prices will start meaningfully recovering in early 2022.

Risks

The marks of the Great COVID Crisis of 2020 will be felt for years to come. Not only will the effects of the economic shocks to employment and income take years to be fully absorbed, but consumer preferences have permanently changed as a result of the health scare. The risks to the baseline forecast are weighted decidedly to the downside because of the numerous unknowns related to COVID-19.

The impending arrival of winter raises concerns that a return to indoor activities will exacerbate the spread of the virus. A second leg downward in the labor and financial markets caused by a renewed wave of COVID-19 this fall and winter could spur a greater than expected decline in house prices.

The development and broad deployment of a highly effective coronavirus therapy or vaccine remains the greatest wild card in the forecast. If a vaccine is delayed, then so too is the timing of the recovery.

The pandemic will lead to even further widening in economic inequality, including housing. In the long run, the housing market will depend on several factors, including consumer preferences for homeownership and the ability of families to save for a down payment. While demand for single-family homes with ample space and large pantries may rise, so too might demand for smaller apartments and condos given the struggle many families will face in saving for a down payment.

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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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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