In Focus

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ECONOMICS

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COVID-19 and Housing: What To Expect

by Benjamin Tal and Katherine Judge

The housing market is frozen. The reduced volume of transactions, alongside the fact that current transactions represent mostly forced deals, means that current market signals are of little value. Any analysis of the health of the housing market should look beyond today's numbers and focus on the near-term trajectory of the economy, and more so, on the nature of the economy into which the recovery will take place.

A Strong Starting Point

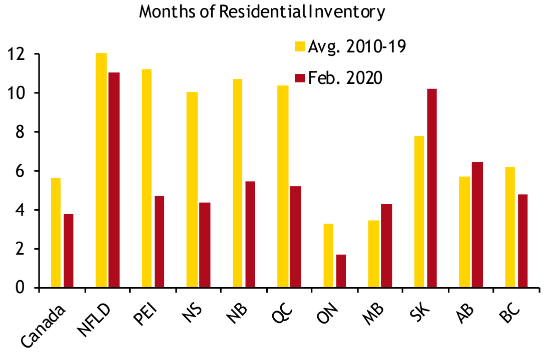
Let's start with the good news (and there isn't much of it). The housing market, in general, began the crisis on solid footing. By many measures, the level of activity was improving following an adjustment period that came after the implementation of the stress test. Against the backdrop of lower mortgage rates, national average home price growth had reached double digits on an annual basis, while unit sales were on an upward trajectory. Months of supply of units was at a post-recession low in February. But the national figures masked weakness still apparent in energy-producing regions. Home prices in Alberta and Saskatchewan were still on a subtle downward trajectory that started during the 2014 oil price shock, with months of supply in those markets still above their longer-term averages (Chart 1).

A Recessionary Recovery

Of course, you cannot make any housing market related predictions without having a working assumption about the nature of the economic recovery, near-term, and post-crisis. As illustrated in Chart 2, there is no reason to doubt the prediction that we are getting closer to the peak of the infection curve, based on the slower rate of growth seen in new cases.

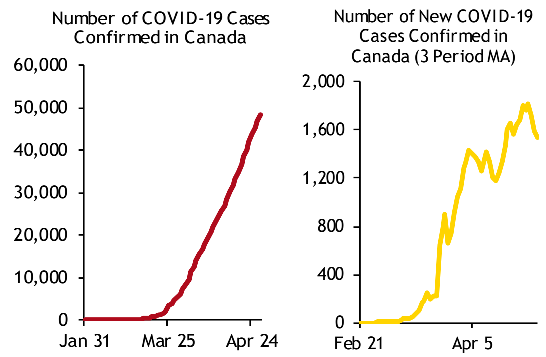
However, our working assumption is that a flattening of the virus curve will not be a green light to go back to normal. The risk is

Chart 1
Markets Outside of Energy-Producing Provinces Healthy Before COVID-19



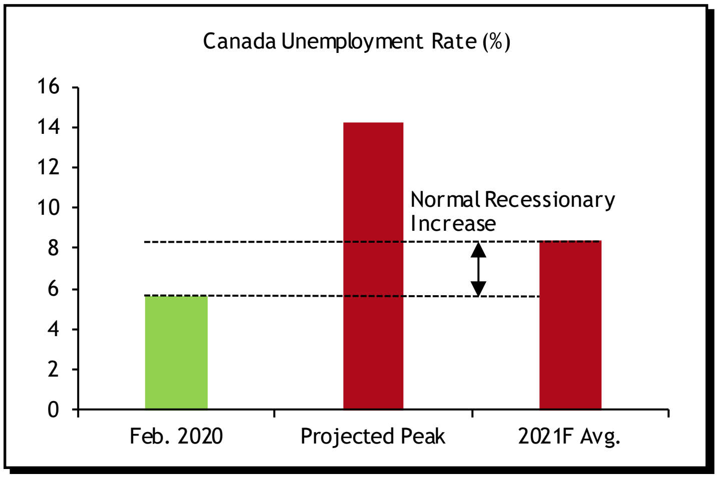
Source: CREA, CIBC

Chart 2
Cases of COVID-19 Still Rising (L), But at a Slower Rate (R)



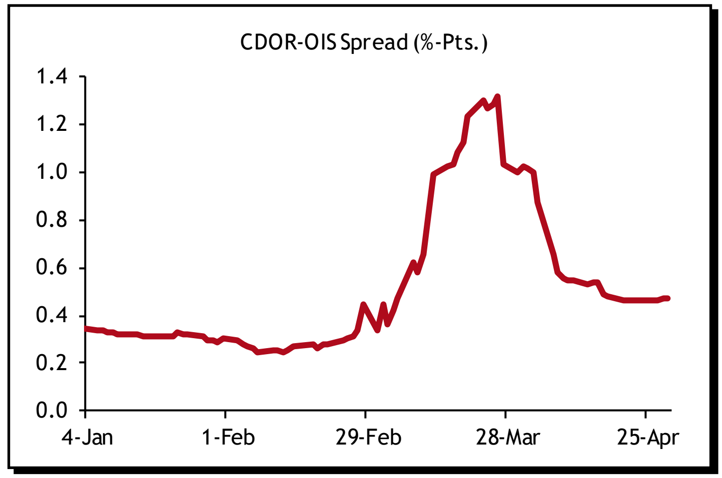
Source: Government of Canada, CIBC

Chart 3
Unemployment Rate Still In Recessionary Territory Even in 2021



Source: Statistics Canada, CIBC

Chart 4
BoC Commitment to Market Liquidity Has Eased Market Stress



Source: Bloomberg, CIBC

that any sign of a second wave of infection will lead to a partial restoration of social distancing rules, which in turn will increase volatility in the trajectory of the economic recovery. Furthermore, in the early stages of opening up, activity might not be as strong as potentially possible, since demand will not go back to normal. Simply put, reopening stores and restaurants does not mean that people will feel comfortable shopping and dining out again.

We expect this kind of volatile growth pattern to prevail in the coming few quarters, until a vaccine is available to all. But the economy of the post-vaccine era will be a different economy. The cumulative damage suggests that when we recover, potentially at one point in 2021, we will be recovering into recessionary conditions. The projected trajectory of the unemployment rate illustrates that point (Chart 3). We are currently in the process of seeing the unemployment rate rise from a pre-crisis rate of 5.5%, to north of 13%. The majority of that increase represents temporary layoffs, and many of those jobs will be regained as we start to recover. But no doubt, a portion of the damage we are witnessing now will be long lasting, as many small businesses will close permanently, and some larger corporations will reduce capacity. So, the move from 5.5% to 8% in 2021 is in line with a recessionary economic environment.

Implications for Housing

Given this scenario, it is clear that the housing market will face challenges in the coming 12-18 months. Granted, the unprecedented action taken by the Bank of Canada to lower borrowing costs and inject liquidity into the system is finding its way to lower mortgage rates (Chart 4). But the cost of borrowing is always secondary in an environment of low confidence, increased unemployment, and slower income growth.

In the coming few quarters, housing activity will dance to the volatile tune of economic activity. During that period, we expect continued reduced levels of activity, and an unreliable and volatile price mechanism. In the immediate period following the introduction of a vaccine, and as we enter the recessionary recovery period, we see the functionality of the housing market returning to normal, at a lower level of activity relative to its pre-crisis trend.

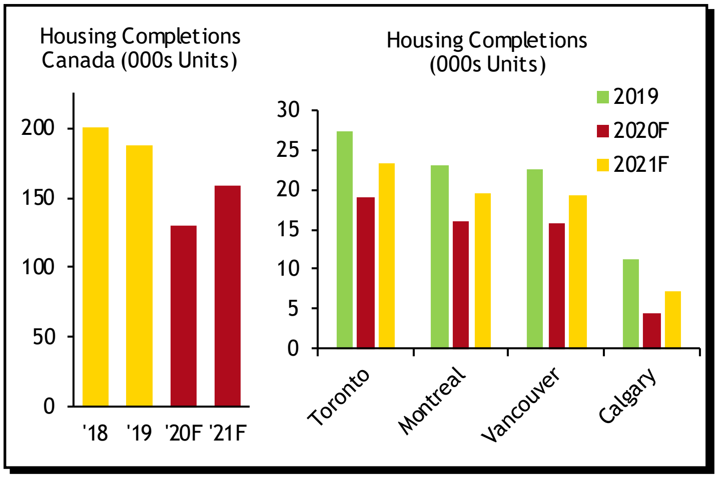
The following is a brief discussion of our expectations of different segments of the housing market.

Housing Completions and Starts

Following a relatively modest 190,000 completions in 2019, this year was supposed to see a record number of completions, led by the GTA, which was expected to see a record-high 29,000 completions in the high-rise segment of the market alone. This of course, is not going to happen. While work on above-grade construction sites is still permitted, productivity has been reduced dramatically. Developers report difficulties securing trades, social distancing site regulations are notably slowing the speed of construction, and overseas shipments of essential materials are slow to arrive. Overall, based on numerous conversations with developers, we estimate that site productivity is down by roughly 40%, suggesting

Chart 5

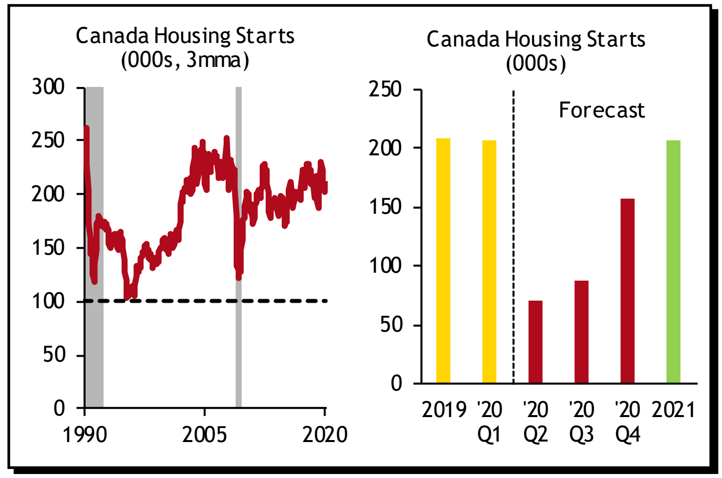
Housing Completions to Remain Strained Into 2021



Source: CMHC, CIBC

Chart 6

Housing Starts Held Up Better in Prior Recessions (L), Expected to Drop to Unprecedented Levels This Time (R)



Source: CMHC, CIBC

a significant delay in completions. We expect the number of completions to average close to 130,000 in 2020 and to remain below 2019 levels in 2021 (Chart 5). The extra cost resulting from that delay will only be partly offset by lower borrowing and construction costs, with uncertainty regarding supply chain related delays remaining an issue.

The delay in housing completions and reduced visibility in the coming quarters will have a significant negative impact on housing starts. Even during deep and painful previous recessions, housing starts in Canada didn't fall below an annual rate of 100,000 units (Chart 6, left). This time around, they will break that barrier. The deep freeze in the market suggests that in the coming months, housing starts will fall from above the 200,000 (annualized) level seen before the crisis, to around 70,000 in the second quarter, and with some luck, rise to 100,000 in the third quarter (Chart 6, right).

Adding to that slowing is a real possibility that some developers might choose to stall new site acquisitions in anticipation of discounted deals and opportunities following the crisis. We expect this trend to be more visible in the condo space in most major cities, with numerous project cancellations likely to be announced. Note that some of those cancellations would have occurred even in the absence of the crisis, as escalating costs of construction had reduced the economic viability of many projects. We also expect increased levels of joint ventures amongst established developers in an effort to defer and slow cash outlays while still keeping the development pipeline going.

Resale Market

The resale market is basically frozen. Sales and new listings in Toronto are down by 69% and 64%, respectively, on a year-over-year basis, as of the first few weeks of April. If you really don't need to, you probably aren't conducting any real-estate transactions at the moment. Therefore, the price signal that we are getting from recent data is both weak and misleading. To get a reliable price signal, you need a large pool of transactions. Today's sample is way too small, and biased due the dominance of forced transactions.

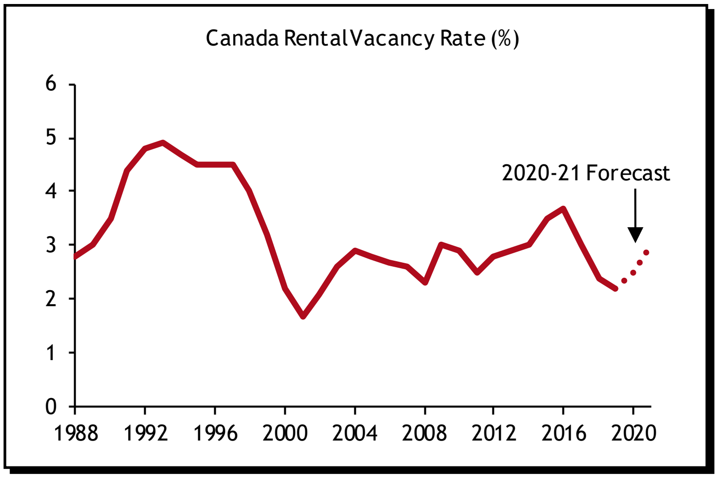
The expected volatility in overall economic activity in the coming quarters will not skip the resale market. Look for large swings in both demand and supply here. By 2021, as the economics of housing returns to fundamentals, we expect an array of factors to result in a weaker market with some downward pressure on prices. Demand will be reduced by a weak labour market and weaker investment activity. Forced sales will add to supply, and probably outweigh the offsetting impact of reduced supply of new units. Overall, as the fog clears, we expect to see average prices 5-10% lower relative to 2019 levels, with high cost units in the high-rise segment of the market seeing the most notable price declines.

Rental Market

The fundamentals of the rental market in the period preceding the crisis were extremely strong. The national rental vacancy rate had fallen to a 17-year low, helped by a drop in that measure for markets ranging from

Chart 7

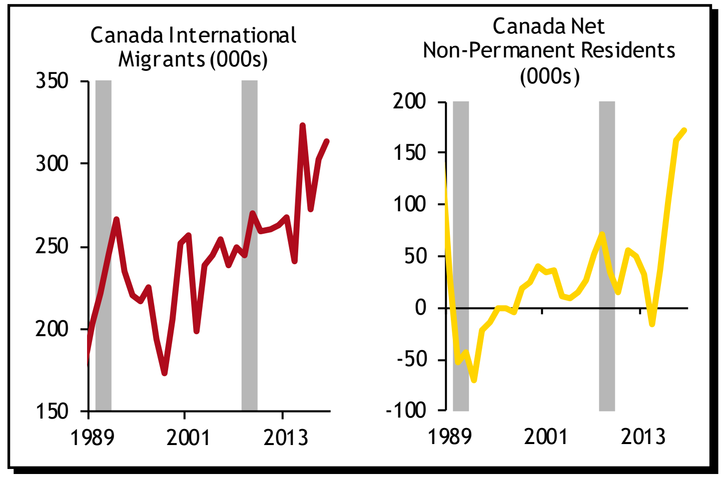
Rental Vacancy Rate to Rise Modestly



Source: CMHC, CIBC

Chart 8

Immigration Continues Upward Trend During Recessions (L), NPRs Not So Much (R)



Source: Statistics Canada, CIBC

Montreal to Halifax, with solid population growth being a main factor behind that. In turn, rent inflation registered a record breaking 5.2% annual pace at the national level last year, with Ontario and BC seeing even faster inflation. Fragility was still apparent in the Alberta and Saskatchewan markets, which will be exposed further during this crisis.

Currently, the market is on hold, with the focus being on non-payment rates and potential government policies aimed at assisting tenants, possibly in line with the program aimed at providing a rental solution to small businesses. Beyond the immediate future, we expect an array of conflicting forces to result in a somewhat softer market. Reduced demand, and higher supply due to the conversion of short-term rental units to long-term rental units, will more than offset the reduced supply resulting from a lower completion rate, reduced purpose-built activity, and weaker investment activity (Chart 7).

The key here is the role of new immigrants and non-permanent residents (NPRs) in reduced rental demand. In the near future, in the absence of a vaccine, it is reasonable to assume that the number of new immigrants and NPRs allowed into Canada will be reduced significantly. In 2019, that number amounted to close to 540,000. Beyond the near-term, and as we enter the recessionary recovery period, we expect the number of new immigrants to gradually resume its upward trend, as was the case in any previous recession, but look for the number of NPRs to edge lower (Chart 8).

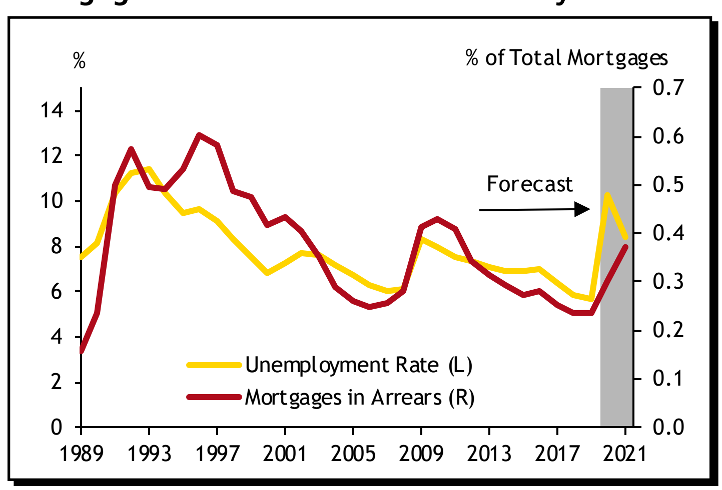
Mortgage Growth to Slow, Moderate Upward Pressure on Arrears

Mortgage activity was hardly booming during the months leading up to the crisis, with the implementation of the mortgage qualification stress test limiting annual growth in mortgages outstanding to just over 5%. With reduced levels of housing market activity, purchasing-related growth in mortgages outstanding is expected to slow notably in the coming quarters, while refinancing activity is expected to accelerate. Importantly, we expect to see a significant slowing in mortgage credit provided by alternative lenders as some players in that space will face difficulties rolling renewals over in an illiquid market.

Furthermore, elevated levels of debt carried by Canadian households will work to amplify the negative shock to

Chart 9

Mortgages in Arrears to Rise Moderately



Source: CBA, Statistics Canada, CIBC

incomes seen from job losses, which will be displayed in a notable increase in the number of mortgages in arrears. We do not expect that increase to occur during the course of this year, as mortgage payment deferrals will work to delay the deterioration. We estimate that at this point, more than four weeks following the introduction of the program, between 10 and 15% of mortgage borrowers have deferred payments. By 2021 however, as the unemployment rate stabilizes at north of 8%, we expect to see the arrears rate rise to just below 0.4% (Chart 9). That level is somewhat lower than suggested by the historical relationship between the unemployment rate and mortgage arrears, as the majority of job losses is expected to be amongst renters, while some of the existing income support from government programs might be extended.