Special Report

Economics and Strategy

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

Is Canadian residential real estate teetering on the brink?

Matthieu Arseneau / Alexandra Ducharme

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Summary:

- In recent weeks a number of observers have chimed in on the current housing market. Some say the market is likely to prove resilient, as in the past. Others worry about a sharp drop in home prices – the CMHC has forecast a decline of 9% to 18%. The great range of the prognoses reflects high uncertainty. For our part, though we do not expect a U.S.-style slump, we foresee a marked drop in prices, about 10%, sharper than in any of the country's last three recessions. In this note we set out the considerations entering into our forecast.

- More than one-fifth of Canadian employment is in sectors likely to find the going tough in coming months – retailing, the accommodation and restaurant industries, arts and entertainment. To us this suggests an unemployment rate in the neighbourhood of 9% over the coming year. Yet these job losses could affect the housing market less than might be thought. The homeownership rates of workers in these trades are among the lowest of all sectors

- So why do we see a sharp decline of Canadian home prices? Because in past recessions, substantial declines in interest rates have favoured stabilization of the housing market, but this time the effect of monetary policy could be much smaller. Interest rates were already very low before the crisis, and given the zero lower bound for central banks, they have very little room to move lower.

- Under current conditions there is another factor that could crimp the housing market. Tourism is likely to be slow for some time, and the possibility cannot be excluded that lodgings currently marketed to tourists on short-term-rental platforms such as Airbnb will be put up for sale for lack of revenue.

- We continue to think the risk of a housing-market slump on the scale of the U.S. bust is low. Unlike the housing boom that preceded the U.S. bust – a boom spurred by relaxation of mortgage-granting standards – the vigour of the Canadian market over the last decade was fuelled by demographics. Moreover, the U.S. crisis was amplified by a wave of strategic defaults. Such a phenomenon is less likely in Canada because the great majority of mortgage loans provide for recourse, in contrast to the no-recourse loans widespread in the U.S.

- On the other hand, there are risk factors in our scenario that could deepen the slide of home prices. For one, a larger-than-expected reduction of immigration in coming quarters. For another, a rise in the minimum down payments as suggested by the CMHC May 15 could lead us to revise down our forecast.

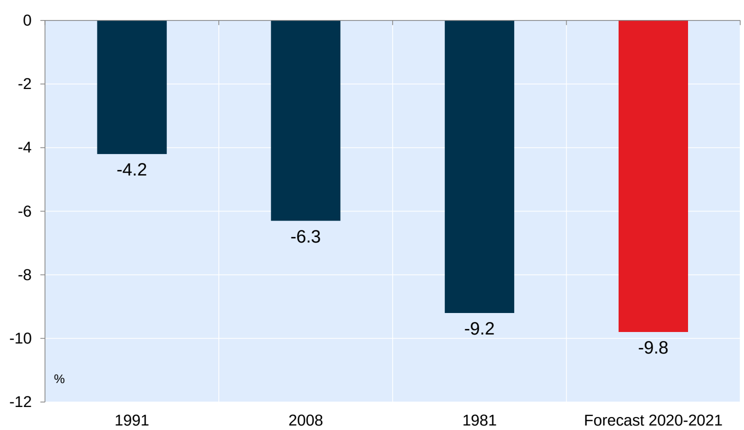
- The home-price declines of our baseline scenario vary from city to city. Among Canada's four largest metropolitan markets, for example, the 7% drop we see for Montreal is less than those we posit for the other three. In Toronto, where we see −13%, and Vancouver (−12%), affordability has been a bigger issue. Calgary, meanwhile (−10%), has been hit by the double whammy of lockdown and oil-price collapse.

Is Canadian residential real estate teetering on the brink?

Since the recession of 2008-09, the Canadian housing market has been seen by some as a vulnerability for the financial system. The sharp contraction of the economy caused the Covid-19 pandemic and its effect on the labour market suggests that the unemployment rate could remain high for some time. In these conditions, what will become of Canadian real estate and home prices?

In recent weeks a number of observers have chimed in on the current housing market. Some say the market is likely to prove resilient, as in the past. Others worry about a sharp drop in home prices – the CMHC has forecast a decline of 9% to 18%. The great range of the prognoses reflects high uncertainty. For our part, though we do not expect a U.S.-style slump, we foresee a marked drop in prices, about 10%,[1] sharper than in any of the country's last three recessions (chart). In this note we set out the considerations entering into our forecast.

Canada: Perspective on home prices in recessions
Home-price declines in the last three recessions and NBF forecast for 2020-21

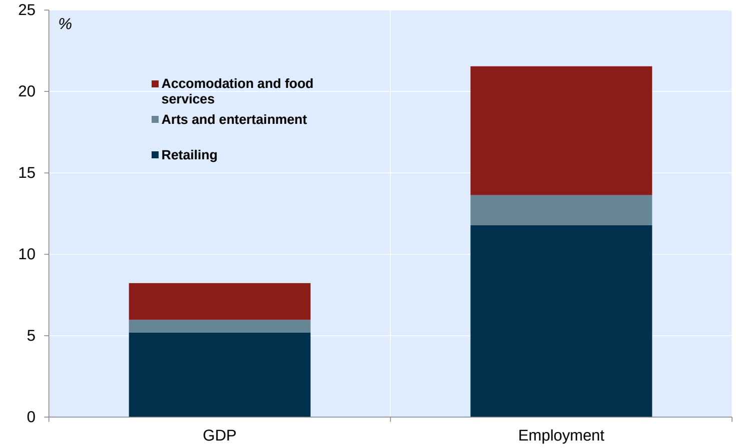


NBF Economics and Strategy (OECD data)

Severe unemployment

The shutdown of non-essential services imposed by the government to reduce the spread of Covid-19 has cost 3 million jobs and a rise of the unemployment rate from 5.6% in February to 13% in April. Though the economy is likely to begin recovering in May as physical distancing measures are gradually lifted, idle labour capacity is likely to persist for some time. More than one-fifth of Canadian employment is in sectors likely to find the going tough in coming months – retailing, the accommodation and restaurant trades, the arts and entertainment industries (chart). To us this suggests an unemployment rate in the neighbourhood of 9% over the coming year.

Canada: Perspective on sectors at risk
Selected industries: % of GDP and % of employment (2019 average)



NBF Economics and Strategy (Statistics Canada data)

Yet these job losses could affect the housing market less than might be thought. The homeownership rates of workers in these trades are among the lowest of all sectors (chart). So are the rates of mortgage-holding. In other words, the rise of the unemployment rate this time around could have less effect on the housing market because of the concentration of job losses in these sectors.

Canada: Rates of homeownership and mortgage-holding by occupation

Industry of primary household maintainer	Homeownership rate of household %	Proportion of households with a mortgage %
Utilities	86.8	64.8
Mining, quarrying, and oil and gas extraction	84.2	63.6
Agriculture, forestry, fishing and hunting	82.4	45.8
Public administration	76.7	58.9
Wholesale trade	75.4	55.0
Finance and insurance	75.3	57.2
Manufacturing	73.4	54.1
Construction	72.5	53.4
Real estate and rental and leasing	72.1	48.6
Professional, scientific and technical services	71.6	50.4
Educational services	71.6	52.4
Transportation and warehousing	70.8	53.2
Health care and social assistance	64.9	48.9
Information and cultural industries	64.4	49.8
Other services	63.3	44.6
Retail trade	60.4	43.3
Arts, entertainment and recreation	59.8	40.4
Administrative and support services	52.9	38.1
Accomodation and food services	43.6	32.2
Total employees	68.6	50.1

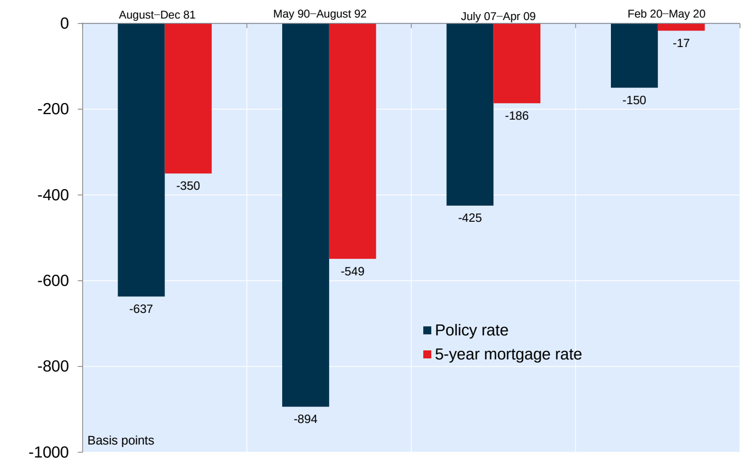
NBF Economics and Strategy (Statistics Canada data, 2016 census)

So why do we see a sharp decline of Canadian home prices? Because in past recessions, substantial declines in interest rates have favoured stabilization of the housing market, but this time the effect of monetary policy could be much smaller. Interest rates were already very low before the crisis, and given the zero lower bound for central banks, they have very little room to move lower. The 5-year mortgage rate has declined only 17 basis points from the beginning of the present

[1] From the peak to the trough (2020–2021), on a quarterly basis, of the Teranet–National Bank National Composite House Price Index.

crisis, which is very little compared to the declines of other recessions (chart).

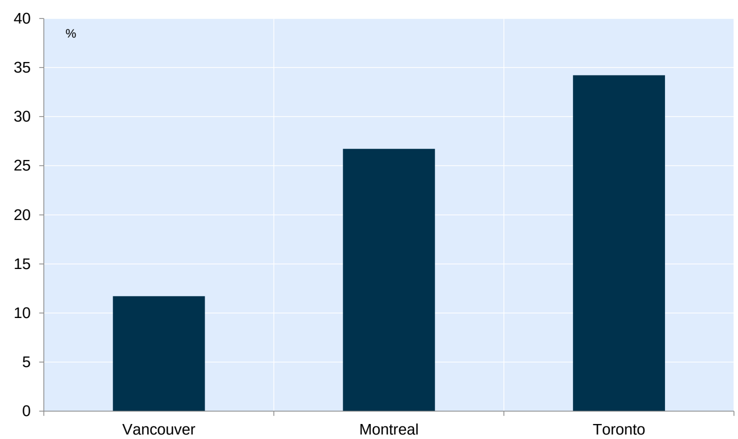
Canada: Past phases of monetary easing in recessions
Changes in policy rate and in 5-year mortgage rate



NBF Economics and Strategy (Statistics Canada data)

Under current conditions there is another factor that could crimp the housing market. Tourism is likely to be slow for some time, and the possibility cannot be excluded that lodgings currently marketed to tourists on short-term-rental platforms such as Airbnb will be put up for sale for lack of revenue. If 25% of Airbnb rental properties were put on the market, they would boost listings 34% in the Toronto market, 27% in Montreal and 12% in Vancouver, exacerbating oversupply in the coming months (chart).

Potential effect of Airbnb properties on resale market listings
Percentage increase in listings if 25% of Airbnb properties were on sale

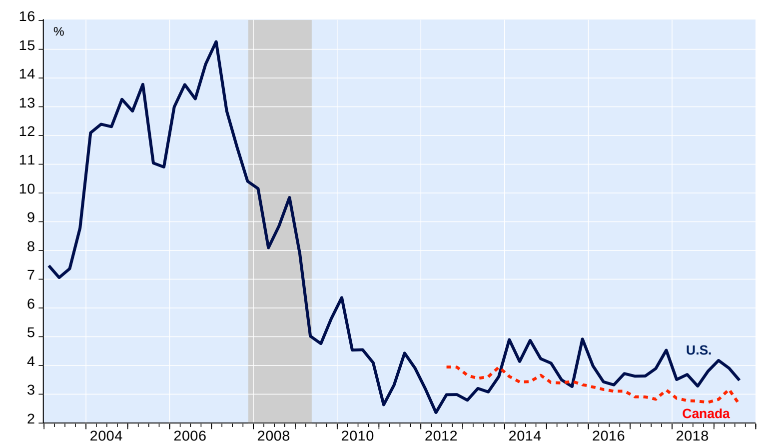


NBF Economics and Strategy (data via insideairbnb.com, CIGM, TRREB, REBGV)

A U.S.-style slump?

We continue to think the risk of a housing-market slump on the scale of the 35% drop in U.S. home prices from 2006 to 2012 is low. Unlike the housing boom that preceded the U.S. slump, a boom spurred by relaxation of mortgage-granting standards, the vigour of the Canadian market over the last decade came not because of a relaxation, but in spite of a tightening, of mortgage-granting standards. Maximum amortization period was shortened, minimum down payments were increased and stress-testing qualifying interest rates were raised (see annex for more details). In addition, Canadian financial institutions remained prudent during this expansion, as attested by the proportion of new loans granted to borrowers with low credit ratings. This proportion was stable during the period at one-quarter the U.S. average of the years 2004 to 2007 (chart)

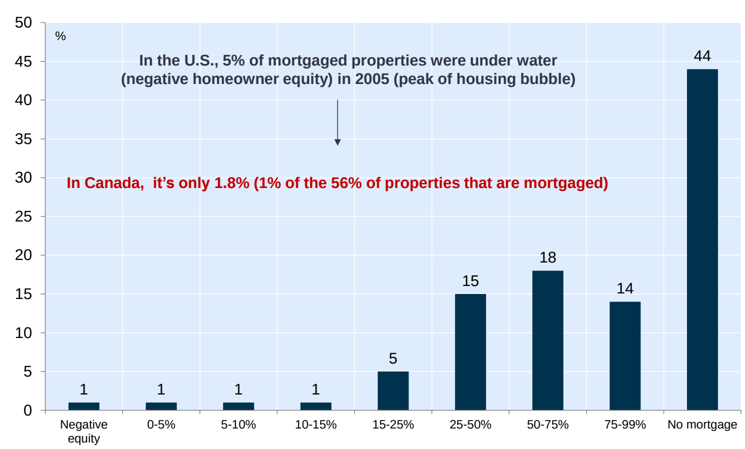
Canada: No slackness in mortgage-granting standards
% of mortgage loans granted to homeowners with low credit ratings (<620)



NBF Economics and Strategy (data from Equifax and New York Federal Reserve)

Moreover, the U.S. crisis was amplified by a wave of strategic defaults. Such a phenomenon is less likely in Canada because the great majority of mortgage loans provide for recourse, in contrast to the no-recourse loans widespread in the U.S. Also, the proportion of mortgage holders with negative equity is currently 1.8% in Canada, one-third of the percentage prevailing at the height of the U.S. bubble (chart). By our calculations, a 10% decline in home prices would put only 3% of Canadian homeowners under water.

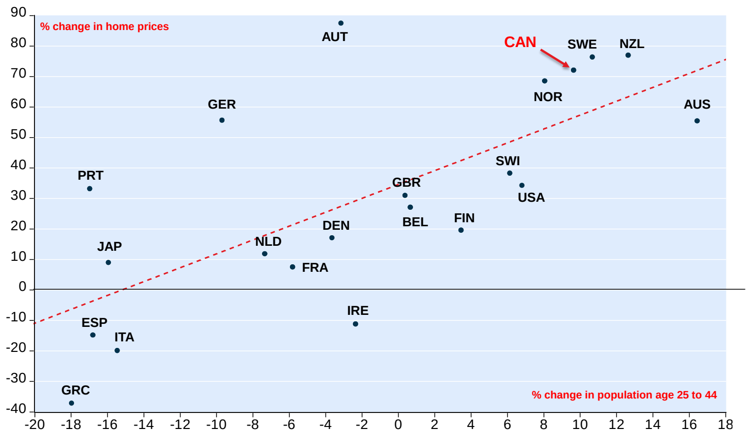
Canada: Perspective on risks of strategic default
Distribution of homeowners by % equity in value of home



NBF Economics and Strategy (data via Mortgage Professionals and Attom)

The vigour of the Canadian housing market in recent years has been fuelled by demographics. Canadian immigration policy is unique in both its dynamism and its predilection for "economic" immigrants (see our Special Report of February). Year in, year out, about 60% of immigrants are in this category, i.e. selected for their ability to integrate quickly into the labour market. Moreover, immigration has never before been so concentrated in the cohort aged 25 to 44, crucial for household formation. The trend of this cohort is a key determinant of divergences among countries in the trend of home prices since 2008 (chart). In every country, including Canada, where this cohort grew more than 8% over the 11 years from 2008 to 2019, home prices rose at least 50%.

Canada: The key role of demographics in the housing market
Change in population aged 25 to 44 vs. change in home prices, 2008-2019

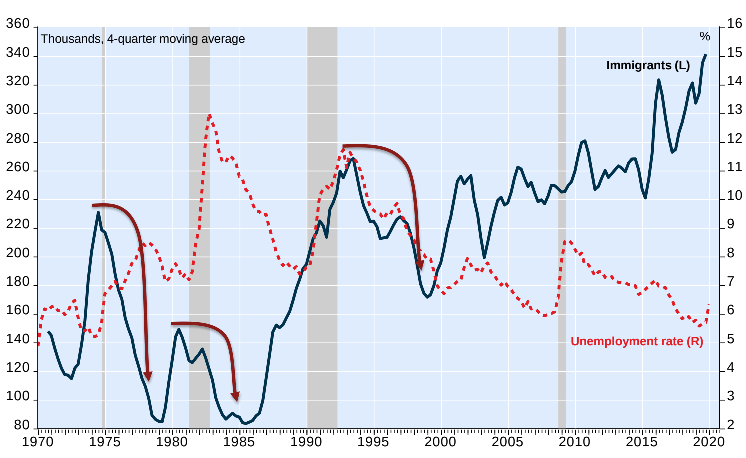


NBF Economics and Strategy (data from U.S. census, Statistics Canada, Eurostats, OECD)

Risk factors

There are risk factors in our scenario in addition to a worse-than-anticipated economic contraction. As mentioned above, immigration has steadily supported the housing market in recent years. For now, there is nothing to indicate that the government intends to change immigration quotas, but Washington's suspension of immigration to the U.S. has highlighted such a risk. Though Canadian immigration quotas were not reduced in the last recession, we note that in each of the last three recessions, immigration declined in the face of a tough labour market (chart).

Canada: Immigration and unemployment rate, 1970–2019



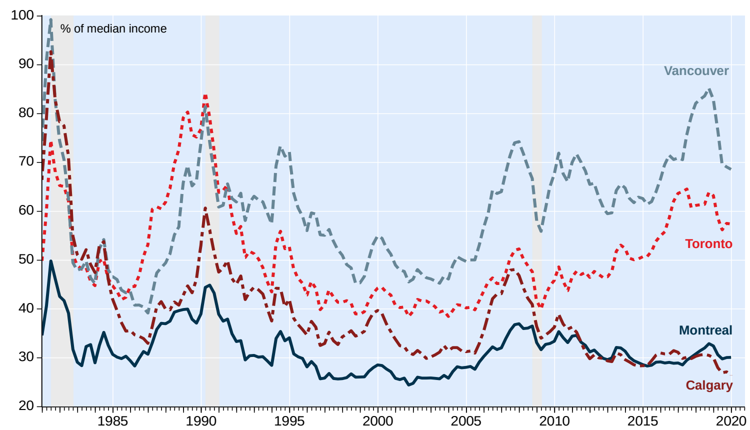
NBF Economics and Strategy (Statistics Canada data)

Another risk to our scenario of a decline of only 10% in Canadian home prices is the possibility of tightened restrictions on eligibility for credit. The CMHC surprised observers May 15 by suggesting the possibility of raising minimum down payments to limit possible losses on its loan guarantees. In our view, such a policy in a time of recession would amplify the risk of home-price deflation by excluding potential homebuyers whose savings for a down payment have taken a hit in financial markets. We think the government should instead consider relaxing its financial-stability measures of recent years to lower the risk of sending home prices into a nosedive.

Regional divergences

The home-price declines of our baseline scenario vary from city to city. Among Canada's four largest metropolitan markets, for example, the 7% drop we see for Montreal is less than those we posit for the other three. In Toronto, where we see −13%, and Vancouver (−12%), affordability has been a bigger issue (chart). Calgary, meanwhile (−10%), has been hit by the double whammy of lockdown and oil-price collapse.

Canada: Housing affordability since 1981 in four largest markets
Monthly mortgage payment on median-priced home (25-year amortization, 5-year term)

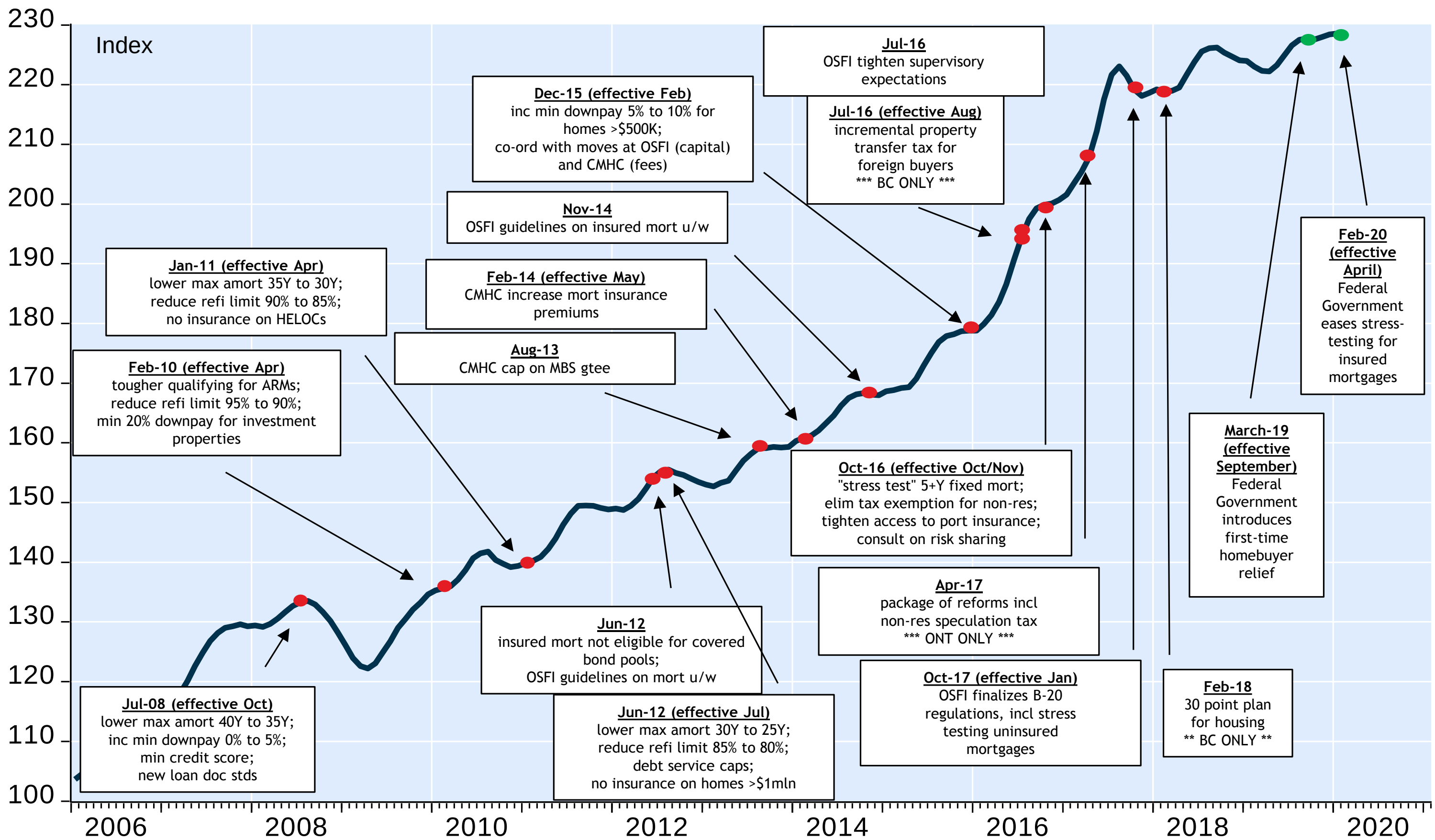


NBF Economics and Strategy (data from Statistics Canada, Teranet–NBC, CREA)

Annex

Canada: Perspective on macroprudential measures

Teranet-National Bank home price index and timing of measures



NBF Economics and Strategy (data via Teranet/National Bank)

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Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Krishen Rangasamy
Senior Economist
krishen.rangasamy@nbc.ca

Paul-André Pinsonnault
Senior Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault
Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rate Strategist, Economics and Strategy
warren.lovely@nbc.ca

Taylor Schleich
Associate, Rates Strategist, Economics and Strategy
taylor.Schleich@nbc.ca

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