Housing Market Digest

Canada, October 2022

Interest Rates

In March 2020 I gave myself permission to quit forecasting, and decided that it's better to talk about risks. So, I am now seeing an elevated risk that by next spring Canada could be in a severe recession, which could cause the loss of as much as one-half million jobs. Current excessive interest rates might cause economic devastation for a lot of Canadians. I see multiple paths to that.

- One of those paths, which is getting a lot of attention, is the financial distress that will be experienced by some people renewing mortgages or as the result of sharp, unexpected and unplanned-for rises in the costs of floating rate finance (mortgages, HELOCs, and other consumer finance).
- But, even more important in this risk assessment is job losses. Most home owners can find a solution to higher debt service costs – so long as their income is uninterrupted. But, when a job is lost, ability to service debts can be severely impaired.
- A third part of the path to a recession is that asset values (home prices and values of investments) have fallen sharply. Wealth effects (positive or negative) take time to play out. Reduced confidence causes reduced spending: this is where the risk of substantial job losses could originate in the coming months.
- There is no guarantee that asset values have bottomed.
- If we start to see material amounts of job losses late this year/early next year, there could be cascading economic consequences - a downward spiral involving the economy, the housing market, and asset values.

I have been arguing for a while that the attempt by the Bank of Canada (and other central banks) to reduce inflation by depressing demand is wrong-headed, because the inflation is originating from supply-side issues. Depressing demand won't fix those problems - it will make them worse, because the higher interest rates will make it harder to fix the supply issues. ***As part of this, in five years the housing supply crisis will be even worse.***

Comparing the Costs of Owning and Renting

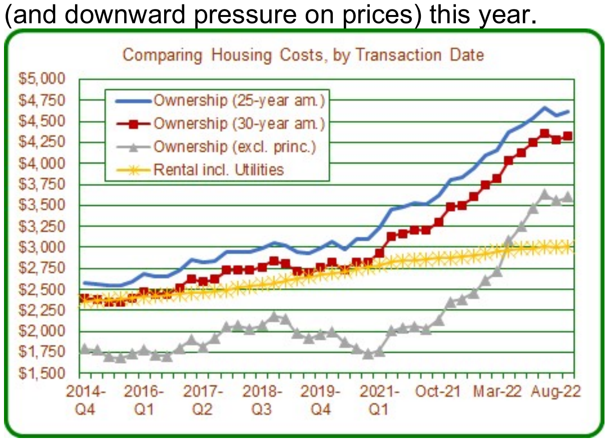
In September last year, I published a report (sponsored by Royal LePage) that showed that the cost of owning is often substantially lower than the cost of renting. See the third item on this page: https://www.wdunning.com/recent-reports

I provided a short update in the June edition of this report. That update showed that the sharp increase for interest rates had changed the relationship, causing the cost of ownership to exceed the cost of renting. Here is another update, using data up to September.

A reminder: in calculating the cost of ownership, I include costs for utilities, condo fees (where applicable), realty taxes, insurance, and an allowance for repairs. For financing, I include only the interest part of the mortgage payment because the repayment of principal is actually a form of saving, not a cost. Estimates of rents are updated using the rent component of the Consumer Price Index. That data reflects all occupied units, not just recent occupancies or available units.

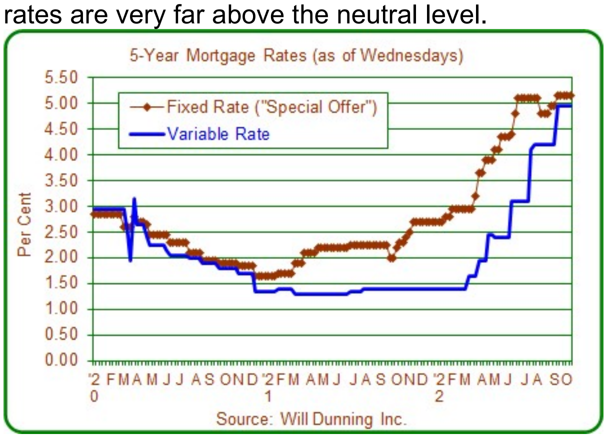
Up to mid 2021, the analysis used quarterly data. Since then, the data is monthly.

This chart compares the costs of owning versus renting, taking averages for 278 "cases" across Canada. For the first 7 years, the total cost of ownership slightly exceeded the cost of renting. But, a more useful concept of ownership costs excludes the part of the mortgage payment that is repayment of principal (since that should be seen as a form of saving, not as a true cost). On this basis, the net cost of ownership (the grey line) was far below the cost of renting (the yellow line) for most of the analysis period. But, at about the end of last year, increases in interest rates caused that relationship to change, and since this April, the net cost of owning has exceeded the cost of renting, by considerable amounts: as of September, the average difference for the 278 cases is $588 per month. This evolving data goes a very long way in explaining housing market trends, including the strong sales and rapid price growth that had been seen until recently, and the much weaker sales (and downward pressure on prices) this year.



This chart summarizes the data in a different way, showing the monthly gaps between the net costs of owning versus the cost of renting equivalent dwellings. Until late 2021, the data showed a very large “ownership advantage”. For the period up to the end of 2019, the average ownership advantage was $596 per month.

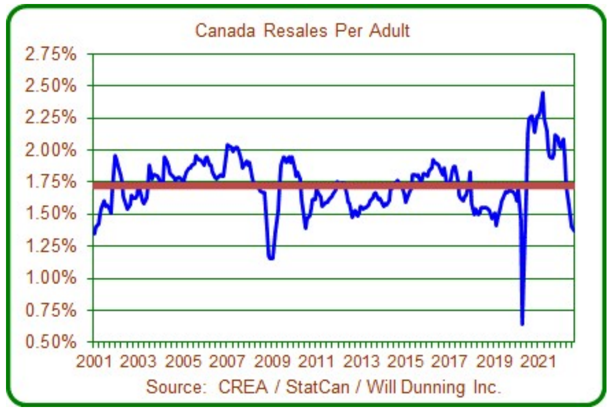
Taking the results from the prior analysis (based on data for May), I calculated that a “neutral” interest rate would be 2.6% (this is the rate at which the ownership costs advantage would be restored to the average seen during 2014 to 2019. Now, taking the data for September, the neutral mortgage interest rate is 2.7%. Current mortgage rates are very far above the neutral level.



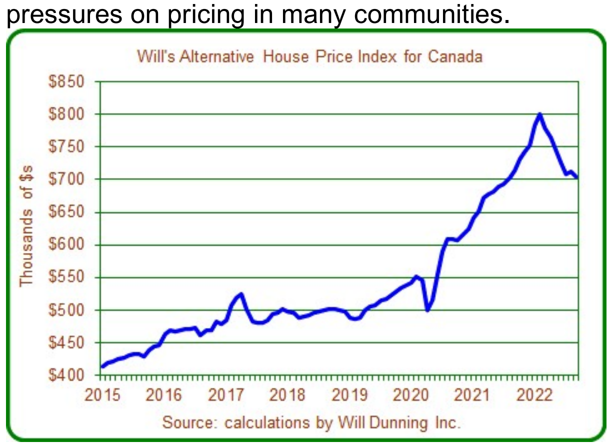
As an alternative calculation: at current interest rates, prices would need to fall by another 46% to restore the historic (pre-2020) ownership advantage. I am not predicting that this extremely large fall will happen, but I am emphasizing that current high interest rates are creating an enormous risk for the housing market and therefore for the broader economy.

Resale Market

The sales rate continues to fall, to an annualized rate of 419,900 in September. This is now 24% below the population-adjusted long-term average. Sales continue to partly reflect interest rates seen earlier. During September, there will have been some purchases based on rate commitments made in June, at rates as low as 4.4%. Since July, rates have been closer to 5% and there is likely to be some further reduction of sales in the coming months.



My alternative price index hasn’t changed much in the last two months. As of September, it is down by 12% from the peak in February. It is possible that inventories of listings will creep upwards in the coming months, creating new downward pressures on pricing in many communities.



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