Housing Market Digest

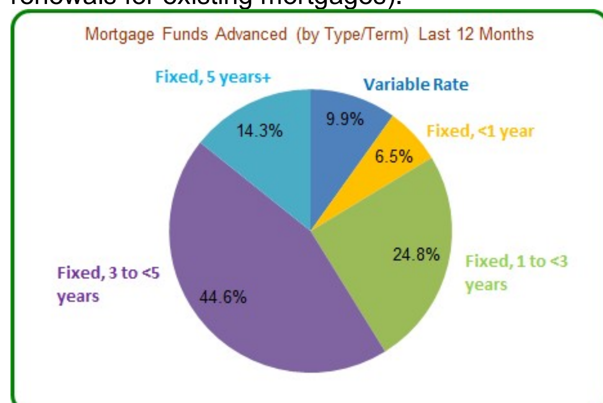
Canada, June 2024

One-Quarter Point Doesn't Matter

I see some people saying that a ¼ point reduction in the Bank of Canada's policy rate is a turning point. Really?

Firstly, more than 25 years ago, I developed a rule-of-thumb that changes in interest rates have meaningful impacts only if they are ¾ of a point or larger. That rule still seems to work.

More importantly in the current situation, the BoC rate (and therefore prime rate and variable mortgage rates) are now so high that they don't matter, because most financing depends on longer-term fixed rates (my current opinion-estimate for variable rates for uninsured mortgages is 6.65% versus 5.7% for 3-year fixed rates and 5.6% for 5-year fixed). This chart shows Bank of Canada data on the dollar volumes of "funds advanced" by charter banks (this includes new purchases and refinances, but mostly it is renewals for existing mortgages).



At some future time, the BoC policy rate and therefore variable rates will have fallen by 1 full point (perhaps late this year or early next year). But, they will still be higher than fixed rates, and therefore they will still have very little impact on purchase decisions and on the consequences of mortgage renewals, which will be at fixed rates.

So far, the impact of renewals on mortgage arrears is microscopically tiny. This is because while there have been large increases in monthly payments, income growth has allowed most borrowers to afford their larger payments. I discussed this at greater length, here: https://www.theglobeandmail.com/investing/personal-finance/household-finances/article-mortgage-stress-tests-cause-more-harm-than-good-heres-how-to-fix-them/

But, the renewals have forced the borrowers to adjust their budgets, and this has very slowly impaired the broader economy (indicators for employment have begun to deteriorate, starting late last year). Until interest rates are much lower, those negative economic impacts will continue to accrue gradually. Those high mortgage payments will be locked for some time, and any reductions in interest rates will not undo the consequences.

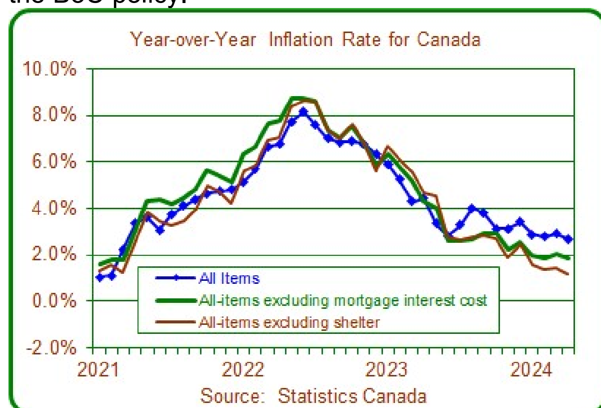
The more important economic issue is - when will high interest rates start to affect construction activity, which will cause substantial job losses? So far, the construction sector has remained very busy, due to projects that were already under construction, as well as starts of projects that were committed when rates were much lower. At some point, work will slow and employment in construction will begin to fall. That downturn will probably occur quite gradually, but it will continue for a long time, well into 2026 and possibly into 2027. Eventually, this will become a big deal. This chart shows data up to March. It appears to have peaked, and might be poised to start the downward turn.

I've said this many times: in a modern economy with large amounts of mortgage indebtedness, the greatest risk to the economy is a substantive reduction in housing values that results in a downward interaction between the housing market and employment (Ontario saw this happen during the first half of the 1990s – it was really ugly, for a

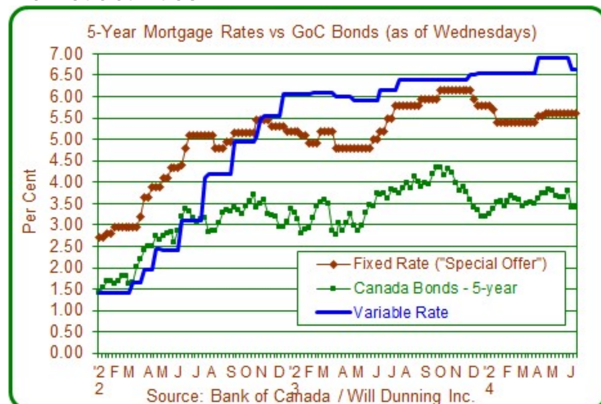
long time). The greatest risk for the Canadian economy and our financial system is that the BoC policies might generate a downward spiral.

Some economists (most of the mainstream) believe that since the inflation rate is still above the 2% target (2.7% as of April), it is important for the BoC to continue to move cautiously.

On the other hand, for the past four months, the year-over-year inflation rate that excludes “shelter” has been by 1.5% or less. The only reason that the inflation rate remains above target is that the BoC policy is driving shelter costs. The federal government needs to unilaterally amend its agreement with the BoC, to state that the relevant measure of inflation must exclude the impacts of the BoC policy.

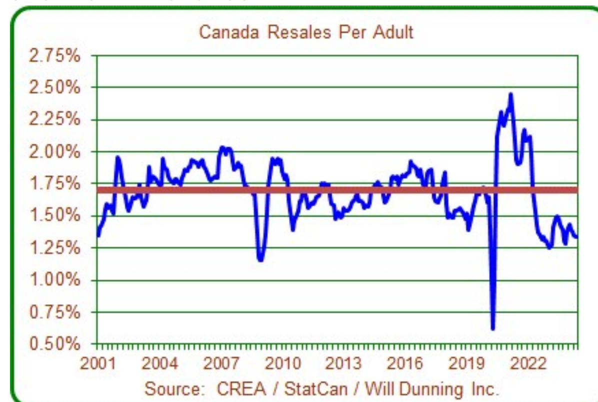


Last point: fixed mortgage rates need to be a lot lower (no more than 3.75%, versus the current 5.6% that is typical for uninsured 5-year mortgages). The BoC has some influence on bond yields (and thus fixed mortgage rates) through its market activities.



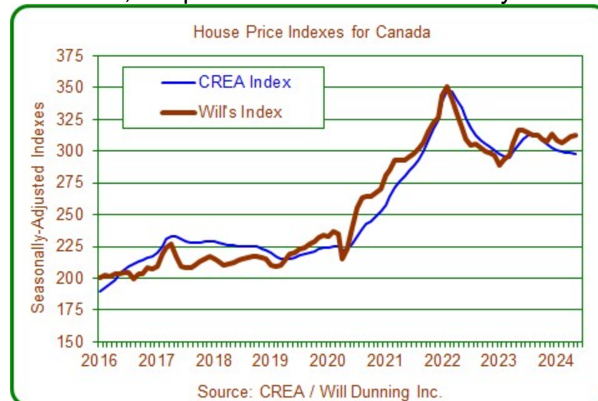
Resale Activity

Sales fell again during May (the fourth consecutive small drop), to an annualized rate of 448,800. On a population-adjusted basis, this is 21% below the long-term average (which is now 568,000). The weakest conditions are in Toronto and Vancouver and their hinterlands.



Meanwhile, listings continue to creep upwards from low levels (for both flows of new listings into the market and inventories of active listings in the market). Sales-to-listings ratios are now close to their balanced market thresholds (in May they were: for new listings 53%, versus the 52% threshold; for active listings the ratio is 23% versus the 13% threshold)

Reflecting the current “balanced market” indicators, the price trend is still essentially flat.



How to Reach Will Dunning Inc.

Email: wdunning1955@gmail.com
Web site: www.wdunning.com
Twitter: @LooseCannonEcon

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