MOODY'S ANALYTICS

RPS REAL PROPERTY SOLUTIONS

ANALYSIS

October 2019

Canada Housing Market Outlook: The Fundamentals Start to Pull

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Introduction

Canada's housing market seems on course for a soft landing given the lack of deterioration in mortgage debt arrears so far. Nevertheless, there is a perceptible downturn in house price appreciation led by Toronto and Vancouver, though this downturn has combined with falling mortgage rates to help resales recover in the past few months. That house prices have not fallen further is due to very tight resale markets in the Ontario metro areas for single-family homes and in the Vancouver area for condo apartments.

Two new developments have led to a slight downgrading of the short-term house price forecast. First, new single-family home inventory is starting to pile up, particularly in the Prairie metro areas, which will exert some downward pull on the resale market. Second, the forecast for household incomes has been re-estimated in line with new Canadian Income Survey data for 2017, and this has led to slightly slower household income growth with resulting downward pull on house prices. The first cause may be good news, though, as a looser new-home market will help overall affordability in the short term. But beyond the next two years or so, tighter mortgage lending will pull down on demand and will continue to drag on appreciation.

Nevertheless, tighter mortgage lending is starting to have an effect, as slowing house price growth has stabilized the previous upward trend in homeownership costs and should soon start to pull down on average mortgage debt-to-income ratios, preventing any serious deterioration in mortgage debt service.

Canada Housing Market Outlook: The Fundamentals Start to Pull

BY ANDRES CARBACHO-BURGOS

Two full years have passed for Canada's housing market since the onset of the reaction to the 2013-2016 housing bubble. It made little difference to the policy problem that the housing bubble was centered almost entirely in the Golden Horseshoe region around Toronto and in Greater Vancouver. The Bank of Canada, the Office of the Superintendent of Financial Institutions, and the Canada Mortgage & Housing Corp. were in agreement that policy interventions by the British Columbia and Ontario governments would not be sufficient to restore affordability and thus intervened with national policies.

Two years after the BoC started to raise interest rates and a year and a half after the introduction of the OSFI's B-20 guideline stress test, the overall results are mixed but lean toward favorable. Home sales are still down from their 2017 peak, though they have started to recover in the resale market; on the other hand, the ratio of average housing costs to disposable income—as measured by the BoC's housing affordability index—has stabilized and the ratio of the median home value to median family income has started to fall over the past year after a long period of increase. Unfortunately, the combination of higher mortgage rates compared with 2016 and slower income growth continues to push up the ratio of mortgage debt service to disposable income, so Canada has not yet achieved a soft landing from its earlier housing bubble.

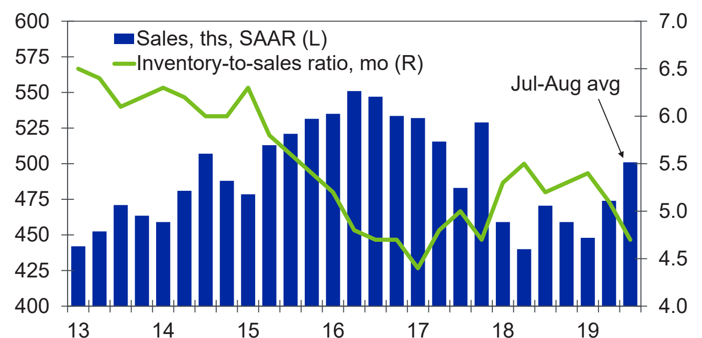
The key indicator, as so often, is the trend of house prices. For Canada as a whole, the resale and new-home price trends have been flat since 2017, though prices are now falling in the Vancouver metro area. But RPS-measured house prices in Ontario are flat at best or still rising at worst; since Toronto remains overvalued, the lack of a correction indicates that low affordability will continue to pull down on Ontario house prices for the next few years.

Recent Performance

Turnover in the resale market now seems to be recovering, if only because mortgage rates have fallen in the past few months. After peaking at 550,000 annualized resales in mid-2016, resales fell to 450,000 in early 2019. However, in the second and third quarters, resales have started to recover and are now at 500,000 (see Chart 1). The recent recovery is likely prompted by a slight decline in mortgage rates as the BoC has kept the policy rate steady even though five-year bond rates have fallen. Sales of new detached homes have yet to show recovery and have fallen to a low of little more than 40,000 annualized as affordability problems persist.

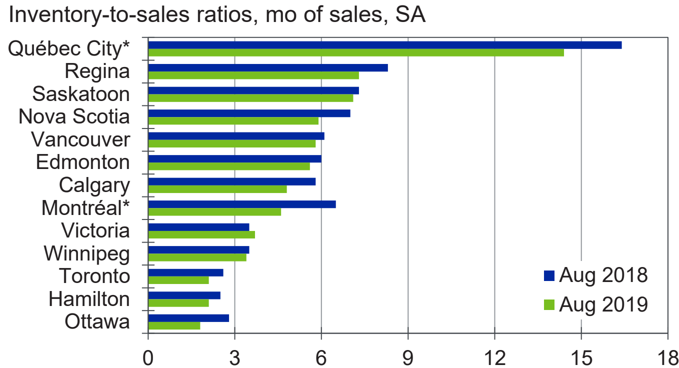
A tight resale market as indicated by the listings-to-sales ratio is a significant reason why prices have failed to fall as much as they should have given various policy interventions intended to reduce demand. The inventory-to-sales ratio for Canada has fallen steadily to a cyclical low of 4.7 months of sales, according to Canadian Real Estate Association data. Of course, this average simplifies from highly asymmetrical regional housing markets. Currently, Québec City is the only metro area with an excessively loose housing market (see Chart 2). The key outliers are the Ontario metro areas; Hamilton, Ottawa and Toronto all have current inventory-to-sales

Chart 1: Resale Market Regains Traction



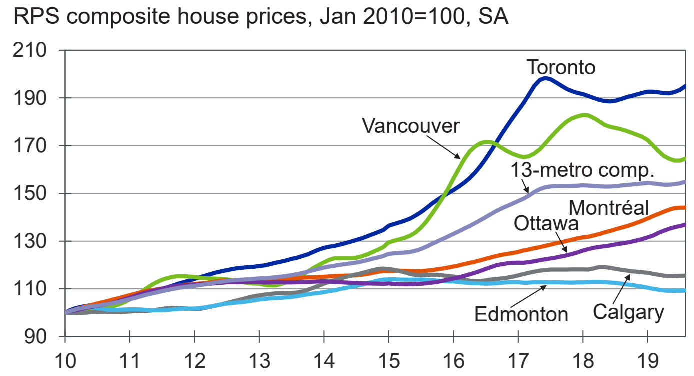
Sources: CREA, Moody's Analytics

Chart 2: Tightest Markets Are in Ontario



Sources: CREA, Québec Realtors, Moody's Analytics *Not seasonally adjusted

Chart 3: The Toronto-Vancouver Plateau



Sources: RPS, Moody's Analytics

ratios of less than three months of sales. Injecting additional supply into Ontario's housing market remains a critical issue.

House price dynamics have not changed much over the past six months. Chart 3 shows the 10-year composite transactions-weighted RPS indexes for the six largest Canadian metro areas. Although the index for Vancouver has started to correct and the index for Toronto has plateaued, both metro areas still have the largest 10-year price growth and have pulled up the 13-metro area composite index above the indexes of the other metro areas. Of the 13 metro areas in the RPS national transactions-weighted composite index, only Montréal and Ottawa have shown a steady trend, indicating the lack of either a supply-shortage housing bubble or serious affordability problems.

Charts 4 and 5 show short-term price dynamics for these 13 metro areas over the past six months. In both the February and August charts, Vancouver is in full correction mode, as a combination of low affordability, the transfer tax on foreign purchases, and a greater likelihood for borrowers to run into the B-20 stress test debt service ceilings has pulled down on metro area housing prices. Toronto looked fragile in February but has become steadier, though it still has weak appreciation as of August, the last month with RPS data. Montréal has had a more solid upward trend, but it too has started to slip in recent months. Appreciation is still slightly negative for the Prairie metro areas other than Winnipeg, as well as for Halifax. Only Ottawa shows a strong and steady house price trend over the past six months.

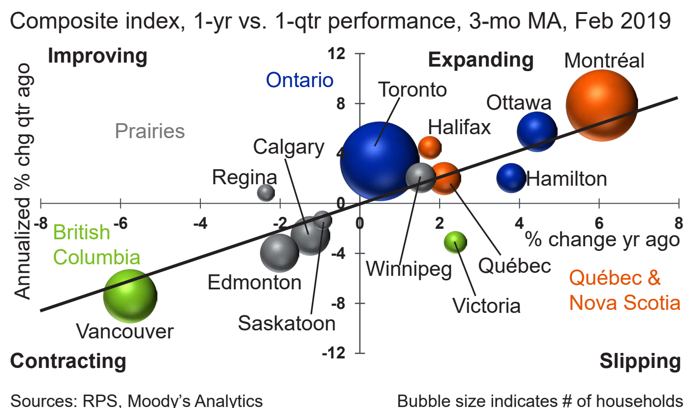
Policy effects

Given the clear changes in sales levels and price appreciation between 2016 and now, it seems undisputable that policy interventions have drastically slowed demand. The key question is whether they have led to a more sustainable housing market that does not destabilize affordability. The OSFI claims that the long-term effects are beneficial: The share of mortgage originations with a loan-to-income ratio greater than 450% has fallen from a peak of 20% in mid-2017 to little more than 14% today thanks to the stress test, while renewal rates and amortizations have not been significantly affected.[1]

The reduction in loan-to-income ratios will make a difference in the long term, but in the short term this effect is offset by the increase in mortgage rates through early 2019 and slower income growth over the past two years. Mortgage debt service ratios tracked by Statistics Canada have increased from 6.4% of disposable income in mid-2016 to 6.8% in mid-2019; total debt service

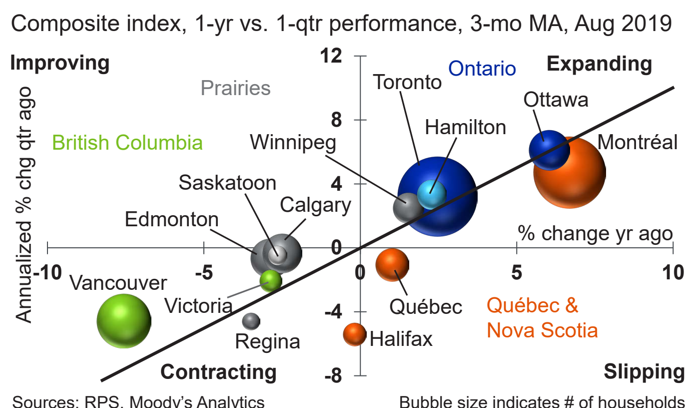
1 See "Residential Mortgage Underwriting Practices and Procedures Guideline (B-20)," OSFI, June 10, 2019.

Chart 4: Toronto Stumbled Early This Year…



Sources: RPS, Moody's Analytics Bubble size indicates # of households

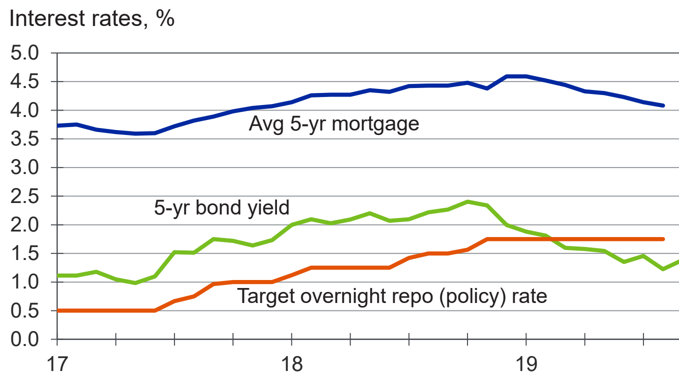
Chart 5: …But Now Looks More Solid



Sources: RPS, Moody's Analytics Bubble size indicates # of households

Chart 6: Time for the BoC to Lower Rates?

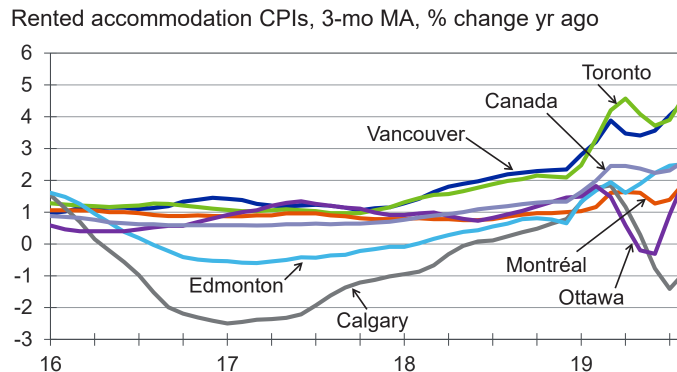
Interest rates, %



Sources: Bank of Canada, CMHC, Moody's Analytics

Chart 7: Rent Growth Is Accelerating

Rented accommodation CPIs, 3-mo MA, % change yr ago



Sources: Statistics Canada, Moody's Analytics

has increased from 14% in mid-2016 to 14.9% by the second quarter of this year. The B-20 guideline may have been a step in the right direction, but it has not yet reversed the trend in the overall burden.

The good news is that mortgage rates have started to come down since earlier this year thanks in large part to the extended pause in policy rate hikes by the BoC (see Chart 6). Nevertheless, the conventional mortgage lending rate is still nearly 50 basis points above its bottom rate in early 2017, which has dragged on purchase demand and helped to push up debt service ratios. The BoC can make a good claim that the rate hikes through late 2018 were needed to deflate asset price bubbles—house prices not the least—and the drag on home sales has been considerable; whether the resulting slowdown in price growth has been worth the housing market pain is still up for debate.

Parallel: Apartments and rentals

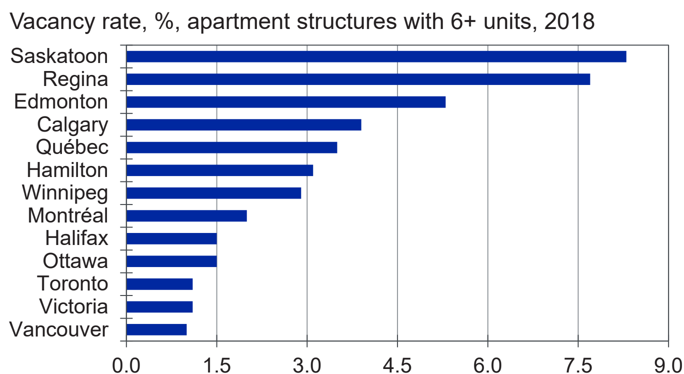
Although most housing market attention is on single-family home purchases and to a lesser extent the condo market, the rental market interacts with the purchase market and can either feed the house price bubble or conceivably help to deflate it. Higher rents increase the rate of return for a home as an asset and would thus tend to drive up its price; at the same time, higher house prices also increase maintenance and insurance costs and thus drive up rents. A rent-house price spiral comes to an end when it hits borrower net worth and credit quality constraints: High-enough rents make it impossible for prospective first-time buyers to afford down payments on a desired home, so that a purchase of this home would be synonymous with either a much larger mortgage insurance burden or much lower credit quality.

If the CPI data for Canada are any indication, only the house price portion of the rent-price spiral has been interrupted by policy interventions. The rented accommodation CPI for Canada accelerated from 1% growth at the end of 2017 to 2.5% by August of this year; the strongest acceleration was for Toronto and Vancouver (see Chart 7). Of the six largest Canadian metro areas, only Calgary seems to have falling rents.[2]

The simplest way to explain accelerating rent growth is to look at rental market tightness. While there are no rental vacancy rate data for this year, the CMHC numbers for apartment structures in 2018 paint a stark regional contrast: apartment vacancy rates that are relatively, if not absolutely, high in the Prairie metro areas and abnormally low in Ottawa, Toronto, Vancouver and Victoria (see Chart 8). The apartment vacancy rate numbers do not paint an absolute picture of relative tightness; CMHC's numbers for vacancy rates for combined totals of apartment and townhome structures with three or more units result in higher vacancy for Toronto and Vancouver, indicating that townhomes and smaller apartment buildings are more likely to be vacant. Nevertheless, it seems to be the large apartment market that is driving rent growth. To the extent that high mortgage rates and the B-20 stress test are pulling down on home purchases by potential first-time buyers, they are increasing the pool of renters, which would help to explain the pickup in rents since 2017.

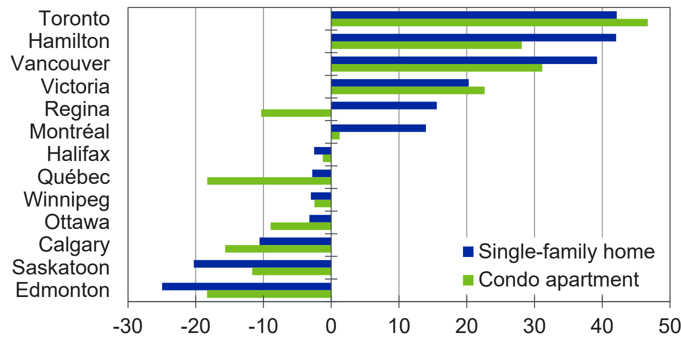
Chart 8: The Big Areas Are Rent-Tight

Vacancy rate, %, apartment structures with 6+ units, 2018



Sources: CMHC, Moody's Analytics

2 The CPI data are subject to the usual CPI caveats: CPI volatility increases in 2019 most likely because these months have not yet been benchmarked; benchmarking will likely reduce the growth rate volatility but is unlikely to change the general upward trend for 2019 itself. Also, the rented accommodation CPI is a gross rent measure that includes the cost of utilities for the renter, so a period of high energy price volatility can also affect the rented accommodation CPI.



Sources: RPS, Statistics Canada, Moody's Analytics

Valuation

The Moody's Analytics forecast model for the RPS house price indexes compares current house prices to long-term trend prices. These trend prices are less sensitive to business cycles and are determined by local household income, population size, the national new-house and land price index (which is used as a proxy for overall land and construction costs), and for a few metro areas, the deflated stock market price index—a proxy for national wealth—interacting with metro area population dynamics. The divergence between the current price and this long-term trend price determines the degree of over- or undervaluation, which is an important driver of the house price forecast.[3]

In addition to standard mechanisms by which an overvalued housing market tends to move into correction territory—reduced demand due to low affordability and increased supply due possibly to resurgent construction—direct policy interventions such as the OSFI mortgage stress tests and provincial ownership transfer taxes are also part of the mean reversion mechanism by which house prices in a region return to their long-term trend values. The house price model itself makes no distinction as to whether mean reversion is accomplished by a hard landing (usually involving foreclosures and extended vacancy for new homes) or a soft landing (falling sales due to tighter mortgage credit).

Chart 9 shows the valuation for the 13 Canadian metro areas in the RPS 13-metro composite index for the second quarter of 2019, the last with full data. Valuation may have changed somewhat since the May Canada Housing Market Outlook report because many of the metro area economic drivers such as households and median family income have been re-estimated, but the overall pattern is the same: The Golden Horseshoe metro areas of Toronto and Hamilton plus the Vancouver/Victoria region of British Columbia show the largest overvaluation. By contrast, the Prairie metro areas show moderate to serious undervaluation due to slower demographics and demand since the 2015 oil price correction. Single-family homes in Montréal are now moderately overvalued, as a tighter housing market has started to push prices up at a faster pace than median income, but overvaluation is still quite manageable compared with in Toronto and Vancouver.

Overall, the regional breakdown is still highly asymmetric. Overvaluation in the two regions in and around Toronto and Vancouver will lead to slower price growth at best and correction at worst. Correction has been taking place in Vancouver for some months now. In the Prairie provinces, undervaluation is prevalent. Normally, undervaluation would lead to stronger price growth as opportunistic purchases become more prevalent, but as the B-20 guideline has reduced the purchasing power of potential buyers, it remains to be seen whether house price growth in the Prairies will pick up in the short term.

Macroeconomic outlook

With Canada's housing market still overvalued on average and with the resale market very tight in Ontario, it is unlikely that the BoC will cut short-term interest rates in parallel with the Federal Reserve. More likely, the target overnight repo rate will remain at 1.75% for more than a year before it starts to increase again; the BoC still wants to bring up the short-term rate closer to its pre-2008 average. The result is that the five-year mortgage rates will rise more or less steadily through 2022 before slowing down but will still rise slowly until it is almost at 6% by the end of 2025.

Table 1 shows the current macroeconomic forecast and Canada house price forecast.[4] Assuming no further downside risks from the U.S.-China trade war or conflict in the Middle East materialize, Canada will not experience a significant slowdown; per capita disposable income will average slightly over 3% growth over the next three years while consumer price inflation will average 2%. But regarding house price appreciation, this relatively stable picture for real income is overruled by rising mortgage rates and the B-20 guideline. Single-family and condo apartment prices are unlikely to show significant growth before 2022, when the pace of increase in mortgage rates starts to slacken. Combined with the B-20 guideline, rising mortgage rates will pull households toward mortgage deleveraging. Both the median house price-to-income and mortgage debt service-to-disposable income ratios will start to fall in the coming year, though not rapidly, and will then fall steadily over the next five-year period.

That resale market house prices will have only a mild decline on average for the next two years despite tighter mortgage lending will be due to the new-home market, which is now quite loose but will put subsequent downward pressure on residential construction, slowing down housing stock growth. The current market for new single-family homes shows dangerous signs of excess supply, or at least not building in the needed locations. Chart 10 adds up new single-family home inventory for all 33 census metro areas and divides it by their total absorption. The inventory-to-absorptions ratio bottomed

3 For full details on the Moody's Analytics forecast model for RPS house price indexes, see "Moody's Analytics Canada RPS House Price Index Forecast Methodology," available from Moody's Analytics or RPS.

4 As with previous Canada Housing Market Outlook reports, the first three rows track year-over-year house price changes in the fourth quarter of each year, and the subsequent rows measure yearly averages.

out in mid-2017 at around 1.3 but has now climbed to almost 2.4. This increase in the ratio is to some extent due to overbuilding: Total inventory increased from about 5,500 in early 2017 to 7,500 in mid-2019. But the real driver was falling absorption in Calgary, Edmonton and Vancouver. By contrast, there is arguably too little inventory in Montréal and Toronto. Because of the weak current new-home market plus slower household formation, the outlook for residential construction is contractionary: Table 1 shows not only no predicted increase for housing starts, but also a slow and steady decline to 150,000 annualized starts by the end of 2024, compared with 222,000 in mid-2019. Clearly, deleveraging and slowing demographics will prevent the housing market from being a major source of growth in coming years.

Regional outlook

The current regional outlook for house price appreciation is more subdued than the April forecast that was reported in the May 2019 outlook report. In addition to Canada's single-family house price appreciation slowing slightly from the April forecast, there have been some radical changes for the smaller provinces and metro areas. Over the past month, the disposable income and median income series for Canada and its provinces and metro areas were re-estimated using new raw data from the 2017 Canadian Income Survey and were then reforecast. The new forecasts in some cases led to substantially different growth rates for real income, and these differences fed into the house price forecasts.

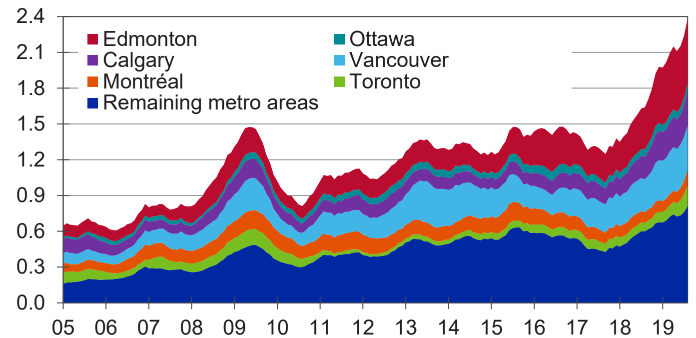
Table 2 looks at the short-term dynamics for single-family house price forecasts for the provinces and all 33 census metropolitan areas. The first column shows the degree of single-family house price overvaluation or undervaluation for metro areas, which was also drawn in Chart 9 for the top 13 metro areas. The Ontario metro areas other than Ottawa and Kingston show serious overvaluation, as does British Columbia. By contrast, the Prairie metro areas other than Regina are seriously undervalued. The current environment of tighter mortgage credit, however, will likely offset any upward push on purchase demand and house prices from undervaluation.

The second column shows house price appreciation in the second quarter of this year, the last full quarter with historical data. Persistence effects from this quarter will carry over into the next three quarters of the forecast, mainly through the "comps" effect of recent transactions on seller asking prices and occasionally on buyer offers. Of the large metro areas, Montréal and Ottawa have had the strongest recent house price appreciation and can count on some of it to carry over into the remainder of 2019. Vancouver is the only metro area with a double-digit annualized house price decline in the second quarter, indicative that low affordability and falling seller confidence are transforming its local market.

The third column shows house price appreciation over the coming year. With single-family house prices for Canada appreciating only 0.7%, several smaller metro areas go into house price decline. Only Montréal and Ottawa show solid appreciation over the coming year, and only Regina and St. John's have strong depreciation; depreciation in Vancouver starts to level off. By the following year, shown in the fourth column, persistence effects from early 2019 have worn

Chart 10: A Glut of New Homes?

Ratio, new single-family inventory to total absorptions*, 3-mo MA



Sources: CMHC, Moody's Analytics

*Total for 33 census metropolitan areas

Table 1: Canada Housing Market, History and Baseline Forecast

	Most recent	2017	2018	2019	2020	2021	2022	2023	2024
Detached single-family house price index, % change*	0.4	7.5	0.1	-0.2	0.3	-0.2	1.9	3.6	4.4
Condo apartment price index, % change*	2.4	13.5	6.6	0.5	-0.1	-0.5	1.3	2.8	3.6
Composite house price index, % change*	0.4	7.2	0.7	-0.4	-0.1	-0.6	1.5	3.2	4.1
Real per capita disposable income, % change	0.6	2.0	0.7	0.9	1.3	1.2	0.7	0.6	0.7
Unemployment rate, %	5.5	6.3	5.8	5.7	6.0	6.4	6.5	6.5	6.6
Avg mortgage rate, 5-yr, %	4.30	3.79	4.36	4.22	4.55	5.01	5.55	5.71	5.79
Housing starts, ths	222.4	220.2	213.2	208.8	191.0	170.3	162.2	155.3	150.9
% change	2.5	11.2	-3.2	-2.1	-8.5	-10.8	-4.7	-4.3	-2.8
Ratio, median dwelling price/median family income	7.9	8.2	8.0	7.8	7.7	7.5	7.4	7.5	7.6
Ratio, outstanding mortgage debt/disp. income	1.15	1.16	1.16	1.15	1.12	1.09	1.07	1.05	1.02

*Q4, yr/yr

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

off and the rising trend in the five-year mortgage rate has returned, pulling down on most appreciation. Montréal will be the only large metro area with appreciation while most metro areas, other than seriously undervalued Saskatoon, will move into mild to moderate depreciation. It is only starting in 2022—not shown in the table—that the upward trend in mortgage rates slows down and Canada starts to revert to mild appreciation.

Table 3 ranks the metro areas by single-family house price appreciation and also compares the April and September forecasts for five-year appreciation. As mentioned, the new forecasts for median family income cause substantial shifts in some rankings and appreciation rates. The extreme case is St. John's, where a downgrading of the income growth outlook results in a reversal of the previously strong April appreciation forecast. Other substantial downgrades include Guelph and Edmonton, whereas Saskatoon is the only substantially upgraded outlook.

Overall, the combination of tighter mortgage credit in coming years and a slightly slower outlook for real disposable income growth has pushed down regional appreciation in this forecast compared with the April forecast. And overall appreciation over the coming five-year period still looks weak compared with the feverish appreciation rates of 2015-2017. But assuming that the weaker outlook for housing does not hurt the rest of the economy, the decline in average mortgage debt-to-income ratios starting this year and the decline in housing ownership costs when mortgage rates level off after two years should result in a soft landing with no major decline in mortgage debt performance and lower long-term financial fragility.

Risks

As often happens, election campaigns lead to policy proposals that combine upside and downside risks.

Table 2: Canada Subnational Forecast, Median Detached-House Price

	% deviation from trend price, 2019Q2*	% change annualized, 2019Q2	Avg annualized house price growth, %, 2019Q2-2020Q2	Avg annualized house price growth, %, 2020Q2-2021Q2
Canada		**-1.4**	**0.7**	**-0.8**
Alberta		-2.4	1.3	-0.4
Calgary, census metropolitan area	-10.6	-3.0	0.7	-0.9
Edmonton, census metropolitan area	-25.0	-2.4	1.7	-0.1
British Columbia		-8.0	-0.7	-2.7
Abbotsford, census metropolitan area	43.9	1.1	2.1	-3.2
Kelowna, census metropolitan area	17.6	-1.9	1.3	-1.9
Vancouver, census metropolitan area	39.2	-10.7	-1.7	-3.2
Victoria, census metropolitan area	20.3	-6.0	-0.1	-3.2
Manitoba		2.2	1.3	-0.1
Winnipeg, census metropolitan area	-3.0	1.8	1.0	-0.3
New Brunswick		13.0	3.1	-1.7
Moncton, census metropolitan area	-3.7	7.3	4.0	-1.2
Saint John, census metropolitan area	1.4	16.0	3.4	-3.4
Newfoundland and Labrador		-3.2	-4.5	-3.6
St. John's, census metropolitan area	16.6	-4.5	-5.6	-4.2
Nova Scotia		-0.0	1.2	-1.9
Halifax, census metropolitan area	-2.5	0.0	1.5	-1.8
Ontario		0.5	-1.2	-1.0
Barrie, census metropolitan area	30.5	-2.4	-0.2	2.3
Brantford, census metropolitan area	38.5	3.1	-1.7	-2.0
Greater Sudbury, census metropolitan area	10.1	14.8	4.3	-0.5
Guelph, census metropolitan area	35.3	-2.0	-1.7	0.7
Hamilton, census metropolitan area	42.0	0.3	-2.1	-2.3
Kingston, census metropolitan area	7.0	6.3	-0.2	-1.8
Kitchener, census metropolitan area	36.1	0.7	-2.3	-2.2
London, census metropolitan area	29.1	7.8	1.1	-0.9
Oshawa, census metropolitan area	38.6	-5.6	-3.0	-0.8
Ottawa-Gatineau, census metropolitan area	-3.2	11.1	2.8	-0.7
Peterborough, census metropolitan area	36.1	-1.0	-3.0	-3.0
St. Catharines-Niagara, census metropolitan area	37.9	2.6	-1.4	-2.3
Thunder Bay, census metropolitan area	16.3	10.4	1.9	-2.2
Toronto, census metropolitan area	42.1	-1.7	-1.6	-0.5
Windsor, census metropolitan area	18.5	5.8	-0.3	-2.6
Prince Edward Island		7.0	-2.4	-4.4
Québec		6.8	5.0	1.0
Montréal, census metropolitan area	14.0	9.6	6.1	1.0
Québec, census metropolitan area	-2.8	1.7	3.0	1.5
Saguenay, census metropolitan area	12.6	6.1	4.8	0.7
Sherbrooke, census metropolitan area	-10.3	9.5	6.9	2.3
Trois-Rivières, census metropolitan area	17.1	-1.0	1.4	-1.7
Saskatchewan		-1.2	-1.3	0.0
Regina, census metropolitan area	15.6	-4.1	-7.1	-8.1
Saskatoon, census metropolitan area	-20.3	-4.9	3.2	7.3

Note: Italicized metro areas are part of the RPS 13-metro area composite index.
*Census metropolitan areas only

Sources: RPS, Moody's Analytics

Table 3: Medium-Term House Price Outlook, Census Metropolitan Areas

Avg annualized projected single-family house price growth, %, 2019Q2-2024Q2

	Apr 2019 forecast	Sep 2019 forecast
Canada	2.3	1.6
Barrie	5.4	4.6
Saskatoon	-0.3	4.5
Sherbrooke	3.1	3.7
Winnipeg	0.9	3.0
Montréal	2.2	3.0
Québec	2.4	3.0
Guelph	5.4	2.8
Ottawa-Gatineau	3.2	2.4
Moncton	0.7	2.2
Halifax	2.5	2.0
Greater Sudbury	1.0	1.9
Edmonton	4.4	1.8
Toronto	3.4	1.7
Saguenay	1.4	1.7
Oshawa	3.4	1.7
London	1.7	1.3
Brantford	1.4	1.1
Kelowna	2.0	1.0
Kingston	1.5	1.0
Thunder Bay	0.8	0.8
Abbotsford	1.0	0.7
Calgary	1.2	0.5
Kitchener	1.3	0.5
Trois-Rivieres	1.4	0.5
St. Catharines-Niagara	1.0	0.4
Saint John	1.0	0.3
Windsor	0.5	0.1
Victoria	1.1	0.1
Hamilton	0.8	-0.1
Peterborough	1.2	-0.3
Vancouver	1.2	-0.3
St. John's	6.5	-0.4
Regina	-2.8	-1.7

Note: Italicized metro areas are part of the RPS 13-metro area composite index.
Sources: RPS, Moody's Analytics

One policy that has already been enacted is the CMHC's shared equity mortgages, which were also discussed in the May Canada Housing Market Outlook report. In brief, mortgage borrowers with incomes under C$120,000 can obtain additional CMHC financing in the form of equity for home purchases, with equity being limited to 5% for existing homes and 10% for new homes. Initial CMHC equity funding was also budgeted to be a maximum of C$1.25 billion. The proposal took effect on July 31. Because of the income ceiling and the limited budget, the proposal was designed to have little, if any, impact on the Toronto and Vancouver housing markets, where an income of C$120,000 is insufficient to purchase most homes even with additional equity financing. Rather, it was intended to provide an additional and sustainable injection to home purchasers in the Prairie and Atlantic provinces and parts of Québec.

Prime Minister Justin Trudeau's proposal to raise the income limit to C$800,000 for Victoria, Vancouver and Greater Toronto introduces upside risks in the short term but downside risks in the long term. The upside risk is to increase the pool of potential homebuyers by improving affordability. The downside long-term risk is that the higher income ceiling would induce larger debt service-to-income ratios even with equity funding, especially if the upward trend for house prices in both regions resumes. A combination of more borrowers with increasing appreciation could thus spell trouble for long-term credit quality.

Andrew Scheer, the Conservative Party candidate for prime minister, has proposed to not only ease aspects of the B-20 guideline stress test, but also abolish the stress test requirement for mortgage renewals. Here also the trade-off is between a short-term injection of purchase demand and longer-term debt service worries. Easing the stress test might increase the pool of fragile borrowers depending on how much the requirements are eased. More important, removing the stress test requirement for mortgage renewals could lead to previously credit worthy borrowers getting into financial jeopardy with a radical change in circumstances such as a recession or a sudden increase in rates if the BoC needs to stamp out inflation.

There remains the downside risk of Canada's larger than average vulnerability to global oil price shocks. In the Moody's Analytics Low Oil Price scenario, for example, some combination of increased U.S. production in the wake of regulation, or a resolution of the Iran-U.S. standoff, or increased OPEC production makes the Brent oil price fall to just below US$40 per barrel and the West Texas Intermediate oil price fall to US$35 per barrel. The resulting income forecast hits the Prairie provinces harder in particular, and by extension house prices would suffer. In this scenario, the RPS national composite house price would fall 2% over 1½ years before recovering. The impact on Alberta and specifically Calgary and Edmonton would be more limited given that house prices were already hit substantially in 2015-2016, but the effect would be larger in smaller, energy-dependent cities.

Barring radical deregulation policies for mortgage lending, Canada's housing market

seems on course for a soft landing given the lack of deterioration in mortgage debt arrears so far. A soft landing, of course, is not as positive an outcome as it sounds. If one accepts that mortgage debt service burdens have risen too rapidly over the past five years, then the necessary reversal involves several years of subdued demand leading to lower growth in turnover and to much slower house price appreciation, including price corrections in the worst-affected metro areas. Even where price correction takes place as in Vancouver currently, the process seems to be orderly, in that sellers are pulling down asking prices in the wake of falling demand plus the weakening of wealth inflows from abroad, and not disorderly in the sense of huge stocks of newly built homes without buyers or increasing delinquency leading to distress sales. Such an orderly process is the necessary prelude to a resumption in the normal process of income growth leading to steady appreciation and is therefore not a harbinger of disaster.

About the Author

Andres Carbacho-Burgos is an economist at the West Chester office of Moody's Analytics. He covers the U.S. housing market, residential construction, and U.S. regional economies. Before joining Moody's Analytics, he taught economics at Texas State University, where he also researched open-economy macroeconomics and income inequality. Born in Chile, he obtained his PhD and master's in economics from the University of Massachusetts at Amherst and his BA in economics from Carleton College.

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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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