The Conference Board of Canada Le Conference Board du Canada

Understanding Ontario's Real Estate Boom

Craig Alexander
Senior Vice-President and Chief Economist, The Conference Board of Canada
September 2017

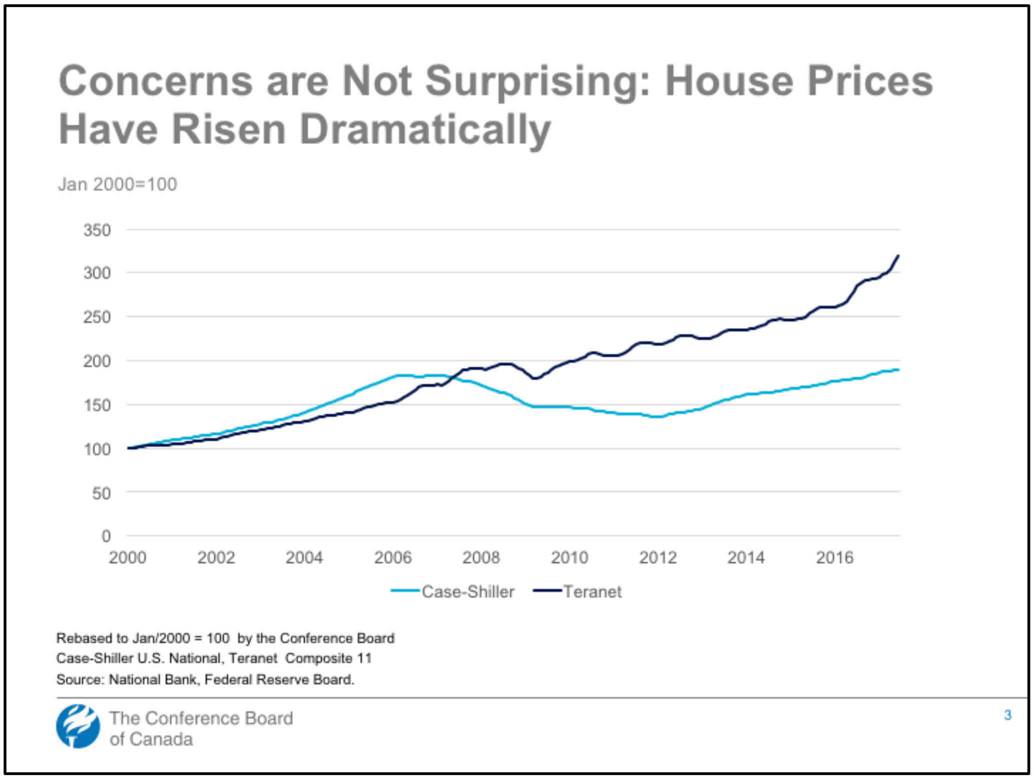
conferenceboard.ca

Dire Predictions Are Not New

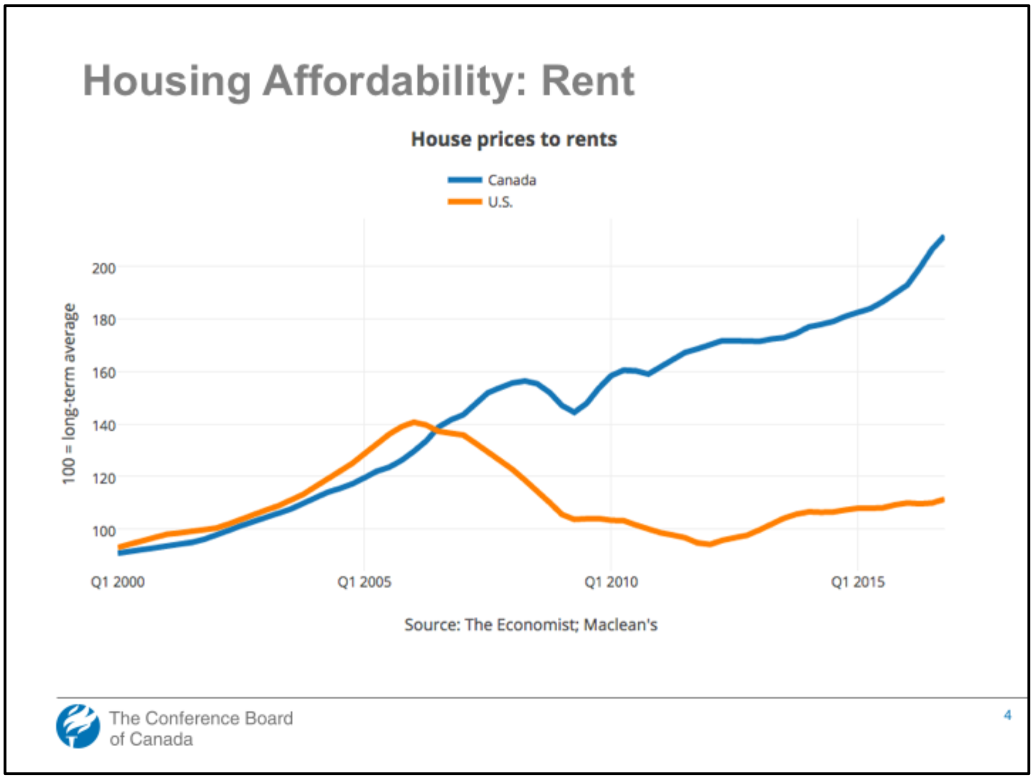
The Conference Board of Canada

2

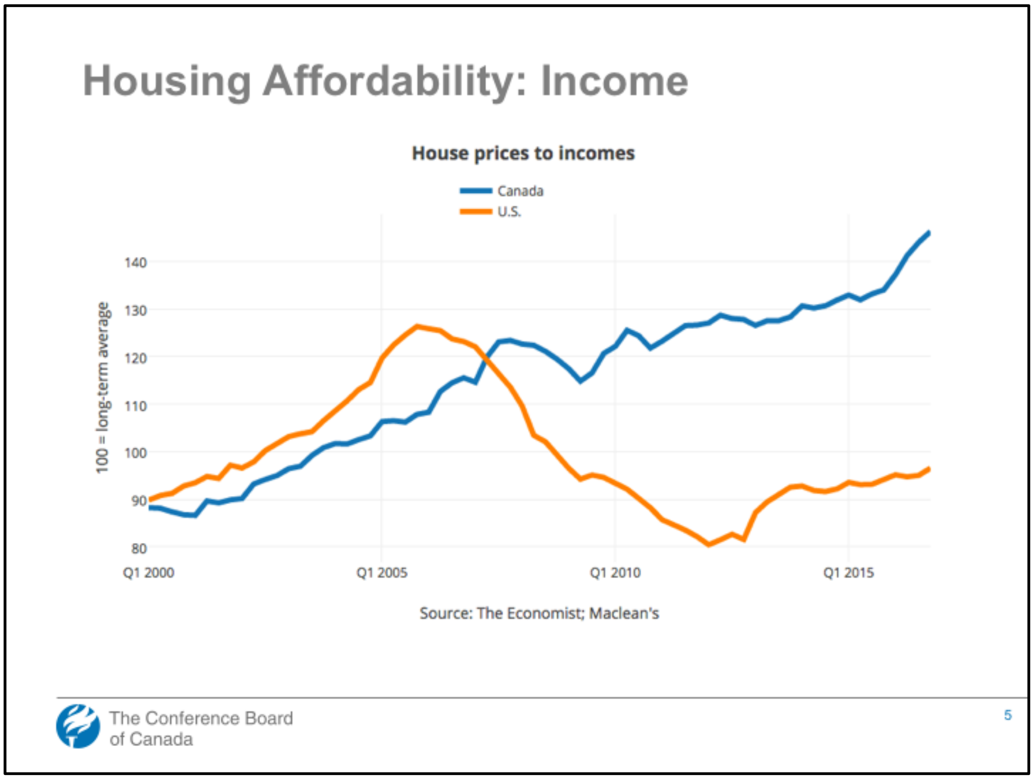
Canada has experienced a significant increase in home prices since 2000
This has led to periodic concerns about a housing bubble



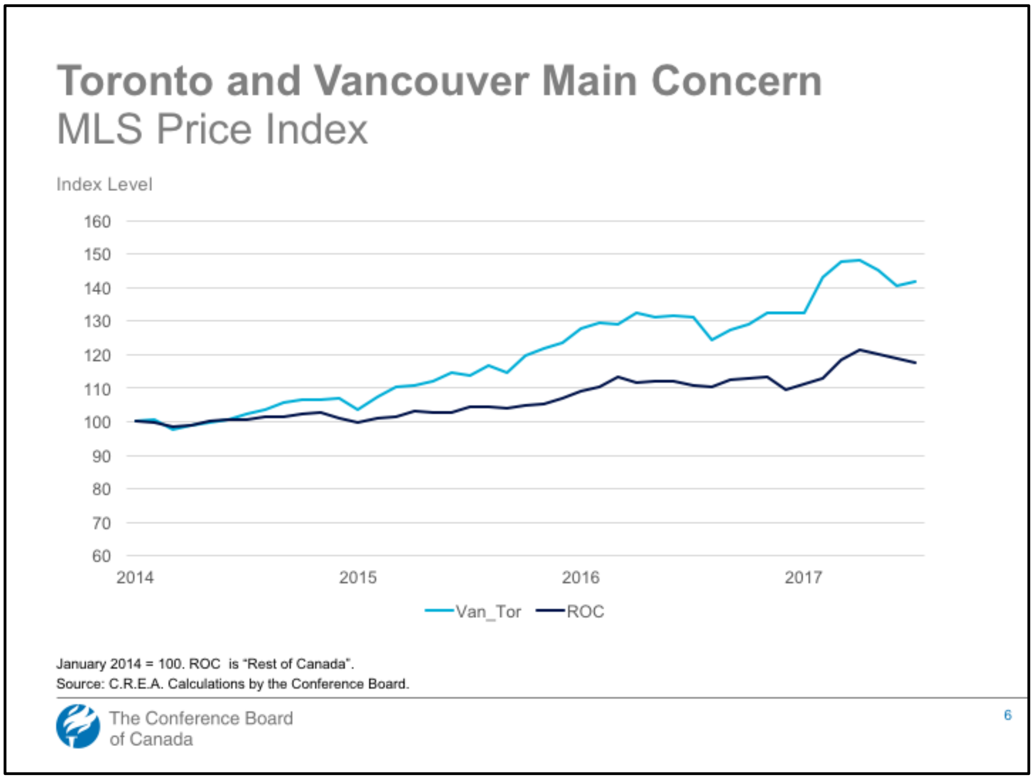
Although it should be stressed that a lot of the US home price appreciation happened before 2000



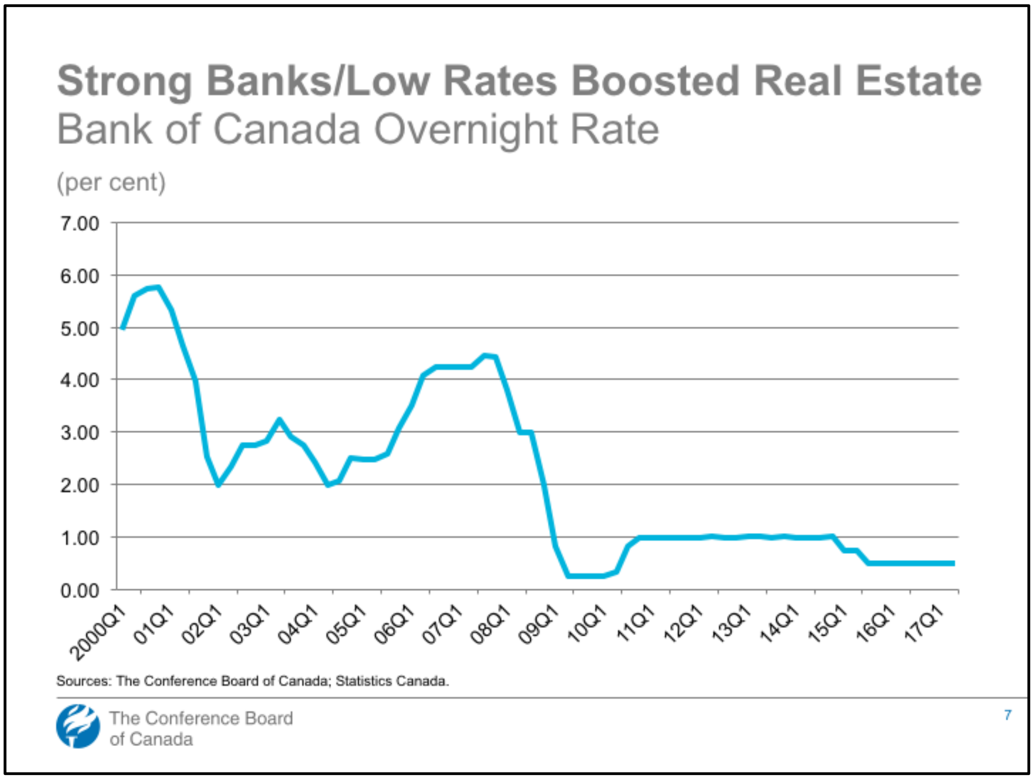
House prices to rent often cited as evidence of a bubble
Problem with this metric is that rent in Canada is heavily regulated and is usually not allowed to rise faster than inflation



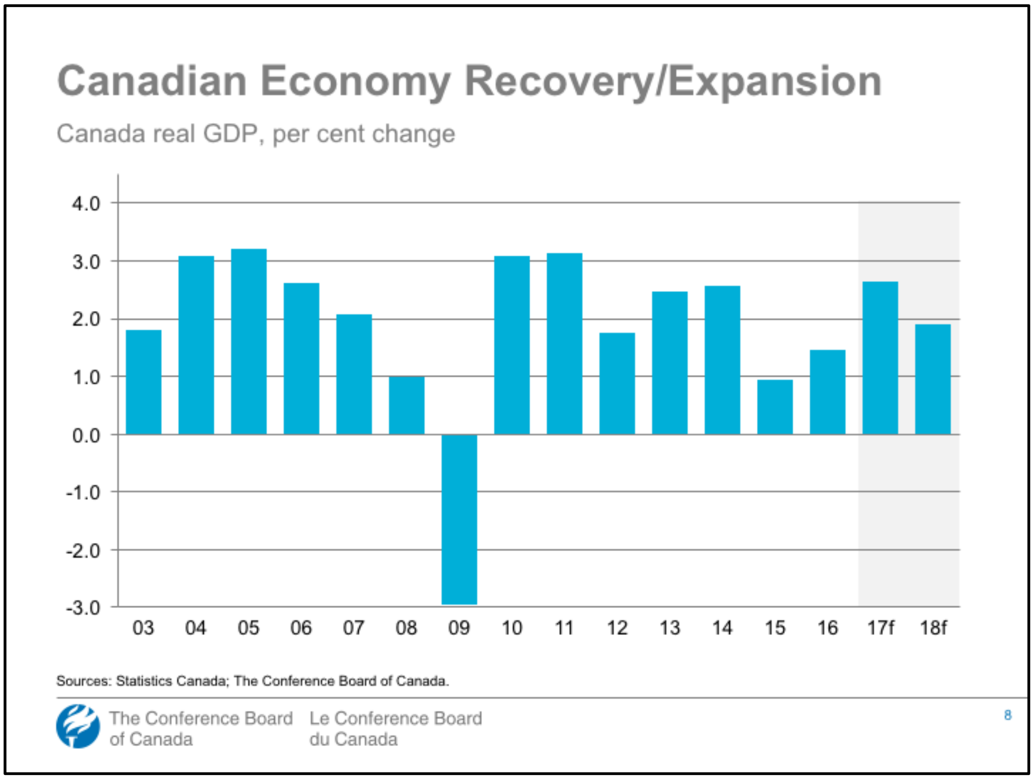
Affordability has deteriorated, as home prices in Canada have climbed faster than income.
This stat is increasingly distorted by parents providing the funding to make the home purchase – ratio is based on the dweller in the house, even if financing is coming from parents



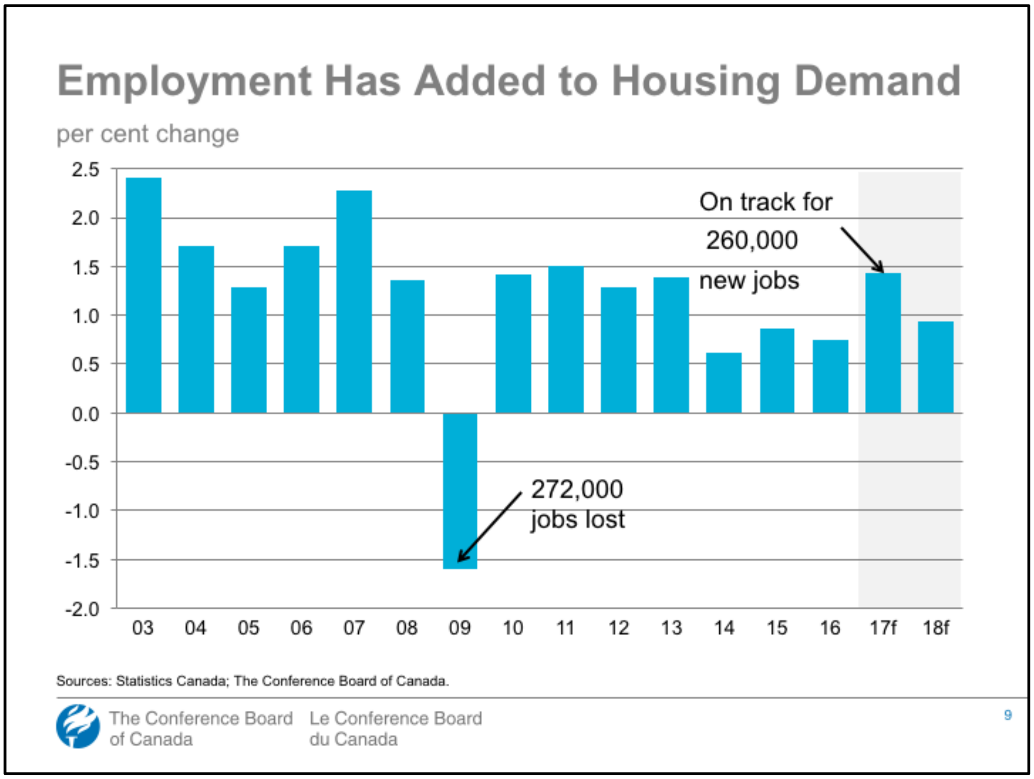
Over last 3.5 years, home prices outside of GTA and GVA have risen by roughly 5 percent per annum – 3% real, which is very sustainable
GTA and GVA have posted annual increase in the double digits



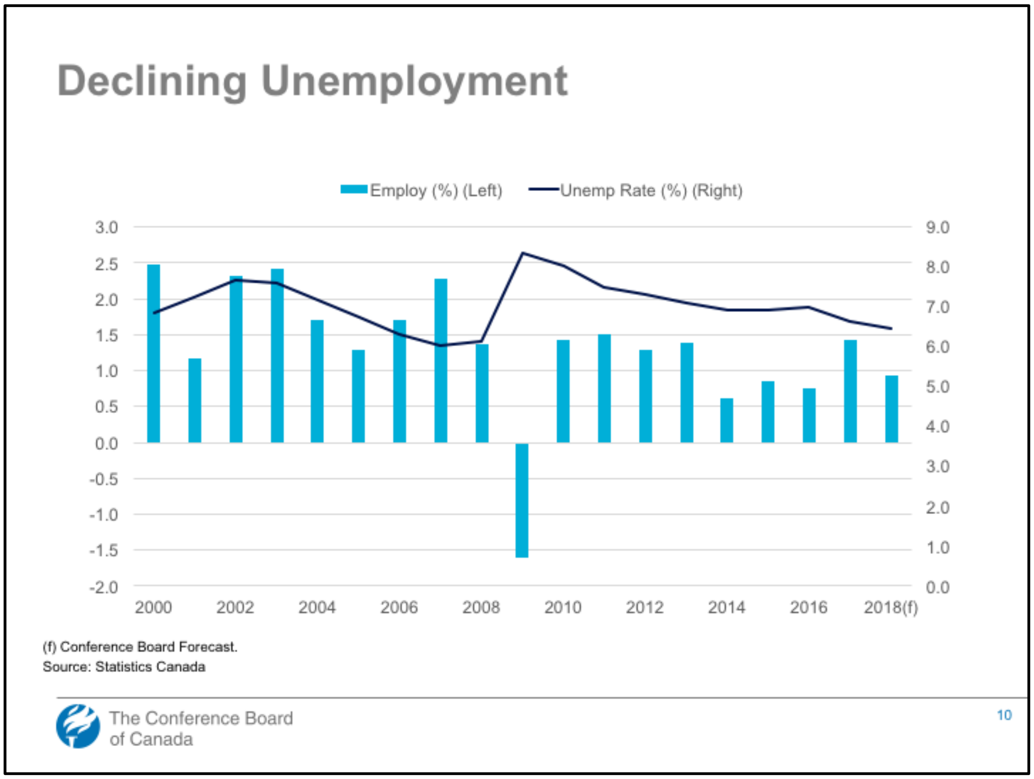
When the financial crisis of 2008 hit, Canadian banks weather the storm. No public bailout. Remained open for business and were willing to lend. This meant that when Bank of Canada cut rates to unheard of levels, it was highly stimulative to the economy and real estate



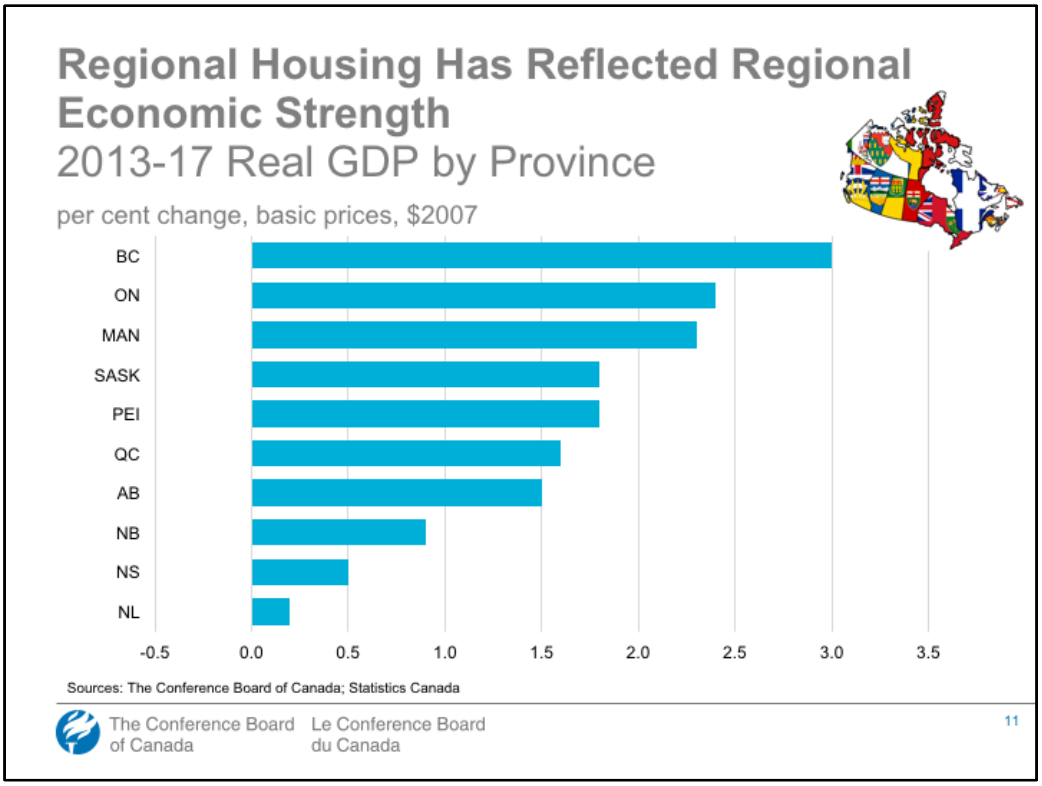
A large portion of the increase in home prices reflects strong economic fundamentals. Economic growth has been solid. Canada led G7 in growth during 2010 and 2011, had a set back in 2015 and 2016 due to commodity shock, in 2017 it will be fastest growing economy in G7



The solid economic growth has created jobs and lowered unemployment rate



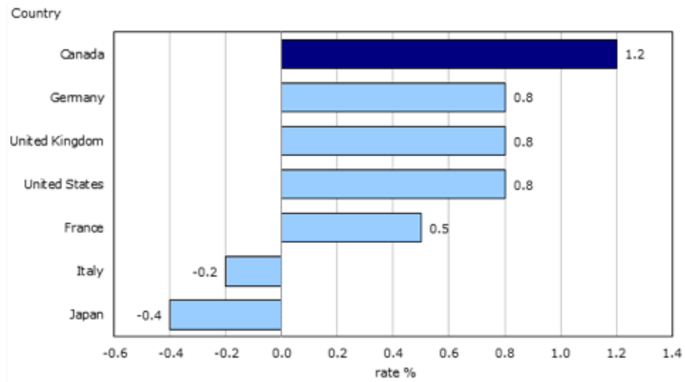
Unemployment not back to pre-recession low, but that was the lowest on record and had large labour shortages. Conference Board estimates full employment is around 5.5 percent, just slightly lower than today



Strength of real estate in BC and Ontario reflect economic performance

Canada Leads G7 in Population Growth: Creates Strong Demand for Housing

Annual population growth rate

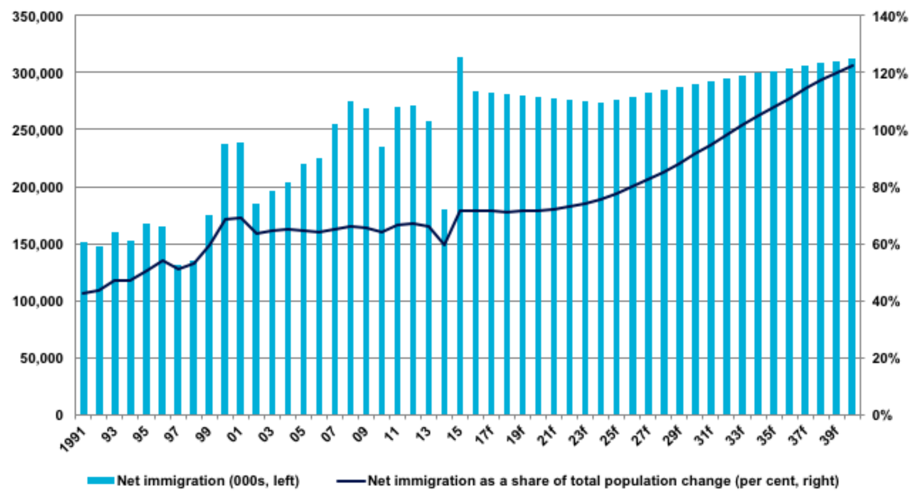


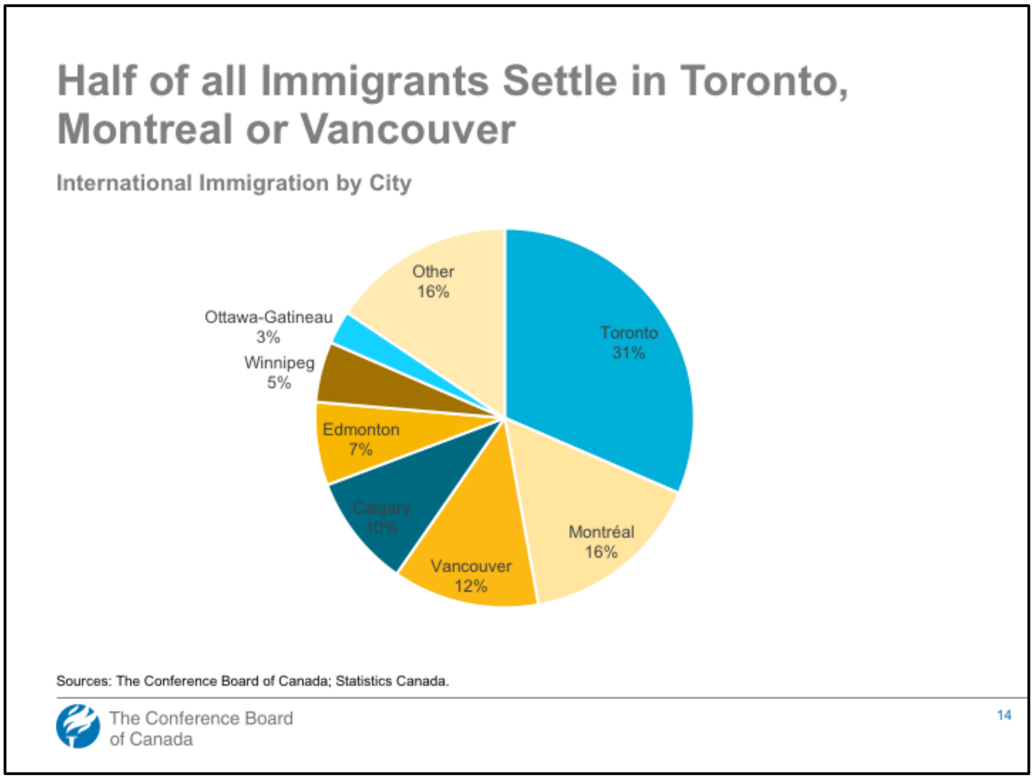
1. For Canada, the most recent annual period available extends from July 1, 2015 to June 30, 2016. For Italy, the most recent annual period available extends from January 1, 2015 to December 31, 2015. For Germany and Japan, the most recent period available extends from October 1, 2014 to September 30, 2015. For the United Kingdom and the United States, the most recent period available extends from July 1, 2014 to June 30, 2015. For France, the most recent annual period available extends from January 1, 2014 to December 31, 2014.

Sources: Statistics Canada, Federal Statistical Office of Germany, Office for National Statistics (United Kingdom), U.S. Census Bureau, National Institute of Statistics and Economic Studies (France), Italian National Institute of Statistics, Statistics Bureau of Japan.

The Conference Board of Canada

Immigration is Key to Canada's Population Growth



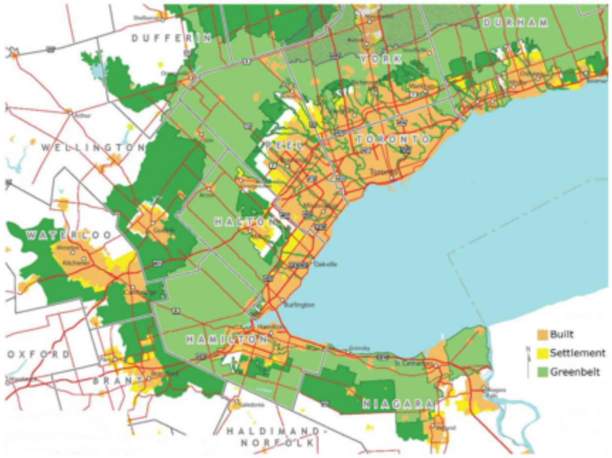


Population is increasingly being fueled by immigration, but immigrants do not spread themselves evenly across the country. Have contributed hugely to real estate demand in GTA and GVA

Quality of Immigration – point system, immigrants contribute immediately, greater contribution to GDP,

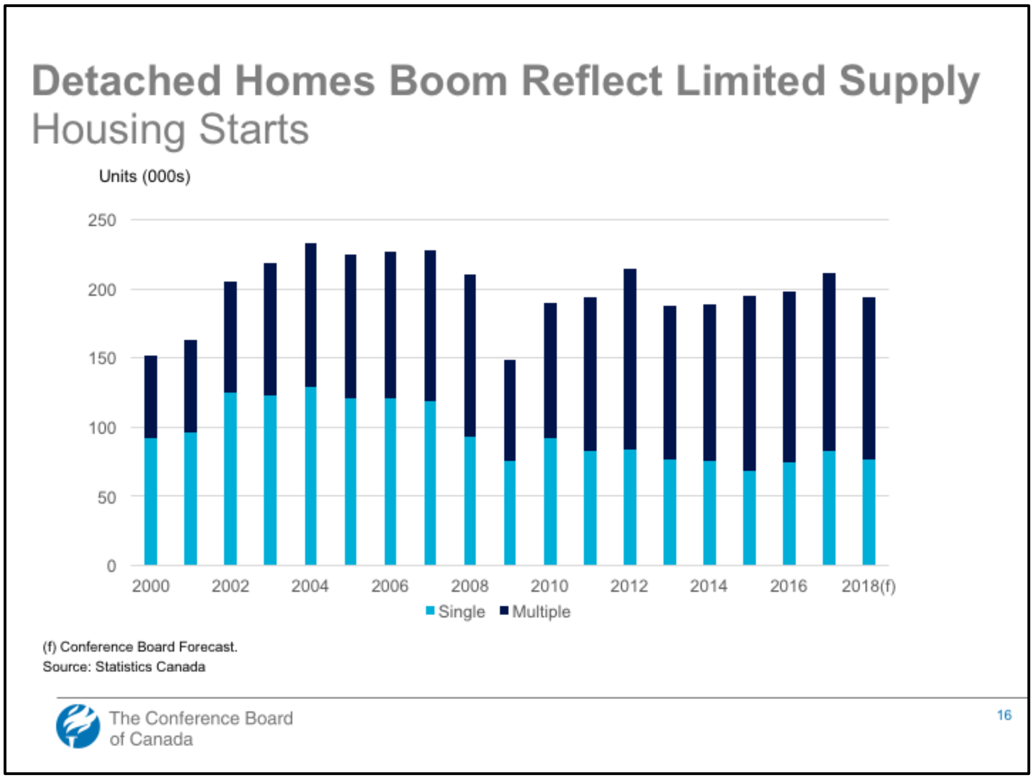
Land Scarcity From Land Use Restrictions

The Ontario Greenbelt

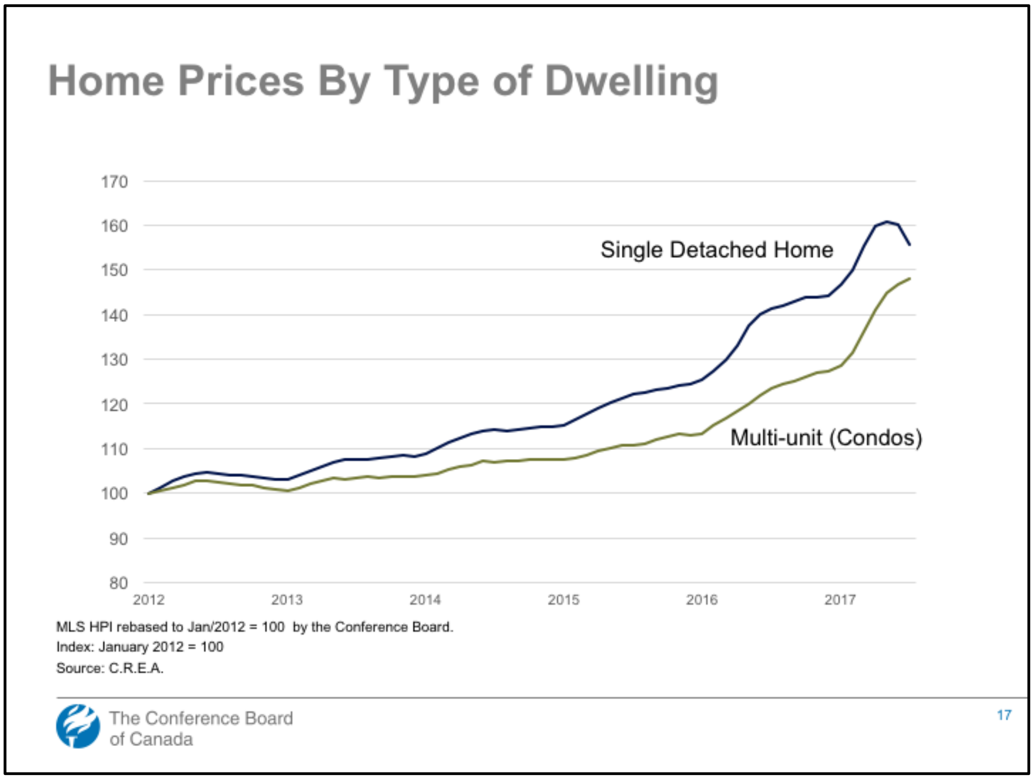


powered by Piktochart make information beautiful

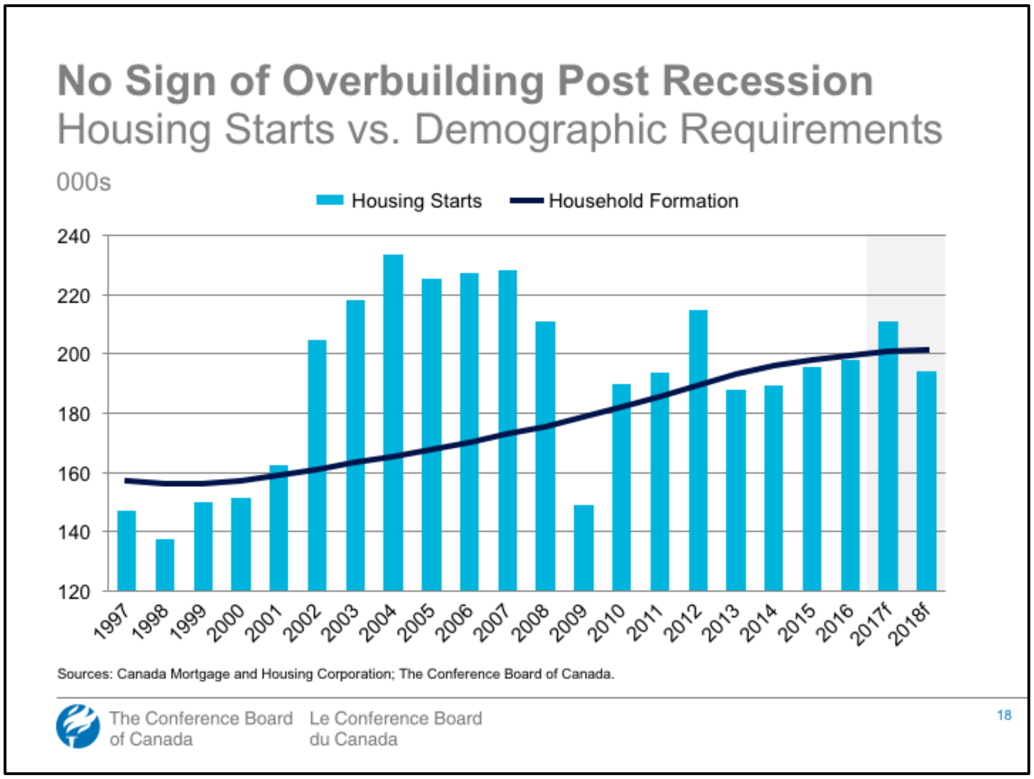
Zoning has also had a big impact. Land scarcity always a problem in Vancouver – surrounded by mountains, divided by rivers, few bridges. GTA had land scarcity imposed by the Green Belt – goal was to restrict urban sprawl and improve environmental outcomes



Result has been a shift towards construction of multi-unit dwellings (condos). But, Canadian culture is raising families in single detached homes.



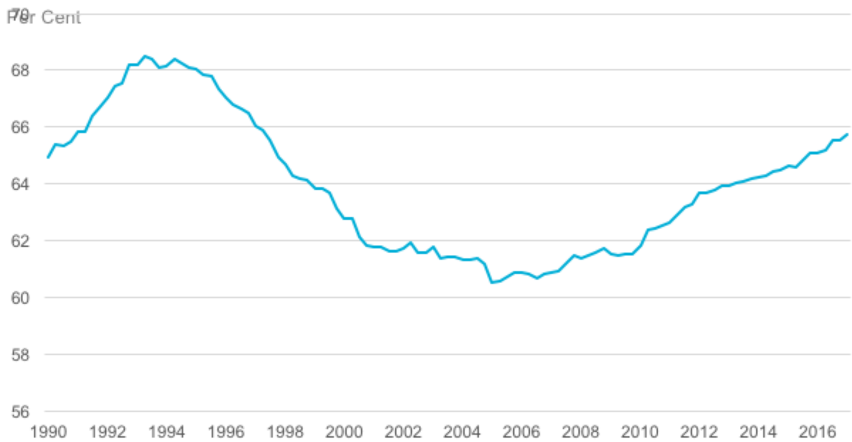
This created a price premium on such dwellings. Until mid 2016, large gap between single home price growth and condos. That changed, and mutli unit prices started rising rapidly in Southern Ontario, which is what motivated regulatory actions.



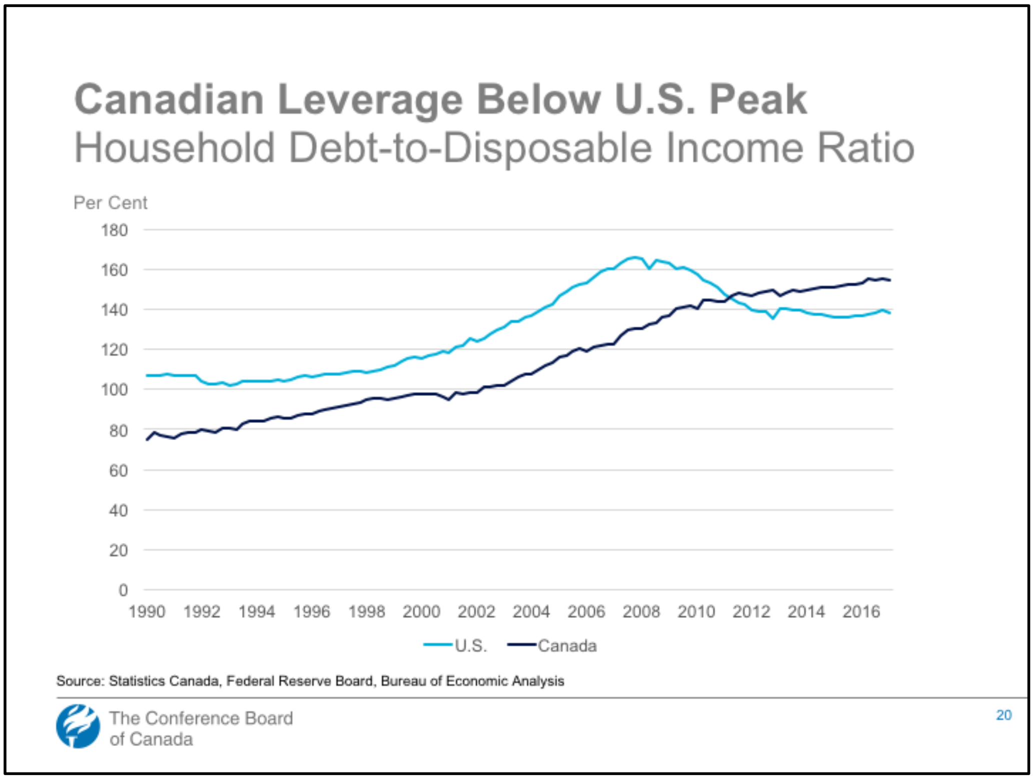
Pre-recession there were worries about excess building. Since the recession, construction has been in line with demographic fundamentals.

Home Purchases Have Been Debt Financed…

Mortgage Debt as Per Cent of Total Household Debt



For Canada. At market value.
Source: Statistics Canada

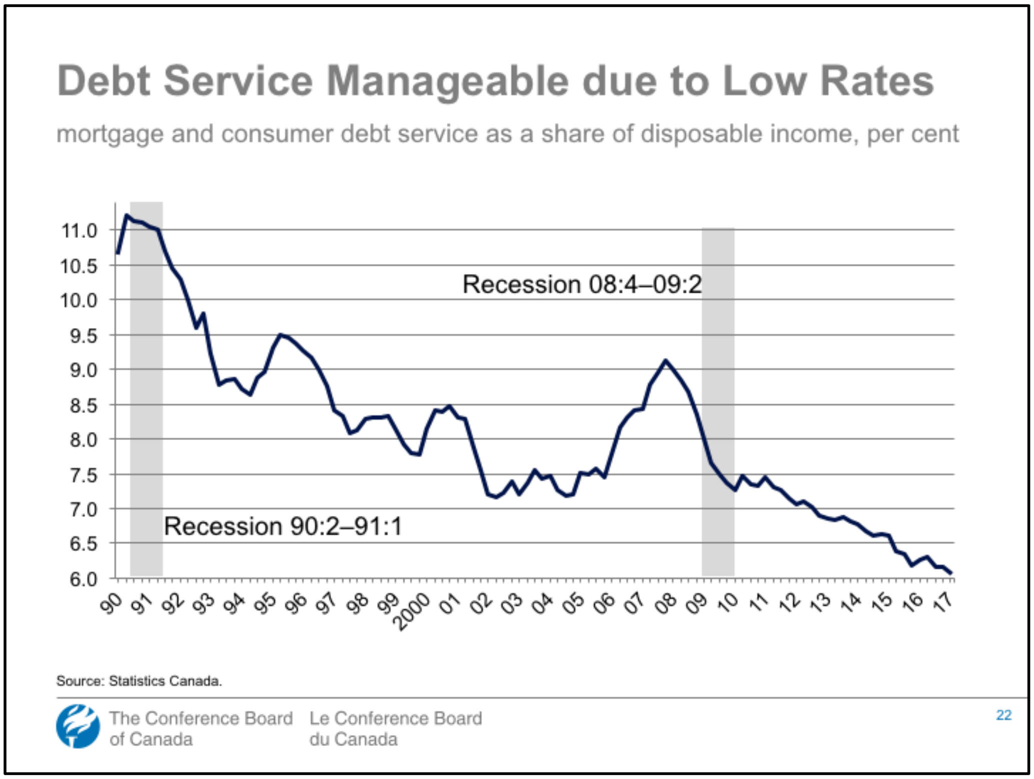


A lot of confusion. US and Canadian household debt-to-income stats use different definitions and methodology. Apples-to-apples comparison shows Canadian ratio is very high, but a bit below US peak. Debt-to-income is a terrible metric. Says nothing about risk. It is comparing a stock to a flow. It includes all of the people with debt and those without. There is no line that says beyond this point you have a problem. It is really meaningless except as a signal that people are borrowing.

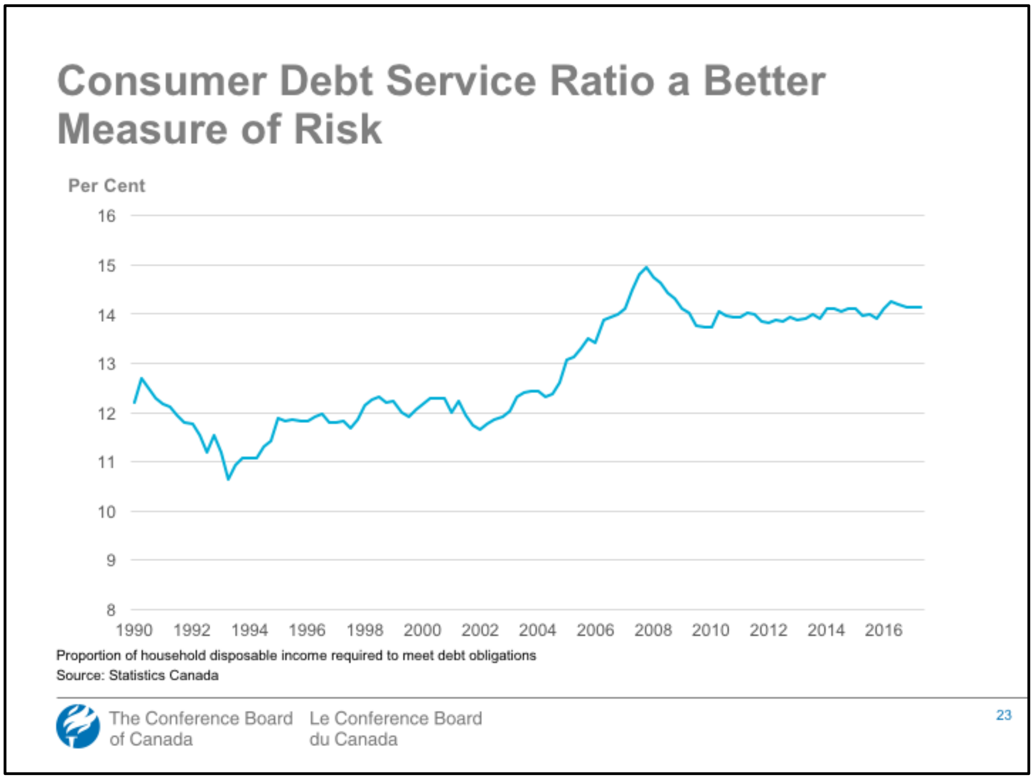
US health care costs a bigger share of expenditure

Debt-to-Income Is Very Poor Measure of Risk

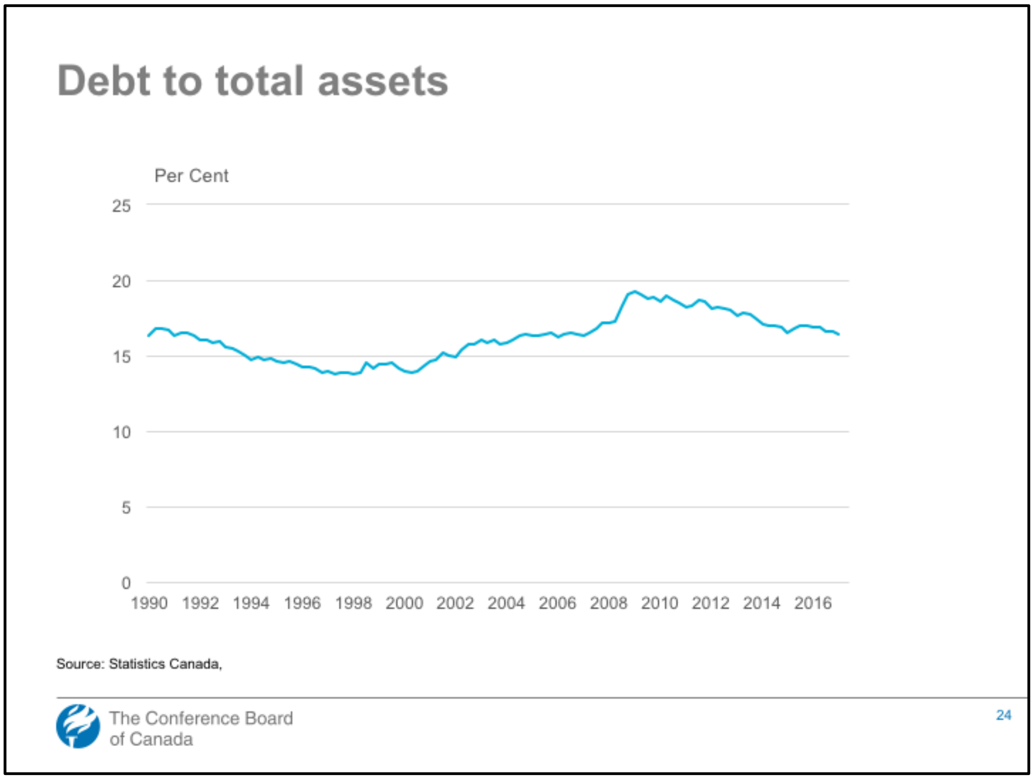
- U.S. peak in 2007 was 165%, Canada using same methodology is currently at 155% -- 10 percentage points lower.
- However, the after-tax income used in calculation misses the fact that all Canadians have public health care provided by taxes, while American's pay for health care with after-tax income. Adjusting for health care outlays so that income is comparable, the Canadian household debt-to-after tax ratio is 17 percentage points below US peak.
- Moreover, debt-to-income measures the stock of debt to the annual flow of after-tax income. Not the right comparison. Stock of debt should be compared to stock of assets. Or, annual debt service costs should be compared to annual after-tax income. The ratio also includes all household debt but compares it to the income of those with and without debt. This makes the exact level of the ratio meaningless.
- There is no statistically relevant level beyond which the risks are acute



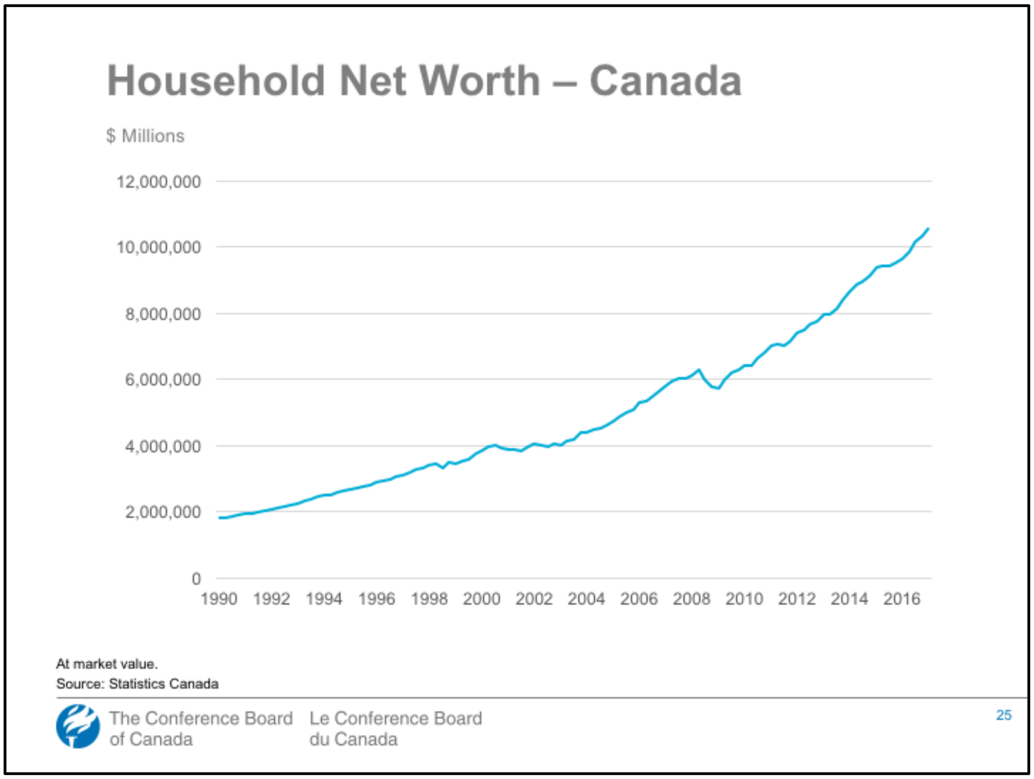
Debt service obligations tell a more appropriate picture of risk. It is comparing a flow to a flow. This slide shows debt interest payments as a share of after-tax income.



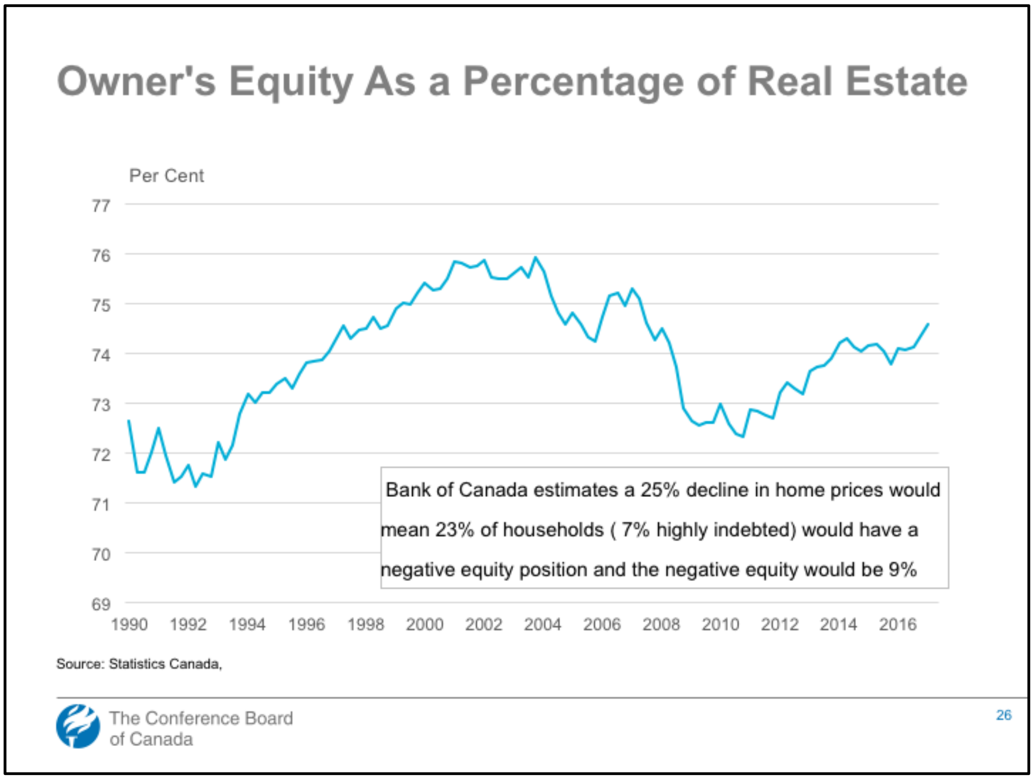
This slide includes both interest and principal payments. Yes, the debt service has increase as a share of income, but only 2 percentage points. The question is what happens when rates rise. A 2 percentage point increase in interest rates might put 10% of household at risk.



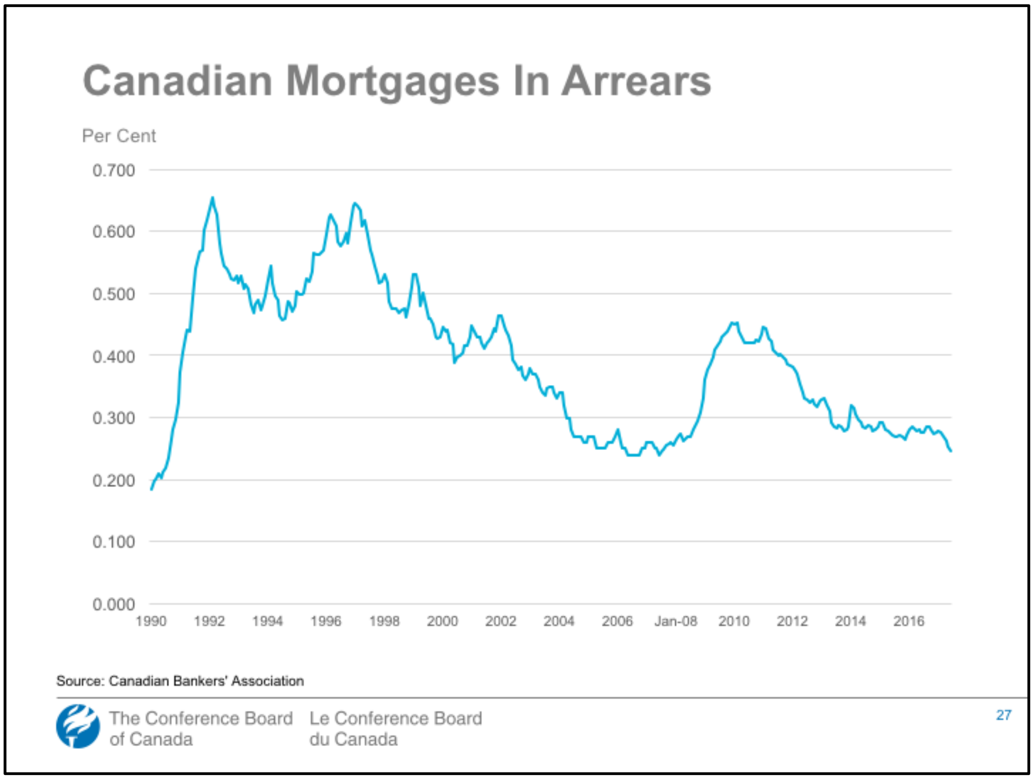
Debt has increased, but so too have assets. Real estate is the single biggest asset household have.



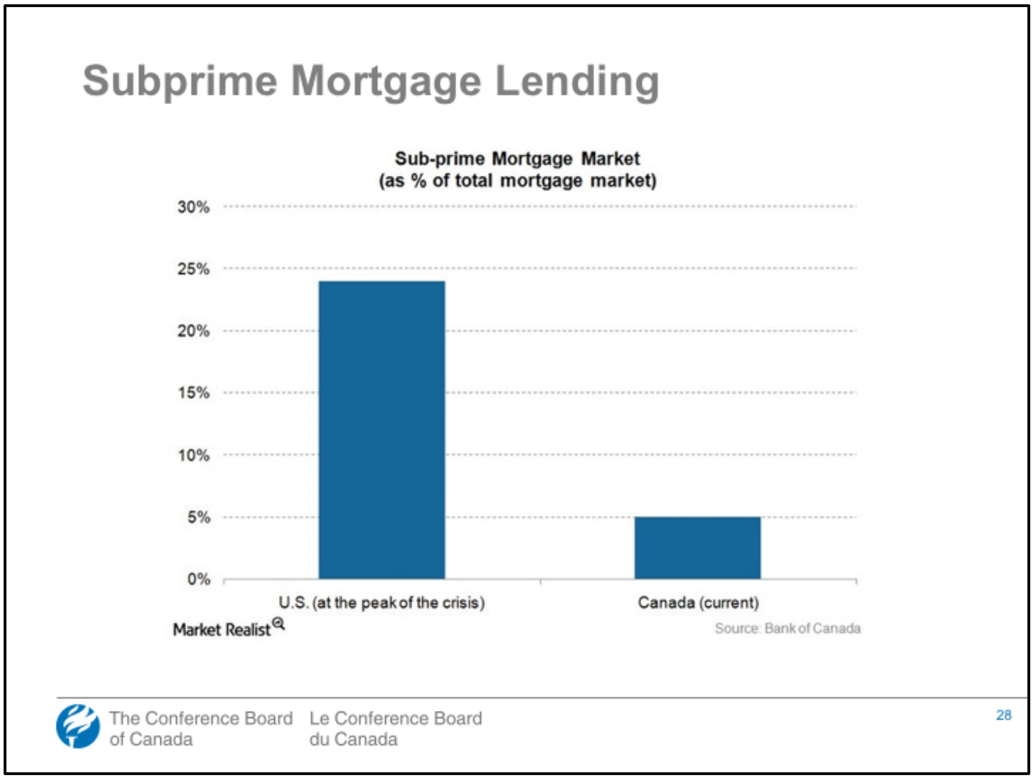
Households are accumulating wealth through home asset appreciation. Not a good measure of risk, because home prices can fall



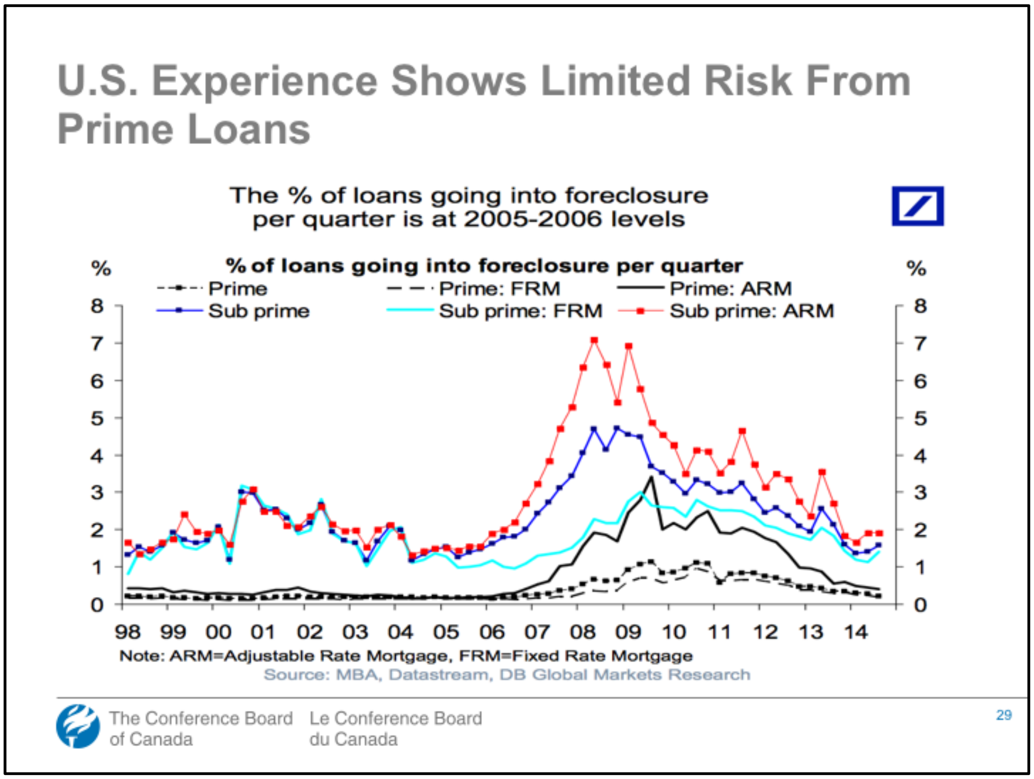
Canadians are conservative and tend to accumulate equity in their homes. Bank of Canada regularly stress tests for vulnerability. The high level of equity provides a buffer for most homeowners except the most recent – and even then buyers are putting 5-20% down.



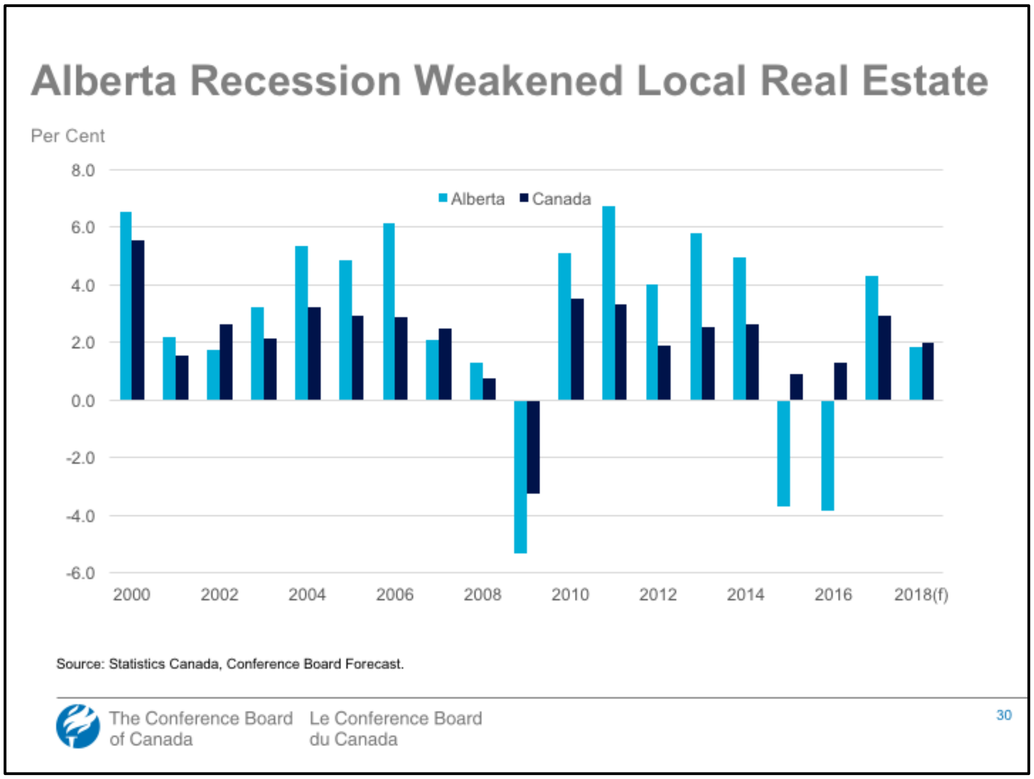
Conservative Canadian borrowing also reflected in low mortgage arrears. Currently below 0.3%. Canadian mortgage arrears have historically been well below those in the U.S.



Canada market is dominated by prime mortgage loans. Market is also well regulated. Only one regulator for major banks – OSFI. Canadian banks also well capitalized. Government prescribed stress tests have included a 30% decline in home prices, and Canadian financial institutions do not fail.

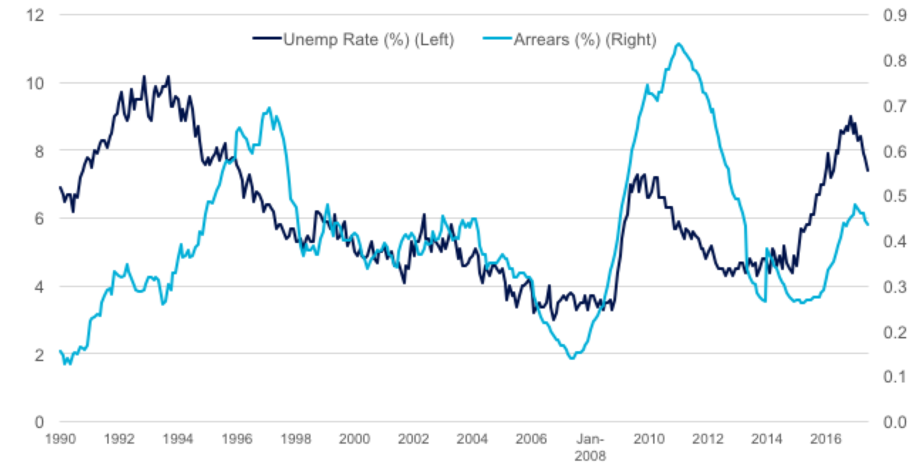


Look at the experience of US prime loan foreclosures versus subprime ARM. If Canada had the US experience, it would be largely limited to the increase in foreclosures going to around 1 percent – and widespread government mortgage insurance makes even 1 percent foreclosure rate unlikely.



We have a recent Canadian experience where Alberta went into recession.

But Unemployment Only Led to Modestly Higher Mortgage Arrears



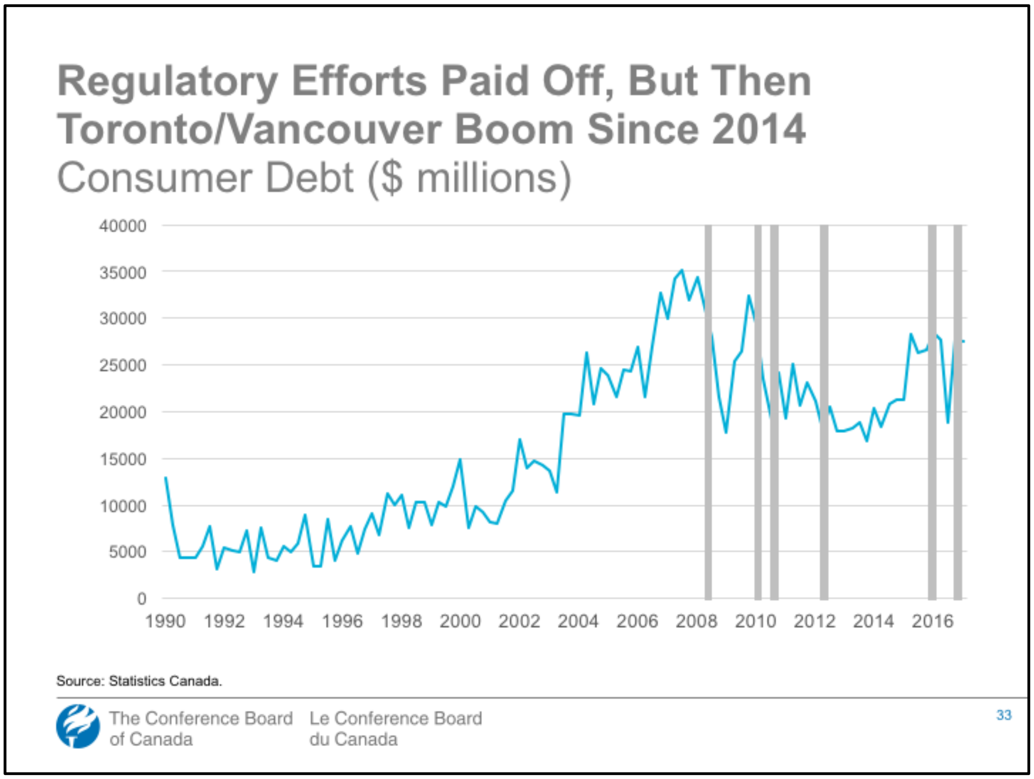
Source: Canadian Bankers Association, Statistics Canada.

The Conference Board of Canada | Le Conference Board du Canada

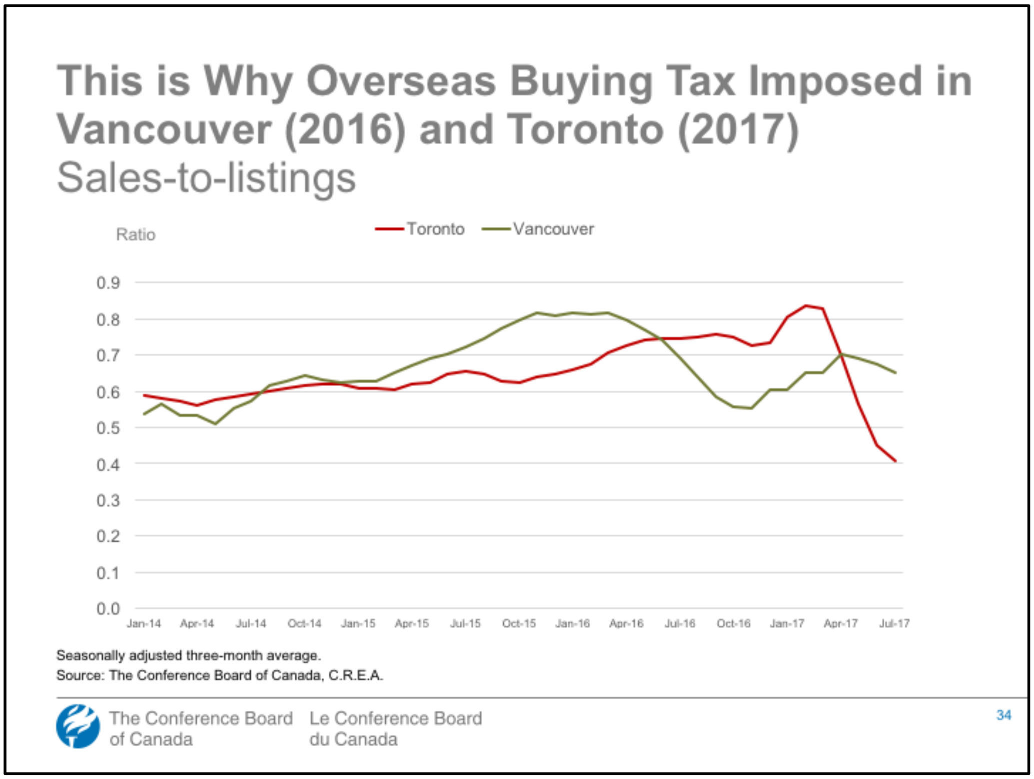
31

The unemployment rate almost doubled, household income fell, and mortgage arrears rose from under 0.3% to around 0.4%

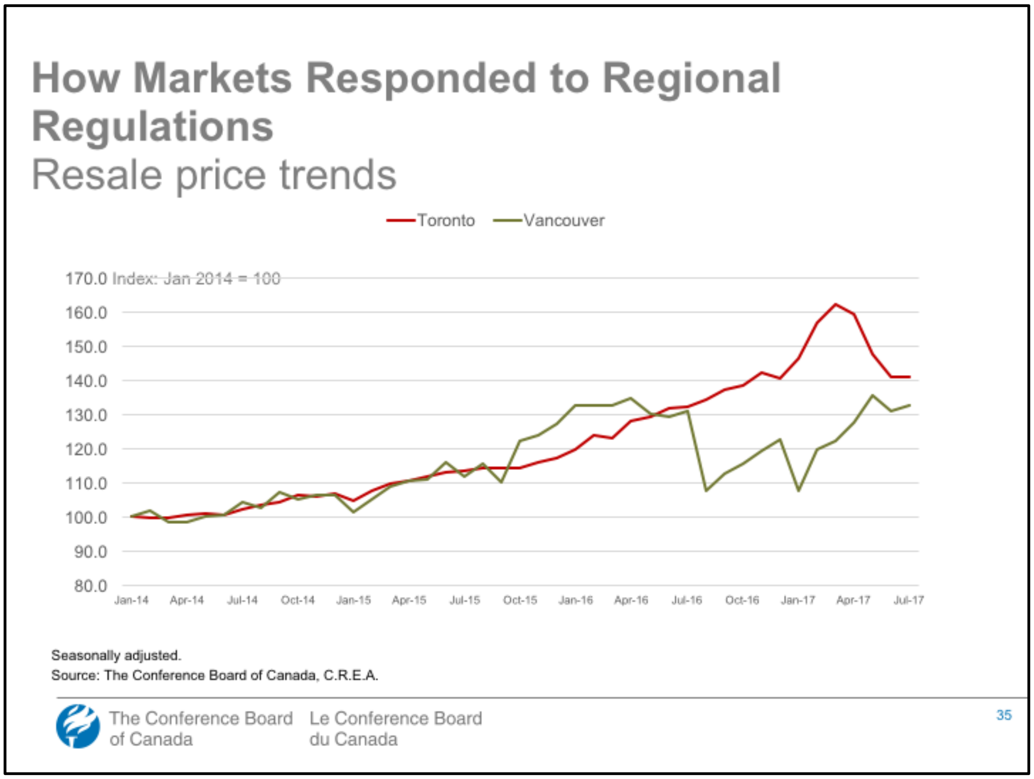
Again, there is risk. The question is the magnitude. The Bank of Canada has been flagging the risks for several years. They made the case that the right approach was targeted policy action. So, we have had many rounds of mortgage policy regulatory tightening



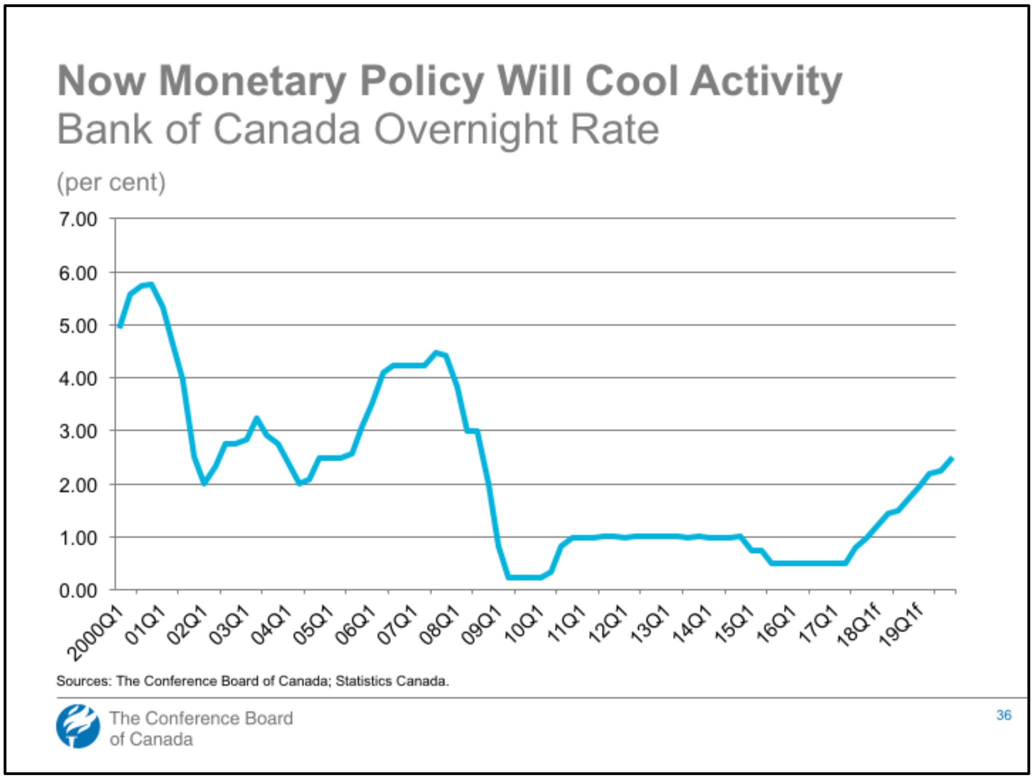
And, it did have an impact until late 2014. Then Vancouver and Toronto heated up.



The next step was narrowly targeted regulatory tightening in BC in 2016 and Ontario in 2017.



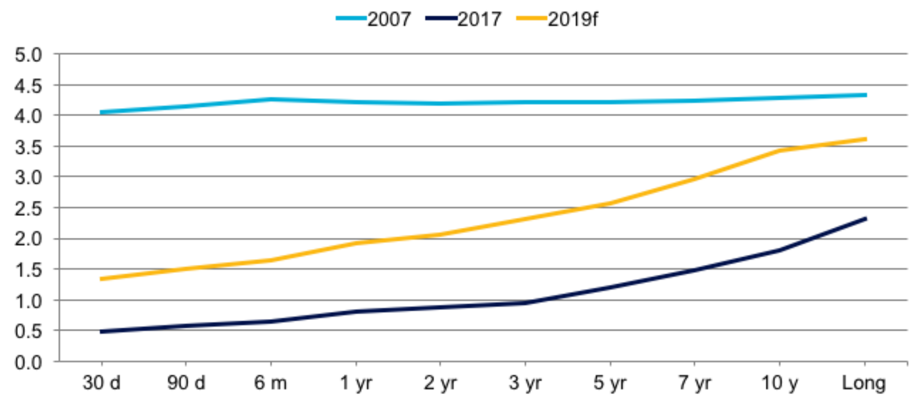
And, one can see the price response in Vancouver and Toronto – note that Vancouver shows that the regulatory action diminished with time



Now Bank of Canada has come off sidelines and is rebalancing monetary policy, which should reinforce moderation caused by regulatory actions. Neutral level of interest rates is around 2.50%

Canadian Yield Curve

government bond and treasury bills, per cent



Sources: The Conference Board of Canada; Statistics Canada.

Canadian Risks, but not US parallels

- Any parallels to the U.S. housing crash and its impact on the financial system are limited.
- First, unlike in the United States, nearly all mortgages in Canada are full-recourse loans.
- Second, there is no evidence that the poor underwriting standards that supported the explosion of subprime mortgages in the United States prior to the crisis are present in Canada.
- Third, much of the Canadian housing finance system is backstopped by CMHC-guaranteed mortgages and, ultimately, by a fiscally sound federal government.
- Bank of Canada focus is on risk of highly indebted Canadians

Watch Out for Bombastic Headlines

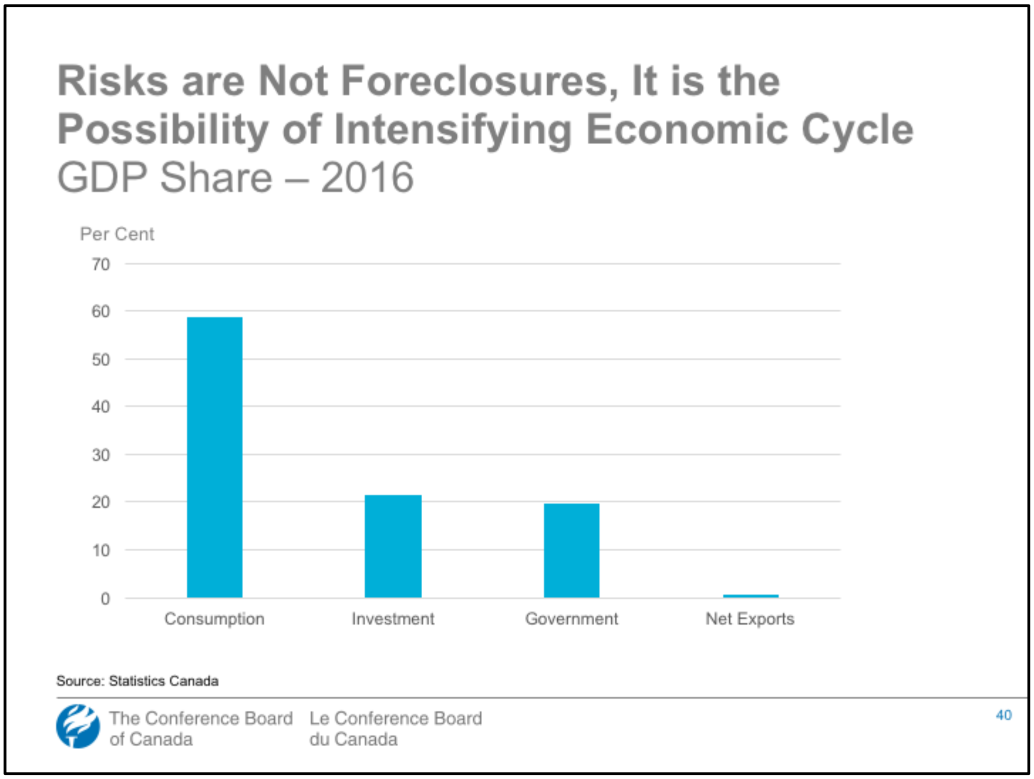
"Subprime lenders' share of the Canadian mortgage market has reached **record** levels, according to data obtained by the *Financial Post*, putting increased risk on the housing market.

Alternative lenders, who are major beneficiaries of that subprime market, now underwrite **2.2% of all mortgage loans**." Financial Post, 2014

During US housing bubble the share of subprime mortgages went from around 5% to almost a quarter of mortgages. Canadian subprime market from all lenders has tended to be 3-to-5% of market.

Also should stress that roughly 90% of Canadian mortgages are recourse loans. Makes a big difference on willingness to default.

There is concern that regulatory action has pushed more of mortgage lending growth out of traditional chartered banks, but the scary headlines often overstate the risk. Yes, subprime lending at a record high. It is a small fraction of the market.



The concern is highly indebted households, and this is warrants examining mortgage books closely. I am not worried about a US-style housing crash. However, I am more concerned that high household debt creates an economic cycle vulnerability. Consumer spending is roughly 60% of GDP. If more income goes to servicing debt or if there is a home price correction that creates a negative wealth effect, it could weaken the performance of the Canadian economy. This is why I am a strong adocate in recent years to the regulatory tightening and why I am pleased the BoC has nudged rates higher.

Summary

- Canada has had a housing boom, which has fueled high levels of household debt.
- Most of the appreciation has been driven by economic fundamentals, but there is some overvaluation.
- Interest rates to rise further and full impact of regulatory actions not yet felt. Nevertheless, real estate conditions in Golden Horeshoe to cool but a U.S.-style crash is unlikely.
- High household debt is a concern, but vast majority of Canadians have been responsible. About 10% of households particularly vulnerable.

The Conference Board of Canada
Le Conference Board du Canada

conferenceboard.ca

@CraigA_Eco