PERSPECTIVE

Beata Caranci
Chief Economist
TD Bank Group

MOVING ON THE MONOPOLY BOARD:
BUYER GRIDLOCK IN THE TORONTO AND VANCOUVER HOUSING MARKETS

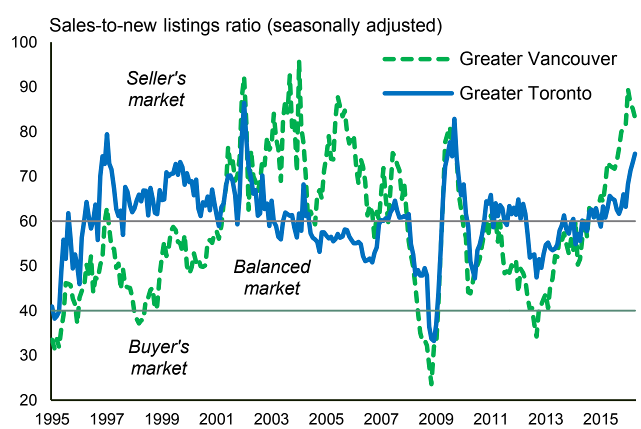
In the game of Monopoly, the first time around the board usually results in the purchase of Baltic or Connecticut Avenue. However, in doing so, sufficient funds remain to purchase Marvin Gardens or Pennsylvania Avenue, where your sights are ultimately set. If the game changes such that Connecticut Avenue fetches the price of Marvin Gardens, would this alter the selection of your first purchase?

An entry-level home was purchased with the intention of "trading up" as your lifestyle changed with children, job or income. But, despite a strong appreciation in the price of your home, trading up still requires a hefty mortgage or reduction in savings. In doing so, you'll likely receive only a modestly better home or neighborhood. Taking into account other costs associated with selling, financially it makes more sense to stay put and/or renovate. If this sounds familiar, you have a case of buyer's gridlock.

This condition does not describe the first-time buyer trying to break into the home ownership market, often cited as the plight of Millennials. Instead, our definition of buyer gridlock refers to an *existing* homeowner trying to trade up from an entry-level home, who is also facing a constrained supply of affordable options.

Analysts often point to the elevated sales-to-listing ratio in the greater Toronto and Vancouver areas (GTA and GVA) as evidence of a seller's market (Chart 1). This should not be thought of as a universal principle. Would-be sellers of entry-level homes have seen less price appreciation relative to homeowners within the trade-up segment. Limitations on data availability prevent our preferred approach of honing in on all types of entry-level homes. But, we can demonstrate the effect by looking at differences in the purchase price of a detached home relative to a condo. The lower price point on the latter makes it representative of an entry-level market segment. On average, it costs twice as much to purchase a detached home than a condo in the GTA market. In the GVA, that price gap has widened to three times the level (Chart 2a). Stretched affordability for a family detached home is particularly acute in the GVA market, a fact well contextualized by the ratio of prices relative to incomes (Chart 2b). At 12 times in the GVA and 8 times in the GTA, these ratios are mirroring those of

CHART 1: TORONTO AND VANCOUVER IN A SELLER'S MARKET



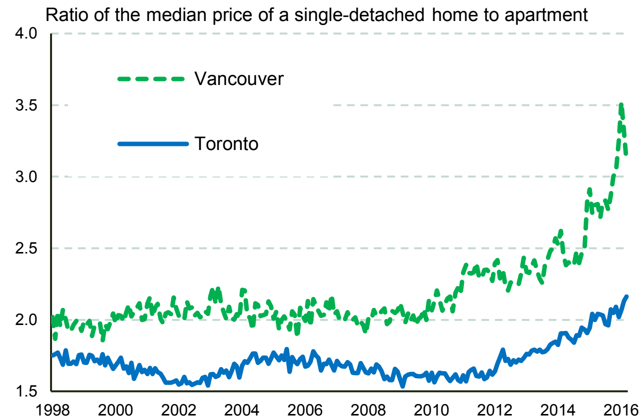
Source: CREA.

some of the hottest markets during the mid-2000 boom in the United States. The end result, trading up is difficult for existing homeowners in the absence of a significant increase in mortgage debt and/or reduction in savings.

"Boohoo", would say a Millennial trying to get into the housing market for the first time. At least existing homeowners have benefited from a rise in equity values. However, Millennials absorb the trickle-down effect of buyer gridlock. It limits their options available for purchase. And, after making the plunge, it can prevent a move to the next step.

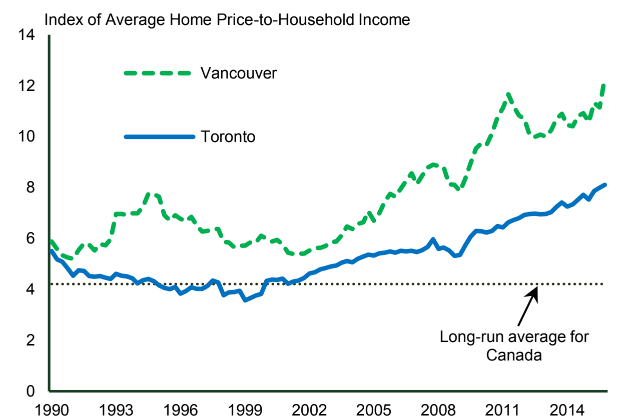
The widening price gap between an entry-level home and a trade-up home becomes a "barrier to entry" for existing homeowners. This reduces churn in the market, elevating prices and scaling back the selection of choices. This buyer gridlock effect is made worse as homeowners respond by renovating their entry-level homes. Keep in mind that the example above used the definition of condos to depict an entry-level home, but this is a function of our data constraint. Many detached homes have historically fit the bill. This is the segment of the market were renovation activity by homeowners has heated up, because they have more flexibility on permit and expansion opportunities. The end result is that a home conversion can take what was once considered an entry-level detached residence into the category of a trade-up, further tightening the available and affordable supply at the lower end of the market. As shown in Chart 3, renovation activity has skyrocketed in the past decade.

CHART 2A: BARRIER TO ENTRY



Source: CREA.

CHART 2B: AFFORDING A HOME IN CORE MARKETS KEEPS GETTING HARDER



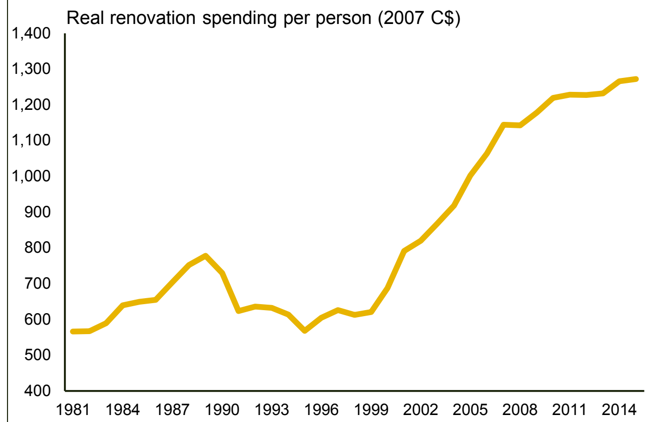
Source: Statistics Canada, CREA, calculated by TD Economics.

The restriction in supply can be observed in two forms in the GTA and GVA markets. There are fewer detached homes available for sale across the entire market. And, of those that are available, a fewer share sit below the median price. So far this year, less than one-third of the listings in the GTA market are under that threshold. Historically it's north of 40%, and as much as 50% a decade ago. In the GVA, the median value of a detached home is over one million dollars and just under one-quarter of the listings fell below that threshold in the first quarter of 2016. This has compressed from ratios that more consistently averaged 40% in earlier years. So as existing homebuyers try to move along the Monopoly board, there are fewer buying opportunities until you cross Kentucky Avenue, and for Vancouver homeowners, it's more like Pacific Avenue! (Image 1)

So what's the implication of buyer gridlock?

Where you sit on the Monopoly board takes on increased importance, as affordability erosion is creeping along the board. First-time buyers are being increasingly confined to a narrow segment of housing type: condos. This is where new supply remains the greatest in the GTA and GVA markets and marks the point-of-entry for the Millennial generation. But, the square footage has been shrinking for the average unit, making this supply of stock not particularly family friendly. Getting out of a condo as preferences or family needs expand is getting harder to do, even with rising incomes. As a result, demand for a detached home is being fulfilled by an outward push into adjacent metros, inflating prices in markets that are further afield to their first-choice destination for live, work and play. However, this comes with a host of other issues, including strained infrastructure and congestion.

CHART 3: RENOVATION SPENDING PER CAPITA JUMPS SHARPLY



Source: Statistics Canada.

In the event of a housing market down-cycle, dynamics suggest that the price-gap between the detached and condo market is unlikely to narrow meaningfully. In fact, it could worsen within the core metro areas where existing condo supply and comparative opportunities for development are more readily available. The true test will come during the next housing down cycle, the catalyst for which would likely need to be a nationwide economic recession. This is also when investors tend to exit the market or significantly scale back their purchase interest. This could compress the price gap between the detached and condo market if investors have been more active in the former. However, judging by the 2008-09 experience, the degree of narrowing in the price gap would be limited. So, for those having difficulty making the step-up now to a trade-up home, a cooler market may offer only a limited advantage.

For first-time buyers, eroding affordability at every level of purchase means that some won't even be able to get into the game, and renting for longer becomes the realistic option. In itself, there's no real disadvantage on this front, but it does require a high degree of financial literacy towards saving for retirement. Paying a mortgage acts as a form of "forced savings", with the added benefit that price appreciation can provide an opportunity to capture a capital gain. In addition, as people age, they can use the equity in their home to downsize and at the same time add to their retirement nest egg. Renters need to manage a larger pool of financial funds relative to their tangible assets.

For existing homeowners, mortgage debt has risen across all age segments and households are more leveraged than ever. This is even true for the Millennial generation, where higher homeownership rates relative to those generations that preceded them have also equated to higher mortgage debt. This too eats into future savings for retirement and carries risk for the broader economy that the next economic down cycle will be more extended than previous ones.

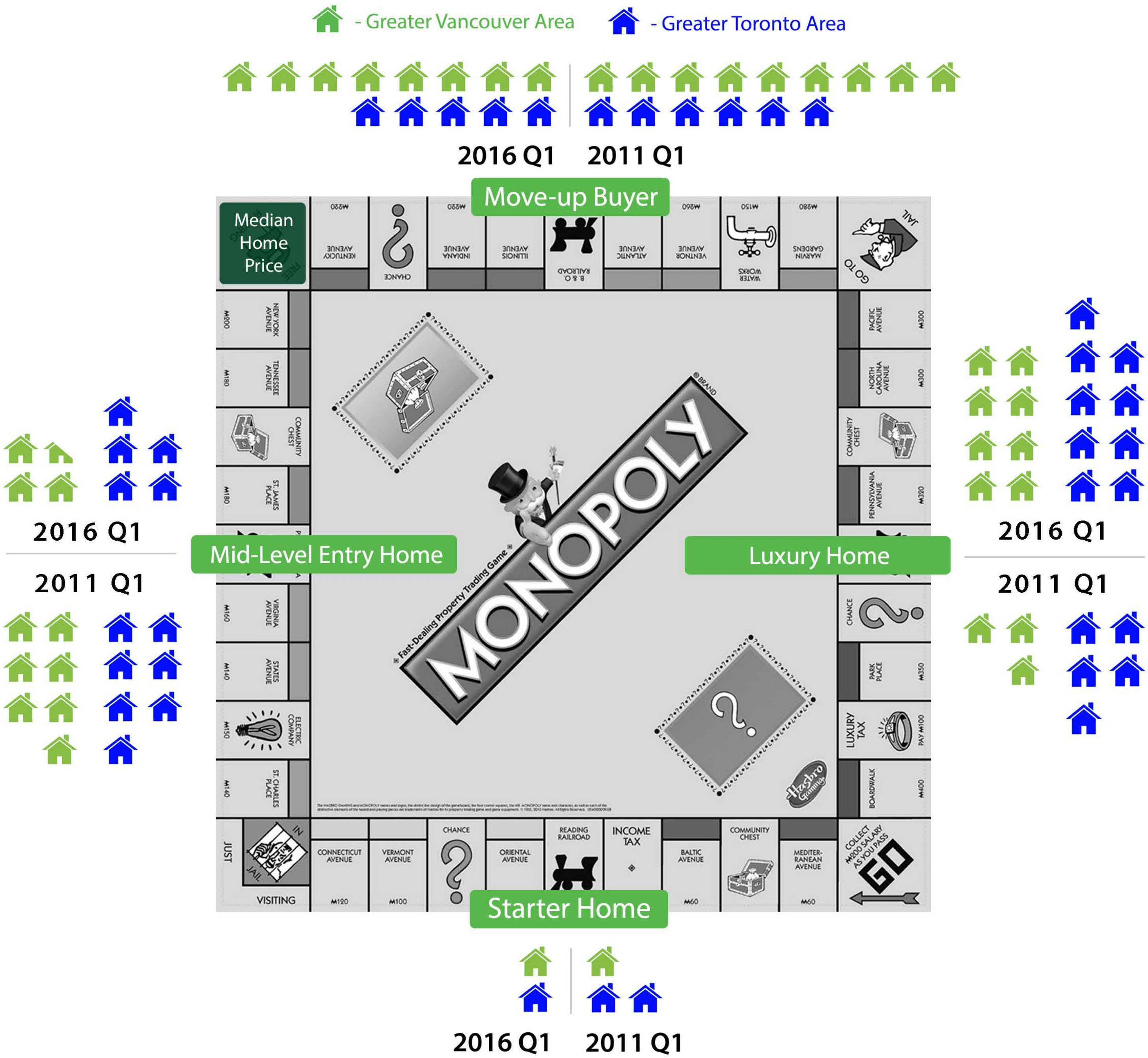
Conclusion

There's no get-out-of-jail-free-card on this board. Buyer gridlock is a function of limited affordable supply in the detached markets due to land constraints, policy and an increasing trend towards urbanization from stronger population fundamentals within the core areas. Population growth in the GTA and GVA markets is roughly twice that of the rest of Canada. This demand-push is further compounded by investor interest (be it domestic or foreign) that is soaking up supply within the various market segments. Baltic Avenue, once considered one of the most affordable, is now fetching the price of St. James Place. Ultimately, Toronto and Vancouver are moving the way of many international cities, where land constraints and population growth forces residents out and up. Out into suburbs and up into condominiums, be it ownership or rental.

Beata Caranci, Chief Economist,
416-982-8067

Buyer Gridlock: Single Detached Homes

2016 Q1, Percent of Total Listings



Price levels were determined relative to the median sales price in the given period where;

Starter home = ½ the median price
Mid-level entry home= everything else up to the median price

Move-up buyer is up to 2X the median
Luxury: 2x the median price and above

Note: Each home symbol is equivalent to approximately 5% of single detached listings

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