OBSERVATION

TD Economics

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TORONTO & VANCOUVER: THE HOUSING MARKETS THAT HAVE ALL EYES WATCHING

Highlights

- The nation's two biggest housing markets, Toronto and Vancouver, seem to have diverged in recent months with the pace of sales slowing and prices declining in Vancouver, while the Toronto market has a full head of steam.
- However, average price changes can be deceiving and other measures indicate the divergence is less dramatic.
- The real parting of the ways seems to be between the market for single-family homes, where limited supply has kept prices firm, and the condo market, where construction booms have kept price increases more modest for both markets.
- In the near term, we expect the divergent fortunes of these big-city markets to diminish, but longer term both markets are likely 15% overvalued. Inventory levels that are already high (Vancouver), or set to head higher (Toronto) make the condo market the bigger concern in both cities.

After ten years of a housing boom in Canada, we are a nation obsessed with house prices, and the question of how much longer they can continue to rise. Nowhere more so than in Vancouver and Toronto, the largest markets that have carried a big weight in the national picture (throughout this report Toronto and Vancouver refer to the CMA region). Early in 2011, the most commonly watched real estate data collected by the Canadian Real Estate Board (CREA) showed that big price increases in Vancouver were inflating the national tally, and now average prices in Vancouver are falling on a year-on-year basis. Meanwhile Toronto seems to chug along at a high single-digit year-on-year pace. What is behind these headlines? Is Vancouver a housing bubble in the process of popping, while Toronto continues to inflate? This paper will explore the similarities and differences in the two markets and how their outlooks compare.

Explaining away some of the recent gap

As is usually the case with average data, it hides a multitude of sins, particularly when it comes to house prices. When other measures of house prices are examined, the difference in the two markets is far less dramatic than the average house price data would suggest (see Table 1). That is because the types of homes sold in a given month can skew the average house price picture. When you compare

TABLE 1. VARIOUS MEASURES OF HOUSE PRICES

	Yr/Yr % chg. - April 2012				09 Trough-to-now % Chg.		Total % chg. 2005 - present			
	CREA	MLS HPI Total	MLS HPI Single Family	MLS HPI Condo	CREA	MLS HPI	CREA	MLS HPI Total	MLS HPI Single Family	MLS HPI Condo
Toronto	8.5	7.9	9.0	4.6	42	33	50	50	51	46
Vancouver	-7.0	3.7	6.3	1.1	44	27	89	63	78	52

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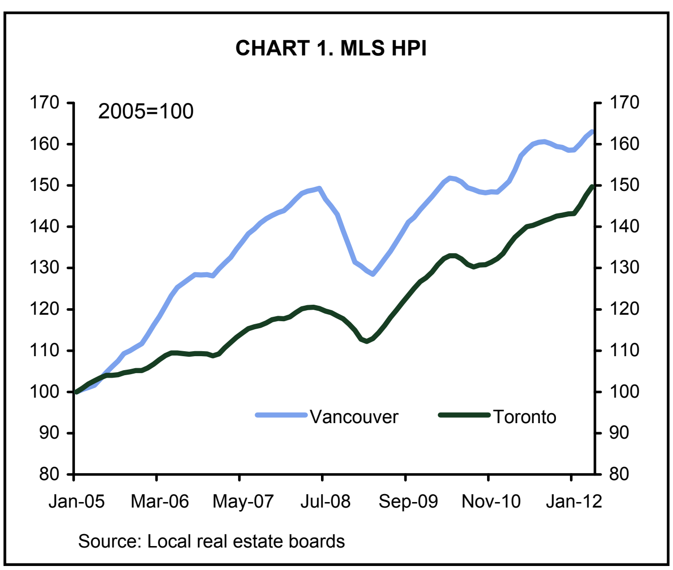
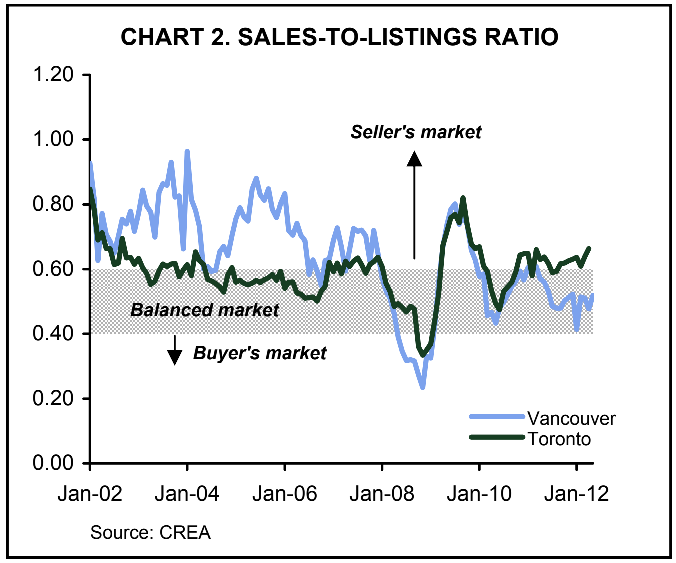
one month's average price to the prior year, you may have a preponderance of small condos one year, and large single family homes the next. If this shift occurred and prices per unit are unchanged, the average price data would show a large increase that never actually occurred. In other words, a change in the composition of sales can create apples-to-oranges comparisons.

The MLS House Price Index (MLS HPI) is one measure – similar conceptually to the Consumer Price Index – that uses statistical techniques to account for the contribution different characteristics make to the price of a home to make a more apples-to-apples comparison of house prices over time in a given market. This measure shows that price increases in Vancouver have still decelerated over the last eight months or so, while the Toronto market shows steady increases, but the divergence is less dramatic (see Chart 1). Anecdotal evidence from CREA suggested that a record level of high-end home sales in Vancouver's priciest neighbourhoods in the first quarter of last year inflated average prices. Now prices seem to be declining when compared to such a high base. A comparison of prices among more similar homes using the MLS HPI shows Vancouver prices are still up 3.7% year-on-year, lower than Toronto's 7.9%, but certainly not falling (see Table 1).

Indicators of unit sales activity and sales-to-listings ratios do show a divergence in the two markets that lines up with a slower pace of price increases in Vancouver than Toronto (see Chart 2). The pace of sales in Vancouver surged in the first quarter of last year ahead of mortgage rule changes, and is now down 16% versus last year's level. Sales in Toronto have steadily improved since mid-2010, and are now up 11% year-on-year. Unit sales are highly volatile and year-over-year comparisons are subject to huge base effects. But, when you look at the trend level of sales, Toronto does have more upward momentum than Vancouver, and its sales-to-listings ratio is higher, indicating a tighter market relative to Vancouver.





In sum, some of Toronto's recent outperformance can be partly, but not fully, explained away by the usual volatility in the data and reflects more signs of Toronto market strength than Vancouver market weakness.

Longer-term perspective: more similarities than differences

A longer-term perspective on sales and prices also provides some further insights on the recent parting of ways between the two markets. In the years leading up to the 2008-09 recession, Vancouver experienced tighter market conditions, and a larger run-up in average home prices (see

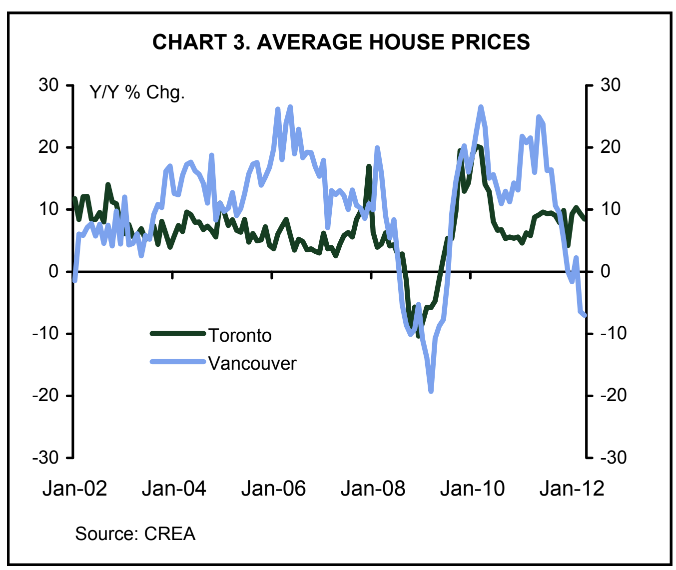


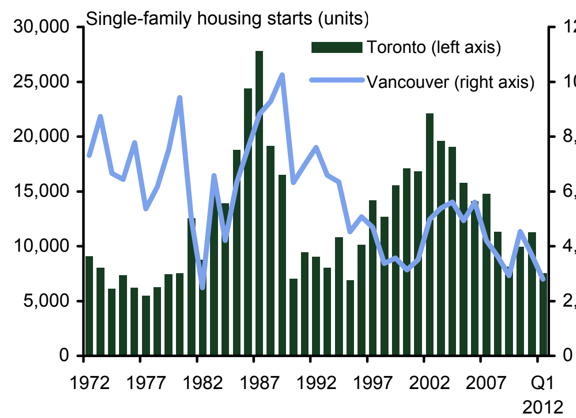
Chart 3). The average price of a Vancouver home rose 90% from 2002-2007, compared to 40% in Toronto. With the standard two-story home as measured by Royal LePage now costing well over a million dollars in Vancouver, and 45% less in Toronto (same differential using HPI as single family index) Vancouver has long been the less affordable city, and that situation has deteriorated over the last several years. Since interest rate cuts during the last recession sparked a resurgence in Canada's housing market, Toronto has seen the greater run-up in prices as measured by the MLS HPI (see Table 1.). Indeed, price gains in Toronto had grown more slowly than a number of other large urban markets, including Montreal, pre-recession. Accordingly, some of Toronto's recent strength may be reflecting a degree of catch-up to these other cities.

Still, taking a step back reveals more similarities than differences between the two housing markets. Both are vibrant big cities, which are attractive to large communities of newcomers and foreign investors. Looking at the economic fundamentals, they have had nearly identical population growth over the past five years, particularly in the critical first-time buyer segment (see Chart 4), and similar rates of economic growth. However, over the period of the last census (2006-2011) Vancouver saw a higher level of new housing units relative to its population growth, compared to Toronto.

Condo construction boom makes the segment the bigger risk in both markets

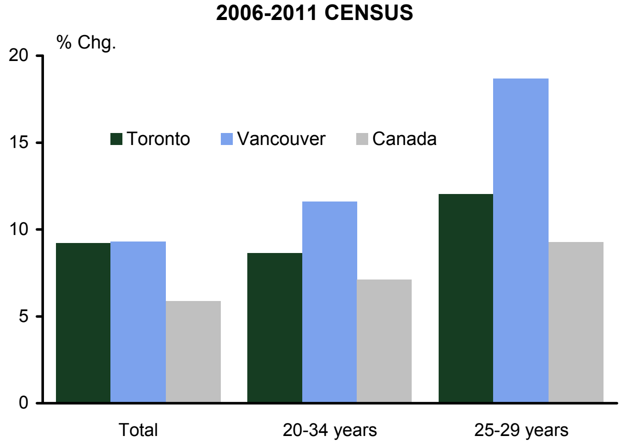
Perhaps the most striking similarity is the fact that both markets have been driven largely by condo activity, reflecting demographic trends, erosion in affordability of single-family homes, land scarcity due to either geography (Vancouver) or regulations (Toronto). Both cities show a low level of single-family home construction in recent years (see Chart 5). Over the past ten years 73% of Vancouver's new housing units were multiples, and 63% in Toronto. Over the past twelve months, those shares are much higher (80% in Vancouver and 74% in Toronto) as development restrictions both through regulations in the case of Toronto, and geography in Vancouver, limit the supply of new single-family homes.

CHART 5. LOW LEVELS OF SINGLE-FAMILY HOME CONSTRUCTION



Source: CMHC

CHART 4. POPULATION GROWTH 2006-2011 CENSUS



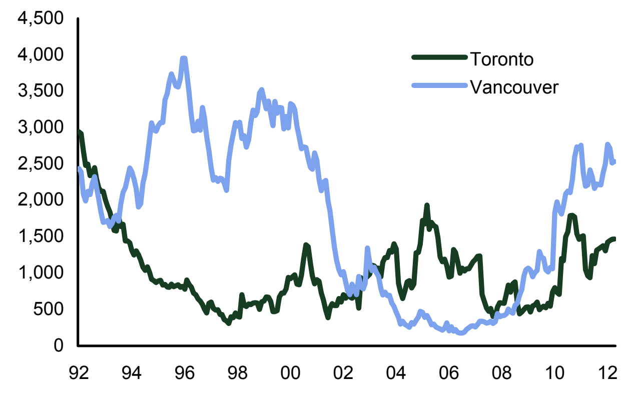
Source: Statistics Cananda, Census data

Undoubtedly, an important share of the condo purchases in both markets reflects investor purchases, driven in part by low rates of return on competing asset classes such as fixed income. For now, investor puchases are also supported by healthy rent inflation in both cities, reflecting their sub-2% vacancy rates. While data on foreign investor participation in real estate markets are scarce, CMHC provides an estimate on total investor-held share of the condominium stock. At last count, between 20-25% of condominiums in Toronto and Vancouver reflect purchases by investors, most of which end up on the rental market.

Despite these favourable longer-term structural trends, the condominium market is notoriously cyclical in nature. And there have been growing signs that the markets have been tilting towards excess supply of new multiples (see Chart 6). The distinction is more one of timing. Vancouver appears to be wrestling with a growing challenge of over-supply while in Toronto, the worries surround over-building and the potential for a supply glut over the medium term.

The higher level of inventories in Vancouver has likely played a role in the fact that when you break down the MLS

CHART 6. NEWLY COMPLETED & UNOCCUPIED MULTIPLE UNITS



Source: CMHC

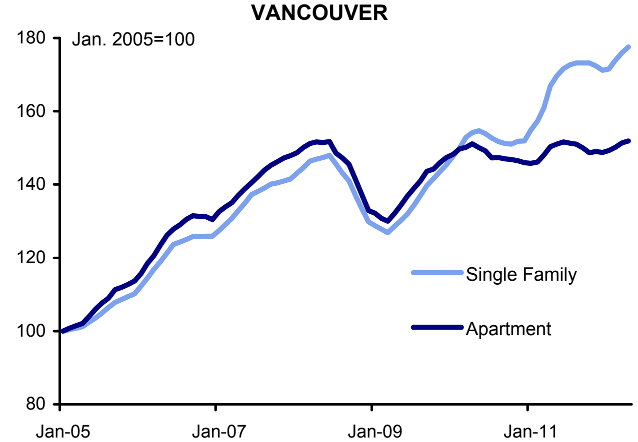
HPI by type of housing, there has been a much more noticeable slowing in price increases in the condo market than for single-family homes (see Chart 7). In fact, looking at the trend in condo prices, you can see there has been essentially no increase in prices since the federal government first began tightening mortgage rules in mid-2008. Interestingly, after slowing building activity during the recession and early stages of recovery in 2008-10, multiple unit construction in Vancouver has rebounded strongly, suggesting some further increase in inventories going forward.

In Toronto, condo prices have been growing at a faster, albeit still moderate, 5% year-on-year rate. Recently, sales figures for condos in Toronto have been very strong, helping to support decent price increases despite the huge number of units available. Some of this relative strength appears to reflect the impact of unseasonably warm weather this winter that has brought some activity forward from the spring market. Nonetheless, busy Toronto condo developers have been active in ramping up supply to meet much of the demand, keeping price growth in check. In contrast, a lack of supply in the market for single-detached homes has supported annual price growth of around 9%.

The newly completed and unabsorbed units in Toronto appear poised to ramp up over the medium term. As Chart 8 highlights, unlike Vancouver, multiple unit construction the Toronto barely fell during the recession and has been on a significant leg up since 2010. Based on first quarter's pace of new condo sales, there is seven quarters worth of supply under construction. While the majority of units have been pre-sold, not all of them have, which raises the risk of growing supply-demand imbalances over the medium term. Nonetheless, these risks maybe less than some fear. Anecdotal reports also indicate that the condo building boom has been increasingly shifting towards high-rise developments (greater than 4 floors) with smaller units (700 square feet or less), which also contrasts with a more balanced composition of low, middle and high rise buildings in the Vancouver market. High-rise condominiums tend to absorb more capital and labour on average, thus slowing down the pace of development. In Toronto, completion times on high-rise projects have lengthened from the typical 2 years to about 4 years, suggesting that new supplies will be spread out over the next several years.

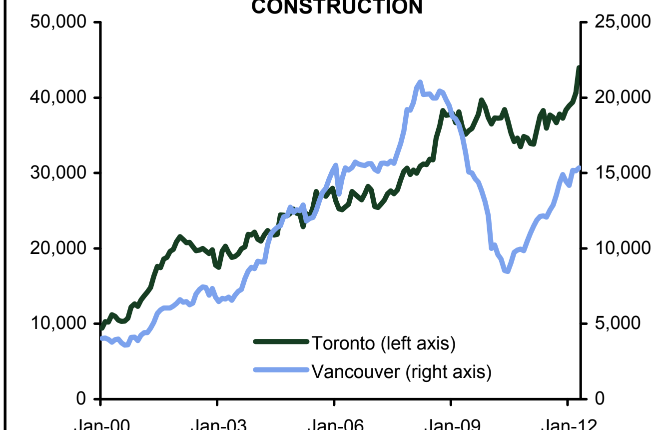
The concern is when the units are completed, do owners put them up for sale again, which would increase the supply on the resale market and put downward pressure on prices? Or, if they go on the rental market, are there are enough renters to absorb the supply set to come on the market over

CHART 7. MLS HPI BY HOUSING TYPE - VANCOUVER



Source: Real Estate Board of Greater Vancouver

CHART 8. MULTIPLE UNITS UNDER CONSTRUCTION



Source: CMHC

the next few years? For now, the rental markets in Toronto and Vancouver are both quite strong with low vacancy rates, helping to mitigate the risks in the near term. Farther out it depends on the underlying strength of the economy and migration into each city. Nonetheless, even if demand stays robust, we suspect that a share of the bulge in units currently under construction will remain unsold and lead to growing inventories. As such, we expect some relative narrowing in the recent inventory gap Toronto has opened up with Vancouver, leading to a further price deceleration in the Toronto condo market.

Markets appear to face similar risks of a medium-term correction

In conclusion, notwithstanding the recent parting of ways in terms of average prices and unit sales data – which as we argue can be partly explained by data volatility – both Toronto and Vancouver markets continue to show more similarities than differences. With a backdrop of low interest rates as well as decent economic and population growth, both markets have experienced brisk price gains since the mid-2000s. And faced with growing land restrictions and worsening affordability, both markets have experienced growing demand for – and supply of – condo units, and outsized price gains of single-detached homes. As evidenced by increasing units under construction and rising inventories of new and unoccupied dwellings, both condominium markets have been showing signs of getting ahead of themselves. While Vancouver's condo market appears to be faced with a larger current challenge, it is likely only a matter of time before Toronto catches up, as the busy pipeline of projects underway are completed. The significant amount of time it takes for builders to bring these projects to completion mitigates, but does not eliminate the risk of over-supply.

These recent developments are consistent with our longer-term view that housing markets – and notably condominiums – tend to follow significant longer-term cycles and that expansions in both city markets are getting long in the tooth. Some observers might point to the recent data in Vancouver as evidence that housing activity is going through a long-awaited correction. But the jury remains out. As we've pointed out, despite the recent pull-back in sales, the market remains in balanced territory and underlying prices are continuing to expand. Besides, there is no apparent trigger for a correction (i.e., interest rate increase or economic shock), which is typically the case. In our view, Vancouver's market is likely to show increased stability over the remainder of this year. Meanwhile, there appears to be little stopping Toronto's market from recording robust gains and continuing to play catch-up with its west-coast counterpart.

Looking out beyond the short-term to the next 2-3 years, we continue to look for both markets to experience a price correction of at least 15%. While the supply increases of multiple units recorded currently and over the past decade will be a contributing factor, the more significant catalyst is likely to occur on the demand side. In particular, the powerful tailwinds that have driven demand in recent years – including low interest rates and households' desire to take on additional credit – are expected to become decidedly less supportive. Economic growth in both regions is likely to be scant at best over the next few years. Moreover, even if the rental market benefits from a softer homeownership market, weaker property valuations would likely put a damper on investor returns, hence leading to a softening in investor demand. In Toronto's market, there remains some question as to how the surge in development of smaller units will match up with future demand. This correction is likely to be reasonably gradual as neither market in our view is showing bubble-like symptoms similar to the U.S. market prior to its massive 30% adjustment. That said, if the Canadian economy were to get hit by a severe shock from abroad, a quicker and more pronounced correction could occur.

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