OBSERVATION

TD Economics

June 6th, 2017

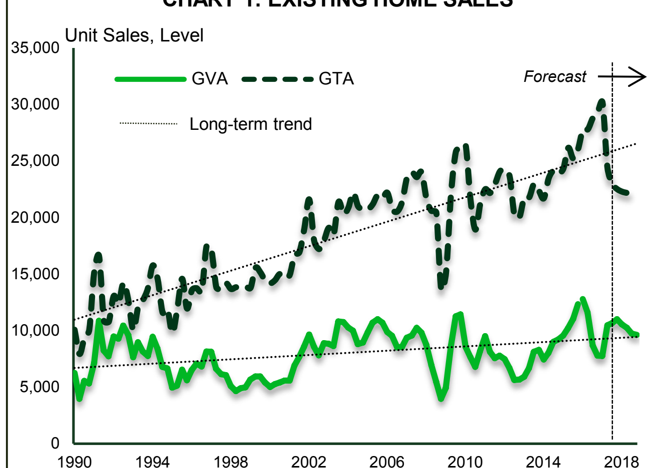
A WELCOME COOL-OFF FOR TORONTO HOUSING MARKET AS LISTINGS REBOUND

Highlights

- Sales in the GTA housing market over the past few months appear to be mirroring trends in the GVA during its period of orderly decline in 2016. While the impact of policy measures – including those recently implemented by the Ontario government – tend to be temporary, prospects for a gradual rise in borrowing rates later this year and in 2018 are likely to mitigate against a renewed run-up.
- While early yet, a key difference between current patterns in the GTA and last year's GVA experience is the jump in resale supply in the former market. While, most measures still point to balanced market conditions in the Toronto region as of May, the additional supply on the market is likely to contribute to a slowdown in home price growth going forward. As such, the deceleration in home price growth is likely to be more broad in the GTA than has been the case in the GVA.
- Strong economic fundamentals will continue to provide support to the GTA housing market as it absorbs the impact of policy measures as well as other headwinds, including those in the non-traditional mortgage market. Sales will likely remain above their 5-year average, while average prices in the region are likely to fall only slightly. The corollary is that a significant degree of over-valuation in the GTA market is likely to persist over the medium term.

In a recent report, TD Economics highlighted that the Greater Toronto Area (GTA) housing market has become too hot for comfort and that speculation was increasingly driving unsustainable home price gains. The provincial government stepped in with a sixteen-measure Fair Housing Plan in April to help cool the market, which included the tracking of citizenship on purchases, a nonresident tax, a vacant land and property tax and finally the expansion of rent control. This week's Toronto Real Estate Board's data makes official what we expected: the GTA market is following in Vancouver's footsteps. Tighter housing policies have helped to kick-start a soft landing in the GTA housing market, while gradually rising interest rates later this year are likely to help solidify it. The spike in listings in Toronto will put more downward pressure on prices through our forecast horizon than we have seen in Vancouver. The market has shifted from tight to balanced fairly quickly, which will likely bring home price growth down sharply. The average home price is now on track for a 12% gain this year, or somewhat lower than the 15% we were anticipating in April. Average prices in the GTA are also on track for a 4% decline next year, largely in line with the 3% decline expected in the Greater Vancouver Area (GVA) this year.

CHART 1: EXISTING HOME SALES



Source: CREA. F by TD Economics as of June 2017

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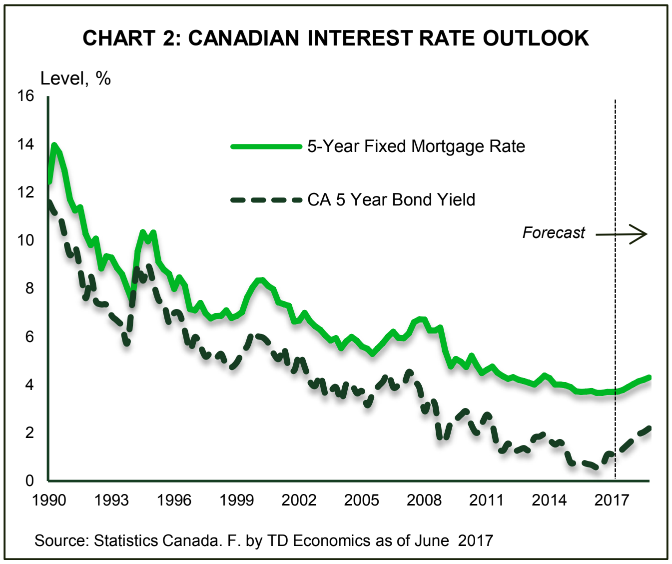


Toronto sales adjustment to match Vancouver, but don't expect a robust rebound

So far, the delayed reaction to the federal government's changes to mortgage insurance qualification guidelines together with effects of Ontario's Fair Housing Plan, have led to a 30% drop in sales from their peak reached earlier this year. The decline was largely concentrated in detached homes (-26% y/y) and semis (-22% y/y), but condo sales were also down 6.4% relative to May 2016 levels. Existing home sales have now moved back in line with their long-run average.

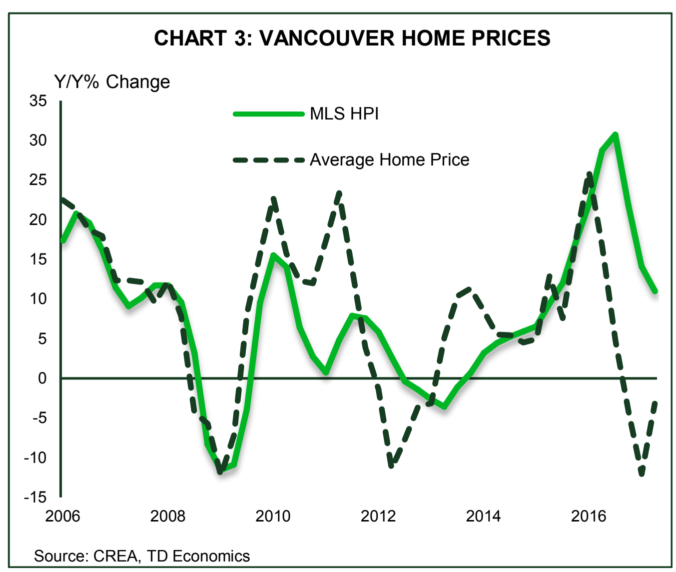
The decline in existing home sales in the GTA, is consistent with the adjustment in Vancouver last year (Chart 1). It is also consistent with the adjustment in sales after each of the five rounds of mortgage insurance regulation changes. However, while policy changes and the reduction in sales activity in Vancouver occurred gradually over the course of 2016, the impact of provincial and federal policy changes on the GTA market was more concentrated this spring.

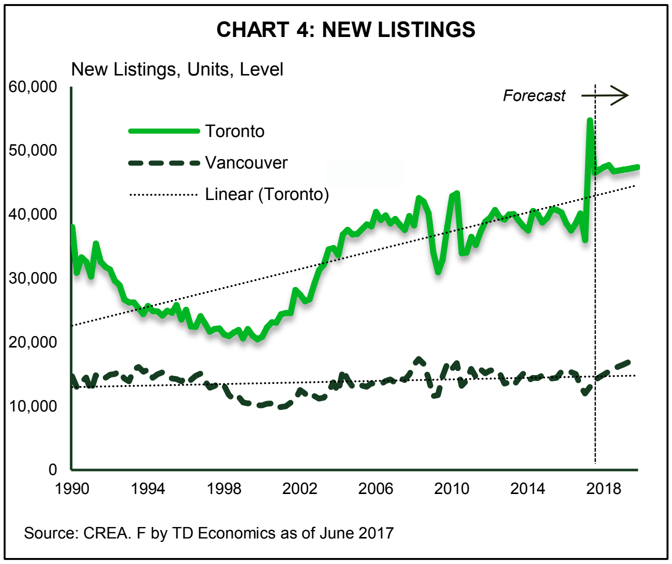
The GVA experience suggests that policy-induced volatility in home sales tends to be temporary. The market can bounce back within several months. In Vancouver, existing home sales had fully recovered from a yearlong slump by last month. However, that recovery in sales was helped along by a reduction in mortgage rates. After jumping 50 basis points between November 2016 and March of this year, mortgage rates fell right back to historical lows in April, helping to cushion the impact from rules changes. It doesn't look like Toronto is going to have a similar cushion. The Canadian economy was on its best three quarter growth streak since 2010, sparking speculation that the Bank of Canada will start raising rates by early-next year. Expectations of Bank of Canada rate hikes are likely to feed into higher long-term yields later this year. The 5-year government bond yield is expected to rise 40 basis points later this year, some of which will feed into higher mortgage rates (Chart 2). By the time the GTA is ready to shake off policy changes later this year, interest rates are expected to be higher. Given lofty home prices, and weak household income growth (below 2% in 2015), the GTA and Vancouver are the most sensitive markets to higher mortgage rates. As rates rise, GTA home sales are expected to remain near longer-term trend levels, while sales in Vancouver are likely to retrace gains made earlier this year.

Higher listings to drive GTA-GVA divergence

The Vancouver experience shows that home prices can take their cue from the overall balance in the market, as measured by the number of sales per listing. The average home price in Vancouver did briefly come down almost 19% peak-to-trough during the last year, largely reflecting a compositional shift in the types of homes being sold. But, with both the condo market and the luxury home market remaining tight, bidding wars were still common. Home prices on a quality adjusted basis continued to grow at a double-digit pace even into May, although they decelerated from a 30% year-over-year gains experienced at the peak in 2016 (Chart 3). Looking at prices in level terms, the quality adjusted index has rebounded from a temporary lull last year, and has now surpassed last year's peak.

The GTA so far seems to be exhibiting similar patterns in the early stages of its soft landing. Average home price growth decelerated sharply to 14% y/y in May, half of its peak pace earlier this year, while the quality-adjusted home





price index continued to grow by 29% y/y. Condo prices are rising more sharply than single-family homes for the first time in seven years.

However, the biggest difference between the home price outlook for GTA and GVA is listings. After a dearth of inventory early in the year the GTA market has seen a sharp increase in new listings to a record high over the April and May period (Chart 4). Most new listings have been for single-family homes, while the apartment market remains relatively tight. While the sharp jump in GTA new listings recently likely reflects a bounce back from record lows in the winter months and unlikely to be sustained at these levels, listings are nonetheless likely to remain elevated over the next two years, underpinning a continued soft landing in the Greater Toronto Area.

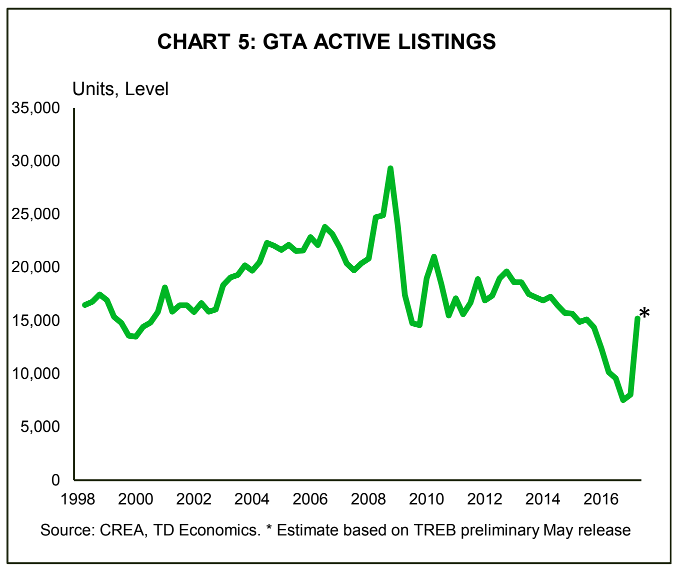
A stronger trend in new listings in the GTA reflects three factors. For one, the sharp rise in new listings is consistent with the view that speculation has likely taken a larger role in driving market activity in the last year (see our recent report). That speculation has been domestic in the GTA, compared to a higher share of foreign investment in Vancouver. Domestic investors tend to flip homes more easily (leading to a rapid rebound in listings), versus a foreign investor who is often in it for the long haul.

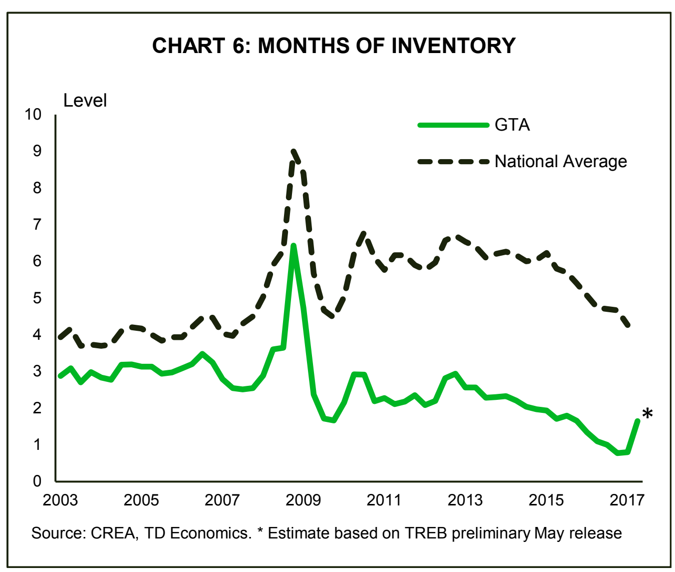
Second, over time, new listings are driven by new home construction. TD Economics has been noting that a record number of new units under construction would eventually lead to higher listings and more balanced market conditions – but construction has taken longer than we anticipated. Many of these units are now starting to reach completion and are ending up on the resale market.

And finally, the Ontario government went one step further on housing policy, by extending rent controls. Before April rent control only applied to units built before 1991, now it applies to all rental units. This is a more dramatic change to the potential return to investments in rental properties than we saw in B.C. With rates of return on rental properties in Ontario already near record lows, these new rules are going to impact investor activity in the short and long run. As the return to being a landlord looks less attractive, more units are likely to come on the market in the near-term. But, over the longer term a lower return to owning rental housing will lead to less investment in construction of new rental housing.

Rise in listings to help restore balance

The GTA's sales-to-new listings ratio is now in buyer's territory, meaning relatively more properties for sale gives





buyers more bargaining power. However, other indicators suggest that the market remains fairly balanced. New listings reflect everything that is newly listed in a given time period (whether it is sold or not), while active listings represent the number of listings that remain following all the sales activity that occurs. This figure is growing quickly in the GTA, but remains well-within its historical range (Chart 5), with the market estimated to still have under two months worth of supply. In other words, it would take just two months of sales to work through the current level of supply. This compares to four months of inventory at the national level (Chart 6).

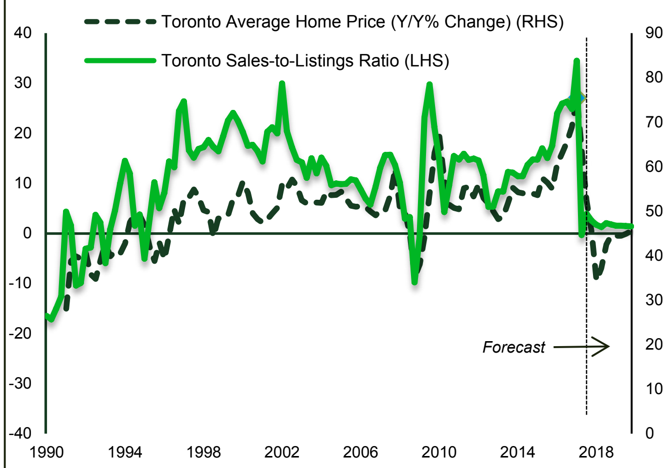
The still tight inventory suggests that home prices in the GTA are not headed for a crash. While two months of inventory is relatively high for the GTA market, the level was similar in the GTA during 2012 and 2013 – a time when home prices continued to grow between 5% and 7% per year, both on an average and quality adjusted basis. Across Canada, active inventory has at times reached as high as ten months in Quebec and seven months in Alberta, with home prices merely stabilizing in these regions during their soft landings, and not collapsing.

Nonetheless, softening market conditions are expected to lead to a sharp deceleration in home prices in the GTA, both on an average and quality-adjusted basis. Overall, we expect the GTA average price metric to rise by 12% this year, before pulling back by a modest 4% next year – in line with the GVA experience this year. Additionally, we expect downward price pressures to broaden across housing classes as market conditions rebalance. Meanwhile, the quality adjusted index is on track for an 11% gain this year, before decelerating to a 4% to 5% pace next year.

Bottom Line

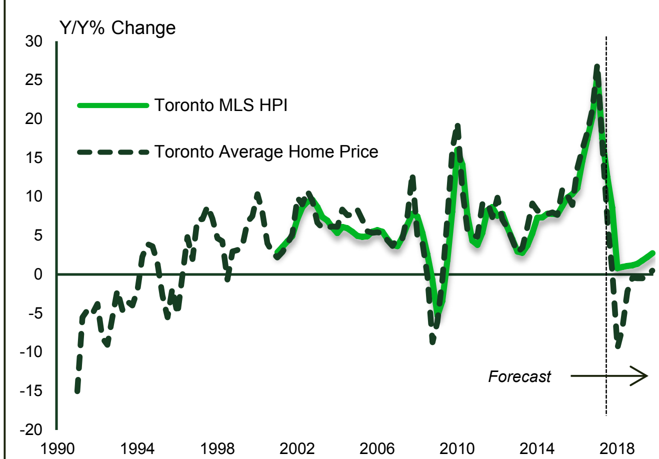
Overall, the mix of policy changes since October have kick-started a soft landing in the GTA housing market. This should be solidified by higher interest rates later this year. A soft landing should see sales return to their longer run trend, while price growth decelerates more in line with underlying household income growth. Overall, the adjustment in the GTA reflects lessened investor activity, and should offer a better opportunity for first time home buyers who now face more choice and fewer bidding wars. However, a soft landing will necessarily enable the overvaluation in the GTA market (estimated near 20%) to unwind only gradually, leaving the market vulnerable to any future economic downturn or potential interest rate shock.

CHART 7: GTA INDICATORS OF BALANCE



Source: CREA. F by TD Economics as of June 2017

CHART 8: GTA HOME PRICE GROWTH



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