SPECIAL REPORT

TD Economics

March 20, 2017

TORONTO HOUSING: THE HEAT IS ON, BUYERS CAUGHT UP IN THE ACTION

Highlights

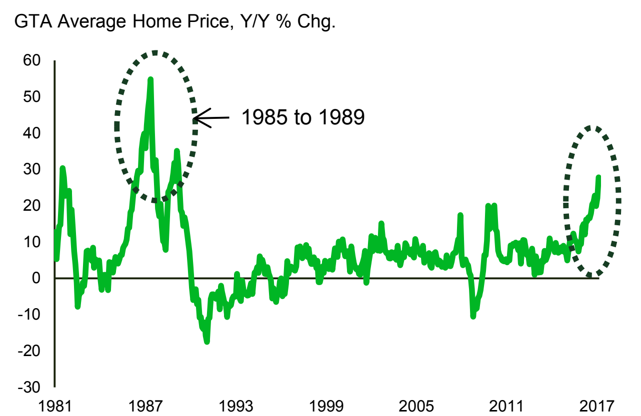
- To say the Toronto housing market is running hot would be an understatement. TD Economics has upgraded the home price growth forecast to range between 20% and 25% in 2017, with sustained strength at roughly 3-5% in 2018. Forecast uncertainty is running higher than usual due to the risk of more buyer speculative activity.
- Historically, it's difficult to find a period across U.S. and Canadian markets where sustained home price growth of this magnitude was not followed by a period of contraction. The longer the cycle runs, the greater the risk of a contraction.
- There are a number of policy tools tested in the global arena with some effectiveness in containing froth in demand, such as a foreign buyers tax and various macroprudential rules.

One of most asked question to economists living in Toronto these days is: what's going on with house prices? The answer: it's complicated. Home prices in the Greater Toronto Area (GTA) have risen by an average of 19% over the past twelve months, marking the fastest pace since the late 1980s.

Whether you subscribe to the view that the heady price gains reflect supply constraints or demand factors (it's both!), the evidence is stacking up that the GTA market has been divorcing from economic fundamentals since early 2016. We caution in drawing comfort from conditions of tight supply or robust demand, as neither preclude the market ending badly or the building of systemic economic risk. Having a debate on whether there's a housing bubble is a distraction, since this tends to be confirmed only retrospectively. What we can say is that when comparing this housing cycle to previous ones that lack a happy ending, Toronto appears to be moving in that direction.

In light of recent developments, TD Economics has upgraded its GTA housing price growth forecast for 2017 to range between 20% to 25%. The lower end requires prices to remain stable over the rest of the year. However, evidence is building that speculative forces are growing deeper roots, which raises the risk that prices will move closer to the top end of that forecast in the absence of policy measures. We look for the effects of higher mortgage rates and eroding affordability to "cool" the GTA market in 2018, but here too we would not be surprised to see an overshoot. Although recent policy discussions have largely been focused on a foreign

CHART 1: GTA AVERAGE HOME PRICE



Source: CREA, TD Economics.

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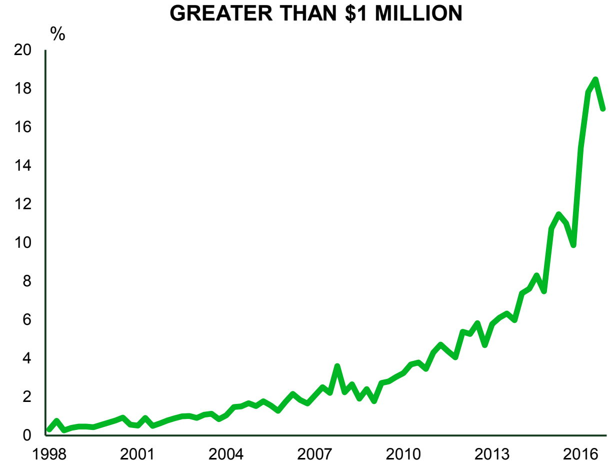
buyer's tax, our analysis suggests speculative demand forces may have become more far reaching within Toronto's housing market.

Strong Toronto home price forecast is not a vote of confidence in market fundamentals

Our Toronto home price forecast ultimately encapsulates two concerns. First, there is little on the docket to cool the market in 2017 in the absence of policy measures. Second, it's getting harder to ignore warning signs that market demand pressures are increasingly reflecting speculative forces.

Tackling the first comment, there are few economic dynamics currently in sight to produce a meaningful increase in mortgage rates that would sufficiently diminish housing demand. The Bank of Canada is expected to remain on hold through this year, leaving yields and mortgage rates influenced by U.S. policy. This should pull Canadian five-year government bond yields up a further 30 basis points by year-end, which is a rather nominal amount. In addition, more recent government policy and mortgage rate changes have been immaterial in slowing housing demand within the GTA up until now. The full effect of changes to mortgage regulations since October and a 30 basis point rise in 5-year mortgage rates since November should now be making its way through the data. Yet, existing home sales accelerated in February, corresponding with a 28% year-over-year price gain. The new stress testing rules likely pushed some first time homebuyers out of the market, but the impact was more than offset by a large bump in sales of units worth more than $1 million (Chart 2).

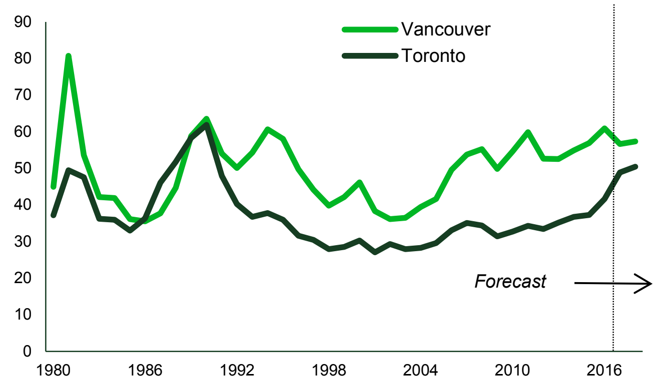
CHART 2: SHARE OF GTA HOME SALES GREATER THAN $1 MILLION



Source: CREA, TD Economics.

CHART 3: SHARE OF INCOME NEEDED TO BUY A HOUSE

Based on an average priced home, average household income, and a 5-year fixed conventional mortgage



Source: Statistics Canada, CREA, forecast by TD Economics as of March 2017.

This brings us to the second comment. Home price forecasts may prove too shallow if speculation and irrational expectations are playing a greater role in driving demand. Models tend to under-predict those influences, and this may explain why tighter mortgage regulations and higher mortgage rates are proving less effective than in the past. Using history as a guide, the late 1980's experience tells us that even with an additional 30 basis point pass-through to mortgage rates this year, the housing affordability ratio would remain below that peak. This offers scope for home prices to make more headway before a tipping point is hit. To be clear, eroding affordability should already be bitting more deeply into demand, and the resilience of the market may speak to the exuberance at work (Chart 3). Comparing affordability metrics for Toronto to cities like Miami and Las Vegas prior to the U.S. housing crash already reveals a worse position on the home front.

A market that is driven by more investor or speculative interest ultimately runs the risk of creating a false expectation of sustainability among first-time buyers amid sentiment colloquially referred to as FOMO (fear of missing out). First-time buyers are taking on elevated levels of debt in order to jump into the market. The Bank of Canada has shown that as of the third quarter in 2016, 49% of insured borrowers in Toronto were already carrying debt that was 450% of their income[1]. The longer this market runs hot, the greater the risks to the Ontario economy.

Speculating on the degree of speculation

In isolation, double-digit home price growth says nothing about whether a market is sustainable. A logic check is required against domestic fundamentals. Two of the most common cited underpinnings to the Toronto housing market are:

1. *Insufficient supply, often attributed to obstructive government policies on land usage and permit processes*
2. *Strong demand, often attributed to population growth*

The data do unequivocally support strong population growth accompanied by tight supply in the resale market. And we wish we could end the discussion here. These forces do not preclude systemic risk building within the Ontario economy. In fact, it is these market forces that have created a perfect eco-climate for buyer speculation to flourish, perhaps creating a false sense of security in its sustainability.

In regards to tight supply, resale listings have failed to keep up with demand, resulting in what we have described as buyer's gridlock. We explained those dynamics in a note last year, and those conditions have only exacerbated since that time. However, it is quite possible that some of the tightening in resale listings also reflects irrational home price expectations. Historical experience suggests that listings become constrained during boom cycles, as buyers hang on to their homes in the expectation of benefiting from further appreciation. Once those expectations are dashed, listings can rise sharply.

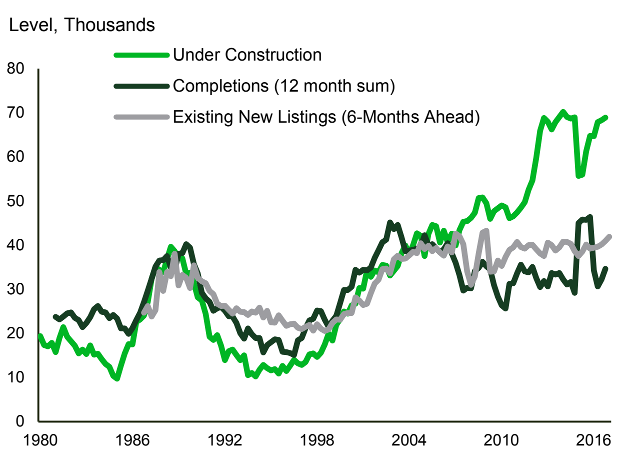
Moreover, the continued escalation in home prices may have generated a greater tendency towards flipping homes for a profit. Repeat sales data suggests that the majority of housing flips occur between one to two years of purchase. According to data by Teranet, there was a clear increase in this activity taking hold in 2016. Roughly 17% of homes were resold within 2 years as of March 2016, up from about 9% a year earlier. If buyer speculation activity is indeed picking up, as we suspect it is, then there is a risk that a good portion of the heated pace of home purchases in 2016 will land back on the market by 2018.

A greater incident of speculative activity in Toronto is not so much an issue that it is going to create a massive pop in supply in the absence of an economic downturn. Rather, it's adding to demand pressures that are constraining supply in the resale market and bidding up prices. In turn, this reinforces a false sense of security among future buyers on the sustainability of the market.

In addition, if low listings within the resale market are being accentuated by speculative activity, it is having a direct effect of creating a supply response in the construction market that also looks inconsistent with fundamentals. Despite criticism laid that government policies are restricting new development, one data anomaly we've noticed is a large wedge has formed between units under construction versus those reaching completion. This does speak to a supply pipeline that is responding to the heated demand influences that have been underway for several years (Chart 4). In addition, relative to the size of the population, there are a record number of new units under construction (Chart 5). And, for the most desired areas in demand, townhomes and single-family, construction is at a 10-year high.

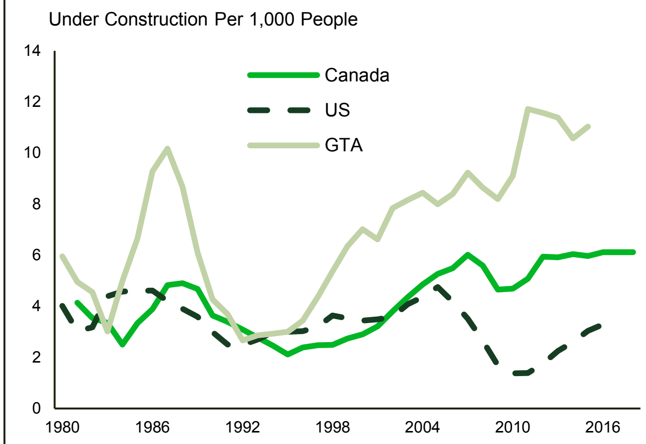
The issue of supply is far more complex than just doing a building count, as it overlooks a key distinction of type versus quantity. The preference for detached homes in close proximity to the core of the city is certainly offering more

CHART 4: GTA HOUSING SUPPLY

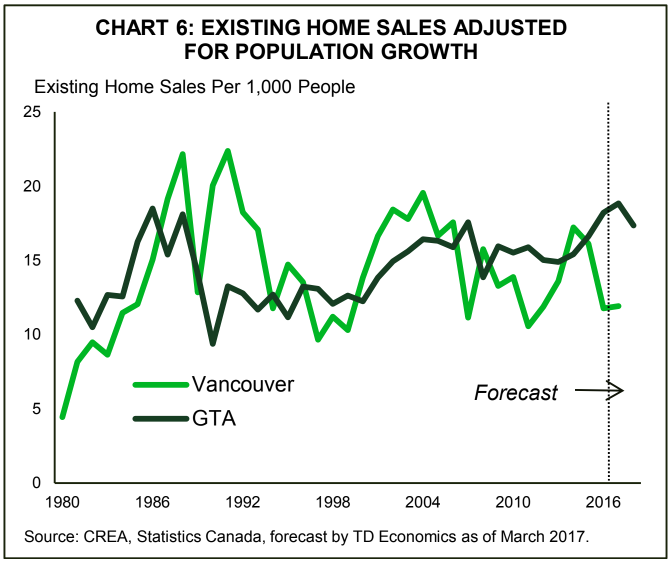


Source: CMHC, CREA, TD Economics.

CHART 5: NEW HOME CONSTRUCTION



Source: CMHC, Statistics Canada, Census Bureau, TD Economics.



limited choice. But, this is a natural outcome of growing cities that necessitates densification (i.e. condo living). A recent issue for Toronto is that even condominium prices are expanding at a rate of 19% year-over-year, which is occurring in the presence of a record amount of new units under construction relative to the population.

Demand-side forces pulling away from fundamentals

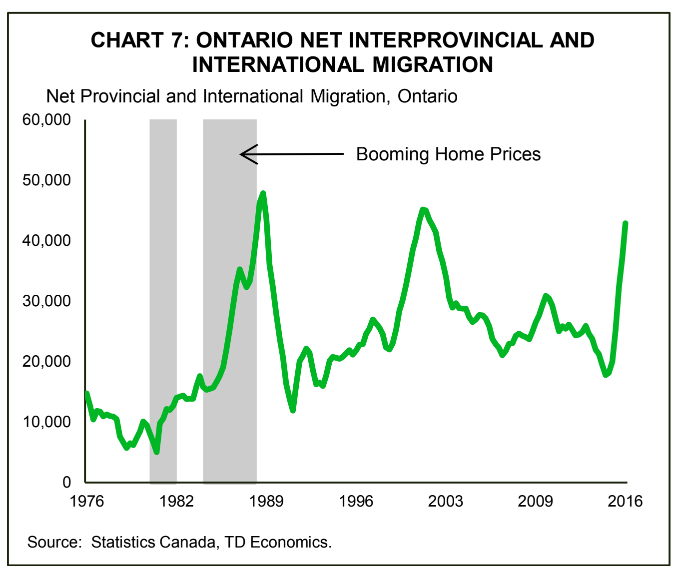
The notion of speculative forces is a bit more obvious on the demand side of the equation. Toronto has roughly two-times the rate of population growth relative to the nation. This is a key pillar to strong sales activity. However, even with this backdrop, home sales are elevated relative to the size of the population (Chart 6). The ratio is mirroring past periods that were characterized as overheated. There also appears to be a clear inflection point at the start of 2016 that produced a dramatically quicker pace of sales in the absence of a parallel shift in fundamental factors, such as household formation. This debunks the view that the pace of sales is *fully* supported by the strength in population growth.

To be clear, Toronto and the densification of populations within urban centers offer solid growth underpinnings, but this doesn't mean the condition is sustainable in its extreme form. Be careful on hanging a hat too firmly on the notion that the GTA's current population profile mitigates downside risks to the housing market. History has demonstrated that reversals do occur (Chart 7).

Coinciding with the timing on the upswing in home sales, Toronto's population growth also reflected a point of inflection towards the end of 2015, when it suddenly quickened. That push into the city was dominated by inter-provincial flows (as oppose to immigration). Looking at where these individuals hailed from, it appears that the hard-hit oil producing provinces have played a role (Chart 8). However, economic recoveries are currently underway in Alberta and Saskatchewan, offering a return of job prospects alongside more favourable housing affordability in those regions. The other population driver is coming from a dramatic spike in non-permanent residents, which also does not appear consistent or sustainable relative to history.

Toronto's lure to foreign investors

Despite a lack of robust data, it's not a big leap of faith to presume Toronto's housing demand is getting an extra kick from foreign investment given the experience of other cities – such as New York, Vancouver, London, Seattle and Melbourne, to name a few. Surveys of realtors and condo corporations suggest that foreigners account for roughly 5% of GTA market activity, but we judge this to be a low water-mark. The Vancouver experience is a reminder that surveys can underestimate this impact. That market too was judged to have a small share of foreign buyers based on informal surveys, which was subsequently shown to be 15% when more tracking rigor was put in place by the government. In addition, TD Economics has been tracking foreign currency and deposits held at Canadian banks as a proxy for housing activity in Toronto and Vancouver (Chart 9). Indeed, the doubling in residential transactions since 2013 in both these markets coincided with a three-fold increase in the amount of foreign money held in Canada. The Vancouver experience also tells us that the spike in demand for luxury homes in the GTA may also be consistent with a demand push from



foreign investors (Chart 10). Vancouver was likely the more favoured destination prior to the introduction of the foreign buyer's tax last August. The risk now is that those funds were displaced to other markets, and Toronto's economic and population fundamentals made for an attractive target.

How will it end and what can be done?

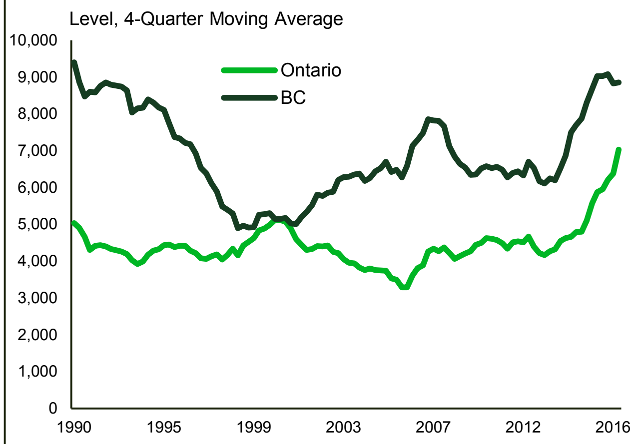
Home prices in the GTA have been rising robustly for the last decade, but a case can be made that 2016 marked a new turning point. For Spaceballs fans out there, prices are moving at light speed, and we certainly want to avoid a market that hits ludicrous speed. Home prices are on track to top 10 times the size of household income in Toronto, and some common metrics point to 24% or more overvaluation.

There have been a number of housing cycles across Canada and the U.S. over the last 30 years to draw comparisons. Historically, it's very difficult to find a period in time where sustained home price growth of this magnitude was not followed by a period of contraction. Some cycles have been short (12 to 14 months), with a moderate 4% to 10% peak-to-trough fluctuation. Others have persisted for almost five to six years, and were followed by a hard and painful landing, with contractions in home prices of over 50%. The longer these cycles are allowed to run and households accumulate debt, the greater the risk of a deeper contraction. So far, the light-speed home price cycle has persisted for 15 months, but the market has been heated for several years. A forecast of 20% price growth for 2017 implies a four-year average pace of 14%.

We still believe that fundamentals will ultimately underpin a soft landing in Toronto's home prices, but acknowledge that there is a wider degree of uncertainty attached to the forecast if speculative forces are playing a greater role than perceived. Flares are certainly going up that buyer expectations may be set too high. This brings us to the lean versus clean debate when concerns arise over asset prices divorcing from fundamentals. While interest rates have proven to be too blunt of a tool to address rising imbalances in the housing market, policymakers have been playing with a number of tools to better target activity.

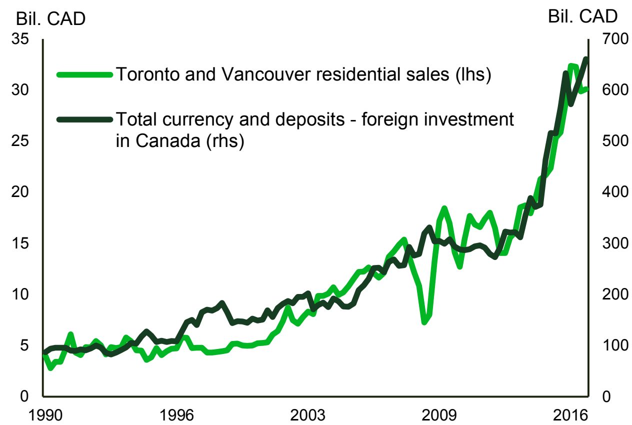
Demand-side measures, while temporary, have historically proven to be more immediate and effective at cooling froth in housing markets than supply side measures due to longer lag times for response. There are many options to cool demand, but there is no single best measure and there would need to be some acceptance that this is ultimately a trial-

CHART 8: MIGRANTS LEAVING OIL-TORN PROVINCES FOR ONTARIO AND B.C.



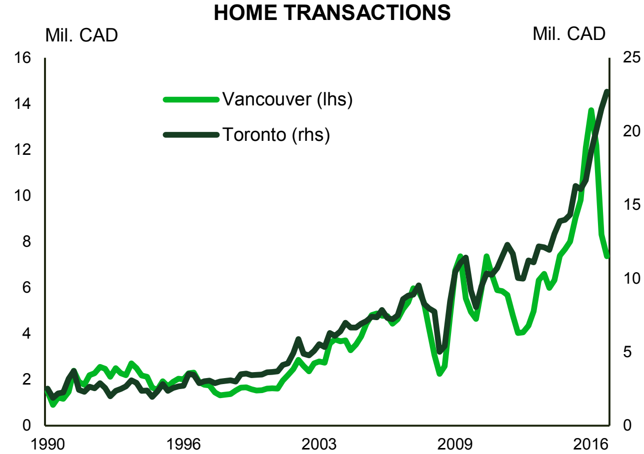
Source: Statistics Canada, TD Economics.

CHART 9: FOREIGN FUNDS IN CANADA VERSUS REAL ESTATE TRANSACTIONS



Source: Statistics Canada, CREA, TD Economics.

CHART 10: VALUE OF EXISTING HOME TRANSACTIONS



Source: Statistics Canada, CREA, TD Economics.

and-error process that can create unintended consequences. But, to do nothing and allow speculative forces to deepen would further risk escalating household debt burdens and economic pain down the road.

Bank of Canada research has proven that tighter macroprudential rules have a bigger impact on housing activity and household debt, with smaller economic costs, than monetary policy tools[2]. The government has used macroprudential rules six times since 2008, largely targeting insured mortgages. Rules that target the cost of carrying a mortgage, such as changing the amortization rate, have proven to be the most effective (Chart 11), whereas recent changes to down payment requirements and income stress testing rules have had limited impact on housing demand. One would expect this to be the case if foreign and domestic investors are taking a greater role in the market. In addition, policy implemented at the Federal level may be too broad in scope for unique influences occurring at the regional level. At this stage, it may be more appropriate for provincial governments to take a greater role in tailoring policy. Conversely, for policies that fall in the domain of the Federal government there could be an inclusion of opt-in and out clauses provided for provinces.

The Ontario Minister of Finance recently floated the idea of a foreign buyer's tax. Indeed, this has become a common tool globally, implemented in parts of Australia, Hong Kong and, more recently, Vancouver. The policy has proven effective in the short-term. Results from the Vancouver housing market showed a calming in both domestic speculative behavior and foreign demand, without creating a landslide in home prices or having deep knock-on effects to the rest of the economy. Existing home sales did fall back down to earth since the tax was introduced, but prices on a quality adjusted have adjusted down by just 2% so far, or 7% for single-detached homes.

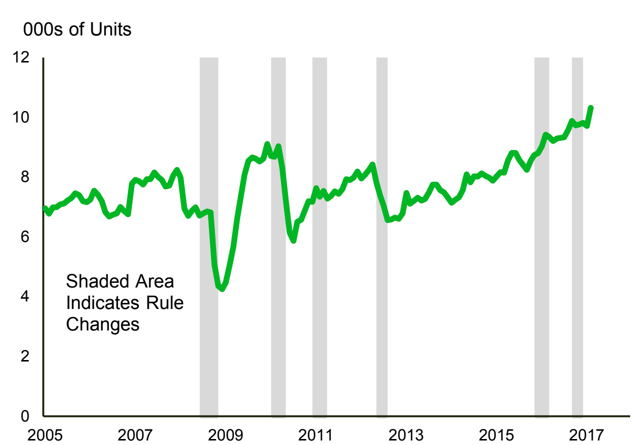
But, these measures can come with unintended consequences. Foreign investment is fluid, and just like water, it will flow from high to low pressure where regulation and taxation are lowest – hence the push into Toronto and the surrounding areas of Vancouver following the implementation of that tax. In the event that the Ontario government wishes to slow housing activity, consideration should be placed on how the tax can impact or encompass surrounding areas via knock-on effects. At the same time, there would be a risk that foreign investment flows into smaller markets like Calgary – although it may be more welcome there to help spur investment and activity. In addition, the foreign buyer's tax in Vancouver is being contested as a violation of trade treaties, so proper implementation measures must be assured.

As time goes by, international experience shows that the foreign buyer's tax, in the form of a land transfer tax, does not choke demand. Purchases tend to bounce back within a year or two of implementation. This may not be a bad thing, as it could allow time for some cooling in the market as fundamental factors work their way through, such as higher interest rates and any adjustment in population migration flows. The tax policy also demonstrates that the fear of driving money away permanently is overstated if the housing market truly has strong underpinnings to continue to attract investment.

One caution to note is that if a tax is only targeted to foreign investors and it turns out that domestic speculation is playing a large or larger role relative to the past, then an unintended outcome might be that investors and homeowners view any price volatility as a buying opportunity. This could limit the ability to temper speculative activity and enhance domestic economic risks. Some consideration may need to also be given to measures that squeeze speculation out of the market more broadly, and not just foreign demand.

On the domestic front, currently flipping and investment in housing is taxed one of three ways. If it's a primary residence, a seller pays no tax on the sale of a property. Second, if there is a sale of a second property (say a rental), the seller pays a capital gains tax on the sale, where 50% of the gain is taxable. Third, if a property is purchased with the express intent of renovation and profit, the seller pays

CHART 11: GTA EXISTING HOME SALES



Source: CREA, TD Economics.

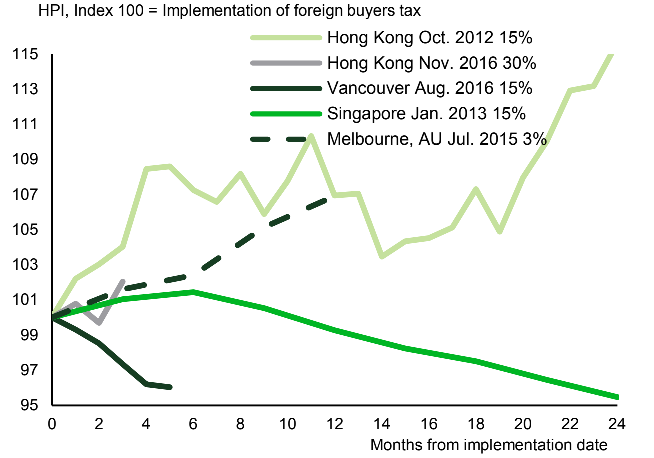
business income tax on the sale, which depending on the tax rate, could be significantly higher than the capital gains tax. The current system may allow too many flips to pass the primary residency exemption rule, which might explain why Teranet data showed a pick-up in resale activity within the one-to-two year timeframe.

The Federal Government implemented a new review process in October of last year to ensure the exemption is not abused. The process needs time to have proven results given that it is just being enforced. But if unsuccessful, one suggestion that has been floated is to layer on a progressive capital gains tax (CGT). This would likely need to go hand-in-hand with a foreign buyer's tax in order to temper excess demand, and could be where provinces are offered an opt-in or out option depending on their assessment of the market.

A progressive CGT would attempt to deter potential flippers and domestic speculators in the secondary market by penalizing the sale of properties based on the amount of time that they are held beyond the current policy. The tax would be structured such that the longer the period of time between acquisition and sale of the property, the less the seller will be taxed at the time of sale. These rules, however, may simply alter the amount of time investors hold properties. In addition, raising real estate taxes can have notable knock-on effects to the domestic economy by reducing household wealth and disposable income.

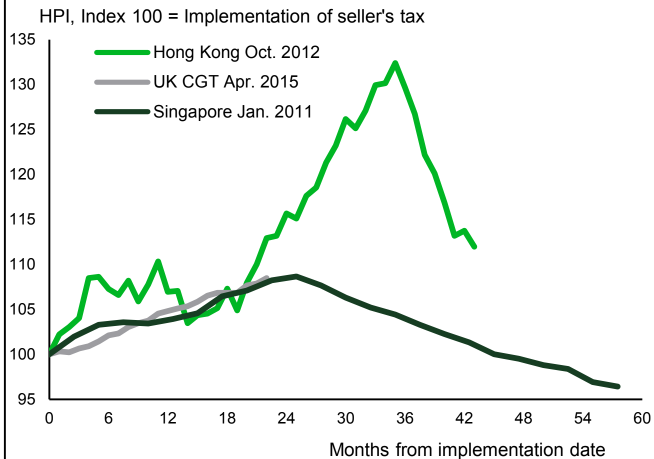
It's unlikely that any policy that's chosen will be a set-it-and-forget-it deal. International experiences have shown that tax structures need continual review and adjustment. For instance, Hong Kong introduced a 15% foreign buyer's tax in 2012 and recently doubled it to 30%. The Australian state of Victoria started with a 3% foreign buyer's tax in 2015, saw no impact and recently moved it to 7%. Ultimately, any decision on policy should be designed with a key objective in mind: change the incentive scheme that currently encourages outsized speculation or underpins the expected rate of return on that speculative purchase.

CHART 12: INTERNATIONAL EXPERIENCE ON TAXATION AT TIME PURCHASED



Source: Haver Analytics, National Statistical Agencies, TD Economics.

CHART 13: INTERNATIONAL EXPERIENCE ON TAXATION AT TIME SOLD



Source: Haver Analytics, National Statistical Agencies, TD Economics.

These policies are the lowest hanging fruit left in today's environment of heavily indebted households that cannot afford anything more than a soft landing in home prices. Whatever the policy option, or combination chosen, consideration should also be given to how it can be made counter-cyclical. In the context of an economic downturn, restricting investor interest would be counterproductive to generating growth and should therefore be loosened in such instances. And, it goes without say that the government should demonstrate a commitment to recycling any revenue gains from taxes into increasing options around affordable housing, to help restore livable cities for all levels of income.

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Endnotes:

1. Bank of Canada Financial System Review, December 2016. Table 1, Page 9. http://www.bankofcanada.ca/wp-content/uploads/2016/12/fsr-december2016.pdf

2. Sami Alpanda, Gino Cateau, Césaire Meh. A Policy Model to Analyze Macroprudential Regulations and Monetary Policy. Bank of Canada Staff Working Paper. February 2014. http://www.bankofcanada.ca/2014/02/working-paper-2014-6/