The Winter of Discontent:
Housing Markets Enter 2019 on a Soft Note

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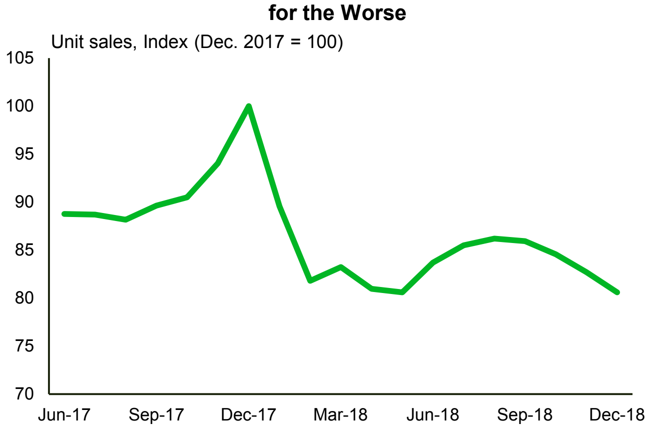
Highlights

- After a post B-20 summer bounce, housing markets have lost some steam. Canadian home sales dropped for 4 straight months to close 2018 and price dynamics have been similarly weak.
- The unexpectedly soft momentum of late has shifted the balance of risks around our 2019 forecasts for home sales and prices to the downside.
- Still, barring a shock to incomes or employment, several factors should help prevent another sustained deterioration in housing markets in 2019. Chief among these factors include another year of strong population growth, healthy labour market conditions and a more patient Bank of Canada.

2018 was undoubtedly a challenging year for housing markets, as the imposition of federal and provincial regulatory measures combined with rising mortgage rates weighed on demand and prices. However, after significant weakness in the early part of 2018, hope was building that markets had stabilized. Indeed, Canadian home sales increased 7% from May through August, in what amounted to a post B-20 bounce. However, since August, momentum has turned. Home sales have fallen for 4 straight months, essentially erasing the gains made in the summer (Chart 1). What's more, the rate of declines has accelerated. On the price front, dynamics have been similarly weak to close 2018. This turn of events has led the Bank of Canada to abruptly change their characterization of the housing market, dubbing it "weaker-than-expected" earlier this month rather than its previous reference to "stabilizing".

The extent of the recent weakness has surprised us as well. Our most recent forecast issued in December (see Table 1) called for a relatively stable sales and price performance on average in 2019. It remains early days, but suffice to say that the unexpectedly soft momentum of late has tilted the balance of risks around our 2019 view to the downside. Still, barring a shock to household incomes or employment, we cite some key factors that suggest that an improvement in market conditions by mid-year remains a reasonable bet. One in particular is affordability levels, which have benefitted modestly from a scaling back in Bank of Canada rate hike expectations.

Chart 1: Canadian Home Sales Take a Turn for the Worse

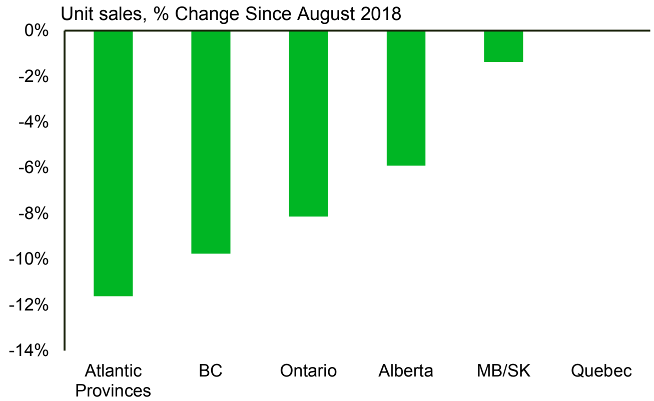


Source: CREA, TD Economics

Which markets are responsible for the sales decline?

Since August, sales have fallen across the board, with rising mortgage rates and tighter lending conditions recorded earlier in the year driving activity lower in 9 of 10 provinces. (Chart 2). Quebec provides the lone exception (with flat sales activity) as solid economic conditions kept the market afloat late in the year. This same factor fueled an outperformance for 2018 overall, with strength

Chart 2: Broad-based Weakness in Housing Activity Since the Summer



Source: CREA, TD Economics

largely concentrated in Montreal. Tight conditions in Montreal pushed benchmark prices higher by 6% last year – amongst the strongest growth of any major market.

On the opposite end, the sharpest declines since August have been in Ontario, B.C., and - somewhat surprisingly - Nova Scotia and New Brunswick. Softer activity observed in the latter two markets is less concerning given their inherent volatility, sturdy economic conditions, accelerating population growth, relatively low household debt levels, and good affordability conditions.

In Ontario, weakness since August has been driven by Toronto, Ottawa and Hamilton. Comparatively, Ottawa's market is on the soundest footing as housing remains affordable and its population is expanding at a strong pace. Higher mortgage rates have had a disproportionate impact in Toronto and Hamilton, as households in these regions are highly indebted and housing remains overvalued relative to fundamentals. In Toronto, this has been true for some time in the single-family segment, but affordability has also deteriorated for condos, thanks to robust price growth (Chart 3). Challenging affordability has also led to more renters staying put in Toronto, instead of jumping into homeownership. And, while legislation put forth by the PC government ends rent control for new units, it is maintained for existing units (the majority of the rental stock), leaving an incentive for renters to remain where they are. Strong growth in condo prices could also be making ownership of these units a more difficult proposition for investors. This is because it implies that higher, and perhaps excessive, rents must be charged in order to cover the carrying costs of these more expensive units.

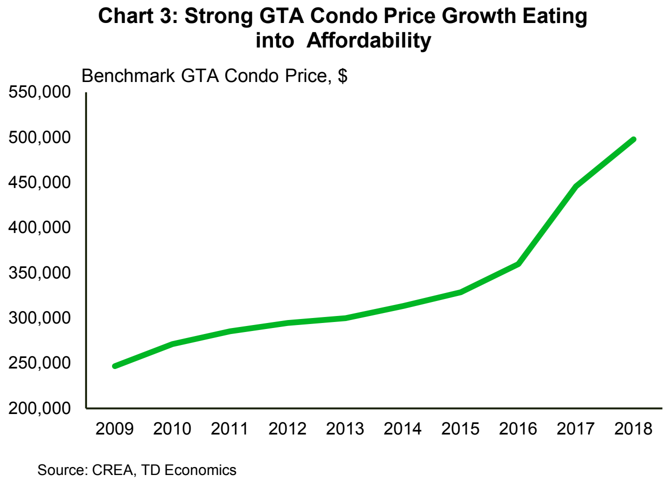
Since August, the extent of weakness observed in B.C. has been eyebrow-raising. Indeed, the largest downward surprise relative to our most recent forecast has come in B.C., with strained affordability in key markets biting into demand. Although activity was softer in the majority of markets in B.C., Vancouver was the principal driver of the decline. Sales have yet to find bottom in Vancouver and conditions worsened significantly in November and December. The provincial speculation tax was introduced in

Table 1: Canadian Housing Market Forecast as of December 2018

[Year/Year % Change]

	Existing Home Sales			Existing Home Prices		
	2017	2018	2019F	2017	2018	2019F
Canada	**-4.7**	**-11.1**	**3.6**	**3.9**	**-3.6**	**2.5**
Newfoundland & Labrador	-6.0	-5.0	0.4	-2.6	-1.4	-1.1
Prince Edward Island	4.1	-4.6	9.8	13.9	4.0	-0.5
Nova Scotia	4.7	4.6	2.6	3.4	3.4	2.0
New Brunswick	6.4	1.3	2.1	2.5	5.8	5.8
Québec	5.6	4.9	4.9	4.5	5.2	4.1
Ontario	-9.9	-13.7	5.4	9.0	-1.8	4.8
Manitoba	-0.8	-6.0	5.0	3.4	1.2	3.3
Saskatchewan	-2.4	-7.1	3.5	-2.1	-2.3	-2.3
Alberta	4.3	-7.2	-3.5	0.2	-2.4	-2.2
British Columbia	-7.5	-24.5	2.7	3.4	0.9	-2.4

Note: Annual home prices are based on quarterly averages. Annual sales are based on quarterly sums.
Source: CREA, Forecast by TD Economics



late October, adding to the mix of challenges facing the market. Reduced confidence – reflected in elevated financial market volatility – may have also impacted buying. In addition, less speculative activity is impacting demand, as is moderating global growth, particularly in China.

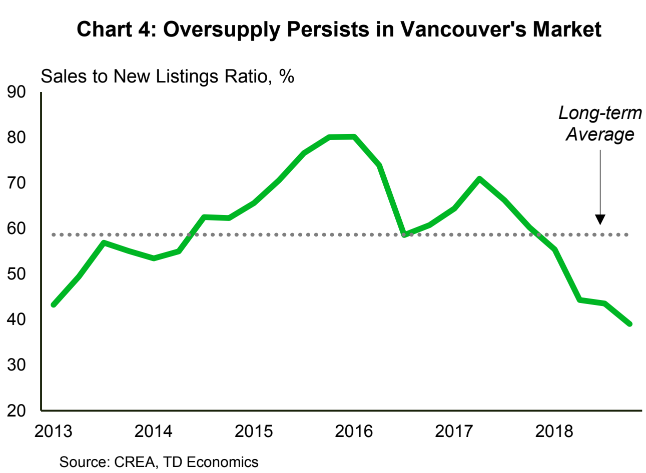
Resale markets remain oversupplied in Vancouver (Chart 4). New listings barely budged last year, despite a huge drop in sales, while active listings jumped higher. With conditions favouring buyers, benchmark prices dropped into negative territory for the first time since 2013. In the new home market, the amount of unsold new units also ticked higher in the second half, although the level remains below average. However, with massive amount of units currently in the construction pipeline, unsold supply could move higher, risking further downward pressure on prices.

Sales have also fallen in Alberta since the summer, likely impacted by oil sector turmoil. Activity has also dropped - though to a lesser extent - in Saskatchewan, Manitoba, Newfoundland and Labrador and PEI. Oversupply persists in oil producing provinces - not only for resales, but also in the markets for newly built homes and rentals. As such, prices are falling in Alberta, Saskatchewan and Newfoundland Labrador, with further declines likely in 2019.

Where do we go from here?

Relative to our December forecast, the backdrop appears softer for housing markets across the country heading into this year, suggesting that even holding on to last year's average sales levels and prices in 2019 could be challenging. Still, assuming no major negative shock to incomes or employment, markets should be able to escape an even worse outcome. This latter point is important, and underpinned by several factors:

- **Population growth is likely to be strong (Chart 5):** Immigration targets have increased from 310k in 2018 to 331k in 2019 while non-permanent residents should keep flocking to Canada. Moreover, a significant portion of Canadian residents are in their household formation years, providing a solid foundation for demand.
- **The economy will continue generating jobs (Chart 6):** Our forecast calls for over 150k jobs being added in 2019 while unemployment remains low. This should keep household incomes growing at a reasonable pace.
- **Policymakers are preaching patience:** Although the Bank of Canada maintains a tightening bias, the next



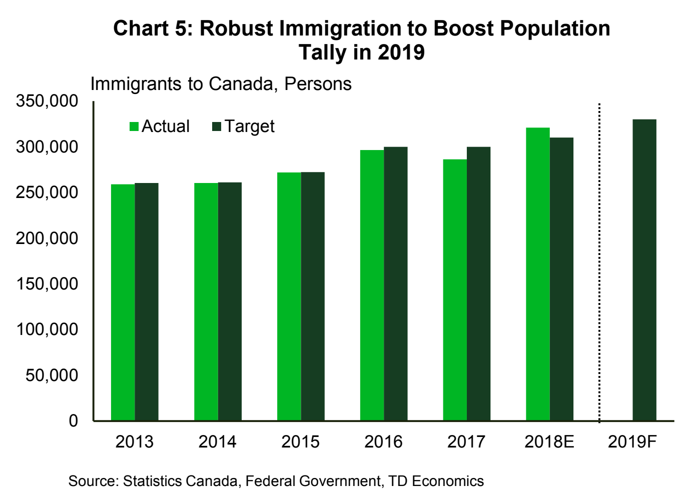
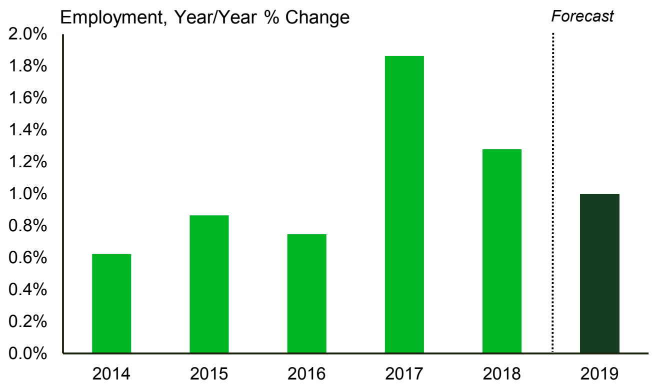


Chart 6: Job Growth to Remain Healthy in 2019



Source: Statistics Canada, TD Economics

hike likely won't come until later in 2019, instead of early 2019 as previously expected. Notably, bond yields have moved significantly lower since November, which should feed through into lower mortgage rates (Chart 7).

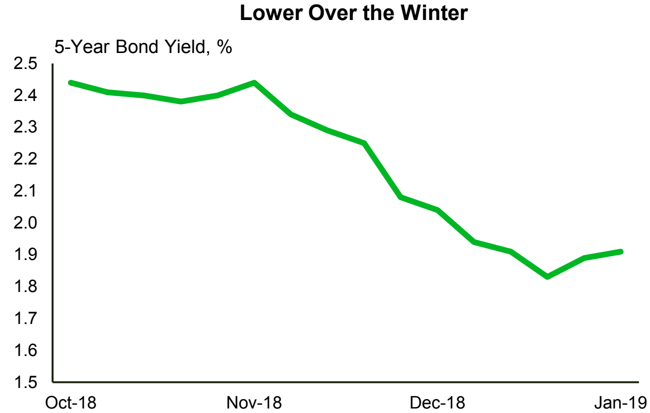
Several other factors should abet these positive fundamental forces. For starters the "bank of mom and dad" remains open, providing a valuable source of funding for first-time buyers. Secondly, although mortgage rates have risen, some households can mitigate the impact of these increases by stretching their amortizations or reverting back to the original amortization schedule if they undertook more rapid principal repayments (see report).

In Toronto and Vancouver, strong condo price growth has caused relative price gaps between single-family homes and condos to narrow significantly. This provides a window for move-up buyers to trade into larger units, thereby helping resale activity. Outside of Toronto and Vancouver, an important (and perhaps overlooked) point is that markets in Ontario and B.C. are holding up much better (Chart 8). In Ontario for instance, conditions in these markets favour sellers in the aggregate, with rapid price growth in places such as London and Ottawa. Notably, regions outside of Toronto accounted for about 60% of total homes sold in the province last year.

In B.C., the picture isn't quite as sanguine, though market balance outside of Vancouver is not too far off historical norms. Meanwhile, some markets stand as notable bright spots for the outlook. For example, prospects are quite healthy for Vancouver Island, as the region continues to draw retirees, the labour market is strong and housing is inexpensive. These positive trends are reflected in home prices, which grew at a 10% annual rate in December. The outlook is also relatively upbeat for Northern B.C. Indeed, sales vastly outperformed the overall province last year while prices advanced by 8%. Further upside is possible over the medium term as development of the massive LNG project begins in earnest. Demand is also holding up relatively well in Victoria while the market remains tight and price growth is firm.

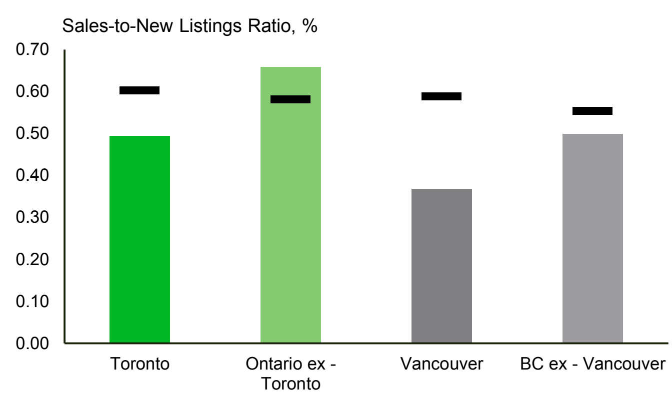
Finally, markets in Quebec and most Atlantic Provinces should add support this year, given decent economic growth prospects in these jurisdictions, rapidly expanding populations and an affordable housing stock.

Chart 7: 5-Year Bond Yield Heads Lower Over the Winter



Source: Bank of Canada, TD Economics

Chart 8: Markets in Ontario & BC Are Firmer Outside of Toronto & Vancouver



Note: Dark lines represent long-term averages.
Source: CREA, TD Economics

Bottom Line

The post B-20 bounce has faded into a distant memory, with housing markets across the country weakening significantly since the summer. With few signs of a near-term stabilization in the December resale data, market activity looks poised to begin the year on a weaker footing than expected. Still, barring a negative economic shock, several factors should prevent markets from a further sustained deterioration through 2019. These include another year of strong population growth, healthy labour market conditions and a more patient Bank of Canada.