

A Bubble Ready to Burst?

Insights on the outlook for housing in Canada

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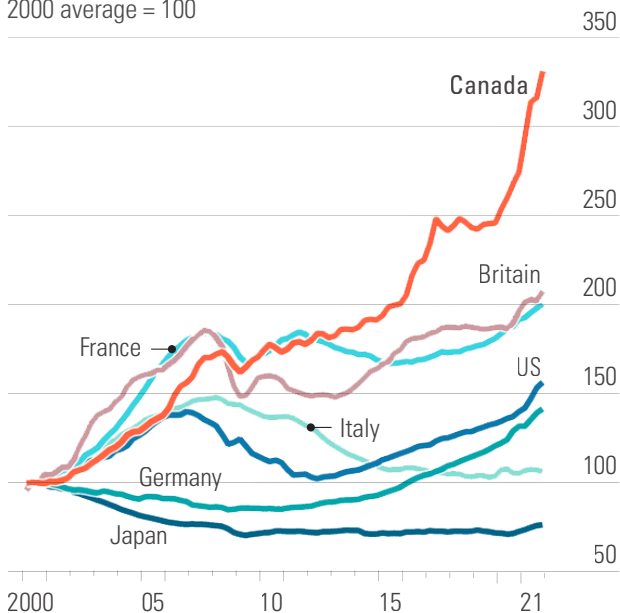
The incredible rise of Canadian housing prices

Canada's housing market has been attracting attention both domestically and globally for most of the past two decades.

For example, *The Economist* reminds us regularly that Canada's real house prices have significantly diverged from those of other G-7 countries.

Whoa, Canada!

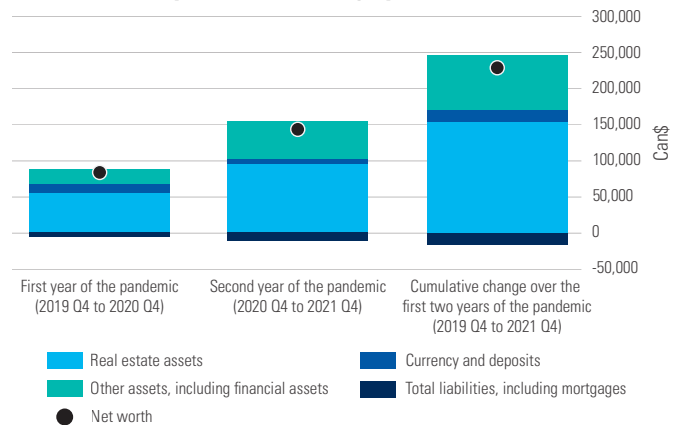
G7 countries, real estate prices
 2000 average = 100



Source: *The Economist*, June 11, 2022. Data sourced from the Federal Reserve Bank of Dallas.

Housing prices have risen in parabolic fashion since early 2020. This has helped fuel economic growth and a massive wealth effect, providing critical support for the economy during the COVID recovery.

Contribution to the change in household net worth since the start of the pandemic, average per household



Source: Bank of Canada, Financial System Review, June 2022. Statistics Canada and Bank of Canada calculations.

According to the Bank of Canada, the wealth of the average Canadian household ballooned by \$250,000 during the pandemic, with about \$150,000 from housing alone.

But extreme housing price increases also come with heightened stability risks. As the table below shows, whether we are looking at the house prices-to-income ratio, the house prices-to-rent ratio or growth in private sector credit, Canada more often than not ranks at the top of the list. The signal the table sends is simple: over the last seven years, Canada's housing prices have been in a cyclical upswing that is stronger than most comparable countries.

With multiple metrics raising alarm bells, there are ample reasons to be concerned about the state of Canadian housing.

The big question is: are we in bubble territory? The answer is important because bubbles eventually pop, and when they do, it can be very painful.

Housing prices: International comparisons

Country	Base of 100 in 2015		Nominal price index (% change YoY)	Real price index (% change YoY)	Private sector credit growth
	House price-to-income ratio	House price-to-rent ratio			
Czech Republic	148.4	176.1	41.3	24.3	22.2
Netherlands	147.2	160.6	32.9	21.6	5.5
Canada	146.6	160.5	34.1	21.2	26.9
Portugal	146.0	159.1	24.2	12.9	7.8
New Zealand	145.4	158.1	39.2	28.3	27.1
Austria	140.2	137.3	30.2	17.8	10.4
United States	139.6	142.5	38.1	21.9	11.9
Germany	138.0	151.0	25.0	12.7	11.4
Spain	124.6	132.1	9.6	1.0	6.4
United Kingdom	121.1	130.1	22.1	9.5	9.0
Denmark	120.7	132.7	21.6	15.2	2.9
Australia	119.5	141.6	28.4	18.7	27.6
Switzerland	117.5	123.8	16.4	12.7	14.2
Sweden	117.4	131.6	18.9	8.3	25.1
France	112.8	128.8	12.9	8.1	13.0
Norway	111.1	126.7	23.9	13.2	30.4
Japan	110.1	114.6	12.8	12.5	-2.7
Belgium	107.7	119.1	15.3	4.5	9.2
Poland	106.0	120.9	21.8	7.9	6.3
South Korea	105.2	112.8	24.9	16.2	21.1
Finland	97.9	102.6	8.0	1.9	4.9
Italy	93.7	104.9	8.8	0.5	6.2

Source: iA Global Asset Management, Macrobond, as at October 7, 2022.

The importance of housing in Canada

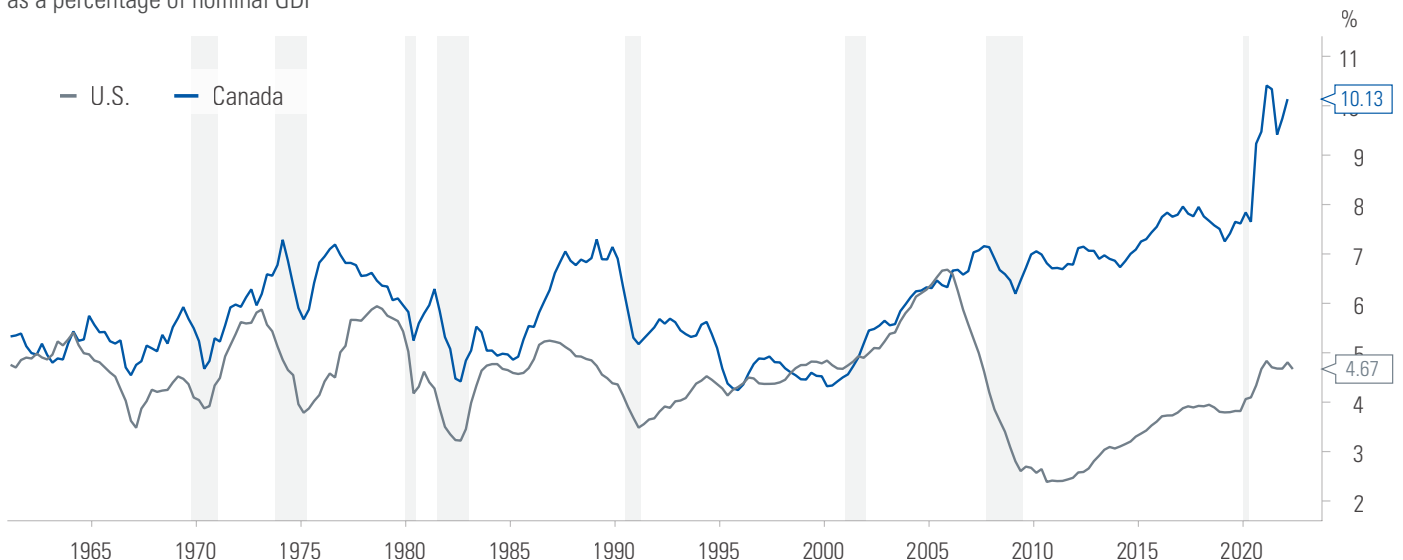
Canada's economy is particularly exposed to a slump in the housing sector.

Residential investment as a share of Canada's GDP has reached more than 10% over the last year – the

highest in the G-7 and amounting to close to \$250 billion in 2021 alone. This is about twice the relative size of the equivalent U.S. figure.

Residential investment

as a percentage of nominal GDP



Source: iA Global Asset Management, Macrobond.

An important piece of the puzzle is that housing is about more than construction and renovation.

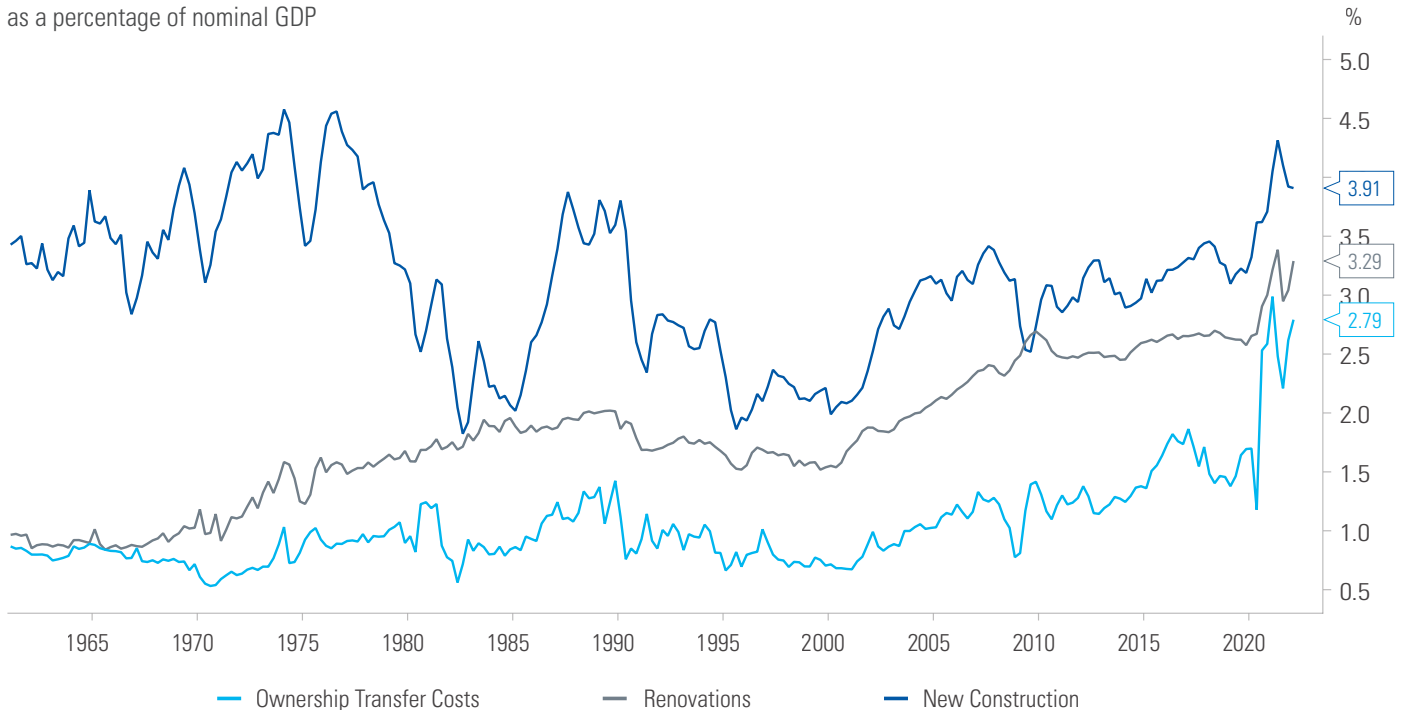
Ownership transfer costs – including realtor fees, land transfer taxes and other transaction costs – also add up, accounting for about 2.5% of Canada’s GDP in 2021. These components are likely to be the most sensitive to any contraction in housing activity and could create an economic headwind even if construction and renovation activity remain resilient.

As housing-related activities have gained in importance, Canada’s economy has become quite sensitive to interest rates, meaning that cyclical forces could be detrimental to Canada’s financial stability.

Beyond these purely economic considerations, housing also has social implications. Housing affordability creates demographic inequalities, with the younger population facing steep price-to-income ratios, making ownership merely a dream for many Canadian households. As inequality is detrimental not only to a country’s long-term prosperity but also to its social well-being, understanding the underlying drivers of the housing market is of vital importance for more than purely economic reasons.

Components of residential investment

as a percentage of nominal GDP



Source: iA Global Asset Management, Macrobond.

Housing is not in bubble territory

While the housing market has reached frothy levels more than a few times in past decades, our view is that we are not currently in bubble territory, nor have we been at any time since 2010, contrary to what some have argued.

This is not to suggest that the housing market will not face tough times ahead. In fact, the risk of a correction – and the resulting headwinds for Canadian growth – is currently quite elevated.

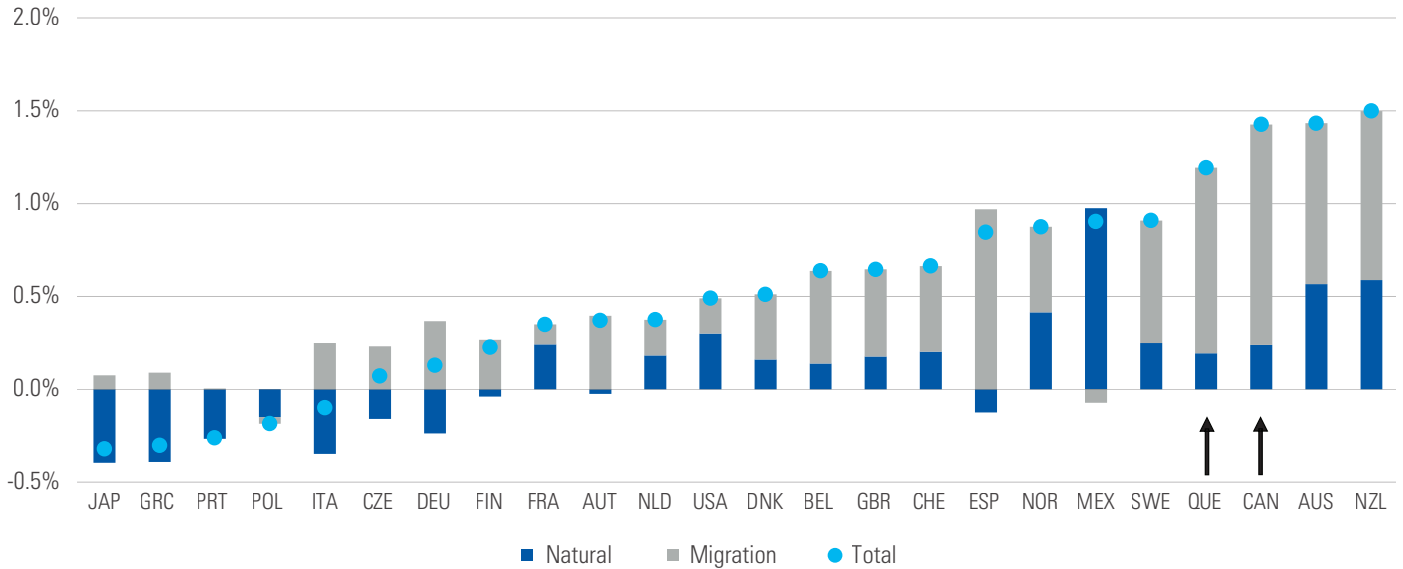
It starts with demography

Any analysis of the housing market needs to start with demography. As of the 2018 census, Canada's population growth rate is the highest among developed countries. Importantly, about 80% of our population growth comes from immigration.

Not only is Canada the destination of choice for immigrants, it is also the best in the world at attracting the most educated. OECD data shows that about 60% of the foreign-born population aged 15–64 has a post-secondary education – well above our closest competitors.

Canada: A perspective on population growth

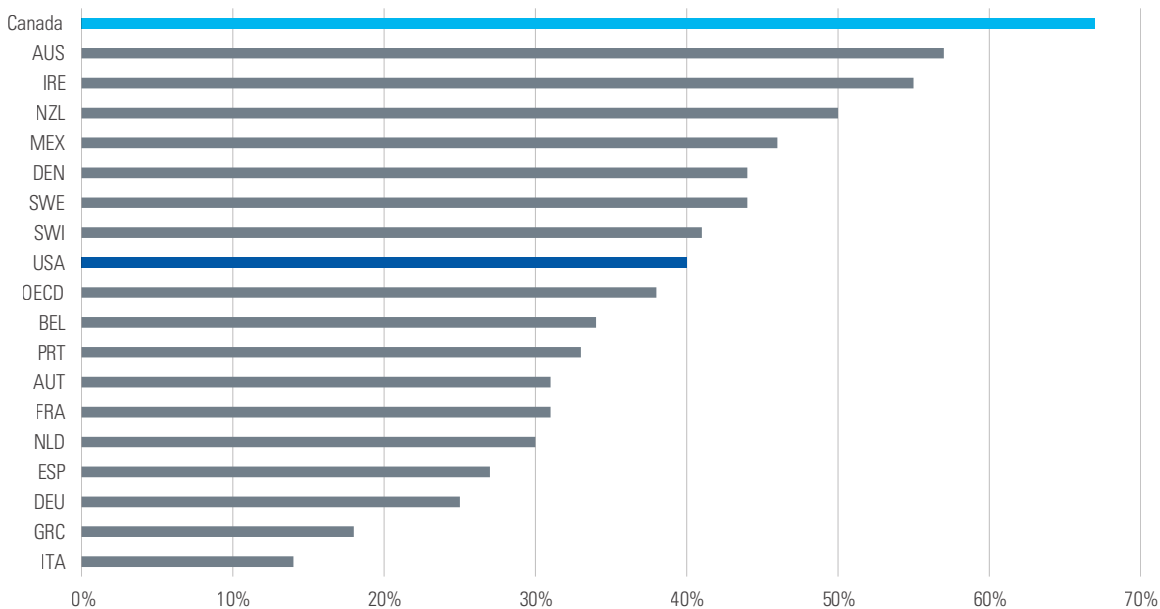
Population growth in 2019, natural vs. migration



Source: Statistics Canada, U.S. Census, iA Global Asset Management.

Canada's foreign-born population is highly educated

% of foreign-born residents aged 15–64 with post-secondary education (2019–2020)



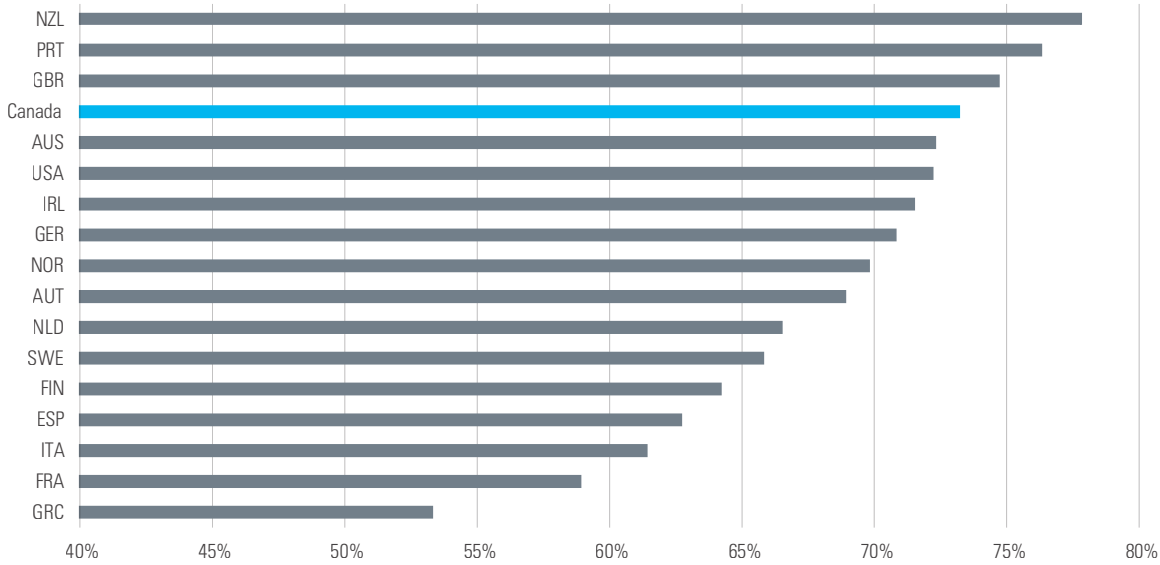
Source: Statistics Canada, U.S. Census, iA Global Asset Management.

Being educated helps immigrants secure employment, which increases the likelihood that they will be able to afford property.

Canada’s favourable demographic profile has acted as a sort of economic “secret weapon” that fuels a strong

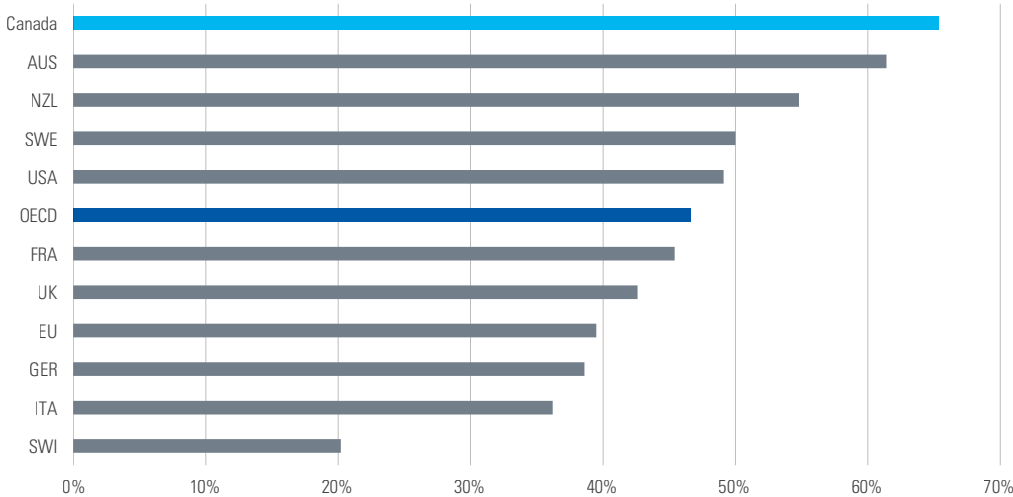
and stable growth rate. But it has also pushed housing prices to relatively high levels and made the Canadian economy, and its housing market, more vulnerable to interest rate hikes and lulls in migratory flows.

Employment rate of foreign-born population (15–64), 2019



Source: OECD, iA Global Asset Management.

Homeownership rate of foreign-born population



Source: OECD, iA Global Asset Management.

Does it end with rising rates?

Another key factor that pushed housing prices higher over the last decade was the regime of mostly declining mortgage rates.

To understand the impact of mortgage rates on Canada's housing sector, it is important to understand refinancing dynamics.

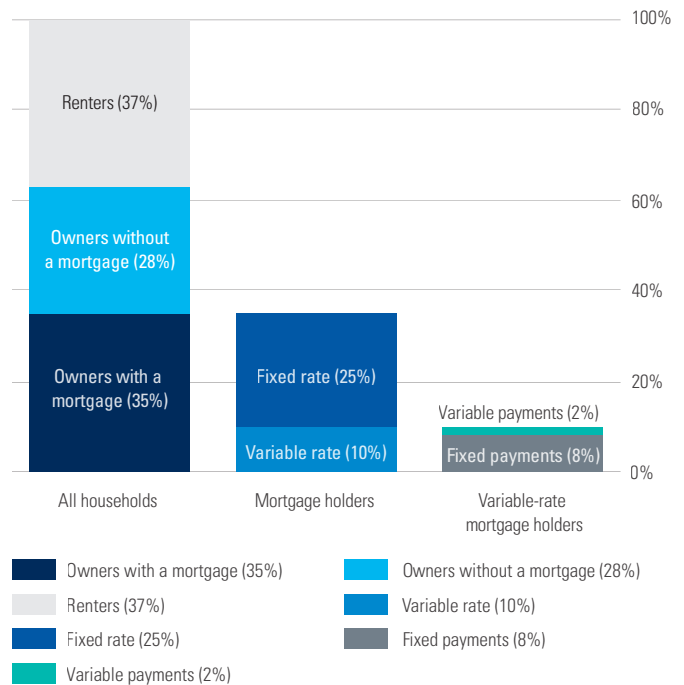
As of Q1 2022, 71% of mortgage holders held a fixed-rate loan, typically with a 5-year maturity. While this figure remains elevated, it is currently somewhat lower than the historical average of about 80%.

The Canadian mortgage market is thus dominated by vintages of borrowers renewing their loans every 5 years.

The 5-year change in 5-year fixed mortgage rates is thus a determinant variable: a negative value means a vintage of borrowers is refinancing at lower rates than the previous renewal/origination, and a higher rate means that interest costs will be higher.

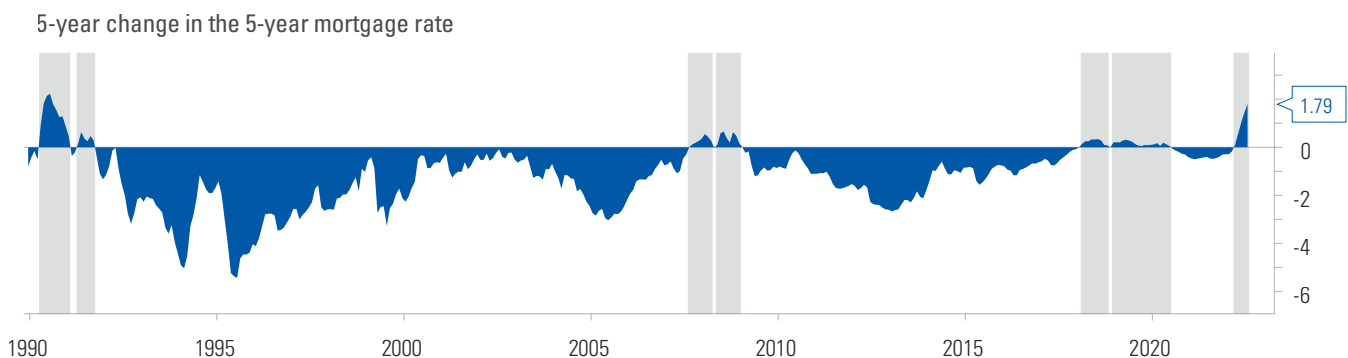
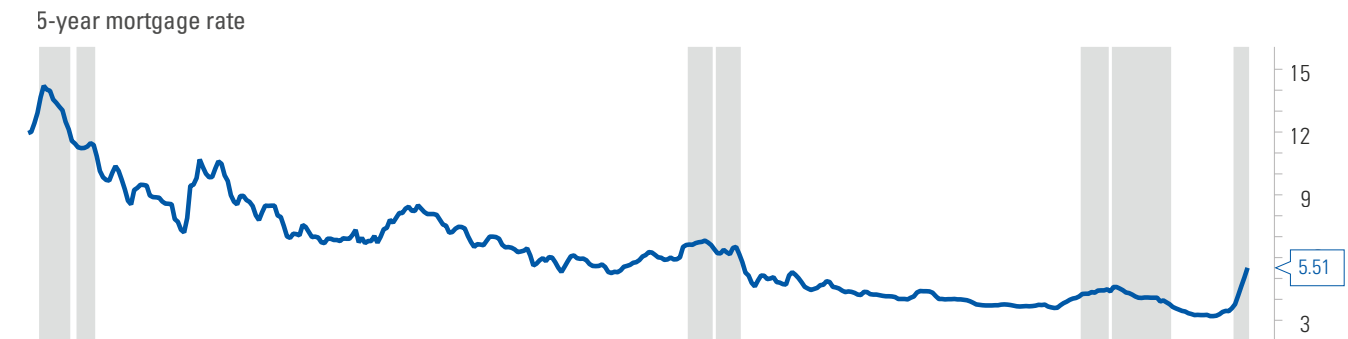
Naturally, the amount owed gets smaller over time, which partially cushions the interest rate hit. But the potentially rising overall cost of ownership is what could create issues for existing homeowners.

About one-third of households have a mortgage, the majority of which have a fixed rate



Source: Bank of Canada, Financial System Review, June 2022. Data as at Q4 2021 and based on Statistics Canada and Bank of Canada calculations.

Canada: 5-year mortgage rate rising from all-time lows



Source: iA Global Asset Management, Macrobond.

For the 30-year period leading up to Q2 2022, the refinancing cycle has been characterized mostly by lower interest costs, which sustained prices. However, borrowers who have to refinance in today's environment of

aggressive Bank of Canada rate hikes are seeing mortgage rates about 1.5% higher than their previous fixed rate, which will likely translate into higher monthly payments.

Housing and speculation

The COVID period of 2020–2021 was marked by historically low interest rates and ample liquidity. These two factors were likely key determinants in pushing housing prices higher, as were lockdowns and the emergence of remote work, which for many Canadians created a need for more space.

As housing is very sensitive to interest rates and prone to speculative buying and selling, it is no surprise that there has been plenty of anecdotal evidence of froth in the market, with stories of bidding wars and abnormally high resale activity.

Is there a parallel here with other speculative asset classes?

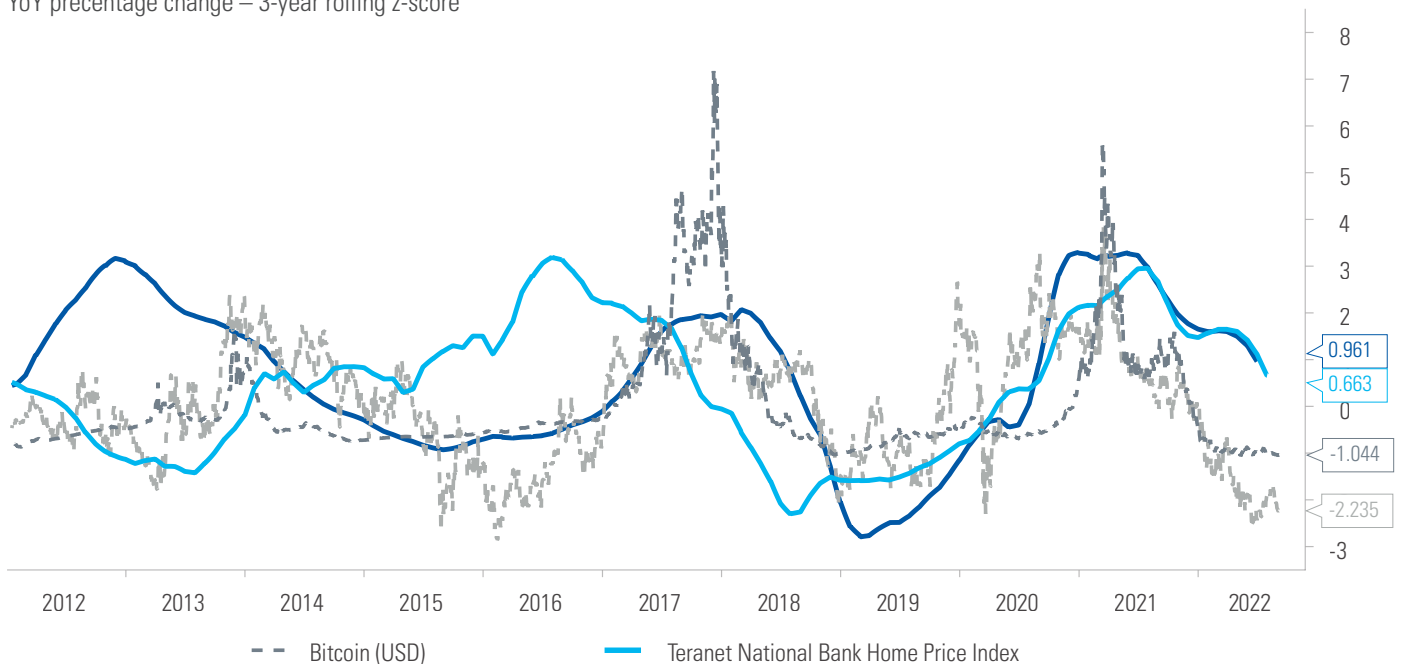
Looking at the recent spike in prices of cryptocurrencies and the tech-heavy Nasdaq, we do see some similarities with the behaviour of housing prices on both sides of the border.

Canadian and U.S. housing prices have seldom been correlated over the past decade, but moved in tandem with speculative assets through the COVID period. This suggests housing was caught in a similar wave of speculation, fueled by low rates and ample liquidity.

Regardless of whether speculative activity is the cause of some or most of the 50%+ rise in the average price of a Canadian house between late 2019 and early 2022, the likely next step is for prices to give back some of these gains amid rising mortgage rates and tightening liquidity conditions.

How speculative have housing prices been recently?

YoY percentage change – 3-year rolling z-score



Source: iA Global Asset Management, Macrobond.

Housing and financial stability

Notwithstanding the above, if a housing bubble were to burst, Canadian taxpayers would likely have to foot the bill, given the \$400 billion in mortgages guaranteed by the CMHC.

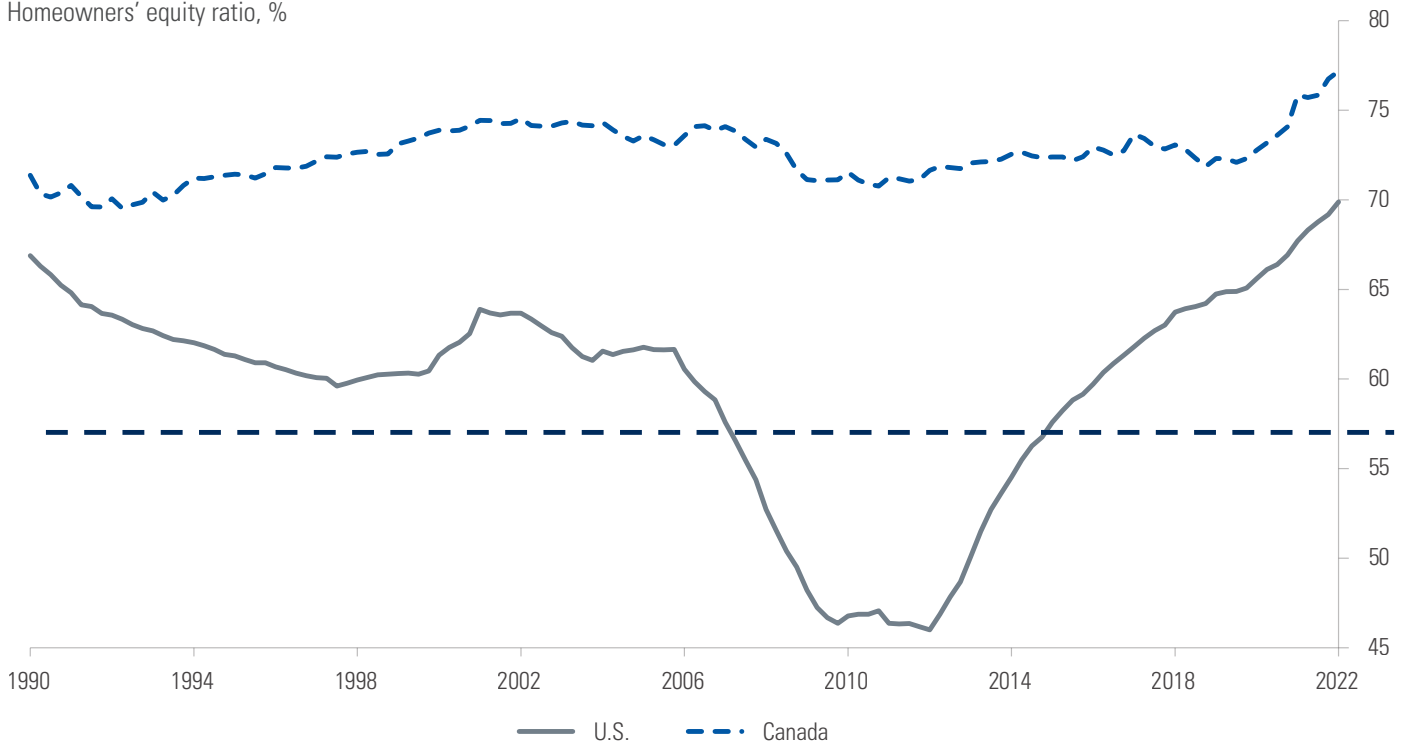
But there are promising signs. A reduced appetite for credit, as well as the rise in existing home prices, pushed the Canadian homeowners' equity ratio (the portion of housing stock that is not financed by a mortgage) to

77.2% in Q1 2022 – the highest value in the more than 30-year period beginning in 1990 and above the historical average of 72.5%.

The well-capitalized nature of the Canadian real estate market is significant because it serves as a cushion for financial stability in the event of a decline in housing prices. In other words, a meltdown like the one the U.S. experienced in 2008 seems unlikely in Canada.

Canadian homeowners' equity at an all-time high

Homeowners' equity ratio, %



Source: iA Global Asset Management, Bloomberg.

Where do we go from here?

Our analysis leads us to conclude that, while housing prices are certainly frothy as of fall 2022, the risk of a bubble-bursting scenario is very low. A more likely path for the next 2–3 years is one of the following.

Scenario 1: Stagflation – 40% probability

In this scenario, inflation remains somewhat sticky and does not return below the 3% level before the first half of 2024.

The Bank of Canada is forced to raise its overnight rate to 4–4.5% in 2023, thus holding back the Canadian economy and choking growth.

The result is a stagflationary environment lasting about 12–18 months, with low household and business confidence, but no massive layoffs.

A housing crash is avoided but prices come under significant pressure, falling between 20% and 30% – a big drop, but not enough to wipe out all the gains since 2019.

This is our base case scenario, with odds of 40%.

Scenario 2: Sticky inflation and hard landing – 25% probability

In this scenario, inflation remains stickier than consensus expectations, meaning the total inflation rate remains above the Bank of Canada's 1–3% range well into 2025, and monetary policy has to be tightened much more than forecast, raising the overnight rate to 5% by the end of 2023.

This would push the economy into recession, unemployment would rise, and household income as well as consumer confidence would fall.

As a result, housing prices would fall by about 30–40%, giving back most, if not all the gains since 2019.

We put the odds of this happening at around 25%.

Scenario 3: Softening inflation and soft landing – 20% probability

In this scenario, total inflation hit its peak in June 2022, followed by a somewhat smooth normalization towards the Bank of Canada's target rate, crossing below 3% around the end of 2023.

The Bank of Canada is successful in orchestrating a soft landing, as it stops tightening monetary policy after 2022. The overnight rate is raised until it reaches 4.0% and remains at this level throughout 2023.

Housing prices normalize somewhat, but the fall is limited to about 10–15% from 2022's highs, thus keeping most of the gains seen since late 2019.

We put the odds of this scenario at about 20%.

Alternative scenario: Prices continue to rise – 15% probability

Although the 2- to 3-year outlook for housing prices remains decidedly tilted towards the downside, some inflationary factors could remain at play.

For example, demographic growth could get even stronger over the coming years if there is a shift in immigration policy, or a shock to the global economy (e.g., another pandemic or an escalation of geopolitical tensions resulting in more armed conflict) could lead central banks to swiftly reverse course on monetary policy, driving rates lower and fueling higher housing prices.

We estimate the combined odds here at about 15%.

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Rooted in history. Innovating for the future.

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