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Is there an 'ou' in Housing?

Is Canada's red-hot housing market in trouble – or are overvaluation estimates overblown?

News stories about the Canadian housing market being a bubble about to burst abound right now. But are they accurate? Observers are raising red flags about Canada's housing market – saying it is overheated, although few of them agree on the extent of the overvaluation. With estimates ranging as high as 60%, the more extreme news reports warn that Canada's housing-market bubble will eventually pop, while others on Bay Street are predicting a gradual cooling.

Prolonged low interest rates coupled with a lower loonie have sparked foreign interest and while low interest rates have increased affordability, some pundits say that affordability will be compromised with any shift in interest rates. That doesn't appear to be coming any time soon with the most recent moves by the Bank of Canada reducing the overnight rate by a quarter of a percentage point to 0.5%. But critics claim that the reduction will just add fuel to a fiery hot housing market.

Some of these arguments may compound the anxiety of Canadian homeowners, two-thirds of whom make monthly mortgage payments, but the accuracy of the more extreme views is questionable. That's because in Canada, the real estate situation is not homogeneous across the country. Because of its sheer size and the diversity of its urban markets, Canada's real estate picture is multifaceted. The Canadian Real Estate Association (CREA) reports that the most expensive markets like Toronto and Vancouver saw monthly sales in May and June that were at their highest levels in years, and that across the country the national average increase in June was 9.6% from a year ago. When you remove these two cities from the equation however, the increase was a much more subdued 3.1%.

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The golden rule of real estate still applies: location, location, location. In Vancouver for example the average two-storey detached home is now selling for more than $1.27 million. Prices have been driven up due to several factors: the natural geographic boundaries that create a finite scarcity for development, an increase in foreign investment where prices in international markets for housing make the somewhat frothy prices in Vancouver look relatively inexpensive, and young buyers seeking housing.

A similar picture emerges in Toronto with strong demand from international and younger buyers. This uptick in demand and rise in housing prices is in part due to Toronto's reputation for being amongst one of the best places in the world to live and do business. According to CREA, the average cost of purchasing a condominium, townhouse or low-rise property in Toronto has jumped 38% in five years.

Financial analysts jump into the fray

It doesn't help that financial analysts have used different data to arrive at their conclusions. Deutsche Bank, for example, compared house prices in Canada at the end of last year to statistics on rent and income, then averaged the two calculations and concluded that the Canadian housing market was over-valued by 60%. They arrived at this figure by calculating the price of houses in different Canadian cities to the average rent paid in those cities, and then did a separate calculation comparing the average income of households in those cities to average house prices. The bank then measured those calculations against ratios that determine affordability.

More recently, The Economist jumped into the fray, giving Canada the dubious distinction of having the most over-valued housing market in the world. Examining house prices in 26 countries, including China, the U.S., Japan and Greece, the magazine concluded that Canadian housing is over-valued by 89% compared to rental prices, higher than any other country on its list. In comparison to income, Canada's housing market is over-valued by 35%, The Economist said, ranking third behind Belgium and Australia. This argument is substantially weakened when you consider that the rental price used does not consider the majority of markets where rental housing stock is not directly comparable to the ownership stock.

While such simplified comparisons attract attention, the magazine does concede that "the nuances of each market are many and varied". That may, in fact, be an understatement.

Overestimating overvaluation

Among the nuances ignored by Deutsche Bank and The Economist, their data on Canadian income figures, compiled by the Organisation for Economic Co-Operation and Development (OECD), do not include income from investments or government. When these figures are included, some economists say house prices in Canada are over-valued by only 8%.

Similarly, the OECD collects data on rent from statistics used to calculate Canada's consumer price index. Statistics Canada says these figures do not correspond to market rents, nor do they capture increases in rent that have occurred over the last year or the slower growth in condominium prices, which account for most of the new rentals in Canada's major cities. Basically what this means is that if the price of houses goes up more quickly than rental payments then the data will show that housing has become more expensive and less affordable in comparison to rental payments. In cities like Toronto for example, many people rent condominiums, not apartments. Since condominium prices don't rise as quickly as the price of houses, the ratio of rental payments compared to condominium prices is lower, so housing (including condominiums) remains more affordable.

None of these quibbles has stopped other commentators from issuing similar cautionary forecasts about Canada's over-valued housing market. In March, the International Monetary Fund (IMF) observed that house prices in Canada had risen 60% since 2000. However, it is worth noting that reputable affordability indexes are typically used to stress tests books of mortgages and many 'overheated' markets are not far off or are in line with the long-term (25-year) averages.

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Noting that Canada's average household debt level had risen to 150% of disposable income, the IMF said that the country has taken steps to reduce the housing market's vulnerability to sudden adverse shocks. "Slower mortgage credit growth and higher quality borrowers appear to be the direct result of tighter lending standards on insured mortgages," the IMF said. The tighter lending standards apply equally to non-insured mortgages. Regulations set out the requirements for federally-regulated lenders on all aspects of residential lending. Non-federally regulated lenders tend to also follow suit to meet the requirement of their underlying fund sources for compliance.

At the same time, tighter standards have prompted many homebuyers to finance their purchases with uninsured mortgages, said the IMF. Uninsured loans now account for two-thirds of newly issued mortgages, and are also contributing to an increase in housing demand.

Some observers say that this increase in uninsured mortgages adds to the risk of a major market correction when interest rates rise and house prices fall. They also say that mortgage insurance provided by the Canada Mortgage and Housing Corporation (CMHC) contributes to rising house prices by enabling banks to lend more freely. Worthy of note is that all default insurance lenders are subject to regulations which require they comply with the regulatory standards.

Canadian housing market only modestly overvalued

The CMHC makes its own calculations about the value of Canada's housing market, using an exhaustive process that involves four different models. Comparing home prices with such variables as after-tax income, population growth, construction costs and affordability, CMHC compares its models to three different measures of house prices from the Canadian Real Estate Association, the Teranet-National Bank house price index and Statistics Canada. At the end of the exercise, CMHC can measure over-valuation in 12 different ways.

Comparing its models, CMHC said last year that house prices in Canada ranged from 13% under-valued to 16% over-valued. In a report earlier this year, the housing organization reaffirmed its conclusion that Canada's housing market is only moderately over-valued and that some markets face higher risks than others of a market correction.

"Modest overvaluation based on national indicators reflects a variety of price conditions across the country," said CMHC's Chief Economist, Bob Dugan, "with some centres showing more signs of overvaluation than others. Likewise, housing market risk factors such as overheating, acceleration in house prices and overbuilding also vary by [urban market]." In addition, the risk of adjustment varies based upon housing type within a specific markets, (i.e. speculative condo investment) is more likely to be affected by any adjustment versus singly family detached dwellings.

Not only does the CMHC regard overvaluation as "modest", but other informed commentators such as the Bank of Canada and the National Bank of Canada also remain relatively unperturbed by the condition of Canada's housing market.

National Bank data, for example, show that home affordability is in line with historical trends, while debt-to-household disposable income remains consistent. With interest rates remaining low for the foreseeable future, says the bank, Canada looks poised for some price correction, but dismisses the threat of a housing bubble.

Mortgage payments in line with historical averages, debt levels reasonable

According to National Bank, monthly mortgage payments are in line with historical averages in all major Canadian cities, a result of lower-than-average mortgage rates. The debt of Canadian households amounts to 153% of their disposable income, higher than the U.S.,

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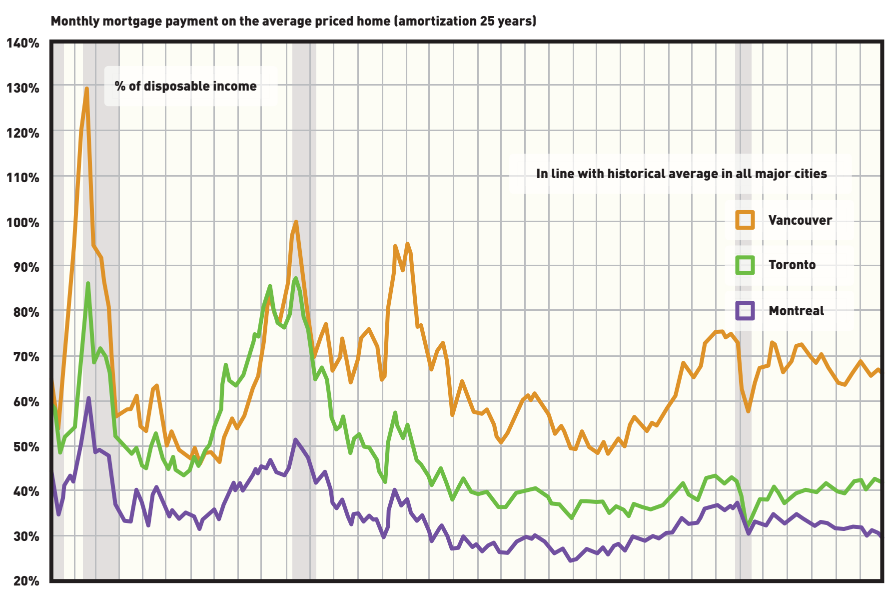
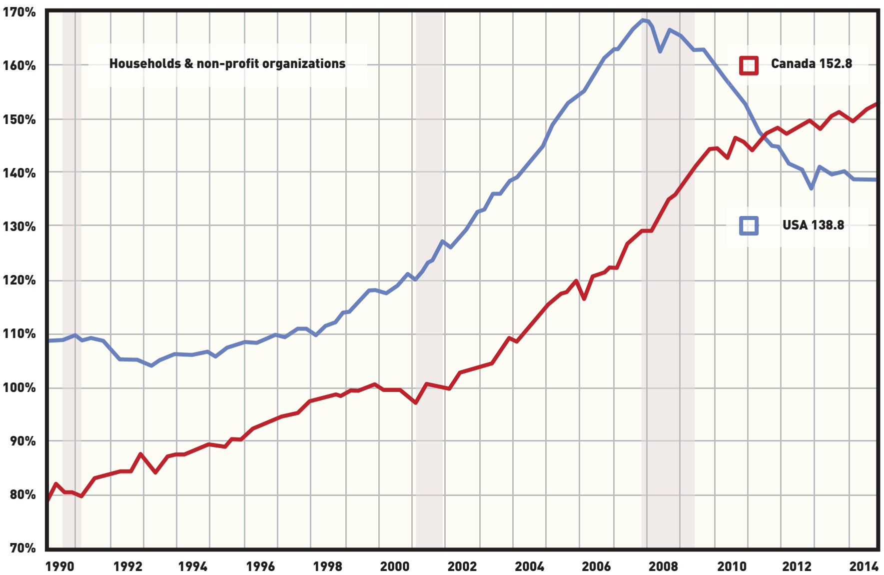
Perspective on home affordability



NBF Economy & Strategy (Statistics Canada, CREA, Teranet - National Bank)

Debt to household disposable income



NBF Economy & Strategy, data from Statistics Canada, Federal Reserve and BEA

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at 139%, but well below countries like Denmark, Switzerland and Australia.

The bank also points out that international comparisons are misleading, because they don't capture domestic idiosyncrasies such as health-care expenditures, which account for a much higher proportion of disposable income in the U.S. than Canada, or homeowners' equity as a share of residential assets, which is far higher in Canada than the U.S. National Bank also observes that 36% of Canadian homeowners have no mortgage at all.

"We would need either a massive rate shock or a massive unemployment problem to generate a bad default experience,“ says Canadian economist David Rosenberg. "There are many mitigating factors, such as the strength of the asset side of the balance sheet, the face that Canadian homeowners have substantial skin in the game, and the fact that the cost of carrying this debt touched yet another record low in the first quarter [of 2015]."

Canada's household disposable income levels stable

The Bank of Canada issued an equally prudent assessment of Canada's housing market in its most recent Financial System Review in June. Acknowledging regional differences, the Bank acknowledged that "overvaluation in the Canadian housing market remains a concern."

But it pointed out that "the share of household disposable income allocated by Canadians to required payments on mortgage debt has been relatively stable since 2008 and that delinquency rates for household loans remain low."

Noting that one-quarter of outstanding mortgages carry a variable rate of interest, the Bank said that "an increase in interest rates could cause households with variable-rate mortgages to have higher-than-anticipated costs to service their debt. This would be problematic for households with less discretionary income and fewer liquid financial assets." But the Bank also said that most new borrowers of variable-rate mortgages "have the financial capacity to accommodate higher interest rates." Further, there are two types of variable rate loans in the Canadian market, the Adjustable Rate, Adjustable Payment loan, or ARAP, and the Variable Rate loan or the VRM. Both loans require borrower qualification based on significantly higher posted fixed rates, thus ensuring significant cushion in the borrower's capacity in the event of interest rate increases. In addition, both loans typically offer the option to convert to a fixed rate loan at any time. so if rates started to move up, borrowers could mitigate those increases to some extent.

House prices likely to stabilize in line with economic fundamentals

Even if house prices fall, the Bank said they would have to decline by at least 20%, with little or no expectation of recovery, "before borrowers with negative equity would even consider a strategic default on an outstanding mortgage."

"Overall," said the Bank of Canada, "high house prices are mainly the result of ongoing strength in consumer demand spurred on by historically low interest rates. As the economy gains strength and interest rates begin to normalize, the most likely scenario is one in which house prices stabilize in line with economic fundamentals."

What's a homeowner to do?

So what's a homeowner to make of all this? A good question to ask yourself is, 'Can I afford my payments?' Housing is different than other investments in that it is not a short-term proposition. Most Canadians plan to live in their homes for a long time. They are typically not buying on speculation. So what is the true sensitivity to interest rate increases or house price declines? Your house is only worth what the next person will pay for it. So the key is, 'Can I manage my carrying costs today and into the future?' If the answer is yes, this helps to ensure that any short-term fluctuations in the value of your home or interest rates do not impact your long-term decision making. IQ