ECONOMIC VIEWPOINT

Canadian Residential Real Estate Outlook

The Housing Market May Have Begun to Cool, but There's No Need to Panic

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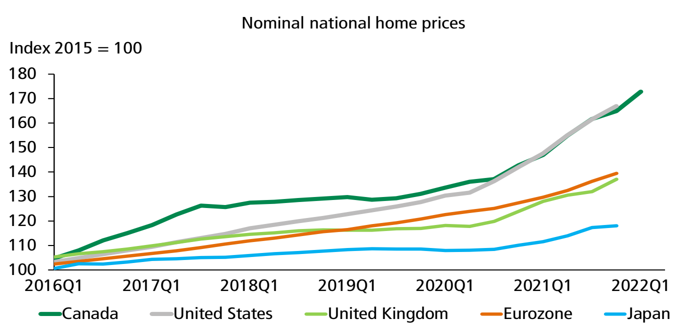
The story of Canada's housing market is well known. In the run-up to the COVID-19 pandemic, Canada posted world-leading price gains. Then lockdowns and remote work sent Canadians to far-flung places looking for more space. This caused prices to increase almost exponentially in communities that had been largely insulated from the rapid escalation in home values in Canada's largest cities. But as life begins to return to normal and the Bank of Canada tightens monetary policy to bring down decades-high inflation, the Canadian housing market is beginning to roll over. Nationally, this could mean a decline in the average home price of 15% from its February 2022 peak by December 2023. And the adjustment is likely to be most acute in those provinces and communities that experienced the fastest rise in prices during the pandemic. That said, we don't expect home prices to fall to their pre-pandemic level or trend in any province before the end of 2023, with average home values remaining as much as 25% above their December 2019 mark at the end of next year.

Canada's housing market has been on a wild ride since the pandemic kicked the already hot market into overdrive. With prices having peaked nationally at 50% above their December 2019 level, the first cracks in the housing boom have begun to show as borrowing costs have moved higher. But how much are home prices likely to come down over the next couple of years? And which provinces and communities are expected to see the biggest adjustments?

What Went Up Is About to Come Down

Canada is no stranger to high and rising home prices. But the pandemic supercharged this trend, as COVID-related lockdowns led to a sharp increase in remote work and a desire for more living space. Households fanned out far and wide, pushing prices to unprecedented heights at an equally unprecedented pace in suburbs and smaller communities surrounding major urban centres. Canadians also moved across provincial borders, fleeing to far-flung places that allowed them to have more space and amenities than in locked-down cities. And this isn't just a Canadian phenomenon, as the United States and other advanced economies saw similar trends during the pandemic, albeit to a less dramatic extent (graph 1).

GRAPH 1
Canada leads major economies in pandemic-era home price gains

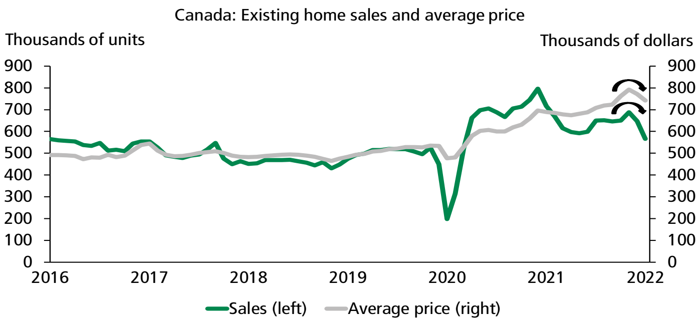


Source: Organisation for Economic Co-operation and Development

At the national level, the average price of an existing home rose from nearly \$530,000 at the end of 2019 to slightly over \$790,000 at the February 2022 peak—a 50% increase in just over two years. Since then, prices nationally have been sliding at an accelerating pace, falling by 2.6% m/m in March and by a further 3.8% in April (graph 2 on page 2). At the same time, existing home sales declined by 5.9% in March and a much more dramatic 12.6% in April, for a nearly 18% drop in sales since February 2022.

While two months of data don't make a trend, we believe they do suggest that the Canadian housing market has reached an inflection point. Gains in prices and sales accelerated in late 2021

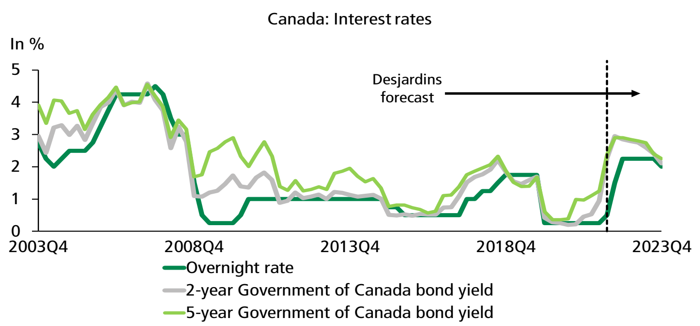
GRAPH 2
The Canadian housing market has likely peaked



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

and early 2022 as homebuyers wanted to get ahead of Bank of Canada interest rate hikes. It should therefore come as little surprise that higher borrowing costs quickly took the wind out of the sails of the Canadian housing market (graph 3).

GRAPH 3
Borrowing costs have risen considerably and may go up even further



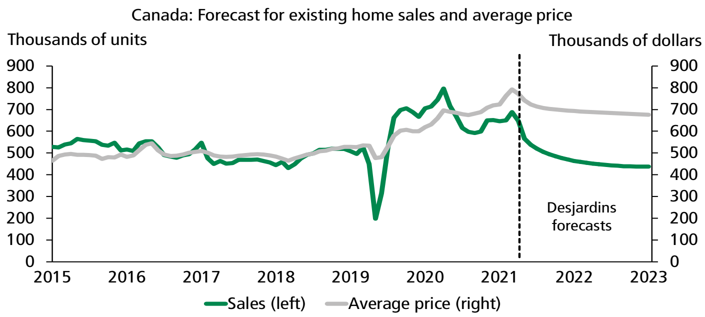
Sources: Bank of Canada and Desjardins, Economic Studies

Looking ahead, we believe ever-higher borrowing costs are going to weigh on housing market activity as increasingly interest-sensitive households batten down the hatches for the impending storm. This is expected to lead to sustained weakness in sales activity, thereby keeping persistent downward pressure on prices. But to be clear, we're of the view that while there will be a correction in the Canadian housing market, there won't be a collapse. Specifically, while we expect the average national home price to fall by 15% from the February 2022 peak to about $675,000 by December 2023, this is still nearly 30% above the December 2019 level (graph 4). As such, while some Canadians may lose their sleeves, we don't expect Canadian households on the whole to lose their shirts.

A Different Housing Trend for Every Province

Canada is a country of large, diverse provinces, all of which exhibit their own distinct housing market trends. But the increase in remote work during the pandemic encouraged migration

GRAPH 4
Home sales and prices are expected to correct but not collapse

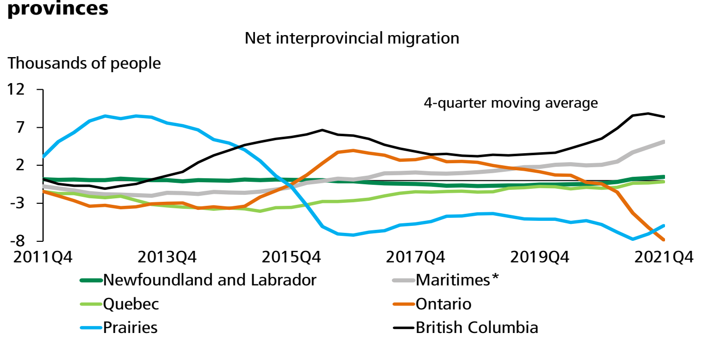


Sources: Canadian Real Estate Association and Desjardins, Economic Studies

within and across provinces in a way which was unprecedented in history. Where families once left city centres in the pursuit of more space once kids came along, they could now move much further afield, including to rural communities and provinces with better affordability.

Net interprovincial migration became a key driver of housing market activity in provinces such as New Brunswick and Nova Scotia. According to Statistics Canada, the Maritime provinces saw the fastest pace of inward migration from other parts of Canada in at least the past 20 years (graph 5). This led to the largest provincial gains in average home price in Canada during the pandemic, ranging from 60% to 70% at their pandemic peak relative to December 2019.

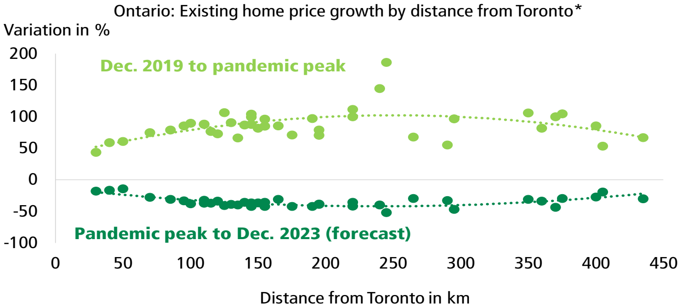
GRAPH 5
BC and the Maritimes saw population inflow from other provinces



*The Maritimes include New Brunswick, Nova Scotia and Prince Edward Island.
Sources: Statistics Canada and Desjardins, Economic Studies

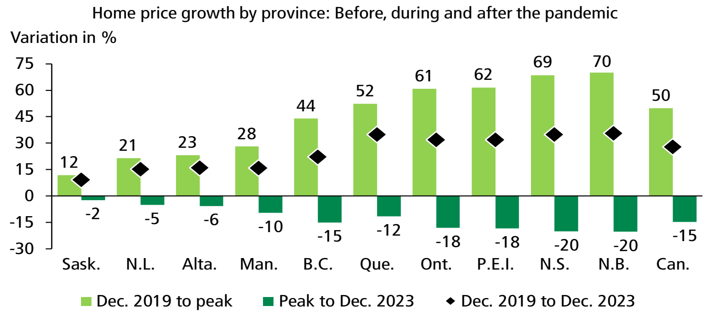
In contrast, while larger provinces were the source of this migration to smaller provinces with greater affordability, the biggest catalyst of their pandemic housing market activity was intraprovincial migration. This trend is often referred to as "drive until you qualify," as people ventured to live further afield than ever before in the hunt for more space as lockdowns dragged on (Moffatt, 2021). In Ontario, for example, Torontonians found room to stretch out in Hamilton,

GRAPH 6
Areas that saw the biggest price gains should also see the steepest declines



*Excludes Thunder Bay, Timmins and Sault Ste. Marie.
Sources: Canadian Real Estate Association, Google Maps and Desjardins, Economic Studies

GRAPH 7
Home prices will fall, but likely not as much as they rose during the pandemic



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

London and Barrie (graph 6). Bancroft, Ontario of all places saw the most significant average price gain, reaching over 185% above the December 2019 level at its peak. Residents of British Columbia and Quebec hit the road with similar gusto, with recreational properties in outlying regions underpinning the provincial gains.

Finally, the Prairie provinces as well as Newfoundland and Labrador followed their own trend. Oil prices slumped in the early part of the pandemic as demand for gasoline and jet fuel took a nosedive, bringing energy sector activity and job creation down with it. This led to further outward migration from these provinces, exacerbating a trend that began back in 2014–2015. As a result, these provinces experienced the most modest average home price gains during the pandemic.

As we look ahead to how the national housing market correction will play out at the provincial level, in some ways it's expected to be the inverse of what we saw during the pandemic. For instance, those provinces that experienced the most dramatic price gains—notably the Maritime provinces—should see the largest corrections. In contrast, those provinces that saw home prices increase the least—the Prairie provinces and Newfoundland and Labrador—should see the least correction coming out of the pandemic. And finally, the big provinces of Ontario, Quebec and British Columbia are expected to experience housing price corrections in between those of the Maritime and energy-producing provinces. Quebec is set to see the least correction among the big provinces given its much greater housing affordability and less overvalued market.

Importantly, we don't anticipate any Canadian province to see the average existing home price fall below its pre-COVID level (graph 7). This suggests that while the correction should be broad-based, even those provinces that are likely to experience the biggest changes in valuation won't lose all the home equity created during the pandemic. This reflects several factors. For the country as a whole, remote and hybrid work arrangements are expected to persist in some capacity, helping to provide some support to prices in smaller communities in particular. In the Prairie provinces, sustained high commodity prices should underpin inward migration and housing market activity. In Ontario and British Columbia, renewed international immigration post-pandemic should limit the housing market correction, especially in the major centres of Toronto and Vancouver. In the years just before the pandemic, around 40% of international immigrants to Canada came to these two cities alone. And with the Maritime provinces still among the most affordable regions in Canada to live, falling home prices should be partly offset by Canadians wooed by greater affordability.

In Ontario, the Devil Is in the Local Details

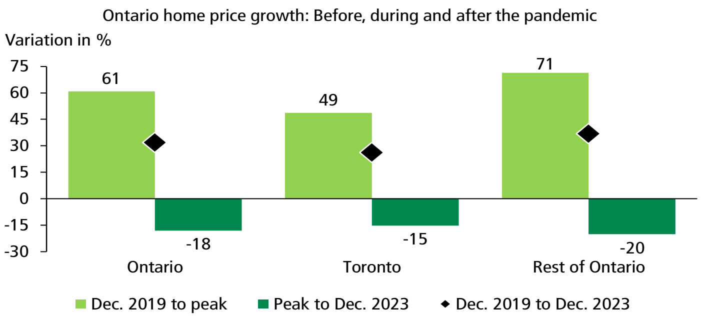
While Canadian provinces and the country as a whole are expected to see home prices decline but remain above their pre-COVID levels, individual communities will be impacted very differently. It's difficult to envision the housing markets of some smaller communities maintaining their unprecedented pandemic price gains as people return to in-person work on a more regular basis.

Ontario is a great example of where this trend has played out. In the two years preceding the pandemic, average home prices rose by around 13%. But during the pandemic, the average existing home price rose by over 60% province-wide from December 2019 to the provincial peak in February 2022, soaring from $645,000 to $1,040,000 (graph 8 on page 4). Average home prices in Toronto increased by nearly 50% over the same period, rising from almost $875,000 to just shy of $1,300,000. At the same time, communities outside of Toronto saw even bigger price gains, rising by over 70% between December 2019 and February 2022, from over $480,000 to just north of $825,000.

Not surprisingly, the run-up in home prices during the pandemic has considerably eroded affordability in Ontario. According to the Desjardins Affordability Index, Ontario cities were among the least affordable in Canada as of the first quarter of 2022 (graph 9 on page 4). And from a historical perspective, all the Ontario cities studied posted record-low affordability at the start of this year (graph 10). Importantly, these large Ontario cities aren't generally communities that have seen the biggest price increases. As such, they may just be the tip of the iceberg when it comes to eroding housing affordability in Canada's most populous province.

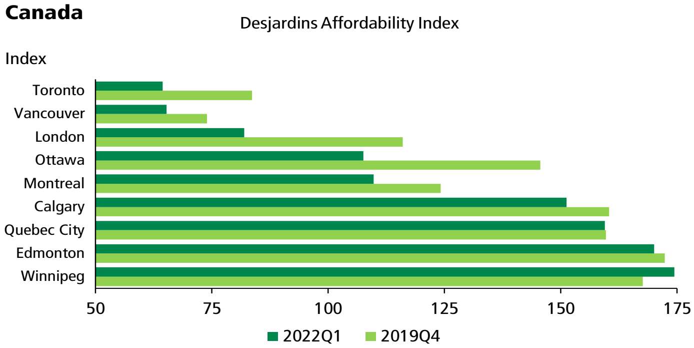
As a consequence, we expect the housing market correction in Ontario to be led by a decline in sales activity and prices in smaller centres outside of major urban areas. We think prices will fall the most in communities that saw the biggest price increases during the pandemic and therefore the most erosion in affordability. That means communities within a few hours' drive of Toronto are likely to see sales activity and prices cool the fastest as borrowing costs rise and commuting becomes more common (graph 11). Proposed legislation to end blind bidding and other practices believed to be leading causes of recent price appreciation should also bring down home prices somewhat. But again, we don't anticipate average home prices in any of these regions to fall below their pre-COVID starting points due by and large to high levels of international migration and ongoing hybrid work arrangements.

GRAPH 8
The biggest price swings in Ontario will be outside the GTA



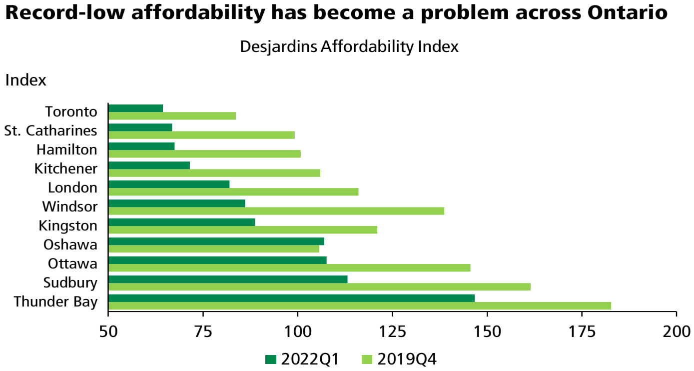
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

GRAPH 9
Ontario cities are among the least affordable places to live in Canada



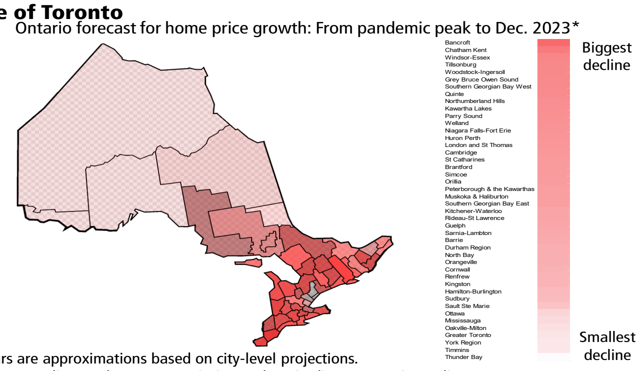
Sources: Bank of Canada, Statistics Canada, Canadian Real Estate Association, Conference Board of Canada and Desjardins, Economic Studies

GRAPH 10
Record-low affordability has become a problem across Ontario



Sources: Bank of Canada, Statistics Canada, Canadian Real Estate Association, Conference Board of Canada and Desjardins, Economic Studies

GRAPH 11
We'll likely see the largest corrections within a couple hours' drive of Toronto



*Colours are approximations based on city-level projections.
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

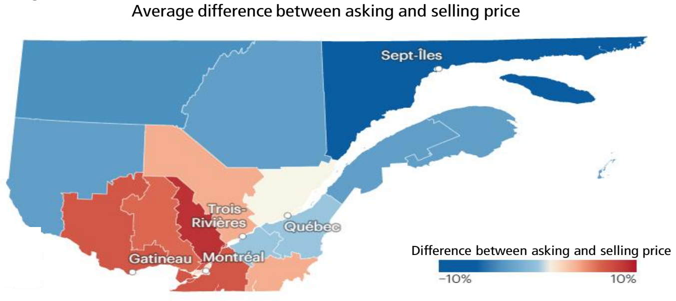
Prices Should Fall Less in Quebec than in Ontario

The residential real estate market in Quebec has also been hot since the start of the pandemic. But the increase in the average home price has been less drastic than in Ontario and the country as a whole. At the start of 2020, resale market conditions were already tighter in Ontario and prices were increasing more rapidly than in Quebec. The pandemic only made things worse, leading to a more acute price spike in Ontario than La Belle Province.

However, the dynamic in the two largest metropolitan areas of each province, namely Toronto and Montreal and their surrounding areas, was similar. Population migration out of the larger centres accelerated in the months following the start of the pandemic. The influx of buyers into the areas surrounding the island of Montreal has led to an unprecedented tightening of market conditions. This pressure accelerated price growth on the outskirts of the island. Multiple offer situations and overbidding exacerbated this trend and have increased mainly in administrative regions of western Quebec (graph 12 on page 5).

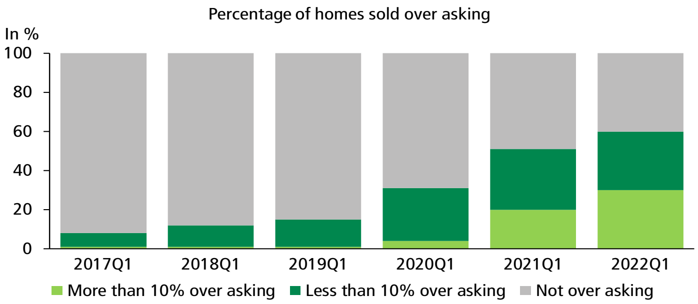
The market didn't slow down this spring, and the one-upmanship even intensified (graph 13 on page 5). This begs the question: Is this the last burst of activity before the lull?

GRAPH 12
Overbidding was still quite common in many areas of Quebec in Q1 2022



Sources: Quebec Professional Association of Real Estate Brokers by the Centris system, Le Devoir and Desjardins, Economic Studies

GRAPH 13
Overbidding got even worse in the Montreal CMA in Q1 2022



CMA: Census metropolitan area
Sources: Quebec Professional Association of Real Estate Brokers by the Centris system, Le Devoir and Desjardins, Economic Studies

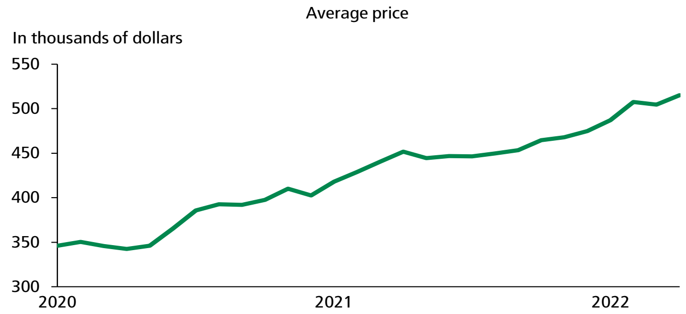
Although there's still a housing shortage, the first signs of increasing supply and flagging demand are beginning to appear. The simple fact that fewer buyers are jostling to purchase the same properties should gradually reduce overbidding. This is expected to start to send prices lower, likely in the coming months.

Unlike Canada and Ontario, prices continued to rise in April in Quebec (graph 14). The average home price grew 2.1% to a record-high $515,187. But while the pullback may start later than in Ontario and the rest of Canada, it's nonetheless expected to arrive.

Quebecers' lower rate of indebtedness and much higher savings rate mean household finances are less precarious than elsewhere in Canada (graphs 15 and 16). Although affordability has deteriorated in Quebec, the situation is less critical than in Ontario. However, rising mortgage rates are already making it harder to borrow, especially for first-time buyers. Quebec is also expected to see cooling demand and a gradual increase in supply in the second half of 2022. Next year, the federal ban on the purchase of non-recreational residential properties by non-residents and the new tax rules for properties held less than 12 months aimed at limiting investor purchases should further slow the residential market.

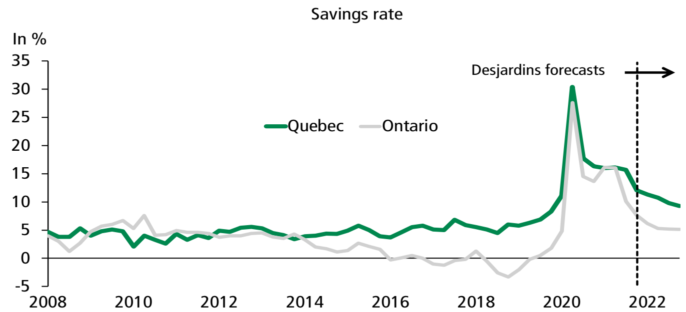
The drop in prices from peak to trough at the end of 2023 is expected to be 12%, less than the anticipated decline in Canada as a whole. The last time Quebec saw a sustained period of home depreciation was in the early 2000s. At the time, prices dipped 6.6% over the course of a few months. Prices fell again in

GRAPH 14
Home prices continued to climb in April in Quebec



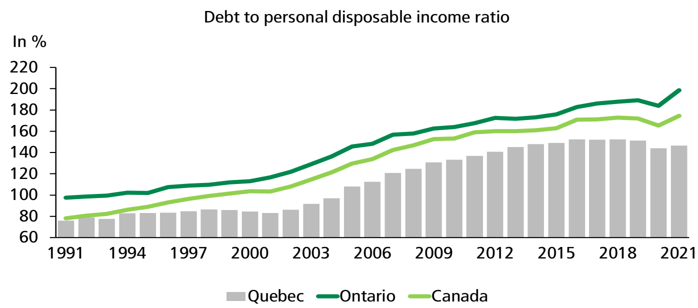
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

GRAPH 15
Quebecers continue to have a much higher household savings rate



Sources: Institut de la statistique du Québec, Ontario Ministry of Finance and Desjardins, Economic Studies

GRAPH 16
Quebecers have lower rates of household debt than Ontarians and Canadians as a whole



Sources: Statistics Canada, Canada Mortgage and Housing Corporation, Bank of Canada, Institut de la statistique du Québec and Desjardins, Economic Studies the early 1990s before staying nearly unchanged for an extended period. This time around, the price correction is likely to be more pronounced given the price spike that preceded it.

Despite the anticipated cooling in the Quebec housing market, the average price at the end of 2023 is still expected to be about 35% higher than it was at the end of 2019 just before the pandemic began. Ontario and Canada should see bigger declines, but prices are likely to still be about 25% higher than they were pre-pandemic. The correction will likely just wipe out the excesses of the housing boom. In previous real estate cycles, the price decline coincided with a return to a market surplus. This time, overbidding makes the market more vulnerable to a rapid price correction without the market necessarily going into a surplus. A steeper correction can't be ruled out, depending on how well the housing market can withstand rising mortgage rates.

Conclusion

It looks as though the Canadian housing market correction we expected has begun, though it's still concentrated in a small number of markets. But there's no need to panic. While a correction in the range of 10% to 20% is likely by the end of next year in most provinces, average home prices are expected to remain above the pre-COVID level and trend. As such, the anticipated correction should bring more balance to the Canadian housing market.