ECONOMIC VIEWPOINT

Canadian Residential Real Estate Outlook

The Correction Continues, but Affordability Is Set to Improve in 2023

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Despite taking a brief reprieve in August, home prices and sales are expected to continue their downward slide. This is largely due to the ongoing rise in interest rates and borrowing costs facing households. We remain of the view that those provinces that experienced the most pronounced pandemic gains will also see the most precipitous post-pandemic corrections. Chief among these are the Maritime provinces and the areas surrounding Toronto, Vancouver and Montreal. Commodity-producing provinces should fare better than most, as resource prices are set to fall further but remain above pre-COVID levels. There is a silver lining to our outlook, however. Affordability is poised to improve in Canada, with the largest advances likely in Edmonton, Calgary and Winnipeg. And affordability is slated to gradually improve in Ontario and Quebec but remain well below pre-COVID levels through the end of 2024. Overall, greater affordability should support a housing market rebound starting in 2024, although efforts to boost supply must be maintained to accommodate Canada's fast-growing population without generating new froth.

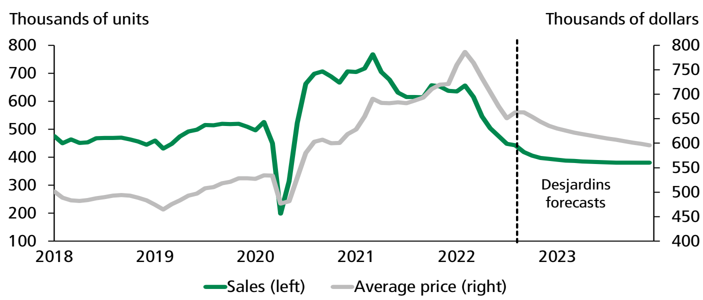
It's been a tough year for the Canadian housing market, so many took heart from August's tentative stabilization. But will it last? What's next for Canadian housing? Will affordability ever improve? If so, when will it be enough to support a market recovery? We address these questions and more in this latest housing note from Desjardins, Economic Studies.

The Housing Correction Took a Breather in August

The Canadian housing market correction took a bit of a breather in August. Nationally, the average home price increased by 1.9% over July—the first monthly gain since February 2022 (graph 1). At the same time, home sales fell by 1.0%—the most modest decline since the housing downturn began. This has provided some room for optimism in what has been an otherwise dismal six months for Canadian housing.

But digging into the regional details, there are some smudges on this rosy view. Only three provinces saw a price increase: Ontario (1.8%), Nova Scotia (2.8%) and Saskatchewan (0.1%). The remaining seven provinces saw their average price decline, including big provinces such as Alberta (-1.6%), Quebec (-0.7%) and British Columbia (-0.1%). The benchmark home price index that's used to compare sales "apples to apples" fell for the sixth consecutive month, dropping by 1.6% nationally in August (graph 2 on page 2).

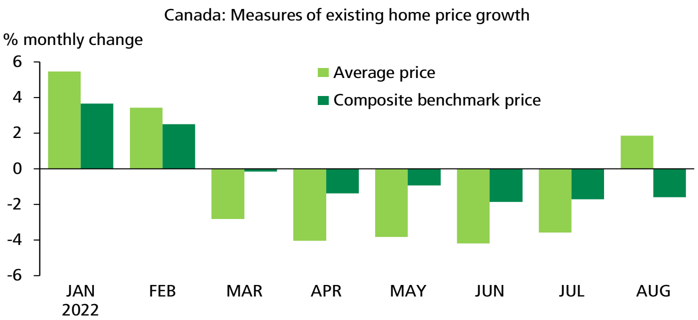
GRAPH 1
Existing home sales and prices are correcting, but aren't expected to collapse in Canada



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

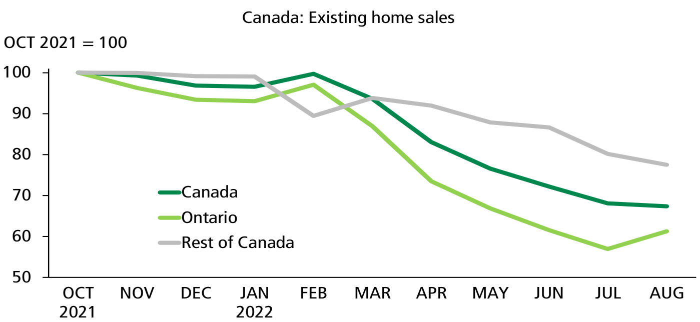
On the sales front, the news was even worse. Ontario was the only province to see an increase in existing home sales in August. That said, two thirds of communities saw prices advance in the province. Taking Ontario out of the equation, home sales in the rest of the country fell by 5.4%, the sharpest monthly decline since May (graph 3 on page 2). Manitoba (-9.4%), Quebec (-6.8%), British Columbia (-5.4%) and Alberta (-4.7%) posted notable declines. In Atlantic Canada, sales were down 3.4%.

GRAPH 2
Existing home price measures sent mixed messages in August



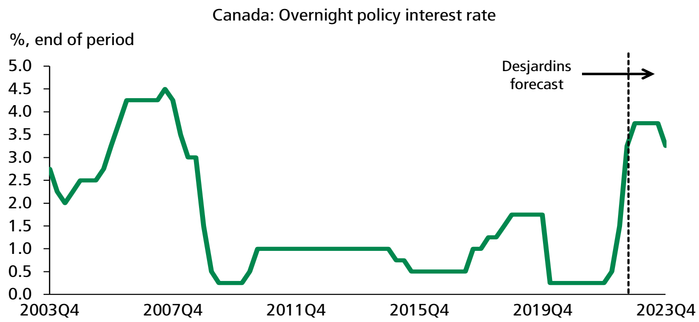
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

GRAPH 3
Existing home sales have fallen rapidly from their recent peak



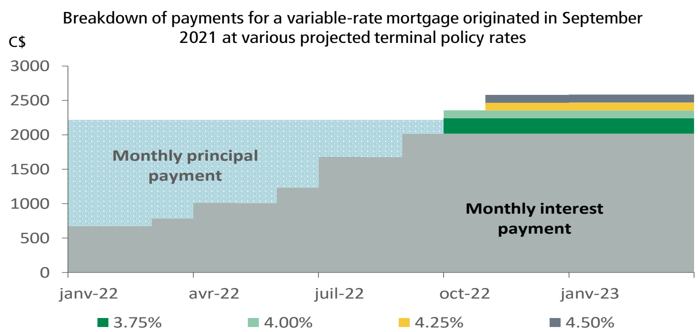
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

GRAPH 4
More hikes are coming, but we're getting close to the terminal rate



Sources: Bank of Canada and Desjardins, Economic Studies

GRAPH 5
Variable-rate mortgages could begin to put stress on the system



Sources: Bank of Canada and Desjardins, Economic Studies

Don't Expect Relief on Rates Any Time Soon

On the whole, August home sales shouldn't inspire the sort of confidence the headline numbers suggested. So where does the Canadian housing market go from here?

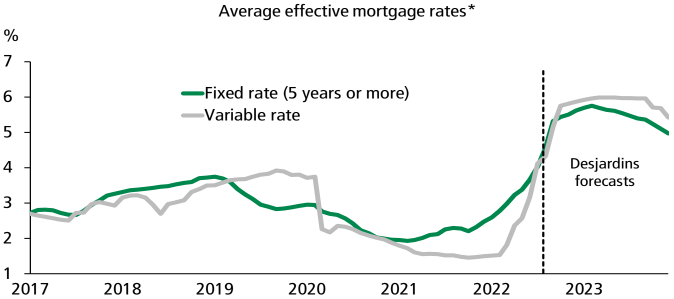
That will largely depend on the future actions of the Bank of Canada. After starting the year at 0.25%, the Bank's policy rate has increased by 300bps to 3.25%. Hikes were "front-loaded," with the policy rate increasing most recently by 100bps in July and another 75bps in September. And the Bank of Canada doesn't look to be finished yet. Citing still elevated short-term inflation expectations, its most recent policy statement said that "[g]iven the outlook for inflation, the Governing Council still judges that the policy interest rate will need to rise further." We take this to mean that another 50bps hike is likely in October and that—while not our current baseline scenario—a further 25bps increase in December is not entirely out of the question (graph 4). This would take the policy rate to at least 3.75% by year's end, when the Bank may stop to take stock of the effects as they reverberate through the economy into 2023.

What does this mean for borrowing costs? According to a recent *Economic Viewpoint*, a policy rate above 4% could trigger early resets for some homeowners with variable-rate mortgages (graph 5). This would further dampen housing market activity and possibly push mortgage insolvency higher. Homeowners with a fixed-rate mortgage up for renewal soon will also see their monthly payments climb as mortgage rates have risen dramatically.

All told, higher rates will continue to weigh on the housing market. That's the intent. If the Canadian economy slows to the point where core inflation returns to its 2% target, the Bank will be able to declare mission accomplished. But until then, it will err on the side of hawkishness to keep household borrowing costs elevated (graph 6 on page 3).

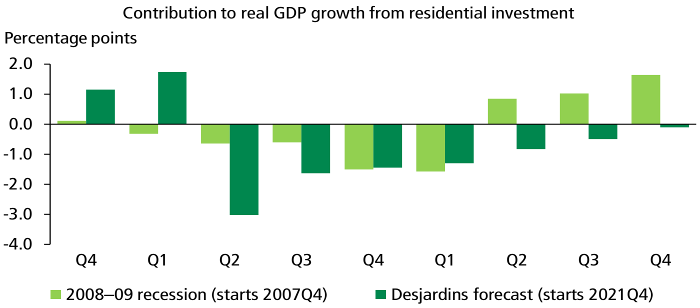
Rising borrowing costs should continue to put the squeeze on the existing home market. And if past experience is any guide, this will spill over into new home construction as well. Together, declining home sales and construction will drive down residential investment, causing it to weigh on real GDP growth (graph 7 on page 3). This is likely to lead to a recession early next year, ultimately prompting the Bank of Canada to cut interest rates by the end of 2023. (See our recent *Economic and Financial Outlook* and *Economic Viewpoint* for more information on our recession call.)

GRAPH 6
Borrowing costs are on the rise and are likely to climb further in Canada



* Weighted by the size of cash advances.
Sources: Bank of Canada and Desjardins, Economic Studies

GRAPH 7
Residential investment will be a substantial drag on real GDP growth

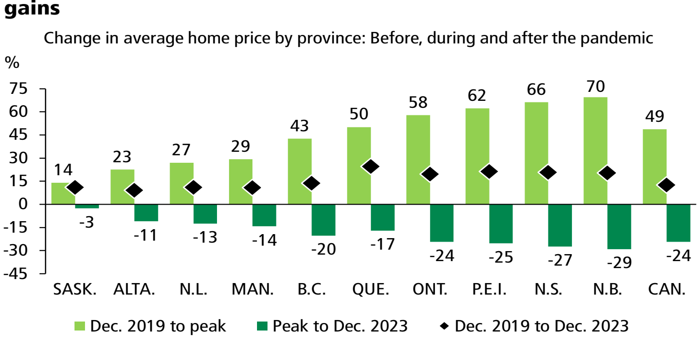


Sources: Statistics Canada and Desjardins, Economic Studies

Unpacking Trends in Provincial Markets

But the national numbers don't tell the whole story. We continue to be of the view that those provinces that saw the largest ramp-up in pandemic-era prices are also the most likely to see prices fall furthest from their peak (graph 8). Our analysis also suggests the average home price should end 2023 above its December 2019 level in all ten provinces. But admittedly, the path to this result has not been as smooth as we anticipated when we published our first national forecast back in June. Prices have proven stickier in some provinces and communities than we expected in our *August Update to Our Canadian Residential Real Estate Outlook*. Other markets have contracted more quickly. But on balance, we believe this narrative continues to hold up in today's rising-rate environment.

GRAPH 8
Home prices are falling, but should keep some of their pandemic gains

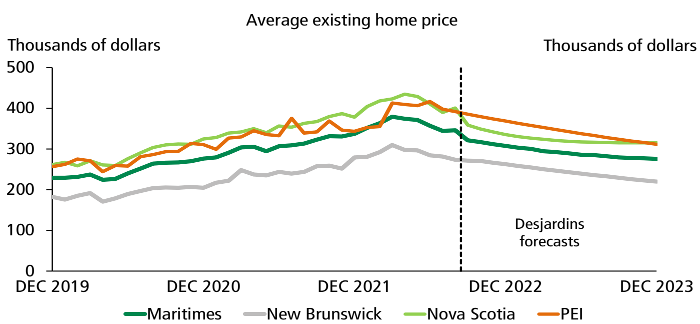


Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Maritime Provinces

The Maritimes are the posterchild for this rapid price increase followed by a slow return to normal. Broadly in line with expectations, New Brunswick has seen its average home price decline every month since reaching a high in March 2022. At just below $275,000 in August, it had fallen nearly 12% from its March peak. In contrast, the average home price peaked a little later in Nova Scotia and hasn't followed as steady a trend lower, even inching slightly higher in August. Similarly, after falling for a couple of months from what was thought to be its pandemic peak in March, the average home price reached a new high in Prince Edward Island (PEI) in June. It has since resumed its downward trend, which we expect to continue. This should be the case for New Brunswick and Nova Scotia as well (graph 9). As in the rest of the country, this is partly the result of higher interest rates. However, interprovincial in-migration also played a central role in the exuberance of the Maritimes' pandemic housing market. We expect a reversal in this trend as hybrid working arrangements make it less convenient for people to migrate to the East Coast than when full-time telework was the norm. This said, migration to the Maritimes from the rest of Canada, particularly Ontario, has proven to be stickier than we had anticipated.

GRAPH 9
Home prices are expected to continue to decline in the Maritimes

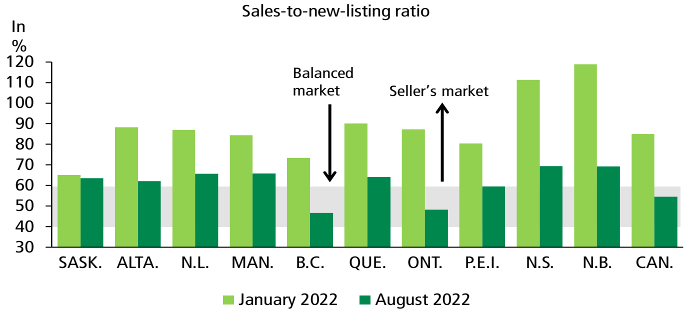


Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Ontario

Until recently, Ontario led the national decline in existing home sales. While experiencing some reprieve in August, transactions were still down 37% from their February 2022 peak. With listings having only gradually declined since February, the sales-to-new listings ratio quickly returned to balanced territory in April 2022 for the first time since early 2019. It's remained there since, almost dipping into a buyer's market in July for the first time since 2008 (graph 10 on page 4).

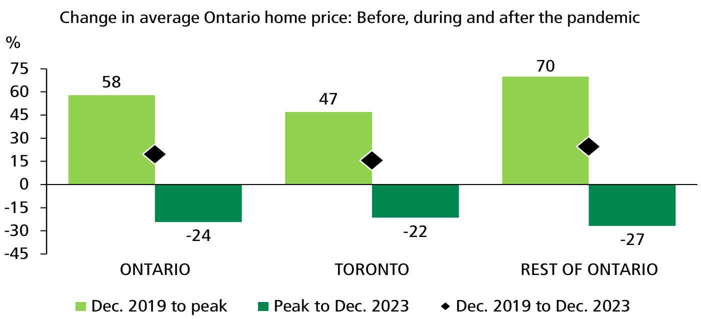
GRAPH 10
Sellers have lost the upper hand since the housing market rout began



Sources: Canadian Real Estate Association and Desjardins Economic Studies

But the recent improvement in Ontario's existing home market isn't expected to last. Highly indebted households in the province are particularly vulnerable to rising interest rates. In communities surrounding the Greater Toronto Area (GTA) that saw the largest pandemic run-up in sales and prices, affordability has eroded more than elsewhere in the province and, in some cases, the country. What's more, employees returned to work in September 2022 with a fervour not seen since the start of the pandemic. Indeed, life in general seems to be getting back to normal. In all likelihood then, the prospects for sustained sales and price support in communities outside the GTA should continue to fade over the outlook (graph 11).

GRAPH 11
The biggest price swings in Ontario will ultimately be outside the GTA



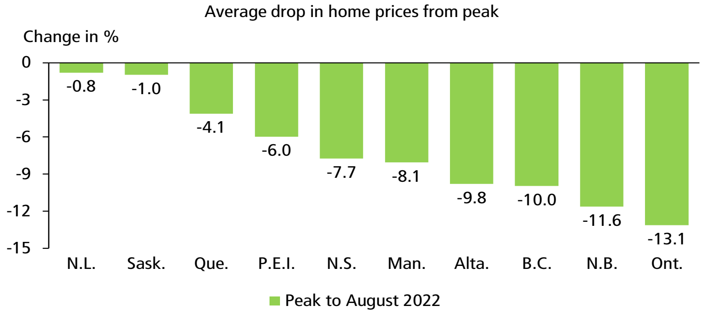
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Quebec

The existing home market continues to cool in Quebec as well. But although affordability has deteriorated due to rising interest rates, the situation isn't as critical there as it is in some other provincial markets. As a result, the recent decline in sales and prices has been more limited in Quebec compared to Ontario and elsewhere in Canada.

Since peaking in April, the average price has fallen 4.1%, less than in most other provinces (graph 12). This is in line with our projection a few months ago that the price correction would be less material in Quebec. Nevertheless, the decline will continue, and by the end of 2023 is expected to reach 17%.

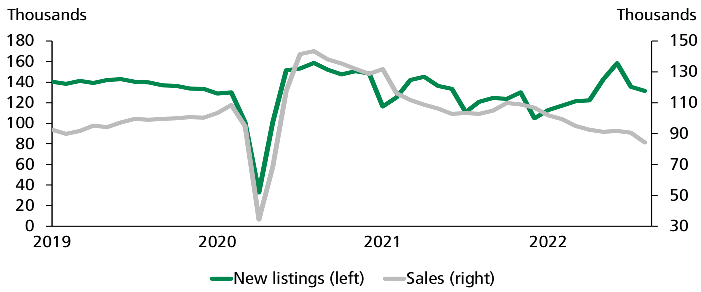
GRAPH 12
Price declines vary widely across provinces



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

While sales have continued to soften, the increasing the number of new active listings is relieving pressure on the resale market (graph 13). This has pushed the existing home market nearly back to balance, with sellers losing the upper hand last spring. There are fewer multiple offers, and overbidding has quickly become a thing of the past.

GRAPH 13
In Quebec, sales continue to decline and more homes are staying on the market



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

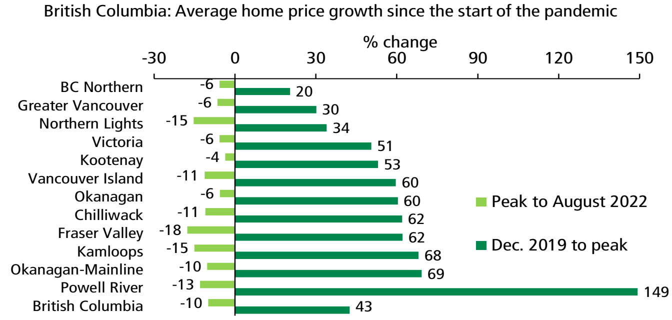
As expected, severely overheated local markets have seen the biggest corrections. In Greater Montreal, the median price has already fallen by almost 10%, or $55,000, from the peak last spring. In regions where overbidding was rare, prices should stabilize, with some experiencing slight declines (see *Spotlight on Housing*).

Affordability should start to improve soon as interest rate hikes end and prices continue to come down. This will help to entice prospective buyers off the sidelines. But the coming economic downturn will encourage households to be cautious. The real estate market will continue to cool over the next few quarters until the housing market finds its footing again and the economy picks up steam after a period of weakness. We therefore expect existing home sales to stabilize towards the end of next year before starting to rise again in 2024, with prices firming up thereafter.

British Columbia

When it comes to the housing correction, British Columbia (BC) looks a lot like Ontario. Sales have been declining steadily since hitting a high in February of this year. Through August, BC transactions are off 45% from their peak, the biggest slowdown in the country. Much like in Ontario, communities outside the major urban centres saw the most outsized gains in sales and prices during the pandemic. And these communities have seen among the largest corrections so far (graph 14). While we think the worst of the correction is largely over for Vancouver, the rest of the province has further to fall before hitting bottom.

GRAPH 14
Most of the biggest home price swings in BC have been outside of Vancouver



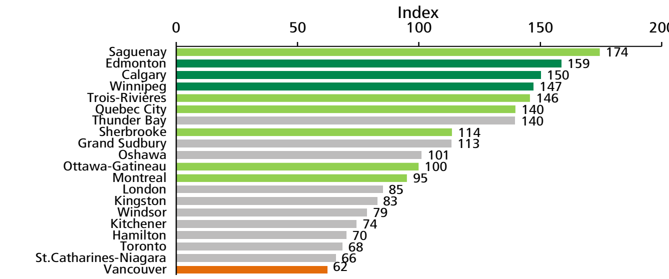
Sources: Canadian Real Estate Association and Desjardins Economic Studies

Commodity-Producing Provinces

The commodity-producing provinces of Alberta, Saskatchewan, Manitoba and Newfoundland and Labrador are largely bucking the national trend, with both sales and average home prices relatively more stable everywhere but in Alberta. This housing market stability can be chalked up to high commodity prices and a more modest run-up in activity during the pandemic. Looking ahead, we expect these provinces to see a more muted correction than the rest of the country as commodity prices remain elevated and nation-leading housing affordability leaves households less exposed to rising rates (graph 15).

These drivers of housing market health are in part what makes Alberta such an anomaly. So far, it has looked more like Ontario and BC than the other commodity-producing provinces in terms of its sales and price correction. This is in part a normalization of sales activity, which accelerated far more quickly in Alberta during the pandemic than in the rest of the net oil-producing provinces. However, Alberta home sales year-to-date have remained elevated

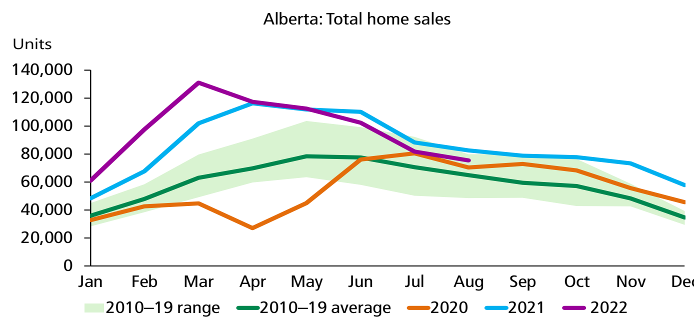
GRAPH 15
Communities in the Prairies are among the most affordable in Canada



Sources: Statistics Canada, Canadian Real Estate Association, JLR Land Title Solutions, Equifax Corporation, Conference Board of Canada and Desjardins, Economic Studies

relative to historical ranges (graph 16). We also think Alberta's economy will benefit from the tailwinds created by prolonged high oil prices. As such, it isn't likely to see average home prices correct as much as BC, central Canada or the Maritimes through the end of 2023.

GRAPH 16
Alberta home sales are still historically high



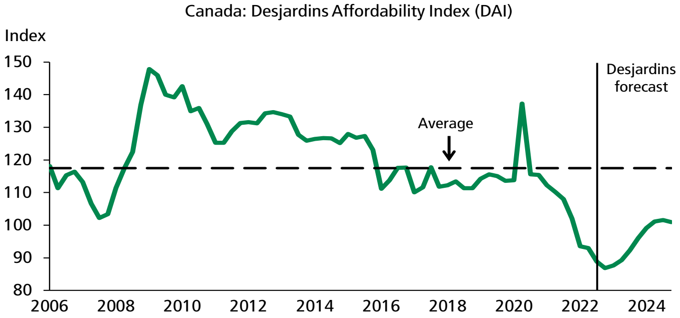
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Improved Affordability Will Be a Silver Lining

It's tough to be optimistic about the future in the middle of a correction. But remember, this too shall pass. As interest rates continue to rise to levels not seen since before the Global Financial Crisis, the impact on the economy is evident. That means it's only a matter of time before central banks pause to assess the damage. And when they do, longer-term rates should start to move lower reflecting future interest rate cuts, which we think will start in Canada by the end of 2023 (graph 4 on page 2).

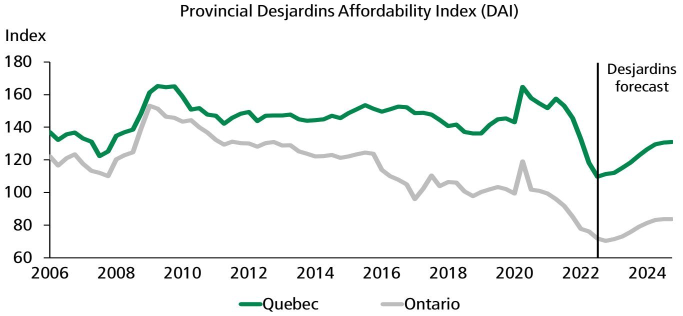
We believe this reversal in borrowing costs combined with lower home prices will improve affordability (graph 17 on page 6). And while affordability is still well below its historical average nationally, this will be the first time since the start of the pandemic that affordability didn't deteriorate.

GRAPH 17
Affordability is expected to gradually improve but remain challenged



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

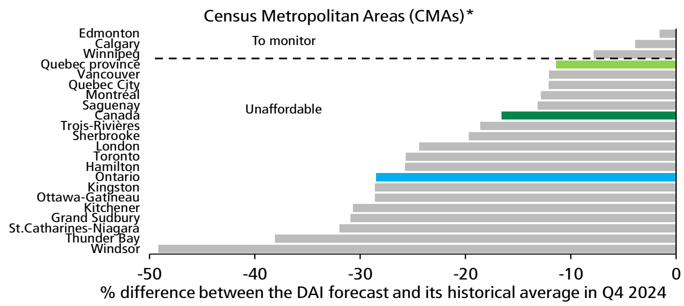
GRAPH 19
Quebec will continue to be much more affordable than Ontario



Sources: Statistics Canada, Canadian Real Estate Association, JLR Land Title Solutions, Equifax Corporation, Conference Board of Canada and Desjardins, Economic Studies

In some parts of the country, affordability is expected to improve enough to nearly return the Desjardins Affordability Index (DAI) to its historical average by late 2024. Edmonton and Calgary are included in this group, and Winnipeg isn't far behind (graph 18). Quebec's improvement in affordability could leave Ontario in the dust (graph 19). Despite one of the sharpest home price corrections nationwide, Ontario is still expected to be highly unaffordable. We expect its affordability index to return to levels last seen in early 2021, just before the market really took off. As such, it could be a long time before affordability in Ontario returns to even its average pre-COVID level.

GRAPH 18
Affordability will remain below its pre-COVID average through 2024



*A CMA refers to one or more adjacent municipalities centred on a population centre.
Sources: Statistics Canada, Canadian Real Estate Association, JLR Land Title Solutions, Equifax Corporation, Conference Board of Canada and Desjardins, Economic Studies

Conclusion

It's been a rough ride for the Canadian housing market this year. And while the August data may have provided a glimmer of hope, we think it's most likely a false dawn for a rebound in the Canadian housing market. As interest rates continue to move higher and the impact of past rate hikes increasingly weighs on growth, we expect further weakness ahead. This will be a marked drag on growth and will combine with slower consumer spending and global economic challenges to push the Canadian economy into recession in the first half of 2023.

But there's room for optimism as we move through next year. We expect affordability to begin to improve nationally in early 2023 for the first time in a couple of years. As rates begin to fall on expectations of monetary policy easing in the second half of the year, affordability should continue to improve further. However, outside of a few markets, we expect Canadian housing to remain less affordable than it was before the pandemic.

In a June *Economic Viewpoint*, we discussed how this speaks to Canada's structural shortage of adequate housing and touched on a number of ways this deficit should be addressed. One of the challenges for governments will be to mitigate the impact of the economic slowdown on homebuilding activity. Success on this front would maximize the odds of a healthy, sustainable housing recovery that gives Canadians a fair shot at buying an affordable home that meets their needs.