

How low will house prices go?

Prices are headed down for the long term.

Jan 17, 2013, Tim Shufelt



(Photo: Andrew McLachlan/All Canada Photos/Corbis)

Last summer, having surveyed their local real estate market, and finding themselves spooked by deteriorating prices, Rheanna Mushet and her husband, Justin, decided to sell their Burnaby condo. “We wanted to cash out,” Mushet says, adding that they may end up living in her parents’ basement for a while as they wait out the downturn in the Vancouver market. “We’re going to make sure we get the most for our money. There’s no hurry.” She only regrets not acting sooner. By the time they listed, buyers were no longer competing for the privilege of overpaying. For six months, the Mushets waited for an offer and showed their condo to prospective buyers who seemed to be almost looking for a reason to pass. “They were very choosy,” she says. “It’s not on the right floor. The ceiling’s not high enough. There’s a stain on your carpet.’ Just the silliest things that before wouldn’t even be a consideration.” They finally

agreed to sell for \$22,000 below their original asking price to the first person to make an offer. She accepted the fact that her condo just wasn't worth what she had hoped. Many other sellers are soon going to have to come to the same realization.

Before every housing correction, there's a Looney Tunes moment. In the animated universe, there's a gravitational peculiarity that briefly suspends an overzealous pursuer in mid-air, just long enough to flash a HELP! sign, before plummeting off the cliff he failed to navigate. When it comes to overheated real estate, there is a pause that follows the outset of a correction, during which the market fails to realize there is nothing below but air.

The pattern is familiar: it starts with slowing sales activity. Listings begin to generate fewer offers. Would-be homeowners start to see the sense in holding off. In Toronto, where less than a year ago a rundown semi-detached could sell for \$100,000 or more over asking price, the era of the bidding war is fading. "Buyers are sensing that prices are going to come down, so why buy now?" says Thomas Neal, a Royal LePage agent in Toronto, where housing transactions in December slid by 25% from the prior year. In Vancouver, the number of homes sold last year trailed the 10-year average by 25%. It is in those two markets where the twin epicentres of the Canadian housing shakeup reside. But the ground is beginning to shift under the national market as a whole. Those kinds of numbers support the view that "a potentially severe housing correction is underway," says David Madani, an economist at Capital Economics, who for months has been predicting a 25% decline in Canadian home prices.

PREDICTION: THE AVERAGE PRICE OF A HOME IN CANADA HAS ALREADY BEEN FALLING FOR MONTHS. HOUSE PRICES IN OVERHEATED MARKETS WILL CONTINUE TO TUMBLE BY 20% OR MORE—AND THEY'LL STAY DOWN FOR YEARS

But as usual, one-half of the market refuses to look down. "We've got a number of sellers who say, 'If we're not going to sell for a particular value, we're not going to sell at all,'" says Victoria real estate agent Tony Joe. "A lot of people are still pricing their properties based on yesterday's market." So, even though demand is weakening, prices have yet to fall for most of the country.

The reluctance of sellers to compromise is understandable, given recent history. For more than a decade, real estate in Canada appreciated almost without interruption. Even the financial crisis and ensuing Great Recession registered as little more than a blip. Meanwhile, most economists take the current trends as indicative of a “soft landing” for the sector, with just a slight moderation in prices afoot. But asking a bank economist or real estate market insider about the likelihood of a soft landing is like “asking your barber if you need a haircut,” says George Athanassakos, a finance professor at the Richard Ivey School of Business, who expects a “severe correction,” and soon. The current resilience in home values could simply be the brief mid-air pause before physics brings about the plunge fated for inflated housing markets and cartoon coyotes alike.

People tend to have short memories about real estate, Neal says. Since 2000, the average home price in Canada has shot up by 125%, which has reinforced the perception that residential real estate is infallible.

Just as excessive faith in home appreciation can overheat a market, so too can a change in sentiment accelerate and intensify the downside. With the rate of home ownership now close to 70%, and with household debt at a record high, much of the financial health of Canadian households is inextricably linked to home values, making it the kind of dominant concern that not only affects household finances, but consumer psychology and confidence.

Even most bank economists believe Canadian housing is overpriced somewhere in the range of 10% to 20%, perhaps more so for the hottest condo markets. That’s manageable as long as interest rates and unemployment remain low, says Doug Porter, deputy chief economist at BMO Capital Markets. Absent an external economic shock that would ultimately put Canadians out of work, there is no reason to expect markets to correct hard and fast, he argues. “What would force people to feel that they have to sell at much deeper prices, given that the interest rate environment is likely to remain quite benign at least through next year?” Without a trigger, there should be no national housing crash, Porter says.

But there are some mortgage professionals who argue that the catalyst for a national reaction has already arrived by way of the federal government, which deliberately cooled the market by tightening mortgage regulations. Those changes would have disqualified almost 10% of all 2010 homebuyers, according to a report by Will Dunning, chief economist for the Canadian Association of Accredited Mortgage Professionals. “That’s taking a lot of demand out of the market,” Dunning says. “You’re putting the housing market at risk, and the broader economy.”

Now Dunning says the market is “weak enough it could result in prices falling in many places across the country.”

If everyone who bought a Toronto condo planned to live in it, the potential market downside would be limited. Owner-occupiers are less concerned with short-term fluctuations in market value; they need to live somewhere. Investors, on the other hand, are driven by different criteria. And it is investor demand that has supported the endless supply of glass towers in downtown Toronto, accounting for 75% to 95% of the pre-construction purchases for those projects, mostly to service a red-hot condo rental market, says Ben Myers, executive vice-president at condo research firm Urbanation. “Developers are saying it’s a very small percentage of end users that are purchasing in the market.”

In 2011, Toronto had record condo sales of more than 28,000 units. “The kind of construction we’ve seen is absolutely off the charts,” Porter says. “It is the kind of market that is so heavily supported by investor demand, we could have a temporary spell of a pretty serious correction.” Investors are potentially more likely to sell when prices decline, which could ultimately flood the condo market with resale listings. With 240,000 more planned condo units yet to be built in the Toronto area, many are worried about a burgeoning supply-demand imbalance. Already, investors are backing away from the Toronto condo market, which reported a drop in third-quarter unit sales of 30%. Developers reacted to both slowing sales and a record high level of unsold inventory by launching just five new projects in the third quarter in the 416 area, which typically sees 15 to 20 new projects per quarter. Investment demand also looms over Vancouver, where the condo market spent most of the year in full retreat. Since May, the benchmark condo price in Vancouver has already fallen by 13%. If the expectation of appreciation disappears, another layer of demand could shrink from the market. **Ohad Lederer**, an analyst at **Veritas Investment Research**, calculates that investors buying condos to supply the rental market are accepting annual returns of less than 4%. “That only makes sense if buyers believe that prices will go up.” But if prices in those two markets fall significantly, as **Lederer** believes they will, condo investors could face some tough decisions. “That’s where the intestinal fortitude of those investors will be tested,” he says.

The stability of housing in Canada relies on a Goldilocks economy—not too strong and not too weak. Economic expansion could lead to rate hikes, which would expose the unsustainable finances of many indebted households. On the other hand, a destabilizing economic event could trigger the housing crash Canada avoided in 2009. The historic crash in the United States is not likely to be repeated here. The U.S. bubble was more a product of risky lending. “A lot of people were allowed to take on debt with little or no prospect of paying it back,” Porter says. In Canada,

debt is better distributed among middle and upper-income borrowers, he says. “There still is a relatively solid credit-vetting process in Canada.” Still, many Canadian homeowners are stretched thin. According to a Euro Pacific Capital report, high-risk mortgages make up more than \$500 billion of Canada’s \$1.1 trillion housing market.

The average home price, at more than \$350,000 (which is double the median existing home price in the United States), now sits at about five times the average household income. Housing investment is close to peak levels at more than 7% of GDP—about the measure reached in both the late 1970s and late 1980s, Athanassakos says. “Right after that, the market collapsed in both cycles.”

Canadian demographics no longer support inflated prices, Athanassakos argues. The proportion of Canadians of the age when homes are typically purchased is at a turning point and is set to decline, which historically has been a powerful indicator of housing trends. “The long cycle is most of the time affected by demographics,” he says. And a very long cycle it could be. He foresees a 20-year span of declining home prices. There need not be an explicit economic trigger for an acute housing correction. The imbalances are already there. Changing sentiment could be the spark, **Lederer** says. “When it turns, it turns very fast.”