Has Canada's housing bubble finally reached bursting point?

By Alex J. Pollock

Both Canadian and foreign observers have watched with wonder as Canadian house prices have continued up and up, waiting for the inevitable correction and fall. Average Canadian house prices are more than 3 times as high as they were in 2000. They already looked very high in 2012, five years ago, but have risen rapidly, by another 43%, since then. They have inflated measured household net worth, inflated household debt and debt-to-income ratios with rapidly expanding mortgages, caused the number of realtors in Toronto to expand by 77% in the last decade, and they display "an element of speculation," in the careful words of the Governor of the Bank of Canada, Stephen Poloz.

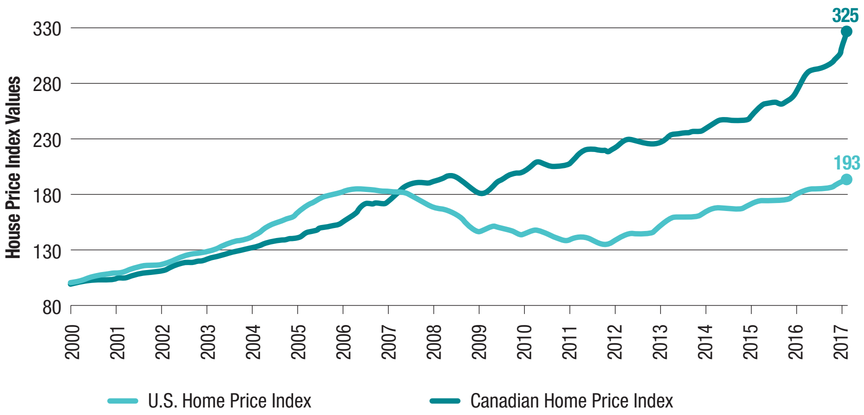
The national Housing Market Assessment of the Canada Mortgage and Housing Corporation "continues to detect strong overall evidence of problematic conditions… due to overvaluation and acceleration in house prices." This is pretty clear language for a government agency which is itself heavily at risk in the mortgage sector.

"The longer it goes, the bigger it gets, the more you start to be concerned," said Governor Poloz in June of this year.

It has gone on very long and gotten very big. Although Canada has a sophisticated and advanced financial system, although the central bank and financial regulators have, a number of times, tightened lending rules to try to moderate the house price inflation, and although the cities of Vancouver and Toronto have put on fees to slow down foreign house buying, the boom has continued. On the other hand, this is not surprising, since the Bank of Canada, like its U.S. counterpart, has run negative real interest rates for most of the last eight years. These reliably induce asset price inflations and promote bubbles.

As shown in Graph 1, the Canadian house price inflation dwarfs the infamous U.S. housing bubble, which imploded starting in 2007, as well as the U.S. price run-up of the last five years.

Graph 1 Two housing Bubbles – House Prices in Canada and U.S. 2000-2017 (2000 = 100)

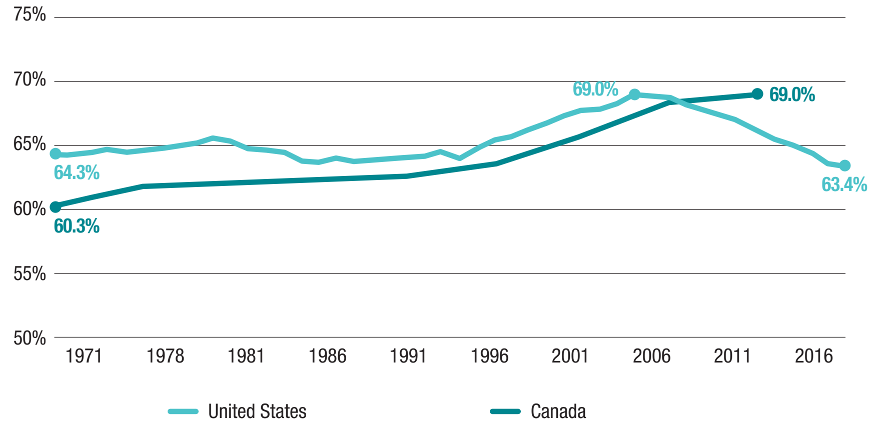


Source: S&P Case-Shiller U.S. National Home Price Index; Teranet-National Bank (11-city) Canadian Home Price Index

To add some perspective to the comparison, total residential mortgages in Canada are C$ 1.5 trillion, or $ 1.2 trillion in U.S. dollars. This is equal to about 11% of the U.S. outstanding mortgages of $ 10.3 trillion. In contrast, Canadian 2016 GDP of C$ 2.0 trillion, or $ 1.6 trillion, is 8.7% of the U.S. GDP of $ 18.6 trillion. Thus, mortgage debt in Canada is much higher relative to GDP than in the U.S.: 73% compared to 55%.

Notably, 73% is about the same ratio as the U.S. had at the peak in house prices in mid-2006.

Graph 2 Homeownership Rates: U.S. and Canada 1971-2016



Source: United States Census Bureau and Statistics Canada

Home ownership ratios in the two countries have been similar over time, but Canada's last census (2011) shows 69% home ownership, compared the recent 63.4% in the U.S. As shown in Graph 2, this reflects the pumping up of the U.S. home ownership rate during the housing bubble, then a more than 5 percentage point fall in the wake of its collapse. Whether Canada will experience a similar fall in its home ownership rate with a deflation of its housing bubble is yet to be seen.

Canada's house prices certainly look toppy to many people: "There's no question house prices can't continue at this level" is the conclusion of senior Canadian bank economist Jean-Francois Perrault. "Signs are looking increasingly negative for [the] Canadian housing bubble… The party is increasingly over," says a "Seeking Alpha" investment commentary. But calling the timing of the top of a bubble is always tricky. It may make us think of how then-Federal Reserve Chairman, Alan Greenspan, suggested in 1996 that U.S. stock prices were excessive and were displaying "irrational exuberance." After his speech, stock prices continued to go up for three more years. In the event, they crashed in 2000, so Greenspan turned out to be right in the long term – but he missed the timing by an embarrassingly long way, and failed to reissue his warning in 1999 when the irrational exuberance was at its maximum.

Has the Canadian housing bubble reached bursting point at last? Has it possibly seen a "canary in the coal mine"? One house price index for metropolitan Toronto, Canada's largest city and financial capital, fell 4.6% from June to July. Although prices are still up strongly from a year earlier, the number of house sales was down 40% from the previous year. At the same time, there was "a surge in new listings as homeowners saw a downturn looming and rushed to list their houses before prices fell… adding a flood of new inventory to the market," reported the Toronto Globe and Mail.

Was that a summer blip or a changed trend? The Toronto realtors' association suggested that it "had more to do with psychology." Yes, booms and busts in house prices always have a lot to do with psychology and sharp swings between greed and fear in beliefs about the future. There are, the realtors' association said, "would-be home buyers on the sidelines waiting to see how market conditions evolve" – waiting for lower prices, that is. The problem is that if enough people wait for lower prices, the prices will get lower.

"Everyone agrees it's a bubble; now the question is, how it ends," says another Canadian economist, David Madani, who predicts it will be a hard landing with house prices falling 20% to 40%. But whether Canada's long-running house price boom will end with a bang or a whimper, a hard or soft landing, a difficult time or a disaster, is just what no one knows. If house prices fall significantly, a lot of unrealized, paper "wealth" will disappear (it was not really there in the first place), mortgage defaults will increase, credit will become tighter, politicians will overreact, and real estate brokers will grow fewer instead of multiplying. But Canada will not necessarily follow the housing bubble deflation patterns of the U.S., or of any other country – the U.K., Ireland or Spain, for example.

Comparing Canada and the U.S., two key institutional differences are apparent. One is that Canadian residential mortgages have full recourse to the borrower, in case the price of the house is insufficient to cover the mortgage debt. This case becomes more likely after a bubble, especially for those who bought near the top. In contrast, in the U.S., either by law or practice, most mortgages are non-recourse, and can effectively be settled by "jingle mail" – moving out and sending the keys to the lender.

A second key difference is that the overwhelming majority, 87% of residential mortgages in Canada, are held on the balance sheets of depository institutions. C$1.1 trillion of the mortgages are on the books of the chartered banks, and C$ 191 billion of the credit unions, for a combined C$ 1.3 trillion out of total mortgages of C$ 1.5 trillion. In contrast, U.S. depositories hold $ 2.4 trillion in whole mortgage loans and $ 1.8 trillion in residential mortgage-backed securities, which combined make $ 4.2 trillion; so only 41% of the total mortgages are on the books of the banks. This gives Canadian mortgage finance an entirely different institutional structure. In the U.S. case, most mortgages were and are held by investors in mortgage securities, who have no direct relationship with the borrowing customer and no role in making the loan in the first place. While at one time promoted as a more advanced system, this made managing the deflation of the U.S. housing bubble much more difficult.

On the other hand, there is an important similarity between the Canadian and U.S. cases: major government guarantees of mortgages, thus government promotion of mortgage debt and exposure to mortgage credit risk. In the U.S., this happens through the guarantees of mortgage credit risk by Fannie Mae, Freddie Mac, and Ginnie Mae, which now add up to $ 6.1 trillion or 59% of the total residential mortgages. The Canada Mortgage and Housing Corporation (CMHC), itself explicitly guaranteed by the government, insures C$ 502 billion of mortgage loans, or 35% of the total market. In addition, it guarantees C$ 457 billion of mortgage-backed securities – but the securities largely contain government-insured loans, so this is a double guaranty of the same underlying credit risk.

How would CMHC fare if the Canadian bubble turns into a serious house price deflation? We may find out.