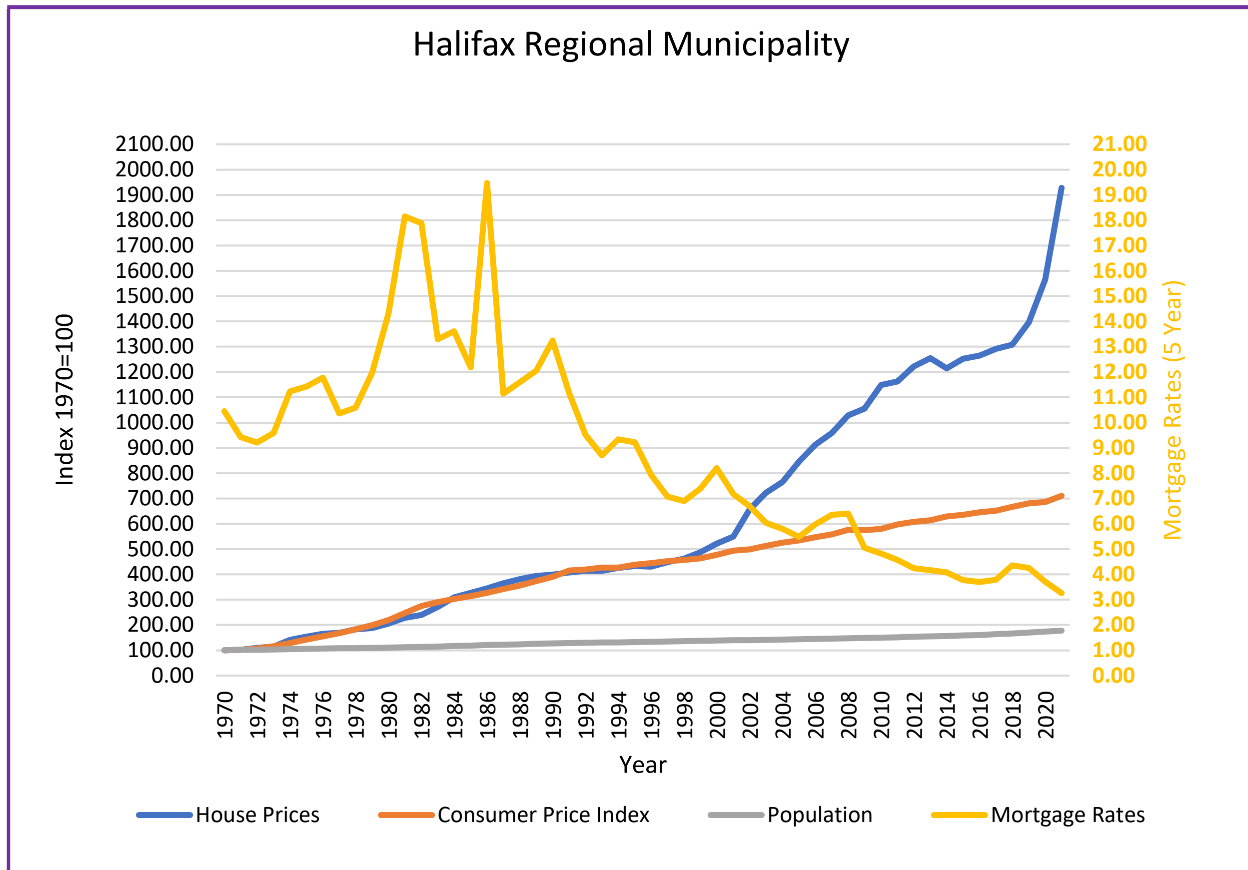
Housing Bubble?



Source: Statistics Canada, CMHC, NSAR, Turner Drake Research.

In an excess of zeal your researcher polled his colleagues on ideas for this Newsletter. "How about the red-hot housing market in HRM, is it a bubble? When will prices stop rising? What happens if interest rates increase, will they force a lot of folks out of their homes? Is inter-provincial migration going to continue once the Covid-19 pandemic slows? What is going to happen in the next 3, 5 or 10 years?". Whew, be careful what you ask for! However, the subject was topical, we had lots of data… and it was a human-interest story… many younger colleagues, attempting to purchase their first home, are competing with thirty or more offers, some bids twenty percent above the asking price. What could go wrong!

We are used to hearing of rapidly escalating house prices, but in far flung lands and easily explained away… London, England? Too many pub lunches of bangers and mash washed down with copious amounts of ale. Vancouver? All that rain; it would drive anybody crazy. Toronto? Due to… well, living there. But Halifax? Even Covid-19 behaves itself here!

Delving into The Data

Querying Google about the cause of residential house price increases in Canada will yield 21.6 million answers. Space constraints dictate that we be a little more succinct. Suffice it to say, the explanations are many and varied. So, what does the data tell us? We focused on the Halifax Regional Municipality (HRM) because our CompuVal© Knowledge Base contains a wealth of information on single house prices dating back to January 1970. It is possible of course that some of the housing price drivers in HRM may be atypical so we will do our best to identify where such may be the case.

Average property prices for a single-family home in the Halifax Regional Municipality (HRM) were $562,000 in May 2021… modest by comparison to large metropolitan areas such as Toronto or Vancouver, but a 23% increase over the previous year. Multiple offers are now the rule, rather than the exception, with winning bids $50,000 to $75,000 over the listing price. Purchases by "out of province" parties, sight unseen, are frequent. Some are Covid-19 refugees, residents of provinces hard hit by the virus who have discovered they can work from home anywhere so why not relocate to an area with scenery and a relaxed lifestyle that has demonstrated it can weather the pandemic relatively unscathed. The fact that the sale price of their present home is two or three times higher than a comparable property in HRM is froth on their beer, a nice bonus of tax-free cash, and much lower mortgage payments in the future are attractive too. So, a temporary phenomenon then which will disappear once Covid-19 has left us alone? Not quite. A closer look at the price behavior of single-family homes in HRM over the past fifty years reveals that there are other forces at work.

Our Halifax Regional Municipality graph above shows the trajectory of Single-Family House prices, the Consumer Price Index (CPI), Population and Mortgage Rates for the period January 1st 1970 to May 31st 2021. For comparison purposes we have reduced the House Prices, CPI and Population to a common index base 1970=100 and have graphed them against the left vertical axis. House prices are the yearly average. The Mortgage Interest Rates are based on a five-year term and are graphed against the right vertical axis. House prices increase (or decrease) because of a disequilibrium between demand and supply. An excess of demand over available supply results in prices rising, and vice versa. Supply in this instance refers to properties available to purchase, rather than the entire inventory of housing stock, so it can be impacted if home owners choose to withhold their properties from the market.

House price increases over recent years have been dramatic and are the subject of much angst amongst purchasers, especially those attempting to get their first foot on the ladder. They are also a cause of concern because they restrict labour mobility and reduce the availability of affordable housing. The latter was the subject of the lead article in our last Newsletter (Spring 2021 Vol. 2 No. 121) and is the focus of the "Affordable, Attainable, Available" article in a recent blog on our corporate website www.turnerdrake.com. Closer scrutiny of the House Price line in the graph shows that it falls into three distinct time categories: 1970 to 1998, 1999 to 2018, and 2019 to 2021, epochs hereinafter referred to as "Standard", 'Sport" and "Suicidal".

Standard Mode (1970 to 1998)

This was a time when rationality ruled the residential property market in HRM. As is well demonstrated by the graph, house price increases were driven by rises in the cost of living as measured by the Consumer Price Index. Hardly surprising since the CPI is also a good surrogate for wage increases, and they in turn directly influence access to mortgage finance. In statistical terms 99% of the house price index increase is "explained" by changes in the CPI index. Effectively house prices were flat in constant dollar terms and rose by an average of 5.62% per annum in nominal (current dollar) terms. Supply and demand were in equilibrium. The driver of residential property price increases during this epoch was the inflation rate.

Sport Mode (1999 to 2018)

As shown on the graph, mortgage interest rates declined steadily between 1990 (13.24%) and 1998 (6.90%). They then climbed for two years, peaking in 2000 (8.20%) and then started to fall again, rising slightly in 2006 to 2008, then falling steadily with a small blip upwards in 2018 (4.36%). The falling mortgage rates are the driver for increasing housing prices during this period. By 1998 mortgage rates had fallen to 6.90% and housing prices started to escalate rapidly. Was this the tipping point at which purchasers piled into the market, confident that mortgage rates were not going to increase again, or perhaps even continue their decline? It appears so. In statistical terms 87% of the house price index increase is "explained" by changes in the mortgage rate. During this period house prices increased at almost three times the inflation rate (CPI). So what about elsewhere? Mortgage interest rate reductions were not unique to Canada. We researched economies that followed a similar trajectory to this country to see if there was a similar pattern in house price escalation. Eureka, such was the case! The Bank for International Settlements indicates that residential property prices started to escalate rapidly in the United States in 1998; and Canada, Australia and the United Kingdom in year 2000; as mortgage interest rates declined. Ipso facto, the driver of residential property price increases during this epoch was falling mortgage interest rates.

Suicide Mode (2019-2021)

Since 2019, single family house price increases in the Halifax Regional Municipality have been supercharged, rising by 38% over the past two years (see graph); an astonishing increase in an area not known for irrational exuberance. Are we in a bubble? Wikipedia describes a real estate bubble as "the rapid increase in the market price of real property such as housing until they reach unsustainable levels and then decline". More popularly a bubble is described as "a sudden rise in price based on obviously implausible or contradictory beliefs… which is doomed to collapse under the weight of its own irrationality". We looked at the origin of bubbles in our Fall/Winter 2013 and Spring 2014 Newsletters (Vol. 2 Nos. 97 & 98) and related the sad story of the Dutch sailor who, in 1636, added an onion to his lunchtime meal of fine red herring and was promptly jailed by its enraged owner. The "onion", it transpired, was actually a common-or-garden tulip bulb then worth $75,000 in today's money… Tulipomania, the first recorded example of crowd inspired speculation, was at its peak! Pity the poor fellow, less than a year later he could, had he wished, have supplemented his bread and water with tulip bulbs costing 95% less. Timing then, as now, is everything.

The late Dr. Kenneth Galbraith, an eminent Canadian economist, suggested that all bubbles "have involved debt that, in one fashion or another has become dangerously out of scale in relation to the underlying means of payment". Easy access to capital, and the belief that an opportunity has been created by a new product, or financial instrument, feeds the buying frenzy … which in turn increases prices and "creates wealth" drawing more buyers into what becomes a self-fulfilling prophesy … until an event occurs which reveals the absurdity of the buyers' behaviour. Retribution is fast and brutal: prices collapse, buyers go belly up. But that is not really the situation today. True, the low interest rates have enabled purchasers to acquire homes they would not otherwise have been able to afford; but in most cases they are largely motivated by the necessity to place a roof over their head, tinged with the desire to invest in an asset over which they have control and which, they hope, will return a capital gains tax free nest egg when they sell. In our earlier research we listed the seven conditions common to bubbles:

(1) They can be sectorial (affect only one type of real estate), local, regional, national or international in scope.

(2) Excess liquidity—easy access to debt for those wishing to enter the market.

(3) A "new" type of real estate or financial instrument creating the belief that an opportunity exists to amass wealth. Financial innovations are frequently hailed with an enthusiasm best reserved for the Messiah. In reality, every financial "innovation" is a variant on the same theme: the creation of debt secured by real estate. Their recurrent emergence is a tribute to memory myopia: their innovation a salute to opacity, complexity and the ability to relieve the washed of their wealth. Financial memory is brief; about two decades.

(4) Growing and rampant speculation: new entrants into the market contribute to a feeding frenzy buttressed by the belief that since everybody else is getting rich it must be right ("crowd think").

(5) The specious association of money and intelligence e.g. "the bank wouldn't give me the mortgage if the property was not worth it".

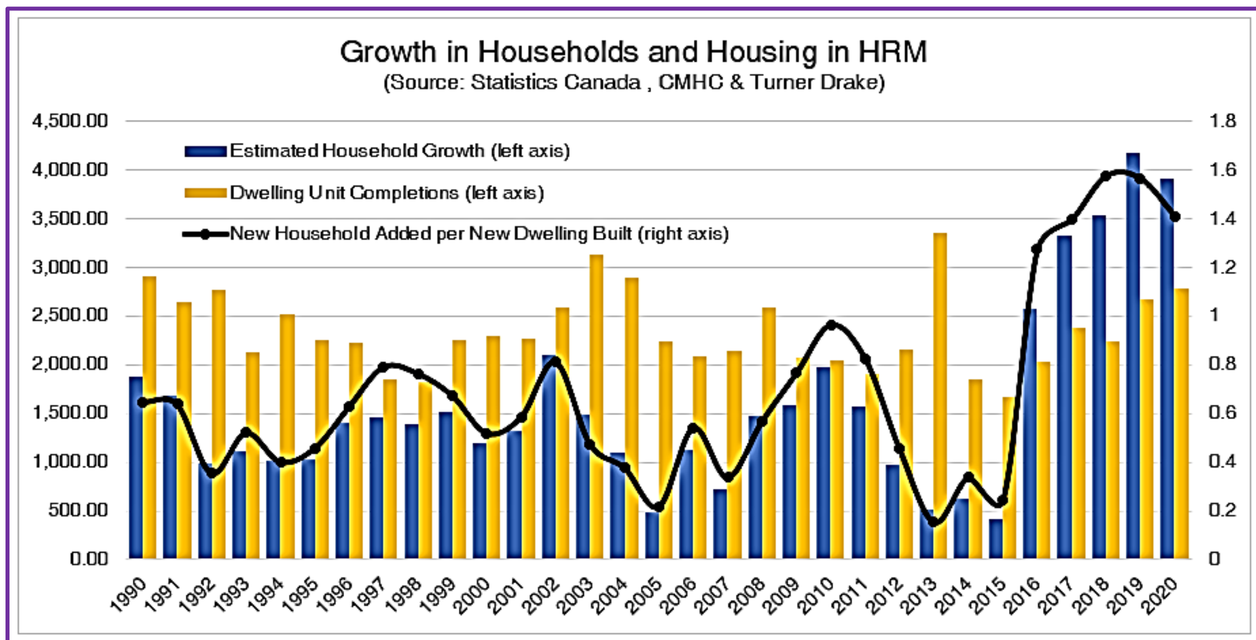
(6) A reluctance to consider end user demand—the belief that end users will materialise once the product is brought to market (aka "build it and they will come" syndrome). Supply expands well ahead of demand.

(7) Capital values increasing much faster than rental rates or income growth. Servicing the debt load is dependant on subsidising it from the capital value growth i.e. by remortgaging at even higher levels of debt to "liberate" capital value for use in debt servicing.

The present rise in house prices meets some of these conditions but not all, and it would be difficult to describe purchasers' behavior as "irrational exuberance". The recent spectacular rise in residential property values is **not** a bubble.

In our Spring 2021 Newsletter (Vol. 2 No.121) my colleague, Neil Lovitt's article "What the Housing?!" looked at population growth and its impact on housing as a whole and pointed out that while the Covid-19 exodus to Atlantic Canada from elsewhere in the country gained much media attention it was really a sideshow; overall interprovincial migration was not significantly different in 2020 than in previous years. However, we are now in 2021 and there is plenty of empirical evidence that the virus, coupled in many cases with the ability to work from home wherever the company's customers are located; the desire to embrace a more relaxed lifestyle in a beautiful, and affordable, region; and the desire to live close to family and perhaps eventually retire here; are triggering interprovincial immigration. It is not possible yet to measure the impact but prices are driven by marginal purchasers and those moving from Ontario or British Columbia may liberate substantial equity if they sell their homes there. Neil also pointed out that the collapse

of oil prices had reduced out migration from Nova Scotia to Alberta by half, whilst in-migration from Alberta had remained steady. Increased immigration from outside the country, which kicked off in 2016 with the much-publicized landings of Syrian Refugees, resulted in Nova Scotia's immigration increasing from 610 international immigrants per year (2005-2015 average) to more than 1300/annum since then, before waning in the face of the pandemic in 2020 and 2021. However, this is unlikely to have impacted house prices significantly since most of the immigrants would have rented apartments. The latter comment applies as well to international students choosing Canada for their education, instead of the United States, because of American President Trump's hostility to foreigners and those of the Muslim faith in the United States. Overall, the foregoing are not compelling reasons alone for the rapid increase in single house prices which started in 2019 and has continued unabated through the Covid-19 lockdowns last year and this. And despite excitable media reports of well heeled purchasers from elsewhere in Canada buying homes sight unseen, it is likely that they too are froth on the beer, rather than the main driver of the house price increases. In summary the foregoing would have had some impact on demand, but they are not the major factor.



Neil also looked at supply and produced the above graph (which your researcher is happy to poach) showing household growth (demand) and dwelling unit completions (potential supply). The excess of demand over potential supply started in 2016 and continued through 2020. It is in stark contrast to the prior twenty-six years and may have contributed to the run up in residential house prices and rents. My colleague Alex Baird Allen also looked at actual supply as indicated by residential sales listings on the Nova Scotia Association of Realtors' Multiple Listing Service. Her conclusions are presented in a recent blog "Affordable, Attainable, Available" on our website www.turnerdrake.com. Total sales listings (supply) had declined steadily from 2017 to 2020 but had been fairly steady in the prime January 1st to June 16th selling season and had actually increased in 2021. On balance it appears that supply is a contributing factor but not the main driver of housing price increases.

Starting in 2020 Covid-19 drove up the price and reduced the availability of building materials. This has had a major impact on building costs that will only slowly be ameliorated in the future. Although it is possible, hopefully probable, that the main disruption due to the virus will be behind us by the Fall, Covid-19 is likely be with us in its various forms for another five years, lurking in the shadows ready to jump out and dampen productivity. Whilst the increased costs have not yet found their way into the supply side of the property price movement equation they will do so in the future.

If you eliminate everything else, what remains must be the cause! The main price driver of the dramatic, residential price increases during the 2019 to 2021 epoch was falling mortgage interest rates (they increased slightly in 2018 and 2019 and then continued to fall) but the price increases have been amplified by restricted supply, increased

interprovincial immigration triggered in part by Covid-19, and continued, reduced emigration to the oil patch in Alberta.

Future Price Movements

This is the tricky bit, where we hoist ourselves with our own petard. Eminent publications such as The Economist predicted ten years ago that Canada's housing market was overpriced, though their focus was on hot spots such as Toronto and Vancouver. Weighty institutions such as Merrill Lynch and the Bank of Montreal have predicted a fall in Canadian house prices (we doubt that Halifax featured prominently in their thinking). Fools rush in where angels fear to tread so here goes, but first the caveats. We assume that interest rates will stay low, no more than a hundred basis points above their present level… and that the Federal, Provincial and Municipal governments will resist the temptation to fund their Covid-19 costs by imposing additional taxes on residential homes.

This is what our crystal ball shows us. Interprovincial immigration is likely to continue and international immigration will resume. Oil is likely to decline in importance as the world re-orientates itself to non-fossil fuels, so the present reduced emigration to Alberta will continue. Building costs will fall back but will stabilise above their pre-Covid levels for the foreseeable future. Economic activity will resume but will continue to be disrupted by Covid-19 variant flare ups for the next five years. The majority of the baby boomers, those born between 1946 and 1966, will start moving into apartment living (Winter/Spring 2019 Newsletter Vol. 2 No. 115) between the ages of 65 and 75. Assuming that the peak age for selling their homes is 70, most of their homes will come on the market between 2016 and 2036. We are in the first part of that period now and it does not appear to have adversely impacted housing prices yet. However, as it gathers pace it will increase supply and should act as a brake on house price increases in some areas. Our projection is that *prices will continue to increase*, albeit at a less frenetic rate than the last two years but well above the rate of inflation, for the next five years. They will continue to increase thereafter, with some ups and downs depending on the economy, at a rate consistent with the inflation rate (as measured by the Consumer Price Index).