Toronto Housing: Hot and Hotter

Sal Guatieri, Senior Economist • sal.guatieri@bmo.com • 416-359-5295

While Vancouver's housing market braces for a chilly winter, Toronto's is still a ball of fire. With record sales, accelerating prices and embers jumping to previously sedate pockets (condos and surrounding regions), there is little sign of cooling. Will new mortgage rules and worsening affordability see Toronto follow in Vancouver's icier footsteps in 2017?

After gaining momentum in 2015, **Toronto's market set a blistering course in 2016**. Resale activity posted double-digit growth to new highs (*Chart 1*). Condos—the only affordable option for many first-time buyers—led the charge (*Chart 2*). After rising 10% in 2015, benchmark prices soared twice as fast last year—likely the biggest annual gain since the late-1980s bubble (*Chart 3*). The average price of a detached home now tops a cool one million dollars, cheap only by Vancouver's standards.

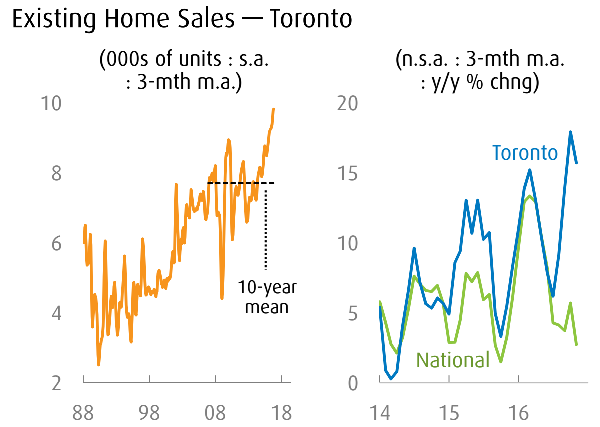
It's not hard to explain why house prices are sizzling. When powerful demand forces—low interest rates, more prime-age first-time buyers (the millennials), relatively low joblessness, rising net provincial migration (notably laid-off Albertans), and strong international immigration—meet lean supplies, prices can only move one way: up (*Chart 4*).

But harder to explain is why prices actually sped up across all housing segments and regions, even those without extreme shortages. **Resale condo prices vaulted** from a sustainable 4% pace in recent years to 15%. Regions on the outer rim of the Greater Toronto Area (Oshawa) and surrounding regions (Hamilton, Brantford, Cambridge, the Niagara Region, Guelph and Barrie) also had double-digit price gains (Oshawa's benchmark soared 30%). Those seeking a detached home, but unwilling or unable to take on a giant mortgage, faced a gruelling and more expensive commute.

It's true that strong demand has reduced the previous overhang of unsold new condo units, with supply plumbing a record-low 5.2 months relative to demand in Q3, according to Urbanation. However, the larger resale condo market is only slightly tilted toward sellers. Fundamental drivers of housing demand, though supportive, did not accelerate in 2016. Employment actually stalled last year after jumping nearly 5% in 2015. Residential mortgage growth (for chartered banks) picked up only moderately to 7½% in the province in the first three quarters of the year, suggesting credit didn't ramp higher in the GTA. Mortgage rates were little changed. So what gives?

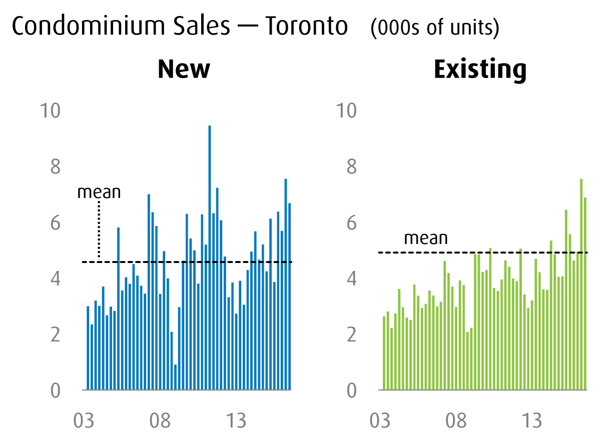
While data on speculation and foreign investment are notoriously scarce, **anecdotal evidence suggests the latter has helped juice**

Chart 1
Raising the Roof



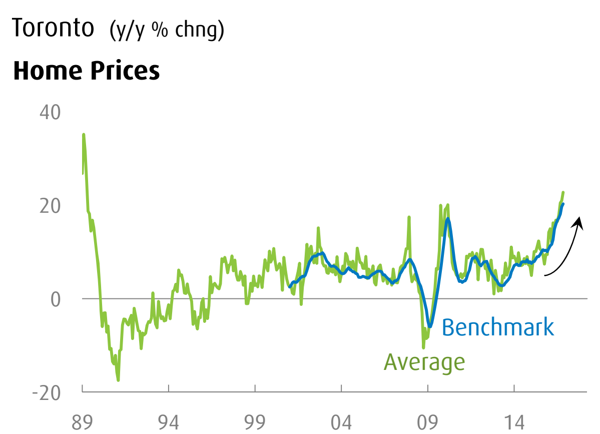
Sources: BMO Economics, Haver Analytics, CREA

Chart 2
High Living



Sources: BMO Economics, Urbanation Inc.

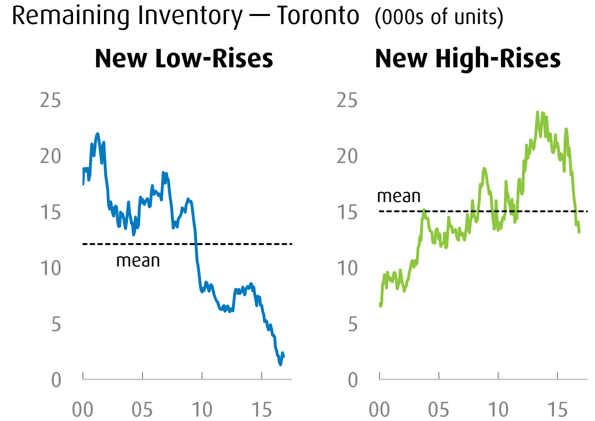
Chart 3
That '80s Show



Sources: BMO Economics, Haver Analytics, CREA

prices. It's probably no coincidence that prices have ramped higher in Toronto, Victoria and Seattle. All three were cited by global real estate monitor Juwai.com as destinations favoured by non-resident buyers jilted by Vancouver's 15% property transfer tax. Indeed, B.C government data confirm a sharp slide in non-resident transactions in metro Vancouver after the tax went into effect. Urbanation says foreign investors bought 5% of recent new condo units in the GTA. That's not insignificant, though it pales compared with domestic investors who bought just over half of new units (in line with earlier trends). Investors continue to provide much needed supply, as condo rental vacancy rates fell to 1.0% in October 2016 from 1.8% a year ago, spiking rents 9%.

Chart 4
Not a Lot of Lots



Sources: BMO Economics, RealNet Canada

What will 2017 bring for Toronto's housing market? Barring an abrupt shift in demand fundamentals—a spike in interest rates, a job-killing recession or a reversal in foreign capital flows—the **market should stay vibrant**. A recent Ipsos Reid poll found that Torontonians remain optimistic, with 18% looking to buy in the next two years, up from 15% a year ago. Nearly half still pine for a place with a backyard.

Table 1
Want Affordability? Think Small

Mortgage Payments as a % of Median Family Income[1] — Toronto

	'05:Q1	'15:Q4	Oct.-Nov. '16	Oct.-Nov. '16
Mortgage Rate	5.7%	3.9%	3.9%	If 5.9%
All Types	**33**	**43**	**51**	**62**
Single Family	38	51	62	75
Bungalow	34	46	57	69
Condos	20	24	27	32

Based on 25-year amortization, avg. of 1- and 5-year posted fixed mortgage rates, benchmark house price, down payment equal to half of annual income[1] (about 10% today); [1] = median family income is estimated after 2014 using average annual growth in previous 10 years
Sources: BMO Economics, BoC, Stats Canada, Haver Analytics, CREA

But two forces will dampen sales and prices in 2017: worsening affordability and stricter mortgage rules. With the benchmark property price running at 8.7 times median family income, the typical household would need to spend half its (gross) income to service mortgage payments on a newly purchased property in the GTA (*Table 1*). This might seem like a bargain compared with Vancouver (where two-thirds of income is required), but it pales in comparison with one-third of income in 2005 and one-fifth of income in other major cities such as Montreal and Calgary. We judge that less than half of the 126% rise in home prices since 2005 reflects the nearly 2-ppt drop in mortgage rates and 27% rise in family income. The typical family in the GTA is priced out of the detached market, with condos the last refuge, and even that won't last long if prices continue to escalate.

The full effects of the mortgage rule changes will begin to bite early this year—after prospective buyers who were pre-approved for a loan under the old rules have jumped into the market. The Bank of Canada's recent *Financial System Review* found that nearly half (49%) of borrowers who took out an insured mortgage in Toronto in the year to September would not have qualified under the new stress test (and note that insured mortgages account for about 40% of resale transactions nationwide, implying that one-fifth of potential transactions could be affected). **To qualify under the new rules, many potential buyers will need to settle for a less expensive home.** Those seeking a benchmark GTA property (priced around $690,000) who were close to the maximum debt-service ratio under the old rules would now only qualify for a home that's 19% less expensive under the new higher qualification rate (assuming a 10% down payment). This could push more buyers into the condo market. However, Urbanation estimates that condo resales will decline roughly 10%-

to-15% within a year, while price growth will slow to about 5%—a fairly modest payback from recent heated activity. **We expect Toronto home sales will come off their highs this year, while price growth will simmer down to the mid-single digit range.** A near record number of housing units under construction (69,000) will also corral price growth (*Chart 5*).

Chart 5
Reaching for the Skies

Toronto (000s of units)

Housing Units under Construction

Sources: BMO Economics, Haver Analytics, CMHC

If Toronto's market doesn't pipe down, it will continue to fan household debt and become ever more vulnerable to a correction when demand fundamentals weaken. The *Financial System Review* found that the number of highly indebted households (with loan-to-income ratios in excess of 4.5) has mounted in and around the GTA, as more home buyers chased prices higher. In Toronto, the percentage of new insured mortgages by highly indebted households rose from about one-third to nearly one-half (49%) in the past two years. This compares with a moderate 5-ppt increase to 18% nationwide, and to a still-low 13% share in Montreal and Ottawa.

Should interest rates rise sharply, even currently affordable condos could become too expensive for the median-income family (as is already the case in Vancouver). A 2-ppt increase in mortgage rates would push the typical household close to the maximum carrying-cost ratio (39% of gross income) required for an insured mortgage (after including condo fees, property taxes, insurance and heating costs). An income-chopping recession would also push this ratio higher.

Bottom Line: Toronto's housing market should have another good year, but price growth will be much slower (and more sustainable) than last year. Longer-term risks deserve close attention, especially if prices don't simmer down.