RBC ECONOMICS | **RESEARCH**

CANADIAN HOUSING

October 12, 2016

Vancouver housing market: cooling but not collapsing

- Following a period of significant overheating, the Vancouver-area market entered a cooling phase this spring. We expect further weakening in demand and moderation in prices in the near term.
- Although downside risks dominate, a wholesale collapse is unlikely for two reasons: 1) economic and demographic underpinnings for the market remain solid; and 2) Vancouver is still well positioned to attract wealth and investment despite the new tax on foreign buyers.
- The BC government has signaled a shift in its housing policy toward engineering a cooldown in prices in Metro Vancouver and we expect this to result in a significant moderation in price increases.
- Five factors pose particular risks to our base case: 1) policy; 2) the 'foreign element'; 3) speculation; 4) new supply; and 5) local economy's dependence on housing.
- All of these factors contain highly uncertain elements that could potentially trip up the market.
- In our view, home listings are the indicator to watch for early signs of trouble. Any sustained surge could signal that speculators (and owners at large) are 'cashing-in their chips'.
- For the most part, Vancouver's affordability challenges are structural in nature and result from the tensions arising from a solid economy, growing population and strong influx of wealth rubbing against quite restrictive geographic limitations. While policy initiatives can ease tensions for certain categories of housing (e.g. high-rise condos and rental units), owning a single-detached home in Vancouver is unlikely to ever become affordable by Canadian standards.

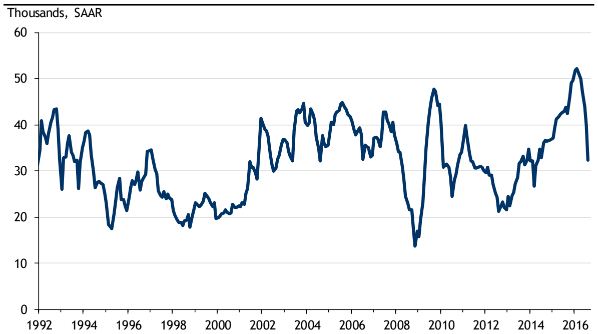
In cooling mode...

Home resale activity has moderated considerably in the Vancouver area since reaching an all-time peak in February 2016 (on a seasonally adjusted basis), stringing six consecutive monthly declines of totaling 38% by August. The pace of decline accelerated progressively since spring, reaching -7.0% m/m in June, -9.3% in July, and a plunge of -18.8% in August. Despite this substantial cooling in activity, the Vancouver-area market has yet to slip into conditions favouring buyers. The sales-to-new listings ratio, at 0.55 in August, is consistent with a balanced market, whereas the sales-to-active listings ratio, at 0.24 in September, suggests that sellers still hold control of pricing. Lessening market tightness, however, has meant that upward price pressure has begun to ease. Benchmark prices slipped for the first time (-0.1%) in nearly three years in September. Relative to a year ago, the rate of price increase slowed to a still-red hot 28.9% in September from 31.4% in August and 32.6% in July.

...after a reaching the boiling point earlier this year

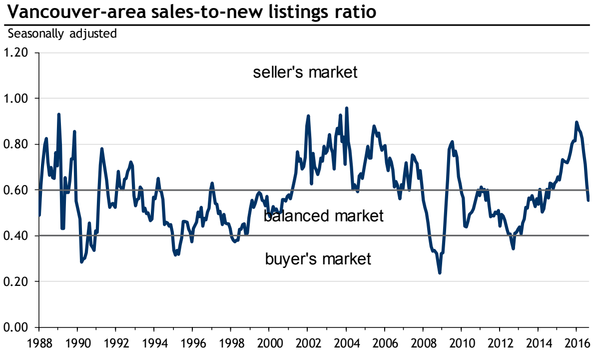
The period of a little more than three years leading up to the current downturn in activity saw one of the stronger housing market rally in the Vancouver area in modern times anywhere in Canada. Home resales

Vancouver-area home resales



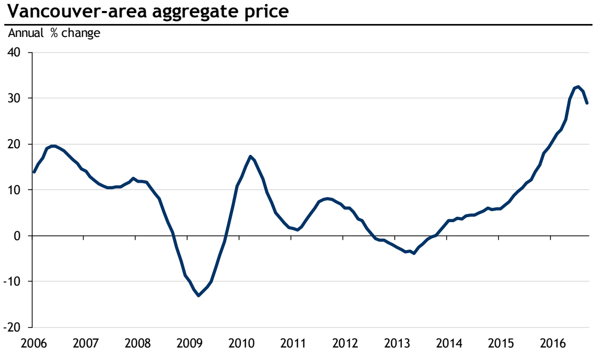
Source: CREA, RBC Economics Research

Vancouver-area sales-to-new listings ratio



Source: CREA, RBC Economics Research

Vancouver-area aggregate price



Source: CREA, RBC Economics Research

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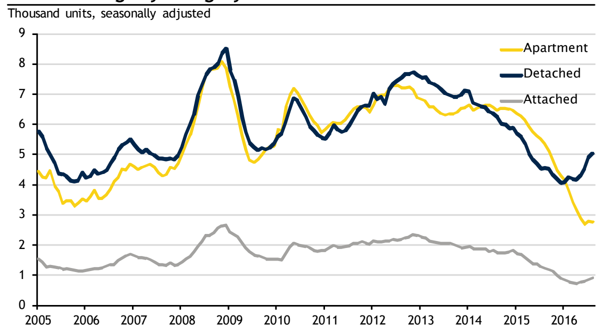
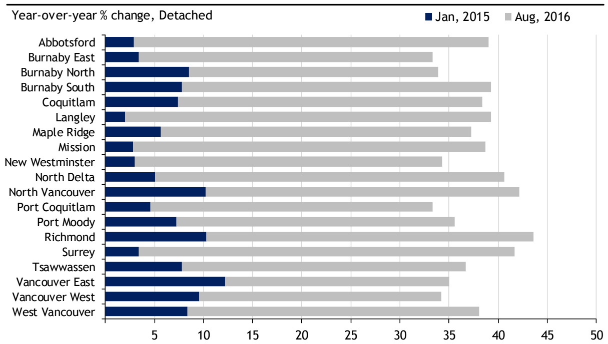
Active listings by category: Metro Vancouver



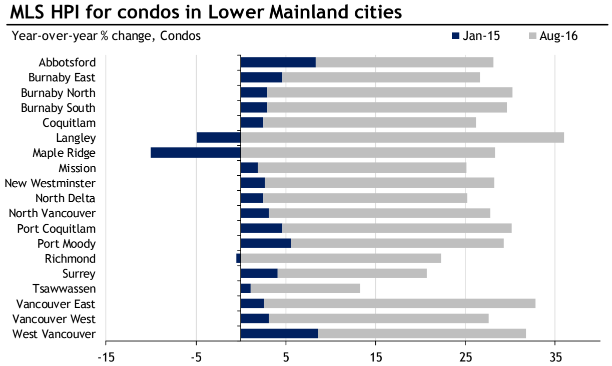
Source: Greater Vancouver Real Estate Board, RBC Economics Research

MLS HPI for detached homes in Lower Mainland cities



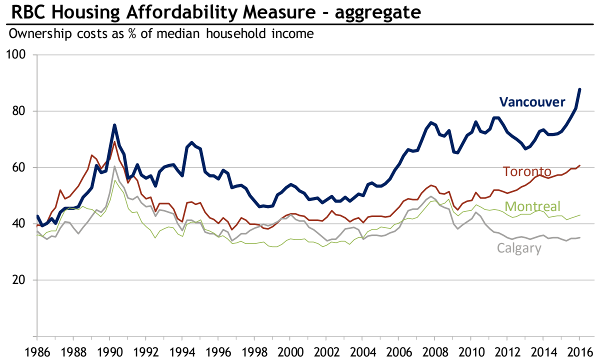
Source: Real Estate Board of Greater Vancouver, Fraser Valley Real Estate Board, RBC Economics Research

MLS HPI for condos in Lower Mainland cities



Source: Real Estate Board of Greater Vancouver, Fraser Valley Real Estate Board, RBC Economics Research

RBC Housing Affordability Measure - aggregate



Source:Brookfield RPS, Royal LePage, Statistics Canada, Bank of Canada, RBC Economics Research

surged by more than 130% between the fourth quarter of 2012 and first quarter of 2016. The last leg of this rally, which kicked in around the beginning of 2015, was a period of particularly rapid property appreciation fueled by booming demand colliding against limited supply of homes available for sale. In fact, active listings fell markedly during this period in large part owing to concerns of sellers being unable to afford to buy another property in the region—this also could be possibly attributable to current owners holding out for even higher prices. The composite benchmark price has ballooned by more than 45% since the start of 2015 to $932,000 (the benchmark for detached homes rose by 57% to just under $1.6 million and for condo apartments by 34% to $512,000).

Alarm bells have been ringing

This last leg of the rally since early 2015—and surge in prices it produced—has raised alarms about overheating and erosion (or rather destruction) of affordability. It has long been a fact that properties are very expensive in a handful of upscale neighbourhoods of Vancouver and for single-detached homes; however, this ballooning in prices in the past year and one-half has been widespread across cities and housing types within the region. Single-detached homes have led the surge (up by an astounding 57% since January 2015); however, condo apartments also appreciated very rapidly (up 34% during that interval, including an outsized increase of 24% in the past year alone). During the 12-month period ending August 2016, all cities but one within the overall region have seen increases of at least 20% in aggregate prices. In short, there has been no way to escape the intense heat in the Vancouver-area market.

Housing affordability seriously out of reach for locals

The surge in property values occurred without a commensurate rise in local household income and this significantly exacerbated already-stretched affordability conditions for local homebuyers. For a typical (median) Vancouver-area household, the costs of owning an average home have risen from 70% of pre-tax income in early 2015 to 90% by the second quarter of 2016, thereby representing the most significant deterioration in housing affordability in more than a quarter century in Vancouver. Owning a home at market prices, therefore, is effectively out of reach for the majority of local households. This is especially the case for a single-detached home, which required an astounding 127% of pre-tax income most recently. A condo apartment is significantly less onerous at 44%, although it is still a stretch for many Vancouver households. Compared to ownership, renting is the more affordable housing option in the area (a two-bedroom apartment claiming approximately 28% of household income); however, availability is a major issue. Vancouver's rental vacancy rate was less than 1% the last time it was measured by CMHC in the fall of 2015, the lowest rate in seven years.

Local fundamentals are solid but not *that* strong

To be sure, some degree of heat can be justified by supportive local fundamentals. The Vancouver area has seen impressive job gains in the past year and population has grown at one of the faster rates among major Canadian cities, and of course, interest rates continue to be exceptionally low. Nonetheless, such constructive market fundamentals cannot fully explain the frenzy that gripped home buyers during the last leg of the rally between early 2015 and early 2016 when skyrocketing prices appeared to stimulate demand rather than temper it. We believe that buyers motivated purely by expectations of capital gains have played a significant role in boosting demand—and therefore prices—in the Vancouver market during that period. The steep drop in active listings tells us that local move-up buyers likely have retrenched materially from the market, and overstretched affordability in turn tells us that local first-time buyers also likely have cut back their participation. We believe that the more active players, therefore, have been investors, speculators and buyers from outside the Vancouver market.

Enough is enough: the BC government intervenes...

In the face of rapidly deteriorating affordability and concerns about housing risks in the Vancouver area, the BC government has made a number of policy moves since its 2016 budget that have signaled a shift toward a more interventionist approach to housing. The first moves announced in the February budget were a rejigging of the property transfer tax on newly built homes (that exempted Canadian citizens or permanent resident from paying the tax on properties priced up to $750,000 while boosting the tax rate from 2% to 3% on property value exceeding $2 million) and the collection of data on foreign buyers (which began in early June 2016).The second move occurred at the end of June with the announcement that the BC government reclaimed regulatory oversight of the province's real estate industry, thereby ending self-regulation. The third and arguably bolder move came on July 25 when the provincial government announced a new 15% tax on purchases by foreign nationals or entities controlled by foreign nationals that became effective five working days later on August 2, 2016.

...on the heels further tweaks of federal mortgage rules

These policy initiatives at the provincial level came on the heels of another round of mortgage insurance rule tweaking at the federal level that raised the minimum down payment from 5% to 10% on properties valued between $500,000 and $1 million in mid-February. While applying broadly across Canada, this change clearly targeted higher-priced markets such as the Vancouver and Toronto areas. More federal policy action followed more recently. Federal Finance Minister Bill Morneau announced on October 3, 2016, that his government will close a loophole that allowed non-residents to claim the principal-residence exemption on capital gains tax on homes sold in Canada. The Minister also indicated that, effective October 17, 2016, the rules for qualifying for mortgage insurance will be more uniform across mortgage types and terms. Meanwhile, the 'deep dive' into housing issues that the Finance Department initiated in June is ongoing and a study group composed of representatives from the federal and provincial governments, and Vancouver and Toronto continues to explore policy options at all levels of government. In parallel to these policy investigations and discussions, the federal ministry of families, children and social development (overseeing CMHC) is in the midst of conducting sweeping consultations toward developing a national housing strategy, one component of which being tackling affordability challenges in large urban markets such as Vancouver.

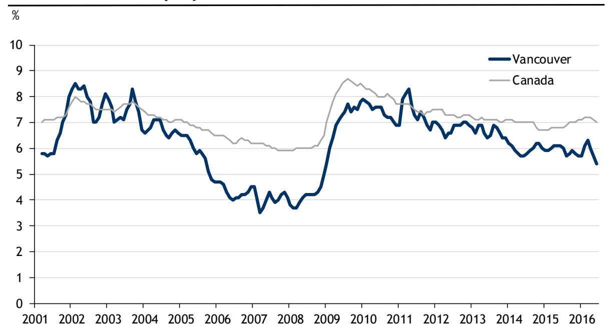
City of Vancouver to tax empty units

Addressing the lack of affordable housing has been a key focus for several years at the City of Vancouver. Various measures set forth include rezoning certain areas of the city to increase density, requiring new development projects to include affordable units or size of units suitable for families, and offering city lands for development. In June, Vancouver received legislative clearance from the provincial government to impose a tax on empty housing units. The new tax is scheduled to be implemented in January 2017; however many details have yet to be released at this stage.

So what's next? Further cooling and price moderation ahead;...

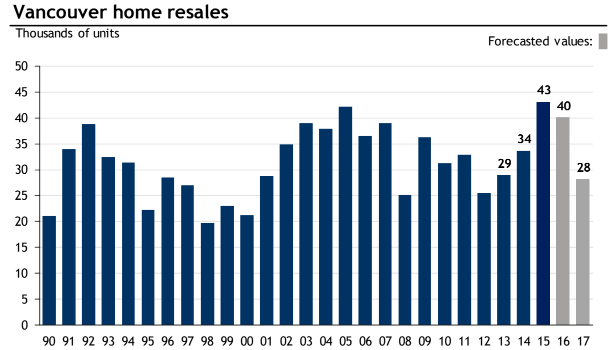
In light of the substantial decline in home resale activity since February,

Vancouver unemployment rate



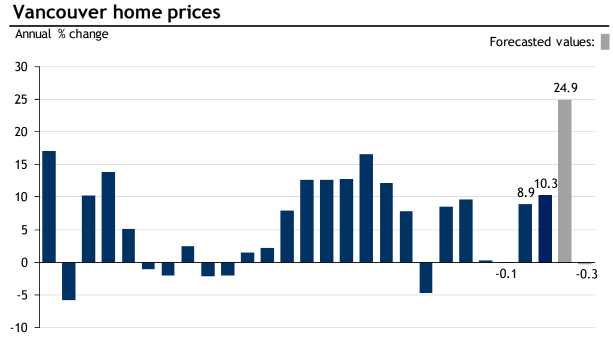
Source: Statistics Canada, RBC Economics Research

Vancouver home resales



Source: CREA, RBC Economics Research

Vancouver home prices



Source: Brookfield RPS, Royal LePage, RBC Economics Research the Vancouver market clearly has passed an inflection point. We expect that cooling forces will continue to dominate in the near term as a downgrade in price expectations chips away at speculative activity in the area; yet, we believe that this market 'landing' will be orderly thanks to still-supportive economic and demographic fundamentals. Our base case sees further resale weakness through the remainder of 2016 before things stabilize next year, although our projected annual tallies show a more substantial –30% decline in 2017 relative to –7% in 2016. Our base case for benchmark price levels is a slight downward drift that would result in significant moderation in the annual rate of increase and bouts of month-to-month declines during the coming year. On an annual basis, we project the aggregate price benchmark to moderate from a gain of 25% in 2016 to zero in 2017.

...however, five factors pose particular risks

That being said, the outlook for the Vancouver market is highly uncertain because we are, in many ways, in uncharted territory. In our opinion, there are five factors that pose particular risks to our base case: 1) policy and rules; 2) the 'foreign element'; 3) speculation; 4) new supply; and 5) local economy's dependence on housing.

Policy: front and centre,... and bearer of more surprises?

Policy in its various forms and at various levels of government easily is the factor most likely to influence the outcome for Vancouver's housing market, and yet it is one of the most difficult to predict because so many considerations enter into play. Clearly, policymakers are very sensitive to Vancouver's affordability challenges and are under intense pressure to do 'something' about it, especially at the provincial and municipal levels. The surprise introduction of the new 15% tax on purchases by foreign nationals in Metro Vancouver by the provincial government is a case in point. While the effectiveness of the tax will be revealed over time, we believe that the bigger point is that it signals the provincial government's intent on engineering a cooling in prices—if this tax does not do the trick, it likely will be followed by other measures until prices moderate. Indeed, the BC government already stated that "it is working on additional measures to address the complex causes of rising home prices in Metro Vancouver". What constitutes policy success is less clear, however. The provincial government's goal to ensure that "the dream of home ownership remains within the reach of the middle class" offers few clues on how it will measure progress.

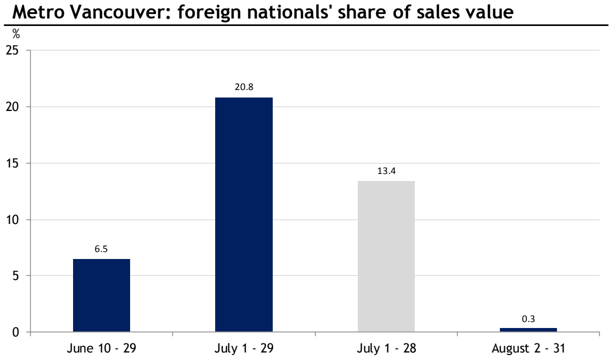
Macro prudential efforts, collectively, could be potent

In parallel to broader policy initiatives, there is a host of macro prudential measures of a more 'technical' nature being rolled out by regulatory bodies, agencies and industry addressing various dimensions of housing risks that will affect the Vancouver market. These include more stringent requirements on lending institutions from OSFI and increased oversight of realtor practices by the BC Real Estate Council. Perhaps as importantly, there is a renewed drive on the part of agencies such as the Canada Revenue Agency and Fintrac to enforce existing tax and money laundering rules. Collectively, these various macro prudential and enforcement efforts have the potential to dampen activity in the Vancouver area in the short term; however, much of it is difficult to know at this stage.

Foreign buyers: will they keep coming?

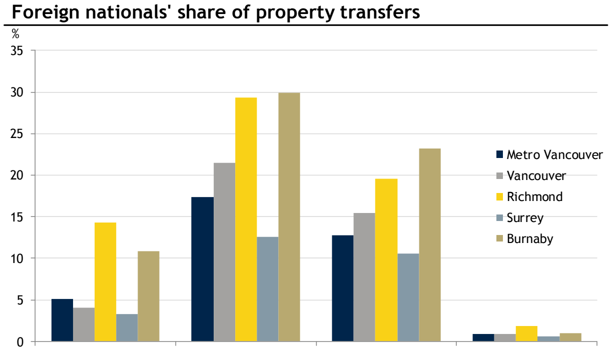
The recent publication of new statistics on the nationality of buyers showed that in the month prior to the late-July announcement of the 15% tax on foreign nationals, approximately 10% of homes purchased in Metro Vancouver were bought by foreign nationals (and about 18% in Rich-

Metro Vancouver: foreign nationals' share of sales value



Source: BC government, RBC Economics Research

Foreign nationals' share of property transfers



Source: BC government, RBC Economics Research mond and Burnaby), thereby confirming the long-held notion that buyers coming from outside Canada play a significant role in the Vancouver-area market. The data covering the June to August 2016 period also confirmed that foreign buyers tend to participate at the higher end of the market, the average value of properties that they purchased exceeding the value of properties bought by Canadians or permanent resident by nearly $250,000 (or 27%). In the four weeks that followed the implementation of the new tax on August 2, 2016, foreign nationals' share of home purchases plummeted to less than 1% in Metro Vancouver, although this number was distorted by a stampede to register transactions at the Land Title Office (where statistics are collected) on the last business day of July to beat the tax. While we expect purchases by foreign nationals to recover partially from the drop in August in the coming months, the new tax has introduced a thick layer of uncertainty.

Vancouver is still attractive for international investors

We have no doubt that the new tax will put a damper on foreign buyer interest in Vancouver in the near term; however, we believe that Vancouver will continue to attract investment from wealthy individuals—especially those from China given the strong connection already established—once the initial shock from the tax has run its course. Vancouver offers a sought-after lifestyle and prestige for wealthy Chinese that only a handful of other international cities can boast. These cities include Hong Kong, Singapore, Sydney, Melbourne and London—all of which impose some form of restrictions on foreign buyers (e.g., special stamp duty or capital gain tax). The new tax, therefore, is unlikely to be a major deterrent for wealthy investors. Compared to the peer group, Vancouver high-end properties still appear to be 'affordable' despite looking excessively expensive from a Canadian perspective.

Strong base and flow of wealthy immigrants

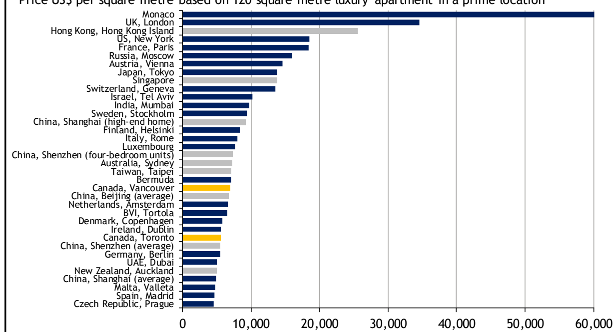
An arguably even more powerful force in the Vancouver-area market is the strong base and inflow of wealthy immigrants that keeps fueling homebuyer demand, especially at the higher end of the scale. Over the years, Vancouver has attracted a disproportionate share of investor-immigrants under the former Canadian Investor Immigrant Program (cancelled in 2014), which channeled substantial wealth into the city. A similar, and still operating program in Quebec reportedly maintains a strong flow of wealthy Chinese immigrant-investors in the Vancouver area to this day, as immigrants are not legally bound to settle in the province of application. High net worth immigrants are drawn to Vancouver for the same reasons as foreign investors (desirable lifestyle, political and economic stability, and prestige), as well as other factors such as good schools, clean environment and the 'global passport' that Canadian citizenship offers. We expect that Vancouver's 'brand' will remain strong among wealthy immigrants, as will housing demand from them.

Speculation: a grey area that could potentially tip the market over

By our reckoning, much of the market frenzy between early 2015 and early 2016 was due to factors other than local fundamentals, and we suspect that buyers motivated by expectations of capital gains have played a prominent role. Admittedly, speculative activity is much of a grey area with limited hard data to track. Statistics released earlier this year by the provincial government would indicate only a small uptick in property flipping (homes resold within 12 months of first purchase) recently; however, we believe that speculators have tended to hold on to their residential investment to capitalize on rapid price appreciation at a time when returns on other types of investment have been significantly lower. A marked slowdown in home price increases in the area and, more im-

World's most expensive cities to buy a home

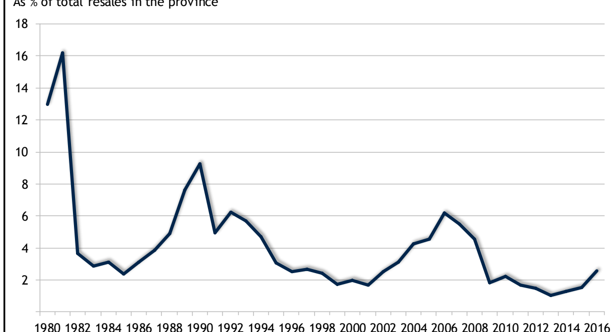
Price US$ per square metre based on 120 square metre luxury apartment in a prime location



Source: Global Property Guide, Colliers International, RBC Economics Research

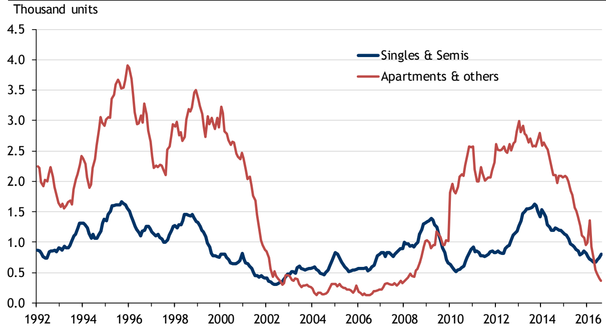
Sales of homes bought less than 12 months earlier in BC

As % of total resales in the province



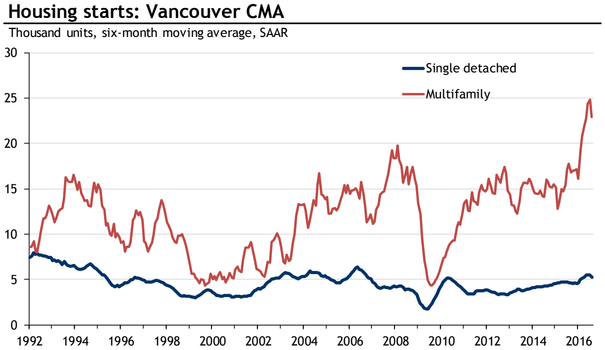
Newly completed and unsold housing: Vancouver CMA

Thousand units



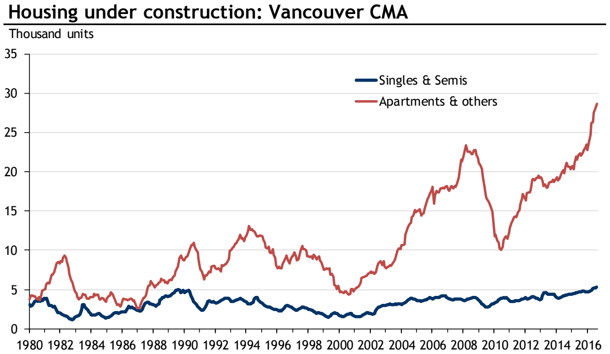
Source: CMHC, RBC Economics Research

Housing starts: Vancouver CMA



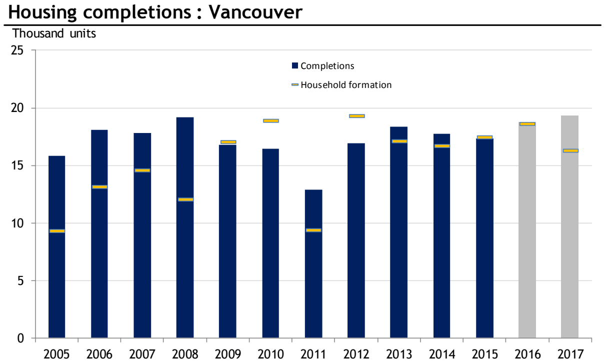
Source: CMHC, RBC Economics Research

Housing under construction: Vancouver CMA



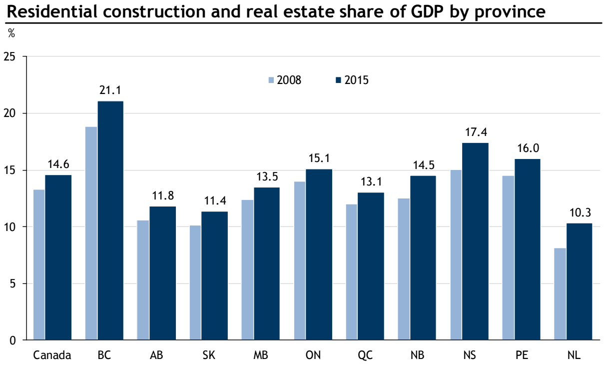
Source: CMHC, RBC Economics Research

Housing completions : Vancouver



Source: CMHC, BC Stats, RBC Economics Research

Residential construction and real estate share of GDP by province



Source: Statistics Canada, RBC Economics Research

portantly, a downgrade of capital gain expectations have the potential to alter housing investment dynamics considerably, even turning speculators from buyers to sellers. It is important to note that a sharp change in sentiment would not be out of character for the Vancouver market. Home prices in the area historically have been notoriously volatile, recording some of the larger cyclical swings (both up and down) among major Canadian cities.

Supply: record-high levels of construction could overshoot demand

Very tight demand-supply conditions since the middle of 2014, escalating prices and a dearth of recently-built but unsold inventory have elicited a very strong response from builders in the region. After rising by 8.6% in 2015 to a 23-year high of 20,900 units, housing starts have surged by 46% in the first nine months of 2016 to an average of 29,600 units on an annualized basis. If sustained during the remainder of this year, this level would set an all-time mark for the area. As of August 2016, there were a record 34,000 units under construction—a 35% rise since the end of 2014. Most of the increase has been in multi-dwelling units; however, single-detached starts also rose sharply. There were slightly less than 5,000 single-detached homes under construction (an all-time high for the area) and more than 29,000 multi-dwelling units. We believe that such strong construction activity will boost the supply of newly built homes meaningfully in the period ahead. Following modest back-to-back declines in 2014 (to 17,700 units) and 2015 (to 17,300 units), new home completions are poised to rise by more than 8% to 18,800 units in 2016, and we think that there is scope for 2017 completions to surpass the recent cyclical high of 19,150 units achieved in 2008. This would come at a time when household formation is projected to moderate in the Vancouver area, thereby signaling a material increase in availability and also a potential for the supply of new units to overshoot demographic requirements. It is important to note that construction timing uncertainty can be substantial—especially for multi-dwelling projects.

Local economy: strong but vulnerable to a housing downturn

The base case scenario for Vancouver's economy remains bright thanks to a highly qualified workforce, strong entrepreneurial spirit and the city's status as Canada's Pacific Gateway. It must be said, however, that economic activity in the area depends heavily on housing both directly and indirectly. Statistics for British Columbia show that the residential construction and real estate industries represented 21.1% of provincial GDP in 2015—up from 18.5% in 2007 and far exceeding the national average share of 14.6%. In fact, BC is the province most dependent on the housing sector. The flip side of this dependence is that it is also the province most vulnerable to a housing downturn. Any sustained period of significant weakness is likely to have material adverse consequences for the local economy. The risk is that such weakness could trigger an negative feedback loop between housing and the economy, and resulting in a deep correction.

There are upside risks too

While we believe that risks are skewed to the downside in the period ahead, we should not dismiss the possibility that the market can surprise us to the upside. The Vancouver area has been a 'special' housing market for a long time, and demand (including by foreigners) could be more resilient, supply (including new builds) could remain tighter, and prices stronger than we expect. Policy attempts to cool it down may meet the same fate as in peer cities such as Hong Kong and Singapore where it took many rounds of measures over several years to have the intended effect. If there is one lesson from Vancouver's ascension as the most expensive market in Canada since the early 1990s is not to underestimate its strength.

Where to look for signs of trouble? Listings

Given how far prices have been driven upward and overstretched affordability has become for local buyers, there are concerns about a possible collapse in prices in the area. So where should we look to detect trouble early on? We believe that the strongest signal would come from a sustained surge in home listings—possibly indicating that speculators are 'cashing-in their chips'. It would announce an impending imbalance that would set the stage for a significant price correction.

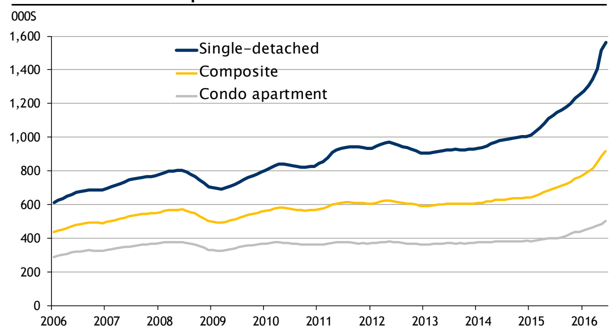
Some perspective on potential price correction

A 'collapse' in prices often is meant to be a 25% to 30% decline. In the case of the Vancouver area, however, a drop of this order would roll the clock back only nine or 12 months since prices have escalated by more than 30% in the past year alone. To be sure, a 25%-30% drop would be unsettling for the market, governments and the economy at large; still, most of the financial stress would be concentrated among recent buyers—therefore a very small subset of owners. It also should be said that a 25%-30% price drop would help restore affordability in the area. In fact, it would be seen as welcome news by many would-be buyers that have been priced out of the market in recent years.

Conclusion: some cooling in store but affordability issues to persist

The Vancouver-area housing market has entered the cooling phase of its cycle and we expect further weakening in demand and moderation in prices in the near term. Given the particular set of factors at play (including a shifting policy environment), downside risks dominate, although we believe that a wholesale collapse is unlikely. Much has been said in recent past about Vancouver's major affordability challenges. For the most part, these challenges are structural in nature. They result from the tensions arising from a solid economy, growing population, desirable location and strong influx of wealth rubbing against quite restrictive geographic limitations. While policy initiatives can ease tensions for certain categories of housing (e.g. high-rise condos and rental units), owning a single-detached home in Vancouver fundamentally has become a luxury and likely will remain the exclusive domain of wealthy buyers. Vancouver is among a select group of world cities where wealthy individuals have chosen to live, and the corollary of this is that they set the standards for valuation. This does not preclude single-detached prices from falling—indeed there is mounting evidence that they are being marked down—however, it is highly unlikely that they will ever come down sufficiently to become 'affordable' for average local buyers. Consequently, this will require further adjustment in housing expectations for many Vancouver residents. Vancouver's high ownership rate (slightly above 65% in 2011) is bound to ease gradually toward levels seen in other major global cities.

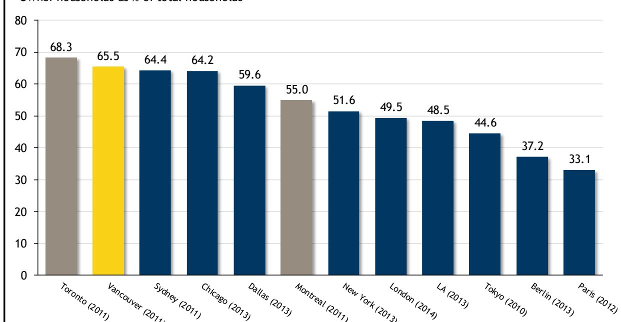
MLS HPI benchmark price - Vancouver Area



Source: CREA, RBC Economics Research

Home ownership rates for major global cities

Owner households as % of total households



Source: Statistics Canada, Australian Bureau of Statistics, US Census Bureau, UK Statistics Authority, Statistics Japan, Statistisches Bundesamt, Insee, RBC Economics Research