CURRENT ANALYSIS

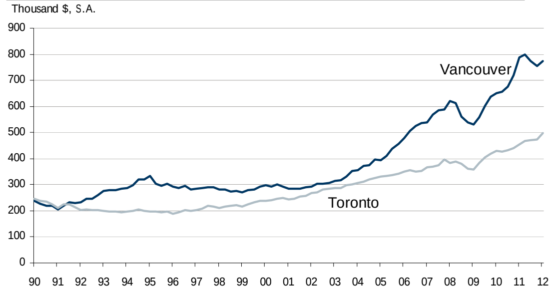
April 2012

Vancouver's housing market: moderation in store but vulnerable to a harsher outcome

- Signs of cooling have emerged in the Vancouver-area market in the past year. Since reaching their peaks in the early months of 2011, both home resales and prices declined quite noticeably.
- With affordability, or rather *un*affordability, having moved off the scale in the past three to four years, the historically volatile Vancouver-area market is undoubtedly under substantial stress. Indeed it is vulnerable to a marked correction.
- Although such a correction cannot be ruled out, we believe that the most likely scenario is one of a modest price decline, possibly in the order of 7% to 12% from quarterly peak to trough over the medium-term.
- We expect a more measured decline because: 1) the strong gains in property values from 2009 to early 2011 were overstated by MLS average price data; 2) we find few signs of imbalance between demand and supply at present; and 3) we expect the Vancouver-area market to remain well supported by a fairly favourable macroeconomic environment and strong demographic fundamentals.
- While there has been a rapid increase in new multiple units under construction in the Vancouver area last year, we do not expect this increase to materially outstrip the market's capacity to absorb the new units at completion in the next year or two.
- Nonetheless, market pressure and risks are likely to intensify in the medium term, when we expect rising interest rates to start to bite more.
- Risks will be further heightened by Vancouver-area valuation's dependence on a strong and steady flow of wealthy foreign buyers and recent immigrants — a phenomenon that is both poorly documented and potentially vulnerable to adverse external shocks.

Chart 1

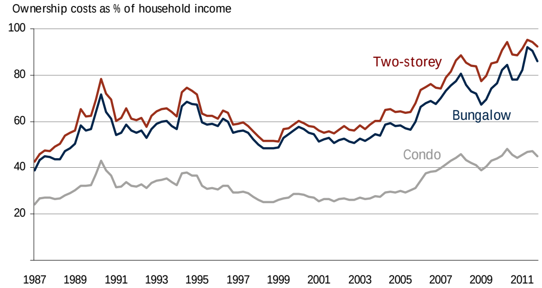
Average prices of homes sold on MLS



Source: CREA, RBC Economics Research

Chart 2

Vancouver housing affordability



Source: Statistics Canada, Royal LePage, RBC Economics Research

An expensive market, nothing new here

The Vancouver area housing market has long been the most expensive in Canada, taking the title from Toronto in the early 1990s (see **Chart 1**). It has also been periodically the source of concern when surges in property values were interpreted as possible bubbles threatening the stability of the market. Indeed, the recent run-up in prices from the recession lows of early 2009 to record highs in the middle of 2011 (a period during which the average price of homes sold on the MLS system surged 50%, almost double the strong 29% increase in Canada) has fueled such anxiety.

Extreme unaffordability weighs on local housing demand

With affordability, or rather *un*affordability, having moved off the scale in the past three to four years (**Chart 2**), the Vancouver-area market is undoubtedly

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Chart 3

Vancouver home resales

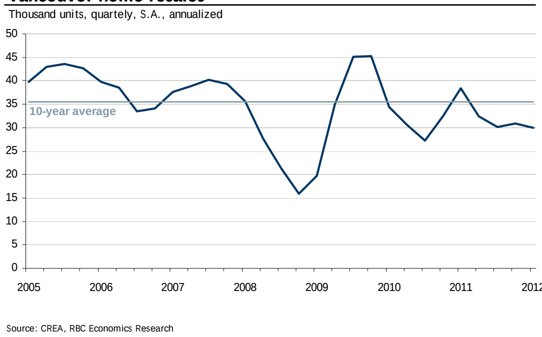
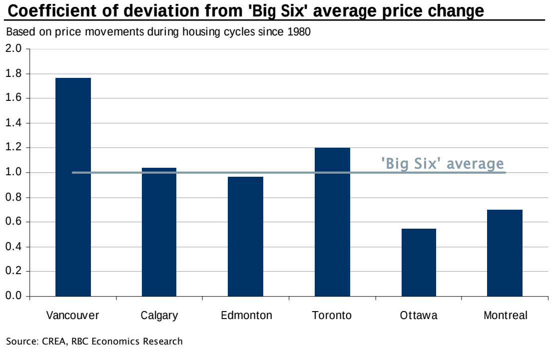


Chart 4

Coefficient of deviation from 'Big Six' average price change



under substantial stress. Not even Toronto — who's early 1990s prolonged downturn serves as the benchmark to ascertain housing market trouble — ever showed such poor affordability. A typical Vancouver-area homebuyers would need to allocate 92% of their income to carry the costs of a two-storey home (based on market price) and almost 45% for a condominium apartment. Needless to say, these represent very difficult financial hurdles for ordinary households to clear and demand for housing is being restrained as a consequence. Signs of market cooling emerged in the past year. Home resales dropped nearly 20% between the first and fourth quarter of 2011, to levels below the 10-year average (**Chart 3**). The average price of homes sold on the MLS system in the Vancouver area fell 5.5% between the second and fourth quarter of last year, although the newly published MLS Home Price Index (HPI) composite declined by a more modest 1.3% in recent months. Could there be a sharper correction in store?

A traditionally volatile market...

It is a fact that when Vancouver-area home prices move, they move a lot. This market has historically displayed wider price swings than other parts of the country — both in the up and down directions. **Table 1** on page 7 shows that Vancouver was the only 'Big Six' market showing greater-than-average price variation in all housing cycles since 1980 — although it did not display the greatest variation in each case, being exceeded by Toronto during the late 1980s-early 1990 boom-bust episode and by Edmonton during the mid 2000s boom. On average, the percentage change in prices during up and down cycles in the Vancouver area has been 77% greater than the (arithmetic) average change among Canada top six markets (see **Chart 4**).

...but appreciating faster in the long term

Despite such volatility, Vancouver area home prices have trended upwards at a faster pace over the long term than those in the other Big Six markets both in nominal and real terms (**Table 3**, page 8) – confirming the old finance maxim that the higher the risk (volatility), the higher the reward. On a nominal basis, the average annual rate of increase since 1980 was 6.8% in the Vancouver area and this exceeded rates of 6.0% for the Big Six and 5.6% for all Canadian markets. On an inflation-adjusted basis, Vancouver's 3.5% similarly outpaced long-run rates of 2.6% for the Big Six and 2.2% for all of Canada.

How vulnerable is the Vancouver area market to a substantial downturn?

Poor affordability, signs of market cooling in the past year and characteristically large price movements when they occur indeed point to higher-than-average risks in the Vancouver area market. We have raised concerns about this market's vulnerability to a downturn for at least two years now. That being said, this should not be interpreted as a forecast of imminent collapse or other disastrous outcome. In fact, we believe that the most likely scenario is one of a modest price decline, possibly in the order of 7% to 12% from quarterly peak to trough, which we think will be taken in stride by the market.

A measured decline in store

We forecast home prices only at the provincial level and on the basis of home value estimates by Royal LePage, not MLS averages. While prices could well show a small gain this year in British Columbia, we expect a declining cycle to set in in 2013 and that would likely run beyond next year, primarily reflecting a softening in demand due to a gradual rise in long-term interest rates. Our modeling suggests that B.C. prices could fall by nearly 5% on an annual basis over the medium term. Given that the Vancouver area represents more than 40% of the provincial market and assuming that prices elsewhere in the province will be mostly stable, the implied drop in Vancouver is slightly more than 7% on an annual basis or up to 12% on a quarterly basis depending on the assumed quarterly pattern.

Why such a measured decline is expected?

There are several factors arguing in favour a modest and orderly adjustment in the short term. First, the sense that the Vancouver market had gone 'wild' until recent months is somewhat overblown. The price rally that followed the 2008-09 recession, while significant, was not quite as dramatic as the increase in the average price of homes sold on the MLS system might indicate, especially during the last leg of it in early 2011. Alternative price measures reveal less spectacular (though still solid) increases (**Chart 5**). Consequently, the degree to which the Vancouver area market might have become overvalued and overstretched is likely exaggerated by the MLS figures.

Unusually strong activity at the high end of the market last year

The MLS averages last year were skewed by unusually strong increases in the sales and prices of highly sought-after properties in upscale neighborhoods. During a particularly frenetic interval in the winter and spring of 2011, for instance, outsized gains in detached home prices in Vancouver West, West Vancouver and Richmond — the three most expensive neighborhoods in the Vancouver area and where single family homes usually represent roughly 10% of the area's total sales — accounted for the bulk (close to 12 percentage points) of a 16%, four-month surge in the area's average price. Outside of these three neighborhoods, prices rose by a much more modest 2%.

Few signs of market imbalance at present

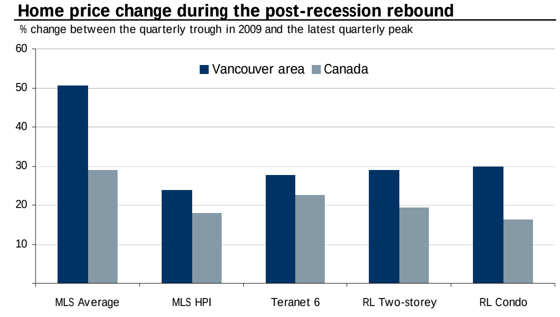
Second, we see few confirming signs of imbalance currently that would typically forewarn some imminent drastic corrective move by the market. The sales-to-new listings ratio – an indicator of tightness between the demand and supply of existing homes and which has shown a fairly strong correlation with price movements in the past – remains at safe levels (**Chart 6**).

Builders exhibit a fair degree of restraint

On the new home construction side of the sector – where any evidence of overbuilding could signal serious trouble – it appears that builders generally continue to exhibit a fair degree of restraint. The rebound in housing starts from the recession lows has been measured, with levels stabilizing since last summer below their average during the five years prior to the recession

Chart 5

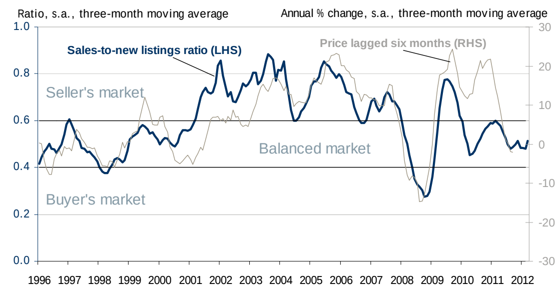
Home price change during the post-recession rebound



Source: RBC Economics Research, CREA (MLS), Teranet, Royal LePage (RL)

Chart 6

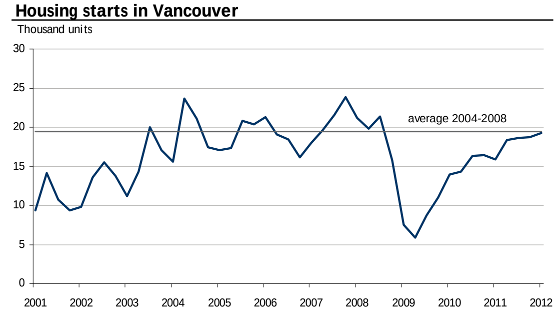
Vancouver sales-to-new listings ratio and average home prices



Source: CREA, RBC Economics Research

Chart 7

Housing starts in Vancouver

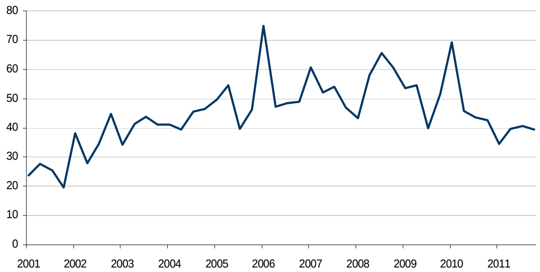


Source: CMHC, RBC Economics Research

Chart 8

Home completions in Vancouver

Thousand units

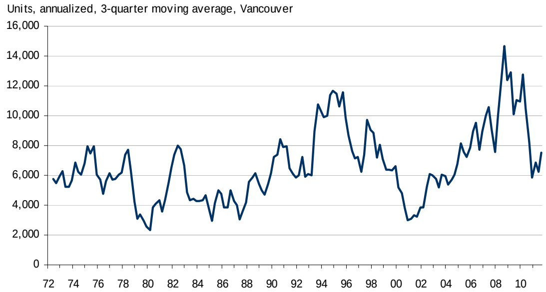


Source: CMHC, RBC Economics Research

Chart 9

Multiple units completed in Vancouver

Units, annualized, 3-quarter moving average, Vancouver

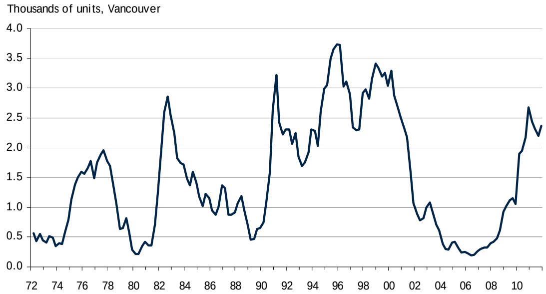


Source: CMHC, Statistics Canada, RBC Economics Research

Chart 10

Multiple units completed and unoccupied in Vancouver

Thousands of units, Vancouver

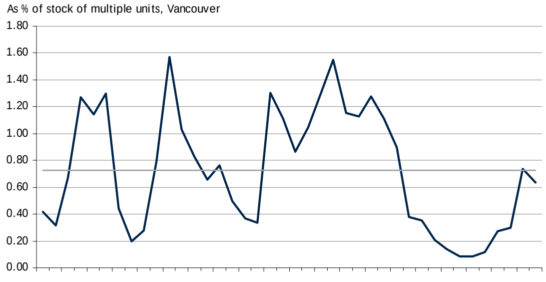


Source: CMHC, Statistics Canada, RBC Economics Research

Chart 11

Multiple units completed and unoccupied relative to stock

As % of stock of multiple units, Vancouver



Source: CMHC, Statistics Canada, RBC Economics Research

(**Chart 7**). And, the market so far has not been flooded with new units. If anything, the number of new units reaching market (housing completions) has trended downwardly recently (**Chart 8**).

Unabsorbed condo units rising but still in line with historical norms

There is perhaps some concerns in the multiple unit segment of the market, where a surge in new condominium apartments that hit the market in early 2010 (which included Olympic village units; **Chart 9**) has tested the market's absorption capacity. This surge, and an earlier wave of new condo units completions in 2008, propelled the stock of unoccupied multiple units higher since 2008 (**Chart 10**). While this recent uptrend is unmistakable, the current situation is still in line with the historical norm if measured as a share of the stock of all multiple units in the Vancouver area (**Chart 11**).

Fairly favourable economic conditions lend support

The third factor arguing in favour of a milder rather harsher outcome in the Vancouver area market is the relatively favourable economic conditions expected this year and next. Although global uncertainty will continue to present downside risks, we expect the British Columbia economy to remain on a modest growth track, with provincial real GDP forecasted to grow by 2.6% and 2.9% in 2012 and 2013, respectively. This will sustain job creation in Vancouver, contribute to lower unemployment, generate income gains and, ultimately, lend support to housing demand. Very low interest rates this year and next will also continue to underpin demand for housing. We expect the Bank of Canada to keep its overnight rate unchanged at 1.0% until late in 2012 and then raise it only gradually thereafter to 2.0% by the third quarter of 2013 – which would still constitute a historically low level. Longer-term rates will start rising this year but at a measured pace.

Strong in-migration will be sustained

Lastly, we anticipate that strong levels of in-migration in the Vancouver area will persist in the period ahead, thereby maintaining positive demographic fundamentals. Despite Vancouver's reputation as an expensive market, it continues to be one of Canada's premier destinations for migrants, with the area seeing a rising trend in the total number net migrants (international, interprovincial and intraprovincial) (**Chart 12**) since 2002. This has translated into accelerating growth of households (**Chart 13**). Going forward, CMHC projects household formation to stabilize in the 16,000 to 18,000 range, which would be close to the average of the past five years.

If the Vancouver area market is this unaffordable then why is housing demand so resilient?

The Vancouver area is clearly the least affordable market in Canada – and is also among the least affordable in the world. Demand for housing in the area has held up reasonably well under the circumstances but, as we mentioned above and shown in **Chart 3**, recent levels of sales are not exactly booming. If anything, overall demand in the area is a little soft (resales were below their 10-year average during the latter half of 2011), which we ascribe to a large degree to poor affordability. Thus, in our view, Vancouver's unaffordability is indeed weighing on demand.

Clear distinction between the detached and condo segments

The story on the demand side is split between the two major segments: a small but powerful group of homebuyers appears to be driving the detached homes segment while the rest of the fast-growing population fuels demand for the more affordable housing categories such condominium apartments.

Detached home segment: limited supply, deep-pocketed buyers

The high cost of housing in Vancouver reflects in large part the geography of the area which places physical limitations on the availability of land for housing. The effect of scarce land shows up most directly in the value of single detached homes, where average prices reached nearly $900,000 in the overall Vancouver area by the end of 2011 – and well above the $1 million mark in highly sought-after neighborhoods. During the run-up in prices in 2010 and 2011, there was a particularly strong influx of buyers of upscale detached homes that pushed against limited supply of such properties.

Who's buying expensive detached homes? Don't look for statistics

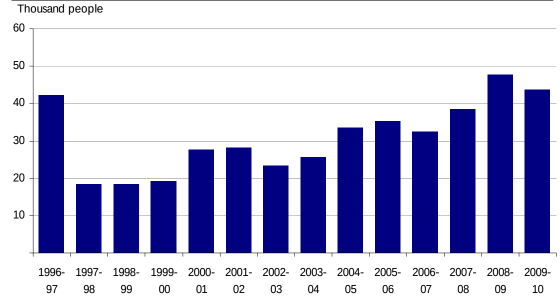
The identity and motivation (e.g., owner-occupied or investment) of these buyers are poorly documented statistically; however, local reports abound on the significant role played by wealthy immigrants and foreign investors – primarily from mainland China. It is true that Vancouver attracts a disproportionate share of investor-immigrants who, by definition, are wealthy individuals (or have family ties to them). In the last three years for which we have data (2008 to 2010), for instance, the number of investor-immigrants in Vancouver (more than 5,400 per year) was twice that of Toronto (2,700) and nearly four times that of Montreal (1,400). This type of immigrants represented roughly 12% of total net migrants (international, interprovincial and intraprovincial) in the Vancouver area (**Chart 14**). This is far from a perfect proxy for measuring the size of the wealthy homebuyer component but it nonetheless supports the notion that Vancouver is a magnet for deep pocketed individuals. Whether the wealthy newcomers are, in fact, buyers of homes is a question where reliable statistics remain absent at this point.

Condos are the main housing option for most homebuyers

In many ways, demand for condominium apartments in the Vancouver area is being sustained by the sky-high prices for detached homes. The majority new households are financially unable to live in a detached home. By virtue of being the most affordable housing type, therefore, apartments are for many Vancouver-area households – especially the young and first-time homebuyers – the main housing option. Strong interest in condominium apartments is clearly evident in the resale market where they represented nearly 40% of all existing home sales in 2011 (**Chart 15**). This strong interest can also be seen in new construction, where multi-family dwellings represented roughly four out of five housing starts in the area in 2011 (**Chart 16**).

Chart 12

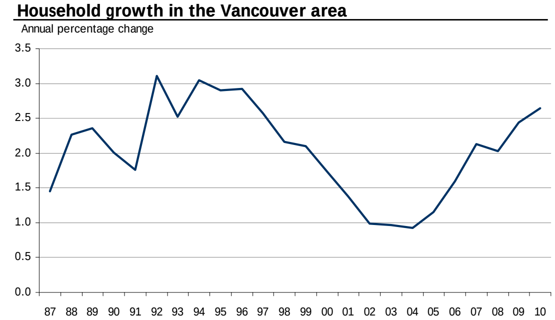
Greater Vancouver net migration



Source: BC Stats, RBC Economics Research

Chart 13

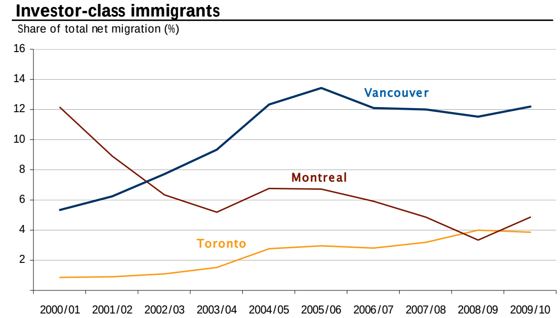
Household growth in the Vancouver area



Source: BC Stats, RBC Economics Research

Chart 14

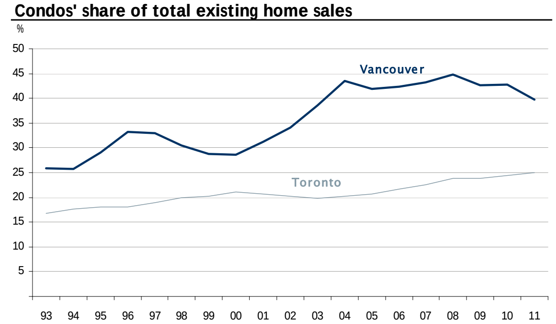
Investor-class immigrants



Source: Citizenship and Immigration Canada, Statistics Canada, RBC Economics Research

Chart 15

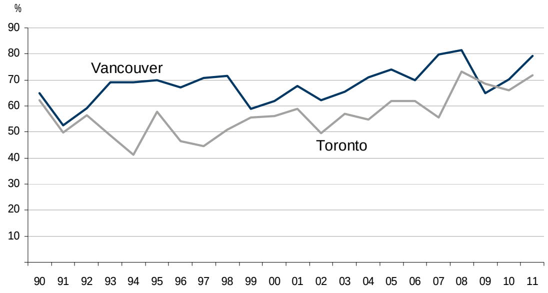
Condos' share of total existing home sales



Source: CREA, REBGV, RBC Economics Research

Chart 16

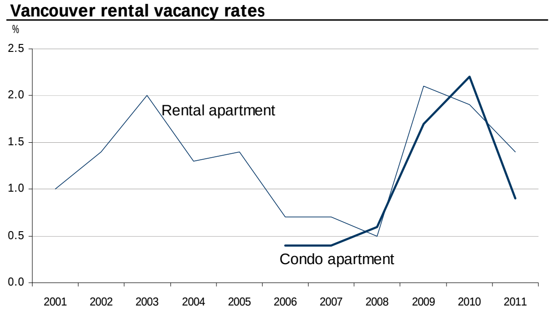
Multi-family dwellings' share of housing starts



Source: CMHC, RBC Economics Research

Chart 17

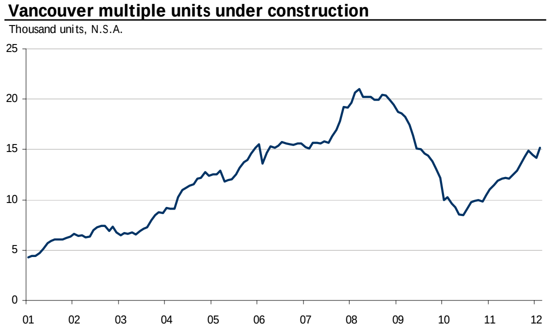
Vancouver rental vacancy rates



Source: CMHC, RBC Economics Research

Chart 18

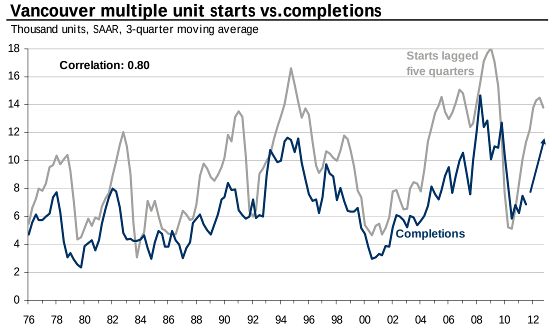
Vancouver multiple units under construction



Source: CMHC, RBC Economics Research

Chart 19

Vancouver multiple unit starts vs.completions



Source: CMHC, RBC Economics Research

Condos play a significant role in the rental apartment market

It should be noted that demand for condominium apartments not only comprises owner-occupants but also investors who, in turn, place the units in the rental pool. The latter phenomenon has gained significance over the years. CMHC estimates that almost 26% of condominium units in the Vancouver area are now part of the rental pool. In the past two years, almost half (46%) of the newly built condominium units were directed to that pool. During the same interval, condominium units accounted for half (49%) of the increase in the area's new rental units – nearly all the other half were other 'secondary' rental units such as rented homes and 'accessory suites'. In short, condominium apartments are a key source of new rental supply in the virtual absence of new purpose-built apartment buildings.

Very low condo rental vacancy rate at present

To date, demand for rental units has entirely absorbed the supply of new condo rental units. The vacancy rate for condo rental units even fell in 2011 to a very low 0.9% from 2.2% in 2010. Consequently, there is little evidence that the strong presence of investors in the Vancouver condo is putting the market at immediate risk (**Chart 17**).

Rising supply of condo units on the way

While we see few signs of imbalance in the Vancouver condo market at the present time, some challenges are likely to emerge. The current trajectory in the number of multiple units under construction (**Chart 18**) — and which will reach market within a period of up to two years typically – hints that there could well be sustained upward pressure on the number of unoccupied condo units over the next couple of years. Based on a strong relationship between multiple unit starts and completions five to six quarters later, the rebound in condo construction since the end of 2009 will bring a rising supply of newly completed units to market in the period ahead (**Chart 19**). The relationship suggests that the number of completed multi-family dwelling units could rise from 6,700 in 2011 to about 10,000 in 2012 — a big jump but from a low level and to a point that would still be slightly below the average (10,400 units) during the 2006 to 2010 period. We believe that such a rise would be unlikely to push the number of unoccupied condo units much beyond the long-term average (when measured as a share of the multiple unit stock). In other words, while signs of a condo overbuild are likely to emerge in the Vancouver area later this year, we do not expect them to point to a substantial imbalance.

Medium-term pressures

In our view, the bigger pressures in the Vancouver-area market will surface during the medium-term, when rising interest rates start to bite more. While our forecasted path for interest rates keeps them historically low by the end of 2013 (the current cut-off point of our forecast period), the rate renormalization process will not end there. As monetary stimulus is unwound further in Canada beyond 2013 (assuming that the Canadian economy stays on a sustained growth trajectory), the restraining effect of higher interest rates on housing demand will be felt quite strongly in Vancouver — due to the area's elevated home prices and corresponding large debt servicing costs. This cooling of demand at a time when the supply of new units (mostly condos) will still likely be on a higher plateau, will create more intense downward pressure on prices. We expect that the bulk of the price decline in the Vancouver area will take place around 2014 (give or take a few quarters).

Conclusion

The most likely scenario for the Vancouver-area market is a modest decline in home prices (perhaps in the 7-12% range, peak to trough) over the medium term. Admittedly, such a measured easing would be somewhat atypical for this market, which traditionally displays much wider swings. It would also represent a fairly benign outcome considering the extremely elevated property valuations in the area that have undermined affordability to never-before-seen levels in the annals of Canadian real estate. The main reason for our guarded view is that other key factors — sustained economic growth, employment gains, low interest rates and strong in-migration — will provide a broadly supportive environment, helping to offset most of the stress caused by poor affordability. Also, we see few confirming signs of imbalance currently that would forewarn a disorderly decline in the short term.

Nonetheless, much of the Vancouver-area market's high valuation hangs on the strong and constant flow of wealthy buyers coming from abroad — a phenomenon that is poorly documented. Unless we get better measurement of this phenomenon, the dynamics of the Vancouver-area market will remain rather opaque, putting any assessment at risk of missing critical market developments. For this reason, and the fact that the extremely poor affordability levels, quite frankly, make us uncomfortable, we urge caution. The Vancouver area market is more vulnerable to a significant downturn than other Canadian markets if an unfavourable economic scenario or unforeseen shock (e.g., a change in China's policy regarding capital outflow) were to unfold.

Table 1

Nominal home price change* during housing cycles in Canada's largest markets**

Total percentage change and duration of the change in quarters

		1980s recession	Late 1980s boom	Early 1990s recession	Mid-1990s rally	Late 1990s downturn	Mid-2000s boom	2008-2009 recession	2009-2011
Vancouver	% change	-36.1	77.6	-14.4	32.9	-19.4	105.0	-13.1	52.6
	Duration	*6*	*16*	*4*	*9*	*15*	*22*	*3*	*9*
Calgary	% change	-29.3	70.0	-8.3	nil	nil	92.4	-13.4	12.3
	Duration	*14*	*20*	*3*	-	-	*12*	*6*	*9*
Edmonton	% change	-18.7	35.5	nil	nil	-7.9	181.7	-11.1	8.6
	Duration	*15*	*10*	-	-	*7*	*26*	*7*	*5*
Toronto	% change	-5.5	148.5	-25.4	nil	nil	44.9	-10.5	34.9
	Duration	*4*	*17*	*16*	-	-	*23*	*3*	*9*
Ottawa	% change	-4.7	23.8	nil	nil	-6.8	52.8	-5.1	25.4
	Duration	*2*	*10*	-	-	*6*	*15*	*2*	*10*
Montreal	% change	-7.6	75.0	-5.4	nil	-11.6	56.2	-4.7	22.7
	Duration	*2*	*25*	*3*	-	*7*	*12*	*2*	*11*
'Big Six' average	% change	-17.0	71.7	-13.4	n.m	-11.4	88.8	-9.7	26.1
	Duration	*7*	*16*	*7*	-	*9*	*18*	*4*	*9*
Canada (all markets)	% change	-9.8	100.4	-9.4	nil	-4.3	68.3	-10.9	32.4
	Duration	*3*	*17*	*5*	-	*15*	*23*	*2*	*10*

* Declines are peak to trough; increases are measured for the period during which prices broke above trend growth.
** Some liberty was taken in matching periods of home price with housing cycles. Local markets can and do show leads and lags relative to 'national' cycles.
'nil' indicates that the price movement did not break away from trend.
n.m = not meaningful.
Source: Canadian Real Estate Association, RBC Economics Research

Table 2

Real home price change* during housing cycles in Canada's largest markets**

Total percentage change and duration of the change in quarters

		1980s recession	Late 1980s boom	Early 1990s recession	Mid-1990s rally	Late 1990s downturn	Mid-2000s boom	2008-2009 recession	2009-2011
Vancouver	% change	-44.4	60.3	-19.6	24.9	-21.2	82.9	-12.5	45.8
	Duration	*6*	*16*	*4*	*9*	*15*	*22*	*3*	*9*
Calgary	% change	-40.9	40.7	-12.3	nil	nil	70.5	-14.9	10.0
	Duration	*14*	*20*	*3*	*-*	*-*	*12*	*6*	*5*
Edmonton	% change	-32.6	22.7	nil	nil	-11.1	131.8	-13.6	6.9
	Duration	*15*	*10*	*-*	*-*	*7*	*26*	*7*	*5*
Toronto	% change	-15.0	98.0	-32.4	nil	nil	28.7	-10.6	26.9
	Duration	*4*	*17*	*16*	*-*	*-*	*23*	*3*	*9*
Ottawa	% change	-9.4	11.2	nil	nil	-9.9	39.3	-5.1	17.9
	Duration	*2*	*10*	*-*	*-*	*6*	*15*	*2*	*10*
Montreal	% change	-12.6	29.1	-6.7	nil	-14.2	45.4	-3.5	16.0
	Duration	*2*	*25*	*3*	*-*	*7*	*12*	*2*	*11*
'Big Six' average	% change	-25.8	43.7	-17.7	n.m.	-14.1	66.4	-10.0	20.6
	Duration	*7*	*16*	*7*	*-*	*9*	*18*	*4*	*8*
Canada (all markets)	% change	-16.5	67.9	-14.8	nil	-9.8	48.1	-10.5	25.6
	Duration	*3*	*17*	*5*	*-*	*15*	*23*	*2*	*10*

* Declines are peak to trough; increases are measured for the period during which prices broke above trend growth.
** Some liberty was taken in matching periods of home price with housing cycles. Local markets can and do show leads and lags relative to 'national' cycles.
'nil' indicates that the price movement did not break away from trend.
n.m = not meaningful.
Source: Canadian Real Estate Association, RBC Economics Research

Table 3

Long-run annual average price increase

In percentage

	Nominal	Real
Vancouver	6.8	3.5
Calgary	4.8	1.3
Edmonton	4.4	1.0
Toronto	6.1	2.6
Ottawa	5.6	2.2
Montreal	4.8	1.6
'Big Six' average	6.0	2.6
Canada (all markets)	5.6	2.2

Source: CREA, Statistics Canada, RBC Economics Research