Insanity of housing conditions

Hilliard MacBeth

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The torrent of news regarding residential real estate in Canada and related matters such as mortgage financing and the instability of at least one lender accelerated last week.

The uproar around the news that Canada's largest alternative lender had to seek emergency funding meant that almost everyone involved ignored the release of CMHC's quarterly assessment of the risks facing the housing market.

There are some interesting tidbits in the report. And I would like to suggest a new category to their proprietary risk assessment ranking, borrowed from comments about the U.S. housing bubble of a decade ago.

The report from Canada's government-owned housing insurance agency, CMHC, assesses the degree of risk and overheating in the housing market.

The previous report in January 2017 included a "red alert" warning regarding Canada's housing market. This month's report, available here, ranks Canada's housing market status as **red** or "strong evidence of problematic conditions" although one market, Regina, was downgraded from "strong evidence" to "moderate evidence" or **yellow**.

Canada's housing market remains at **red**, which seems correct given Toronto's double digit price growth in the last twelve months and Vancouver's continued extreme pricing.

It's interesting to note that the CMHC ignores financing conditions in their four-factor rating system, as the CMHC is on the hook for payments on mortgages that default for about 40 percent of the value of Canadian residential mortgages. The total value of mortgages outstanding is about $1.4 trillion.

The four factors used to assess the risk are:

- Overheating
- Sustained acceleration in house prices
- Overvaluation of house prices
- Overbuilding

The specific markets that qualify for the **red** ranking — strong evidence of problematic conditions — are Victoria, Vancouver, Saskatoon, Hamilton and Toronto.

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Anyone following the housing market closely would be nodding their heads over four of these. But Saskatoon? That's a headscratcher.

Saskatoon qualifies for **red** because of a decline in real disposable income and evidence of overbuilding. As well, the report mentions that rental vacancies are about 10 percent, well above the threshold for trouble in that category which is 7.1 percent.

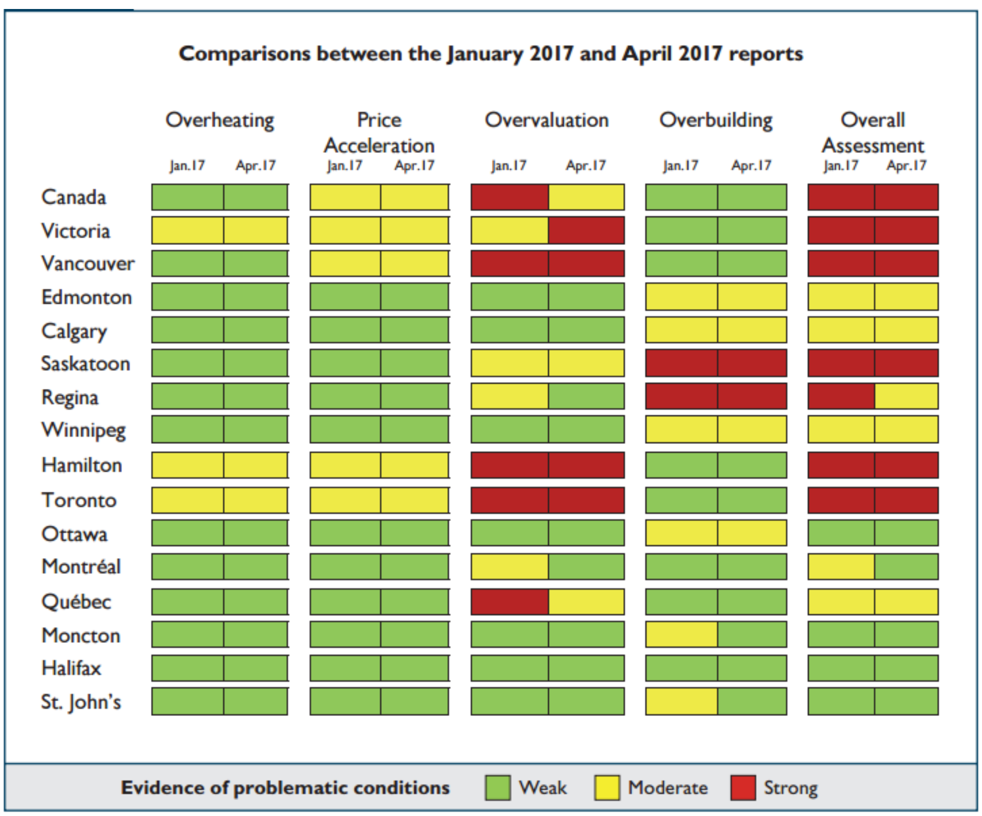
On the other hand, Edmonton and Calgary are ranked at **yellow** — moderate evidence of problematic conditions.

The two largest Alberta cities escape the "strong evidence" ranking partly because house prices are weakening, it seems.

The problems in Vancouver and Toronto continue and that's why the **red** ranking applies to those cities and Canada overall. Issues cited are:

- Overvaluation
- Price acceleration
- Lack of listings
- Declining inventories

For Toronto the report also mentions that there isn't sufficient income growth and population growth to justify the price increases.

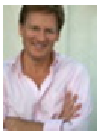


Source: Canada Mortgage and Housing Corporation

As far as it goes this report is useful reading.

But where's the assessment of the impact of the changes to the rules for mortgage qualifications and availability of insurance? The rules were tightened quite dramatically by the very same CMHC that puts out this report. But there is no mention of the potential impact of the rule changes on availability of mortgage financing and house prices. And what about the extreme levels of unaffordable house prices in the two most overheated Canadian markets?

As author of *The Big Short* Michael Lewis said:



"The simple measure of sanity in housing prices, Zelman argued, was the ratio of median home price to income. Historically, in the United States, it ran around 3:1; by late 2004, it had risen nationally, to 4:1. "All these people were saying it was nearly as high in some other countries," says Zelman. "But the problem wasn't just that it was four to one. In Los Angeles it was ten to one and in Miami, eight-point-five to one."
― **Michael Lewis, The Big Short: Inside the Doomsday Machine**

Source: W. W. Norton & Company

So the CMHC could use the simpler factor of the median house price to income ratio instead.

The median house price to median household income level in Canada and in each of the Canadian cities is easily measured. The CMHC would find that those ratios in Toronto and Vancouver far surpass the extreme levels in the U.S. at the peak, which was between 4.0 and 4.5. At the nadir of the correction in 2010 that ratio dropped to below three times.

The current level in Toronto for single family homes would be more than 10 times, while Vancouver has been above 10 times for several years. Those levels for unaffordability are more extreme than Miami and Los Angeles before those markets crashed.

To use the colourful language of the author of *The Big Short* that's the very definition of insanity. So I propose that we call the housing conditions in those two markets **— insane**.

What colour could be used for this new proposed category for extremely problematic conditions? I'd welcome any suggestions.

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