Better Dwelling – March 2, 2023

Canadian Real Estate Affordability Got Worse With Higher Rates, What Gives?

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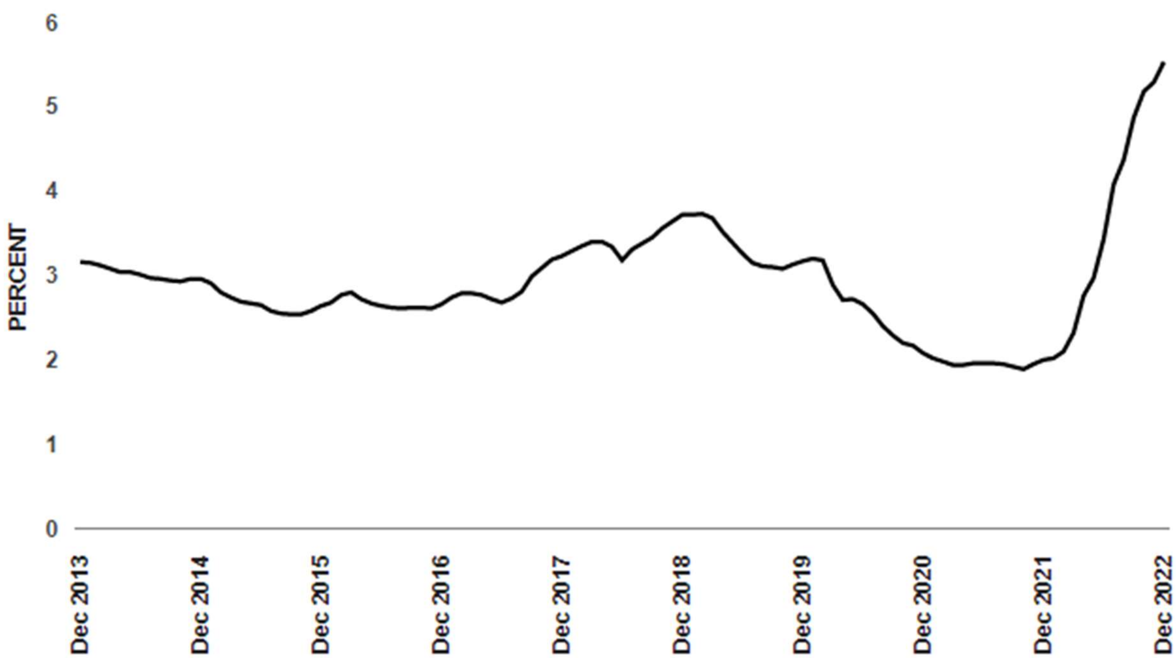
Canadian real estate prices are falling with higher mortgage rates, but has it made it easier to buy? **Bank of Canada** (BoC) data for December's new uninsured mortgage loans shows the highest rates in well over a decade. Interest costs are rising faster than prices are falling, meaning worse affordability. The hiccup is due to the speed at which rates increased, and affordability is expected to improve in the coming months.

Canadian Mortgage Rates Have Surged To The Highest Level In Over A Decade

Mortgage rates are on the climb, which isn't news to anyone in Canada. It's the speed they climbed that's remarkable. Average interest on a new mortgage jumped 0.24 points to 5.53% in December. It was 3.53 points higher than a year before, more than doubling the record low recently experienced. Canada hasn't seen a mortgage rate this high since the Great Recession.

Canadian Mortgage Rates Have Been Surging Higher

The average rate paid on new residential mortgages in Canada.



Source: Statistics Canada; Better Dwelling.

Prices have yet to reflect the full increase in mortgage rates, despite coming down from peak. Home prices peaked in March 2022, the same month the BoC began raising rates. Over that time, prices dropped 17.5% (-$151,300) from the record high to the latest December 2022 mortgage data release. It's a big discount, and helps when it comes to those prohibitively high down payments.

However, the industry is quick to point out this hasn't helped with affordability. Monthly mortgage payments for a benchmark home at the average contract rate went from ~$3,150 to ~$3,650. It's a sharp increase for less than a year, especially if you're on a budget or a cashflow negative investor.

A common take shared by mortgage professionals is that the total cost of a house is much higher. Using the lifetime cost of principal and repayment, and averaging the contract rate, the math checks out. A peak benchmark home would cost $915,000 over 25 years, while one in December 2022 is closer to $1,275,000. Not much of a price drop in the end, eh? There are a few caveats here though, even ignoring the lack of feasibility when it comes to using stimulus rates for the whole mortgage life.

Rising Interest Rates Take Time, and The BoC's Rush Doesn't Change That

The BoC fell behind the curve, raising rates significantly later by misreading inflation. Their own research shows a move in rates requiring 18 to 24 months to be fully reflected at market. If we assume January 2023 was the last hike, that means the impact won't be fully seen until the middle of next year. If rates keep climbing, as many prominent economists are forecasting, even later.

Just because the BoC started late doesn't mean it can cram in the time lost by a bad read. That take is the central banker's equivalent of needing to look good this weekend, so you do 5,000 sit ups and hope it cancels out the past two years of gains. Hopefully it happens, but it won't. The market needs time, just like it took time to become bloated.

Matching the March 2022 peak-price payment affordability requires a big drop. Mortgages at December 2022 levels require a benchmark home to drop 12.5% to fall to $630,000. That's a level well within range from **Oxford Economics** and **Fitches'** forecast.
Even **BMO** and **RBC** are around there. That helps with the issue of down payments, but payments weren't "affordable" at peak.

Affordability isn't always achieved by falling prices or cheaper mortgages though. Many firms see price stagnation, and higher wages working together. This would see the real cost of housing fall, even if sticker prices don't. By creating a stable price environment, the real (inflation-adjusted) burden drops.

Higher rates also shift demand to end-users. Since low mortgage rates reduce operating costs and increase leverage, it attracts investors. The intentional introduction of excess demand helps to increase competition, and price growth. **Investor demand also displaces buyers**, since they're better financed. An RBC executive stressed this point when he explained investors **replaced first-time buyers in their portfolio**. Yeah, we've reached the point where banks discuss excess credit.

Did higher rates make housing cheaper? Not yet, the opposite happened—as anticipated. Though cheap financing doesn't really help end-users when they face prohibitively high down payments and are outbid by investors with more leverage and incentive, fueled by those rates.

As higher rates work their way through the economy, affordability will improve with healthier demand.