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Bank of Canada expected a steeper home price decline. Why it could still come

 Craig Lord || October 26, 2023

The Bank of Canada says home price drops driven by the recent hikes to interest rates weren't as steep as monetary policymakers would usually expect, thanks largely to a "structural" lack of supply.

But economists who spoke to Global News say the housing correction likely isn't finished, with more declines to come.

Carolyn Rogers, senior deputy governor at the Bank of Canada, discussed the central bank's view of the housing market on Wednesday after holding interest rates steady for the second consecutive time.

She said that the housing market has been more resilient to rate hikes to date than historical patterns would have suggested.

Rogers explained that home purchases are among the most sensitive parts of the economy to respond to interest rate changes, as they're big-ticket items typically bought with a loan.

"As interest rates come down, house prices will move up a bit and they'll come off as interest rates come back up," she said of historic norms.

"We haven't seen that same dynamic," Rogers continued.

"They've come off a bit this time, but we're not seeing, relative to the degree of rate increases, the decline in house prices that we would expect."

Home prices did see a material drop in the first stages of the Bank of Canada's tightening cycle.

Between March 2022 when the central bank began its rate hikes to January 2023 when it announced a "conditional pause" in tightening, Canadian Real Estate Association data shows an 18-per cent drop in the aggregate benchmark price of a home.

After that point, home prices rose another eight per cent in the spring rebound before peaking again in June, with a relatively slower decline in aggregate prices observed nationally since then.

Stephen Brown, deputy chief North America economist at Capital Economics, tells Global News that the housing correction proceeded "broadly" as expected in the first stage of the Bank of Canada's tightening cycle.

"Really, it's that rebound that was the surprise," he says of the spring resurgence.

Home prices might have further to fall

From the Bank of Canada's view, the "structural lack of supply" of homes has been a barrier to a steeper housing correction.

The Canada Mortgage and Housing Corp. has said the country needs to add some 3.5 million housing units to restore affordability in the market by 2030.

"Really, until we address that supply issue, interest rates on their own are not going to help us get back to a housing affordability situation," Rogers said Wednesday.

Rachel Battaglia, an economist with RBC, agrees that home prices have been "buoyed" by a lack of available supply in spite of higher ownership costs tied to rising interest rates.

The most recent easing in home prices since June has come with more regional variation than the downturn of 2022, Battaglia notes. Canada's most expensive housing markets in Ontario and British Columbia have taken a harder hit while some cities in Alberta like Calgary are continuing to see growth.

She attributes the resilience of Alberta's housing markets to the lower debt-to-household income levels in the province and relative strength of the commodity-rich western economy.

"This current correction period doesn't appear to be as all-encompassing as the last, for now," Battaglia says.

But both Brown and Battaglia tell Global News that they believe home prices have further to fall as the pain of higher interest rates takes hold on homeowners in the months ahead.

"The downturn is likely to last a few more quarters," Battaglia tells Global News.

Unlike last time the Bank of Canada's policy rate was on pause, fixed mortgage rates tied to bond yields have not eased — something that helped to give some buyers a leg up in the housing market in the spring, Brown says.

This time around, Brown expects higher interest rates will continue to drag on home resales, driving a price decline of roughly five per cent from today's levels.

TD Bank economist Rishi Sondhi echoed Brown's forecast in a report released Thursday, calling for a five-per cent drop in average prices and a 10-per cent drop in sales activity by the end of the first quarter of 2024, at which point he expects activity to pick up again.

Mortgage holders feeling vulnerable

Brown's estimates for the housing correction assume there won't be a high degree of forced selling among current homeowners, many of whom are feeling stressed about renewing their mortgages into a higher interest rate environment.

A Royal LePage report released Thursday shows 31 per cent of mortgage holders are set to renew in the next 18 months. Of that cohort, 74 per cent say they're worried about the impact of higher interest rates, according to the survey based on Nanos polling between Sept. 8-14.

Despite anxiety among homeowners, the Bank of Canada's latest Monetary Policy Report released alongside Wednesday's decision shows higher rates haven't yet caused too many problems in the mortgage space.

While the central bank indicates that "financial stress" has risen among households since the pandemic, it finds that delinquency rates for mortgages remain near "all-time lows."

The same can't be said for other types of credit, which are seeing a growing share of borrowers falling behind on payments by 60 days or more, the report showed. It singled out delinquency rates on car loans as surpassing pre-pandemic levels as of late.

While the Bank of Canada report says indicators of financial stress "point mainly to non-mortgage holders," Brown notes it would be a mistake to assume the people struggling to make payments on car loans and credit card debt aren't also the same ones facing rising mortgage costs.

Consumers will typically do everything in their power to avoid missing mortgage payments and having to sell their home, he says, which could mean defaulting on other loans first.

When people cut their spending elsewhere to stay on top of rising mortgage payments, that's a force that can chill the economy and lead some companies to job cuts, Brown explains. That loss of income can act as the final domino that forces a homeowner to default on their mortgage.

“We see weakness in those auto loans, credit cards as a precursor to a weaker economy and job losses, that then triggers higher delinquency rates for mortgages,” he says.

If the Bank of Canada feels it has to keep its policy rate higher for longer, and the economy sees a deeper downturn than expected, Brown says a steeper price drop of 10-20 per cent is in the cards next year.

“If the bank is forced to keep interest rates high for longer … then it increases the risk that we see job losses and therefore forced home sales and therefore a much, much greater weakening of the housing market,” he says.

Bank of Canada governor Tiff Macklem said Wednesday that the economy’s pathway to a “soft landing” that tames inflation without falling into a recession is “narrower.”

RBC is projecting Canada’s unemployment rate will rise a full percentage point from today’s levels to 6.5 per cent a year from now.

Battaglia says that while the jump might seem significant, 6.5 per cent unemployment is not too high by historical standards. Additionally, that rise doesn’t necessarily all have to come from job losses; Canada’s overall employment has been growing in 2023 even as the jobless rate rises thanks to record levels of immigration feeding into the country.

Battaglia also pointed to Canada’s mortgage stress test, which makes homebuyers and mortgage renewers qualify at higher rates to guard against potential jumps in the cost of borrowing, as giving another “safety net” to the housing market to avoid a wave of forced selling.

A gradual rise in unemployment and “quieter sales” in the coming quarters should help swing conditions into the housing market back to buyers’ favour, she says.

Rogers said that the Bank of Canada will provide more detail on how households are faring amid higher interest rates in its upcoming financial system review, set for release next month.