THE GLOBE AND MAIL

OPINION

What’s next for Canada’s housing market in this age of uncertainty?

It is very unlikely that our housing market will look the same 10 years from now

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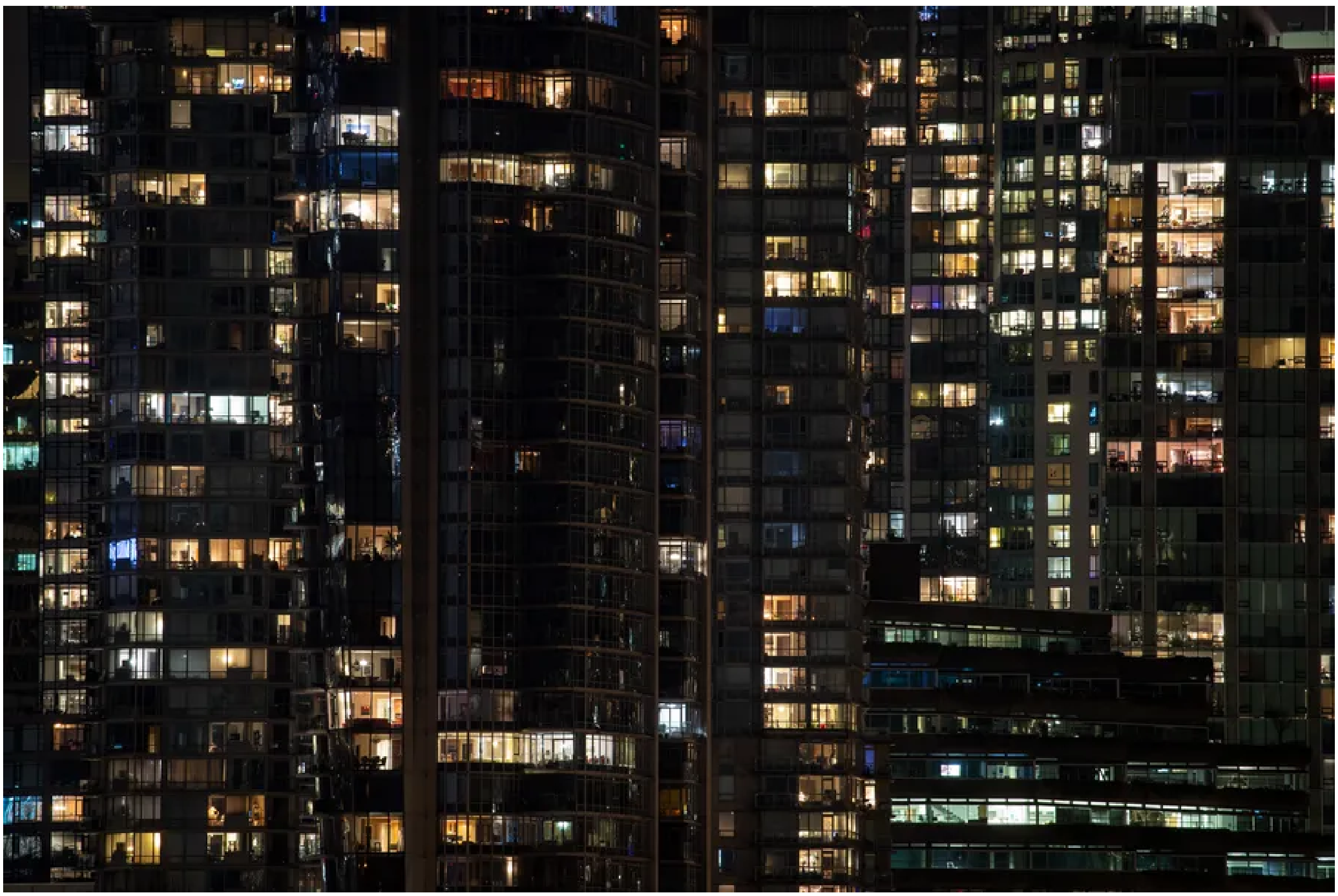

Condo units light up at night in Vancouver's Coal Harbour neighbourhood. Vancouver is one of the least affordable places in Canada to buy property or rent an apartment, but even in many smaller cities housing is increasingly out of reach.

DARRYL DYCK/THE CANADIAN PRESS

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The state of the housing market is a perpetual preoccupation for Canadians. Home prices have been rising faster than inflation for decades, but prices have really accelerated during the COVID-19 pandemic, putting even more pressure on housing affordability.

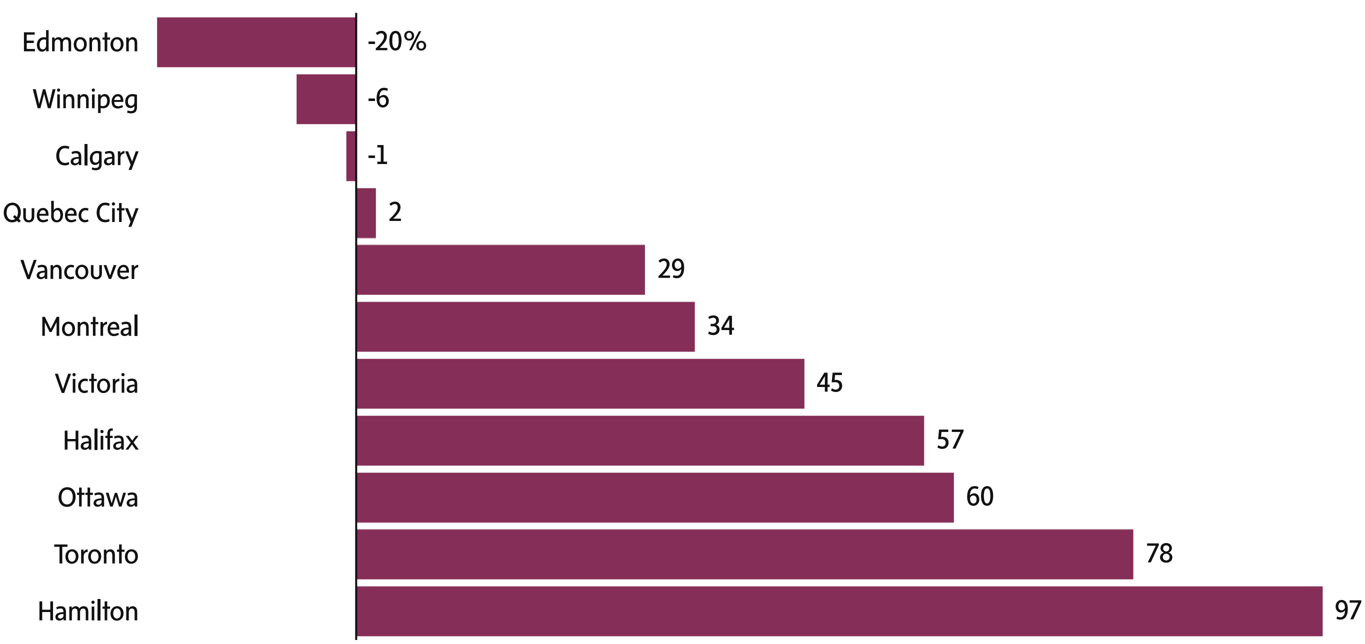
This has prompted a renewed debate as to whether our housing market is in a bubble. If it is, we face the risk of a significant and unpredictable decline in home prices when it finally bursts, which is unnerving for homeowners but especially so for prospective buyers.

The fact that economists have been engaged in a housing bubble debate for several years should be a warning that no one really knows what housing prices ought to be. We should never confuse confidence with certainty, especially in economics.

Careful economists usually point to the limitations of their models, often adding the phrase "all other things equal" to their conclusions, whichever side of the debate they are on. That is because there is always a possibility home prices are being driven by something they have not considered, in which case all other things are not equal at all.

Canada's housing affordability gap, 2021

The percentage difference between actual house prices and affordable house prices for the average household, based on borrowing capacity



THE GLOBE AND MAIL, SOURCE: PARLIAMENTARY BUDGET OFFICER

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It is noteworthy that rapid housing price inflation is not unique to Canada. There are at least two important drivers of housing prices common to all countries that have been getting less attention than they deserve.

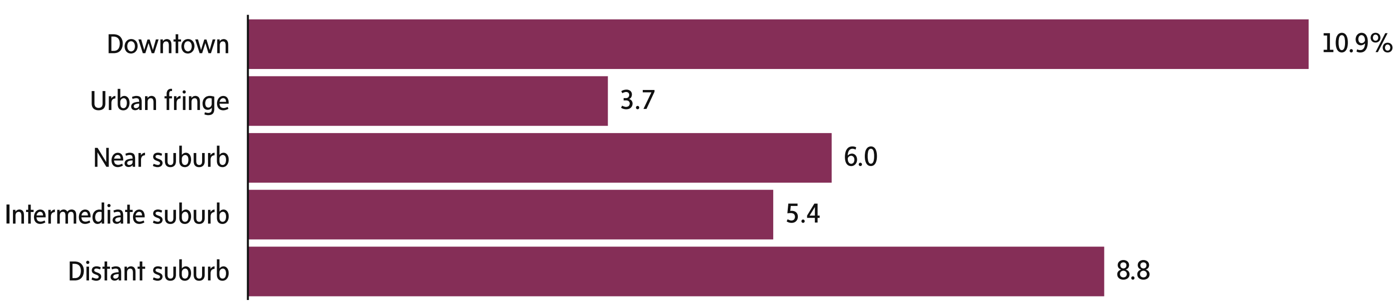
The first driver is population growth. Obviously, failing to build sufficient housing to accommodate new arrivals to Canada will translate into upward pressure on home prices. The recently released report of the Ontario Housing Affordability Task Force documents this very well and suggests several ways of boosting housing supply, such as allowing greater density in established neighbourhoods and requiring higher-density building in the suburbs.

However, even if we were somehow to build exactly the right number of new homes to meet rising demand, existing home prices would still trend upward.

The reason for this price uptrend is that time is money. As the population of a city grows and prompts new housing construction in the suburbs, each new homeowner finds themselves a little further away from downtown than the previous one. The trip downtown becomes a little longer, in terms of both distance and time spent on congested roads or on public transit. That can add up to a lot over a lifetime.

To shorten their commute, people have always been willing to pay more to live closer to the centre of a city. Therefore, as a city grows outward, the prices of existing homes closer to the centre go up.

Population growth rate by driving distance to downtown, census metropolitan areas, 2016 to 2021



THE GLOBE AND MAIL, SOURCE: STATISTICS CANADA, NOTE: THE DRIVING DISTANCES FROM DOWNTOWN TO URBAN FRINGE, NEAR SUBURB, INTERMEDIATE SUBRUB AND DISTANT SUBURB ARE LESS THAN 10 MINUTES, 10 TO 20 MINUTES, 20-30 MINUTES, AND 30 MINUTES OR MORE, RESPECTIVELY.

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Canada's relative attractiveness as a destination for immigration has never been higher, and the federal government plans to take advantage of that by welcoming more than 430,000 immigrants into the country this year, a number that will rise to more than 450,000 by

2024. It follows that existing home prices in most Canadian cities will continue to rise – all other things equal, of course.

The second home-price driver common to most other countries is very low interest rates. Low interest rates encourage more people to become homeowners earlier in their lives, boosting demand and causing prices of existing homes to be bid higher.

This effect is well understood, but a home should also be thought of as an asset that delivers services to the owner long into the future. Renting a condo for $2,000 a month for, say, 50 years, will cost $1.2-million altogether, before allowing for inflation. Buying the condo today is equivalent to receiving $2,000 a month for the next 50 years.

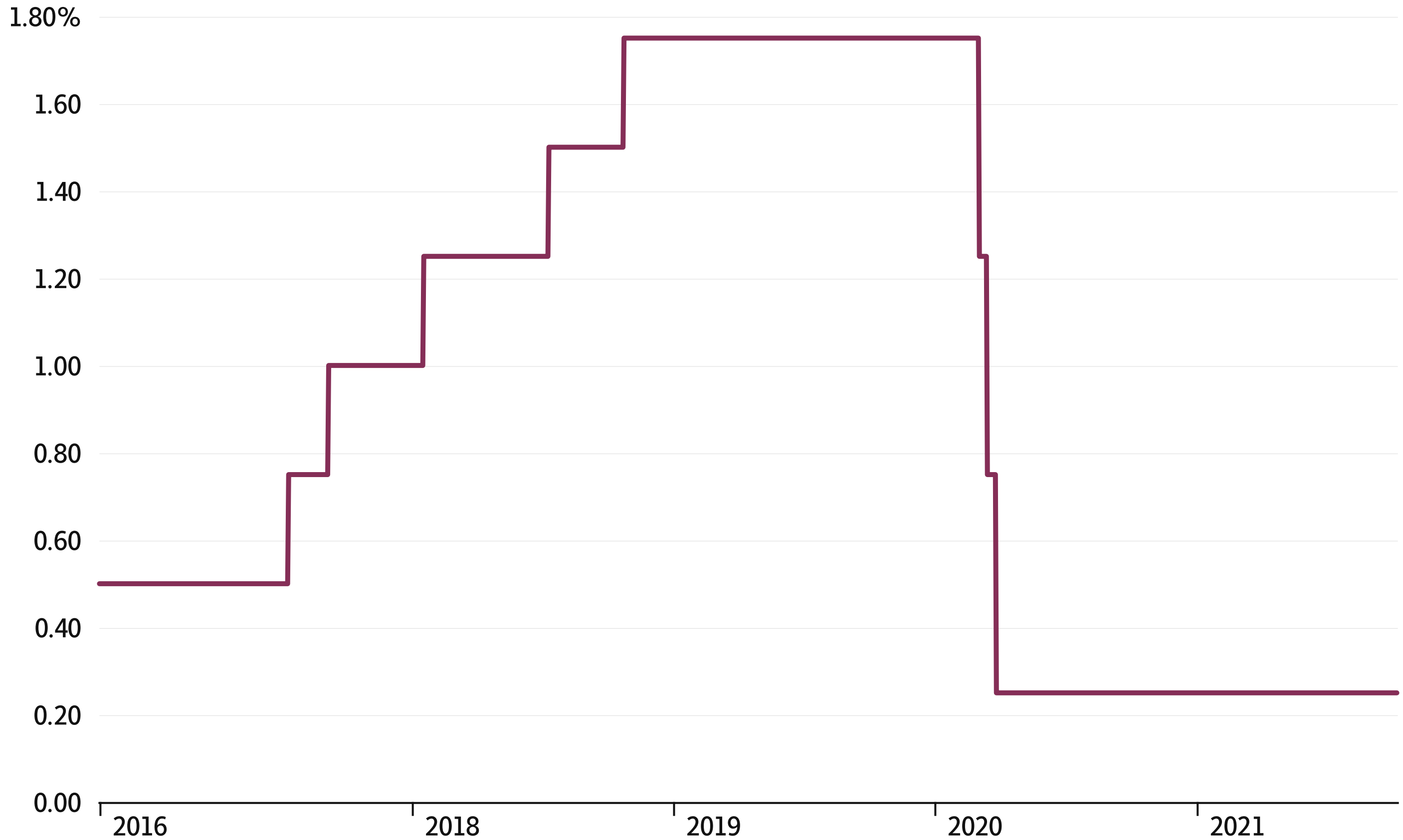
The present value of that future income stream is higher the lower the rate of interest. Therefore, the price one is willing to pay to own that home today instead of renting it increases when interest rates fall. This asset valuation effect is the same as the one that boosts the stock market, as shares also deliver a stream of earnings long into the future.

Since interest rates are as low as they have ever been, it follows that house prices have been boosted globally by this asset valuation effect, in much the same way as the stock market has.

Further, it follows that as interest rates rise toward more normal levels, house prices could decline – all other things equal, of course.

Bank of Canada interest rate

Daily overnight target rate, per cent



THE GLOBE AND MAIL, SOURCE: BANK OF CANADA

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All other things are not equal, however. For home prices to fall significantly as interest rates edge higher, the downward asset valuation effect would need to overwhelm the persistent upward pressure on prices coming from continued population growth due to immigration.

The net effect of these two contrary forces is difficult to forecast, but if the outcome was a decline in prices, this would certainly not constitute proof that we are in a housing bubble today. In a bubble, prices rise – and later fall – for purely speculative reasons, not because of changes in fundamental price drivers.

Obviously, there are many other fundamental factors one could consider in trying to forecast home prices: New housing construction could accelerate; a higher share of new building could be centrally located high-rises; zoning changes could allow for more densification in old urban neighbourhoods; the continuing shift toward hybrid home/office work arrangements could prompt even more people to locate further from urban centres. The more you think about housing, and the more drivers you consider, the more difficult it becomes to declare the housing market is in a bubble.

In short, the outlook for home prices is highly uncertain. There is a risk that home prices will decline from present levels, but it is far from a certainty. They could simply keep rising.

A decline in house prices is probably not the biggest risk homeowners face, anyway. When a market bubble pops and prices fall, it creates a huge problem for people who need to sell their home, as the sale proceeds could be less than their mortgage. In contrast, those with no intention to move can simply take the long view, as history shows house-price declines are usually reversed over time.

Canada's immigration plans suggest a future price correction could follow the same pattern. Even if an unexpected drop in housing prices causes long-term homeowners to feel less wealthy and to rein in their household spending, the associated slowdown in the economy would be temporary.

A residential neighbourhood on Squamish Nation land in North Vancouver.

DARRYL DYCK/THE CANADIAN PRESS

The biggest risk homeowners face is that they lose their job and can no longer make their mortgage payments. People rarely lose their homes just because the market price falls. However, I would expect job insecurity risks to grow in the next several years and those risks to spread to the housing market. The reason is that powerful forces acting beneath the surface of the world economy will generate rising economic and financial volatility. These forces are akin to the tectonic forces grinding beneath the Earth's crust – they move slowly and predictably, until suddenly they collide and give rise to economic and financial earthquakes that can cause a lot of damage.

The most important of these forces is technological progress. We have recently entered the Fourth Industrial Revolution, which is based on digitization, artificial intelligence and advances in biotechnology. Like the steam engine, electricity and the computer chip industrial revolutions that came before, this technological leap will deliver untold benefits to society – along with painful structural change, rising income inequality and increasingly polarized politics.

This is all happening at a time when other major forces are also growing in intensity: the population aging as the postwar baby boom matures, a spectacular rise in government indebtedness and the need to engineer a historic energy transition to achieve net-zero carbon emissions.

This complex cocktail of unusual forces contains the potential for unpredictable bouts of economic and financial volatility in the years ahead. Past interactions between technological waves, growing income inequality and rising indebtedness have led to depressions (1873-96, 1929-39) or stressful jobless recoveries (early 1990s, early 2000s).

The Fourth Industrial Revolution could disrupt up to 15 per cent of the global work force, according to the World Economic Forum. When we factor in a rapidly aging population and the need to transition to net-zero carbon emissions, uncertainty about the future verges on the incalculable.

An electronic ticker shows market activity at the Toronto Stock Exchange Tower.

CHRISTOPHER KATSAROV/THE GLOBE AND MAIL

Just as earthquakes are understood and yet are a complete surprise when they do occur, our economic environment will become harder to forecast as these forces build.

Company sales will vary unpredictably, causing household employment and income to become less secure. Short spells of unemployment will become more frequent for some people – punctuated by sudden worker shortages when the economy recovers – and technological advances will cause longer spells of unemployment for others.

Employment and income volatility, combined with more variability in interest rates, will spill over into the housing market. Home buying and selling activity and housing prices will also become more variable, both up and down. Our biggest financial decisions will become riskier, whether they are made at the kitchen table or at the boardroom table. I call it the next age of uncertainty.

Many people will see it as the job of governments and central banks to protect us from this rising tide of risk. However, central banks will have less room to manoeuvre, with interest rates likely to remain lower than in the past, and government fiscal capacity will be constrained by the overhang of pandemic debt and the rising needs of an aging population. Moreover, the economy itself will become far less predictable.

Economic models may need to be rebuilt to cope with this new environment, just as they needed to be rebuilt after they failed to anticipate the events of the 1970s.

Accordingly, companies and their employees will face this rising tide of risk together. Households will carry a higher stock of savings, so they are more prepared for temporary spells of unemployment.

Companies will carry more liquidity, too, but they will also invest more capital and human resourcing in risk management to improve their resilience and convert rising risk into value for shareholders.

Framers work on a house under construction in Airdrie, Alta.

JEFF MCINTOSH/THE CANADIAN PRESS

Given the tectonic forces in motion, one of the biggest risks confronting companies will be worker shortages. Already, companies that cannot demonstrate progress on the way to net-zero carbon emissions are being punished by their shareholders, their banks, their customers and their employees. In future, companies that fail to attract and retain the right people to succeed will be punished in the same way.

These forces point to a progressive shift in market power from employers to employees. This could show up in many ways. Today, we are watching as employers organize hybrid work models, in which operational requirements are balanced against employee flexibility and working from home. Tomorrow, perhaps we will see a growing number of employers offering in-house child care to strengthen employee retention.

Since the biggest source of risk faced by a household is the decision to purchase a home and then pay for it, employers looking for ways to foster employee retention could see an opportunity. They could help employees manage housing risks by guaranteeing an employee's mortgage with a bank or perhaps offering to act as mortgagor themselves. It is even possible that employer-owned housing will emerge as a form of compensation and risk management.

Any compensation arrangement that helps to ensure a stable, productive work force and therefore more stable company profitability would be rewarded by investors. In a world of scarce workers, what matters to the employee matters to the employer, so progressive risk sharing between employee and employer seems a likely evolutionary path.

People abhor volatility and risk. Even if they acknowledge risk is two-sided – that luck can be good, as well as bad – uncertainty is stressful. History has demonstrated good luck dominates bad luck, on average, over long time periods. Technological progress justifies optimism about the future.

Along the way, however, households, companies and governments will need to adapt to rising levels of risk, including in the housing sector. Consequently, it is very unlikely that our housing market will look the same 10 years from now.

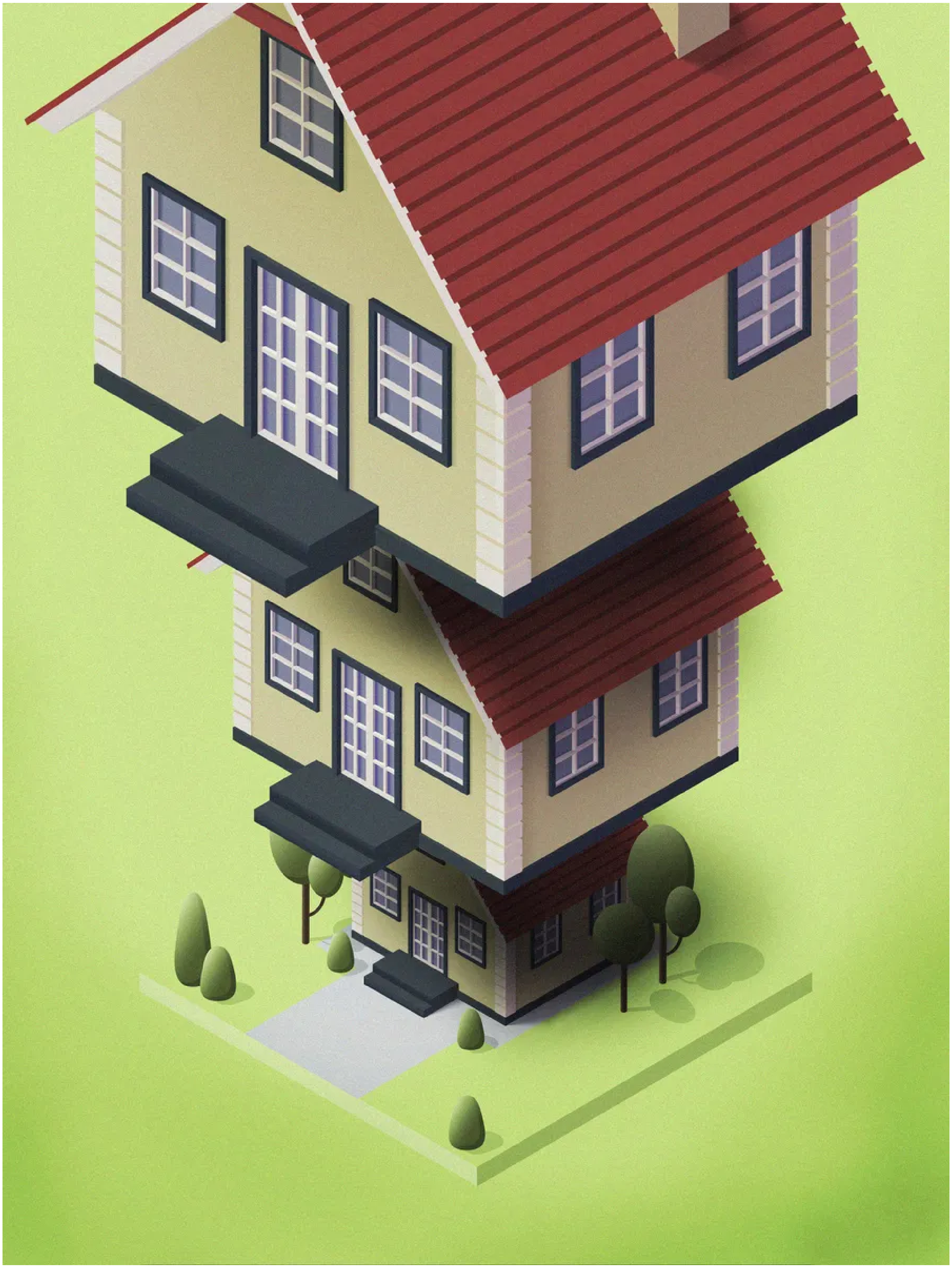

ILLUSTRATION BY KATRINAKU

Canada’s housing markets: More from The Globe and Mail

STRESS TEST

On this episode of the Stress Test podcast, hosts Rob Carrick and Roma Luciw take a trip to Belleville, Ont., for the real story about how a hot market has made housing less affordable in small-town Canada.

ROB CARRICK ON HOUSING

- Despair about affording a home has this immigrant to Canada wondering what kind of country we’re trying to build
- The quiet menace that could slash the value of your home
- Five signs Canada’s housing market is completely bonkers

IN DEPTH

- What happens to your home’s value when your neighbourhood floods?
- Here’s the income you need to afford rent in major Canadian cities
- David Parkinson: Surging housing prices have created pockets of vulnerability that may put the broader economy at risk