Housing Wealth Impacts

Some useful analysis of the current sizzling housing market, and what it might look like if it cooled off significantly, or even if it just failed to keep the current steaming hot pace going.

Today I borrow heavily from a timely article put out this week by RBC Economics, which fits neatly in to the recent narrative we have been discussing in this column. At question: How vulnerable is Canada's economy to a housing downturn? Although most of the heat has been in Toronto and Vancouver, this, of course, has some spillover effect right here in the central interior, as real estate investors and families consider Prince George as a viable alternative.

Government interventions have contributed to take some pressure off the Vancouver real estate market, although it still remains firmly in seller's territory—a trend evident in close to 60% of markets across the country. Housing-related expenditures now account for a record share of the overall economy and have become a key growth contributor. As housing activity looks increasingly unsustainable, how vulnerable is the Canadian economy to a housing downturn?

Housing has played a key role

The rising importance of housing activity to the overall economy reflects a broad mix of factors, from the construction of new homes to the fees associated with robust home sales that are captured in the residential investment component of GDP. This measure— commonly used as a proxy of housing activity in the economy—reached a record high of 7.7% at the end of 2016 nationwide.

In fact, the surprising strength of residential investment was the primary driver behind the Bank of Canada's decision to bump up its latest economic growth forecasts.

Homeowners, feeling flush, spend elsewhere

The pronounced upswing in home sales—and accompanying price gains - over the past decade has no doubt bolstered household spending thanks to homeowners feeling wealthier. Concern that households will curb their spending in the face of a housing downturn is warranted. Rising housing wealth amongst households likely contributed to the record levels of car sales in Canada and an insatiable appetite for renovations in the recent housing upswing. Vehicle purchases, eating out at restaurants, spending on recreation, cultural events and financial services all have a tendency to slow somewhat against a backdrop of declining home sales. This tends to occur over a period of 6-9 months following the beginning signs of a housing downturn. Renovation activity has been exceptionally strong in the period since the 2008/09 recession, making it more susceptible than usual to a housing market downturn. Historically, though, the drop in the value of home renovations tends to be less pronounced than that of homes sales, declining by about one-third of the sales drop.

5% of the economy is highly exposed to a sales slump

Home sales and housing-related spending (for instance, on renovations) don't usually move in lockstep over the housing-market cycle. Real estate commissions and legal costs associated with home sales, however, are highly correlated to sales activity. The lengthy and robust run in home sales led to a tripling of their share of GDP this cycle. For these transactions to continue to add to GDP growth would require the recent run-up in sales activity to carry on, an unlikely outcome given current conditions.

Should sales activity reach a tipping point, homebuilders would curb their development plans. A case in point: When home sales fell by 30% in 1990, activity generated by new-home construction began to decline in the following quarters and subsequently fell by just over 30%. This shaved nearly $10 billion off the economy with the homebuilding share of GDP falling from 4% to just over 2% by mid-1991. In the current market, the direct relationship between homebuilding, transfer costs and existing home sales implies 5% of the economy is highly exposed to a sales slump.

Gauging the (possible) impact

Low borrowing rates, a lack of inventory, speculation, and strong demand fundamentals bolstered the pace of home sales in Canada in 2016 and early 2017. Knock-on effects have emerged in response with new-home construction clocking in at elevated levels, fees generated from sales activity rising and homeowners filling their residences with new sofas and television sets. Tallying up the contributions of everything from the building of new homes to the costs of maintaining and running a home, housing-related expenditures climbed to a record 25% share of the Canadian economy in 2016. Not all of this activity is vulnerable to a downturn in home sales. Close to 15% of the economy has a degree of exposure to a drop in home sales, but only 5% has a strong relationship (close to 1:1 for ownership transfer costs and new home construction).

There is always the risk that households pull back more on spending now than in past downturns given elevated levels of household debt and prospective increases in interest rates. That said, this exercise provides some guidance about how a housing market downturn could play out in the broader economy. For example, based on the historical correlations described above, a broad 30% drop in home resales, and attendant spillovers to building activity, house prices, and consumer confidence could translate into a hit on the economy of around 1-2%, with a drop in ownership transfer costs and new home construction accounting for two-thirds of that decline. We don't expect a downturn similar to that recorded in the early 1990s or even in the United States leading up to the financial crisis. But after Canada's years-long housing-market party, a mild hangover is likely to follow, with important implications for Canada's overall economy.

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