

Report by economist Will Dunning. Will Dunning operates a consulting firm that specializes in analysis of housing markets.

BC Housing Market Overview

This is my third quarterly report for Landcor. I have to say that I am shocked – SHOCKED – by what I have found. Now that I have looked closely at the numbers, a decade's worth of prejudices have been blown away. What I see is a stable market, which has good prospects of remaining stable and healthy for some time. I also see that, as a result of prolonged shortages, housing in BC is fully-priced and a sharp rise in interest rates could be quite disruptive.

There was a time when the BC housing market was in a dangerous interaction with employment, but that was a decade ago.

- Falling interest rates during the first half of the 2000s kick-started a surge of housing sales (in these charts “poly” refers to trend lines that are generated by Excel).
- Strong sales resulted in rapid price growth (see Figure 2), which had three important consequences:
 - 1.) Strong house price growth created a powerful “wealth effect” that boosted job creation to very high levels (see Figure 3).
 - 2.) Rapid rise in prices encouraged home buying, to levels higher than were justified by economic fundamentals – I call this the “speculative motive”.
 - 3.) By mid-decade this combination was resulting in “a mutually re-enforcing upward spiral” – let’s call that a bubble. This kind of situation almost always ends badly – very badly.

Coincident with the popping of the housing bubble in the US during 2007 to 2009, it started to look like BC might follow the same path. But, falling interest rates came to the rescue.

During the past three years:

- Sales have been relatively stable, at a level that is much lower than previous. However, this level of sales is fully justified by economic fundamentals – speculative froth appears to have been removed from the housing market.
- Price growth has moderated.
- During 2010 to 2012, jobs were being created at a healthy pace – somewhere around 1.5% per year. Conversely, recent data (shown in Figure 3) suggests that job creation has plunged - I'll get to that in a moment. (In short, I don't believe that data.)

The sales data in Figure 1 show a drop during 2012, followed by a quite strong rebound. There are some special circumstances that caused this. Effective July 2012 the federal government withdrew mortgage insurance for mortgages with amortization periods exceeding 25 years. The elimination of 30-year amortizations for these mortgages raised monthly payments by the equivalent of a one percentage point rise in mortgage rates. Consequently, home sales dropped sharply across Canada. Since then, two factors have produced a recovery:

- 1.) The impact of the policy change has gradually waned. I estimate that two years later, the negative impact has been reduced by one-half – but this policy continues to cause housing activity to be weaker than it should be, and
- 2.) Secondly, as can be seen Figure 1, mortgage interest rates have retreated this year, which has boosted activity.

All things considered, trends in the BC housing market can be explained by economic conditions and the policy environment. The era of an artificially over-heated market appears to be well in the past.

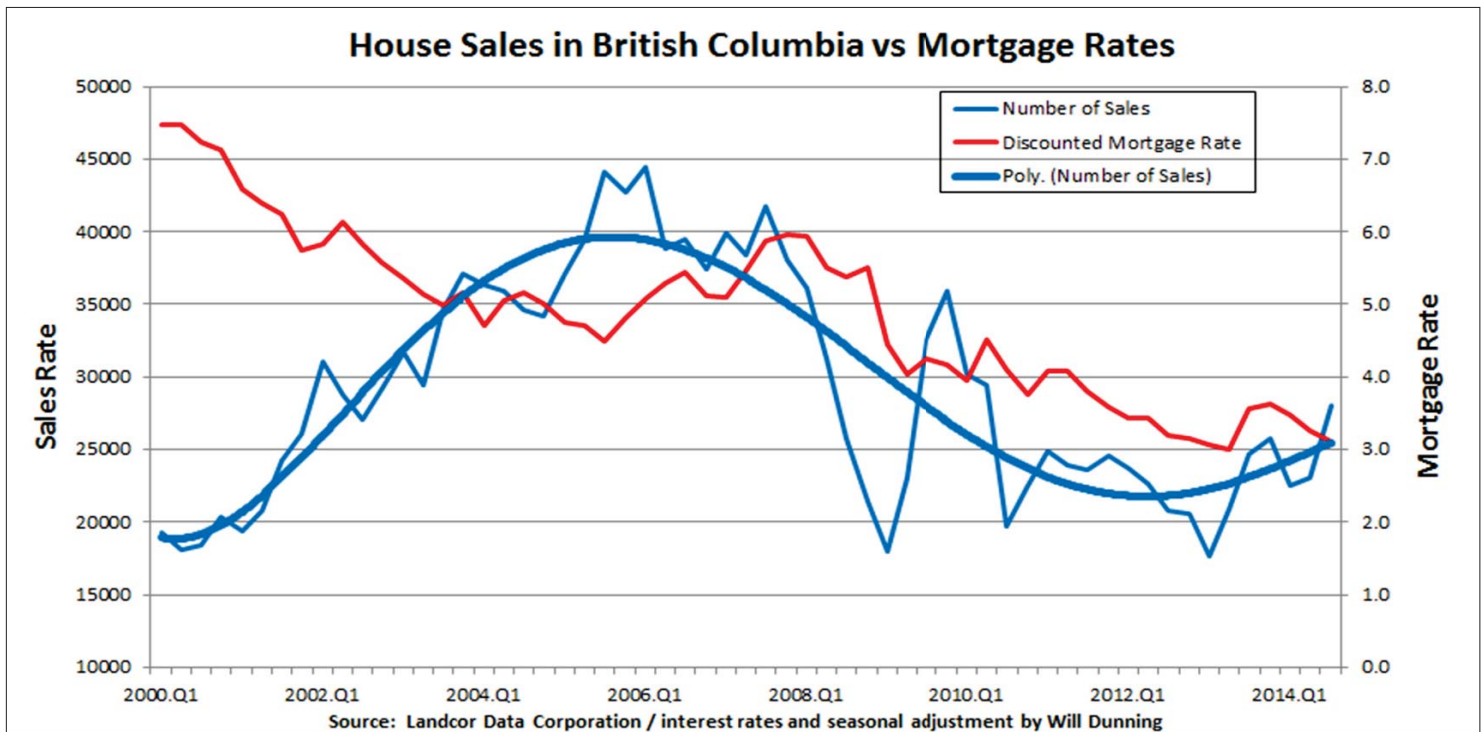


Figure 1

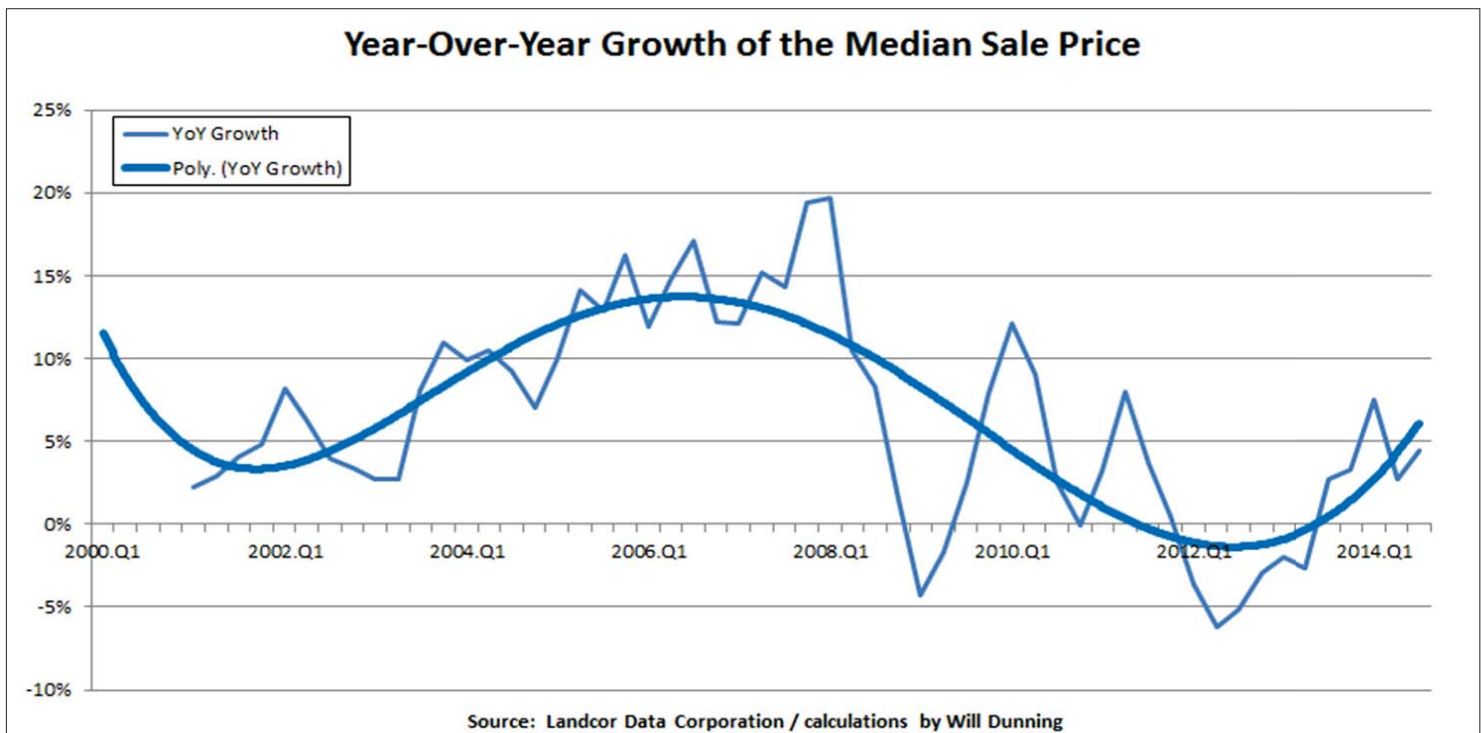


Figure 2

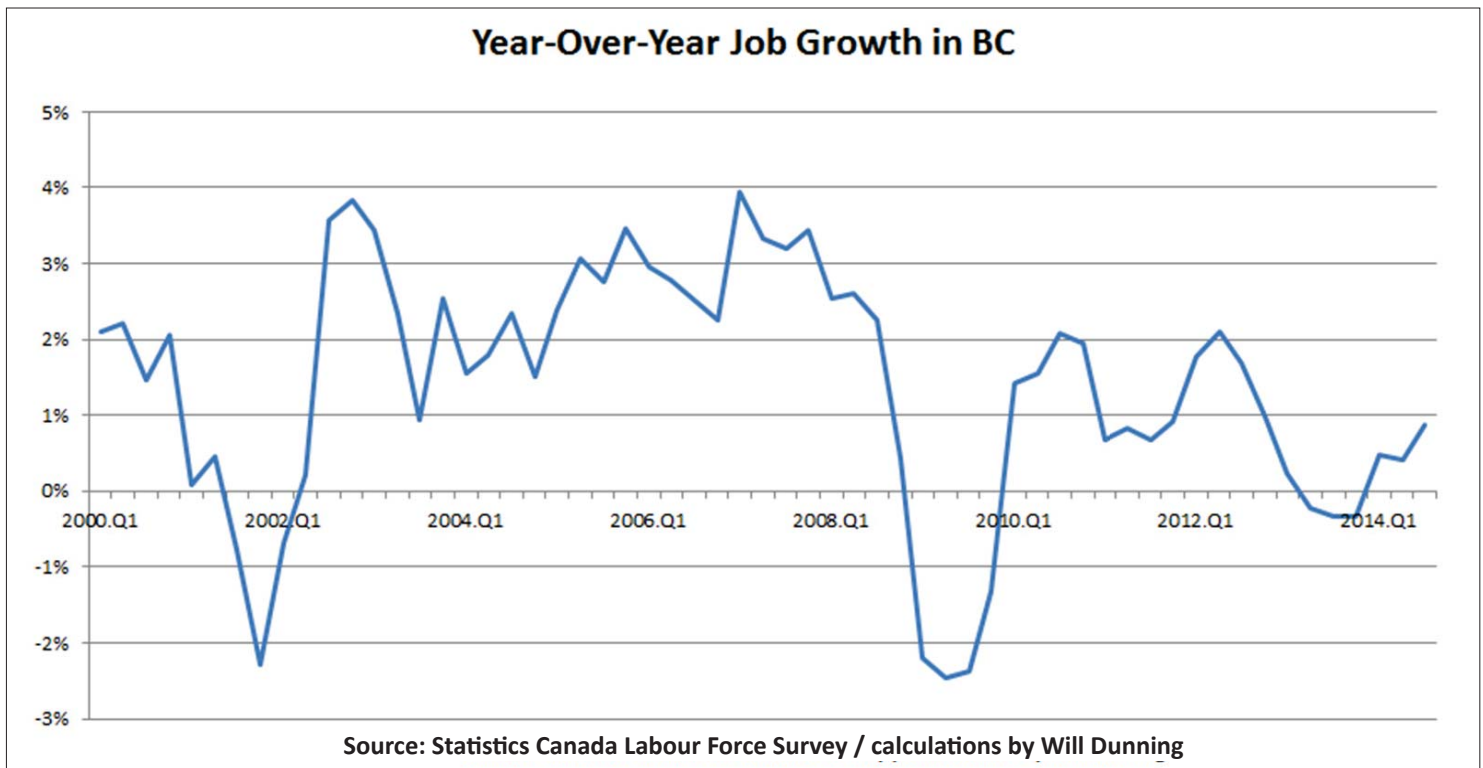


Figure 3

“Canada has the Most Over-Valued Housing Market in the World”

We keep hearing this statement. It is based on some number-crunching by the Organization for Economic Co-operation and Development (“OECD”), which looked at ratios for house prices versus rents over time, across countries. Last year, I published a research report that investigated “How to Dissect a Housing Bubble” (it can be found in the Recent Reports section of wdunning.com). The main conclusion is that the OECD ratio was based on bad data. Recalculating the ratios using data on prices and rents from the Royal LePage House Price Survey, the price-to-rent ratio has increased but much less than is widely believed.

The second major point in that paper is that the ratio of rents-to-prices (after adjustment for taxes and utilities of applicable) is a capitalization rate. Guess what? During the past decade and a half the cap rate for owner-occupied housing in Canada has essentially followed mortgage interest rates. Thus, the rise in the house-to-rent ratio in Canada is not so much evidence of over-heating as it is that the market works!

Moreover, as can be seen in Figure 4, for all of Canada there is now a lot of space between the cap rate and the mortgage rate, meaning that there is room to tolerate a future rise in mortgage rates (at the end of this data in 2013-Q4 there was a full one-point gap; today, the gap would be close to two points). I conclude from this, that in Canada overall, the housing market is not over-heated at present. In this data, there were two periods when cap rates were lower than mortgage rates; when interest rates rose during the “tech bubble” of 15 years ago and just prior to the recession of 2008/09. Those might be seen as periods of over-heating in housing markets, but maybe they were just because interest rates rose prematurely.

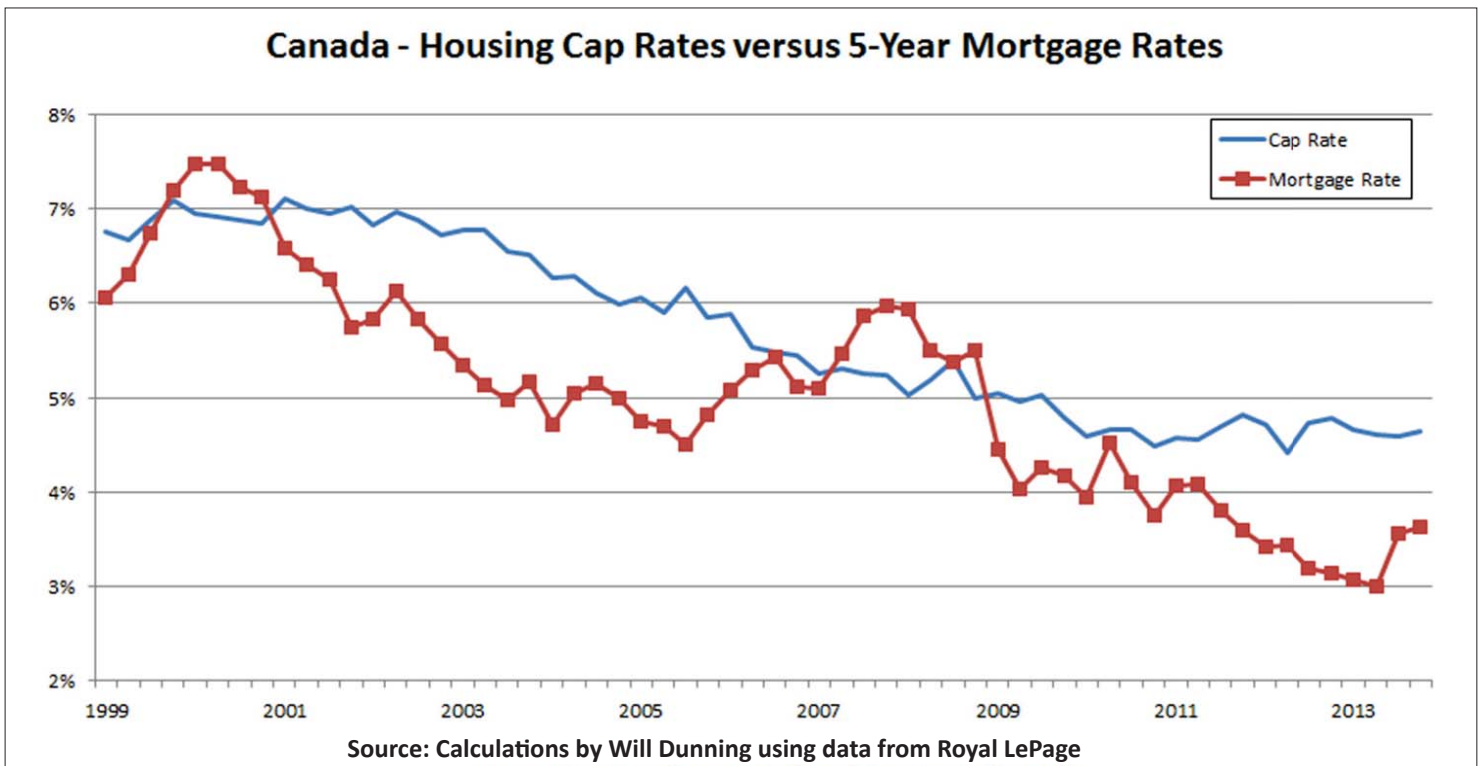


Figure 4

For BC, however, there is less room between the cap rates and mortgage rates. At the end of the dataset in 2013-Q4, the cap rate was almost equal to the mortgage rate. Today, there might be a gap of about one point. In the BC data, there have been more periods that might be considered over-heated. Based on this data, I would say that BC is more vulnerable to higher interest rates than Canada as a whole. So, what's your expectation about interest rates? Interest rates might rise by about a half point during the coming year, and a quarter point per year thereafter. Housing markets can absorb this.

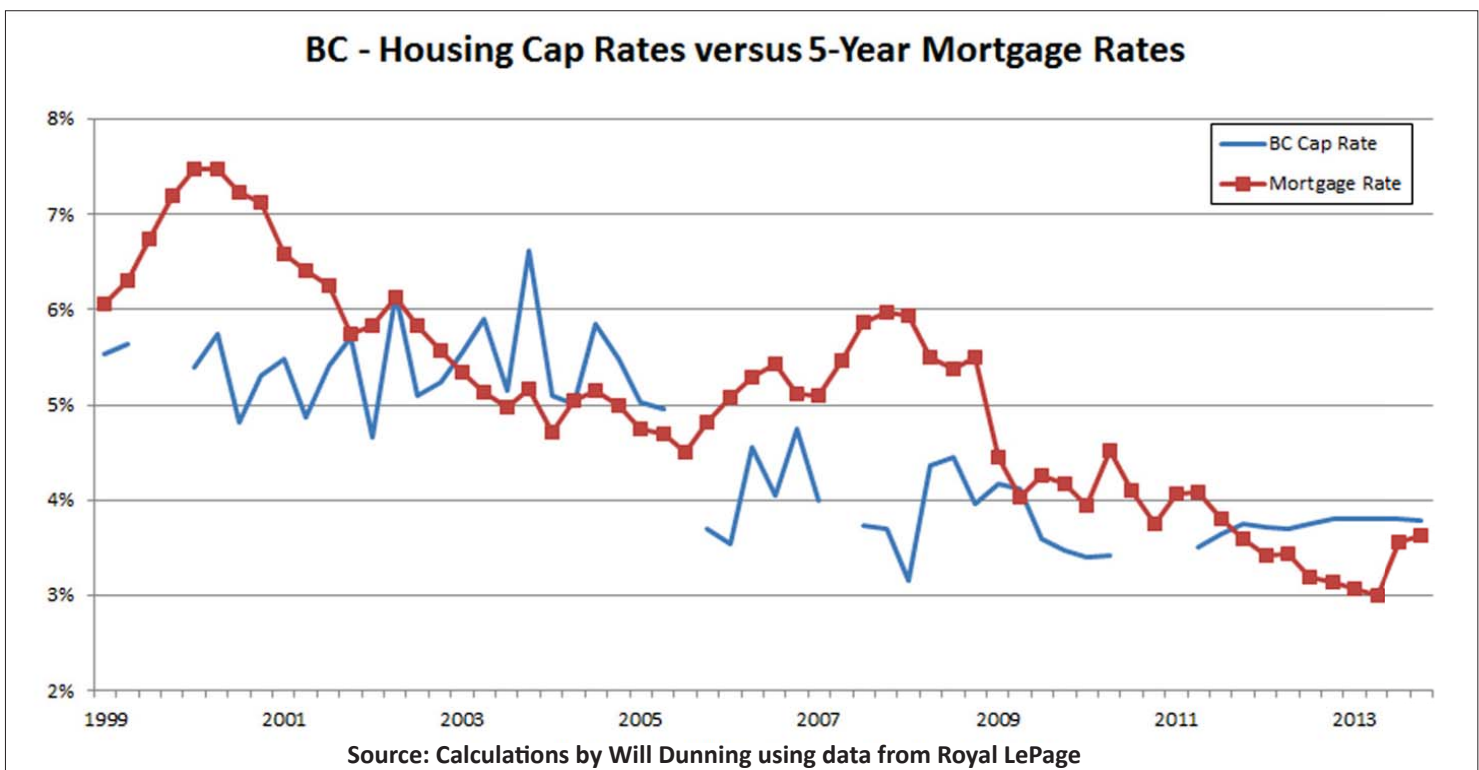


Figure 5*

*For some data points insufficient data is available to complete the calculations

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Employment in BC – a Bad Economy or Bad Data?

The employment data in Figure 3 indicates that BC has experienced a sharp slowing of job creation during the past two years. If this data is correct, it would mean that housing demand will slow in BC.

But, is that data correct? It comes from a sample survey, and like all sample surveys it has a “margin-of-error”, which is a polite way of saying that sometimes it is wrong. Because of the design of the survey, those errors can persist for long periods of time.

Statistics Canada has another survey (“Survey of Employment Payrolls and Hours”, or “SEPH”) which uses data from companies. However, this data comes out almost two months later and it doesn’t get very much attention. Figure 6 contrasts the two datasets (to make it easier to read, I have converted both of the datasets into indexes). The two surveys show very different pictures: LFS (Labour Force Survey) suggests that there has been very little job creation during the past two years while SEPH shows continued growth at just over 2% per year.

Prima facia there is no reason to say which one is right. But, I know that the LFS data can be wrong. Plus, the SEPH data is consistent with what we are seeing in the housing market. Therefore, I am inclined to say that the BC economy is still in quite good health and is still able to support a healthy, balanced housing market.

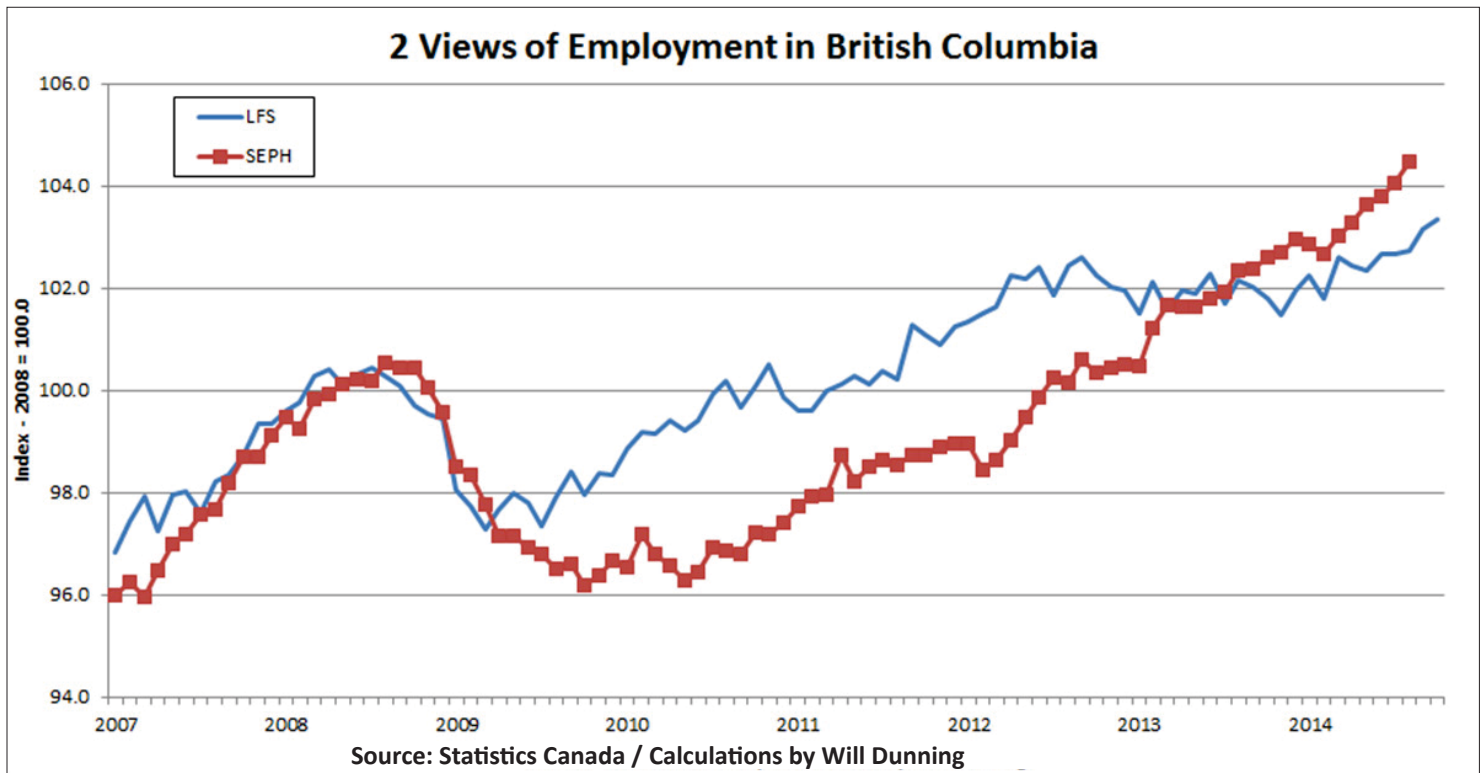


Figure 6

Will Dunning has been analyzing housing markets since 1982. His consulting firm provides custom analysis to clients in the private, public, and non-governmental sectors.

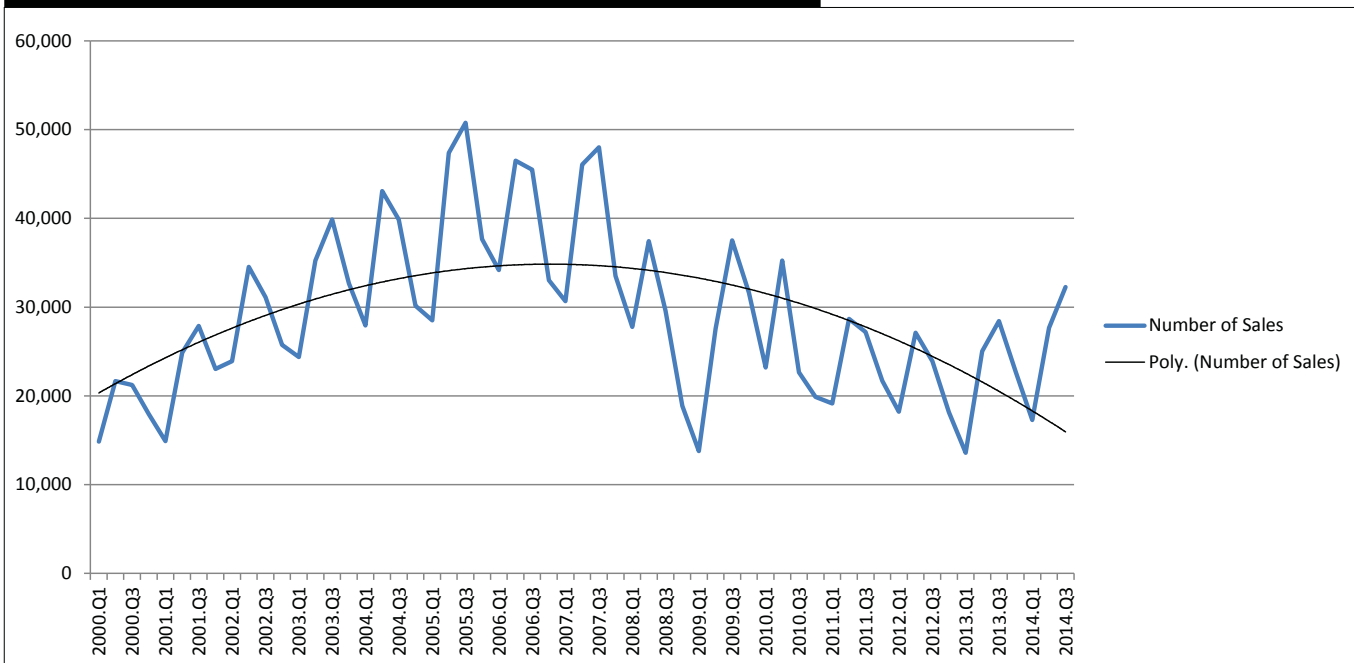
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BC Residential Sales Summary for Q3 2014

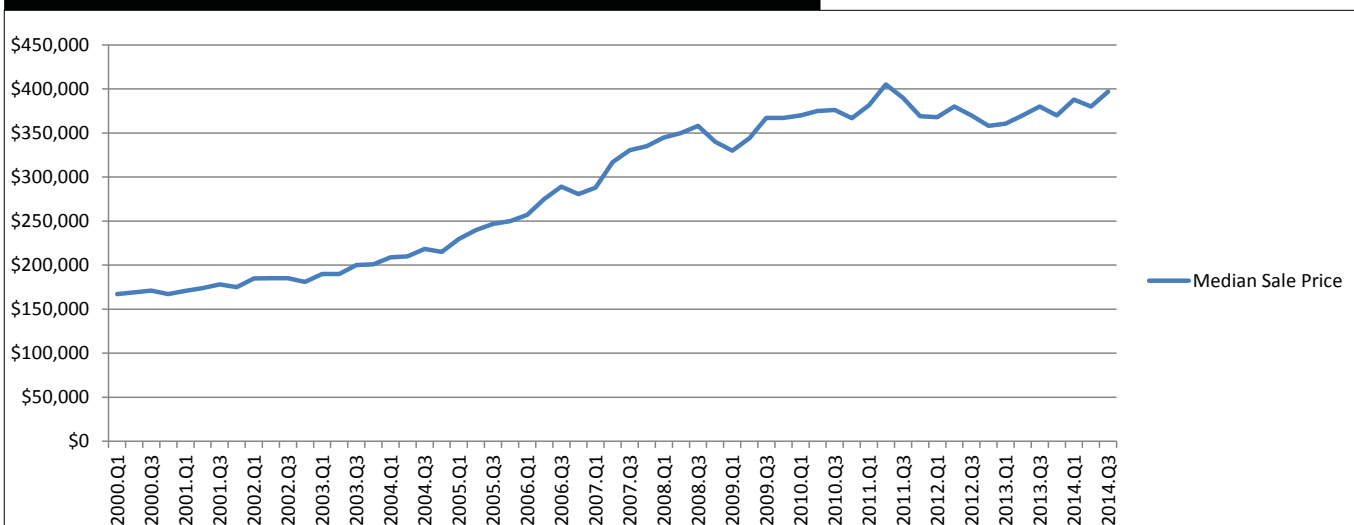
¹% change Q2'2014- Q3'2014 ²% change Q3'2013- Q3'2014

BC		Q3 2014	Q2 2014	% Chg ¹	Q3 2013	% Chg ²
Number of Sales		32,266	27,674	16.59%	28,430	13.49%
Total Value of Sales		\$17.46B	\$14.72B	18.62%	\$14.72B	18.65%
Detached	Average	\$538,877	\$524,730	2.70%	\$509,683	5.73%
	Median	\$509,000	\$495,000	2.83%	\$488,500	4.20%
Condo	Average	\$336,942	\$310,705	8.44%	\$327,564	2.86%
	Median	\$339,000	\$312,800	8.38%	\$328,900	3.07%
Attached	Average	\$378,495	\$367,933	2.87%	\$368,528	2.70%
	Median	\$360,000	\$355,320	1.32%	\$360,000	0.00%

Quarterly Sales Counts/BC All



Quarterly Median Sale Prices/BC All



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