THE SARETSKY REPORT

JUNE 2022

SARETSKY
GROUP

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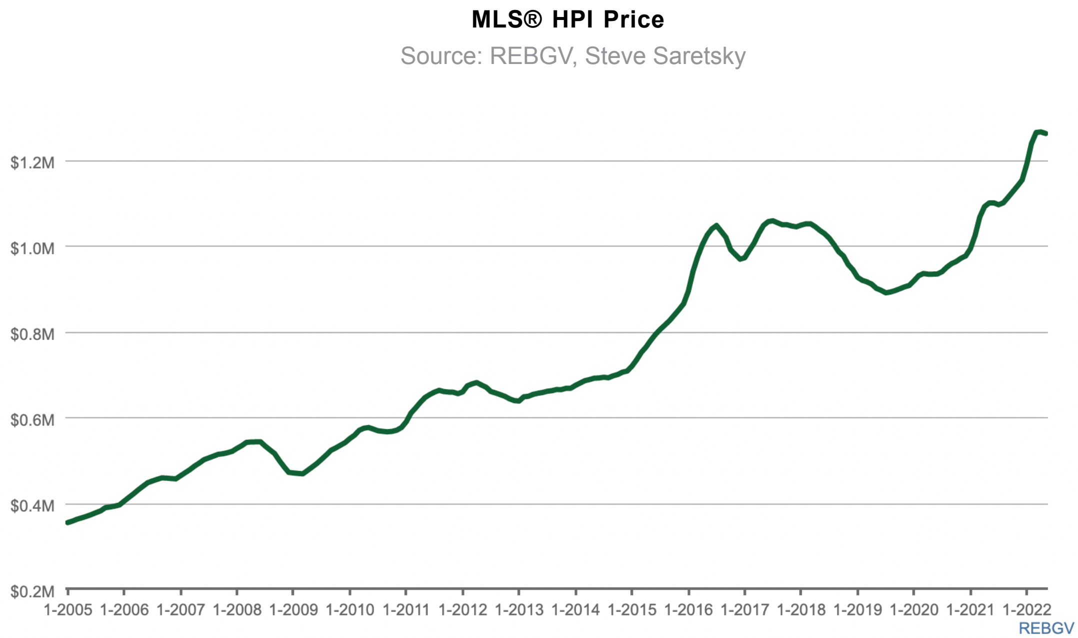
OPENING THOUGHTS

As has been the theme for the past few reports, inflation and interest rates remain front and center. Inflation remains stubbornly high and central banks are panicking to reign it in. They are now tasked with the impossible mission of killing enough demand to bring commodity prices (energy) down, without triggering a financial mistake and or recession. Keep in mind Canada has one of the worst balance sheets in the G-20, with total non financial debt to GDP at over 350%. Households, corporations, and governments in Canada are highly levered. Vancouver & Toronto housing prices have benefited immensely off cheap leverage, which is now going away, at least temporarily. Again, lets just run some simple numbers here. The benchmark price of a home in Greater Vancouver, which measures the cost of your typical home across all property segments (houses, condos, townhouses) equates to $1,261,100 as of the end of May.



Assuming 80% LTV, on a 30 year amortization and a 5 year fixed mortgage, at current rates of 4.5% that equates to a monthly payment of $5087. Run the same math but assume your mortgage rate is 2.5% which was the going rate just 4 or 5 months ago and that equates to an extra $1107 per month on your mortgage payment. In other words, you're getting the same house as before but you get the luxury of paying an extra $1100 dollars per month.

It should therefor come as no surprise that housing demand has fallen off rather significantly. Greater Vancouver home sales dropped 32% year-over-year in May, or 11% below their ten year average. Affordability was already an issue and rising interest rates have only exacerbated this. Many buyers are now waiting/ hoping for prices to fall to at least partially offset the cost of borrowing.

Nonetheless, the Bank of Canada is intent on moving forward, raising rates again by another 50bps here in June. Listening to the Bank of Canada's press conference after the announcement, it sounds like they are willing to induce a recession in order to get inflation lower. We will find out soon enough.

While home buyer demand has dropped off, the rental market is heating up. According to Zumper, one of the largest rental platforms in the city, the average rent for a 1 bedroom condo is up 15% year-over-year, with the median rent at $2300 per month. Based on my conversations with property management companies, tenancy applications are surging with prospective tenants competing quite frequently. Anywhere you go rental prices are on the rise. Here's some insightful data from Local rental platform Liv Rent.

Average Rent by Listing Type (Unfurnished)

Municipality/City	1 br.	2 br.	3 br.
Vancouver	$2,367	$3,285	$4,334
Langley	$1,777	$2,288	$3,022
Burnaby	$2,116	$2,809	$3,049
Surrey	$1,648	$2,143	$2,776
Richmond	$2,070	$2,740	$3,649
North Vancouver	$2,385	$3,189	$4,560
West Vancouver	$2,461	$3,461	$4,885
Coquitlam	$1,850	$2,359	$3,024
New Westminster	$1,829	$2,272	$3,503

liv.rent

Suffice to say, if you're a landlord worried about the rising cost of mortgage rates, rents should offset some of that pain.

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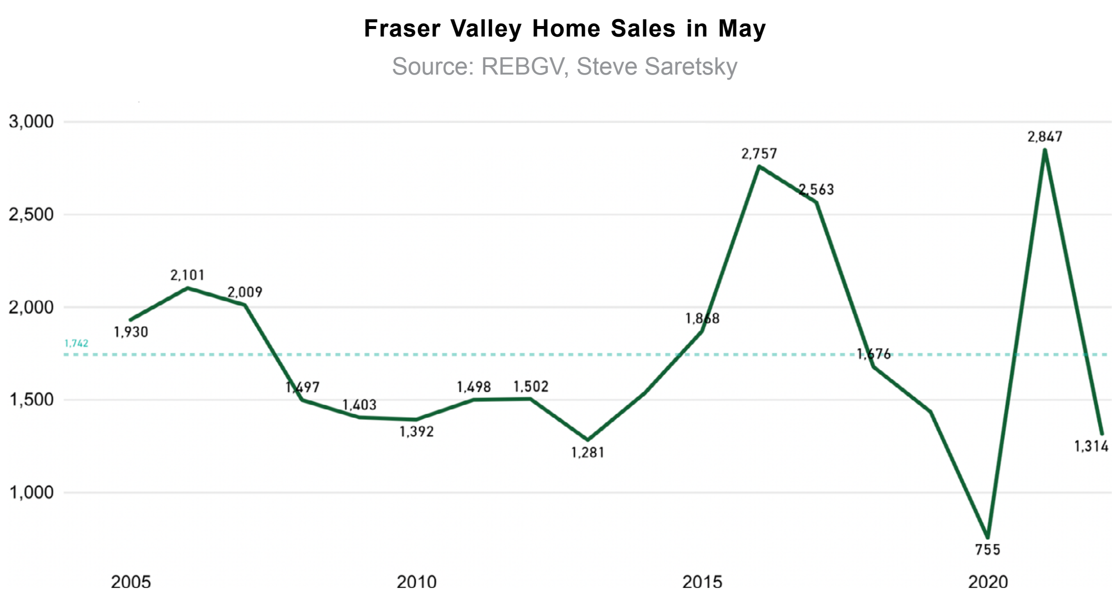
THE SUBURBS CONTINUE TO SLOW, BUT NO PANIC

As we talked about in last months report, the suburbs are under pressure. Rising mortgage rates and a boom that was inevitably bound to slow are both hitting at the same time. Fraser Valley home sales plummeted a whopping 54% year-over-year in May. Sure, home sales hit all time record highs last May so this comparison is rather tough, but still. Sales in May were 25% below their long term historical average.



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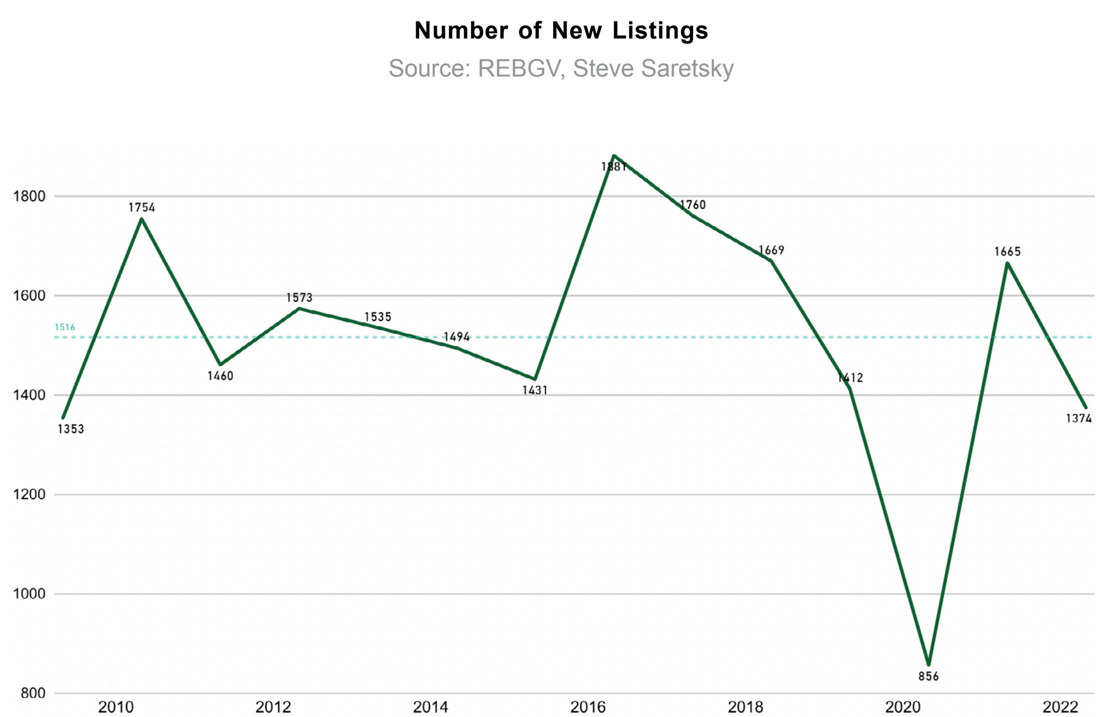
It doesn't take a genius to figure out prices are adjusting rather quickly. Here's a quick look at the price correction detached houses in the burbs. Median price declines from the peak:

Surrey: -15%
Abbotsford: -14%,
Langley: -13%

What's most interesting about this price correction is that new listings for sale have remained quite muted. In other words, this price correction is not due to a flood of new listings. Sellers are not panicking and flooding the market because interest rates are up. Quite simply, demand has fallen, sentiment has soured, forcing motivated sellers to take lower offer prices. Here's a chart highlighting a 17% year-over-year decline in new listings for Fraser Valley detached houses. In fact, new listings are running below their long term average for this time of year.



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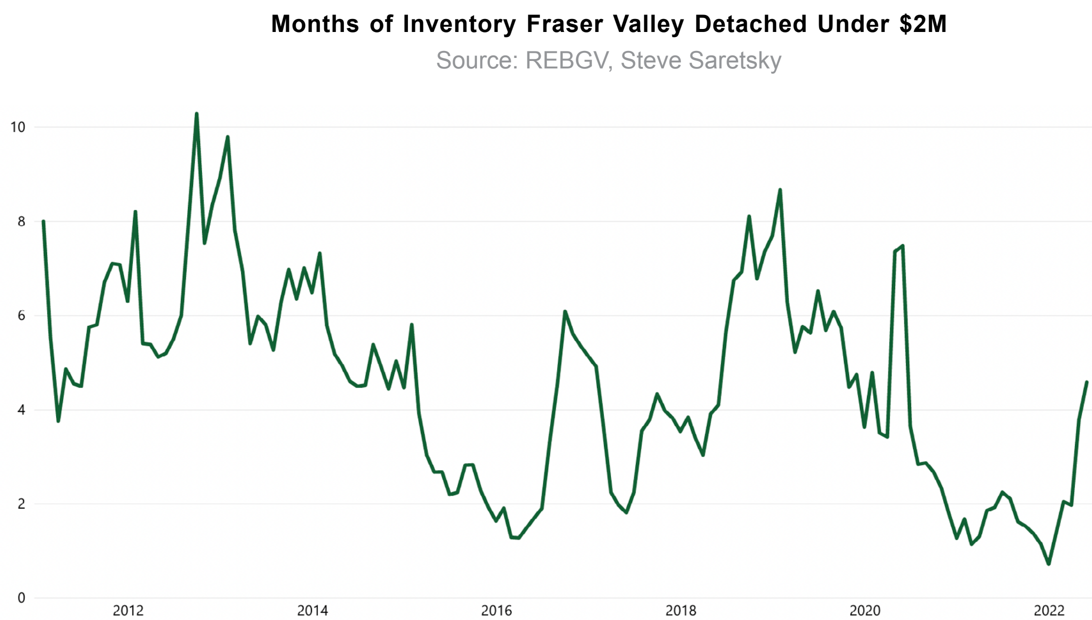
So new listings are actually quite low, but demand has fallen off quickly. This is best highlighted via months of inventory, which was grown from a low 0.7 in December to 4.6 months in May.



Inventory can continue to grow even without a surge in new listings. It doesn't take a flood of panicked listings hitting the market to push prices lower, just weaker demand.

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CANCELLED PROJECTS INCOMING

The pre sale market tends to lag the resale market. As demand weakens in the resale market, and buyers start to see prices coming down, it eventually slows pre-sale purchases. Considering the fact that investors account for the majority of new home sales, sentiment is important. The pre-sale market has been on fire the past eighteen months, it is now slowing.

Now what do you do if you're a developer and you see an aggressive central bank that is hell bent on raising interest rates, weakening buyer demand, and still elevated construction costs? For many developers, the answer is to hit the pause button. That is now playing out.


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The industry has cancelled 4600 units of housing in the past three weeks because of construction costs increases and interest rate rising - Jeff Thomas Group Head Development Kingsett Capital

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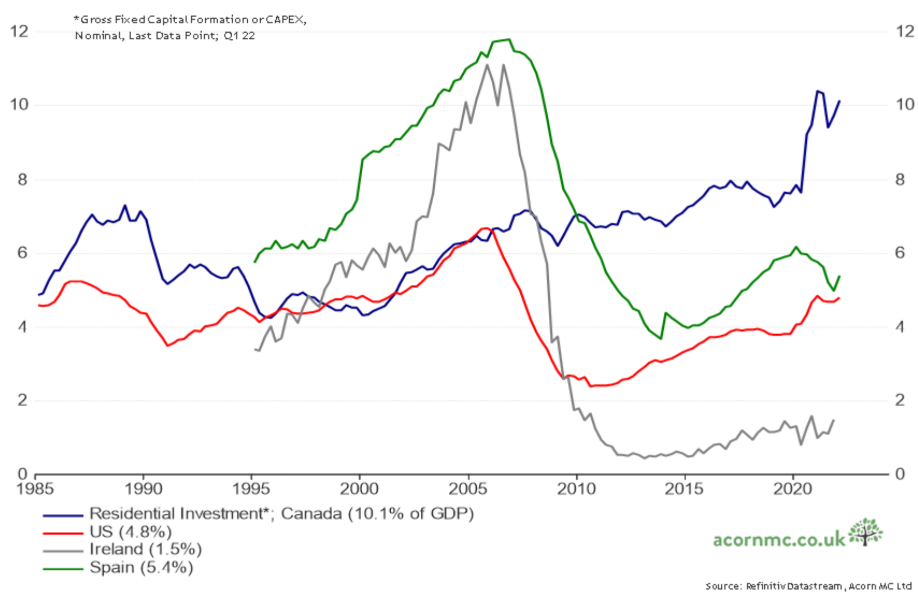
Keep in mind, in BC developers typically need to sell about 60% of units within 12 months in order to remain compliant with BC Government regulations and in order to secure construction financing. If you are worried about hitting those targets, or feel you can't pass on either the rising cost of construction or financing costs to the end buyer then you seriously have to contemplate the feasibility or profitability of a new development.

The key takeaway here is that not only are home sales slowing rather significantly, but we will soon see housing starts roll over. Not good considering residential investment and household consumption account for over 80% of Real GDP growth in Canada over the past 5 years. Residential investment in Canada accounts for nearly 10% of GDP, with the Bank of Canada hiking into a slowdown.



Keep in mind it's still very early but something worth watching considering how large of a role the housing market plays in the overall economy.

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MORTGAGE MUSINGS

The Canada 5 year bond yield, which prices the popular 5 year fixed mortgage, is now sitting at 3.1%. This is the highest reading since March 2008.

If you walk into your bank today, the lowest 5 year fixed rate mortgage for uninsured borrowers is about 4.5%, and we are some inching closer to 5%. We haven't seen these rates in over a decade, and as we discussed in report earlier, this is the biggest reason behind slumping housing activity. A lot of people ask me what they should do, lock into a fixed rate mortgage or variable rate?

If you know for sure that you're going to be in a property for the next 5 years then fixed is typically the way to go. However, over 50% of Canadians end up breaking their 5 year mortgage before the term expires, often incurring huge fees to break their term early.

Variable rate mortgages have typically been trading at a discount, especially more recently. Hence why over 60% of new originations in the past year have been variable rate mortgages. What's important to understand is that most variable rate mortgages at the big banks (besides Scotia and First National) are typically FIXED payment mortgages. In other words, just because the Bank of Canada is raising interest rates it does not mean your monthly mortgage payment will increase. Your monthly payment stays the same but the amount paid towards your principal declines and more goes towards servicing the interest.

Typically fixed rate variable mortgages have a trigger clause of about 350bps. What this means is that if your variable rate was 1.5% when you first got it, and interest rates increase to 4%, this will trigger a clause in your mortgage, prompting the bank to increase your monthly mortgage payment. While this is likely a slim probability for most, what's is important is the following:

When you renew your mortgage in 5 years, less of your principal will be paid down. The balance of the mortgage will renew at the prevailing rates (likely higher) and your remaining mortgage balance will be amortized over the remaining life of the mortgage. For example, if you originally had a 30 year amortization you will renew your mortgage at a 25 year amortization. In other words, you face two payment shocks, higher interest rates and an outstanding balance that will be amortized over 25 years and not 30.

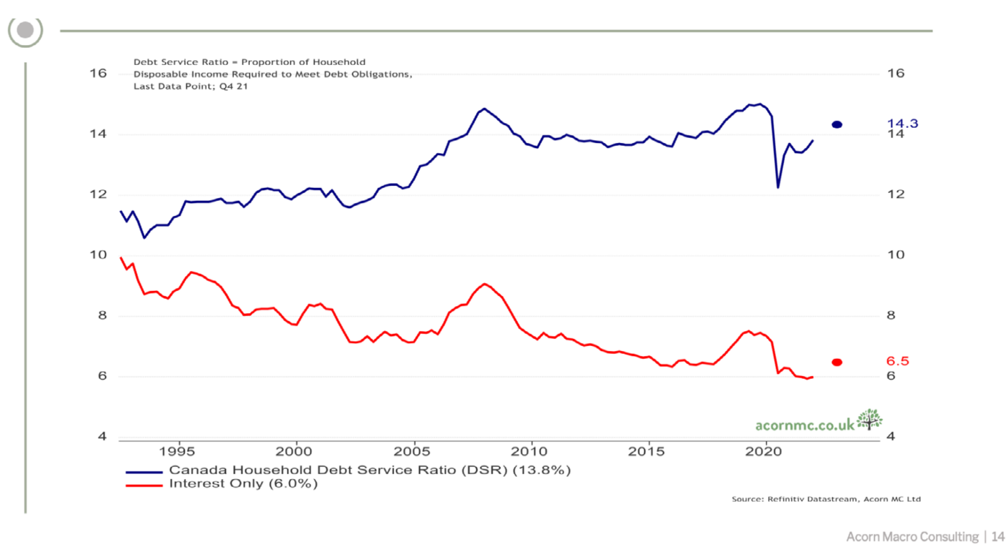
You can always try to refinance and extend the mortgage back to 30 years but this will require you to requalify.

If borrowers are worried about having a larger than expected balance/payment increase upon renewal they can always do accelerated mortgage payments to pay down the balance quicker. Some lenders will allow up to 20% lump sum payments per year.

Anyways, this is a lot to digest but basically homeowners are now facing rising mortgage costs on renewal, this is quite rare given rates have basically been falling for the last 30 years.

Debt service ratios are projecting to hit record highs in Q1 of 2023 as a result.

Debt Service Ratios with Model Estimate



ABOUT STEVE

Steve Saretsky is a Vancouver residential Realtor and author behind one of Vancouver's most popular real estate blogs. Steve is widely considered a thought leader in the industry with regular appearances on BNN, CBC, CKNW, CTV and as a contributor to BC Business Magazine. Steve has advised developers, hedge funds, and fund managers on the Vancouver housing market and is a regular speaker at industry events.

Steve Saretsky provides real estate services throughout Greater Vancouver. To inquire about listing or buying a property, please email: steve@stevesaretsky.com.

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