THE SARETSKY REPORT

JULY 2022

SARETSKY
GROUP

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OPENING THOUGHTS

I'm a bit later than usual in writing this report and it's probably for the best. As of this writing on July 13th, the Bank of Canada raised interest rates a monstrous 100bps, the single largest increase since 1998. This will have significant ramifications for the housing market, not just psychologically but financially.

One of the pillars supporting the housing market has been variable rate mortgages. They've been dirt cheap, averaging more than 150bps cheaper than the fixed rate mortgages this year.

Insured 5-year fixed-variable spread

Source: Rob Mclister

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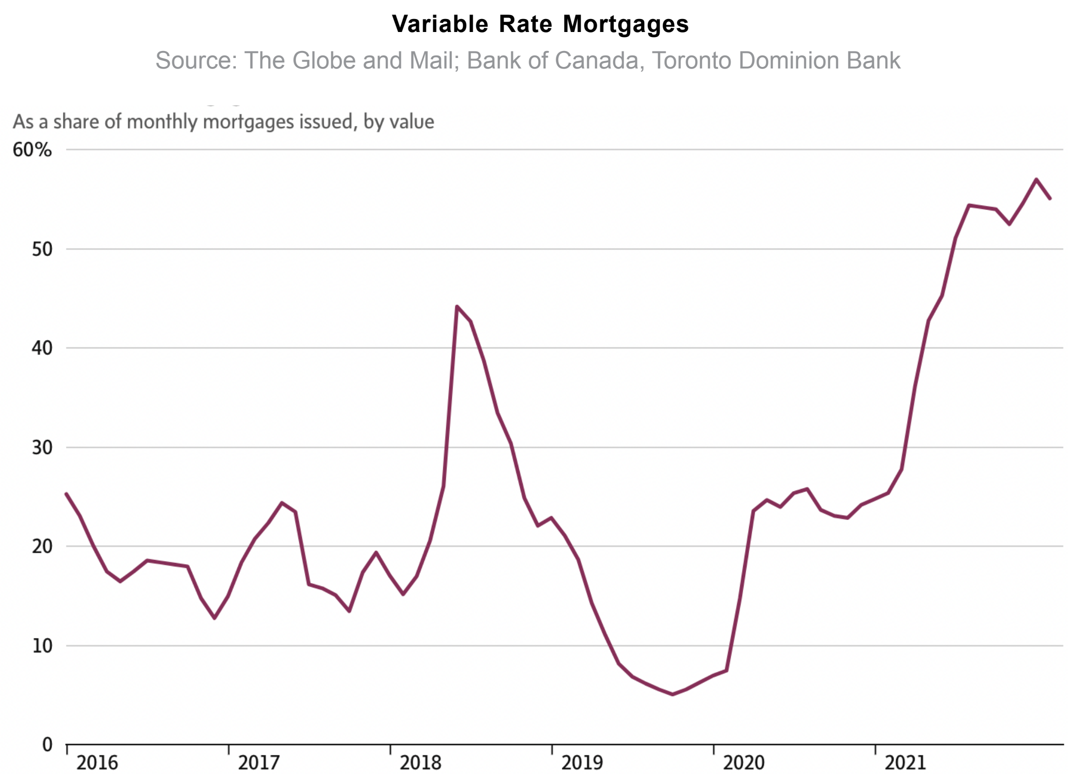
For this reason, we've seen an increasing number of new purchasers opting to go with variable rate mortgages. So far this year, over 50% of new mortgage originations have been variable, a historically high figure.



If you were going with a variable rate mortgage in recent months you were not subject to the higher mortgage stress test. Remember the mortgage stress test qualifies the borrower based on the minimum qualifying rate of 5.25% or their contract rate PLUS 2%, whichever is higher. In other words, with variable rate mortgages hovering around 3%, you'd only be stress tested at 5.25%, compare that to borrowers opting for fixed rate mortgages and you'd be getting stress tested near 7% (5% mortgage rate plus 2%). Now you can see why a borrower would go with a variable mortgage.

Now that the Bank of Canada has raised interest rates by 100bps this will instantly bring the typical variable rate mortgage to about 4.2%, which means you'd be getting stress tested at 6.2%. In other words, the average home buyer just lost about 10% of borrowing capacity in one fell swoop. It's not hard to figure out what happens next. The pool of prospective, or rather, qualified home buyers, is shrinking.

June home sales in Greater Vancouver fell 35% year-over-year, and 21% below their ten year average. Again, this shouldn't be surprising once you run the math. Let's compare the cost of carrying a home today vs in January, just six months ago. Assuming 20% down, 5 year fixed rate mortgage with a 30 year amortization.

January home price $1,190,000 x 2.5% mortgage rate = $3755 / month

June home price $1,235,900 x 5% mortgage rate = 5277 / month

So you get the same home with the privilege of paying an extra $1522 / month

With the Bank of Canada aggressively moving interest rates higher, you can now apply similar math for variable rate mortgages.

While nobody knows where interest rates will end up, if you believe the market, Overnight swaps are suggesting the Bank of Canada will hike the benchmark rate to 3.75% by the end of this year. While I remain skeptical the Bank will get there, it's worth noting that would equate to a 350bps increase in interest rates this year, which is approximately the amount required to trigger most fixed rate variable mortgages. In case you need a primer, 80% of all variable mortgages outstanding are fixed payment variable. The monthly mortgage payment stays the same until it becomes negative amortizing (not enough principal being paid down), this number tends to be roughly 350bps higher than the original contract rate.

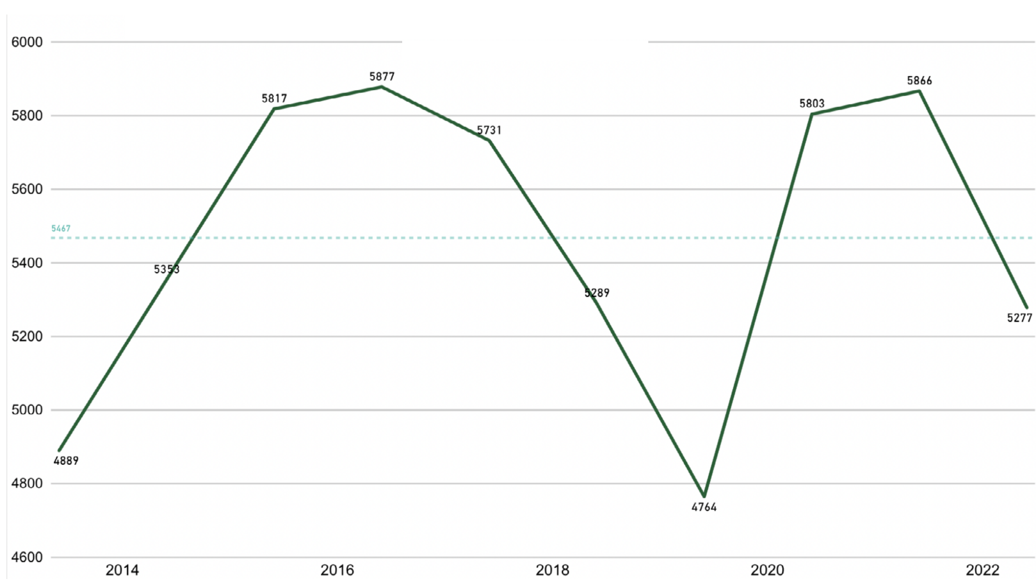
Suffice to say this would be a hot mess and i'm guessing the banking regulator would be itching to step in, likely creating new policy to extend amortizations. Remember back in 2007 we had 40 year amortizations. This product is already available for multi-family commercial via CMHC. Don't think it can't happen again on the residential side.

WEAK DEMAND,
NOT A FLOOD OF SELLERS

It's no secret that prices have been moving lower since the peak in February. However, despite the popular narrative, it's not due to a flood of panicked sellers throwing their inventory on the market. In fact, new listings in Greater Vancouver were down on a year-over-year basis across all segments. New listings are running 3% below their ten year average

Number of New Listings:June, All Property Segments

Source: REBGV, Steve Saretsky



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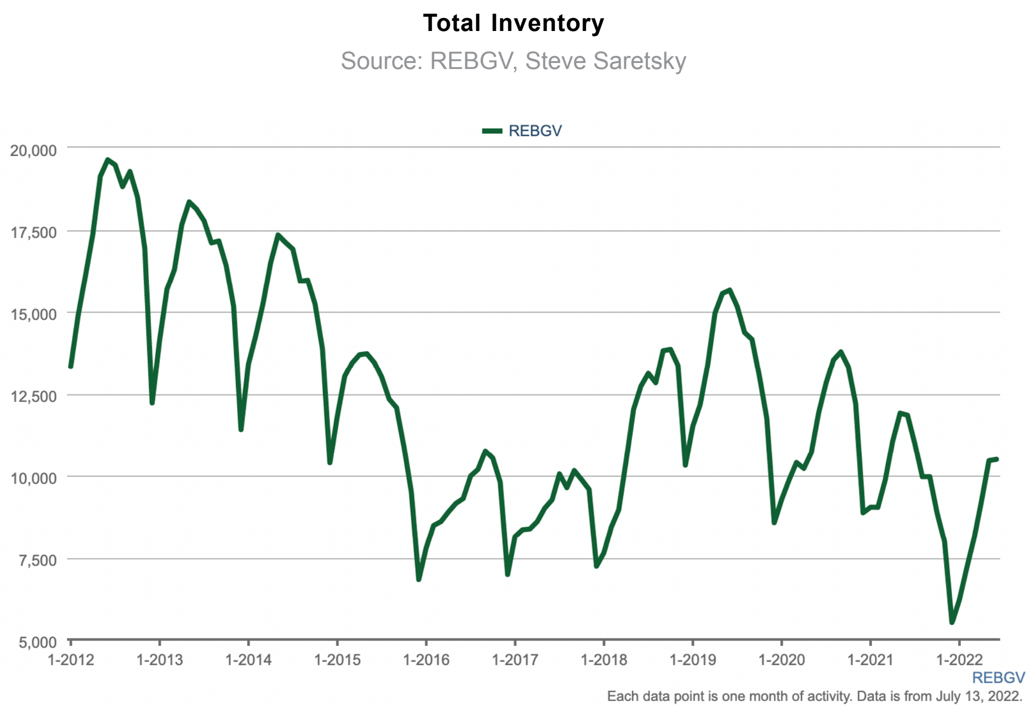
Furthermore, total inventory for sale is actually DOWN from last year, dropping 11% from last June. Hard to believe there are actually FEWER homes for sale today than there was a year ago in a blistering hot sellers market.

Current inventory for sale across all property types remains low on a historical basis.



However, buyer demand is so weak that months of inventory for sale is still building. It currently sits at 4.2 months of inventory, which is typically considered a balanced market.

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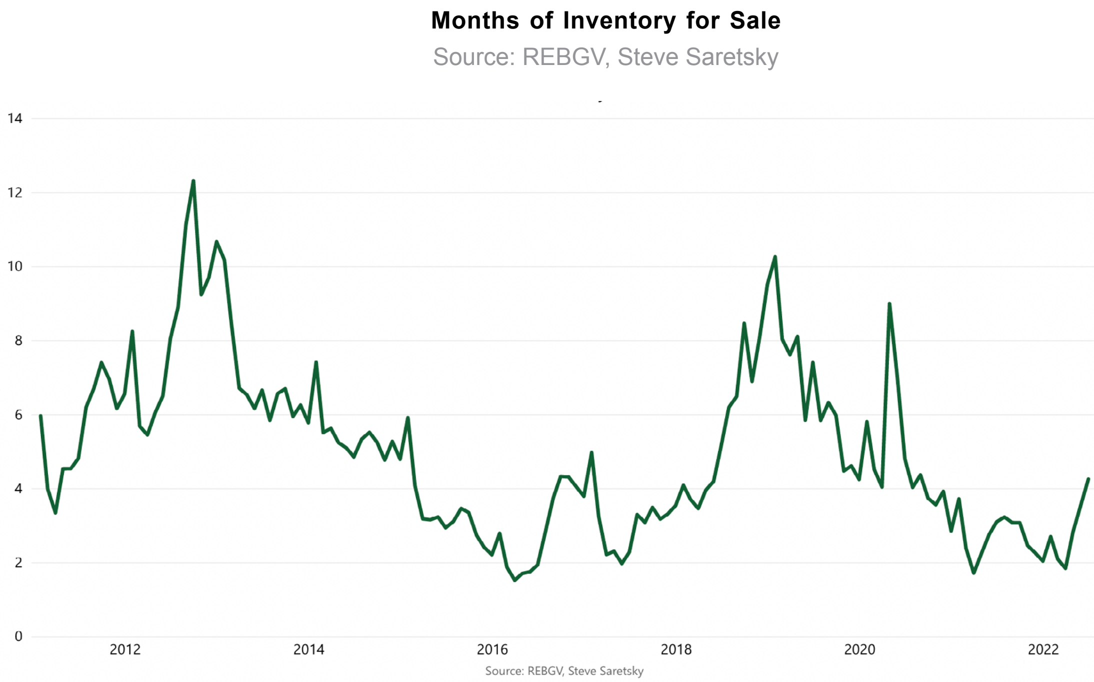

Basically what's happening here is prospective buyers are in shock over rapidly rising interest rates. While some no longer qualify under higher interest rates, the majority of them appear to be on hold, waiting for a better entry point. These buyers are going to need more inventory to come to market in order to pressure sellers into reducing prices a whole lot further. There's a good chance that happens, but as we can see, it takes time for inventory to accumulate, Vancouver is rarely an oversupplied market.

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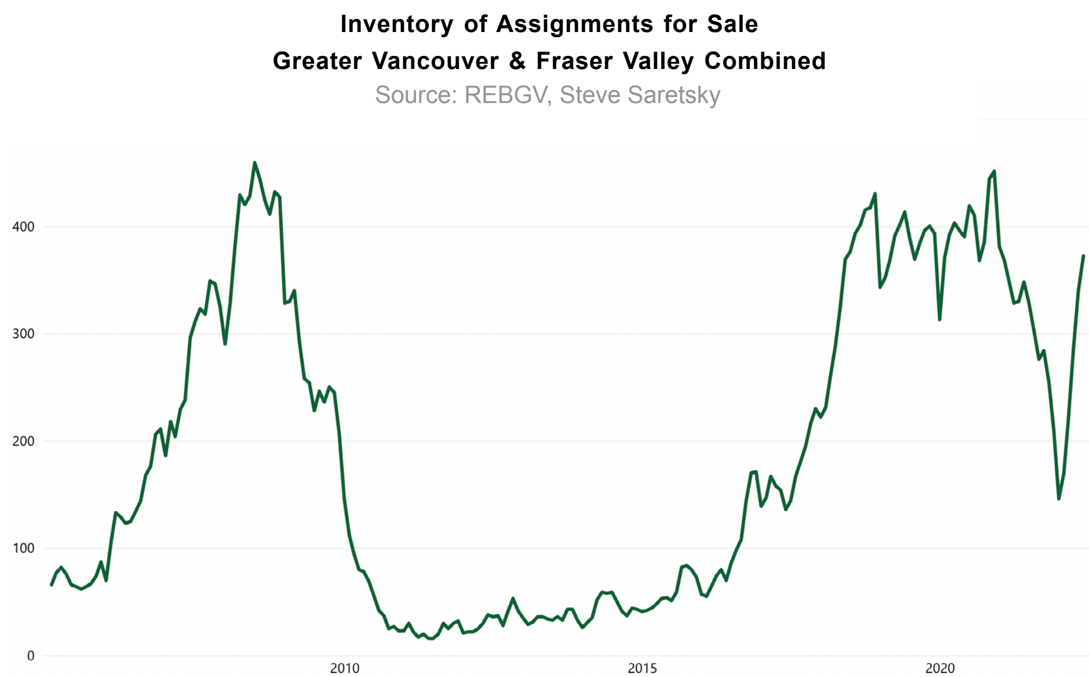
PRE-SALE ASSIGNMENTS BACK ON THE RISE

Rising interest rates and declining resale prices do not bode well for the pre-sale market. The pre-sale market is heavily dependent on investors. Many new project launches today are asking prices that are well above similar new construction resale prices, so what is the incentive to tie up money in a pre-sale contract for the next 3-4 years if the price outlook does not appear favorable?

We are now seeing an uptick in new pre-sale assignment listings across Greater Vancouver and the Fraser Valley. It appears pre-sale buyers are trying to sell existing obligations.



There could be some interesting opportunities here as some pre-sale buyers will have issues obtaining financing in this rapidly rising interest rate environment. In our experience, very few pre-sale purchasers lock in financing several years out. So long as buyers purchased at the right time and have enough equity they should be fine to close they might just have to go through the private lending channel. It will be buyers who purchased near the top that could have issues with appraisals and or higher interest rates impacting their ability to qualify. This is still very early days and is certainly not an issue at the moment, but if the housing correction drags on into next year we expect to see some opportunities.

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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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