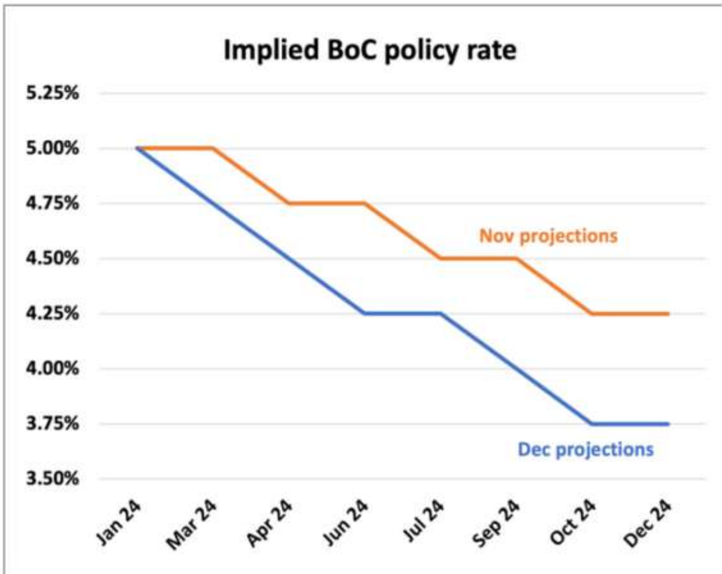
THE EDGE REPORT

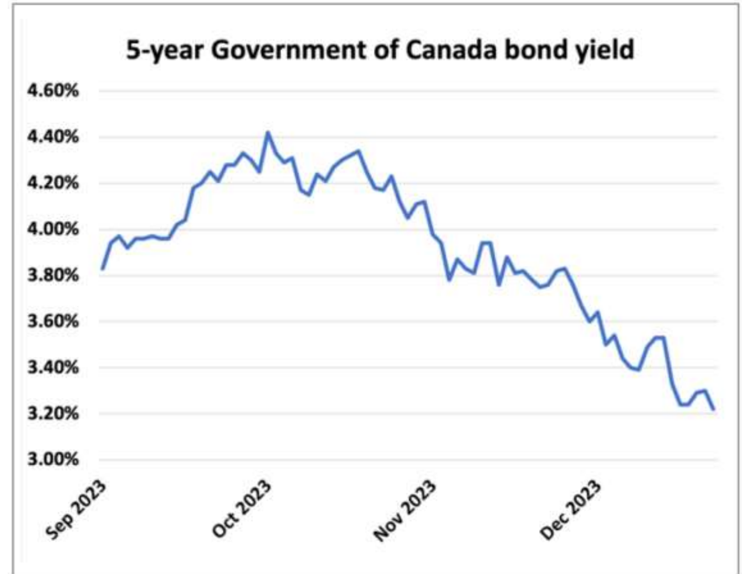
December 2023

1) *Big shift in rate cut expectations*

Let's start with some good news: Markets continue to expect significant rate cuts in 2024, with a full 1.25% of cuts now expected by the end of the year. That's significant adjustment to expectations just a couple weeks ago:

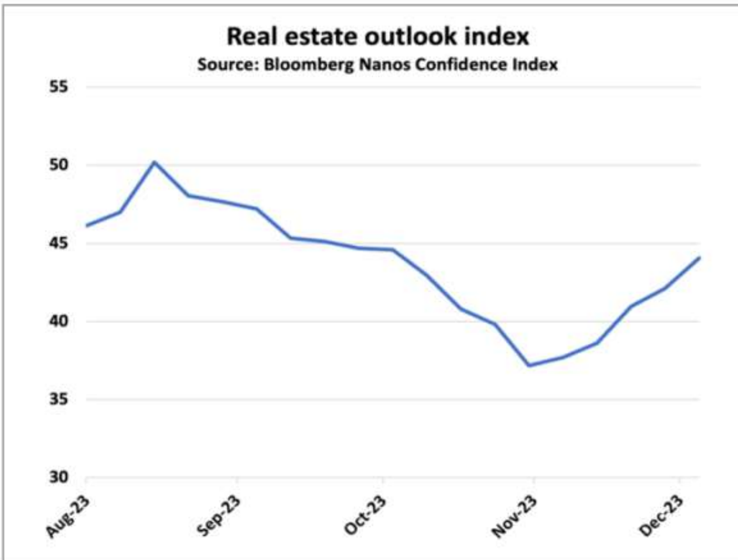


Rate cut expectations are filtering through to the bellwether 5-year Government of Canada bond yield, which remains a primary driver of pricing on the classic 5-year fixed rate mortgage. At time of writing, yields are hovering around 3.2%, a dramatic 120bps (1.2%) drop from the September peak:



Consequently, and to much fanfare, we're seeing mortgage rates finally start to drift meaningfully lower. Deep discounted 5-yr fixed rates have fallen more than 50bps from the October highs, with some insured offerings down closer to 100bps. And there will certainly be more to come if bond yields hold here.

All else equal, we should expect incrementally stronger demand for mortgages in coming months, particularly as we head into the key spring selling season when lenders tend to compete hard on rates. There's also now clear signs that consumer sentiment towards real estate is improving. The turnaround in recent weeks coincides with the Bank of Canada (BoC) signalling their intentions to pause before cutting next year.



Here's a key takeaway: Inventory levels are still relatively tight in most of the country... even after 18 months of high rates and crappy sales. We're barely above 4 months of inventory nationally, which is lower than at any point from 2010 to 2020. Population growth is immense and new supply is contrained (much more on that below). It's not unreasonable to think that rate cuts will reignite some level of demand and cause a firming in prices in the back half of next year... or perhaps sooner.

The big risk is a re-acceleration in inflation, so we have to cover that quickly. The Consumer Price Index (CPI) in November rose 3.1% relative to last year, slightly higher than consensus estimates for a 2.9% reading, but not enough to be a major concern.

It is notable however, that core CPI - which factors heavily in BoC decision making- rose 0.4%m/m which pushed the 3-month change to relatively spicy 1.0%. Those core measures are still running at 3.6% y/y... well above the 1-3% band, but clearly moving in the right direction. If anything, we may see some discussion/debate around the timing of rate cuts in 2024, but there's nothing here that remotely suggests that the BoC will be pushed off the path towards cuts early next year.

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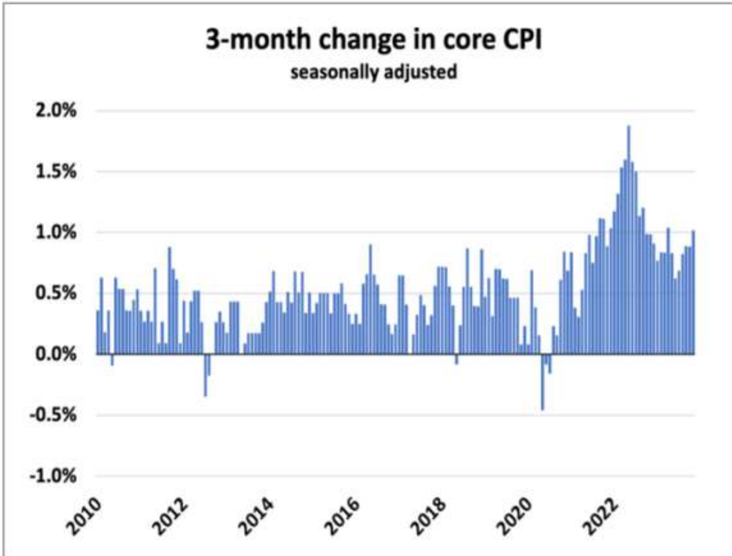
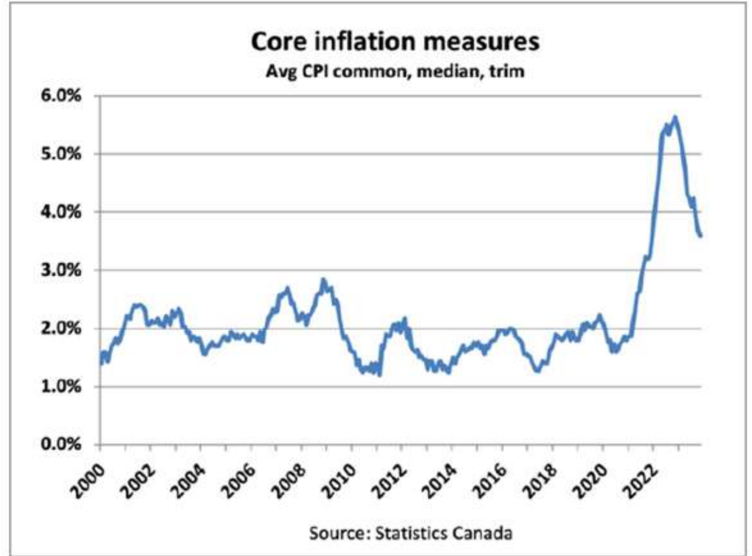
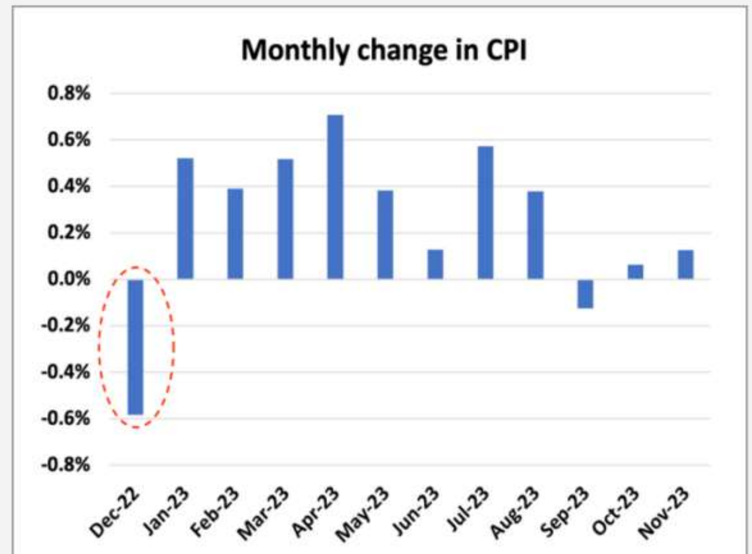




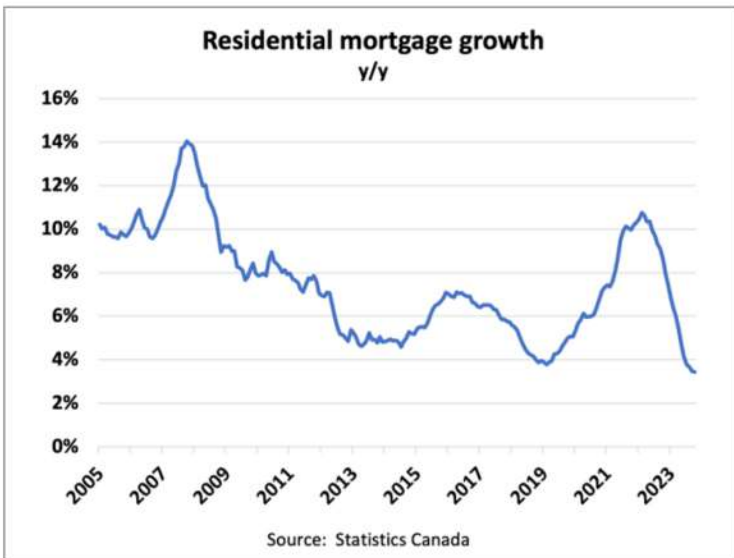
One thing to watch: There's a good chance that headline CPI ticks UP next month, so don't be shocked when that happens. Remember, the headline number is simply the sum of the previous 12 monthly changes. December 2022 saw a 0.6% monthly DECLINE in the CPI, and that number is set to drop out of the mix. In other words, unless we get another unusually large decline in next month's CPI, the headline y/y inflation reading will rise. Be prepared for that since some of your better-informed clients may ask if its cause for concern. It isn't!



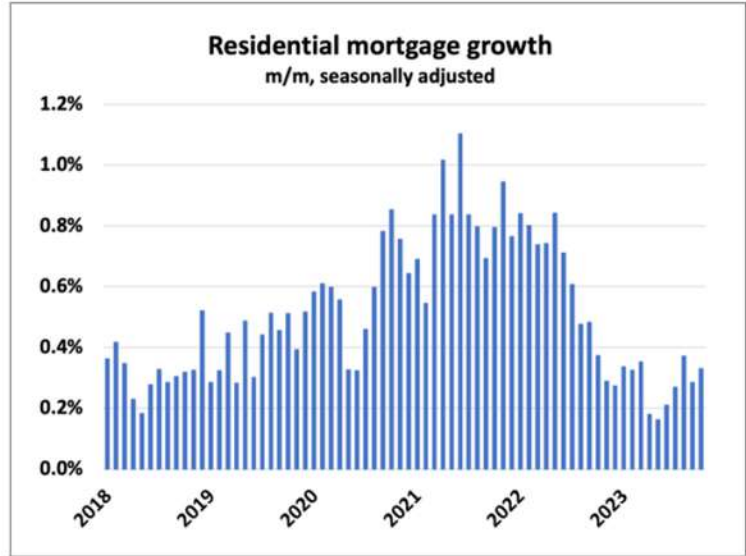
2) *Mortgage market update: Mortgage growth bottoming, borrowers betting on cuts*

i) Mortgage growth hits fresh 20-years lows

Mortgage debt outstanding grew just 3.4% m/m in October, the weakest rate of growth since 2001. There are, however, signs that demand has stabilized. The seasonally adjusted monthly growthrate has now clearly bottomed and has risen for 4 of the past 5 months:

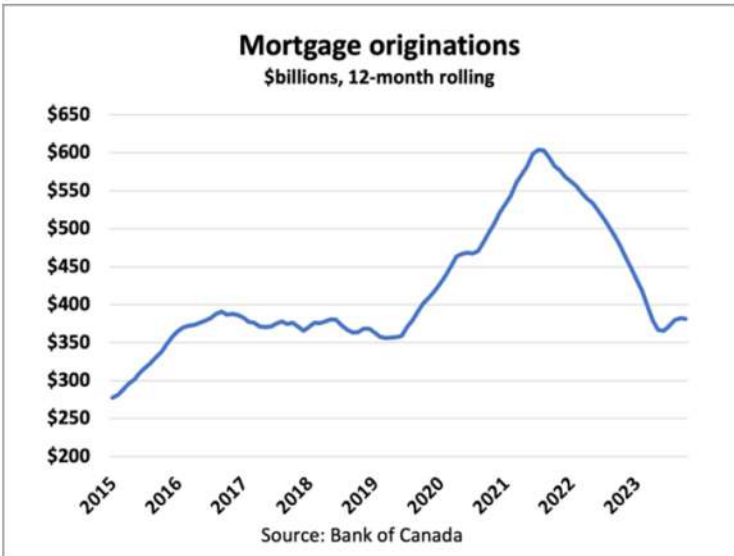


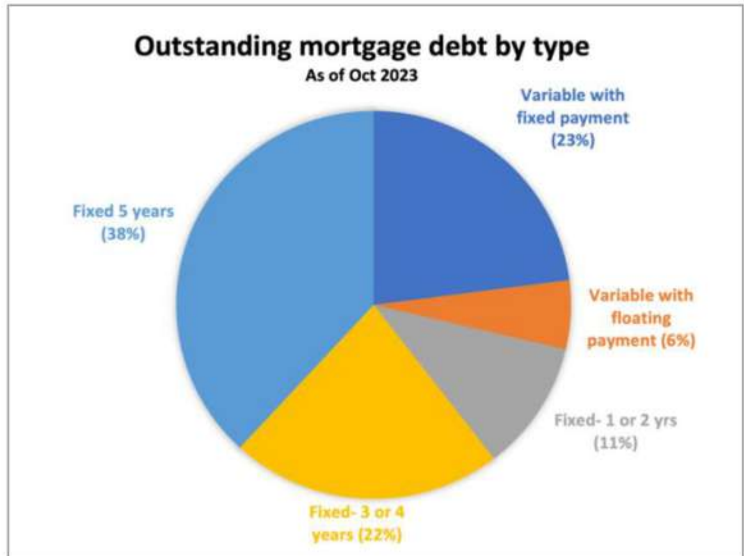
Source: Statistics Canada

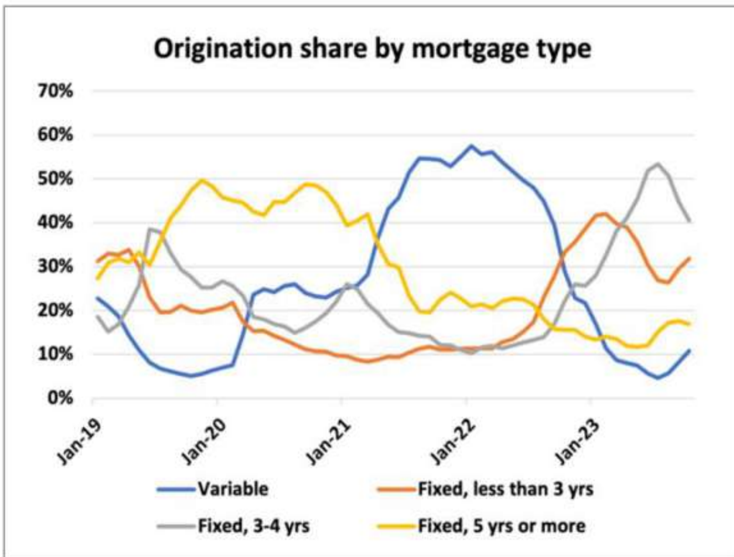


ii) Borrowersbet on BoC rate cuts

Mortgage originations have clearly stabilized, albeit at levels well below the 2022 peak. There are clear signs that borowers are expecting a Bank of Canada rate cut in the not-too-distant future. Consider the sudden resurgence in variable rate loans which have more than doubled as a share of originations in the past 3 months. They still represent only 11% of new loans, down from a peak of nearly 60%, but the sharp inflection is hard to miss. Similarly, short-term fixed loans of 1 or 2 years have also seen surging popularity over the past 3 months, now accounting for a third of new mortgages:







iii) A look at mortgage debt outstanding

In spite of the massive popularity of variable rate loans in 2021 and early 2022, they account for less than a third of all mortgage debt outstanding. The most popular term in Canada remains the 5-year fixed rate at just under 40% of all current mortgage debt. Next comes variable followed by 3 and 4-year fixed at 22% and short-term 1 or 2-yr fixed at 11%:

iv) Bank of Canada on rate resets

I highlight the data on mortgage debt outstanding since it's important in the context of interest rate resets in coming years.

The BoC released an important staff research note this week titled, *"The impact of higher interest rates on mortgage payments"*[1] Among the key takeaways:

- By the end of November 2023, about 45% of the mortgages... had seen an increase in payments. By the end of 2026, virtually all remaining mortgage holders in this group will go through a renewal cycle
- [...] 80% will face a payment increase by the end of 2025

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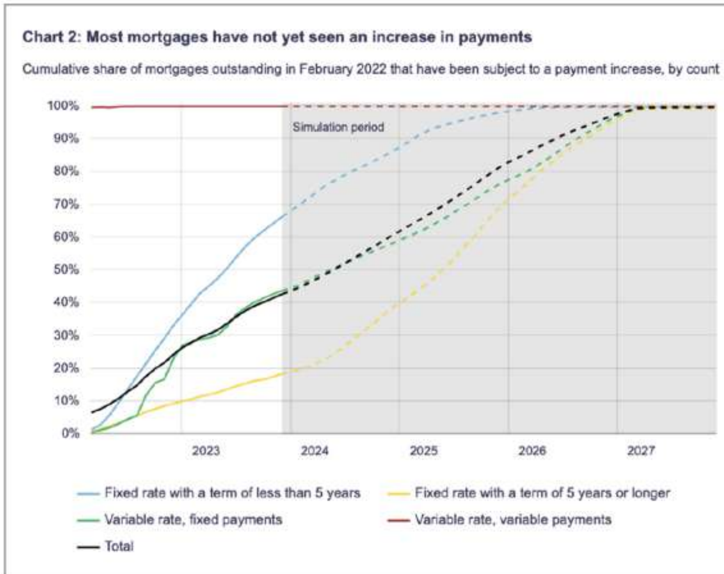
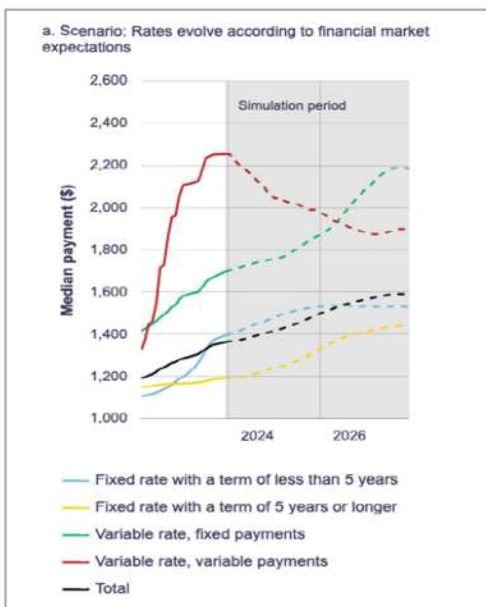


- Among variable-rate mortgage holders, those with fixed payments who have not taken action to avoid large future increases will be impacted at renewal. For this group, median payments are expected to increase by 54%

- Under our scenario... the median monthly mortgage payment for all outstanding mortgages will increase from $1,200 in February 2022to $1,600 by the end of 2027 - an increase of 34%

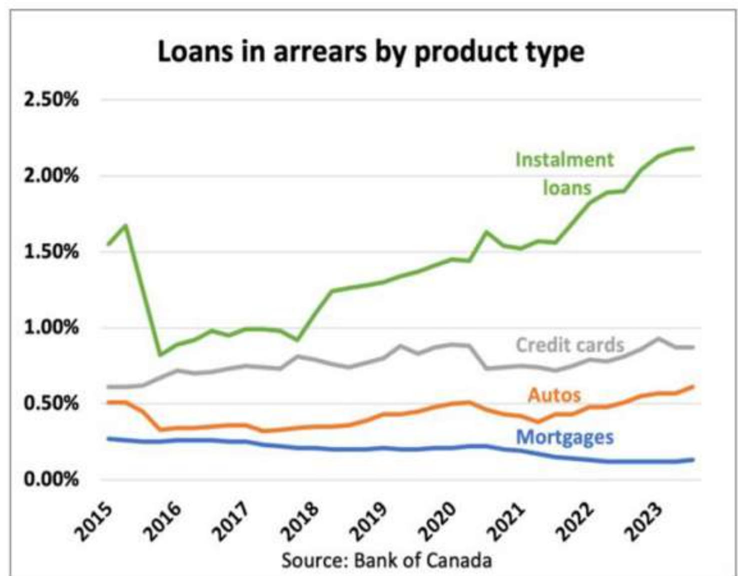


- Overall, most borrowers will need to make adjustments, sometimes signficant, to ensure they are able to continue to pay their mortgage

- One key implication of this work is that as long as they continue to experience income growth, most mortgage payments over the coming years. However, borrowers who stretched to enter the market or who were anticipating rate decreases by the time of renewal may find the adjustment more difficult.

v) Arrears remain remarkably stable in Q3

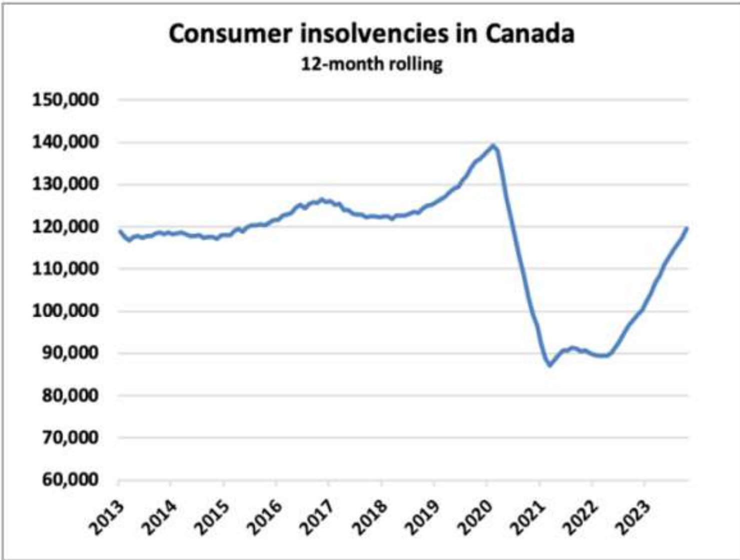
In spite of all the legitimate concerns around the state of Canadian borrowers, the reality is that there are few signs of stress yet. The Bank of Canada released arrears data for Q3. Yes, auto delinquencies are at decade highs, as are other instalment loans, but credit cards look okay, and mortgage delinquencies have barely budged off the lows:

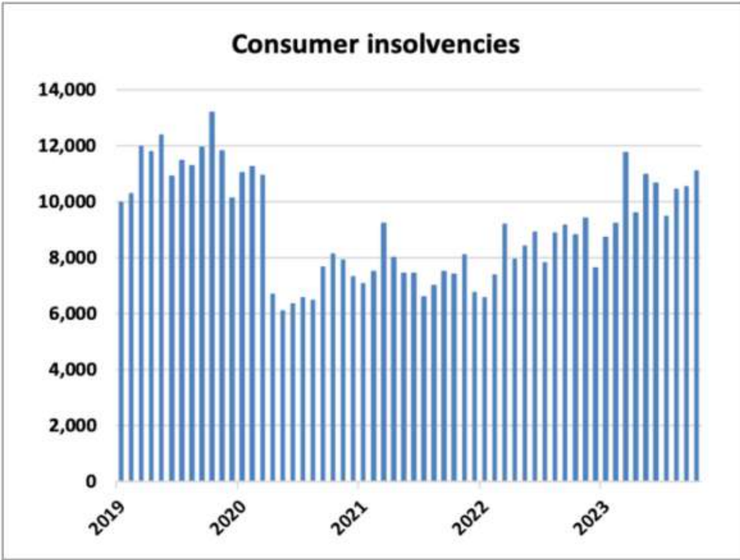


[1] https://www.bankofcanada.ca/2023/12/staff-analytical-note-2023-19/

vi) Insolvency data is a bit concerning...

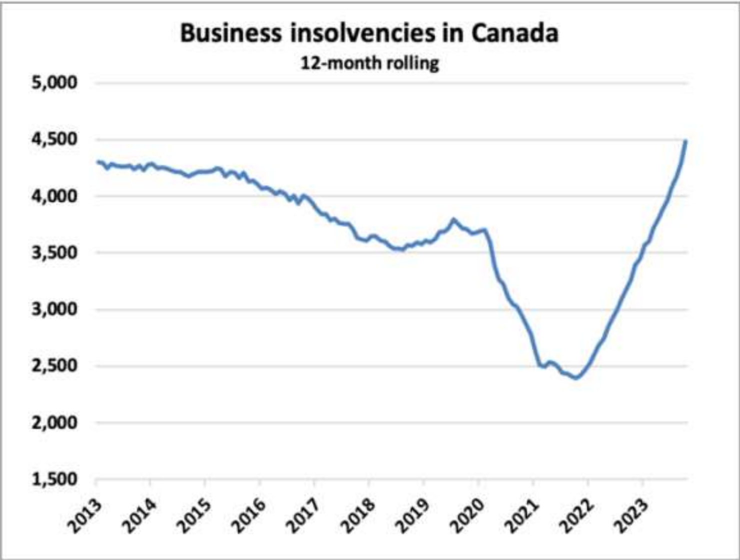
Consumer insolvencies were up 26% y/y in October, but filings are only now getting back to pre-COVID levels. Hardly alarming.

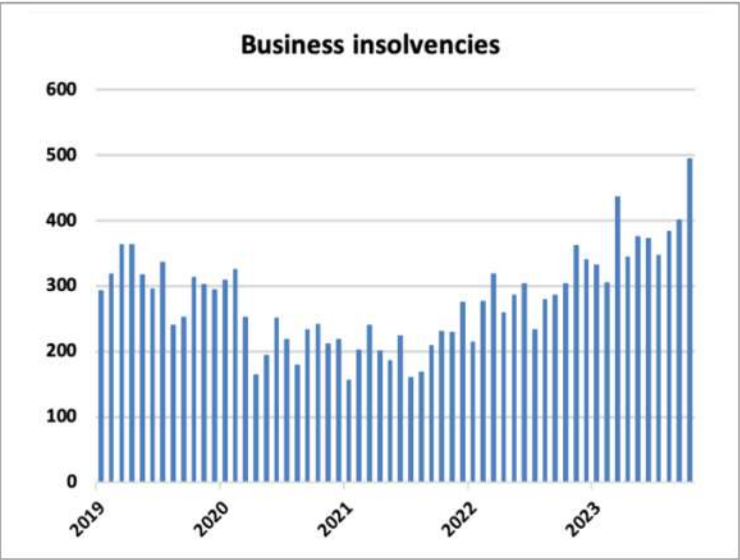




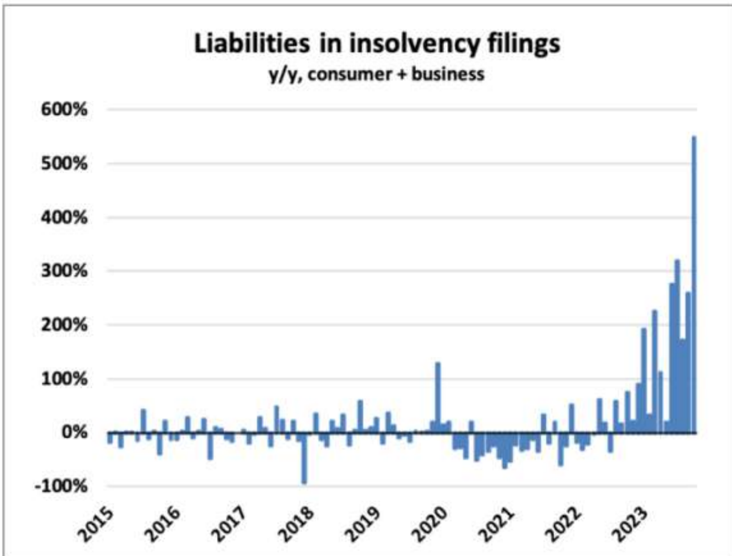
But there is something a bit concerning: The dollar volume of liabilitiesin those filings surged 90% y/y. Chalk this up to an increase in homeowner bankruptcies where liabilities tend to be much higher than for non-homeowners.

Whatever concern I may have around households, it pales in comparison to what's happening on the business side where insolvencies spiked 63% y//y in October to hit the highest number of any month since 2011:





And liabilities in those filings are exploding higher as larger businesses run into problems. Combined with consumer liabilities, they are running over 500% higher than last year at this time ,the largest annual increase since the financial crisis.



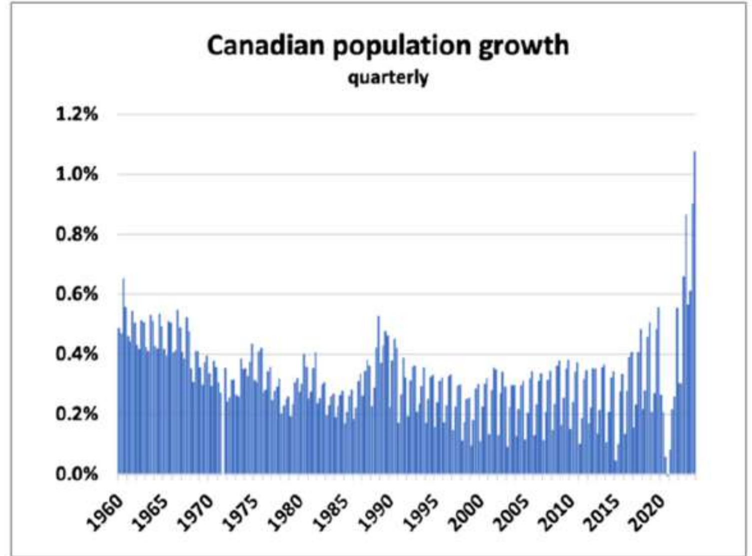
The reality is that as businesses go, so goes the economy. It's yet another indicator that we are probably heading for recession in early 2024. The Bank of Canada knows this, and I believe that's why we're now seeing them pivot.

3) *Supply and demand: Unbelievable population growth meets falling supply*

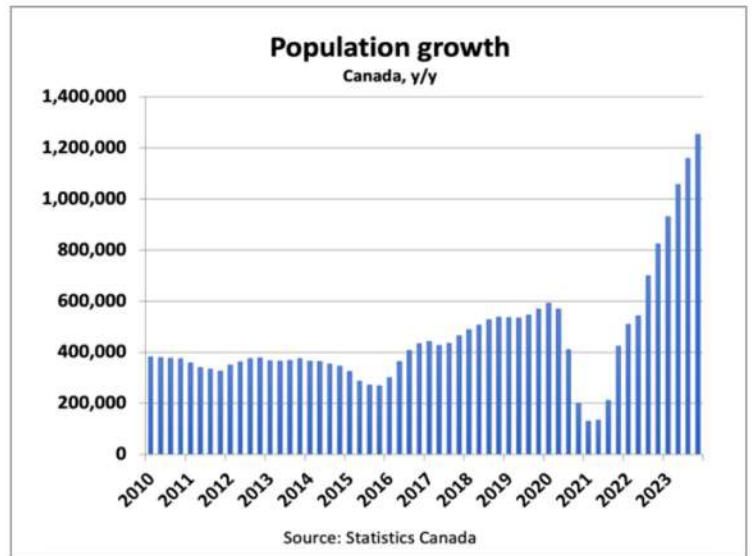
Insane population boom

It's become a quarterly tradition to stare in disbelief every time the population data is released. This latest reading was one for the books.

To start at a high level, Canada's population surged by a stunning 431,000 people in the three months between July and October. That translates to a 1.1% QUARTERLY growth rate... the highest since 1957:



That brings annual growth to 1.25 million people or 3.2%, with Alberta leading the country at a whopping 4.3% growth rate. No wonder the Calgary market continues to outperform!



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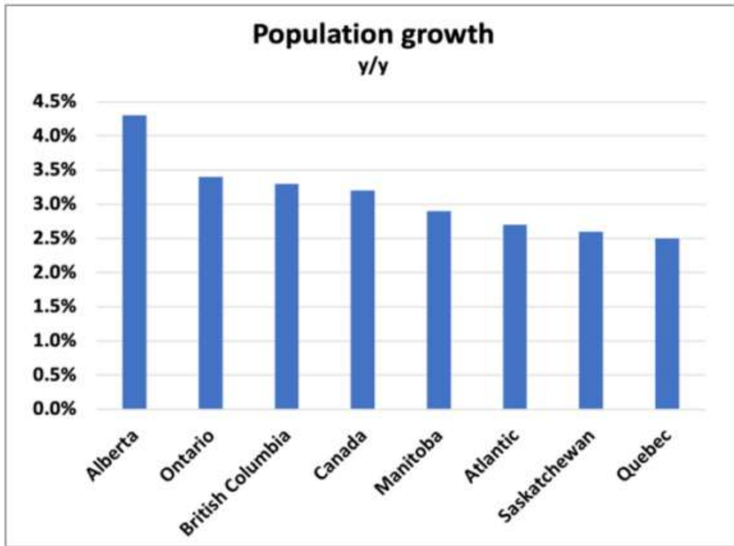
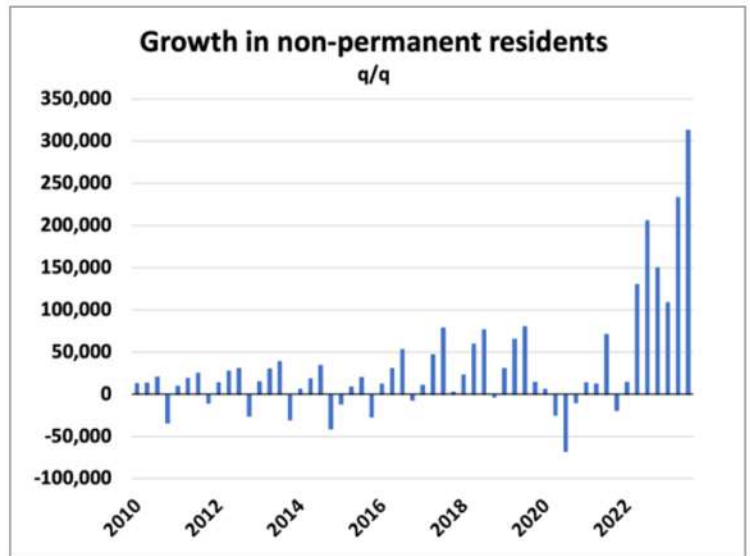
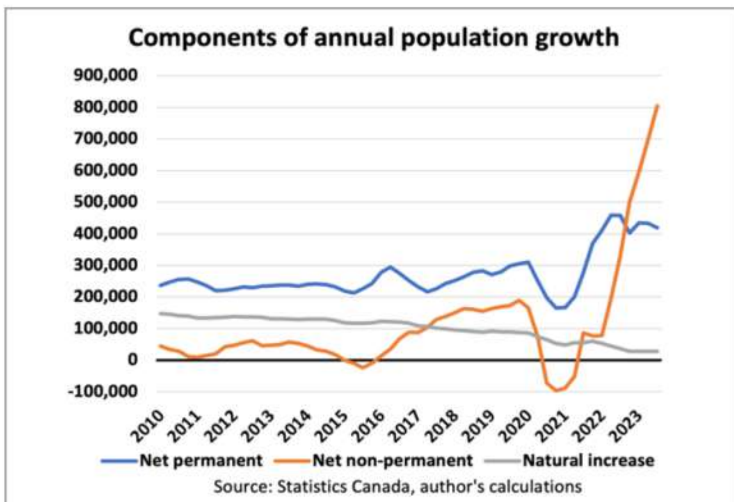




Once again, the devil is in the details, and there's much more here than meets the eye. For starters, note that net permanent immigration declined slightly and is well below the 2022 peak (blue line in the chart below). This is the cohort that has the official target in Ottawa and that gets all the attention. It's currently netting out at around 400,000 y/y (we bring in close to 500,000 and then lose around 100,000 who move to Costa Rica or wherever).

The big move was once again in the non-permanent resident cohort which grew a stunning 313,000 in the past 3 months alone and has now ballooned by 805,000 or 47% in the past year. That is INSANE!



Source: Statistics Canada, author's calculations

Here's how the quarterly and annual increase breaks down:

	Past 3 months	Past year
Total NPRs	313,000 or 14.2%	805,000 or 47.1%
Work permit holders	164,000 or 16.4%	467,000 or 66.9%
Study permit holders	77,000 or 13.3%	122,000 or 23.0%
Work AND study permit holders	27,000 or 9.9%	87,000 or 40.7%
Asylum claimants	32,000 or 12.5%	96,000 or 49.8%
Other	12,000 or 12.5%	32,000 or 50.7%

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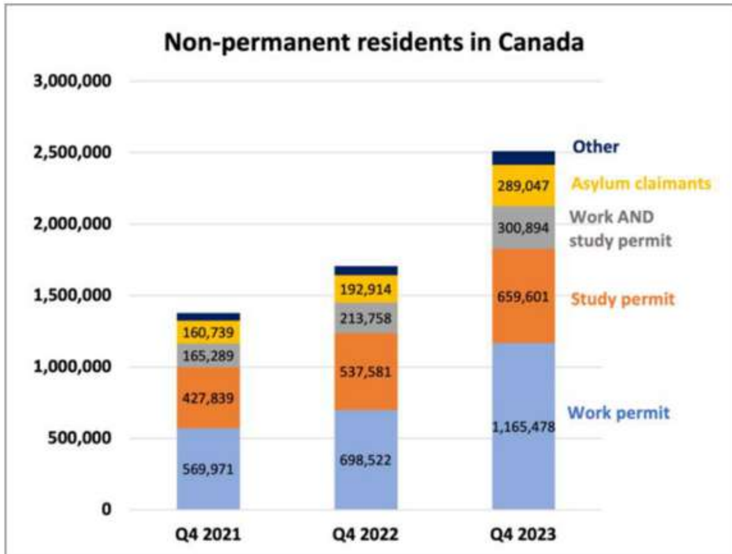
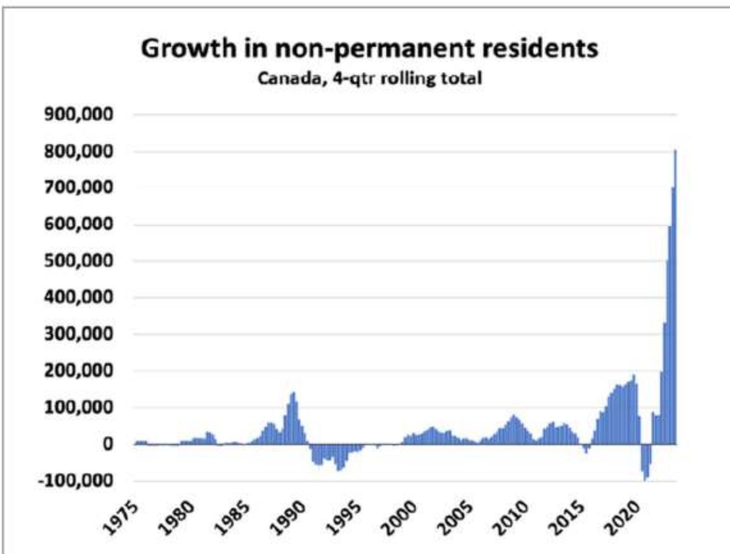
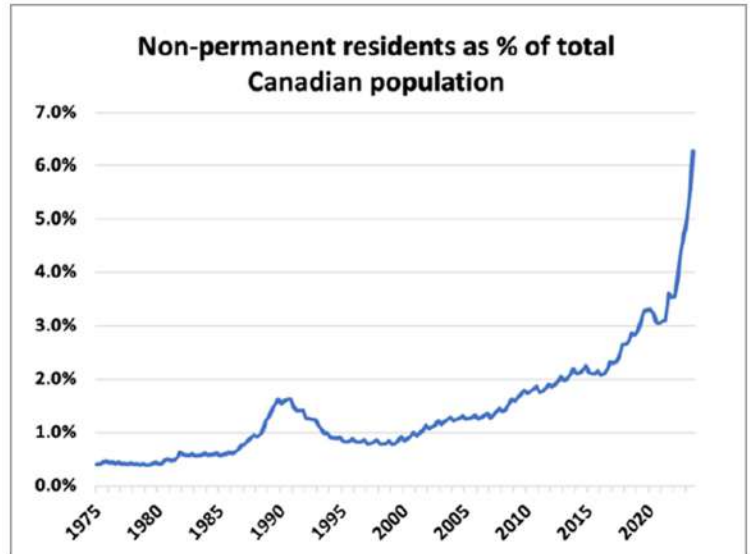
Here's another way to visualize these absolutely crazy numbers!



Adding 805,000 non-permanent residents in one year is clearly unprecedented, but it's easy to lose track of just how out of norm that is. For context, the chart below left shows annual growth in non-permanent residents back to 1975. This cohort now represents more than 6% of the entire Canadian population.





Now before anyone thinks this is any sort of new normal, I'm going to go out on a limb and call a top. Remember, in order to sustain this rate of growth, we have to bring in ANOTHER 800,000 NPRs next year. That means 800,000 ON TOP of any who may leave when their permits expire. It won't happen for two reasons.

i) **The labour market is already softening.** Job vacancies are collapsing and the unemployment rate is up nearly 1% from the lows. Where will the demand for ANOTHER 470,000 temporary workers come from?

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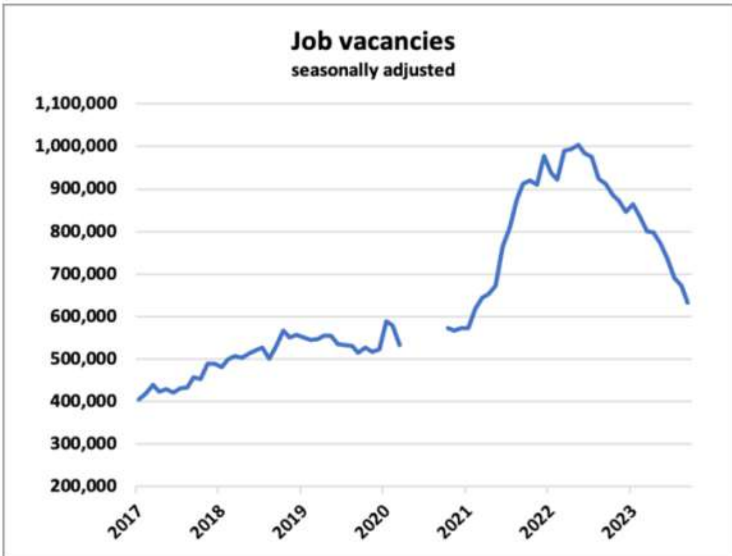


ii) **The gig is up for the international student scam. It's shameful** how this country has allowed rampant abuse of international students by for-profit "educational" institutions... and I use that term very loosely here. This won't continue. The feds just doubled the savings requirement for international students, who now must prove that they have access to $20,635 before being granted a study visa. Previously it was $10,000.

Canada · CBC Explains

Canada has new requirements for international students hoping to come study. Here's what you need to know

Applicants will soon need to show they have access to $20,635 instead of $10,000

Justin Li · CBC News · Posted: Dec 08, 2023 6:16 PM EST | Last Updated: December 9

Students are seen walking at McGill University in Montreal on Aug. 23. (Ivanoh Demers/Radio-Canada)

In addition, the feds put "diploma mills" on notice this month. Check out the language from Immigration Minister Marc Miller:

Federal government hikes income requirement for foreign students, targets 'puppy mill' schools

Ottawa also winding down policy that lengthened time graduating international students could work in Canada

The Canadian Press · Posted: Dec 07, 2023 3:49 PM EST | Last Updated: December 7

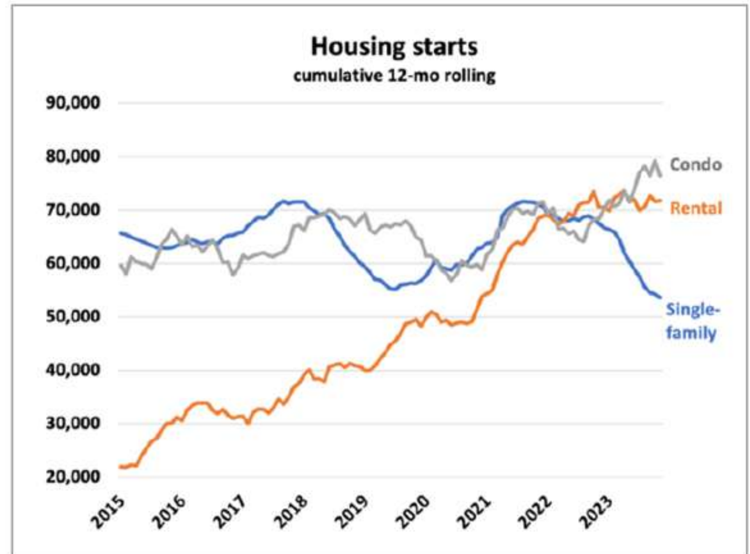
Immigration, Refugees and Citizenship Minister Marc Miller holds a press conference on Parliament Hill in Ottawa on Thursday, Dec. 7, 2023. (Sean Kilpatrick/The Canadian Press)

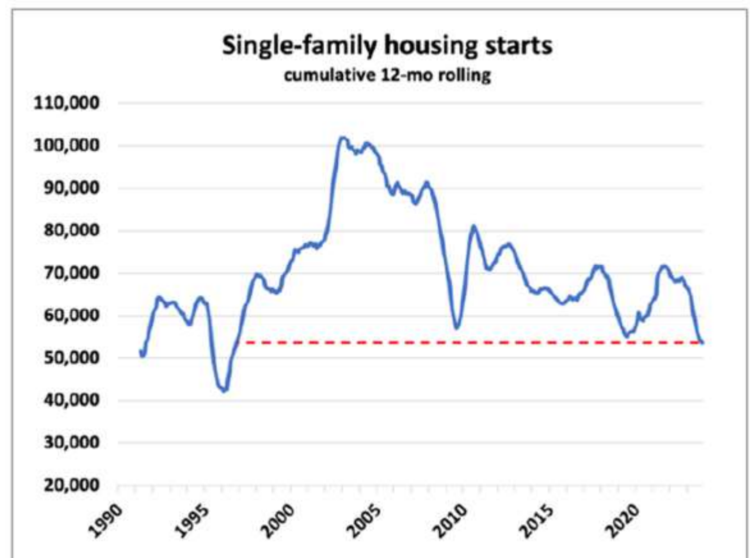
"There are, in provinces, the diploma equivalent of puppy mills that are just churning out diplomas, and this is not a legitimate student experience."

"There is fraud and abuse and it needs to end."

"Clearly, we have become a country that has been targeted for abuse and exploitation by some unsavoury actors"

"Enough is enough. If provinces and territories cannot do this, we will do it for them, and they will not like the bluntness of the instruments that we use"





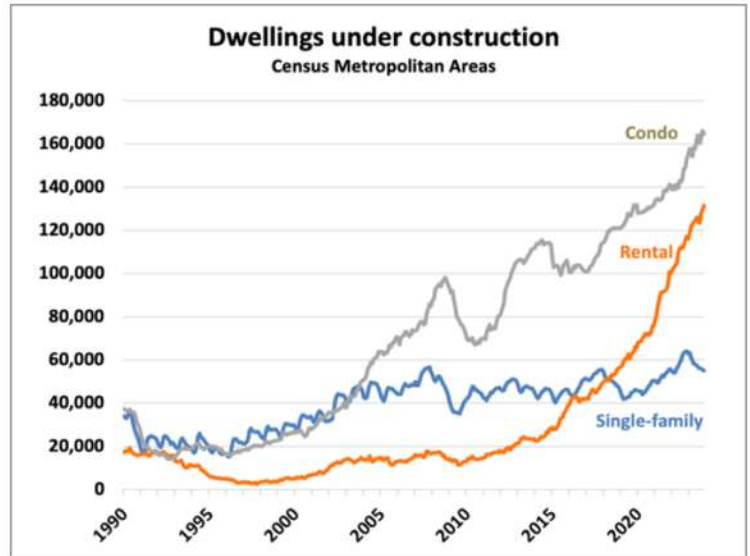
To be clear, all of the students and work permit holders can and likely will stay in Canada. It won't matter because to sustain this current rate of growth, we need to add ANOTHER 800,000. It's just really hard to see how that happens, and I think within a year to 18 months, we'll be back to roughly 500,000 annual growth... which is still massive in the context of the past 20 years, but is at least a little more manageable.

New supply tumbles

At the same time that population is booming, new supply is falling. Seasonally adjusted housing starts plunged 22% in November, the third largest monthly decline since the Financial Crisis. The decline is particularly acute in the single-family segment where we've seen starts over the past year fall to the lowest level since 1997:

I know a supply crisis doesn't seem likely with sales as weak as they have been recently, but I think it's a very real risk in 2025 and beyond based on these trends. We know demand will normalize at some point. What will the supply picture look like when that happens?

I would focus specifically on the single-family segment. The pipeline of dwellings under construction remains very solid overall, but it is skewed heavily to condos and purpose-built rentals. I could see a situation where condos and, yes, even rentals are balanced, but we have a severe shortage of single-family homes in just about every metro across the country:



4) *Monthly resale analysis: Sales slip but new listings evaporate*

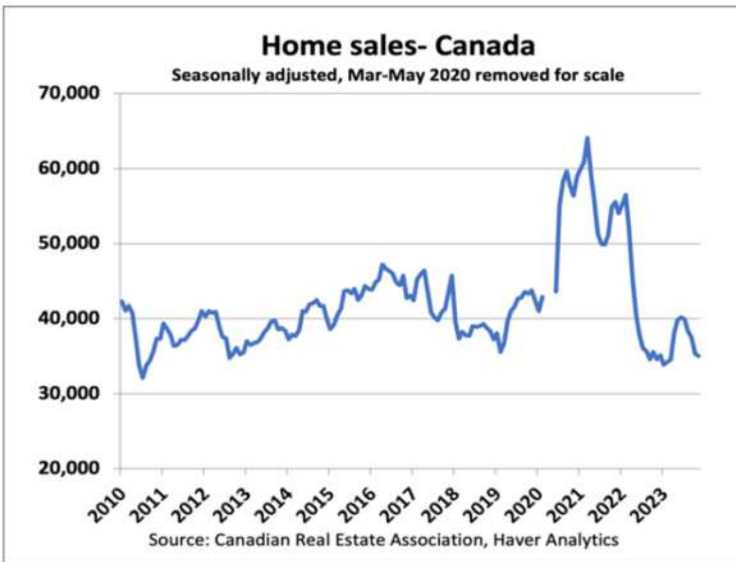
The key data from last month is summarized below.

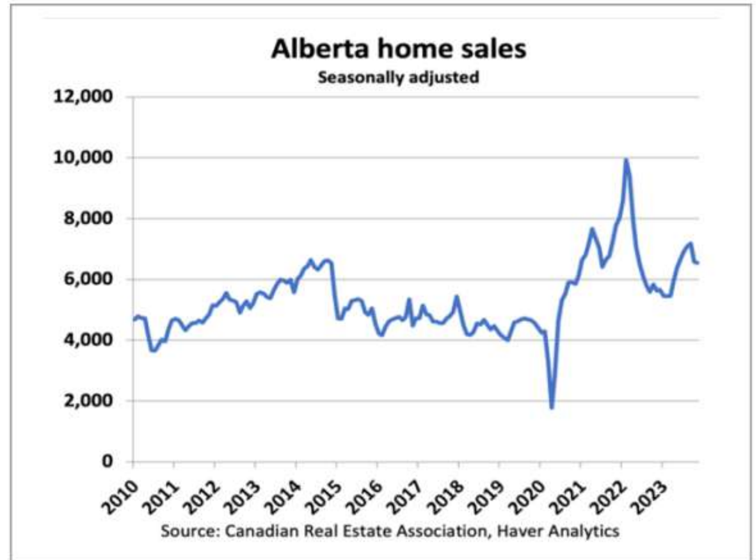
	Sales		New listings		Active inventory		House prices (HPI, seasonally adjusted)	
	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted	y/y	m/m seasonally adjusted
Canada	+1.3%	-0.9%	+7.9%	-1.8%	+18.1%	+1.7%	+0.6%	-1.1%
BC	+5.4%	-5.5%	+5.5%	-1.6%	+23.9%	+4.6%	+3.7%	-0.4%
AB	+16.3%	-0.5%	+12.5%	+3.4%	-2.1%	+0.8%	+8.4%	+0.9%
QN	-5.4%	+1.5%	+9.8%	-3.4%	+47.3%	-0.6%	-0.5%	-1.7%
QC	-2.4%	-2.2%	+7.3%	-3.0%	+9.6%	+4.0%	+3.9%	+0.0%

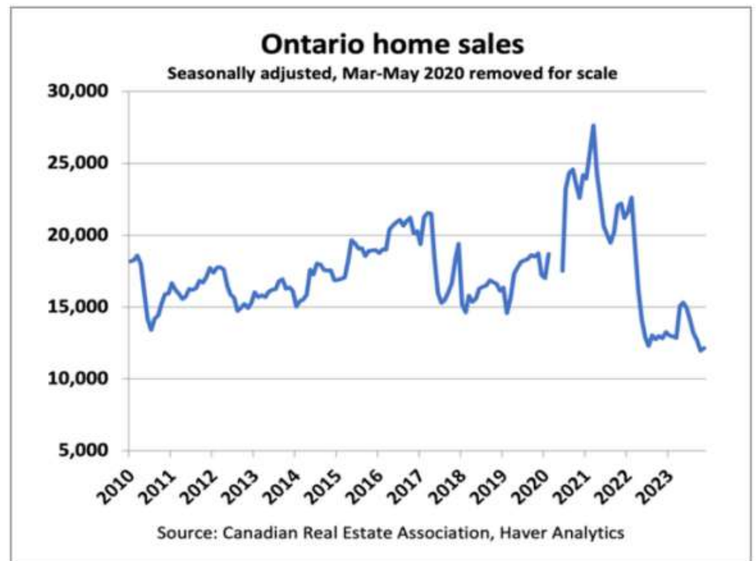
Key takeaways:

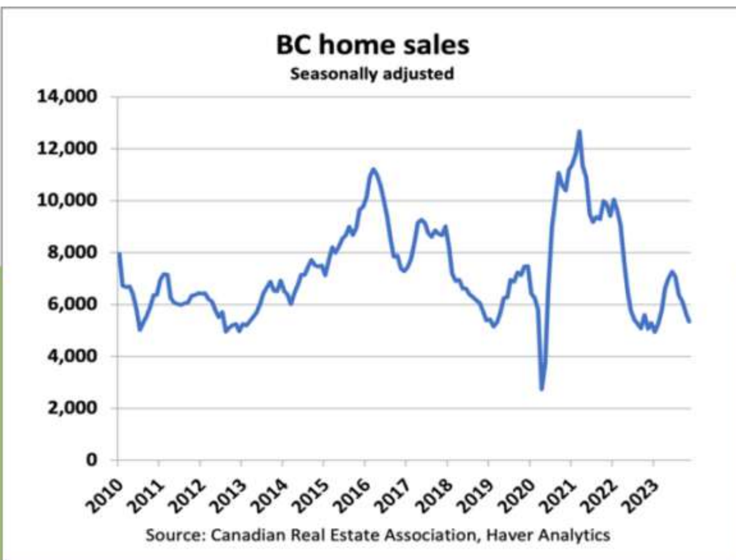
i) Home sales slip in November

Home sales remained under pressure in November, with transactions down 0.9% nationally led by declines in BC (-5.5% m/m) and Quebec (-2.2% m/m). In contrast, Ontario saw sales tick up 1.5%.









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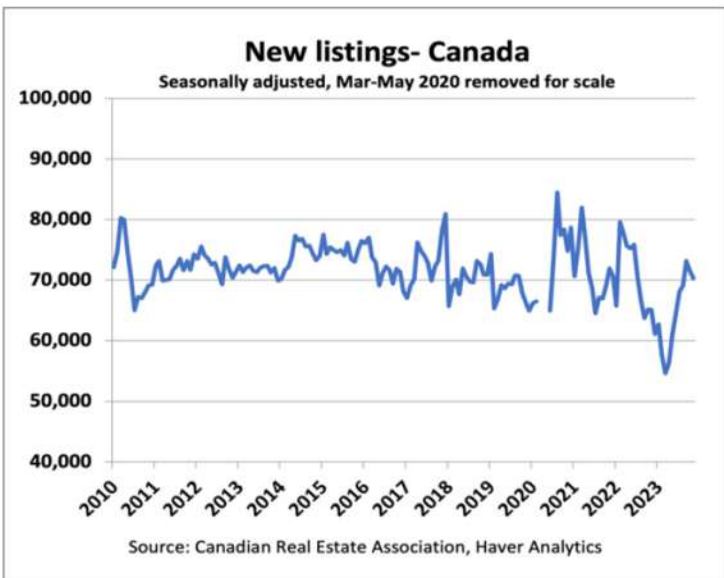
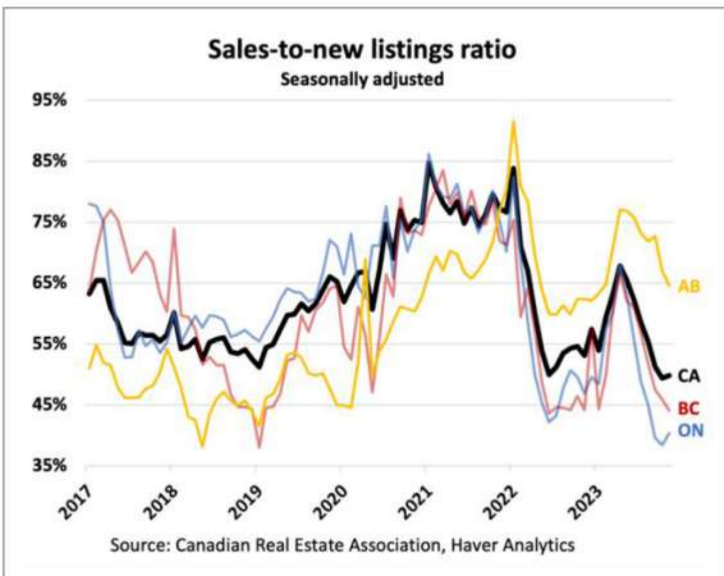
ii) New listings fall, market balance stabilizes

New listings, which had been trending higher since the summer, pulled back 1.8% in November led by a 3.4% decline in Ontario. That slowdown in new supply helped stabilize the sales-to-new listings ratio at just under 50% nationally:

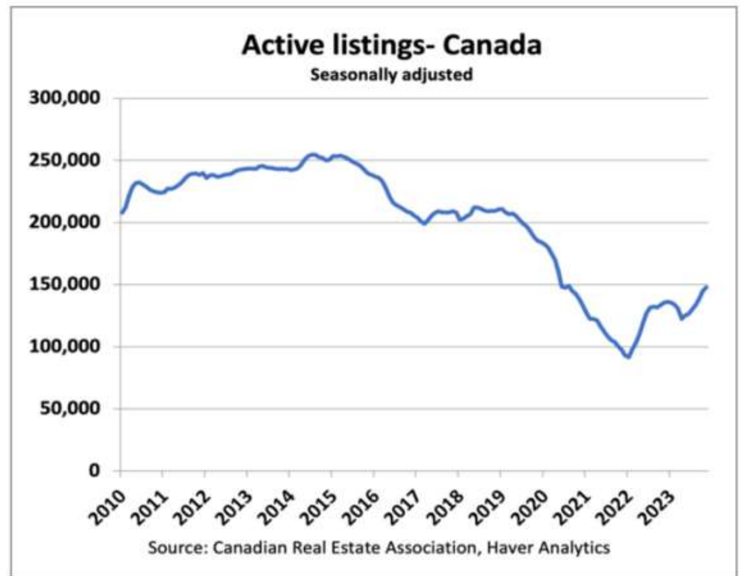




iii) Inventory rises, but more slowly

Active inventory rose 1.7% m/m seasonally adjusted in November led by a 4.6% increase in BC and a 4.0% jump in Quebec. In contrast, inventory levels fell 0.6% in Ontario, the first seasonally adjusted decline since April.

Active listings nationally had been growing by more than 4% monthly in September and October, so this represents a sharp decelaration that could signal a peak in listings in coming months:



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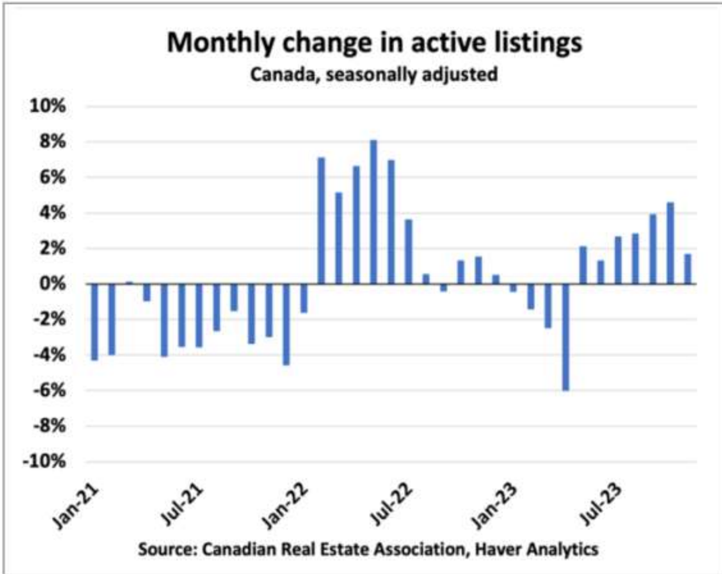
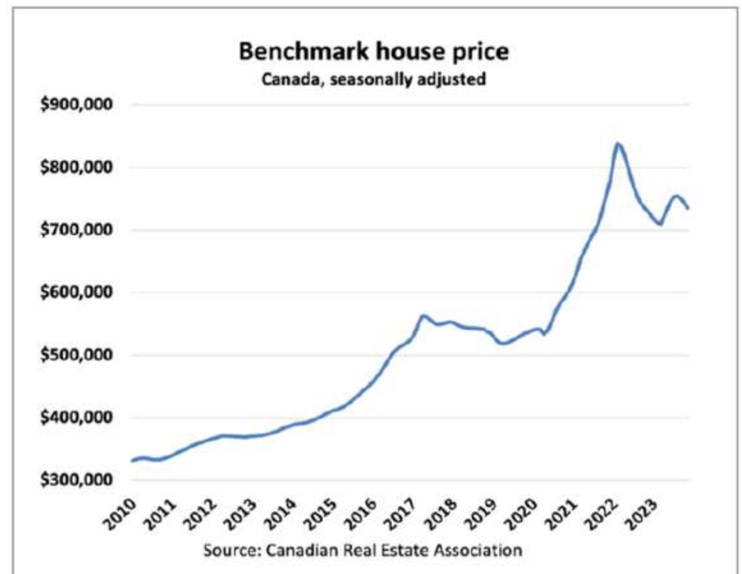


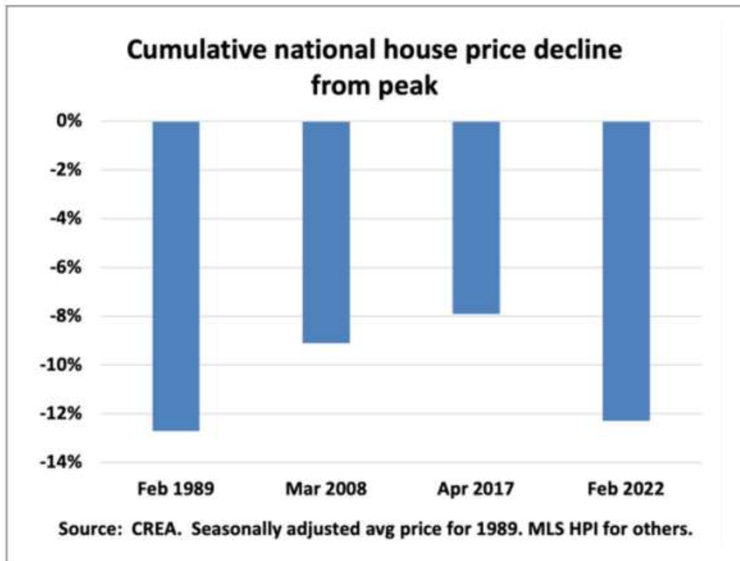
Inventory levels nationally are up nearly 20% over the past 6 months after accounting for normal seasonality, but the distribution is far from uniform. Alberta still has fewer listings while Ontario is up nearly 50% in that time frame:

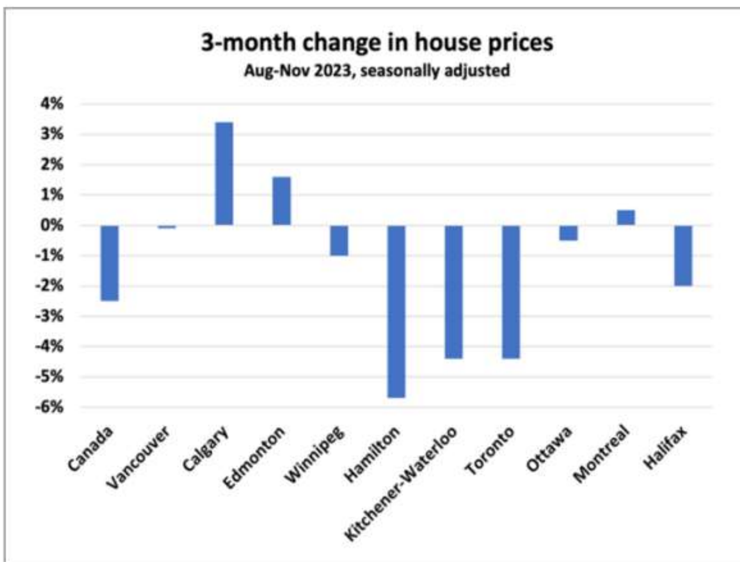
iv) Prices decline

House prices nationally decline 1.1% m/m in October, building on the 0.8% decline in October:

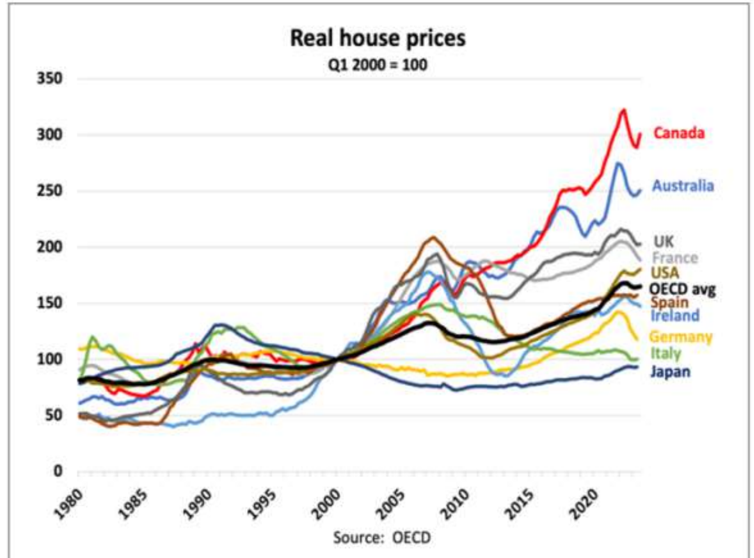


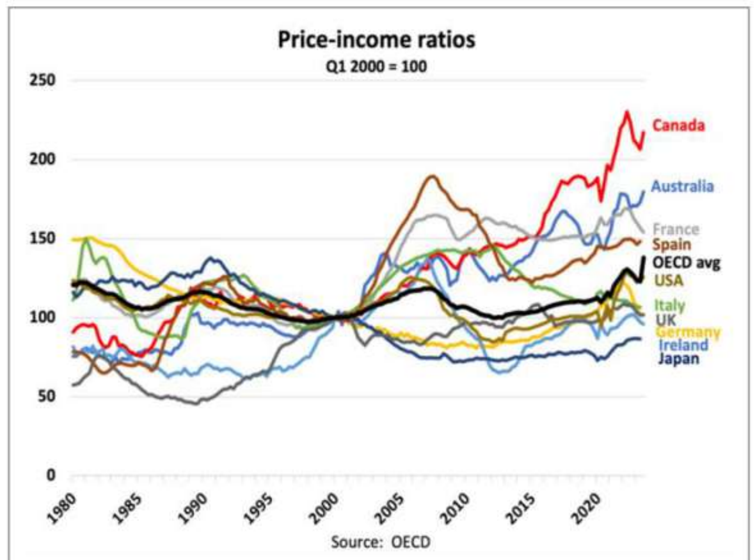
That brings the cumulative decline over the past 3 months to a modest 2.5%, and the declines off the February 2022 highs to just ovr 12%. The declines remain concentrated in the Southern Ontario metros:





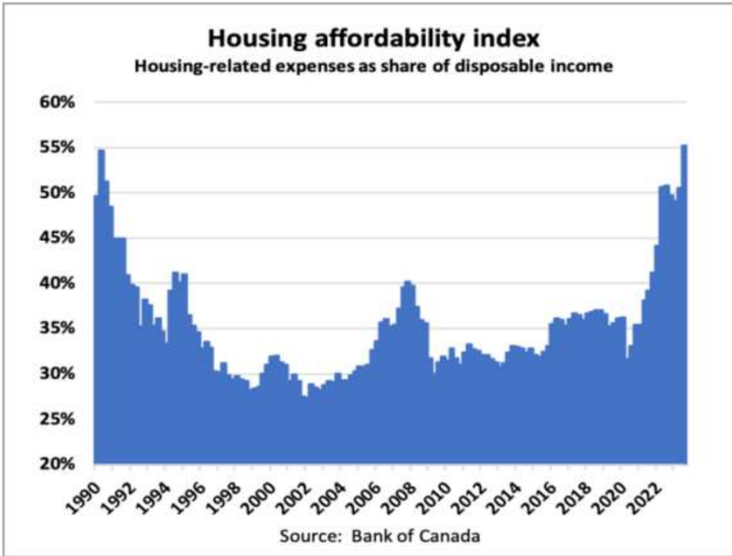
Related, the OECD updated their global housing database earlier this month. It's always striking how much house prices in Canada have outperformed our global peers, particularly in real terms and relative to incomes:



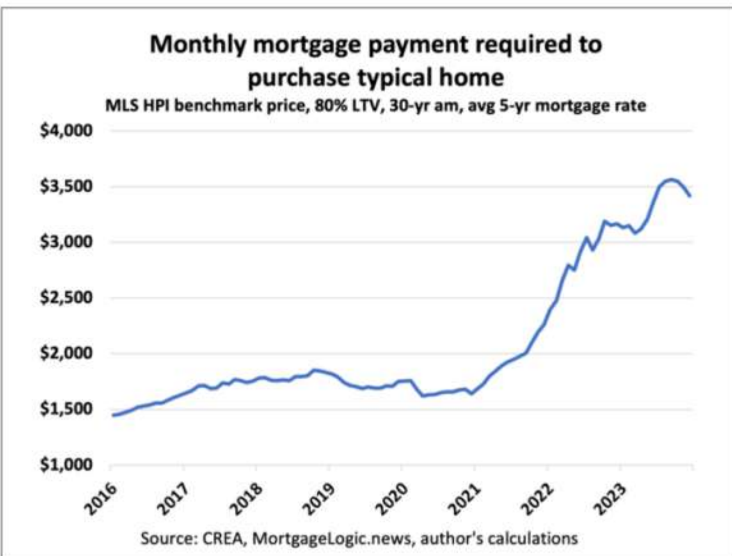


v) Affordability bottomed in Q3

We learned this month that housing affordability in Q3 hit the lowest since at least 1990 according to the Bank of Canada:



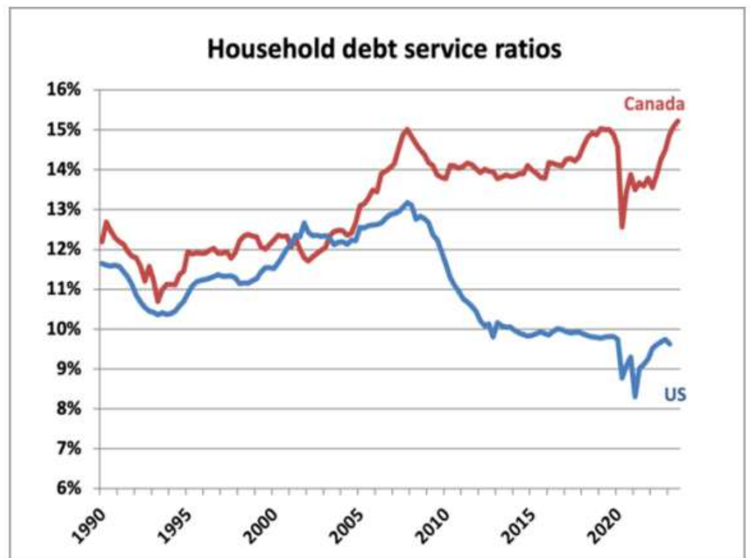
However, softening prices and the recent pullback in rates means that affordability has started to improve over the past couple months. The monthly payment required to purchase a typical home has fallen by $182 since August:



5) *Consumer check: A Closer look at household debt*

I've made the point before that the household debt service ratio (DSR) is one of the most important macroeconomic variables to track since it helps predict consumer spending and non-performing loans at Canadian banks.

We learned last week that this metric just hit the highest on record going back to 1990. Meanwhile new data from the BIS shows that Canada is near the top of the heap globally:



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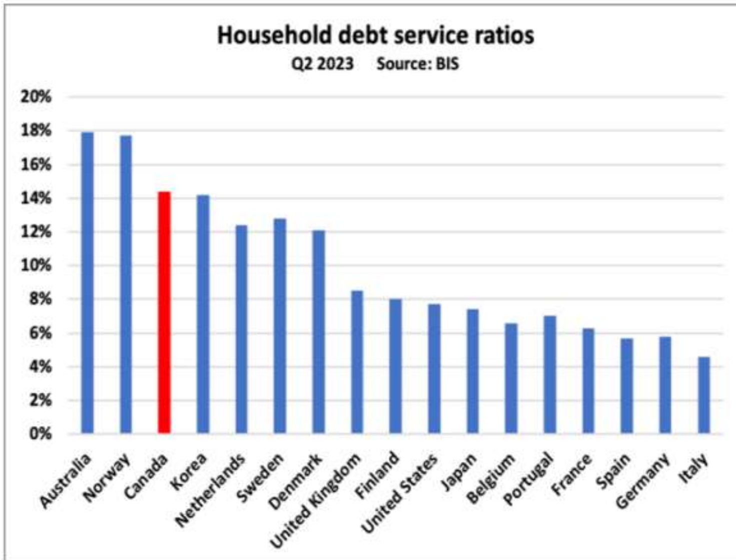
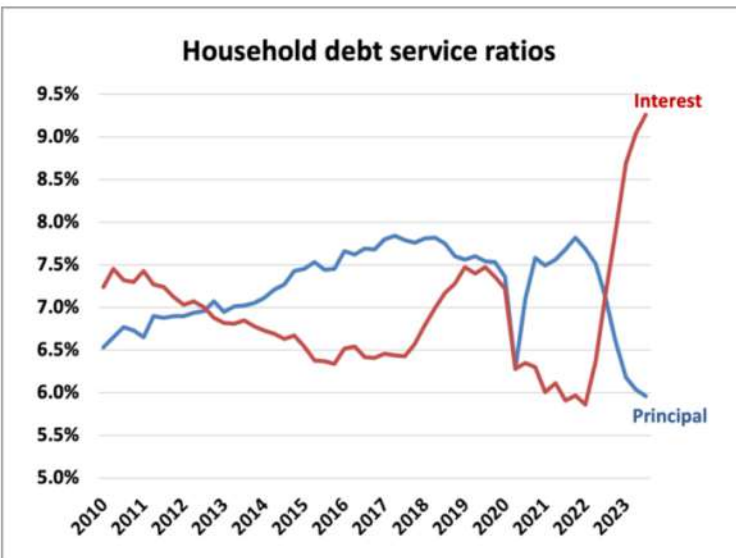
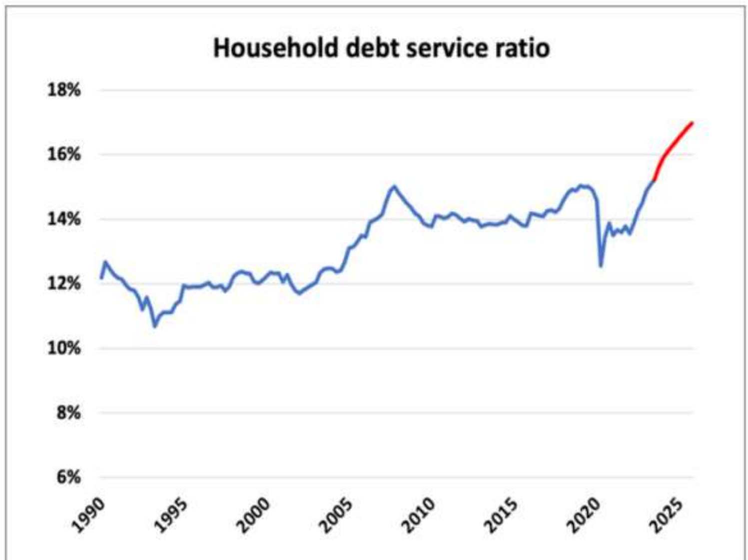


But it could be worse. If we pull the DSR apart into the interest and principal components, we see a continuation of the same bizarre trend we've observed for the past year: Interest expenses are surging but principal repayment is plunging. For context, principal repayment as a share of income is LOWER today than it was in Q2 2020 when we had national mortgage deferrals due to the pandemic. That is a wild stat!



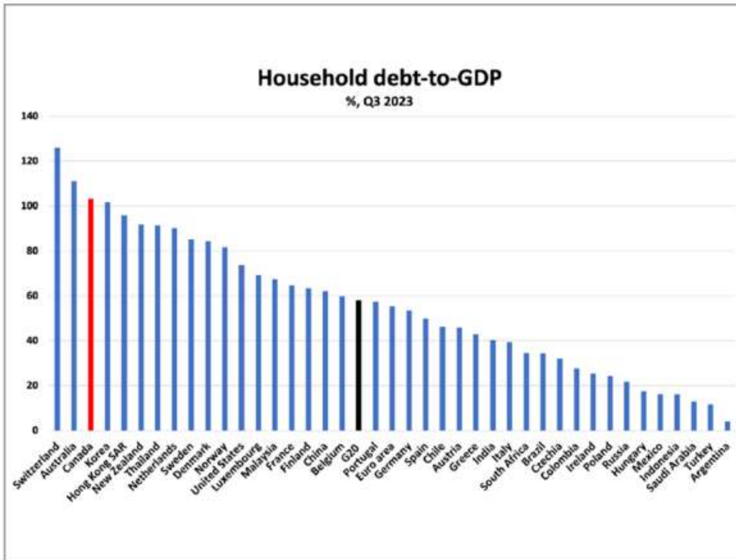
The culprit remains the proliferation of static payment variable rate mortgages which have the effect of reducing principal repayment as rates have risen.

The issue is that if we model out what this ratio will look like in coming quarters, it's not pretty. Below I assume a 2% quarterly growth in aggregate disposable income (which is probably generous), a 1% quarterly growth in debt outstanding, and a normalization in rates and amortization by year-end 2025:

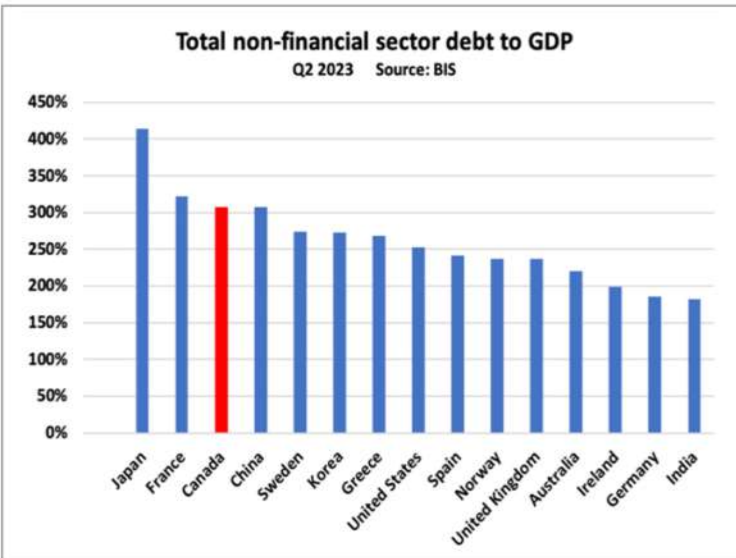


In reality, falling rates will likely prevent a worse-case scenario, but this ratio will almost certainly rise for at least another year.

The stone-cold truth is that Canada is a highly levered economy that has run head-long into a significant rate hike cycle, and we have to assume that there will be some fallout long after rates have ultimately peaked. Consider that household debt-to-GDP is near the top of the G20:



And if we add ALL debts across all companies and all levels of government, it totals over 300% of GDP. We're one of only 4 countries in that +300% group, along with the likes of Japan, France and China:



So that's the bad news, and unfortunately it means that consumer spending will be weak for a while and we should expect mortgage delinquencies to continue to rise right through 2024 even as the Bank of Canada cuts rates.

But there's good news too. Yes, Canadians are indebted, but we also have plenty of assets backing those debts. Currently households have roughly $6.50 in assets for every dollar of debt. Outside of 2020 and 2021, that's the highest this ratio has been since the Financial Crisis. So, yes, some pain is coming and is frankly long overdue, but ignore anyone calling for a US-style economic crisis. It's not in the cards.