SPOTLIGHT ON HOUSING

Construction and Renovation: Rising Costs and Interest Rates Take Their Toll

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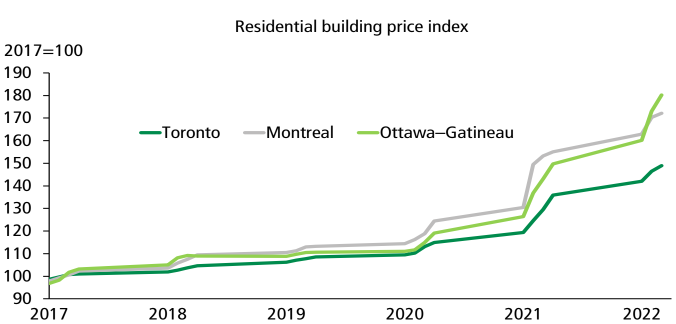
Quebec's housing market continues to cool. Existing home sales are down, and the average sale price has dropped 5.5% since peaking in April. Housing starts came in at an annualized 50,123 units in September, a 19.7% year-over-year decline and nearly 60% off the all-time high in January 2021. Higher borrowing costs are also slowing renovation spending, which started trending lower this spring in volume terms. And while resale prices continue to fall, construction and renovation costs remain elevated, further dampening activity. Rising interest rates haven't yet had their full effect on the housing market, so existing home sales, new construction and renovation spending will continue to weaken over the coming months.

New Construction Is Being Hit on Two Fronts

While the focus in recent months has been on falling resale prices, residential building prices are still up sharply, especially in Toronto, Montreal and Ottawa-Gatineau (graph 1). Construction costs continue to climb, and material shortages are putting some projects behind schedule. According to the Canada Mortgage and Housing Corporation's report, these delays are driving up the cost of new buildings and reducing the affordability of rents and units once the buildings are complete. It's therefore no surprise that housing starts are down dramatically in Quebec (graph 2) across market segments.

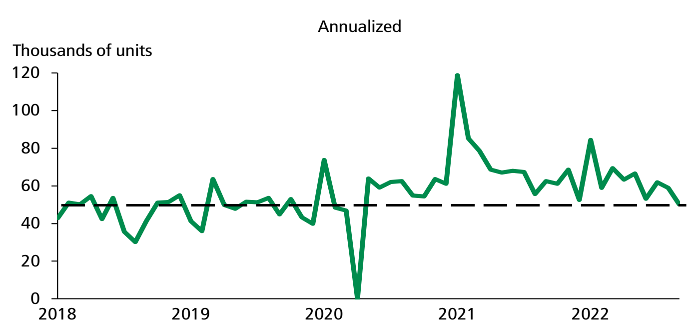
As interest rates have gone up, so too have borrowing costs, eating into the profits of heavily leveraged developers. This has slowed starts of rental apartments in particular, as the rent needed to cover construction costs would be out of reach for the target market. More and more projects are being rethought, delayed or scrapped altogether despite the ongoing rental housing shortage. From January to September of this year, starts of traditional rental apartments in Quebec were down 5.3% compared to the same time last year. Unless the government offers the necessary financial incentives, construction activity will continue to languish.

GRAPH 1
Residential building prices continue to rise



Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 2
Housing starts are back near 50,000 units in Quebec



Sources: Canada Mortgage and Housing Corporation and Desjardins Economic Studies

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But the provincial picture is mixed. Since the beginning of the year, construction has been declining in several major urban centres (table 1) while increasing in many suburbs on the Island of Montreal and in several medium-sized population centres. Trends vary in communities with fewer than 50,000 people, but total housing starts have been relatively stable. Rental apartments account for about 60% of all new housing in the Montreal CMA, so weak apartment construction is dragging down the total number. Quebec is expected to post a second straight annual decline in rental housing starts in 2023 after hitting a record in 2021 (table 2 on page 4).

TABLE 1
Rental apartment construction hasn't declined everywhere in Quebec this year

URBAN CENTRES	STARTS JANUARY TO SEPTEMBER 2022 (NUMBER OF UNITS)	STARTS JANUARY TO SEPTEMBER 2022 (Y/Y CHANGE)
Gatineau	2,010	+25%
Montreal	11,649	-19%
Quebec	4,580	-15%
Saguenay	60	-26%
Sherbrooke	783	-28%
Trois-Rivières	579	+115%
Medium-sized urban centres*	1,839	+104%
Small urban centres**	1,790	No change

*Urban centres with 50,000 to 100,000 inhabitants; **Urban centres with fewer than 50,000 inhabitants.
Sources: Canada Mortgage and Housing Corporation and Desjardins Economic Studies

Senior housing construction is already down 50% compared to last year. Due to the pandemic, the vacancy rate in Quebec senior housing rose to 12.8% in 2021. As a result, we've seen much less construction activity in this segment. Given current market conditions and higher borrowing costs, a recovery seems far off.

Home Construction Is Down More than Rental Apartment Construction

Home and condominium construction has declined sharply. Rising mortgage rates and property prices have sidelined many potential buyers. From January to September, starts of new homes were down 22.5% compared to the same period last year, and condo starts were off 16.4%. Housing starts have plummeted in all market segments provincewide, including single-detached homes (-22.0%), semi-detached homes (-17.3%) and row houses (-33.9%). And while construction is down in most major urban centres and small towns alike, keep in mind that 2021 was a near-record year. Total housing starts in Quebec are expected to fall about 10% this year and 20% next year, but 2023 should look more like 2019 before the pandemic.

Renovation Spending Has Turned Lower

Low interest rates from March 2020 to February 2022 helped borrowers get renovation financing despite rising material and labour costs. Due to the sheer number of new projects and higher costs, renovation spending in Quebec hit nearly $20 billion in 2021, a year-over-year increase of 33.1%. About half this increase was attributable to higher costs. In the first half of this year, both the renovation price index and renovation spending value grew at a slower pace.

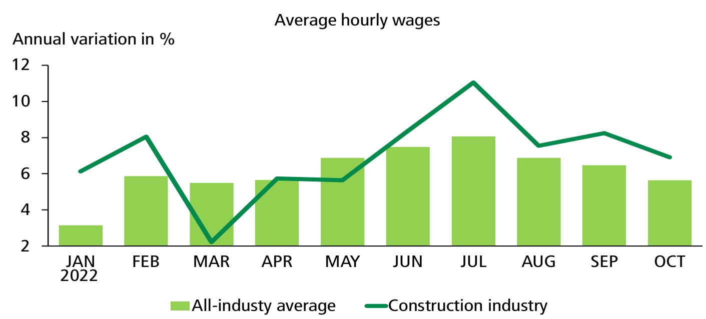
So where will renovation costs go from here? As global supply chain disruptions ease and housing demand wanes, material prices will gradually decline. Renovation spending is expected to fall by about 15% next year on lower material prices and high borrowing costs, which will limit the number of new renos. While the availability of skilled workers should improve as the construction industry slows, higher wages will keep labour costs high. Construction wages are rising faster than the all-industry average (graph 3).

Renovation spending began to soften after spiking during the pandemic. 2022 started off strong before rising interest rates put the brakes on renovation activity this spring, at least in real terms (graph 4). Excluding the price effect, renovation spending will likely fall about 5% this year and 10% next year.

The Resale Market: Overheated No More

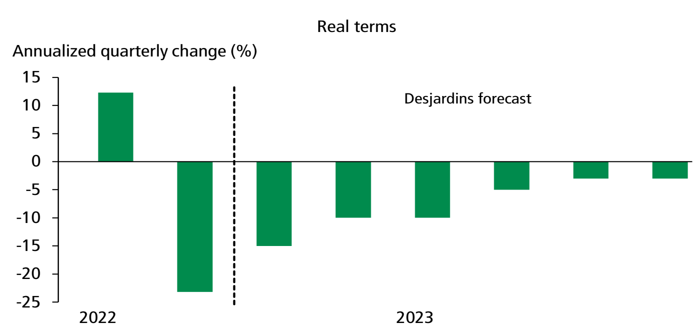
The existing home market rolled over this spring. Sales continue to fall, and inventory has spiked after hitting an all-time low (graph 5 on page 3). As a result, the market is almost back to

GRAPH 3
Construction wages are rising rapidly in Quebec



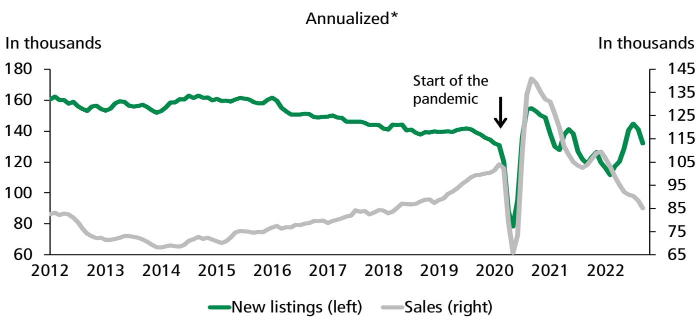
Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 4
Renovation spending has softened in Quebec



Sources: Institut de la statistique du Québec and Desjardins Economic Studies

GRAPH 5
Sales continue to fall in Quebec even though new listings are up



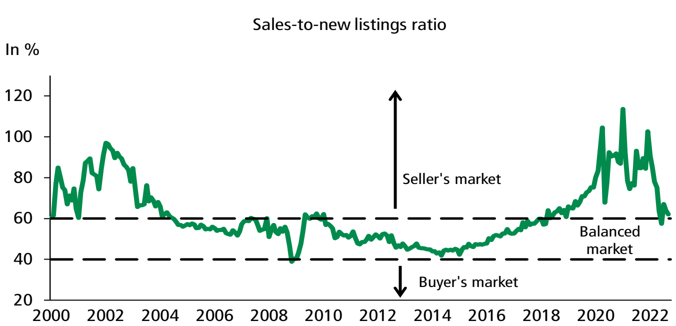
* 3-month moving averages.
Sources: Canadian Real Estate Association and Desjardins Economic Studies

balanced territory, and sellers have lost the upper hand (graph 6). Outsized price growth has given way to a more buyer-friendly market. The frenzy is over, and offers conditional on an inspection or the sale of another property are back. The pressure has eased, and sellers are having to adjust to this new reality.

As expected, bidding wars are becoming a thing of the past. In April, approximately 30% of homes sold for 10% or more above list. According to the Quebec Professional Association of Real Estate Brokers, that figure dropped to 5.8% in September. That's because higher interest rates have reduced demand from two types of buyers: households looking for a home to live in who have now been priced out of the market, and investors who borrowed to purchase multiple properties and are now overextended. Inventory is also up, and some investors are trying to sell, especially in the Eastern Townships, the Laurentians and other resort areas. In many cases, leasing out luxury homes that were financed is no longer a money-making proposition.

The average selling time is still quite low in Quebec: 43 days for homes, 49 days for condominiums and 64 days for two- to five-unit plexes. Sales are down and listings are up for all three property types. But conditions vary by market, and prices are holding up well in many communities. As we discussed in the

GRAPH 6
Quebec's housing market is back near balanced territory



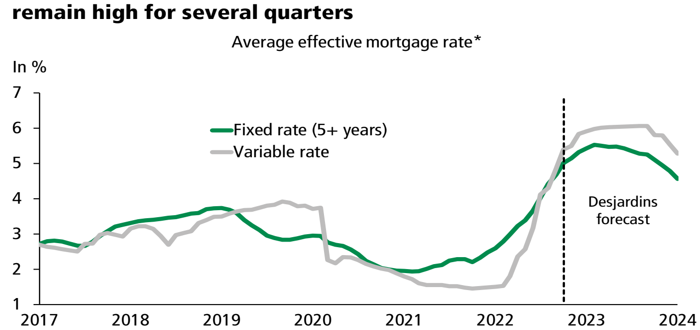
Sources: Canadian Real Estate Association and Desjardins Economic Studies

previous *Spotlight on Housing*, areas that saw a lot of bidding wars, like western and southern Quebec, are more vulnerable to price corrections. Prices are already falling rapidly in Montreal and Gatineau and the surrounding areas.

The Price Correction Will Continue

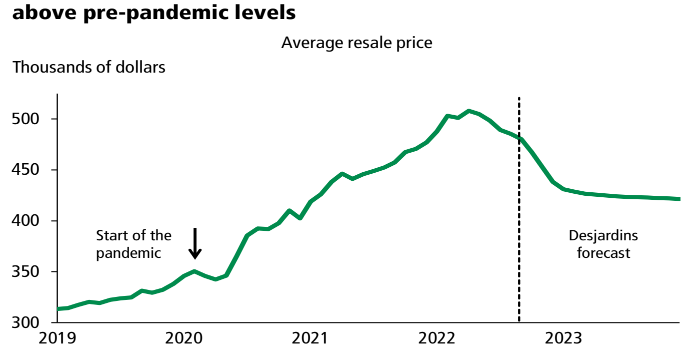
Rising interest rates haven't yet had their full effect on the housing market. Although rate hikes may be coming to an end, according to a recent *Essentials of Monetary Policy*, mortgage rates will remain elevated for some time (graph 7). High inflation is eroding household income, consumer confidence is down, and economic troubles are mounting. We could therefore see the labour market deteriorate slightly, further dampening the resale market in the coming quarters. The average price[1] declined 5.5% from April to September. That figure is expected to hit nearly 17% by the end of 2023 (graph 8). And as we discussed in a recent *Economic Viewpoint*, the price correction will be less severe in Quebec than in many other provinces.

GRAPH 7
Mortgage rates have just about peaked in Canada, but will remain high for several quarters



* Weighted by the size of cash advances.
Sources: Bank of Canada and Desjardins Economic Studies

GRAPH 8
Despite the ongoing correction in Quebec, prices will remain above pre-pandemic levels



Sources: Canadian Real Estate Association and Desjardins Economic Studies

[1] The weighted average price reflects the sales mix (property type and location).

TABLE 2
Quebec housing market outlook 2022–2023

	2019	2020	2021	2022f	2023f
New housing market					
New construction ($B)	**11.7**	**13.0**	**17.6**	**16.7**	**12.5**
Year-over-year change (%)	-1.9	10.7	35.4	-5.1	-25.1
Housing starts	**47,967**	**53,364**	**67,810**	**60,000**	**47,000**
Year-over-year change (%)	2.3	11.3	27.1	-11.5	-21.7
Houses	**13,742**	**15,502**	**21,091**	**16,500**	**11,000**
Year-over-year change (%)	-8.2	12.8	36.1	-21.8	-33.3
Single-detached	***8,989***	***10,437***	***14,826.0***	---	---
Year-over-year change (%)	*-10.6*	*16.1*	*42.1*	---	---
Semi-detached	***2,966***	***3,457***	***4,175.0***	---	---
Year-over-year change (%)	*-1.0*	*16.6*	*20.8*	---	---
Row housing units	***1,787***	***1,608***	***2,090.0***	---	---
Year-over-year change (%)	*-6.6*	*-10.0*	*30.0*	---	---
Apartments	**34,225**	**37,862**	**46,719**	**43,500**	**36,000**
Year-over-year change (%)	7.3	10.6	23.4	-6.9	-17.2
Condos [1]	***8,172***	***7,222***	***8,032***	***6,700***	***5,300***
Year-over-year change (%)	*-17.1*	*-11.6*	*11.2*	*-16.6*	*-20.9*
Rentals [1]	***24,861***	***28,709***	***35,659***	***32,500***	***29,000***
Year-over-year change (%)	*21.3*	*15.5*	*24.2*	*-8.9*	*-10.8*
Conventional rentals [2]	***21,536***	***26,554***	***33,049***	***31,200***	***28,000***
Year-over-year change (%)	*28.6*	*23.3*	*24.5*	*-5.6*	*-10.3*
Retirement homes [2]	***3,159***	***2,017***	***2,567***	***1,300***	***1,000***
Year-over-year change (%)	*-11.4*	*-36.2*	*27.3*	*-49.4*	*-23.1*
Resale market					
Unit sales	**96,349**	**112,162**	**109,473**	**87,925**	**69,950**
Year-over-year change (%)	11.4	16.4	-2.4	-19.7	-20.4
Weighted average price ($k)	**324**	**377**	**448**	**485**	**425**
Year-over-year change (%)	5.2	16.4	18.9	8.2	-12.4
Sales volume ($B)	**30.4**	**40.0**	**46.3**	**42.6**	**29.7**
Year-over-year change (%)	15.5	31.5	15.8	-8.0	-30.3
Other indicators					
Vacancy rate for rental units[3] (%)	**1.8**	**2.5**	**2.5**	**1.8**	**1.5**
Average rent[3] ($)	**800**	**844**	**873**	**915**	**965**
Year-over-year change (%)	5.1	3.8	3.6	4.8	5.5
Renovation spending[4] ($B)	**14.2**	**14.4**	**19.2**	**22.5**	**19.0**
Year-over-year change (%)	3.9	1.3	33.1	17.4	-15.6

f: forecasts; [1] Urban centres with populations of 10,000 or more, the total is slightly below the total for provincial apartments shown above; [2] Included in rental units; [3] Three units or more, biannual survey conducted in the fall; [4] Maintenance and repair expenditures are excluded.
Sources: Canada Mortgage and Housing Corporation, Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies