Is there a risk of a correction in Québec residential real estate prices?

It is a well known fact that residential real estate prices in Québec have been on a tear in the past 10 years. Some observers fear that a real estate bubble may now be forming in the province, which could lead to a sudden plunge in prices. To diagnose the situation, we need to evaluate the financial ability of households to support the current market, and determine whether the recent price increases are based on fundamental factors. A comparative analysis with the situation that prevailed in the 1990s, and to a lesser extent that of the latest recession, would provide a valuable benchmark of market conditions and economic factors that might trigger a price correction. The condo apartment segment, which saw an unprecedented building boom last year, is raising some concerns. Will these new units soon be snapped up? Are we heading towards a surplus market? Is there a significant risk of price declines for condos? This overview will draw some conclusions on all these issues.

- To assess whether price increases are based on fundamental factors, rather than on speculation, Desjardins Economic Studies have created an Affordability Index (graph 1), which takes into account household income, mortgage interest rates, property prices and some ownership costs.

- The Desjardins Affordability Index will tell us whether the rise in prices of the past few years is sustainable for households, and whether market conditions are conducive to a price correction.

- This tool enables us to gauge the financial capacity of households to buy a property. The current ratio of 147 indicates that the average income of Québécois surpasses the level necessary to obtain a mortgage loan for an average-priced home by 47%. A high affordability index indicates that favourable economic factors are supporting the expansion of the real estate cycle, eliminating the risk of a sudden market collapse.

- In the province as a whole, and in the six CMAs, the financial capacity of households to acquire a property, as measured by the affordability index, is close to the historical average and is well above the bottom level of 1990.

- A decline in prices, or a plunge like that which occurred when the real estate bubble burst in the early 1990s, does not appear to be imminent or even likely.
• According to our estimation model, which takes into account prices, income and mortgage rates, current property prices are below the estimated balanced value (graph 2), i.e. the value associated with these fundamental factors.

• At the beginning of 2008, just before the slight price correction that occurred during the recession, property prices were well above the balanced value. The market was also characterized by an overvaluation in 1990.

• Although the numbers vary greatly from one CMA to another, none of the markets seem to be showing an average price higher than the balanced value. That did happen in 2008 and in the early 1990s.

• Despite the nearly uninterrupted ascent of prices since the start of the 2000s, the Québec market does not seem to be overvalued. No real estate bubble is detected.

• The last period of real price declines dates back to the early 1990s. At that time, the resale market was in a surplus position (graph 4) because the ratio of the number of sales to the pool of properties for sale was well below the balance threshold of 40 to 55, as assessed by the CMHC.

• At present, the market is in a balanced state, after being in a shortage position since the start of the 2000s (except during the recent recession, when it was in a balanced position).

• A balanced market is characterized by price increases that are close to the inflation rate, i.e. between 2.5% and 3%. Price growth will stay around that pace in 2012 and 2013 in Québec, compared with 5.1% in 2011.

• For prices to fall, it would take a shock that would drive demand down, such as a significant downturn in employment, or a sudden surge in mortgage rates. That is what happened in the early 1990s (graph 3). In 2008-2009 the moderate decline in employment was not enough to push prices down, since interest rates had fallen to exceptionally low levels.

• It would take a lasting and major correction in employment to send demand for properties tumbling and drive prices down. That downside risk must be taken into consideration, given the very sluggish economic growth currently prevailing in Québec.
The risk of a price decline associated with rising interest rates is less of a concern for the next two years. The global economic and financial situation will keep interest rates close to their historic lows for several more quarters (graph 5).

New construction in Québec has already started its soft landing, with a 5.8% contraction in housing starts in 2011. All the market segments, with the exception of condos, have lost steam; but condo housing starts broke records in Montréal and Québec last year.

Concerns about a risk of condo overbuilding have started to emerge in the Montréal and Québec CMAs.

The number of units under construction is way up in both CMAs (graph 6). For the time being, the number of completed and unoccupied units is relatively low in Montréal, but high in Québec (graph 7).

The time-to-sale is just 10 months in Montréal and 9 months in Québec; those levels were reached a few times in the past 10 years.

Construction needs to taper off this year in order for the situation to remain under control, and to avoid a surplus situation in the new condo market.

The condo resale market is close to a balanced state in both Montréal and Québec. The ratio of sellers to buyers is very low from a historical perspective. The 1990s were characterized by a surplus that drove prices down, with ratios peaking at around 35 in Montréal and 50 in Québec (graph 8). No price decline is expected for existing condos in the short term.
CONCLUSION
In short, several indicators suggest that we can turn off the red alarm signal. For one, the financial capacity of households to acquire a property is close to the historical average. The soaring prices of recent years have been offset by a slight increase in income and, to a greater extent, by low mortgage rates. According to our estimation model, none of the province’s six CMAs are showing disproportionate prices compared to the fundamental factors. Therefore, the Québec residential market does not seem to be overvalued. For prices to decline, it would take a shock, such as a lasting correction in employment or a surge in mortgage rates, that would send demand plummeting. The market would then swing from a balanced state to a surplus situation. Given the sluggishness of the economy, we must of course keep a close eye on the job market, whose future trends present the main downside risk. For now, the yellow warning light is enough.

As far as condos are concerned, new construction needs to diminish to promote sales of the projects that are nearing completion. Despite the high level of unsold new units under construction, the number of months needed to sell them off seems reasonable. Moreover, the condo resale market is close to a balanced state and far from a surplus situation like that of the 1990s, which drove prices down.

All things considered, the foundations of Québec’s residential sector seem to be sound. Barring a significant deterioration in the economy, a price correction (or collapse like that of the 1990s) is not in the cards in the short term. We should keep in mind that even the slight recession of 2008-2009 did not have any major impact on home prices, and stop worrying so much.

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