ECONOMIC VIEWPOINT

How Low Can Prices Go in T.O.?

Even A Severe Recession Likely Won't Make Housing Affordable in Toronto

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Summary

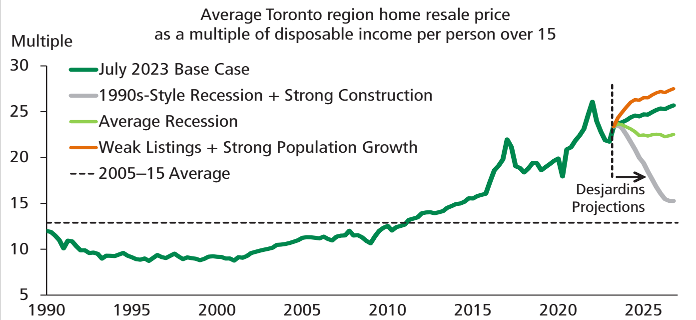
- After years of being priced out of the market, many prospective Toronto homebuyers now sense an opening with a recession looming. But even in the direst of economic scenarios, we don't see affordability returning to Canada's largest city anytime soon.
- Our worst-case scenario is a 1990s-style Ontario recession that would drive average Toronto home values $185k (16%) below current levels by the end of next year. By Q4 2025, prices would sit $340k (30%) lower than in July 2023 (table 1).
- Yet even if that improbable outcome were to materialize within the next three years, it would only bring Toronto's home price-to-per capita disposable income ratio back to still-stretched, late-2015 levels (graph 1).
- Such a significant price decline could likely only come at a massive economic and social cost. Compared to our base-case Ontario forecast, a 1990s-style recession would result in a more than $35B reduction in employment income and almost half a million total job losses by Q4 2025.
- A more bullish house price trajectory is also possible. Our most optimistic scenario for current homeowners sees persistently strong population growth and limited numbers of new listings lifting prices above the February 2022 peak by early 2025.
- Our analysis underscores the extremely difficult starting position for both first-time home buyers and policymakers seeking to improve housing affordability. Consequently, plans to boost the supply of affordable housing can't fall short. It's just not an option.
- All levels of government and the private sector have to work together to address the herculean challenge of adequately increasing new homebuilding. Toronto's—and indeed Canada's—status as a welcoming and prosperous place to live depends on it.

TABLE 1
Toronto Housing Price Scenarios

	July 2023	Q4 2024				Q4 2025			
	$ M	$ M	vs. Q4 '19 (% change)	vs. Feb. '22 (% change)	vs. Jul. '23 (% change)	$ M	vs. Q4 '19 (% change)	vs. Feb. '22 (% change)	vs. Jul. '23 (% change)
June 2023 Base Case	1.15	1.21	40.9	-6.6	4.9	1.26	46.8	-2.7	9.3
1990s-Style Recession + Strong Construction		0.97	12.8	-25.2	-16.0	0.81	-5.4	-37.3	-29.6
Average Recession		1.10	27.9	-15.3	-4.8	1.12	30.0	-13.9	-3.2
Weak Listings + Strong Population Growth		1.28	49.0	-1.3	10.9	1.32	54.2	2.2	14.8

Sources: Statistics Canada, Canadian Real Estate Association, Ontario Ministry of Finance, and Desjardins Economic Studies

GRAPH 1
Even a Severe Recession in Ontario Might Not Restore Housing Affordability to Historical Norms

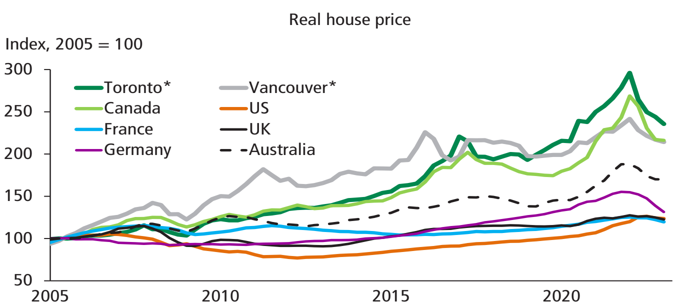


Sources: Ontario Ministry of Finance, Canadian Real Estate Association, The Conference Board of Canada, and Desjardins Economic Studies

Introduction

The tides are turning once again in Canada's biggest housing market. Our country's nearly uninterrupted two-decade run-up in home prices, including the dizzying appreciation that took place during COVID-19, is well documented internationally. However, even within that context, Toronto's experience stands out (graph 2). After March 2022, when the Bank of Canada (BoC) began one of the most aggressive interest rate hiking cycles in Canadian history, prices in the Big Smoke plummeted 18% in the year to February 2023. They resurged early this year as the BoC paused its tightening campaign, but sales activity has taken another beating since borrowing costs increased again in June and July. And to make matters worse, many indicators now suggest a long-expected economic slowdown is imminent. Yet population growth is skyrocketing, and the housing shortfall remains acute while Canadians continue to fiercely debate how we should address record housing unaffordability.

GRAPH 2
A (Global) Poster Child for Unaffordability

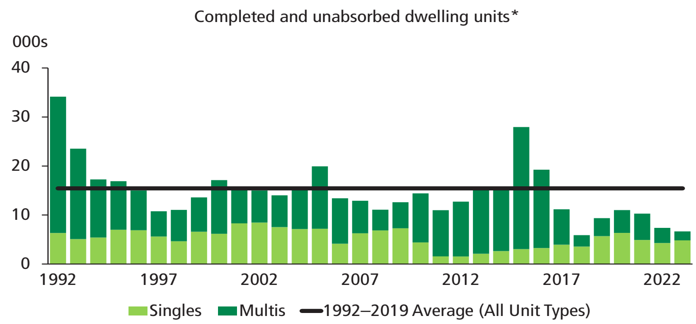


* Adjusted based on provincial household consumption deflators
Sources: Federal Reserve Bank of Dallas, Statistics Canada, Ontario Ministry of Finance, and Desjardins Economic Studies

Against that uncertain backdrop, we've projected where prices and affordability could go in Canada's largest city. To do so, we ran three scenarios using [Ontario's quarterly Economic Accounts] data, local real estate board statistics, and an econometric framework based on the Bank of Canada's forecasting techniques.[1]

As with any shock-minus-control exercise, the choice of base case is important. Here, it affects comparisons of projected and historical home values. We assume house prices will quickly rebound over the next two years—supported by interest rate cuts in 2024–2025, strong demographic growth, and tightly balanced supply and demand. Demographic trends look much more supportive of housing demand now than 30 years ago, as the population is expected to grow sharply, and an increasing number of Millennials are entering their prime homebuying years. Moreover, housing inventory in Toronto is hovering near record lows, in contrast to the early 1990s (graph 3). This is consistent with [CMHC estimates] that Ontario will need to ramp up new home construction more than any other province to restore affordability. Beyond 2024, we expect price gains to slow compared to historical growth as high household debt starts to take a bigger bite. Still, starting with a more pessimistic baseline scenario didn't change our core findings with respect to affordability.

GRAPH 3
Weak Housing Inventories in Toronto to Start Off 2023



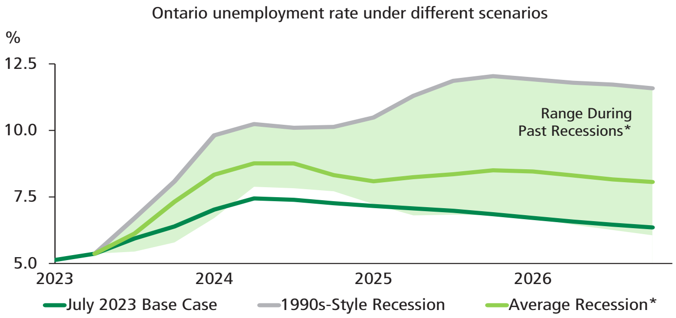
* 2023 figure based on year-to-date growth rates
Sources: Canada Mortgage and Housing Corporation and Desjardins Economic Studies

Scenario 1: Severe Recession in Ontario, Strong New Homebuilding

We used Ontario labour market outcomes from the 1990s recession to build our worst-case economic scenario. While our base case economic and Toronto housing market forecasts already assume there will be a recession in Ontario, it's projected to be mild by historical standards (graph 4 on page 3). In contrast, the 1990s recession was arguably the worst downturn in the province's recorded history. It took four years for output to return to its Q4 1989 peak, seven years to recoup employment losses, and more than 12 years for home prices to recover. If labour market outcomes were to follow a comparable trajectory, it would push Ontario's unemployment rate above 12% by 2025—close to double the maximum in our baseline forecast and far higher than the broader private sector expects. We also assumed that Toronto housing starts would advance in line with the [CMHC's April 2023 high growth scenario].

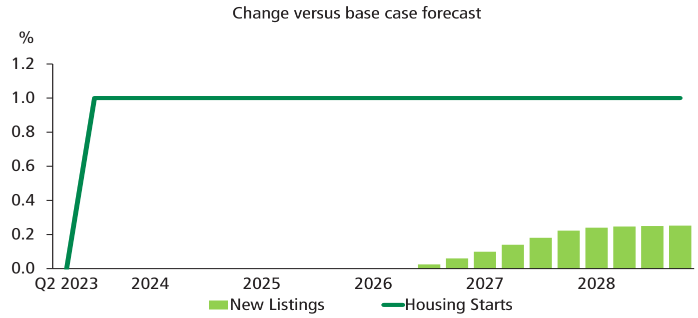
[1] For the purposes of this report, we estimated equations for resale home prices, home sales, housing starts, and new listings for the Toronto region and the rest of Ontario. As in [LENS], our equations assume that all economic agents are forward-looking and variables from the quarterly Ontario Economic Accounts are determined by the expected equilibrium level and adjustment costs. This lets us estimate where prices might go and gives us an idea of how supply and demand in Toronto and other Ontario housing markets interact with economic indicators like disposable income and the unemployment rate. This gives a fuller picture of affordability under different scenarios. Total Toronto income was obtained from The Conference Board of Canada data and assumed to grow in line with Ontario's rate over time.

GRAPH 4
By Historical Standards, Our Base Case Recession in Ontario Is Mild



* Based on Global Financial Crisis, 1980s, and 1990s recession
Sources: Statistics Canada and Desjardins Economic Studies

GRAPH 6
Impact of a Permanent One Percentage Point Increase in Toronto Housing Starts



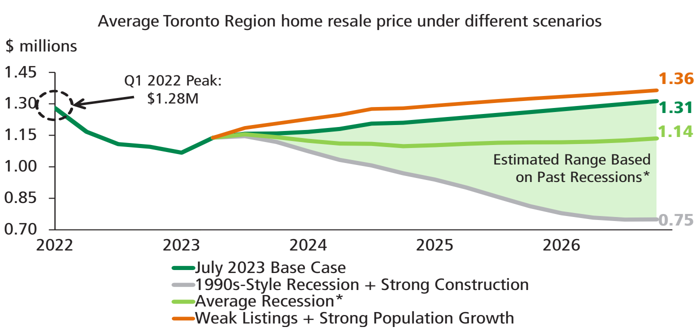
Sources: Canadian Real Estate Association, Ontario Ministry of Finance, and Desjardins Economic Studies

If this improbable outcome were to actually occur, Toronto home prices would fall by $185k (16%) from current levels by the end of next year and end about $340k (30%) below the July 2023 level by Q4 2025 (graph 5). But such a plunge would only bring the home price-to-per capita disposable income ratio back to where it was in late 2015. That was considered to be a record level of unaffordability at that time, and the ensuing froth in 2016 and early 2017 prompted the provincial government to enact a suite of measures to cool the housing market down.

The costs of this worst-case scenario would be enormous. Compared to our base-case economic forecast for Ontario, a 1990s-style recession would result in net total provincial job losses approaching 500k by Q4 2025. By that time, province-wide employee compensation would sit more than $35B lower than in our baseline projections.

It's also worth pointing out that it takes time to build new homes and therefore to boost the housing supply, both in the real world and within our econometric framework (graph 6). Our estimates reflect the historical data for Toronto and the rest of Ontario, which point to a meaningful lag of several years from starts to new listings. Accordingly, differences in housing starts don't significantly alter the trajectory of home prices in our scenarios, which largely focus on the next three years.

GRAPH 5
A Mild-to-Moderate Recession Would Have Meaningful Impacts on Toronto House Prices



* Based on Global Financial Crisis, 1980s, and 1990s recession
Sources: Statistics Canada, Canadian Real Estate Association, and Desjardins Economic Studies

Scenario 2: A Moderate Recession

In our second scenario, we examined what would happen if the broader provincial economy deteriorated at a more typical rate over the next few years. To do so, we assumed that the province's current unemployment rate would rise in line with the average such increase (graph 4). As in our first scenario, this allowed us to assess the potential impacts on housing supply and demand, since unemployment tends to reduce homebuilding and push financially stretched homeowners to list their properties.

In this scenario, Toronto house prices would bottom out by the end of next year at about 5% below July 2023 levels. Combined with a smaller percentage-wise decline in per-person incomes, we forecast a home value trajectory that would slightly improve affordability versus current levels. Unfortunately, this would still only result in a return to early-2021 levels for the price-to-disposable income ratio per person over age 15.

Scenario 3: Weak New Listings, Strong Population Growth

Our third and final scenario is the most optimistic one for current homeowners. In it, we make two assumptions. The first is that annual working-age population growth remains at recent (record) rates of almost 3% through 2026. This would keep housing demand higher than in our baseline economic forecast, which has headcount gains slowing to around 1.5% by mid-decade, as expected by the Ontario government. We also assume that new home listings in the Toronto market remain about 15% below our estimate of the long-run equilibrium level. This is consistent with the average from Q3 2022 to Q2 2023 but would represent a reversal of the trend seen in Toronto since the BoC resumed its rate hikes. However, combined with skyrocketing population gains, this assumption helps illustrate a potential path for prices if short- and medium-term demand-supply balances remain tight.

We estimate that these conditions would lift Toronto home prices about 6% higher than in our base case (graph 7), pushing them past the February 2022 peak by early 2025. Although this would be great news for property owners, it is the least positive of our scenarios for prospective buyers. The sales price-to-disposable income ratio per working aged person would exceed its pandemic-era peak by mid-decade.

Final Thoughts

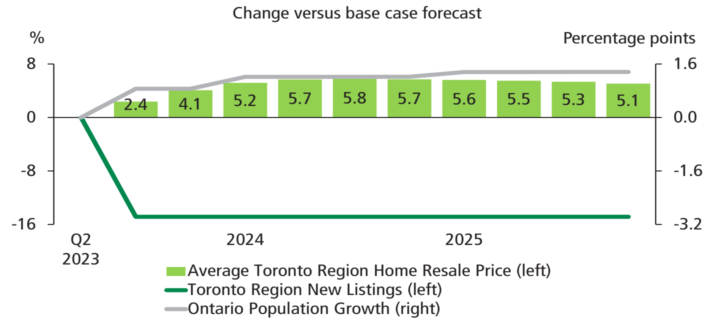
Above all, our analysis highlights the extremely difficult starting position for both prospective first-time home buyers and policymakers seeking to improve housing affordability. This challenge is particularly daunting in Canada's largest city.

The second takeaway is that the health of the Ontario labour market will likely be a major driver of Toronto home sales activity and price movements in the next few years. Investors, policymakers, and the business community should be tracking related indicators closely.

As with any empirical work on economic impacts, it's important to talk about the things we haven't covered. One is how a steep drop in house prices could spill over to the financial markets, which could dent consumer confidence and dampen buyer and seller sentiment over both the shorter- and longer-term. Another factor we haven't discussed is the mix of unit and market types needed to improve affordability, which would have to include the "missing middle," student housing, and purpose-built rental accommodations. An alternative path for interest rates could also be considered, though we think the effects of such a path would likely be mixed. Tighter monetary policy would very likely have outsized non-linear impacts on debt-saddled consumers, as we recently highlighted. Yet our empirical framework estimates mortgage rates based on both Canadian and US market conditions. So, another move from the BoC might not—on its own—be enough to alter our projections for home values or affordability. Moreover, a deep recession would almost certainly result in monetary stimulus that could—if early 2023 is any indication—bring some prime homebuying-age Ontarians off the sidelines.

So, abandon hope, all ye who seek to make home ownership attainable here? We don't think so. Striking as these results may be, we've always known that restoring housing affordability was a long-run process. Our analysis reinforces that view, as well as the need to successfully implement ambitious plans to boost the housing supply. In addition to the fundamental human rights questions raised by severely stretched affordability, our work has previously highlighted the speed with which young people are leaving Ontario, especially the GTA, in search of cheaper accommodations. Thus, despite near-record population growth, Ontario risks eventually losing the entrepreneurship and economic dynamism that young people bring. Meanwhile, as a global financial services hub, Toronto doesn't just compete with other Canadian cities to attract talent, it also competes with cities around the world. Consequently, a lack of affordability means it could lose people to both domestic and international destinations. Our team recently released a guide on how to achieve affordability with a range of policy options for boosting home construction in Canada and Ontario over time.

GRAPH 7
Further Weakness in New Listings Would Drive Toronto Home Prices Higher



Sources: Canadian Real Estate Association, Ontario Ministry of Finance, and Desjardins Economic Studies

Given the above, we think the discussion on housing affordability in Canada needs a change in tone. Considering the depth of the current crisis and the significant amount of time and effort needed to remedy it, we can't waste time on blame or partisan attacks. Instead, we need all levels of government and the private sector to work together to address the herculean challenge ahead. Toronto's—and indeed our country's—status as a welcoming and prosperous place to live depends on it.