TD Asset Management

NEW THINKING

Not Your Parents Real Estate Market

Why changing how we view residential real estate is essential in today's economy

"Is there a housing bubble?"
"How long can this possibly last?"
"I remember this happening in the early 90s!"

Large areas of the Canadian real estate market have seen tremendous price gains over the past decade and beyond. This is something that has been widely discussed, and a topic most people have opinions on. From how it got to this point, to what's supporting it, to what's going to happen next – there are endless views on the state of Canada's residential real estate market.

Extremely low borrowing rates, shortage of housing supply and an influx of foreign investors are all viable explanations to why residential real estate prices have risen. The forces that drive house prices, however, have fundamentally changed and are now more complex than ever before, with globalization being one of the main factors that has changed the dynamics. The purpose of this paper is to help explain the current state of the real estate market, globally and locally, and provide a new way of assessing how we view real estate from an investment standpoint.

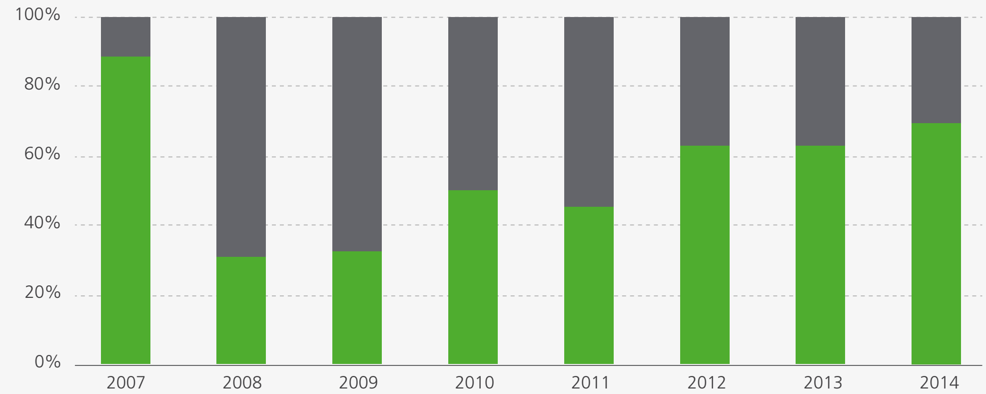
How We Got Here

Since the global financial crisis of 2008/2009, where there was a steep drop in residential real estate prices, we have seen a gradual increase in global house prices, with now roughly 70% of countries experiencing positive growth (see chart to the right). What has caused the run up in property values? The first, and most obvious answer, is low interest rates. Globally, central banks dropped interest rates to rock bottom levels in an attempt to stimulate growth to help economies recover from the depths of the recessions caused by the financial crisis. Consumer borrowing ensued and fueled demand, and by extension, house prices rose globally.

The second, and arguably less obvious reason, is quantitative easing (QE). QE is an unconventional monetary policy tool used by central banks to stimulate the economy when traditional monetary policy, like interest rates, become ineffective. Each QE initiative has pushed borrowing rates lower and consequently propped property prices higher. Last, but not least, are the massive flows from foreign investors that are bidding up house prices – more on this in the next section.

Global House Price Growth

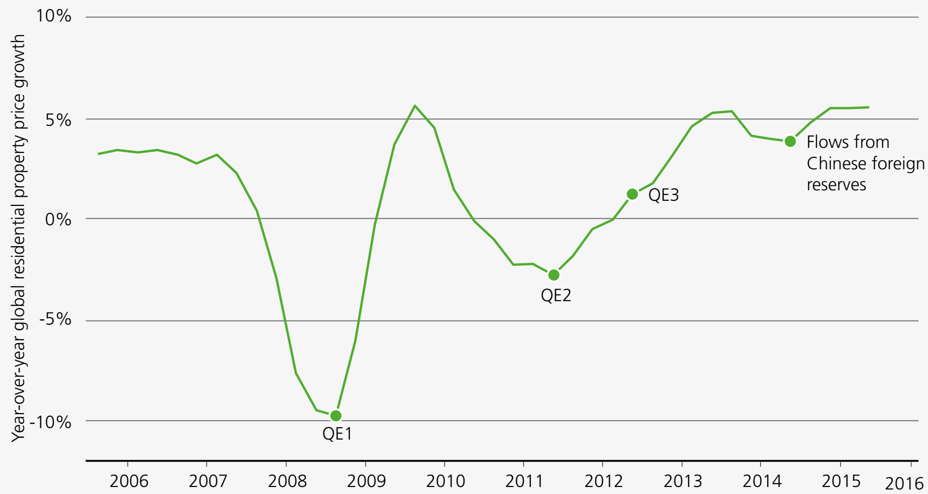
Percentage of countries with positive house price growth



Source: Thomson Retuers Datastream, BIS, TDAM

Quantitative Easing & Residential Property Prices

Low rates driven by QE and capital flows from EM nations have contributed to rising house prices



Source: Thomson Retuers Datastream, US Fed, PBoC, BIS, TDAM

Influence of National Regulations

Chinese capital has been flowing out of China for some time now, heading to various global real estate markets. This trend has had profound effects on certain local markets, particularly within Australia, and more recently Canada. But why has Canada started seeing a more rapid increase?

Australia implemented an updated foreign ownership law, which came into effect late 2015. Under the new regulations, foreigners cannot (with a few exceptions) buy any existing dwelling in Australia and are also limited to buying only new housing developments - which also must be approved by the Australian Foreign Investment Review Board. These new rules are enforced and come with strict penalties.

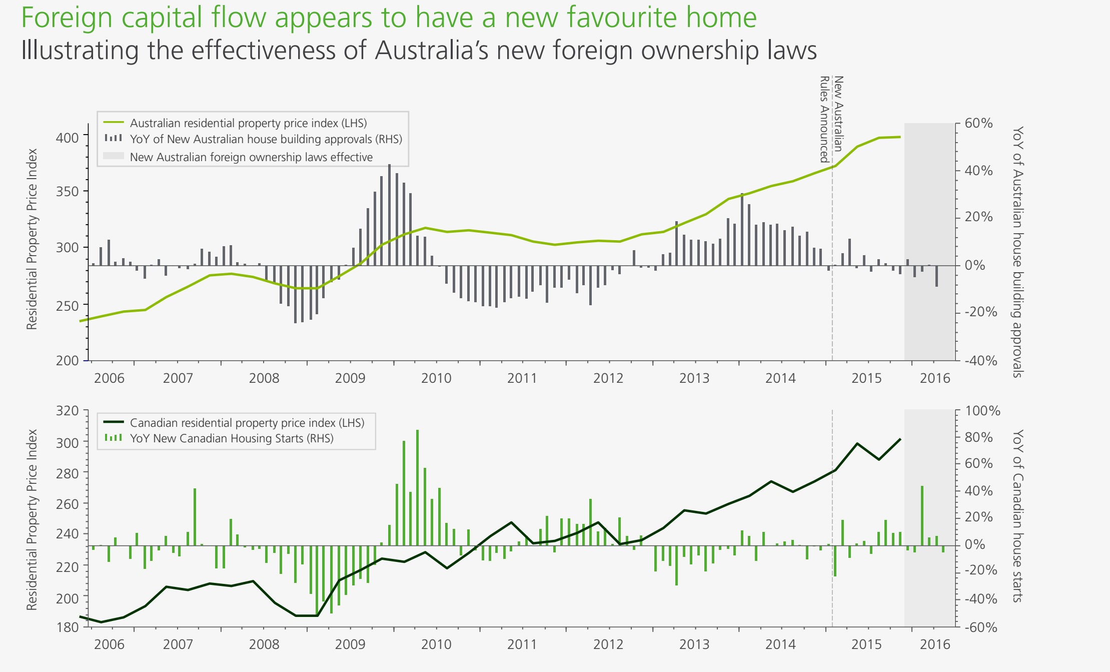
Against this backdrop, new home prices in Australia seem to have leveled off while in Canada, price gains appear to be increasing. Australia has also seen a slowdown in new developments while Canada is seeing an uptick in new home starts. It would appear that foreign capital once destined for Australia seems to be making a new home in Canada. These flows have contributed and can potentially further increase the recent distortion within the Canadian economy.

The Changing Face of the Canadian Economy

Historically, the Canadian economy has heavily relied on the manufacturing and resource industries for economic growth. These industries are traditionally a healthy means to a strong and sustainable economy. However, with the real estate sector of the Canadian economy growing at a very rapid pace, Canadian real estate related activities, including construction, continues to represent a larger share of the Canadian economy.

This shift within the Canadian economy and labour force, however, does not bode well for GDP growth. This shift moves resources away from relatively higher productivity industries to the lower productivity activities of real estate and construction. This in turn also increases the concentration of the Canadian work force to one industry and raises the risks of any shocks to the Canadian housing market.

This has also led to large price distortions between Canadian cities, like Toronto and Vancouver against smaller cities across the country. By looking at the chart to the right, it is clear that there is a divergence in growth between larger and smaller Canadian cities. After the global financial crisis of 2008/2009, the gap between new houses prices in larger cities like Toronto and Vancouver began to accelerate and widen at a very fast rate relative to smaller cities within their respective provinces. This acceleration of new home prices has also been aligned with the outflow of Chinese foreign reserves.

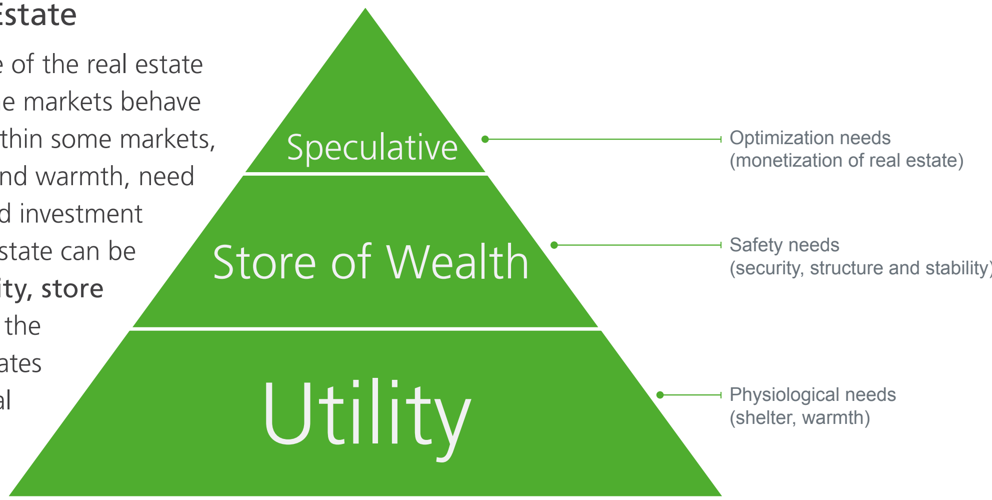


Source: Thomson Retuers Datastream, BIS, Australian Bureau of Statistics, StatsCan, TDAM

There is also evidence showing a divergence of property prices from country and major city level with valuations metrics, like the housing price to income ratio. Divergences in these growth rates have now created affordability issues within these regions with house prices growing exponentially higher than income and rent levels. In Vancouver, the increase in vacant properties due to foreign ownership has created a large strain on the rental market. Low inventories have driven rental rates to extreme levels, where they have now become largely unaffordable for the average income earner. This, as well as the very high house price levels has recently prompted the Vancouver government to intervene and try to stabilize the market.

Three States of Residential Real Estate

When trying to rationalize the current state of the real estate market, it's helpful to understand why some markets behave one way, while others do so differently. Within some markets, the basic needs of real estate, like shelter and warmth, need to be satisfied, while in others, stability, and investment hold more importance. The needs of real estate can be categorized into three different states: **utility, store of wealth and speculative.** By theorizing the real estate market exists in these various states can help provide a deeper view on how real estate is valued in various markets, locally and globally, and be a consideration when reviewing investment plans.



Utility

Within the utility category, real estate is the single largest component of wealth for households. That is, the property is owned for personal use rather than for investment purposes and the utility is derived from "owning your own home" where basic needs like warmth and shelter are met. Each property also has unique features, such as age, building design, and especially location. These combined give each property distinctive characteristics and value. Even in residential neighborhoods with very similar houses, the locations differ (corner vs interior lots).

Another characteristic within this bucket is the clustering of real estate developments. The potential users of a property and competing sites lie within a short distance of each other (e.g. school district, subdivisions). Throughout Canada there are many small towns that have set up after a factory or major employer has moved into a town. Housing valuations are therefore dependent on the continuity of the operations of this employer.

Store of Wealth

Going up the hierarchy of needs, we move into the store of wealth spectrum. Here, property ownership becomes a means of preserving capital as a safe haven asset. Global investment flows (overseas investors) also play a key role in this category. Investments are made in perceived stable jurisdictions as a means to preserve wealth, and as a result, these excess savings from abroad drive price appreciation and create severe price distortions in the destination countries. What's more, research shows cities consisting of similar ethnic and wealth groups will have price sensitivity when there are domestic risks in their homeland. For example, real estate prices within neighborhoods of London consisting of immigrants from Greece were impacted when the domestic challenges of Greece were taking hold[†].

Globalization allows for a free flow of capital and people, making it easier to shift savings (and living) into other countries. Because of this dynamic, today, people are able and willing to pay for access to countries where property rights, education, clean air are the standard, this free movement of capital and people have commoditized these things.

† Home Away From Home? Foreign Demand and London House Prices, April 2015

Speculative

The last state of real estate can be seen as Speculative. Within this category, purchase decisions are heavily influenced by availability and rate of credit, limited housing supply, low controls on cross border flows and are driven by irrational factors based on extrapolations of recent trends.

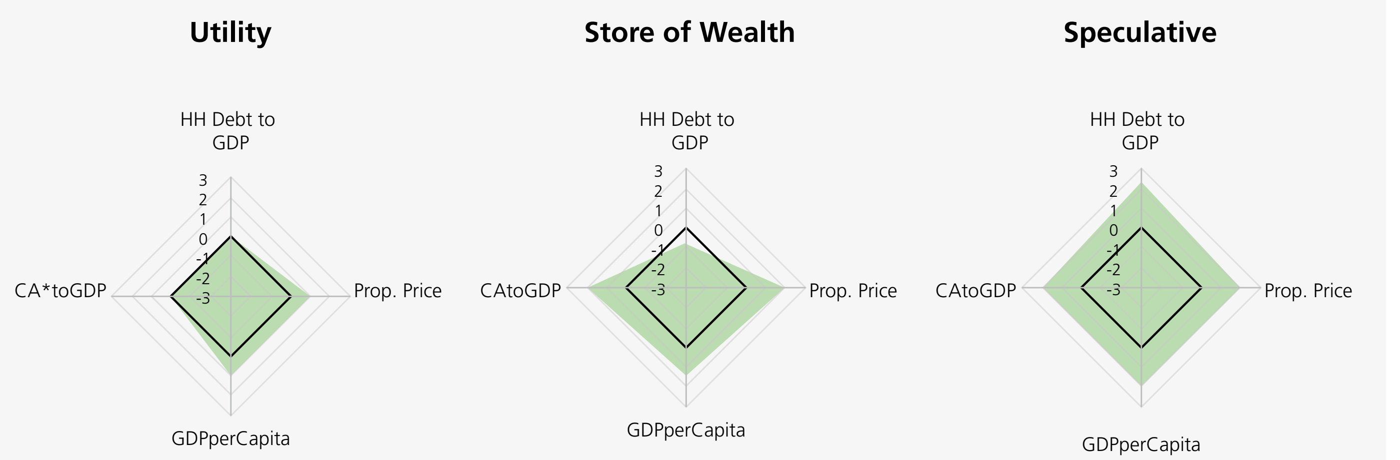
The drivers of purchase/sell decisions can be local or global, and typically feed off each other. Momentum drives prices higher (or lower) and investors see rising prices and rush to buy properties because of a perceived "fear of missing out".

The Economics Behind the Theory

The radar charts below help to illustrate the economics behind the different states of real estate. Starting from the left, we have our utility state. Here, the right axis (property price) and bottom axis (GDP per capita) are pushing above trend, outside of the solid black diamond. This is a result of the local population's real income increasing, and by extension, consuming more. This "wealth effect" flows into higher real house prices.

Moving to the right, in the store of wealth state, people are becoming wealthier as real estate prices increase. Foreign capital may see this as an attractive asset to store wealth (or a way of diversifying their holdings). Therefore, the capital account would start increasing, represented by a shift in the left axis, reflected as a current account deficit.

On the far right, we have the speculative state. Here, local population will likely need to turn more to debt in order to enter the local housing market as local real incomes are not able to keep up with the real estate prices. Credit levels would rise as households are speculating on rising home prices and trying to leverage their returns, which would reflect higher debt levels. This is represented by the top axis (HH Debt to GDP) increasing.



- **Household Debt to GDP** – amount of leverage in the household sector and a measure of vulnerability to changes in credit conditions
- **Current Account to GDP** – a large current account points to much higher investment versus savings. Country is therefore importing capital from abroad.
- **GDP per Capita** - measures relative wealth per citizen. Wealthier countries should have higher relative house prices
- **Property Price** – have prices been rising or falling.

*CA = Current Account

Deciphering Value within the Different States

Depending on what state of real estate a particular market is in, the way property price values are derived can vary drastically. The chart below helps to explain some of the rationale we find to be attributed to each segment of real estate needs.

	Utility	Store of Wealth	Speculative
Measurement and Indicators	Traditional discounted cash flow models are appropriate when valuing real estate: Cap rates, rental yields, cost of carry, discounted cash flow.	Macro variables, like interest rates and inflation are key when trying to assess value.	Within this market it is very hard, if not virtually impossible to derive prices. Often times a best estimate of prices is derived from extrapolating recent trends. Data around increased transactions volumes, credit creation can also help determine a speculative market and, by extension, value.
Findings	Business cycles and local economic influence matter. For example: if a main employer closes/expands, it has a direct impact on prices.	Current account changes exceeded the importance of all other macro variables over a 20 year horizon. In developed and emerging markets, evidence exists that shows a 1 standard deviation increase of the lagged current account deficits led to a 10% real appreciation in real estate prices.	Increased use of credit by local population helps purchase more residential real estate to make a bet on increasing housing prices. Households are needing to take on more debt to enter the housing market, this may be due to increased foreign demand or speculation.
Outcome/Effect	Real income is the main driver of prices.	Current account deficits are associated with sizable appreciation in real estate values.	There is an increased allocation of resources to lower productivity sectors.
Regional Examples	Japan, Germany (many EU nations), Brazil	U.S., U.K, Netherlands.	Canada, Hong Kong, Australia, Sweden, South Korea

Where Do We go From Here?

TD Asset Management believes that global savings and credit growth, rather than GDP growth, will be the main drivers of real estate prices for the foreseeable future. As real estate absorbs more global savings, there will be less for investment which in turn poses challenges for potential global growth. Domestically, certain parts of Canada, like Vancouver and Toronto are displaying characteristics of a speculative market. These trends have led to weaker productivity growth, with many more years of this growth environment expected.

Real estate is a key asset in an investor's portfolio. Depending on what geographic area they are in, it can mean something very different within their portfolios and by extension, financial objectives. Most of Canada will fall into the utility category where homes can be a good hedge against inflation. However, in areas like Toronto and Vancouver that fall into the speculative category, investors should take careful consideration when valuing their total wealth.