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Residential real estate: a reckoning or just a softening?

For the time being, the residential real estate market is holding up, but there are challenges ahead

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Editor's note: Read the latest on how the coronavirus is rattling the markets and what you can do to navigate it.

Residential real estate activity fell dramatically by 65% across Canada since the pandemic struck, the fall reaching levels of -80% in Toronto, according to Royal Lepage, as unemployment, loss of revenue and an immigration slowdown combine to make conditions harder for home sellers, condo owners and multi-apartment landlords.

However, it doesn't seem like buyers are shying away.

"We thought the market would hit pause for a while, and that sellers would be stepping in," says John Pasalis, president of Realosophy. "Over the past couple of weeks, we saw buyers coming in, but not sellers. We have fewer listings now than we had two weeks ago and sales are even slightly picking up."

Conditions also appear good in the multi-residential segment, at least according to numbers coming in from major REITs, reports ***Howard Leung***, REIT analyst at ***Veritas Investment Research***. For example, Killam REIT, present mostly in Ontario and in Eastern Canada, "reported that its rent collection for apartments in April was at 98.6%, ***Leung*** notes. At Boardwalk, with its base in Alberta, the level was 92% as of April 13th. But a collection rate of 90% may not be representative of the overall landlord population and more the fact of professional landlords."

This is not to say that the picture is rosy – or will stay that way in the short-term.

Challenges building up

A major factor to keep in focus is unemployment and, more importantly, reemployment. CIBC Capital Markets predicts that the jobless rate, that stood at 5.5% at the end of February 2020, will swell by two million to a peak of 14%, then fall back to a recession plateau of 8% by February 2021.

"With businesses stretched, how many people will companies rehire? There's no on/off switch here, but rather a gradual restarting of the economy. An outfit that hired 20 employees and cut that down to 3, will maybe only rehire 7 or 8," ***Leung*** says. That will create a lot of softness in all markets, real estate included.

The unemployment situation brings into play the historically high indebtedness of Canadian households, which on average owe $1.78 for every $1.00 of after-tax income. The CIBC report points out that elevated levels of debt will work to amplify the negative shock to incomes seen from job losses, which will be displayed in a notable increase in the number of mortgages in arrears. So far, between 10 and 15% of mortgage borrowers have deferred payments.

Pressure on rentals

This could have a harder impact on the rental market, which is expected to be most threatened in the shorter term. "The jobless are skewed toward youth and part-time workers, which are prominent in retail, restaurants, tourism; and youths tend to play a smaller role in the housing industry," indicates Phil Soper, CEO of Royal Lepage.

"All signs indicate a downward pressure on rent, with tenants who can't afford them," notes Pasalis, who is nervous about condo rentals, many of which are cash flow negative and don't cover their carrying costs. "Can they afford to lose $200 or $300 a month on carrying costs?" he asks. In large urban markets, rents are often higher than the $2,000/month relief contributed by the Federal government.

On their own, the present pressures could quickly precipitate a real estate crash. "But we have a huge backstop in Canada, with banks that can restructure mortgages (unlike in the U.S. where banks massively securitize mortgages), the Canadian Mortgage and Housing Corporation that insures mortgages, the Bank of Canada that can buy bank bonds if they run out of money," says James McKellar, professor of real estate and infrastructure at the Schulich School of Business of York University. Add to that the diverse $200 billion Federal relief programs for individuals and companies. "All that pushes further in time any day of reckoning for real estate in Canada," concludes McKellar..

Immigration?

The hold on immigration is another key factor that will impact real estate. "Because of immigration, Toronto grows by an equivalent of one Calgary every 10 years," notes McKellar.

Seventy-two percent of immigrants who have been here seven years own their house, "so a drop in immigration should not have an impact on the residential market in 2020, but could impact it in three or seven years. The impact will be felt more quickly in the rental market, but that market is very tight. In Toronto, there's less than 1% rental availability, in Montreal, 2%," says Soper.

What to do?

In the long run, things don't seem as dire. "If the recovery unfolds without any major second wave reset, in 12 to 18 months residential real estate will come through the crisis relatively unscathed. Overall, as the fog clears, we expect to see average prices 5-10% lower relative to 2019 levels," CIBC notes.

Analysts agree that for most people, their home is their shelter, and that is a huge value at this moment. If you don't need to sell it, stay in it! "Don't sell, even if you expect a recession," advises Pasalis.

"People think that they should sell and rent, but there is very little potential there. You shouldn't be worried for the value of your home because fundamentals are still solid. Prices might get a little softer, but they will pick up," Soper says.

However, some must sell because of retirement, health or other considerations. If you were thinking of selling in two or three years, you might as well sell now and not take any risk with future developments. "Yes, you might miss a bull market, but if you sell now, you won't lose very much," says Pasalis.

For investors, the REIT market is worth looking at, notes ***Howard Leung***. "They were all sold off together indiscriminately at the end of March despite having rebounded somewhat. But if you do your homework, I think you can find some reward there, but only in individual titles. I wouldn't necessarily go to an index or an ETF."