A WORD FROM THE ECONOMIST

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IT'S INEVITABLE: MORTGAGE TIGHTENING MEASURES WILL SLOW QUÉBEC'S RESALE MARKET IN 2017

A favourable economic environment, but marked with uncertainty

While economic growth is expected to accelerate this year, the arrival of Donald Trump as president of the United States has thrown a veil of uncertainty over the outlook for the Canadian economy. U.S. economic recovery, which is anticipated to be even stronger this year, should normally boost Canada's economy by stimulating exports. In addition, because of the U.S. Federal Reserve's most recent interest rate hike, the Canadian dollar is expected to continue to depreciate against the American dollar in 2017, which is also likely to favour our exports south of the border. However, the increase in exports may not be as prolific as anticipated given the new president's intention to implement several protectionist measures, such as renegotiating NAFTA. The upcoming negotiations on the softwood lumber issue are also expected to be stormy.

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Nevertheless, according to different forecasts from major financial institutions, Canada's GDP is expected to increase slightly faster than potential output in 2017, with growth scenarios ranging from 1.8% to 2.1%. According to these organizations, Québec's GDP is expected to grow by about 1.4% to 1.8% this year.

Québec boosted by strong employment growth

Demand in the housing market will be supported by the job gains that have been made in Québec over the past two years. The year 2016 was particularly strong in terms of employment. According to the Statistics Canada Labour Force Survey, no fewer than 53,000 full-time jobs were created last year, mostly in the private sector. In addition, the gains were primarily among 25 to 44 year olds – an age group that is generally very active on the residential real estate market. It is significant to note that according to seasonally adjusted data, the unemployment rate in Québec reached a historic low[1] of 6.2% in November. For the whole of 2016, the average unemployment rate in the province was 7.1%. It is expected to fluctuate between 6.5% and 6.9% in 2017.

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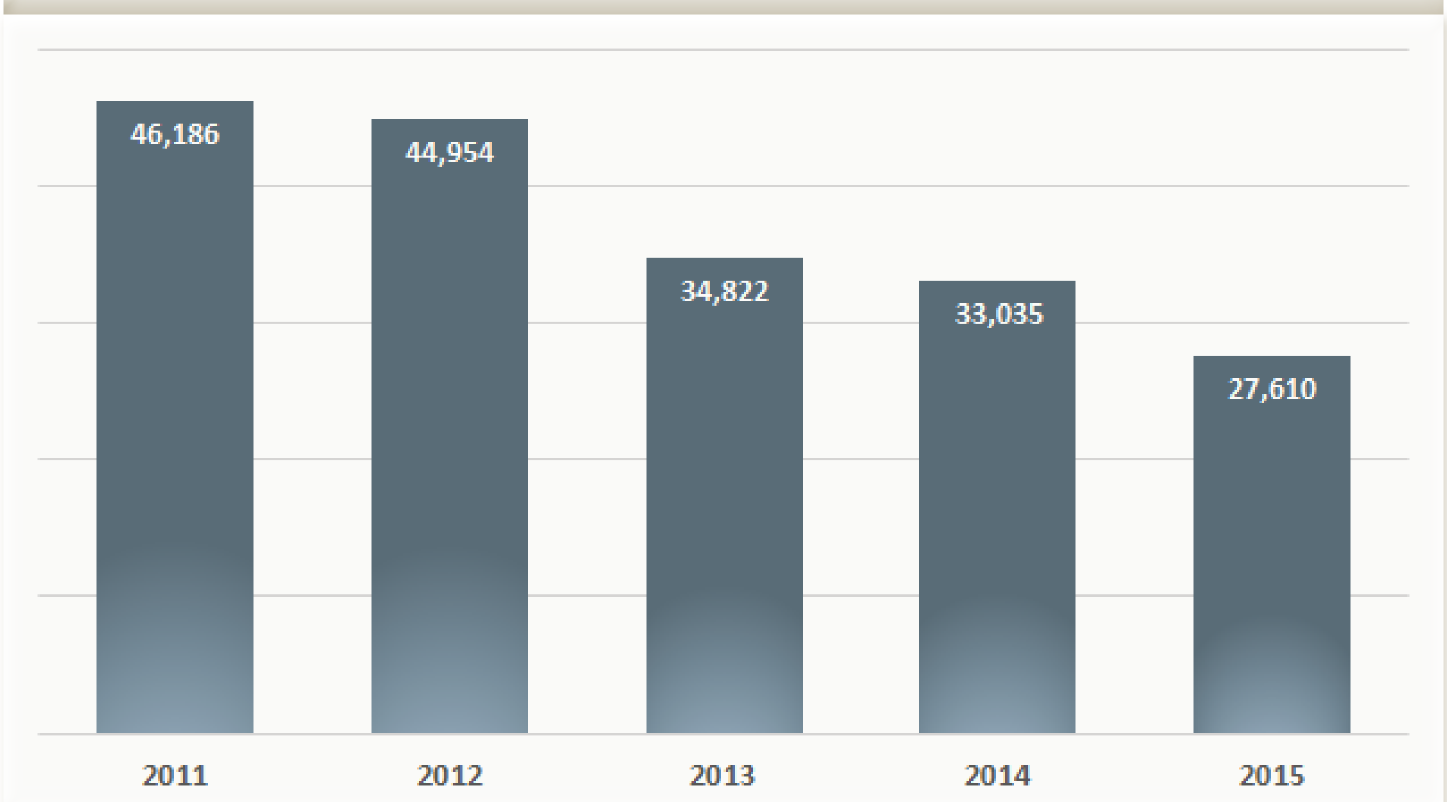
1 Data starts in 1976.

The year 2017 also looks promising in terms of job creation. While the number of jobs increased by an average of 0.8% in 2016, it is expected to increase from 0.8% to 1.4% this year. This represents the creation of between 33,000 and 58,000 jobs for 2017.

Improvement in net migration expected in 2017

After net migration in Québec reached a peak of 51,500 people in 2009 (including the net number of non-permanent residents), it has been slowing ever since (see Chart 1). This is mainly due to a larger number of people who leave Québec for another Canadian province. Statistics Canada's population estimates show that Québec welcomed some 27,600 people in 2015. Thus, although net migration is declining, it has remained in positive territory, which is good news for housing demand.

Chart 1: Net Migration*, Province of Québec



*Including the net number of non-permanent residents

Source: Statistics Canada data adapted by the ISQ.

However, there is reason to believe that a significant reversal in trend has taken place recently. Preliminary estimates for the first half of 2016 are showing significant increases in both net migration (19,400 vs. 10,700) and in the number of non-permanent residents (9,100 vs. 3,000), as compared to the first half of 2015. It goes without saying that if this upturn continues, it will boost the housing market even more in the coming months.

Moving towards an increase in mortgage rates

After several years of having experts anticipate mortgage rate increases that never materialized, this time it's true: we will see a gradual rise in the cost of mortgage financing. It actually began last fall, following the results of the American presidential election. Given Mr. Trump's intention to implement policies that are considered highly inflationary, bond yields have jumped in the United States, causing Canadian bond rates to also rise. We must remember that bond rates are what dictate the evolution of mortgage rates for medium- and long-term maturities. Thus, if economic growth accelerates, additional increases in bond yields cannot be ruled out.

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In addition to the items listed above, other factors will create upward pressure on mortgage rates charged by financial institutions. These factors relate to the new tightening measures introduced in the fall by Canada's Finance Minister and the Office of the Superintendent of Financial Institutions (see: Rainstorm of New Mortgage Rules: A Cold Shower for the Québec Real Estate Market). In particular, the increased capital reserve requirements for insured mortgages for federal financial institutions; the "disqualification" of several types of mortgage loans for portfolio insurance purposes; and a possible method of risk sharing between financial institutions and mortgage insurers, will inevitably lead to increases in the rates charged by lenders.

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Ultimately, we expect that Canadian mortgage rates for a five-year fixed term will rise by 0.25 to 0.5 percentage points[2] by the end of 2017.

The expected impact of the new mortgage rules

In addition to being affected by the upward pressure on mortgage rates described above, first-time buyers, or at least those who were considering becoming first-time buyers, will also be the most affected by the latest mortgage tightening measures (October 2016), the sixth in nine years. The mortgage rate "stress test" that will be imposed on all borrowers who do not have a minimum down payment of 20% (in this case, mortgage insurance is mandatory) will be the most restrictive measure. In force since October 17, 2016, this measure requires borrowers to qualify[3] for the benchmark interest rate published by the Bank of Canada rather than the negotiated rate actually granted by financial institutions. The benchmark rate at the time of writing this document is 4.64%, nearly two percentage points above the rates negotiated with most lenders.

This measure will have two significant consequences: first, it will disqualify many borrowers and second, it will limit the maximum value of loans granted by tens of thousands of dollars for borrowers who intend on borrowing the maximum amount possible. Inevitably, this new "stress test" will have a negative impact on the number of transactions concluded and on price growth.

[2] It should be noted that our forecast is for contractual mortgage rates, not benchmark rates, which could remain stable as they serve as reference rates in the application of the mortgage rate stress test in another measure imposed by Ottawa on October 17, 2016.

[3] According to their credit score, a borrower cannot exceed a maximum gross debt service (GDS) ratio of 39% and a maximum total debt service (TDS) ratio of 44%.

According to a recent survey[4], we estimate that first-time buyers accounted for approximately 40% of residential property buyers over the past five years. This represents some 30,000 Centris® transactions annually. According to the same survey, we estimate that of these first-time buyers, four out of five did not have a down payment of 20%. This means that the equivalent of 24,000 new buyers in Québec would have been subject to the mortgage rate stress test each year. A majority of them would still have qualified, but a significant number would not have, forcing them to considerably reduce the amount they borrow or postpone their purchase. The missing piece of this puzzle is the proportion who would not have qualified.

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The only reference point for this information comes from the analysis of mortgage insurers’ records in the Bank of Canada’s December 2016 Financial System Review. It shows that 26% of Montréal buyers (there is no province-wide data) who resorted to mortgage loan insurance[5] would not have met the new criteria for qualifying at the increased rate in terms of the total debt service (TDS) ratio.

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Sales will drop, but prices won’t

After taking all of these factors into consideration, the QFREB foresees a decrease in existing-home sales in 2017 (see Table 1). Across the province, 72,500 sales are expected this year, a 7% drop compared to 2016. This would be a similar decrease to that observed in 2013 (-8%), following the 2012 mortgage tightening measures that lowered the maximum amortization period from 30 years to 25 years.

Table 1

2017 FORECASTS - Province of Québec

	Number of sales		Median Price - Single-family	
		Variation		Variation
Province of Québec				
2012	77,372	0%	$224,050	+3%
2013	71,194	-8%	$225,000	0%
2014	70,620	-1%	$227,000	+1%
2015	74,123	+5%	$230,000	+1%
2016 (actual)	78,231	+6%	$234,500	+2%
2017 (forecast)	***72,500***	***-7%***	***$234,500***	**0%**

Source and forecasts: QFREB

4 Survey on real estate buying and selling intentions in Québec, QFREB, April 2016.
5 Based on loans granted between the 4th quarter of 2015 and the 3rd quarter of 2016.

As for prices, with modest increases over the last four years (see Table 1), Québec's real estate market had already managed its soft landing, unlike markets such as Vancouver and Toronto. Because borrowing capacity will be limited by the new mortgage rules and because market conditions in several regions give buyers the upper hand, we should not expect to see price increases in 2017. The median price of a single-family home in Québec is expected to remain at $234,500 in 2017.

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Montréal area: well positioned

The outlook for 2017 is slightly better for the Montréal Census Metropolitan Area (CMA) than for Québec as a whole. This is partly due to the fact that the Montréal CMA was the main driver for employment in Québec in 2016. Moreover, in terms of migration, it remains the starting point for most newcomers to the province. Finally, end-of-year statistics revealed a strong presence of experienced buyers on the resale market in 2016, as evidenced by a significant increase in property sales in the $1,000,000 or more price range (+24%) for single-family homes and in the $500,000 or more price range (+26%) for condominiums.

The Montréal CMA was the main driver for employment in Québec in 2016.

Thus, we anticipate that 37,750 transactions will be concluded through the real estate brokers' Centris® system this year, a 5% decrease compared to 2016 (see Table 2). This decrease will simply erase last year's growth, so that the sales level will be similar to that observed in 2015.

Table 2

2017 FORECASTS - Montréal Metropolitan Area

	Number of sales		Median Price - Single-family		Median Price - Condominum	
		Variation		Variation		Variation
2016 (actual)	39,926	+5%	$295,000	+2%	$240,000	+1%
2017 *(forecast)*	*37,750*	*-5%*	*$297,000*	*+1%*	*$240,000*	*0%*

Source and forecasts: QFREB

With respect to prices, the Montréal CMA is expected to register a slight increase, given that the sharp drop in listings in 2016 has shifted market conditions into a seller's market in several areas for single-family homes. We expect the median price of single-family homes to reach $297,000 in 2017, a 1% increase compared to last year. However, for the condominium market segment, which is still showing a slight excess of supply despite tighter market conditions in recent months, we expect that the median price will remain unchanged at $240,000.

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Québec City area: All good things come to an end

Like with sales activity in the province, activity on the Québec City CMA residential real estate market is expected to decrease in 2017.

Even though the Québec City CMA registered the province's lowest unemployment rate (4.6%), it did not benefit from the employment market's good performance in 2016 (-2,800 jobs). Fortunately, employment gains in the two previous years were solid (+7,600 in 2014 and +5,800 in 2015) and this will continue to have a positive effect on housing demand.

The QFREB expects 6,200 transactions to be completed through the real estate brokers' Centris® system this year, an 8% decrease compared to 2016 (see Table 3).

Table 3

2017 FORECASTS - Québec City Metropolitan Area

	Number of sales		Median Price - Single-family		Median Price - Condominum	
		Variation		Variation		Variation
2016 (actual)	6,721	2%	$248,000	1%	$190,000	-4%
2017 *(forecast)*	*6,200*	*-8%*	*$245,000*	*-1%*	*$185,000*	*-3%*

Source and forecasts: QFREB

In addition, we are expecting a slight decrease in single-family home prices in the Québec City CMA. In a context where listings continued their upward trend last year, market conditions remain slightly in buyers' territory. The median price of single-family homes will reach $245,000 in 2017, a 1% decrease compared to 2016. This will be the first price drop in nearly 20 years for single-family homes in the Québec City CMA.

As for condominiums, the situation is different. The number of months of inventory on the resale market has reached 21 months, which reflects a significant oversupply. The median price of condominiums has been falling for the past three years in the Québec City area and, with the impact of the latest mortgage tightening measures, this trend will certainly not reverse itself in 2017. As a result, we expect the median price of condominiums to decrease by 3%, to reach $185,000.

In conclusion, the real estate market's progress will be hampered by the implementation of Ottawa's latest measures

In short, the QFREB anticipates a slowdown of the resale market in 2017 that will result in fewer transactions and stability in the median price of single-family homes across the province. While the impact of the latest mortgage tightening measures will be felt unevenly across the different metropolitan areas, we believe that the expected decrease in residential sales in 2017 will remain modest, reaching levels similar to those observed in 2015. Moreover, the price reductions predicted for certain sectors of Québec will be moderate and will mainly concern the condominium segment in those markets that are most strongly buyer's markets.

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