PRIVATE CLIENT SOLUTIONS

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Insights & Strategies

Housing Crisis or Opportunity?

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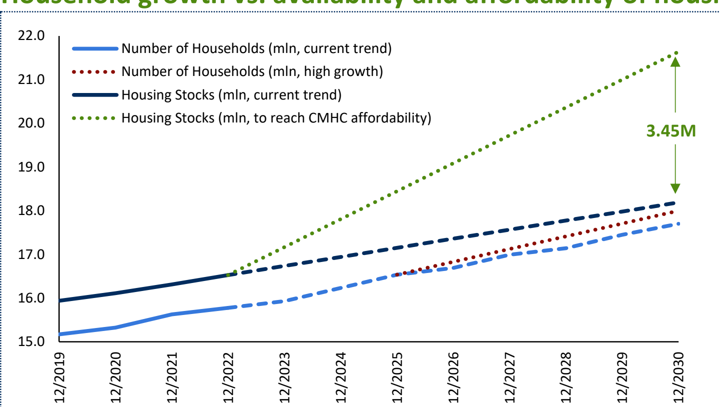
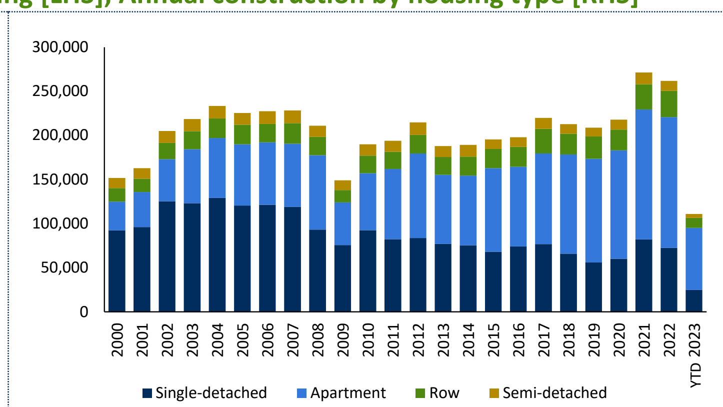
Housing Crisis or Opportunity?

According to the Canada Mortgage and Housing Corporation (CMHC) update released in September, we will need 3.45 million additional housing units, beyond current build projections, to satisfy affordability needs to 2030. To clarify that headline, this is the number of units, beyond the 1.5 million units that are already expected to be built, needed to bring housing into CMHC's "affordable" range. While there is definitely a housing affordability problem in Canada, as interest rate hikes have helped to push housing costs to 50 per cent of disposable income nationally, in Ontario and British Columbia that ratio is a staggering 60 per cent. Many readers may recall the convention in the 1970's that housing costs should be 30 per cent of disposable income, or that this ratio fluctuated in the 35-40 per cent range for much of the last 20 years on a national basis. Depending on immigration and population growth assumptions, the current housing start forecasts indicate that availability and affordability is likely to, at best, stay similar to the current environment and are perhaps more likely to get worse. To achieve the affordability objectives laid out by the CMHC, we estimate that housing starts would need to more than triple from just over 200,000 per year currently, to roughly 700,000 per year, starting immediately.

Anyone familiar with the dynamics of supply and demand should quickly realize that this implies upward pressure on housing prices, although we also have to consider how affordability affects the number of potential participants in this market. The CMHC does do extensive analysis in household incomes in various regions, migration between provinces, and makes certain assumptions about population growth, including expecting the rate of immigration to decline past 2025, but with sensitivity analysis up to 700,000 immigrants per year. So, the question remains as to whether this could become an even more dramatic housing crisis and/or if this creates any opportunities for investors. Despite potentially short-term and perhaps regional volatility or weakness in housing prices, the foreseeable trend should be one of appreciating housing prices due primarily to supply and demand. As this also creates and aggravates affordability, more households will likely have to consider renting instead of buying, which likely creates opportunities in vehicles such as multi-family housing real estate investment trusts (REITs), and other rental property assets. If we do see heightened levels of construction, towards the CMHC's targets, we could see opportunities in building equipment, supplies, and services.

Household growth vs. availability and affordability of housing [LHS]; Annual construction by housing type [RHS]





Source: [LHS] CMHC; Statistics Canada; Data as of September 13, 2023. Number of households: current trend, population growth falling back after the current immigration policy ends in 2025; high growth, current immigration trends continue to 2030. [RHS] Statistics Canada; Data as of June 30, 2023.

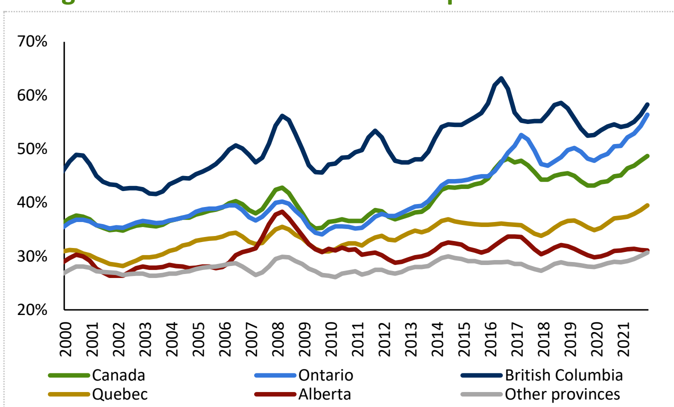
Affordability overall is an issue, and increasingly a subject of dinner party discussions, especially in certain parts of the country. Following some significant increases over the last few years, we have recently seen some (slight) softening of prices in the last 12 months, with the new housing price index pulling back from 126.1 in August 2022 to 125.0 in August 2023. This is still up considerably from the pre-pandemic 103.8 in February 2020.

As you might have guessed given the sticky wage inflation picture in Canada, the costs to build have been increasing. StatsCan's composite of building construction prices across 11 metropolitan areas showed a 7.5 per cent increase in costs from Q2/22 to Q2/23. The largest hike was in Toronto, at 13.0 per cent, with the most moderate being Edmonton at just 0.8 per cent.

The Canadian Real Estate Association (CREA), representing 160,000 realtors, is forecasting a 0.2 per cent decline in house prices in 2023, with a 6.8 per cent decline in transactions. Presumably looking towards more stable rates, and perhaps even the start of rate declines next year, the CREA is forecasting an 11.2 per cent increase in unit sales into 2024, with a 3 per cent increase in the national average home price, to around $723,250.

Regional differences can be quite dramatic when we talk about affordability. Of the 3.45 million home shortfall identified by the CMHC, two-thirds of that would be required in Ontario and British Columbia where the housing cost ratio is already 60 per cent of income.

Rising Shelter Costs as a Share of Disposable Income

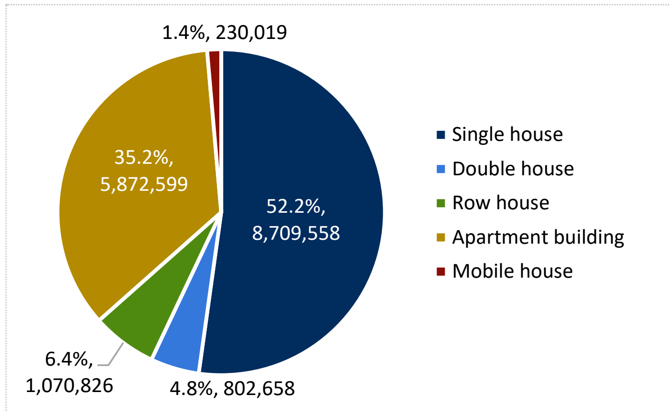


Source: CMHC; MLS; Data as of December 31, 2021.

In Q2/23 Canada had just under 15.4 million occupied private dwellings with an average of 2.4 persons per dwelling, declining steadily from 2.9 in 1981. Total private dwellings were just under 16.7 million. In the CMHC's base case scenario, this number should increase to 18.2 million by 2030, or just over 200,000 units per year.

The existing stock of housing units is mostly single-family homes, at 52.2 per cent, but apartments represent the second largest category, are growing at double the pace, and now represent 35.2 per cent of private dwellings, up from 33.9 per cent in 2016. Recent announcements from the federal government, eliminating the GST from new apartment development may further push this densification initiative to more quickly develop dwelling units.

Single Houses Remain the Majority of Dwellings



Source: Statistics Canada; Data as of June 30, 2023.

With all these moving parts, and likely more initiatives, what does affordability mean to the CMHC? The CMHC is using 2003/04, a period when the economy was stable, in neither boom nor recession, as one target for housing affordability. This would put the affordability ratios at approximately 30 per cent in most provinces, with Ontario at 37 per cent and British Columbia at 44 per cent. A second option is to achieve a nation-wide target of 40 per cent housing cost-to-disposable income ratio, translating to roughly 30 per cent of pre-tax income, and allowing housing prices to then fluctuate by region/province.

Overall, we are skeptical that new home starts will increase as dramatically as needed in the near term and that housing affordability will remain an issue for the foreseeable future. Although we may see flat or slightly weaker housing prices in certain regions for certain periods, specifically if we see weakening in the economy and/or job losses, the likely long-term tightening of supply should drive higher residential real estate prices and similarly rental costs in most regions.

Neil Linsdell, CFA, Head of Investment Strategy
Eve Zhou, Multi-Asset Analyst

Dollars and Dwellings: A Tale of Two Markets

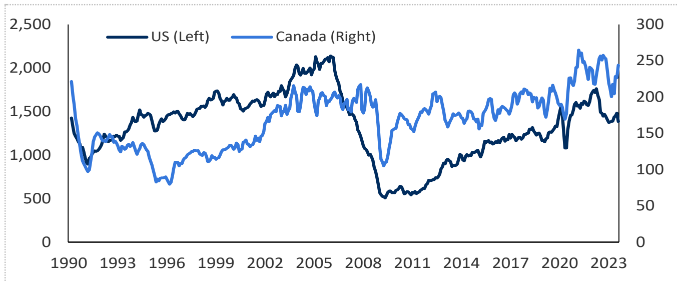
Housing markets are heavily influenced by regional and local factors, such as population growth, the labour market, government policies, regulations, and more. However, in response to the COVID-19 pandemic, central banks across the world eased monetary policies, increasing homeownership affordability due to lower borrowing costs. This increased the demand for housing dramatically, pushing home prices across the world significantly higher since the pandemic began, which has, on the flip side, decreased affordability.

Today, mortgage rates across the world are at the highest they've been in a very long time, keeping home affordability in unprecedented territory in many countries. The low supply of homes is currently the largest contributor to high prices. This is because 61 per cent of outstanding mortgages have a rate of less than 4 per cent, while 90 per cent of mortgages are lower than 6 per cent. Therefore, homeowners who have locked in mortgages lower than today's rates (whether through purchase or refinancing) are unlikely to put their homes up for sale, especially considering the new trend of hybrid work and/or working from home.

In contrast with the US, where ~96 per cent of mortgage interest rates are fixed[1], Canada has structurally different mortgages. Mortgages have either a variable rate or a fixed rate that will reset within a certain number of years. Currently, ~30 per cent of mortgages in Canada have variable rates and another ~30 per cent have fixed rates resetting within five years. With the Bank of Canada having raised rates ten times since March 2022 to tackle inflation, mortgage rates have more than doubled and will continue to severely impact those borrowers whose mortgages reset at much higher rates.

Another driver of higher home prices is the basic economic principle of supply and demand. Demand for homes continues to be stable, but the supply of homes remains scarce. In the US, the supply of existing homes is unlikely to increase as owners hold onto their comparatively low mortgages, forcing potential homebuyers to consider new construction. Similarly, Canada is experiencing a very tight supply of homes due to record low rates during the COVID-19 pandemic. Additionally, the boom in immigration in recent years is putting additional strain on the supply of homes, as more people are competing for the already low number of homes. While hundreds of thousands of homes are currently being built in Canada to tackle this issue, the lack of supply of homes is unlikely to significantly improve for years.

Housing Starts (3-mo Moving Average, in thousands)



Source: FRED; Data as of August 31, 2023

Since it is unlikely that central banks will lower rates anytime soon, the solution for both countries seems obvious: build more homes! However, housing starts aren't suggesting that we'll see the gap in housing close anytime soon. Additionally, elevated rates and higher material costs are taking a toll on builders, who are not incentivized to construct new homes. What if mortgage rates decline? A decline in mortgage rates will likely be met with a surge in the number of consumers wanting to buy homes, which would ultimately put further upward pressure on the prices of homes.

At this time, there is very little that could bring the US housing market into equilibrium in the short to medium term, as it takes a long time for investment in the housing market to shift the supply curve of housing to the right, i.e., increasing the supply of new homes. For now, it seems that the only alternative is for home prices to continue to increase to a point that will produce strong incentives for an increase in new home construction.

On the other hand, the future of the Canadian housing market might be different than its neighbour to the south. Between 2026 and 2028 almost 60 per cent of existing mortgages will reset to higher rates. The good news is that over the subsequent three years, less than 10 per cent of mortgages are expected to reset to higher rates. Therefore, only those currently holding a variable-rate mortgage (~30 per cent of current holders) are being impacted by higher rates. At the same time, the extra payments on those upwardly adjusted mortgages will probably be met with higher wages and salaries due to higher inflation. With inflation expected to continue to slow and economic growth in Canada to resume in 2024, we don't expect the Bank of Canada's monetary policies to remain as restrictive as they are today over the long term. Therefore, future looser monetary policy and an increase in the supply of homes should at least stabilize if not support demand and prices of the Canadian housing market over the next few years.

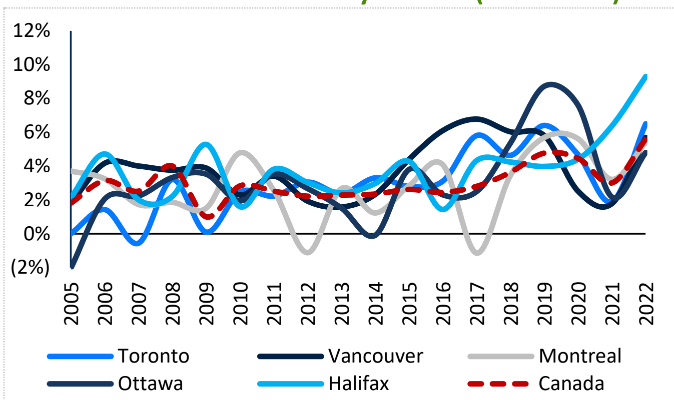
Giampiero Fuentes, CFP, Economist

[1] Federal Reserve Bank of Dallas. "Existing low-rate mortgages blunt impact of recent rate surge"

An Affordable Housing Investment Opportunity with Canadian MFR REITs

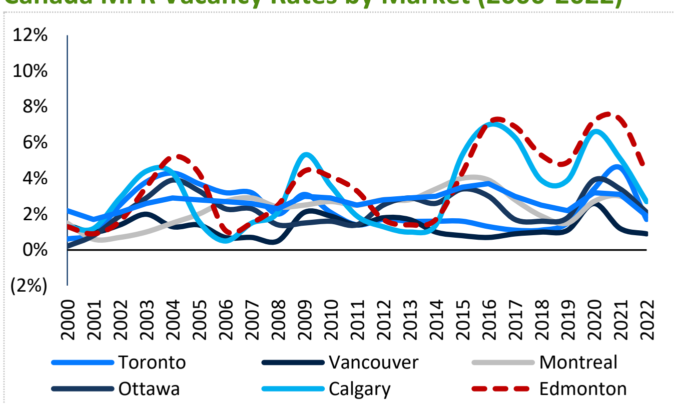
Reduced affordability within the Canadian homeownership market due to rapidly increasing mortgage costs, combined with record levels of immigration and other international non-permanent residents have resulted in robust leasing demand growth for Canadian multifamily rental (MFR) property, outstripping increased new MFR supply levels broadly across Canada. As a result, Canadian MFR average vacancy rates have fallen to 20-year historical lows of less than 2 per cent. In addition, MFR asking rent growth YoY has accelerated to historical highs in most major Canadian rental markets.

Canadian AMR Growth YoY by Market (2005-2022)



Source: CMHC, Raymond James Ltd.

Canada MFR Vacancy Rates by Market (2000-2022)



Source: CMHC, Raymond James Ltd.

To date, the Canadian federal government has increased its focus on improving the supply side of the equation, providing more incentives for both developers and local municipalities, with a recent positive announcement for a new GST/HST rebate for purpose-built rental (PBR) apartment development projects. The Canadian federal government has also committed capital from its $4 bln real estate accelerator fund earmarked for affordable housing projects across the country, with the first $70 mln in fund commitment in London, Ontario. Further, Canada's new housing minister, Sean Fraser, has hinted that the federal government may consider adjusting its foreign immigration targets, and place a potential cap on the number of international students studying in Canada, in order to temporarily reduce demand for Canadian housing and allow for new residential supply to catch up to expected demand.

As housing affordability is expected to be a key issue going forward for many Canadians, we highlight that Canadian MFR REITs offer a relatively more affordable housing option, with average annual rent to disposable income generally in the 20-30 per cent range, below the suggested 30 per cent affordability threshold. Canadian MFR REITs tend to own older MFR buildings (average age: ~40 yrs old), with larger suite sizes (average: ~850-900 sq-ft), which has resulted in lower average monthly rents (AMRs) of around $1.75 per sq-ft (psf), well below condo unit and new build PBR construction rents typically in the $4-5 psf range. Based on forecasted market AMRs, Canadian MFR REITs are generally estimating an AMR mark-to-market opportunity of +20 per cent on average, which generally can be captured by landlords upon suite turnover.

Given the lack of affordable housing options, we do anticipate that annual suite turnover rates may continue to fall below the current average estimated level of around 20 per cent each year. However, we expect market AMR growth to remain greater than regulated rent increases for existing tenants in regulated rental markets. This suggests that Canadian MFR REITs' AMR mark-to-market opportunities could further widen out and offset the negative impact from lower annual turnover rates. Overall, we expect Canadian MFR REITs may be well positioned for mid-to-high single-digit organic growth YoY, supporting future NAV/unit and AFFO/unit growth, and helping to offset any further increases in CMHC-insured mortgage rates, and potential for higher MFR asset cap rates.

The Canadian MFR REIT sector provides differentiated investment strategies, offering investors several ways to gain exposure. **CAPREIT (CAR.UN-T)** is Canada's largest and most liquid MFR landlord with a big city, suburban MFR portfolio. **Boardwalk REIT (BEI.UN-T)** is the largest landlord in non-regulated markets in Western Canada. **InterRent REIT (IIP.UN-T)** is a value-add operator with a strong track record of generating greater unitholder returns, which owns MFR assets in urban and suburban locations in Ontario and Quebec. **Killam Apartment REIT (KMP.UN-T)** is Atlantic Canada's largest MFR landlord, with a strong track record of generating accretion from its development pipeline. Finally, **Minto Apartment REIT (MI.UN-T)** is a small-cap MFR REIT focused on well-located urban MFR assets, mainly in Toronto, and Ottawa.

Brad Sturges, CFA
Managing Director, Equity Research Analyst

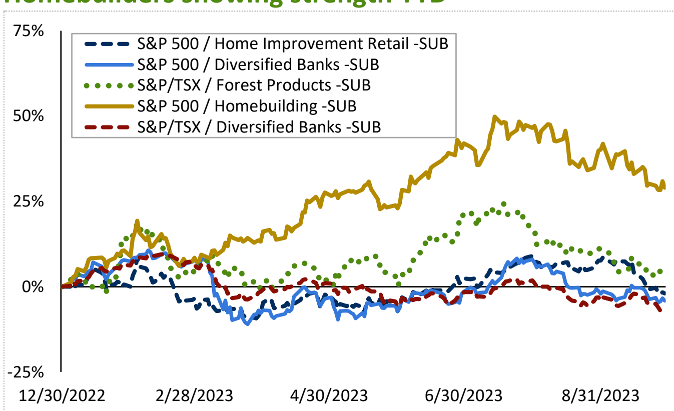
Beyond Homeownership

There are several ways investors can gain exposure to the housing market without having to buy a physical property thanks to equity markets. The title, *Beyond Homeownership*, serves as a guidepost for investors looking to diversify their exposure beyond the traditional real estate plays through their equity portfolios. Publicly traded investment opportunities range from homebuilders, home improvement retailers, construction material suppliers, and financial institutions.

Homebuilders

Homebuilders are the most direct way to gain exposure to the housing market in equity portfolios since these companies actually build houses. Companies such as **D.R. Horton (DHI-US)**, **Lennar (LEN-US)** and **PulteGroup (PHM-US)** in the US are good examples, as their businesses benefit when housing demand is strong. D.R. Horton is the largest homebuilder south of the border by unit deliveries with a focus on first-time home buyers, Lennar is the largest homebuilder by revenue, and PulteGroup is the third largest by unit volume. Investors looking to gain exposure to homebuilders should consider the end-market exposures of these companies as it relates to affordable housing versus more expensive housing options. So far this year, homebuilders have been the best performing housing-related sub-industry having returned over 29 per cent, outpacing the S&P 500, which is up 13 per cent.

Homebuilders showing strength YTD



Source: FactSet, Raymond James Ltd. Priced as at September 29, 2023.

Housing Improvement Retailers

Once owners receive the keys to their new homes, a journey begins that may involve various projects such as repairs and remodeling, benefitting retailers like **Home Depot (HD-US)** and **Lowe's (LOW-US)** trading in the US, and a name like **Canadian Tire (CTC.A-CA)** in Canada. Home improvement retailers offer products ranging from light fixtures to construction materials such as lumber, with their sales driven in part by housing market forces. These companies also have an online presence, catering to the growing online shopping trend. Investors interested in these companies should consider companies with a strong brick-and-mortar as well as e-commerce presence, companies with a robust supply chain that can handle the tough times such as those experienced during the depth of the global pandemic when supply chains were strained, and retailers with a diverse product range that includes both essential and discretionary items.

Construction Material Suppliers

Companies that provide the raw materials to build homes such as bricks, steel, concrete, and lumber offer another avenue for exposure to housing within equity portfolios. Companies like construction aggregates producer **Vulcan Materials (VMC-US)**, or lumber companies such as **Weyerhaeuser (WY-US)** in the US, or **West Fraser Timber (WFG-CA)**, **Interfor (IFP-CA)**, and **Canfor (CFP-CA)** in Canada, are key players in this arena. When construction activity is high, these companies benefit tremendously. In fact, not too long ago lumber prices had reached all-time highs amid increased housing construction activity and demand from people working from home that took on repair and remodeling projects for their homes during the pandemic. The flip side, and to state the obvious, is that these companies are also sensitive to commodity price fluctuations. When looking at raw material suppliers, investors should keep an eye on companies that have hedging strategies in place to mitigate commodity price volatility, and preferably ones with geographically diverse operations to mitigate weaknesses in any particular part of the world.

Mortgage Lenders

Mortgage lenders, including diversified banks such as **JPMorgan Chase & Co. (JPM-US)** and **Wells Fargo & Company (WFC-US)** in the US, and **Royal Bank of Canada (RY-CA)** and **Toronto-Dominion Bank (TD-CA)** in Canada, are examples of financial institutions that in part benefit from positive trends in the housing market. While fluctuations in interest rates impact the industry, strong housing demand impacts lending volumes, which has a positive impact on revenues. Investors looking at the diversified banks should consider institutions with a diversified loan portfolio and solid underwriting standards to mitigate risk.

Final Thoughts

Canadian and US stock markets offer various investment opportunities beyond homeownership. When selecting stocks, our team remains focused on quality names, being companies with a competitive edge, strong balance sheets, attractive financial profile, management teams with a history of navigating through different business cycles, and a long runway of growth opportunities ahead.

Larbi Moumni, CFA, VP, Head of Portfolio Advisory

Fund Spotlight – REIT Commentary

What is your current outlook for real estate? Where do you see the biggest risks and/or opportunities in the next 12-18 months within the sector? How are you positioning your strategy in the current market environment?

Dean Orrico, Middlefield Real Estate Dividend ETF (MREL.TO)

"The publicly listed real estate sector is at a very interesting point in its history. Aside from the embattled office sector, commercial real estate and the multi-family residential sectors are hitting on all cylinders. Despite the solid fundamentals, REITs continue to trade at discounts to NAV which are greater than those seen during the pandemic or global financial crisis. In the last few weeks, we've met with virtually all the management teams of our REIT portfolio companies. They've described how their balance sheets and liquidity ratios have remained healthy during this unprecedented rise in interest rates while still benefiting from the growing demand and constrained supply for their properties. Now that central bankers, including the Bank of Canada and the US Federal Reserve, are at or near the end of the interest rate hiking cycle, a major area of uncertainty is largely behind us, and sentiment is poised to improve significantly. Bottom line is that the REIT sector is well positioned heading into the latter part of 2023 and 2024 with solid fundamentals, attractive valuations, and a much more supportive macro-economic backdrop. Our current focus areas include industrial, multi-family, and data centre/cell tower REITs. Each of these sectors are well represented in **Middlefield Real Estate Dividend ETF (MREL)** and **Middlefield Real Estate Dividend Class (MID601).**

Industrial

The ongoing growth in E-commerce together with the trends to onshore manufacturing and inventory management are driving demand for industrial real estate. While rent growth has slowed from late last year, it continues to increase at very healthy levels.

Multi-Family

Canada has the lowest level of housing per capita in the G7 and it also has the highest level of immigration. Tenants are paying $1,500 to $2,000 per month on average in rent, while market rates are $2,500 to $3,000 per month. As a result, the earnings growth for Canada's apartment REITs is very robust.

Data Centres/Cell Towers

Data generation and storage is expected to grow exponentially, accelerated by the integration of AI across all industrial sectors. US-listed data centre and cell tower REITs continue to trade at attractive valuations with growing demand for their capacity."

Date: September 18, 2023

Lee Goldman, CI Canadian REIT ETF (RIT.TO) & CI Global REIT Class

"REITs have generally been rangebound for the last several months with largely solid fundamentals and financial results weighed against higher interest rates and recessionary fears. There has been a large bifurcation in returns on geographies, subsectors and individual names. On a YTD basis, the better performing geographies include Japan, continental Europe, and the U.S., with weaker performance in Asia Pacific (ex-Japan), and the UK. Canada has performed in line with the returns of the broader global real estate benchmark. In terms of global subsector performance, the largest contributors to returns have been REITs in the data centre, industrial, residential and health care subsectors, with detraction coming from retail, office, and diversified subsectors. Data centre REITs have been fueled by the anticipation of further demand from AI and a pick-up in pricing power. Industrial REITs continue to enjoy mid-to-high single digit organic growth that is expected to be sustained owing to the mark-to-market opportunity embedded in the REIT portfolios. Residential REITs continue to see solid operating income growth with Canada showing solid acceleration and US operating results reporting better in Q2 than feared. Health care is led by a rebound in private pay seniors housing which is expected to continue throughout 2024. Retail REIT underperformance has been somewhat puzzling with REITs reporting robust occupancy, solid rent spreads, and a muted supply picture – concerns over a broader consumer slowdown has likely weighed on the subsector. Office continues to face challenges and, unless there is a large resurgence in leasing activity, the outlook remains uncertain. The rise in U.S. 10-year bonds has been a headwind for the REIT space however recent economic data suggests it is possible that central banks are nearing the end of rate hikes, which could mean we are nearing the upper end of the range in long bond yields. Steady to lower bond yields would be a positive for the space. Overall, global REIT valuations remain attractive trading at a 20%+ discount to consensus net asset value.

As it pertains to **RIT.TO**, REITs have been treading water for several months with decent current fundamentals and financial results being weighed against higher interest rates and recessionary fears. There has been a large bifurcation in returns on individual names and subsectors. Industrial names and apartment names have performed well YTD with the latter showing very low vacancy and sharply rising rents. Retail names have been weak (despite strong occupancy/rising rents) as investors likely fear a slowdown in consumer spending - leading to softer leasing demand from retailers."

Date: September 20, 2023

Luke Kahnert, MBA, CIM
Mutual Fund and ETF Specialist

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