

Focus

Feature Article

Catch-'23: Canada's Affordability Conundrum

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The “R Word” is Resilience, not Recession



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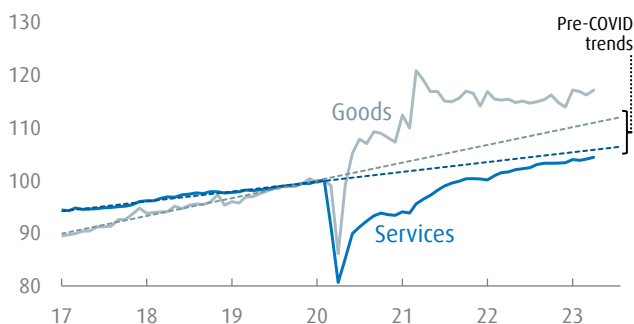
Bond yields forged higher again this week, partly in anticipation of a debt ceiling deal, but also partly in the face of still-high inflation and still-sturdy growth. In fact, one could make the argument that **if the big forecasting mistake almost everyone made in 2022 was to underestimate inflation—present company excluded, of course—the big mistake 40% of the way into this year appears to be that almost everyone has underestimated the resiliency of the economy—present company included.** And this reality is dawning on markets, which are now fully priced for an additional 25 bp rate hike by both the Fed and the Bank of Canada in the summer. Two-year Treasuries jumped 30 bps this week alone, after a similarly sharp rise last week, taking them above 4.6%, a level not seen since SVB failed. It’s a broadly similar picture in Canada, where 2s surged above 4.3%, up 75 bps in a mere three weeks and nearing the cyclical highs hit in early March.

The big and broad rise in yields in recent weeks and the increasing odds of further central bank rate hikes reflects three forces: a **resilient economy, sticky inflation,** and a **challenging fiscal backdrop.** On the first point, the latest batch of U.S. data landed almost completely on the strong side of the ledger. Consumers are still doing their thing, as personal spending thrashed expectations with a 0.8% rise in April, and even 0.5% when adjusted for inflation. This sets consumer spending on course for another positive quarter, after the strong 3.8% advance in Q1. Along with the Chicago Fed’s National Activity Index printing positive last month (signaling above average growth), and it looks like the long-awaited recession has been delayed by another quarter.

Chart 1 Still Some Gas in the Tank

United States (Feb. 2020 = 100)

Real Spending



Sources: BMO Economics, Haver Analytics, BEA

Next week’s key payrolls report may have a different opinion on recession risks, but given the downward revision in jobless claims to modest levels and underlying momentum, we are expecting a solid 200,000 rise in jobs. And the jobless rate is flagging precisely zero weakness, matching 70-year lows. While no one would mistake the current situation for a strong economy—after all, real GDP was up just 1.3% in Q1—**for every sour note, a positive signal pops up** somewhere else. The blow-out quarterly report from Nvidia, driven by AI demand, is but one example of pockets of real strength. Even the housing market is showing a pulse, with new home sales grinding higher from last summer’s lows. That fledgling recovery may yet reverse on the renewed back-up in borrowing costs, but the bigger picture is that the economy is holding up surprisingly well.

The second major factor driving yields back up again is the stickiness of inflation. April’s core PCE deflator topped expectations with a 0.4% m/m rise, nudging up the annual pace in this key metric a tick to 4.7%. Even the Fed’s supercore measure was up by a similar amount last month and is showing no signs of breaking lower. Meantime, the tailwind of lower energy prices may be coming to an end: oil and gasoline prices are still well below the lofty levels of a year ago, but have been drifting higher more

recently. With underlying trends in inflation settling into the mid-4s range, the Fed may well become impatient, particularly if the job market doesn't buckle.

The third and final factor putting some upward pressure on yields is the ugly fiscal picture. The reality is that **even with a quasi-bipartisan debt limit deal, and the obligatory Kumbaya moment, the U.S. fiscal situation is troubling**. Early reports suggest the deal will include a two-year freeze on program spending. That is a welcome drop in the bucket to be sure, but Washington's deficit is currently running at a cool \$1.9 trillion over the past 12 months, or more than 7% of GDP. The debt held by the public has taken a giant \$7 trillion step up in the three years since the pandemic began, an increase of more than 40%. Combined with the rise in borrowing costs, and public interest payments are already up by more than 50% from 2020 levels. As we have opined before, **while one can decry the tactics of using the debt ceiling as a fiscal bargaining chip, one can still agree with the goals**.

It's been a long time since the so-called **bond vigilantes** rode into town on fiscal concerns. But note that the bulk of the recent back-up in Treasury yields has been in real yields, not in the implied inflation premium. This rise in real yields to close to levels not seen in more than a decade suggests that private Treasury buyers are a little more demanding amid fiscal risks, especially since the Fed is busily offloading its holdings. And, there's the small matter that as soon as we do have a debt deal, there will be flood of issuance (albeit mostly T-bills). The bottom line is that above and beyond the short-term factors of a surprisingly resilient economy and sticky inflation, **the tough fiscal picture is alone a solid argument for a higher-for-longer rate outlook**.

Meantime, **Canada's federal budget deficit** looks small when set beside that of the U.S., but the path toward balance appears to have stalled. Ottawa's fiscal monitor for March reported a budget deficit of \$41.3 billion in the twelve months through March, consistent with the \$43 billion shortfall for FY22/23 last estimated in Budget 2023. While that's a moderate 1.5% of GDP, Ottawa continues to spend with some force.

Otherwise, it was a light week for Canadian economic news, with most of the attention on the slew of quarterly bank earnings (which broadly disappointed). But that didn't stop the market from pricing in **higher odds of a Bank of Canada rate hike this summer**. That was partly in sympathy with the shifting outlook on the Fed, but domestic news did little to dissuade the trend. A strong 1.6% rise in the flash reading for April wholesale trade, and a small rise in consumer confidence, hint that the Canadian economy is also holding up so far in Q2. However, that underlying reality may be blurred by the one-two hit to growth from the public sector strike in April, and the wildfire drag on Alberta oil production in May.

As Ben points out in his Thought below, **the big news for Canada next week is the GDP release for Q1 and the preliminary read on April**. Output is expected to start Q2 on a soft note after a surprisingly sturdy 2.5% rise in Q1. But after the dust settles on the special factors, Canadian growth is likely to emerge with more underlying firmness than previously expected. And a key source of that resiliency is the housing market; accordingly, we will be watching the earliest reports on home sales for May which will begin flowing in late next week. If the market shows more signs of recovery, that will fuel the growing odds that the Bank of Canada gets back in the tightening game.

Stubbornness, Two Ways



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This week, stubbornness was in the air. It was rank in the PCE inflation metrics and their worse-than-expected results. And, it wafted from the failure to get a deal done to lift the debt limit before Congress recessed for the Memorial Day holiday.

The PCE price index (PCEPI) increased 0.4% in April, pumping headline inflation by two-tenths to 4.4% y/y. The core PCEPI also rose 0.4%, pushing its annual change up a tenth to 4.7% y/y. These results were all 0.1 ppts above the consensus calls. And, following suit, the supercore PCEPI posted a 0.4% move to keep the yearly figure at 4.5% y/y. There was no consensus forecast here but given that the CPI 'proxy' inched up only 0.1% m/m, the market's whisper number was probably well below the print.

From a short-term trend perspective, there was some improvement. The three-month annualized changes moved from 4.1% to 3.1% for the total, from 5.0% to 4.3% for the core and from 4.8% to 4.3% for the supercore. But the latter two results, when combined with those above, emphasize the **stubbornness of underlying PCE inflation around the 4½% mark**. This is still more than double the Fed's target, hinting that additional policy rate hikes may be required to cut it down.

With the fed funds target range sporting 5-handles (after May's move) and PCE inflation trends sporting 4-handles, real policy rates are now, unequivocally, in positive territory. Initially, this looked like a convenient place to pause and allow time for the 500 bps in rate hikes, \$737 billion in quantitative tightening, and recently reemphasized bank credit tightening to continue working their way through the economy. However, the case for a 'hawkish pause' on June 14 after 15 months of consecutive hiking, which is still our official call, is being undermined. The market is currently pricing in 65% odds of a rate hike next month and is 'all in' for the July meeting. Depending on what happens in next week's employment report and in the next CPI snapshot (due on the first day of the FOMC confab) we could be in this camp too.

Meanwhile, the **negotiations to raise the debt ceiling are going down to the wire... again... the epitome of stubbornness**. There are reports that meaningful progress has already been made and that a deal is in sight. But until a deal is done, the final wording is passed by the House of Representatives (which is in recess until June 5 but Speaker McCarthy said he'll call members back early to vote on a deal) and the Senate (which is back in session on May 30), and then finally signed by President Biden, we're nervous. It's not certain that this sequence can transpire before June 1.

It's also not certain whether June 1 will be the 'X-Date', when the U.S. government is no longer able to honour all its daily financial obligations. However, Treasury had only \$49.5 billion left in its bank account at the Fed, by Wednesday's close (the latest data). This was the lowest level since December 17, 2021. Interestingly, that was the day after the debt ceiling was last raised, by \$2.5 trillion to \$31.4 trillion, which the GOP had blocked the Democrat-controlled Congress (at the time) from doing for months. Hope of lasting until the June 15 tax payment date is all but gone.

Reports suggest the deal will include some discretionary spending cuts for fiscal 2024 and caps (1%) afterwards except for defence and veterans' outlays. The debt ceiling would be raised for at least two years (past the next election) and last as long as the caps are in force. Work requirements for those receiving select government benefits are still a very contentious issue according to reports.

If a deal doesn't get done by June 1, this doesn't mean that the U.S. government will automatically default on its debt. Weekly implied interest payments on T-bills and semi-monthly coupon payments could still be prioritized and there's enough regular cash inflow to cover them. However, all other obligations would be given short shrift, which will have negative economic consequences. According to the Wall Street Journal, Treasury is already preparing to change the way it handles payments... just in case.

In 2011, going down to the wire triggered S&P to lower America's AAA credit rating. Going down to the wire again might not cause other credit rating agencies to follow suit but tripping the wire probably would (even if there is no default on Treasury securities). This week, Fitch and DBRS Morningstar put the U.S. on negative watch. The best sort of stubbornness we can hope for now is the one that keeps negotiators hard at work on Friday and through the holiday long weekend.

U.S. Housing: Flat Is the New Down



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The U.S. housing market's foundation is firming, but it's unlikely to provide much of a springboard for a robust recovery this year.

In the resale market, April existing home sales fell for a second straight month after spiking higher in February, which marked the only increase since early last year. Even with depressed sales, listings remain sparse with a 2.9-month supply. Despite mortgage rates more than doubling since 2021, property owners haven't been forced to sell because most have a job, and many are reluctant to list because they have a sweet deal on a long-term mortgage. While pending home sales held steady in April, a 5.2% slide the prior month has levels basically back to those mined during the pandemic shutdown and Great Recession. Timelier data show new mortgage applications fell again last week and continue to plumb the lowest levels in eight years.

Conditions are somewhat **better in the market for new homes**, with sales jumping 4.1% in April, the sixth increase in seven months. Unlike the resale market, new home supply is more ample at 7.9 months at the current sales pace. The lack of resale listings has buyers kicking the tires on new home lots. Also helping is that prices have fallen more than in the resale market. The median new home price soared from just over \$300,000 (nsa) in the spring of 2020 to nearly \$500,000 last October, but has since pulled back to \$421,000 in April, or by 15%. Builders are more eager to sell than current owners. The upturn in new home sales likely explains the recent bottoming in housing starts, though they remain 22% below year-ago levels. Moreover, sagging building permits flag little chance of a snappy rebound. Although the NAHB homebuilders' index continues to grind higher, it's merely back to a neutral level and still down 28% from a year ago.

Home sales are unlikely to see a strong bounce this year for several reasons.

First, the economy is expected to slip into a mild downturn, lifting the jobless rate by

over one percentage point. While the slump is unlikely to cause much distress (unlike in 2008), it should douse buyer enthusiasm. Second, qualifying for a mortgage has become even tougher due to the recent regional bank stress. Third, mortgage rates are unlikely to retreat much if the Fed stands pat this year, as anticipated. And fourth, due to the minimal pullback in resale prices, affordability remains the poorest in more than three decades. The National Association of Realtors' index, which compares mortgage payments to family income, has fallen of late on a backup in mortgage rates after improving around the turn of the year.

Bottom Line: After a lengthy correction following the pandemic bubble, the U.S. housing market has found its footing, but is unlikely to recover much until next year when the Fed reduces rates and the economy regains momentum. And, if the Fed is forced to tighten policy further to contain inflation, the market could resume a downward slide.

GDP Key for the BoC



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It was a quiet week on the Canadian economic data front, with the reports received decidedly mixed. The **Survey of Employment, Payrolls and Hours (SEPH)** showed employment declined in March, a sharp contrast to the **Labour Force Survey's** 35k-to-40k increase. **Job vacancies** continued to trend lower, with the ninth decline in the past 10 months. The survey also showed **wage growth** decelerating to a one-year low (using the Bank of Canada's metrics). A softening labour market is exactly what the BoC is looking for, as highlighted by Governor Macklem at the **Financial System Review** press conference. Last week's above-expected **CPI** report drove excitement around another rate hike, but we don't believe the case is sufficiently compelling to prompt another push higher just yet. Indeed, headline inflation remains on pace to slow to around 3% by mid-year, which is what the BoC has been forecasting.

The **March/Q1 GDP** report has the potential to change that dynamic. The flash estimate for March GDP came in at -0.1%, continuing the decelerating trend through Q1. April isn't expected to be any better with the public sector strike likely to weigh heavily on the month and potentially driving another negative reading. It's going to be awfully difficult to hike rates following back-to-back negative GDP prints. However, if March is revised into positive territory, and the economy managed to muster enough momentum to push April GDP higher, then the Bank of Canada would be faced with a much firmer economic backdrop than anticipated. **We're looking for Q1 GDP to climb 2.5% annualized**, about in line with the BoC's call, but policymakers are anticipating a slowdown through the rest of the year, and firmer March & April readings would not be consistent with a slowing economy.

Key Takeaway: With the May employment report not out until after the next meeting, the June 7th policy decision could very well hinge on next week's GDP report. The following meeting in July will have notably more data in hand, with another two job reports and the CPI.

Meantime, over in Europe



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With the market's attention solely focused on the U.S. debt ceiling talks this week (understandably so), a couple of other brow-raising developments were happening elsewhere.

It turns out that Germany was in recession at the turn of the year. Thanks to the magic of revisions, and more cautious consumers, Q1 real GDP was revised downward, and showed a 1.3% a.r. contraction (initially pegged as flat), on the heels of Q4's 2.1% drop. It didn't come as a complete and utter shock as worries were percolating after some confidence indexes flagged a problem. The investor-based **ZEW Survey** has fallen for three consecutive months and, in May, saw its first negative reading for the year. Then, the CEO-based **ifo Survey** declined for the first time since October, with particular emphasis on 'expectations', and accompanied by the warning that *"the mood in the German economy has taken a significant hit"*. Clearly, survey respondents were onto something. Interestingly, the **composite PMI** did not pick up on this—it expanded in Q1, and has continued to improve in Q2, with May's reading the highest in over a year. **France** stumbled in May but activity has been growing for the past four months. (Separately, **Greece** has been blithely floating along in the background after last weekend's very market-friendly elections, with 10-year yields trading about 50 bps through Italy, the biggest gap in over two decades.) Meantime, the **ECB** is shrugging off the Euro Area's largest economy's problems and is clearly fully intending to move forward with tighter monetary policy. Some key quotes this week include *"We are not done yet, we are not pausing"*, *"We expect to turn the corner, but I wouldn't say we reached that corner quite yet"*; *"Inflation momentum is still persistent"*; *"we still have some way to go"*, and so on. Interestingly, **France's Francois Villeroy de Galhau**, whose views are more middle-of-the-road, brought up September. *"We have three possible Governing Councils either for hiking or pausing."* All in, we remain comfortable with our expectation for 25 bp rate hikes at the June and July meetings and, to borrow from the Netherlands' Knot, are *"open-minded"* for September.

In the U.K., a recession is no longer expected, but it cannot be entirely dismissed, not with inflation still at multi-decade highs. Yes, headline inflation finally retreated back to single-digit territory for the first time since last August, but food prices continue to soar. In March, the 19.6% y/y surge was the fastest since 1977 and there was barely any change in April (at +19.3%). All the basics—milk, cheese and eggs, vegetables, fruit, breads and cereals, meat and fish—grew at a double-digit pace. Blame it on imports, or *"greedflation"*, or soaring immigration, but sources on the ground also noted the lack of product as increased regulations to allow imported food into the country are slowing things down dramatically. Meantime, core CPI, which excludes food, energy, alcohol and tobacco, is up 6.8% y/y, the fastest increase since 1992. We now look for the BoE's Bank Rate to rise to 5.25% by year-end, with 25 bp hikes at each of the next three meetings, or one more than we expected before the latest inflation results. **Governor Bailey** warned that if the BoE does not get inflation *"back to target and... under control, it gets worse."*



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*Indications of stronger growth and a move toward price stability are **good news** for the economy.*

Good News

Bad News

Canada

- Some oil production restarts as Alberta wildfires ease

Industrial Product Prices -0.2% (Apr.)
Wholesale Trade +1.6% (Apr. A)
Conference Board's Consumer Confidence Index +0.6 pts to 77.3 (May)—3rd increase in a row

SEPH Employment -9,921 (Mar.)
Manufacturing Sales -0.2% (Apr. A)
Raw Materials Prices +2.9% (Apr.)
Ottawa posted a \$41.3 bln budget deficit (Apr.-to-Mar.)—vs. \$95.6 bln deficit in the same period last year

United States

- Core price pressures remain persistent
- Economy proving to be stronger than expected
- FOMC Minutes reveal policymakers nearly split on more rate hikes
- Debt talks continue

Real Personal Spending +0.5% (Apr.)
Personal Income +0.4% (Apr.)
Core Durable Goods Orders +1.4% (Apr.)
Real GDP revised up to +1.3% a.r. (Q1 S)
New Home Sales +4.1% to 683,000 a.r. (Apr.)
Chicago Fed National Activity Index 0.07 (Apr.)
Retail Inventories +0.2% (Apr. A)
U of M Consumer Sentiment revised up to 59.2 (May F)—and 1-yr inflation expectations revised down to 4.2%

Core PCE Deflator ticked up to +0.4% (Apr.)—and **supercore** +0.4%
Goods Trade Deficit widened to \$96.8 bln (Apr. A)
Wholesale Inventories -0.2% (Apr. A)
Initial Claims +4k to 229k (May 20 week)
Pre-Tax Corporate Profits -2.8% y/y (Q1 P)
Pending Home Sales unch (Apr.)—disappointing

Japan

- BoJ Governor Ueda continues to emphasize 2% inflation target... not targeting wages
- Yen weakens past 140/dollar

Manufacturing PMI +1.3 pts to 50.8; **Services PMI** +0.9 pts 56.3 (May P)

Core Machine Orders -3.9% (Mar.)

Europe

- German economy contracts
- U.K. inflation higher than expected amid runaway food prices

Euro Area—Consumer Confidence +0.1 pts to -17.4 (May P)
Germany—GfK Consumer Confidence +1.6 pts to -24.2 (June)
U.K.—Retail Sales +0.5% (Apr.)
U.K.—Producer Prices (Output) slowed to +5.4% y/y (Apr.)

Euro Area—Manufacturing PMI -1.2 pts to 44.6; **Services PMI** -0.3 pts to 55.9 (May P)
Germany—Real GDP downwardly revised to -0.3% (Q1 F)
Germany—ifo Survey -1.7 pts to 91.7 (May)
France—Business Confidence -2 pts to 100; **Consumer Confidence** flat at 83 (May)
Italy—Consumer Confidence -0.4 pts to 105.1 (May)
U.K.—Consumer Prices +8.7% y/y (Apr.)—above expected and **core CPI** accelerated to a 31-yr high of 6.8% y/y
U.K.—Manufacturing PMI -0.9 pts to 46.9; **Services PMI** -0.8 pts to 55.1 (May P)

Other

- RBNZ hikes 25 bps to 14-yr high of 5.50%

Australia—Retail Sales unch (Apr.)
Mexico—Real GDP tweaked down to +3.7% y/y (Q1)

Catch-'23: Canada's Affordability Conundrum



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Catch-22: a dilemma or difficult circumstance from which there is no escape because of mutually conflicting or dependent conditions. Or a paradoxical situation from which an individual cannot escape because of contradictory rules or limitations.

Canada's housing affordability problem is not easing, despite a significant correction in home prices across much of the country, and the problem is unlikely to go away under current settings. While most will argue for a supply-side fix, our longstanding view has been that it's wishful thinking to believe that an industry, already running at full capacity, can simply double output in short order, flood the market with new units and bring prices and rents down. Bank of Canada policy has now appropriately taken froth out of the market, but robust immigration flows continue to fuel demand at a time when there is already peak domestic demographic pressure.

Market Tightening

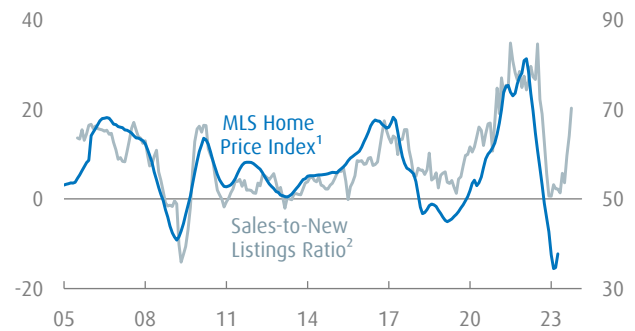
Conditions on the ground suggest that **many markets have found a bottom** after last year's correction. Sales volumes turned up meaningfully through the spring and are now back into the range that prevailed before the pandemic boom. However, a lack of new listings is the bigger factor tightening the market (*Chart 1*). National new listings were running at the lowest non-pandemic level in almost 20 years, despite a population that is now larger by 25%, or by 8 million. Past real estate downturns that evolved from an asset price correction into something much worse have come at the hands of forced selling—think the U.S. during the GFC or Southern Ontario in the 1990s—but we're not seeing that yet.

Among the factors holding back listings are potential sellers not wanting to let go in a down market; not having to let go because of a strong job market and built-up liquidity; less mobility if they're locked into an attractive mortgage; and, a strong rental market for investors to lean on. At the same time, the structure of Canada's mortgage market has blunted the impact of higher interest rates with many variable-rate holders seeing amortizations stretch out, rather than payments rise in real time. OSFI has also stress-tested most buyers such that even those that took out mortgages at the low for rates have proven an ability to pay in at least the 4.75%-to-5.25% range.

As prices level off, that leaves the national benchmark price correction at 16% peak-to-trough. That has simply scrubbed the extreme froth out of the market, but hasn't gone far enough to actually make housing close to "affordable" again (*Chart 2*).

Chart 1
Market Balance Tightening

Existing Homes — Canada



¹ (lhs : y/y % chng); ² (rhs : s.a.)
Sources: BMO Economics, Haver Analytics, CREA

Chart 2
Affordability Is Still Stretched

Canada (% of household income¹)
Mortgage Payment to Household Income



¹ Assumes stable home prices, 10% down payment, 25-year amortization
Sources: BMO Economics, Haver Analytics

Affordability Still Strained

When mortgage rates jump from 1.5% to 5%, maintaining affordability would require a 25% cut in the price of the house, while holding income, down-payment size and amortization length constant. Chart 2 shows affordability over time, accounting for incomes, mortgage rates and house price changes, and the takeaway is that the pandemic-era deterioration has scarcely been touched. To do so would take another leg down in home prices, or a meaningful move down in mortgage rates, neither of which are on the radar for the rest of this year. Over the medium term, however, affordability can be restored by incomes growing in excess of home prices, and we suspect that eventual BoC easing will play a role. The affordability that we're used to, however, is still a long way off.

Another affordability gauge is the path of inflation-adjusted home prices (*Chart 3*). Real home prices in Canada have historically grown about 3% per year dating back to the early 1980s. In the recent episode, even as inflation accelerated to multi-decade highs, real home prices surged by more than a third in the span of two years, opening the widest deviation from its long-run trend in at least 40 years. Fundamentally, housing is a good inflation hedge, so persistent pressure, along with rising building, labour and overall development costs are helping to put a floor under the resale market. But, from an affordability perspective, the price correction has only pulled inflation-adjusted home prices back down to baseline levels.

What about Those Supply Targets?

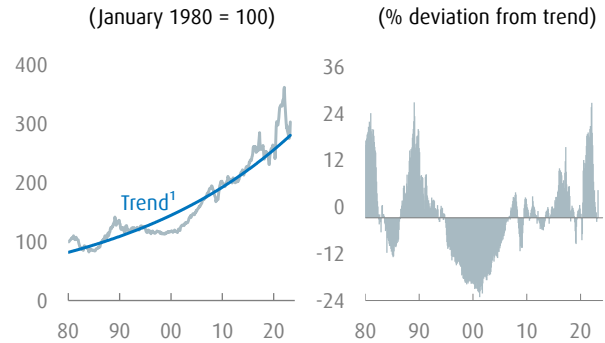
The knee-jerk response by seemingly one and all to Canada's affordability constraints is "more supply". There is no debate that increased supply needs to play an important part in improving affordability.

But there are at least **three reasons why we simply cannot rely on supply alone** to do the job. First, and most obviously, housing supply can only respond gradually, and is essentially fixed in the short run, whereas demand can change in a moment. Second, even over a more extended period of time, there are clearly limits to how quickly supply can respond, given Canada's existing skilled trade workforce, availability of serviced land, and materials. Third, and perhaps more subtly, any success in improving affordability (i.e., lower prices) will sow the seeds for less building in the future.

Moreover, note that the marked deterioration of affordability in the past few years has come at a time when new homebuilding has surged. For example, housing starts in 2021 and 2022 were the strongest on record for a two-year period, averaging 267,000 units, or 40% above the 50-year average pace (*Chart 4*). True, a much greater share of this new building is aimed at condo construction than in the past, with single-family homes accounting for less than 30% of starts in 2021/22 versus a long-run average of just above 50%. This is significant because condo towers take longer to build, and tend to house fewer people per unit. But even completions were at 40-year highs in the past two

Chart 3
Froth Is Mostly Cleaned Up

Real Home Price — Canada

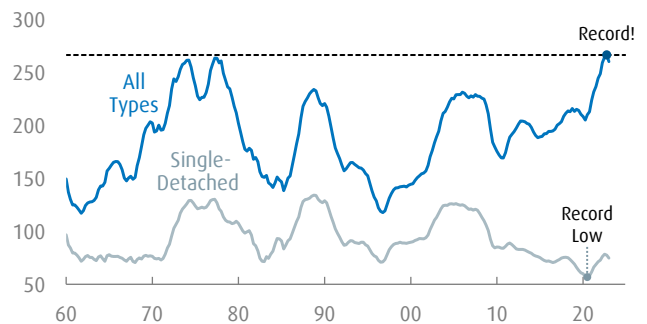


¹ exponential growth trend since 1980
Sources: BMO Economics, Haver Analytics, CREA, Statistics Canada

Chart 4
Supply: The Tide Is High

Canada (000s units : 2-yr m.a.)

Housing Starts



Sources: BMO Economics, Haver Analytics, CMHC

years, and dwellings under construction are running at a record 1.5 years' of supply (at 378,000 units). The point is that **supply has indeed responded in recent years, and yet the affordability needle has barely moved.**

There are some who look at starts relative to population levels, and suggest that they are inadequate. But a more appropriate metric is the growth in the adult population (which is a flow, as are starts). Based on that comparison, the level of new building in the past decade is far from unusually low—on the contrary—at least up until the most recent sprint in population (*Chart 5*).

Investors Playing a Role

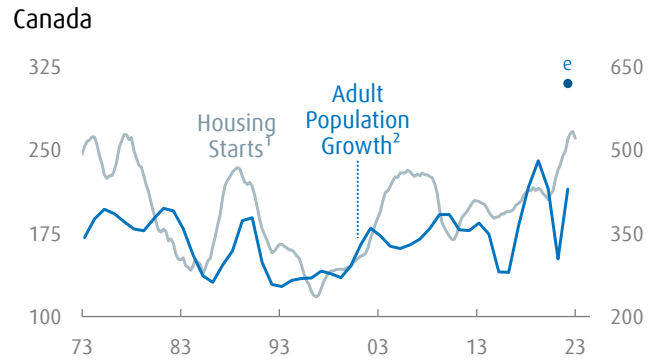
Clearly, there are more fundamental factors at play driving demand and weakening affordability. The investor class is increasingly dominating the Canadian housing market. A recent StatCan study of five provinces (including Ontario and B.C.) finds that over 25% of dwellings are owned by investors as of 2020. If anything, that share likely rose further during the pandemic. While it's no shock that a high proportion of condos are investor-owned, much more eye-opening is the fact that almost 15% of detached homes are now investor-owned, or more than one in seven. Some analysts assert that investor demand helps create supply, so is thus not a big factor in the affordability issue. That *may* be the case in some new condo developments, but is clearly a spurious line of reasoning on existing houses, where investor buying is compounding a tough affordability situation.

Population Flows: A Demand Juggernaut

Beyond that, Canada's strong population growth is no doubt a steady source of support for home price appreciation. Over the short term, the housing market can be swayed by cyclical factors such as interest rates, unemployment and income growth. But over the longer term, demographic trends have the biggest weight on home prices. Evidence from 18 large advanced economies since the start of the century shows that real home prices are closely correlated with population growth over time (*Chart 6*). For example, New Zealand, Australia, and Canada have seen both the fastest growing populations (aside from Ireland) over that period, and the fastest rise in real home prices, while Japan and Italy have been at the other end of the spectrum on both counts.

Regression analysis suggests that every 1% rise in population will be associated over time with real home price growth of just over 3% per year. In recent years, Canada's population has been growing at an average annual pace of 1.5% per year (and a whopping 2.7% in 2022 alone), which is consistent over time with 5% annual home price gains on top of inflation. In any given year that relationship will likely be overridden by short-term factors such as rates or job growth, but it tends to remain strong over time and across economies. Some national housing markets stray from the trend line due to timing factors—the sample period includes a housing boom/bust in Ireland, Spain, and the U.S.,

Chart 5
Trying to Keep Up

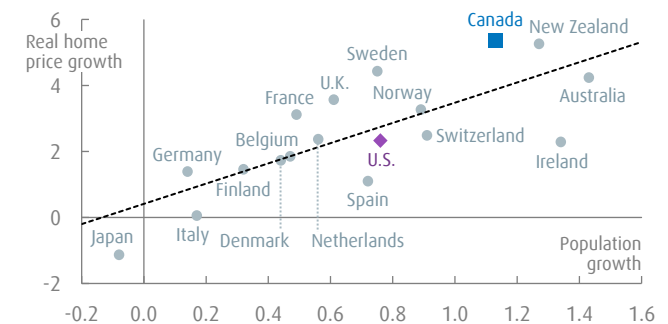


¹ (lhs : 000s units : 2-yr m.a.); ² aged 18+ (rhs : 000s people : 2-yr chng : ann.); e = latest estimate based on quarterly data
Sources: BMO Economics, Haver Analytics, CMHC, Statistics Canada

Chart 6
Real Home Prices and Population Growth

1999–2022 (average annual % change)

Real Home Price Growth vs. Population Growth



Sources: BMO Economics, FRB Dallas

and they are all below the line, while Canada, New Zealand and Sweden are all a bit above the line, perhaps partly reflecting the low level of prices in those countries at the start of the sample period.

But regardless of the starting point, there isn't much debate that **Canada's home price inflation has been much stronger than in most other major economies** over a long period of time (*Chart 7*). The divergence with the U.S. market over the past 15 years is quite stark and cannot be explained away by the small differences in interest rate policies or economic growth.

How Much Is Too Much?

Canada's 2.7% population growth in 2022 was the strongest since at least the 1970s, with more than 1 million people added to the country (*Chart 8*). This comes at a time when domestic demand for housing is just about peaking, with the crest of the Millennial cohort around 32 years old, or right in their household formation and family building years. So, with the construction industry already building at full speed to satisfy domestic demand, we clearly don't have the infrastructure or ability to meet the additional demand created by historic immigration levels. That is reflected in a worsened affordability problem. It's notable that breaking down the population surge of the past year shows that the gain was almost entirely (2.6 pts) driven by international immigration and, of that, more than half was driven by a massive 600k inflow of nonpermanent residents (i.e., students and temporary foreign workers). The result is not only still-high resale prices, but surging rents across many markets, including smaller cities with universities.

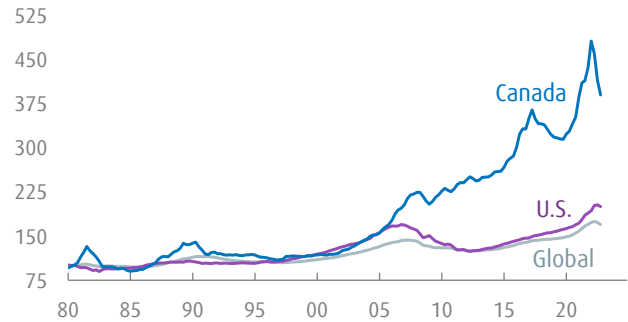
Key Takeaway

Canada's affordability crisis may be an unintended consequence of record international inflows layering on top of peak domestic demographic demand, both of which are combining to pressure a construction industry already near full capacity. The catch is that driving down prices will incent less supply; and at the same time, heightened immigration flows designed to ease labour supply pressure immediately add to the housing demand they are trying to meet. The infrastructure in place and the industry's ability to build clearly can't support unchecked levels of demand, so the affordability conundrum continues...

**Chart 7
Canadian Home Prices: Really High**

(1980 = 100)

Real House Price Index

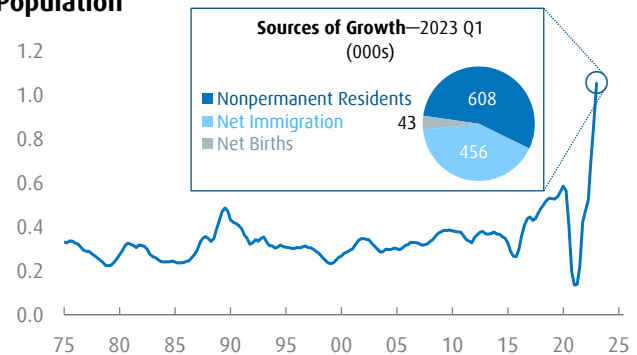


Sources: BMO Economics, Haver Analytics, FRB Dallas

**Chart 8
Population Pressure Point**

Canada (mlns : y/y chng)

Population



Sources: BMO Economics, Haver Analytics, Statistics Canada

Economic Forecast Summary for May 26, 2023

	2022				2023				Annual		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2022	2023	2024
CANADA											
Real GDP (q/q % chng : a.r.)	2.4	3.6	2.3	0.0	2.5	-0.5	-0.7	1.1	3.4	1.0	1.3
Consumer Price Index (y/y % chng)	5.8	7.5	7.2	6.7	5.1	3.7	3.4	3.0	6.8	3.8	2.5
Unemployment Rate (percent)	5.7	5.1	5.1	5.1	5.0	5.2	5.5	5.7	5.3	5.3	5.5
Housing Starts (000s : a.r.)	243	270	281	259	223	249	230	220	263	230	220
Current Account Balance (\$blns : a.r.)	11.0	22.0	-33.7	-42.6	-42.2 ↓	-42.1 ↓	-45.2 ↑	-50.6 ↑	-10.8	-45.0	-55.0
Interest Rates (average for the quarter : %)											
Overnight Rate	0.33	1.17	2.75	3.92	4.50	4.50	4.50	4.50	2.04	4.50	3.88
3-month Treasury Bill	0.39	1.43	2.91	3.96	4.39	4.40	4.45	4.45	2.17	4.40	3.85
10-year Bond	1.92	2.98	3.01	3.16	3.04	2.95	2.95	2.95	2.77	2.95	2.85
Canada-U.S. Interest Rate Spreads (average for the quarter : bps)											
90-day	9	33	16	-22	-39	-79	-83	-83	9	-71	-96
10-year	-2	5	-10	-67	-61	-54	-51	-48	-18	-53	-40
UNITED STATES											
Real GDP (q/q % chng : a.r.)	-1.6	-0.6	3.2	2.6	1.3	-0.5	-0.8	0.8	2.1	1.0	1.3
Consumer Price Index (y/y % chng)	8.0	8.6	8.3	7.1	5.8	4.2	3.7	3.4	8.0	4.2	2.5
Unemployment Rate (percent)	3.8	3.6	3.5	3.6	3.5	3.5	4.3	4.7	3.6	4.0	4.6
Housing Starts (mlns : a.r.)	1.72	1.64	1.45	1.41	1.38	1.38	1.34	1.37	1.55	1.37	1.41
Current Account Balance (\$trlns : a.r.)	-1.12	-0.95	-0.88	-0.83	-0.83 ↓	-0.90 ↓	-0.91 ↓	-0.92 ↓	-0.94	-0.89 ↓	-0.94 ↓
Interest Rates (average for the quarter : %)											
Fed Funds Target Rate	0.21	0.96	2.63	3.79	4.63	5.04	5.13	5.13	1.90	4.98	4.67
3-month Treasury Bill	0.30	1.10	2.75	4.18	4.78	5.20	5.25	5.25	2.08	5.10	4.80
10-year Note	1.94	2.93	3.11	3.83	3.65	3.50	3.45	3.40	2.95	3.50	3.25
EXCHANGE RATES (average for the quarter)											
US¢/C\$	79.0	78.4	76.6	73.7	74.0	74.2	75.3	76.5	76.9	75.0	77.7
C\$/US\$	1.27	1.28	1.31	1.36	1.35	1.35	1.33	1.31	1.30	1.33	1.29
¥/US\$	116	130	138	141	132	136	135	133	131	134	128
US\$/Euro	1.12	1.06	1.01	1.02	1.07	1.09	1.10	1.12	1.05	1.10	1.14
US\$/£	1.34	1.26	1.18	1.17	1.22	1.25	1.26	1.27	1.24	1.25	1.28

Blocked areas mark BMO Capital Markets forecasts; up and down arrows (↑↓) indicate forecast changes; spreads may differ due to rounding

Canada



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Current Account Balance

Tuesday, 8:30 am

Q1 (e) **-\$10.4 bln (-\$41.6 bln a.r.)**Consensus **-\$10.2 bln (-\$40.9 bln a.r.)**Q4 **-\$10.6 bln (-\$42.6 bln a.r.)**

Canada's **current account deficit** is expected to total \$10.4 bln (or \$41.6 bln annualized) in Q4, likely little changed from the prior quarter. That would mark three consecutive quarterly deficits for the broadest measure of trade, following a couple of commodity-price spike induced surpluses in the first half of 2022. The goods trade deficit was about steady from Q4's shortfall, despite a further pullback in commodity prices. On the non-merchandise side of the ledger, the services account deficit hit post-pandemic wides, as travel abroad continued to ramp up. Finally, investment income is expected to struggle as higher rates drive increased interest payments, while direct investment income provides only a partial offset. Our call would put the Q1 current account deficit at a manageable 1.5% of GDP.

Real GDP

Wednesday, 8:30 am

Chain Prices**Q1 (e)** **+2.5% a.r.** **+1.2% a.r.**Consensus **+2.5% a.r.** **n.a.**Q4 **unch** **-2.8% a.r.****Monthly Real GDP****Mar. (e)** **-0.1%**Consensus **-0.1%**Feb. **+0.1%**

Canada's economic resilience was on display in Q1, as favourable weather drove a very strong start to the year. January GDP saw healthy growth, but momentum faded as the quarter wore on. We're expecting growth to clock in at 2.5% annualized, in line with Statcan's flash estimate. Retail sales recorded the largest quarterly increase since 2021Q3, underscoring consumers' ongoing appetite to spend amid a still-robust job market and wage gains. We're anticipating a moderate increase in business investment amid firming equipment imports, while residential activity looks to be about flat and could add to growth for the first time in nearly two years. Net exports are expected to add strongly to GDP growth, with a sizeable draw in inventories providing an offset.

Looking at **March GDP**, the flash estimate came at -0.1%, and we're sticking with that but there's some upside risk given the increase in hours worked, manufacturing activity, and home sales. Even if March comes in flat, it would still highlight that momentum slowed as the quarter progressed. The flash estimate for April isn't likely to look any better as the public sector strike through the second half of the month will likely subtract a few tenths from headline GDP, increasing the odds of a negative reading. While that one-time factor will get reversed in May (as the strike was settled), the wildfires are yet another negative one-time factor, so the rebound will likely have to wait until June.

United States



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Job Openings & Labor Turnover Survey

Wednesday, 10:00 am

Apr. (e) 9,350k^c

Mar. 9,590k

(C = Bloomberg consensus)

Nonfarm Payrolls

Friday, 8:30 am

May (e) +200,000

Consensus +195,000

Apr. +253,000

Unemployment Rate

May (e) 3.5%

Consensus 3.5%

Apr. 3.4%

Average Hourly Earnings

May (e) +0.4% +4.4% y/y

Consensus +0.3% +4.3% y/y

Apr. +0.5% +4.4% y/y

Beige Book

Wednesday, 2:00 pm

ISM Manufacturing PMI

Thursday, 10:00 am

May (e) 46.8

Consensus 47.0

Apr. 47.1

Job growth should continue to moderate in May with **nonfarm payrolls** expected to rise 200,000, down from 253,000 in April and a six-month average of 278,000. The report should more fully reflect tighter lending conditions stemming from the regional bank stress. The labour market appears to be losing speed, with even the recent growth leader—leisure and hospitality—decelerating in April. However, revised-down jobless claims (due to fraud in Massachusetts) suggest the market is far from rolling over. Assuming some bounce in labour force participation, the unemployment rate could edge up after returning to a cycle low of 3.4% in April, a level previously matched in 1969. Aggregate work hours should weaken after turning up for the first time in four months. A soft number would signal a possible mild decline in Q2 real GDP. Average hourly earnings are expected to rise 0.4% after a chunkier increase in April, holding the yearly rate steady at 4.4% and still outside the realm of price stability.

A stronger-than-expected jobs report could have a major bearing on the **Fed's June 14 policy decision**. A further decline in the jobless rate (to the lowest level in 70 years) and another big spike in earnings would raise doubts about whether the FOMC can afford to take a timeout to assess the full impact of past actions and tougher credit conditions. Policymakers will also have an eye on April's **Job Openings and Labor Turnover Survey** to see if job vacancies fell for a fourth straight month, indicating some softening in labour demand.

The previous **Beige Book**, released on April 19, noted "little change" in overall activity despite a slew of economic headwinds, including tighter credit conditions, stalled household spending, and a moderating job market. This paved the way for the Fed to hike rates 25 bps, while signaling a likely pause at the next meeting. The new report, prepared for the June 13-14 policy meeting, could outline a slight downshift in economic activity amid heightened liquidity concerns and moderating job growth. Meantime, comments on inflation will likely highlight easing price pressures. Overall, the anecdotes from the Fed's regional report card will likely allow the central bank to pause for the first time in over a year following an aggressive rate hike campaign.

The **ISM manufacturing PMI** looks to edge down 0.3 pts to 46.8 in May, holding in contraction terrain for seven straight months. Some regional Fed manufacturing surveys showed new orders and shipments continued to shrink. Meantime, the prices sub-index likely increased slightly after piercing above the 50-mark in April. With interest rates expected to stay elevated for some time, the ISM's manufacturing gauge should continue to lose steam, signaling a contraction.

Financial Markets Update for May 26, 2023

		May 26 ¹	May 19	Week Ago	4 Weeks Ago	Dec 31, 2022
		(basis point change)				
Canadian	Call Money	4.50	4.50	0	0	25
Money Market	Prime Rate	6.70	6.70	0	0	25
U.S. Money	Fed Funds (effective)	5.25	5.25	0	25	75
Market	Prime Rate	8.25	8.25	0	25	75
3-Month Rates	Canada	4.51	4.47	4	14	28
	United States	5.28	5.22	6	25	93
	Japan	-0.19	-0.17	-2	-1	-1
	United Kingdom	4.77	4.73	4	15	90
	Australia	3.95	3.93	2	27	68
2-Year Bonds	Canada	4.30	4.00	31	65	25
	United States	4.59	4.27	32	58	16
10-Year Bonds	Canada	3.36	3.13	23	52	6
	United States	3.84	3.68	17	42	-3
	Japan	0.41	0.39	2	3	0
	Germany	2.54	2.43	12	23	-2
	United Kingdom	4.36	3.99	36	64	69
	Australia	3.73	3.59	14	39	-32
Risk Indicators	VIX	17.3	16.8	0.5 pts	1.5 pts	-4.4 pts
	Inv. Grade CDS Spread ²	78	80	-1	3	-4
	High Yield CDS Spread ²	488	493	-5	25	4
		(percent change)				
Currencies	US\$/C\$	73.35	74.05	-0.9	-0.6	-0.6
	C\$/US\$	1.363	1.351	—	—	—
	¥/US\$	140.56	137.98	1.9	3.1	7.2
	US\$/€	1.0708	1.0805	-0.9	-2.8	0.0
	US\$/£	1.233	1.245	-0.9	-1.9	2.1
	US\$/A\$	65.06	66.51	-2.2	-1.6	-4.5
Commodities	CRB Futures Index	258.49	262.13	-1.4	-3.6	-6.9
	Oil (generic contract)	72.23	71.69	0.8	-5.9	-10.0
	Natural Gas (generic contract)	2.22	2.59	-14.3	-8.1	-50.5
	Gold (spot price)	1,940.94	1,977.81	-1.9	-2.5	6.4
Equities	S&P/TSX Composite	19,928	20,351	-2.1	-3.4	2.8
	S&P 500	4,199	4,192	0.2	0.7	9.4
	Nasdaq	12,904	12,658	1.9	5.5	23.3
	Dow Jones Industrial	33,069	33,427	-1.1	-3.0	-0.2
	Nikkei	30,916	30,808	0.4	7.1	18.5
	Frankfurt DAX	15,997	16,275	-1.7	0.5	14.9
	London FT100	7,638	7,757	-1.5	-3.0	2.5
	France CAC40	7,327	7,492	-2.2	-2.2	13.2
	S&P ASX 200	7,155	7,280	-1.7	-2.1	1.6

¹ = as of 11:10 am ² = One day delay

	Monday May 29	Tuesday May 30	Wednesday May 31	Thursday June 1	Friday June 2
China			Manufacturing PMI May (e) 49.5 Apr. 49.2	Services 55.0 56.4	Caixin Manufacturing PMI May (e) 49.5 Apr. 49.5
		Jobless Rate Apr. (e) 2.7% Mar. 2.8%	Retail Sales Apr. (e) +0.6% Mar. +0.3%	Industrial Production Apr. P (e) +1.4% Mar. +1.1%	Capital Spending Q1 (e) +5.4% y/y Q4 +7.7% y/y
Japan					
Europe	UNITED KINGDOM Markets closed	EURO AREA Adjusted Private Sector Credit Apr. +3.8% y/y Mar. +3.8% y/y	GERMANY Consumer Price Index May P (e) +0.3% Apr. +0.6%	EURO AREA Consumer Price Index May P (e) +0.2% Apr. +0.6%	FRANCE Industrial Production Apr. (e) +0.3% Mar. -1.1%
		Economic Confidence May P (e) 98.9 Apr. 99.3	Unemployment May (e) +15,000 Apr. +24,000	Jobless Rate 5.6% 5.6%	Core CPI May P (e) +5.5% y/y Apr. +5.6% y/y
			FRANCE Consumer Price Index May P (e) +0.3% Apr. +0.7%	Manufacturing PMI May F (e) 44.6 Apr. 45.8	
			Consumer Spending Apr. (e) +0.3% Mar. -1.3%	Jobless Rate Apr. (e) 6.5% Mar. 6.5%	
			Real GDP Q1 F (e) +0.2% Q4 unch	7:30 am ET Minutes from ECB's May 3-4 meeting	
			ITALY Consumer Price Index May P (e) -0.2% Apr. +0.9%	GERMANY Retail Sales Apr. (e) +1.0% Mar. -2.2%	
			Real GDP Q1 F (e) +0.5% Q4 -0.1%	ITALY Jobless Rate Apr. (e) 7.8% Mar. 7.8%	
				UNITED KINGDOM Manufacturing PMI May F (e) 46.9 Apr. 47.8	
Other		AUSTRALIA Building Approvals Apr. (e) +2.0% Mar. -0.1%	AUSTRALIA Consumer Price Index Apr. (e) +6.4% y/y Mar. +6.3% y/y	BRAZIL Real GDP Q1 (e) +1.1% Q4 -0.2%	
			INDIA Real GDP Q1 (e) +5.1% y/y Q4 +4.4% y/y	+2.7% y/y +1.9% y/y	

⁰ = date approximate

Upcoming Policy Meetings | Bank of England: June 22, Aug. 3, Sep. 21 | European Central Bank: June 15, July 27, Sep 14

North American Calendar — May 29–June 2

	Monday May 29	Tuesday May 30	Wednesday May 31	Thursday June 1	Friday June 2	
Canada	Alberta Election	8:30 am Current Account Balance Q1 (e) <i>Consensus</i> -\$10.2 bln (-\$40.9 bln a.r.) Q4 -\$10.6 bln (-\$42.6 bln a.r.)	8:30 am Real GDP Q1 (e) <i>Consensus</i> +2.5% a.r. Q4 unch 8:30 am Monthly Real GDP Mar. (e) <i>Consensus</i> -0.1% Feb. +0.1% Noon 2-year bond auction \$4.75 bln	9:30 am S&P Global Manufacturing PMI May Apr. 50.2 Auto Sales^D May Apr. +2.3% y/y Noon 5-year bond auction \$5.0 bln		
				7:30 am Challenger Layoff Report May Apr. +175.9% y/y 8:15 am ADP National Employment Report May (e) +165,000 ^C Apr. +296,000 8:30 am Initial Claims May 27 (e) 235k (+6k) ^C May 20 229k (+4k) 8:30 am Continuing Claims May 20 May 13 1,794k (-5k) 8:30 am Productivity Unit Labour Costs Q1 F (e) -2.4% a.r. +5.5% a.r. <i>Consensus</i> -2.6% a.r. +6.2% a.r. Q1 P -2.7% a.r. +6.3% a.r. Q4 +1.6% a.r. +3.3% a.r. 9:45 am S&P Global Manufacturing PMI (May F) 10:00 am ISM Manufacturing PMI May (e) 46.8 <i>Consensus</i> 47.0 Apr. 47.1 10:00 am Construction Spending Apr. (e) +0.2% ^C Mar. +0.3% Autodata Total Vehicle Sales^D May (e) 14.8 mln a.r. <i>Consensus</i> 15.3 mln a.r. Apr. 16.1 mln a.r. Fed Speaker: Philadelphia's Harker (1:00 pm) 11:00 am 13- & 26-week bill auction announcements 11:30 am 4- & 8-week bill auctions	8:30 am Nonfarm Payrolls May (e) +200,000 <i>Consensus</i> +195,000 Apr. +253,000 8:30 am Unemployment Rate May (e) 3.5% <i>Consensus</i> 3.5% Apr. 3.4% 8:30 am Average Hourly Earnings May (e) +0.4% +4.4% y/y <i>Consensus</i> +0.3% +4.3% y/y Apr. +0.5% +4.4% y/y	
United States	Memorial Day (markets closed)	9:00 am S&P CoreLogic Case-Shiller Home Price Index (20 city) Mar. (e) +0.1% -1.6% y/y <i>Consensus</i> unch -1.7% y/y Feb. +0.1% +0.4% y/y 9:00 am FHFA House Price Index Mar. (e) +0.1% +2.8% y/y <i>Consensus</i> +0.2% +2.9% y/y Feb. +0.5% +4.0% y/y 10:00 am Conference Board Consumer Confidence Index May (e) 99.5 ^C Apr. 101.3 10:30 am Dallas Fed Mfg. Activity May (e) -18.8 ^C Apr. -23.4 Fed Speaker: Richmond's Barkin (1:00 pm) 11:00 am 4-, 8- & 17-week bill auction announcements 11:30 am 13- & 26-week bill auctions \$119 bln 1:00 pm 161-day cash management bill auction \$50 bln	7:00 am MBA Mortgage Apps May 26 May 19 -4.6% 9:45 am Chicago PMI May (e) 47.3 ^C Apr. 48.6 10:00 am Job Openings & Labor Turnover Survey Apr. (e) 9,350k ^C Mar. 9,590k 2:00 pm Beige Book Fed Speakers: Governor Bowman, Boston's Collins (8:50 am); Boston's Collins (12:20 pm); Governor Jefferson (1:30 pm); Philadelphia's Harker (1:30 pm) 11:30 am 17-week bill auction			

^C = consensus ^D = date approximate ^R = reopening

Upcoming Policy Meetings | Bank of Canada: June 7, July 12, Sep. 6 | FOMC: June 13-14, July 25-26, Sep 19-20

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