

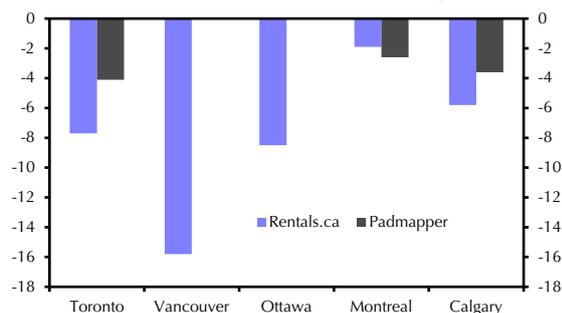


# CANADA ECONOMICS UPDATE

## Tumbling rents a big risk for house prices

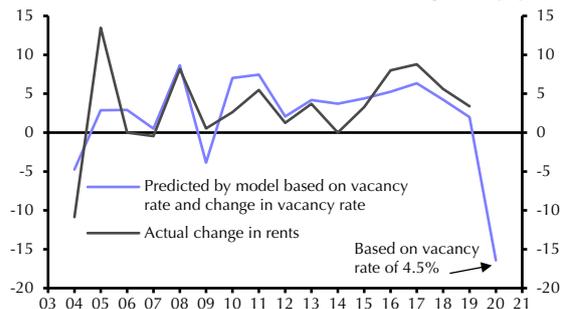
- **Rents in the major cities seem to be falling fast. With property investors basing their price expectations on the assumption that rents would instead keep rising strongly, this represents a big risk to house prices.**
- **There are few time-series for rents, but Rentals.ca and Padmapper.com provide monthly reports that suggest rents are falling quickly in many cities.** For two-bed properties, Rentals.ca reported an 8% m/m drop in Toronto in April, a 9% fall in Ottawa and a 16% slump in Vancouver. We are sceptical of the size of those declines as the figures are based on mean average rents on the site’s listings, which were probably pulled down by institutional landlords listing fewer high-end units. Nevertheless, Padmapper’s report, based on median rents, showed rents falling in Toronto, Montreal and Calgary among others. (See Chart 1.)
- **There are several reasons why rents have been quick to fall.** The surge in unemployment has most affected low-wage earners, who typically rent, and few people will commit to a new property if they are unable to view it in person. Moreover, immigration has all but stopped and the halting of tourism has caused a slump in demand for short-term rentals, so these landlords are now targeting the longer-term rental market instead.
- **Our crude estimates suggest the impact of the drop in immigration and rise in supply could be very significant.** Net immigration has dropped from 30,000 per month to near zero. If all new arrivals rent and the number per household matches the national average of 2.5, that would imply a drop in demand of 12,000 units per month. Meanwhile, academic studies suggest Airbnb removed 31,000 units from the rental market. If all those short-term units returned to the market and immigration halted for three months, it would imply a rise in vacant units of 67,000 and a jump in the vacancy rate to 3.5%, from 2.2%. That would be the highest since 1997 and above the 3% that industry analysts typically refer to as a “balanced market”.
- **Admittedly, those are only crude estimates and there is a lot of uncertainty around how much the vacancy rate might rise by. But the situation nevertheless looks very concerning in Toronto and Vancouver, which receive the bulk of new arrivals and which have the highest share of short-term rentals.** The number of short-term rental units that could return to the Toronto market, at 7,900, is already more than the number of vacant units at the start of the year. Toronto’s population was previously growing at an average of 12,000 per month. Even if we assume a much higher four people per home, that implies 3,000 apartments will not be leased every month while travel restrictions remain in place. All this implies that, by July, the Toronto rental vacancy rate could jump to 4.5%, from 1.5%. It could rise even further at the end of the summer, if departing university students are not replaced by a new cohort as teaching increasingly moves online.
- Rental growth is typically related to both the change in, and the level of, the vacancy rate. That is, a 1%-pt drop from 2% to 1% would normally lift rents by more than a drop from 5% to 4%. With that in mind, a simple regression for Toronto suggests that a jump in the vacancy rate to 4.5% could cause a whopping 15% drop in rents. (See Chart 2.) **Even if travel restrictions are soon loosened and vacancy rates rise by far less than these extreme scenarios, rents seem likely to decline by at least 5% to 10% in Toronto and Vancouver. That represents a big risk for house prices.** Many recent investors reportedly already faced negative cashflows as rents were too low to cover all their expenses. With rents now falling, some may sell properties, which could cause a drop in house prices in excess of the 5% we have pencilled in. (See [here](#).)

**Chart 1: Rents for Two-Bedroom Units (April, % m/m)**



Sources: Rentals.ca, Padmapper, Capital Economics

**Chart 2: Toronto Rents on New Listings (% y/y)**



Sources: TREB, Capital Economics



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