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MORTGAGE TEAM
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HST and the Real Estate Market

We are now past the dreaded July 1st deadline and HST is no longer a concept but a reality that people in BC and Ontario have to adjust to. There was much angst and worry that the advent of the new harmonized sales tax in both provinces would be part of a perfect storm when combined with rising interest rates that would lead to a dramatic slow down in our housing markets. And if the early signs in the market are any indication, one would have to believe that all these fears were valid. As of July 1st, HST came into effect, interest rates were on the rise and sure enough, the real estate market came to a grinding halt in comparison to the heady days of spring. The real question however is; 'How much of the current market conditions are a factor of HST, rising rates and real economic fundamentals versus a self-fulfilling prophecy fueled by misleading headlines?'

The consumer public can be a fickle breed and one that is easily swayed by headlines. Let's take a look at some of the facts and put a little perspective on this. It was just over a year ago that our entire global economy was on the brink of chaos and collapse. Fears were rampant that our global recession would be the next depression. Everyone you spoke to was quick to tell you about how much they have already lost in their homes (although none of them had actually sold their home for a loss…). Everywhere you turned it was doom and gloom. So how did governments around the globe react? By spending money and trying to get you – the consumer to do the same. The result?
Global deficits for virtually every country in the world and record low interest rates.

But let's look at Canada in particular. First of all, we were one of the strongest economies going into the recession and almost all economists would agree that the Canadian recession was a global issue – not Canadian born. In other words, although we may have had solid economic fundamentals, we could not be immune to the global economic influences. Thus is the nature of an export dependent economy. However, since neither our homeowners nor our businesses were significantly overleveraged, Canadians were able to take full advantage of the record low interest rates and as if led by an MTV generation of homeowners who did not have the patience to sit through a long, boring drawn out recession, we started spending. And spending in a way that surprised even the most optimistic of economists. In fact, by the end of 2009, the fears were no longer about recessions, but about another pending housing bubble. Prices in virtually every part of the country – but especially Vancouver and Toronto – had not only rebounded, but in some cases set new heights. Recession? What rescession?

This amazing rebound was in large part fueled by two things: large government spending and record low interest rates. When you combine this with the fact that Canada did not have a true fundamental reason for being propelled into a recession, it is easy to see how we were able to exit it so fast. However, all good things must come to an end. Record low interest rates, by definition have nowhere to go but up and once the provincial governments realize they don't need to keep spending their way out of the recession, they will need to find a way to pay for their newfound debt. And so, the governments of Ontario and BC are faced with the difficult task of trying to convince an unsympathetic public that a new harmonized sales tax is necessary to make up for the spending spree that got us out of the recession. When you combine this with a most certain rise in interest rates and a summer market – you have the perfect storm.

And this is where it gets interesting. The past spring was one of the strongest spring markets in recent history for the real estate industry. Why? Well, let's think about it:

- We are exiting a recession with strong economic fundamentals
- Consumer confidence is strong
- Canadians and Vancouverites in particular are feeling proud of their country/city following the Olympics
- Interest rates are at record lows

Take all of this and add a spring market – which, by definition, is stronger than a winter or summer market. Now add on the fact that the consumer public is being warned that come July 1st, we will be hit with both rising rates and HST – and you have the additional incentive for Canadians to buy before it's too late. The result – one of the strongest spring markets in real estate history.

This leads to the obvious question; how will the HST affect real estate? The answer is two-fold. On the one hand, the advent of HST will have very little real impact on the real estate markets and home values, namely because the new tax is only applied to new homes over $525,000. The sales of existing homes (which make up a far greater percentage of the market) will not be greatly impacted (other than additional costs to legal fees and realtor commissions) and we will begin to see very creative measures by contractors and developers to help offset the real cost of the extra tax on new home sales.
However, from an emotional perspective the impact will be strong and unpredictable.

There were three reasons why the spring market was so strong:

- Fear of rising rates
- Fear of impending HST
- It was a spring market

The inference is that rising rates and HST will cause the market to slow down and come to a grinding halt – and in some cases, that it exactly what appears to have happened. But let's take a look at these fears and see what is really happening.

Rising rates:
Depending on what headline you read, you couldn't blame the average consumer for thinking that interest rates are about to skyrocket. Are rates going to go up? Of course they are. But, are they going to skyrocket? Not exactly. The reason the Bank of Canada lowered rates to historic levels in the first place was to get us spending and buying. It worked – we literally spent our way out of the recession. Now, the reason for raising those rates will be to keep a lid on inflation. The BOC has an inflation target of 2%. When they are concerned that inflation may run past 2% they will raise rates to keep it in check. At present, the Canadian economy is strong enough based on local economic fundamentals to have vibrant growth beyond the 2% mark and therefore justify a slight rise in rates. However, just as we saw in 2008/2009, Canada is not immune to what goes on beyond our borders and is, in fact, largely dependent on the global economy. We need only look to the economic mess that is unfolding in Europe and pending issues still plaguing our neighbors to the south to realize that it is highly unlikely that the Canadian economy will be able to continue at its current pace.
The result: The BOC will raise rates slightly over the summer but be unable to continue to do so into the fall without risking an economic slowdown. Rates will rise – but not to the degree that matches people's fears.

HST:
Many consumers in Ontario and BC rushed to get into the market before the HST came into effect. The truth is that the new tax – whether warranted or not, was not sold to the populace very effectively – especially in BC. In fact, it caused confusion, anxiety and fear amongst the consumer public and none of those emotions are conducive to building consumer confidence. The reality is that the new tax should have a short impact, but not a lasting impact on consumer spending. However, the emotional impact of the new tax will be much stronger and less predictable.
The result: A populace that lacks consumer confidence and is uncertain will typically do nothing. The confusion, anxiety and fear – largely a result of poor education on the government's part, will result in consumers choosing to step off of the playing field and stand on the sidelines. They will hold off on large purchases until they see what the real impact of HST is.

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The Summer Market:

Every real estate market has an ebb and flow to it and the spring is always busier than the summer. In fact it is quite natural for home sales to slow in the summer months, simply because people are on holidays. However, in the summer of 2010, we can add the fears of rising rates and HST to the fact that July and August are slower months and it will give cause to a 'perfect storm' for a real estate slowdown.

What should happen?

The reality is that the real estate markets in both BC and Ontario should see a slight softening over the course of the summer with prices coming off about 3% from their spring peaks. This may be slightly increased by the very real fact that interest rates will have risen another quarter point and the additional cost of the HST thus making real estate that much more expensive in what are already Canada's most expensive markets and therefore that much more unaffordable. These prices should settle over the course the winter, only to rebound in the spring of 2011, once Canadians realize that HST is here to stay and they have adjusted to the new reality. Fear and confusion will be replaced with knowledge and acceptance. They will see that rates have not risen as much as they feared and that even a full percentage higher is still very cheap money. And so, consumer confidence will rebound and the spring of 2011 should recapture the losses of the fall and summer, and the market will continue as it always has. That is what should happen.

What may happen?

We will have to wait and find out, but I can guess one thing. The headlines in papers all across the country will start reporting month over month comparisons showing the impact of HST and rising rates. Canadian consumers will see a drop in real estate prices and mistake what is in fact a natural occurrence of the summer market with a dramatic drop in the real estate market due to HST and rising rates. Fear and confusion will replace confidence and what should be a 3% drop could be misinterpreted as a rebounding recession. Headlines will raise fears that the recovery was a false one and even more consumers will hoard their dollars for fear of making large purchases in a time of downward economy. We will hear how overpriced certain markets are and what should be a 3% drop will become a larger one – not because the market needs a correction, or that HST and rising rates are to blame, but because the consumer public created a self-fulfilling prophecy fueled by headlines and misinformation.

Canada has some of the strongest economic fundamentals in the world. We are the envy of the global banking community. Our real estate is very strong. We know that rates will have to rise, but we also know that they can not go up too much too fast. We know that HST is now here. But we also know that we are resilient by nature and although this will have an impact on the cost of housing; it is not as great as some would have us believe and we will learn to adjust. Here's hoping knowledge replaces fear and that Canadian consumers recognize the difference between a false recovery and a summer market.

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