Is it a blip, or is the GTA housing market on the verge of severe correction?

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Is the recent downturn in the Greater Toronto Area's real estate market a blip or the start of a severe correction?

John Andrew, a professor at Queen's University and executive director of the Queen's Real Estate Roundtable, is calling it a blip. He expects strength to return to the market after prospective buyers get their heads around the Ontario government's recent policy changes. But the business professor cautions there are risks to his prediction.

One is the spectre of rising interest rates.

This week, the Bank of Canada hiked interest rates for the first time in seven years when it lifted its benchmark rate by 25 basis points to 0.75 per cent. The move was widely expected by financial markets.

Prof. Andrew warns that a series of rate hikes in Canada would put pressure on a lot of households – especially in Toronto and Vancouver, where many people hold massive mortgages.

Another factor is the level of trepidation buyers already appear to be feeling after Ontario's introduction on April 20 of a tax aimed at foreign buyers.

"What a quick transition we've seen from a very strong sellers' market to a very strong buyers' market," Prof. Andrew says of the abrupt decline in sales.

Data from the Toronto Real Estate Board show sales plunged 37.3 per cent in the GTA in June compared with the same month last year. New listings last month jumped 15.9 per cent from June, 2016. That tally follows a topsy-turvy May, when sales dropped 20.3 per cent compared with a year earlier and new listings skyrocketed 48.9 per cent for the same period.

The swell of new listings subsided in June after May's surge, but that's partly because June traditionally marks the end of the spring season, when the number of people putting their properties on the market tends to dwindle.

But the GTA market has been in a skid since the Ontario government introduced a slate of new measures aimed at taming runaway price growth. After a blistering first quarter, the province launched a 15-per-cent tax on non-resident speculators who purchase property in a part of Ontario known as the Greater Golden Horseshoe.

The measures appear to have spooked buyers, but even in the weeks leading up to the announcement, some buyers were becoming hesitant about venturing into such a zany market.

Prof. Andrew believes the foreign-buyers tax is the most significant factor in pushing buyers to the sidelines.

Last week, the Ontario government reported that 4.7 per cent of homes purchased in the Greater Golden Horseshoe between April 24 and May 26 were by foreign buyers.

"It's not a very significant number that are being bought by foreign investors," Prof. Andrew says. "But it has changed buyer psychology and that's all it takes."

He says there is not a lot of objectivity or rationale for the market responding as it has, which bolsters his belief that people were just looking for an excuse for the market to cool off.

He believes the percentage reported by the province is a flimsy reason for the market to tank because the tally is not all that reliable. The data were collected over only a few weeks. There's also a relatively high degree of error in such reports, he adds, and they tend to skew on the low side.

A more thorough breakdown of the numbers obtained by The Globe and Mail this week confirms that certain pockets in the Toronto area have much higher rates of foreign investment.

Prof. Andrew adds that it's difficult for the government and industry to know who the actual buyer of a property is. There are various loopholes and exemptions that allow overseas investors to get around the tax, he adds.

People exempt from paying the tax include immigrants who either have or are seeking permanent-resident status, and foreign students studying in Canada.

"That's a no-brainer. That's quite an exemption," Prof. Andrew says of the international-student status. "These are sophisticated investors, and who doesn't want to get a Canadian university or college education anyway?"

John Pasalis, president of Realosophy Realty Inc., thinks the province's numbers need some context.

He notes the data were based on deals that closed – that is, ownership was transferred – between those dates. Mr. Pasalis points out that closing the deal typically happens 60 days after a home is sold. He reckons the majority of these sales took place before the province introduced the non-resident speculation tax.

Also, while the data cover the Greater Golden Horseshoe, most foreign buyers are zeroing in on the GTA.

The numbers obtained by The Globe this week back up Mr. Pasalis's view that the 416 area code and parts of York Region, such as Richmond Hill and Newmarket, have pockets that attract large numbers of deep-pocketed overseas investors.

Mr. Pasalis adds that even 4.7 per cent is meaningful in a market where prices were rising by as much as 33 per cent on an annual basis in the first quarter. Homes purchased in the first quarter required 72 per cent of the average local household's income to cover the carrying costs.

Looking ahead to the fall, Prof. Andrew will be interested to see what the central bank does at its next policy meeting.

"Certainly, the Bank of Canada is very disciplined in not responding to the real estate market," he says, noting that the bank remains focused on keeping inflation in check.

He adds there are real estate markets in Canada that don't need cooling off.

But he figures if the central bank were to raise rates two or three times, housing markets across the country would slump.

"By about the second increase, the response will be 'the gravy train has stopped.' I think we would see a decline in house prices right across the board."

In that scenario, Prof. Andrew's biggest concern is what happens when homeowners' mortgages come up for renewal.

Those with a five-year fixed-rate mortgage, for example, may be facing significantly higher rates when the five years are up. If consumers were stretched with rates below 3 per cent, they will be reeling if they have to renew a mortgage at 5.3 per cent, for example.

The problem is that employees' income levels, on average, are not climbing. Those who took out a mortgage in 2016 or 2017 could feel a lot of pressure in 2020 or beyond.

"In a market like this, they borrow every dollar they can possibly borrow."

Homeowners will find all kinds of ways to cut costs so they can stay in their principal residence, he says.

“They will go to Herculean efforts to not lose their home.”

His fear centres on the investors who own downtown Toronto condo units. In the current low-rate environment, those owners may be able to rent out the unit for $3,000 a month, which covers their mortgage payments and costs. But in a rising rate environment, carrying costs may shoot up to $4,000 a month. Even if the rent has risen to about the $3,300 level during the same period, the owner is no longer recovering expenses.

“Those are realistic numbers,” Prof. Andrew stresses.

He worries about investors in that situation because their commitment quickly vanishes.

Rather than be out of pocket every month while hoping the unit rises in value, the investor is more likely to sell and take any gains from the appreciation above the purchase price.

“A lot of investors will do the math at the same time and they’ll dump them.”

The panic would be compounded by the fact that so many buildings are reaching completion within a relatively short time of one another. That means those unit owners would also be renewing their mortgages at about the same time.

Prof. Andrew says those owners will drop the asking price quickly and repeatedly until the unit sells.

“They want out,” he says. “Investors like that tend not to be patient.”