A Tale of Three Canadian Housing Markets

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While common factors, such as low interest rates and healthy immigration, have underpinned Canada's housing boom in the past decade, the old saw that "all markets are local" still applies. Indeed, the national picture masks vast differences in valuations among three of Canada's four largest cities, with implications for the price outlook.[1]

Nationwide: Moderately High Valuations Though Still Affordable

Average existing house prices have more than doubled in the past ten years, hitting new highs in April (*Table 1*). At 5.1-times median family income, housing is by no means cheap, costing an extra two years of gross income compared with 2001, when the boom began and valuations were closer to historic norms (*Table 2*). Even excluding frothy Vancouver, prices have more than doubled in the past decade to 4.6-times income versus 3.0-times in 2001. Due to ultra-low interest rates, affordability isn't a major issue yet, with first-time buyers allocating about one-third of their disposable income for mortgage payments, as is the norm (*Chart 1*). But high valuations suggest that even a moderate increase in interest rates will slow the market in coming years.

Vancouver: Lotus Land Valuations[2]

Riding a wave of wealthy immigrants, Vancouver's house prices have nearly tripled in the past decade, spiralling beyond the reach of most first-time buyers or non-lottery winners. Demand from China reportedly has been strong, stoked by looser travel restrictions, stricter purchase rules and lofty house prices in China. The average priced home in Vancouver is now an astounding 11.2-times family income, more than double the decade-earlier ratio and the current national figure.[3] *Demographia's* survey ranked Vancouver the third least affordable among 325 world markets, just behind Hong Kong and Sydney, two other cities influenced by mainland Chinese demand. After running only modestly above Toronto's prices in the early 2000s, Vancouver now stands 71% higher (*Chart 2*). While land-use restrictions and high quality-of-life rankings can justify elevated prices, current steep valuations could prove unsustainable if foreign investment ebbs or interest rates climb. How much could

TABLE 1
AVERAGE HOME PRICES, APRIL 2011, NSA

	C$ (in thousands)	Y/Y % Change	10-Year % Change
Canada	373	8.0	122
ex-Vancouver	337	5.1	111
Vancouver	815	21.0	188
Calgary	412	4.0	127
Toronto	477	9.1	91

[1] In Canada's second largest city, Montreal, prices have increased 150% in the past ten years to 4.4-times income, similar to the moderate overvaluation in most other regions.

[2] This note is based on data to April 2011. Newly published May figures for the three cities in question show ongoing strength in sales and prices.

[3] Our valuation metric is based on the average-priced existing house. A reported shift in sales to high-end homes in the past year means the actual increase in average prices is less than suggested by our measure.

TABLE 2

RATIO OF AVERAGE HOUSE PRICES TO MEDIAN FAMILY INCOME

	April 2011*	2007	2001
Canada	5.1	4.6	3.2
ex-Vancouver	4.6	4.3	3.0
Vancouver	11.2	8.6	5.4
Calgary	4.2	4.7	2.8
Toronto	6.7	5.7	4.3

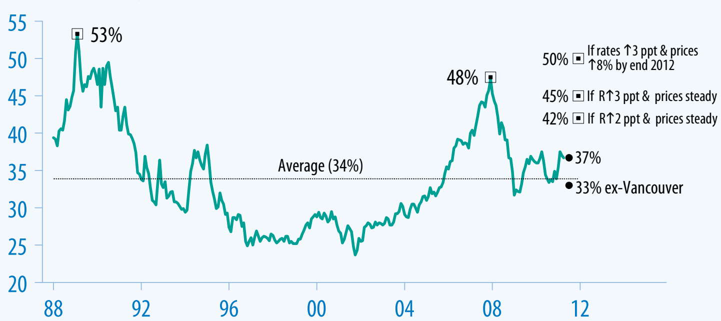
* estimate

CHART 1

HOUSING STILL AFFORDABLE (SO FAR)

Canada (% of household income)

Mortgage Payments



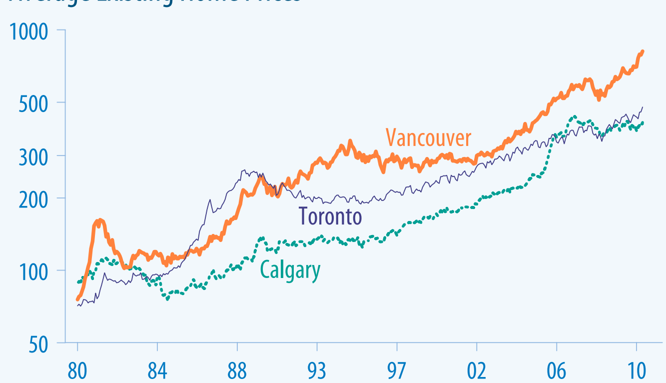
Payments based on 25% amortization, average of 1- and 5-year posted rate, down payment equal to just under one year's income, and average-priced house. Income measured as disposable income per labour force member.

CHART 2

LEADER OF THE PACK

(C$ 000s)

Average Existing Home Prices



prices fall? Four corrections in the past three decades saw declines averaging 21%, and valuations are higher today (*Table 3*). Still, if interest rates stay low and wealthy immigrants continue to pour into the city, prices could stabilize sooner than in past downturns.

Toronto: High Valuations, Again

Greater Toronto house prices have nearly doubled in the past decade, and now stand at a high 6.7-times family income, compared with 4.3-times in 2001. This is comparable to valuations in the late 1980s that were subsequently followed by a 25% slide in prices. But the key difference now is that mortgage rates are under 4% instead of near 14%, which underpins affordability. That said, while high valuations might be sustainable in an ultra-low rate climate, they could come under pressure in a more normal rate environment. Given our outlook for a moderate increase in rates in the next two years, prices could soften or at least stabilize for a while. A possible overhang of condos could aggravate the weakness. *Urbanation* warns that condo rents haven't kept up with ownership costs, suggesting some investors (who buy about half of new units) could sell in the face of higher rates or lower prices, thereby aggravating a correction. That said, continued sturdy immigration, with one-third of the nation's immigrants (or 92,000 people) settling in the GTA last year, should help to cushion the blow.

Calgary: More Reasonable Valuations

Energy-rich Alberta was the country's housing hot spot five years ago. Soaring oil prices and rapid in-migration led to a doubling in Calgary's house prices within four years (*Chart 3*). But lofty valuations, a pullback in oil and the recession spurred a 17% correction between mid-2007 and early 2009. Although the market has recovered more than half its losses, Calgary is still one of the few Canadian cities (Edmonton is another) that have yet to reclaim pre-recession peaks, reflecting payback from overbuilding and a glut of unsold condos. However, valuations have improved since 2007, with prices at 4.2-times income, less than the national norm. Barring a sharp pullback in energy prices, Calgary's house prices stand a reasonable chance of growing alongside incomes in coming years.

TABLE 3

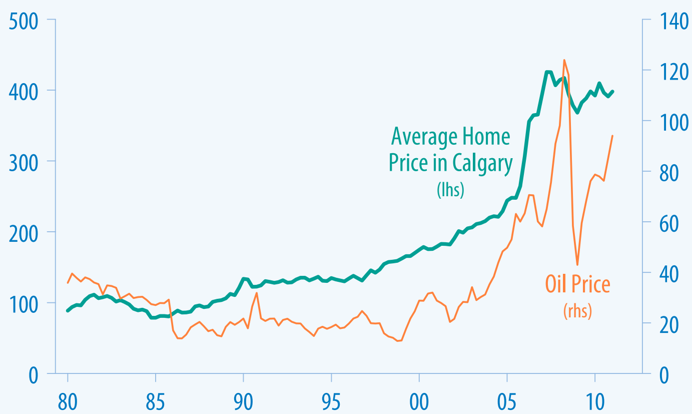
VANCOUVER HOUSE PRICE CORRECTIONS

(quarterly averages : nsa)

Peak-to-Trough Period	% Change
1981:Q2 – 1982:Q4	-36.1
1990:Q1 – 1991:Q1	-14.4
1995:Q1 – 1996:Q4	-20.2
2008:Q2 – 2009:Q1	-13.1
Average	-21.0

CHART 3

RIDING THE OIL WAVE



Average Home Price in Calgary = (C$ 000s)   Oil Price = (US$/barrel WTI)

The Bottom Line: Current valuations flag the possibility of lower prices in Vancouver, steadier to softer prices in Toronto, and firmer prices in Calgary in the near future. Moreover, high valuations in some regions, coupled with elevated household debts, suggest Canada's real estate market is vulnerable to a correction in the event of a rapid increase in interest rates (due to higher inflation), a sharp increase in unemployment (because of a U.S. double-dip), or a slowing in foreign investment (because of a hard landing in China). The housing market's sensitivity to rate increases could, in turn, temper the course of future Bank of Canada tightening.