Special Report

BMO Capital Markets®

Your ambition achieved.®

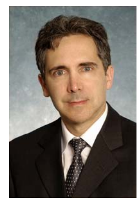
A timely analysis of Canadian economic developments

January 30, 2012

Will Canada's Housing Boom Forge On, Fizzle Out, or Flame Out?

ECONOMIC RESEARCH
1-800-613-0205 • www.bmocm.com/economics

Dr. Sherry Cooper, Chief Economist,
BMO Financial Group
sherry.cooper@bmo.com



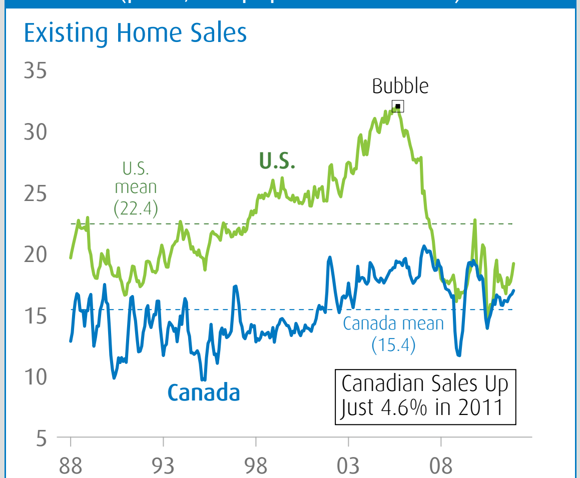
Sal Guatieri, Senior Economist
416-359-5295
sal.guatieri@bmo.com

It's rare to open a newspaper these days without reading about Canada's housing market; and even rarer to read a story that doesn't suggest an imminent collapse. But, like any issue that is as broad and complex as housing, an analysis of both the pros and cons can provide valuable perspective. In our view, **the housing boom will more likely cool than correct, even in condo-driven Toronto**—the target of many scary headlines. The possible exception is pricey Vancouver where the number of unoccupied newly built condos is high owing to the Olympic Village construction in 2010. But Montreal has more vacant condos than Vancouver and a much higher condo rental vacancy rate.

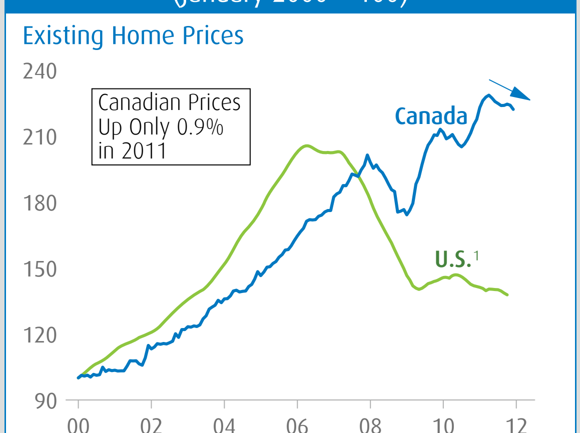
With the exception of a few regions, valuations remain only moderately high across the country, especially when low interest rates, demographics, construction costs, land-use regulations and foreign capital inflows are considered. Low interest rates should hold affordability in check for some time, allowing incomes to catch up with higher prices and restore proper valuations. While the housing boom is unlikely to continue unless mortgage rates drop much further, neither is it likely to bust. **The recent moderation in national sales growth and price appreciation is consistent with a soft-landing** (*Charts 1 and 2*). Of course, an unforeseen shock such as a sharp increase in interest rates or a severe recession could trigger a correction, but neither of these developments is likely.

Concerns about a "bubble" stem from a doubling in nationwide house prices and a rapid increase in household debts over the past decade. Average prices have grown more than twice as fast as family incomes since 2001. Consequently, comparing the current ratio of average resale prices and personal incomes with its long-term trend suggests a moderate degree of overvaluation, though less than before the early 1990s correction or the recent U.S. bust (*Chart 3*). But different metrics yield widely different estimates. Metrics that use new home prices, or compare prices with long-run growth trends, suggest a modest degree of overvaluation. Based on a single-equation model of home prices, the IMF deems the market about 10% overpriced. Similarly, a comparison of CPI owned-accommodation costs to rented-

1: HOUSE SALES MODERATE
(per 1,000 population : s.a.a.r.)



2: HOUSE PRICES SLOWING
(January 2000 = 100)



[1] S&P/Case-Shiller Home Price Index: Composite 20

accommodation costs suggests a 10% overvaluation, as ownership costs have been restrained by low mortgage rates *(Chart 4)*.

Conversely, comparing home prices with CPI rents, as the Economist Magazine does, derives an eye-popping 63% overvaluation *(Chart 5)*. However, the theoretical validity of comparing national house prices to rents is questionable, as it doesn't capture the shift toward ownership spurred by lower rates. Moreover, this metric shows little sign of a bubble in the late 1980s, despite a general consensus that one indeed existed, at least in Toronto, thus casting further doubt on its validity.

One city that appears undervalued is Windsor. Yet this city has suffered substantial job loss and out-migration, validating the low level of prices relative to income (2.5). Similar to Detroit, Windsor suffers from the massive consolidation of the automobile industry. This explains its net population loss and weak demand for housing, which has held house prices to a modest 20% gain in the past decade.

The main takeaway is that the national housing market appears somewhat pricey, but is far removed from bubble territory.

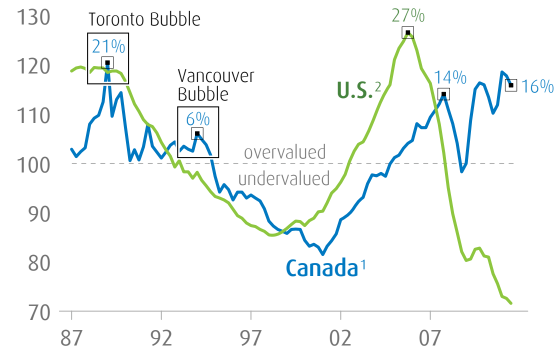
In most major cities, valuations have indeed risen in the past decade but do not appear excessive (*Table 1*). A comparison of average resale prices with median family incomes shows a ratio of 4.9 nationally versus 3.2 a decade ago. **However, elevated price-to-income ratios do exist in four major cities: Vancouver, Victoria, Toronto and Montreal.**

Following a 159% leap in prices in the past decade, **Vancouver's ratio (10.0) has nearly doubled**. This explains why the city is ranked the second priciest, after Hong Kong, of 325 urban centres in Demographia's annual survey comparison of prices and resident incomes. Both of these cities boast an enormous inflow of capital from non-resident Chinese nationals, a factor that has apparently boosted Toronto's home prices relative to income as well. Victoria's ratio is also high (5.7), but has eased due to recent price declines.

Toronto's ratio has climbed to a lofty 6.7 from 4.3 a decade ago, despite slower home-price appreciation (84%) than most other major cities. **Montreal's ratio has nearly doubled** in the past decade due to a 153% jump in prices, though, at 4.5, it remains well below that of the other three pricey cities. The home prices of these cities have been boosted by very positive demographics as large numbers of "echo boomers" reach household-formation age, baby boomers begin to downsize to condominiums, and net immigration continues to add about 200,000 people each year to Canada's population (*Chart 6*). As well, land-use regulations,

3: OVERVALUATION... ONE MEASURE
(long-term trend = 100 : quarterly)

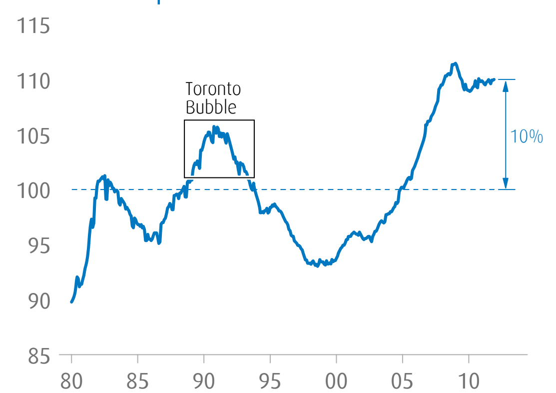
House Price-to-Personal Income Ratio



Does Not Account for Mortgage Rates, Demographics, Foreign Capital Inflow, Construction Costs, etc.
¹ (CREA existing house prices : s.a.) ² (S&P Case-Shiller national prices : s.a.)

4: OTHER MEASURES OF VALUATION
Canada (ratio)

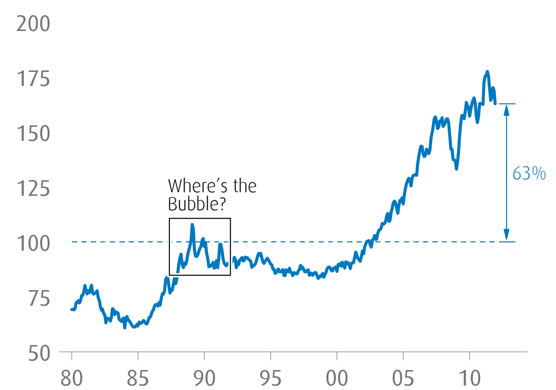
CPI Ownership-to-Rent Ratio



Long-term average = 100

5: NOT BELIEVABLE
Canada (ratio)

House Price-to-CPI Rent Ratio ¹



Long-term average = 100 ¹ (MLS national average price) geographical constraints and rent controls have limited the supply of detached homes and apartment buildings, thus increasing the proportion of multi-family unit construction relative to single-family homes.

For example, in Toronto, a dearth of single-use rental apartment construction has shifted the rental market into condominiums (*Chart 7*). It is estimated that about half of all new condos in the GTA are purchased by investors and 22% of all condos are rented, yet the rental vacancy rate for Toronto condos is a remarkably low 1.1%. Similarly, Vancouver's condo rental vacancy rate is only 0.9%—no evidence of a glut (*Chart 8*). Indeed, according to CMHC data, there are twice the number of newly built unoccupied condominiums (on an absolute basis) in the Montreal CMA than in the GTA where the population is nearly 50% larger. Although the cost of owning a new Toronto condo exceeds the rental income derived from the unit, expected steadier price growth ahead should allow rents to eventually catch up, reducing concerns that investors will dump their units. In Toronto, the condo market has effectively supplanted the rental market due to a lack of new apartment buildings and low rental vacancy rates.

There are an estimated 30,000-to-35,000 new households formed in the GTA and an unknown (though significant) number of non-resident investors each year. The region attracts just over one-third of the country's international immigrants, or roughly 90,000 per year. Chart 9 shows that housing starts and completions (both single- and multi-family units) might have moderately exceeded demographic demand since 2000, but not egregiously so. And, this followed a ten-year period of under-construction. Where the media seems to focus its attention is on the number of units under construction, suggesting that they far outnumber household formations, forgetting that many of these units are in multi-family buildings that will take 1-to-5 years to complete.

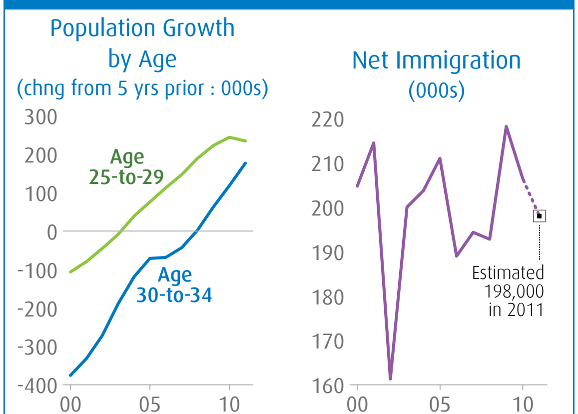
Also dampening over-building fears is the minimum 70% pre-sales requirement for condominium complexes before they qualify for construction financing. Without sufficient pre-sales, many of the planned and active condos will never be built. It is true that pre-sales can vanish if buyers walk away when prices fall, but hefty deposits would certainly curb this behaviour, and banks are now requiring sizable deposits. As well, many developers are prohibiting buyers from selling before closing, curbing some of the speculative fervour. Lenders are coming under increasing scrutiny from regulators in their loans to real estate developers as well as their mortgage lending to households. This, of course, does not mean there won't be a correction, but it does take some of the helium out of a U.S.-style bubble.

TABLE 1: RISING VALUATIONS

	Average Price-to-Family Income Ratio 2001	Average Price-to-Family Income Ratio 2011	10-year Price Appreciation (percent)
Vancouver	5.4	10.0	159
Toronto	4.3	6.7	84
Victoria	3.9	5.7	115
Canada	**3.2**	**4.9**	**104**
Montreal	2.4	4.5	153
Calgary	2.8	4.1	118
St. John's	2.5	3.8	143
Halifax	2.9	3.8	84
Saskatoon	2.1	3.6	182
Ottawa	2.4	3.4	92
Winnipeg	1.7	3.2	171
London	2.3	3.2	72

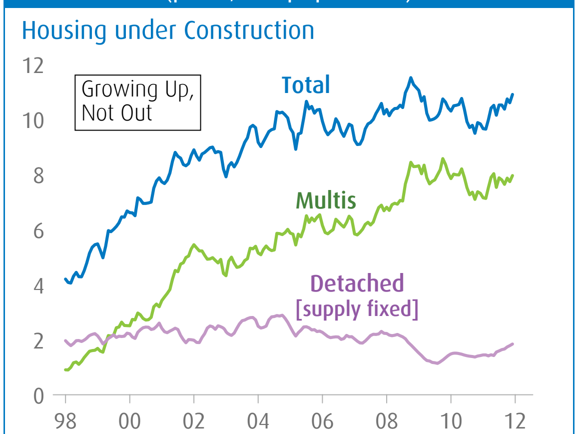
Average resale price = (Q4 average)
Median family income = (2011 est. using 2005-09 ann. avg. growth)

6: DEMOGRAPHICS SUPPORTIVE



Immigrants Add Almost 100,000 Yearly to Toronto Area Population

7: TORONTO MULTIS DOMINATE
(per 1,000 population)



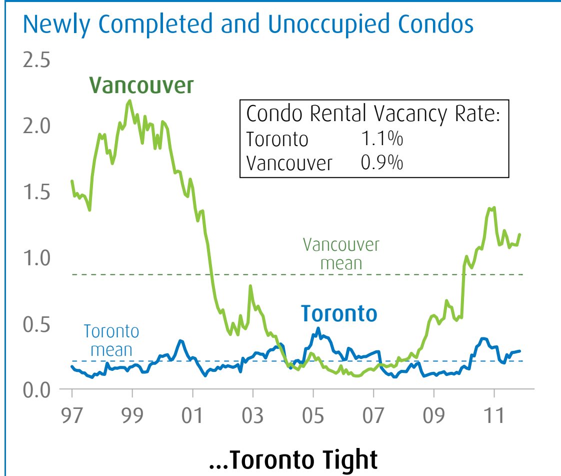
Multis Also Supply Rental Housing

House prices influence demand, but the level of mortgage rates also plays an important role in affordability. **At least on a national basis, the cost of housing is not out of reach for the typical buyer**, though many in Vancouver or Toronto may need to settle for a tiny downtown condo, a small bungalow in lower-priced neighbourhoods, or a place in the suburbs. Because of low mortgage rates, the typical homebuyer still spends **just over one-third of disposable income on mortgage payments, a share that's just modestly above long-term norms** (*Chart 10*). Of course, interest rates won't stay low forever, and even a moderate two-percentage-point increase to more normal levels would put some strain on affordability and slow the market. However, for current owners, moderate rate increases likely won't severely stress affordability given that about 68% of mortgages have fixed terms (many five years or longer), and most variable-rate holders will likely lock-in when rates begin to climb.

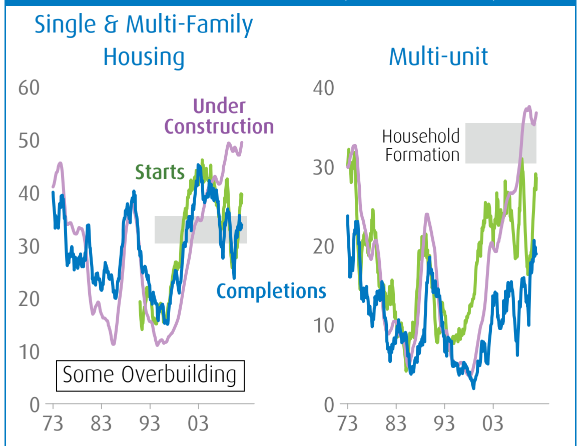
Elevated valuations, however, do imply a risk of a material correction in the event of a shock. First, if interest rates were to spike, say by four percentage points, affordability would deteriorate to levels that preceded the early 1990s correction. However, the chance of this happening in the next two years is low given an outlook for restrained economic growth and low inflation in the advanced economies. **Second, a severe recession** would no doubt reduce affordability and demand. However, unless Europe's credit crisis worsens materially, a recession is not in the cards given current low interest rates. **Third, if foreign investment stalls** due to a hard-landing in Asia or for any other reason, prices would weaken. Unfortunately, due to a lack of data, no one knows for certain how large a factor this has been in driving the boom, and therefore, we don't know what would happen if the inflows stopped, or worse, reversed. Anecdotal evidence, however, suggests this could be a meaningful influence in Vancouver and Toronto, notably for high-end properties and smaller rental units.

Barring one of these triggers, however, a dramatic correction is unlikely. In our view, the **national housing market is more like a balloon than a bubble**. While bubbles always burst, a balloon often deflates slowly in the absence of a "pin". In most regions, where valuations are just moderately high, the air should seep out slowly, as rising incomes catch up with higher prices, allowing valuations to normalize before interest rates do. That's why it's necessary for prices to stabilize in most regions in coming years and possibly decline further in B.C, a process that is already underway (*Chart 11*). Once proper valuations are restored, prices can resume tracking incomes in the long term.

8: NO CLEAR SUPPLY PROBLEM
(per 1,000 population)

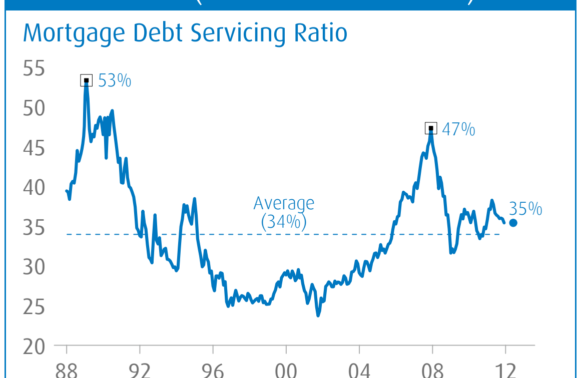


9: TORONTO NEW HOUSING SUPPLY
Phases of Construction (000s of units)



Under Construction = 1-5 years before on market

10: STILL AFFORDABLE
Canada (% of household income)



Based on 25-year 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.

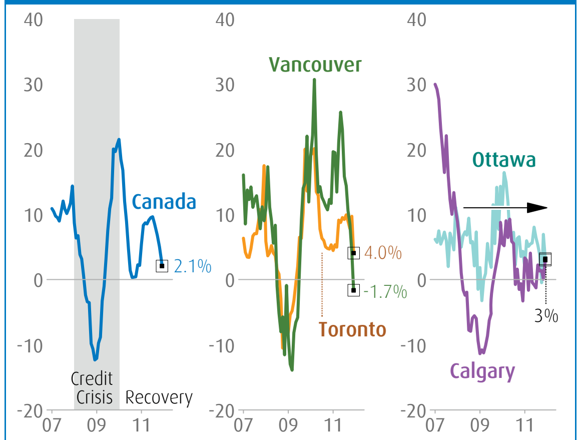
Elevated valuations are not the only factor that will cool demand. **High household debt-to-income levels—encouraged by the fall in interest rates and the easier credit standards earlier this cycle—will also act as a brake on home sales, as they have already for consumer credit and spending growth.** In 2006, CMHC introduced a mortgage with 40-year amortization and no money down. This poured gasoline on the fires of housing inflation. Subsequently, these terms have been meaningfully tightened on three occasions in the past four years—to 30-year amortization and 5% down, with higher qualifying rates and greater restrictions on borrowing for investors—and additional tightening is possible as Ottawa continues to worry about an overheated housing market and high household debt. Since the tightening in mortgage rules last March, housing activity has slowed.

Although growing debts are a concern, **we do not believe that most households are close to an American-style "debt wall", or that they will run into one when rates climb.** Mortgage rates rise more slowly than market rates and, as stated earlier, two-thirds of all mortgages have fixed terms (*Chart 12*). As interest rates rise, most homeowners with variable rates will lock in at still very low borrowing costs. Canadian household balance sheets are in far better condition than American finances, as owner equity is 67% of home value versus 39% stateside, and delinquency rates have remained very low even in periods of deep recession and financial turmoil *(Chart 13)*.

Nevertheless, the run-up in debt over the past decade raises concerns, and points to slower mortgage growth (currently near 8% y/y) and housing demand in the future. But Canadian household debt levels relative to income are not as troublesome as some suggest. Most analysts look at the ratio depicted in the first panel of Chart 14, which compares total liabilities of Canadian households and unincorporated businesses with marketable liabilities of U.S. households and unincorporated firms, both relative to disposable income. The U.S. numbers exclude non-marketable liabilities such as taxes owed and non-market loans to small businesses, which biases downward the U.S. debt levels and portrays Canada in an unfavourable light.

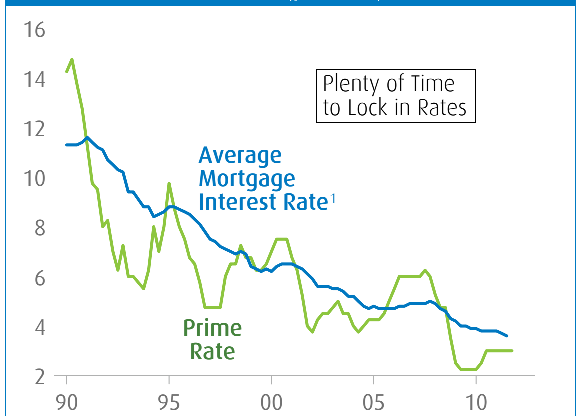
Instead, our preference is to compare equivalent measures of debt relative to before-tax income rather than after-tax income (this accounts for the fact that taxes to cover health care costs depress Canadian relative disposable income). Contrary to some reports, Canadians have nowhere near the debt burden of Americans at the peak of the housing bubble. Even today, after four years of U.S. deleveraging, household debt ratios are lower in Canada.

11: MARKETS COOLING
Average House Price – Canada (y/y % chng)



Toronto Prices Rising More Slowly

12: AVG MORTGAGE RATES ADJUST SLOWLY
Canada (percent)

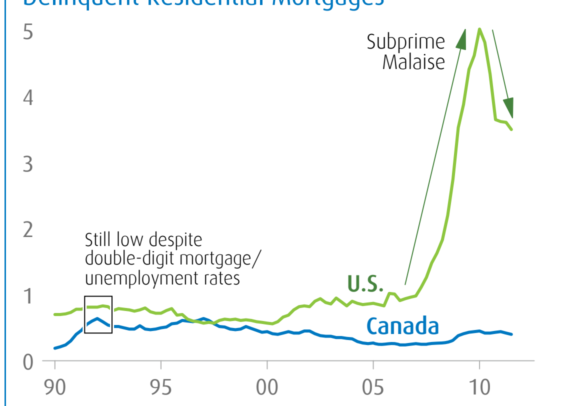


68% of Mortgages Fixed-term

[1] Mortgage interest paid as a percentage of outstanding mortgages

13: CANADIAN DELINQUENCY RATES LOW
(% of total mortgages)

Delinquent Residential Mortgages



Delinquent Residential Mortgages = > 90 days in arrears

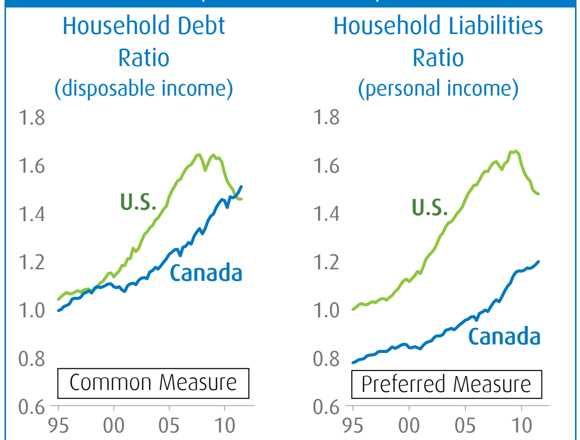
In addition to high prices and debt constraints, an additional factor that will restrain Canadian housing activity is the record-high level of home ownership, suggesting no significant pent-up demand. The homeownership rate has climbed about four percentage points in the past decade to around 70%, which is above the current U.S. rate of 66.3% and even above the peak U.S. rate of 69.2% *(Chart 15)*.

Except for a few remaining hot spots, the national housing boom has already cooled. Sales and price growth has moderated this year, and there are few signs of market imbalances or overbuilding. While existing home sales remain robust at just above levels warranted by demographic demand, they have moderated recently *(See Chart 1 on page 1)*. Demand has been restrained by tighter mortgage rules and recent softer job growth. **Sales have declined in previously red-hot Vancouver and remain soft across British Columbia. By contrast, sales remain strong in Alberta and Saskatchewan** due to healthy rates of in-migration from other countries and provinces, and due to solid investment-led economic growth. Alberta is enjoying the fastest private-sector job creation in three decades. Robust energy production is also supporting **Newfoundland's** market. In addition, demand remains robust in a few major centres outside of these three provinces, notably Toronto, Montreal, Winnipeg, Halifax and Ottawa.

Resale markets are generally balanced across the nation, with a 5.8 months' supply in line with long-term norms, far removed from the "tight" markets of the mid-2000s. However, resale inventories are relatively high in New Brunswick and British Columbia—two provinces where prices are easing, as well as in Québec where price growth has slowed. **There are few signs of overbuilding across the country.** Nationally, housing starts are hovering just moderately above household formation rates. Despite rising demand, Alberta's homebuilding remains relatively low, pay-back from the mid-2000s boom. However, construction in Saskatchewan and Newfoundland is relatively high, spurred by strong demand and rising prices.

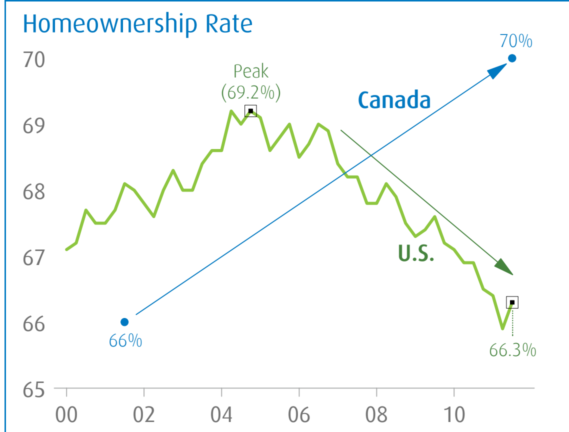
National average prices have steadied since the mortgage rules were tightened again in March. From a year ago, prices are up moderately and remain near record-highs in most provinces, though the rate of increase has slowed from 9% last summer. **Prices are still rising strongly in a few major cities:** St. John's, Winnipeg, Québec City, Saskatoon and Regina. Toronto prices are also up sharply due to lean supplies of detached properties, though the rate of increase has slowed. Outside of Toronto, prices are generally climbing moderately across Ontario, with the exception of Thunder Bay's 20% surge. In Alberta, prices are

14: DEBT RATIOS RISING
(ratio to income)



Household debt includes unincorporated businesses

15: LITTLE PENT-UP DEMAND IN CANADA
(percent : n.s.a.)



Despite No Preferential Tax Treatment

rising only modestly, despite strong job growth and robust rates of in-migration, as markets remain balanced. Barring a collapse in oil prices, Alberta could see steady price gains in coming years.

Once booming **British Columbia is the nation's new weak spot, with prices generally declining**. Vancouver's prices are down from spring highs, and the yearly rate of increase has slowed sharply from previous double-digit rates. Some of the weakness in average prices simply reflects fewer high-end sales and a shift toward lower-priced condos. In fact, a quality-adjusted price index that tracks the "typical" home shows Vancouver prices still higher than a year ago, though declining modestly since the spring. Some real underlying softness is at play, and will likely continue until valuations improve.

Bottom Line: Expect the housing boom to cool rather than crash. Look for home sales, starts and prices to be roughly flat in 2012 across most of the country, with strength in Alberta contrasting with continued weakness in British Columbia.