

Year-End Reflections on Housing

Prepared by Altus Group for CHBA

A (Bumpy) Road to Recovery:

- The recession hit housing demand hard, but recent data suggest a strong resurgence in demand;
- Better conditions in the housing market contrast a very weak economy with emerging risks;
- Recent housing activity is being fuelled by “special demand factors” that may be short lived;
- Canada’s home building sector has certainly avoided the troubles in the U.S., but activity in recent months is likely overstating the strength of the housing recovery;
- Builders should be cautious relying on assumptions of strong sustained growth through the next few years.

A Good Time for Reflection

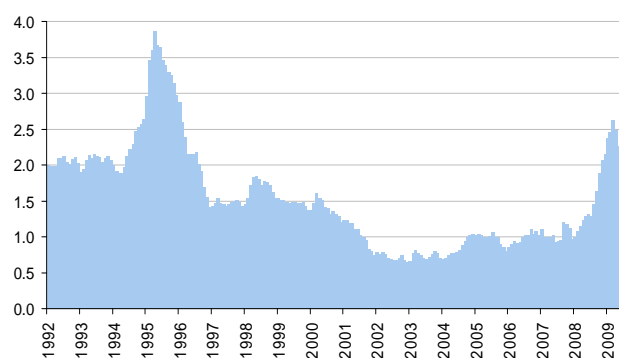
As 2009 comes to a close it is timely to reflect back on housing conditions in Canada. It is also an important time to reflect on potential conditions in the housing market ahead that are likely to have an impact on the home building sector.

In early 2009, the housing sector was hit hard by the international financial crisis and subsequent recession. By the spring, the pace of housing starts had fallen 45% from the year before, following a similar decline in housing resales. Housing prices also showed the strain of the recession, with new housing prices falling 3% and resale prices 4% in the year to April.

Despite these devastating beginnings, housing activity appears to be improving. Since the beginning of 2009:

- The number of existing home sales rose 176%;
- The average resale price skyrocketed some 21%;
- New home sales in Toronto have rebounded to levels not seen since July 2007;
- New home prices are rising in most CMAs; and
- The standing inventory of unsold new homes in Canada peaked at 2.6 months in June (normally it’s about 1 month), but has since steadily fallen to 2.0 months of inventory in October (see Chart).

Months Inventory of New Homes*, Canada



*Completed but unabsorbed homes compared with monthly starts (SA), All Centres of 50,000 population and over
Source: Altus Group Economic Consulting based on data from CMHC

There may be a tendency to read the increased housing activity as evidence that the Canadian economy is solidly in recovery. But, on a variety of other measures the recovery has barely begun and may prove to be slow:

- The 3rd quarter eked out 0.4% real annualized growth in the economy – technically an end to the recession. Despite this, nominal GDP was still some 6.6% lower than a year before.
- Despite a surprisingly strong employment report for November, Canada’s labour market remains very weak. Nearly 500,000 jobs were lost in the early months of the recession and job growth has

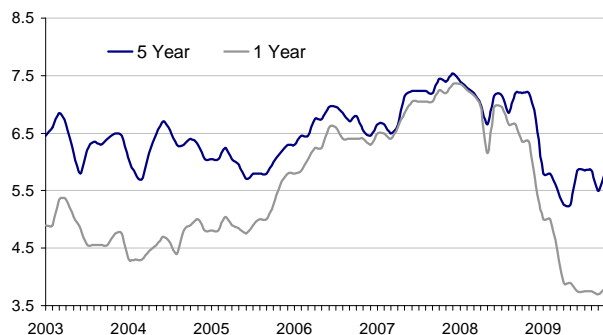
been essentially flat since. There continues to be slack in the economy, so sustained job growth is likely many months away.

- Personal income growth has stalled. After averaging about 3.0% per year over the past five years, real personal disposable income per person advanced only 0.5% in the past year.
- The debt-to-disposable income ratio has risen to 145% - a record high – an emerging risk factor.

These indicators of still-weak economic activity, coupled with emerging risk factors, keep us cautious about the longevity of the current housing market spurt of activity.

Strong housing demand in the face of weak economic conditions point to special demand factors, in particular the strong affordability associated with exceptionally low mortgage interest rates (see Chart). Pent-up demand from the recession, and potentially from a period of relatively bubbly housing prices (in some regions) prior to the recession, is also a special factor.

Typical Mortgage Rates, Percent*



* Prevailing posted rates, Chartered Banks
Source: Altus Group Economic Consulting based on Bank of Canada data

When considering the longevity of current demand, considerations should be given to the future path of interest rates, and to the remaining magnitude of pent-up demand.

- While the Bank of Canada is committed to keeping short-term rates unchanged at least until the middle of 2010, growing debt and borrowing requirements by the public sector in Canada and the U.S. will likely put growing upward pressure on bond yields in the near future. Government bond yields are benchmarks for

fixed mortgage rates, so risks of higher yields are risks of higher mortgage rates in Canada.

- The power of pent-up demand will also likely diminish in the coming months. CMHC has reported a rise in rental vacancy rates and weaker rent growth at the end of 2009. This will create more competitive pressure to home buying. In addition, the Altus Group/Ipsos-Reid FIRM Residential Mortgage Survey showed a rise in first-time buyer intentions earlier in 2009 (in advance of the recent boom) and also showed a decline in intentions in the most recent quarter (a cautionary note for sales through the winter).

Implications for new housing demand in 2010

All told, the recent increase in activity in the housing sector is encouraging. It is certainly suggestive that the housing correction that began in late 2008 in Canada has been much milder than the corresponding troubles in the U.S. that began in 2006. Recent demand for new homes has also helped to clear up new home inventories, which were on the rise through the recession. The surge in housing demand, however, likely will be shorter lived than many may anticipate. Rising interest rates and a cessation of recent pent-up demand will bring more normalcy to the resale market and also limit potential growth in new home demand.

The primary uncertainty at this point is the timing for higher rates. The consensus forecast is for long fixed mortgage rates to rise about one percentage point between now and the end of 2010 – which would not be tremendously damaging to housing demand. The risk is that they could rise much higher. If that occurs, then sharper rises may come as early as the middle of 2010 or could be many quarters away.

Home builders should treat current conditions with cautious optimism. It is important to take advantage of resurgent demand in your marketplace by bringing new housing product to market. Risks of sharply lower housing demand are generally toward the end of 2010 – so be cautious of investments now that may rely on housing demand at that time.