CURRENT ANALYSIS

July 21, 2011

Canadian home resale market forecast update: still heading toward moderation

Forecast in brief

Canada, % change

	2010f	2011f	2012f
Housing resales	-3.9	0.9	0.0
Home prices*	8.4	4.4	0.4

*for a detached bungalow

Forecast assumptions

%, annual average

	2010	2011f	2012f
BoC overnight rate	0.7	1.3	2.6
5-year bond yield	2.4	2.5	3.5
Population growth (y/y)	1.2	1.1	1.1
Unemployment rate			
Canada	8.0	7.6	7.2
British Columbia	7.6	7.9	7.2
Alberta	6.5	5.9	5.5
Saskatchewan	5.2	5.0	4.6
Manitoba	5.4	5.1	5.0
Ontario	8.7	8.0	7.5
Quebec	8.0	7.6	7.6
Atlantic	10.5	10.1	9.6

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Overview

The Canadian housing market is in transition to a more moderate and sustainable pace of activity following a period of exceptional growth during the better part of the last decade. This transition has been punctuated by global events (recession and financial crisis) and policy changes (sharp drop in interest rates, three rounds of mortgage lending rule modifications, and the introduction of the HST in Ontario and British Columbia) that produced tremendous volatility since 2008. Our view is that less turbulent economic and policy environments will support a smoother process going forward. The main policy shift will be one toward progressively higher interest rates, which will cool demand but not deep-freeze it. We expect resales in Canada to grow by 0.9% in 2011 and remain unchanged in 2012; and home prices to increase by 4.4% and 0.4%, respectively. Such results would mark a significant slowing relative to the performance during the 2002-2008 period.

At the provincial level, we forecast the Alberta market to post the strongest growth in existing home sales this year and next, yet the effect on prices will be felt only next year, as property values in the province are expected to appreciate marginally this year. At the other end of the spectrum, we forecast home resales to decline modestly in Quebec in both 2011 and 2012, while prices will continue to rise at one of the faster rates this year among provinces before levelling off in 2012. The perplexing developments in the B.C. market in the past several months—whereby home prices have surged in segments of the Vancouver area market despite slower resales—are expected to be partly reversed in the coming year, making British Columbia the only province experiencing a price decline (on an annual basis) in our forecast for 2012.

Analysis

Resale activity has slowed in recent months

Sales of existing homes in Canada rebounded from last summer's lows, reaching 465,000 units in the first quarter of 2011 (on a seasonally-adjusted and annualized basis) although they have since softened to 443,000 in the second quarter.

This slowing is in line with our view that the latest changes in mortgage lending rules announced in January of this year and implemented in March and April brought forward some demand that would have otherwise occurred later on. In turn, the second-quarter slowing represented somewhat of a 'payback', which will then be followed by a return to mildly stronger activity. A rise to 451,000 units in June is consistent with this scenario although we expect that the level of activity will ultimately settle in the range of 448,000 units in the second half of the year.

Home price increases are subdued if Vancouver is excluded

Home prices in Canada have continued to be firm so far this year, with most regions of the country showing steady if subdued appreciation. Puzzlingly strong gains in the Vancouver market, however, have distorted the national average, thereby exaggerating the headline increase. The Canadian Real Estate Association's (CREA) figures show an 18% surge in average home resale prices in Vancouver in the first six months of 2011 relative to the same period a year ago, which contributed nearly half of the 7.5% rise recorded for Canada as a whole. Excluding Vancouver, the national average rose at a more modest rate of 4.2%.

Our preferred home price measures are the ones tallied by Royal LePage for key housing types, and they suggest that pricing action generally remained under control in the first quarter of this year, with gains at the national level ranging between 3.8% and 4.3%, year-over-year, depending on the housing category. This is also consistent with the 4.0% increase in the Teranet index (which is based on repeated sales in six-major Canadian markets) for the period to April. With headline CPI inflation running at 2.6% in the first quarter of 2011 (and 3.0% in the first five months of 2011), real home price increases are in the 1.2–1.6% range and, therefore, well below 10-year averages of 5.4–6.0%. In other words, the statistics do not point to an excessively rapid rise in home prices overall in Canada at this stage. Any concerns of market 'froth' mostly emanate from developments in the Vancouver area (and, to a much lesser extent, the Toronto area where upward pressure surfaced in recent months).

There will be perfectly offsetting forces are at play…

Beyond the near-term policy-induced movements in home resales, demand for housing in Canada will be shaped by nearly perfectly offsetting forces. On the upside, sustained growth in the economy (our call for Canada's real GDP growth is 3.2% in 2011 and 3.1% in 2012) will boost demand via stronger employment and family incomes; and continued net-migration (assumed to be in the vicinity of the recent 250,000 level) will keep demographic fundamentals supportive. On the downside, expected increases in interest rates (we forecast the Bank of Canada to lift the overnight rate by 75 basis points by the end of 2011 and another 125 points next year) will dampen demand by raising the proportion of household budgets spent on servicing their elevated debt and by eroding housing affordability, which has recently shown signs of strain. We believe that the net effect of these forces will be close to nil, thereby leaving resales activity largely flat overall.

…which will leave overall sales of existing home largely flat nationally

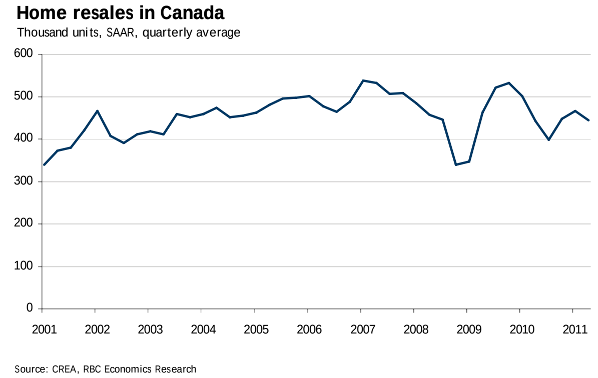
We project sales of existing homes in Canada to inch higher overall this year to 451,200 units from 447,000 units in 2010 (an increase of just 0.9%) and remain essentially unchanged next year at 451,300 units. Such levels would be 4.0% lower than the average during the past seven years and more than 13% lower than the all-time high registered in 2007. Flat resales trends would contrast starkly with average annual increases of 6.6% in the seven years that preceded the 2008 market downturn and recession.

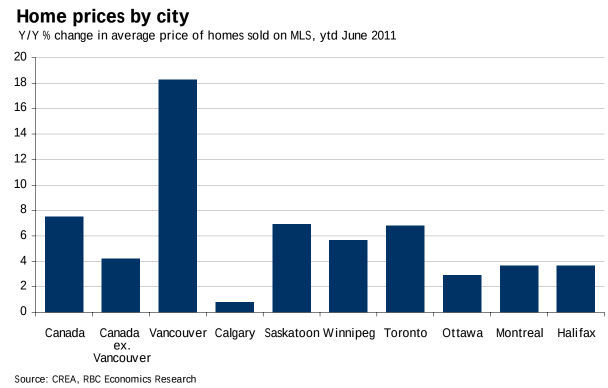
Alberta to lead the way

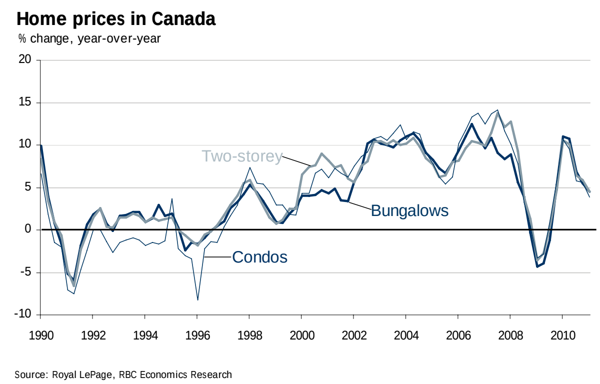
Regionally, we expect the **Alberta** market to lead the way with growth rates of 7.0% and 6.2% in 2011 and 2012, respectively. This would, however, represent only a partial recovery from the substantial 13.6% drop in 2010. Our forecasted resales levels of 53,200 units and 56,500 units this year and next will pale in comparison to the 72,000 average during 2006-2007 at the climax of Alberta's housing boom. The combination of attractive housing affordability and broadening economic recovery in the province will support stronger housing demand going forward.

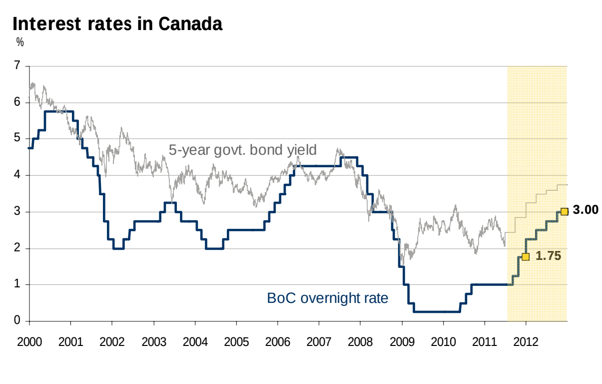
The other **Prairie Provinces**' markets are expected to post solid gains in activity of approximately 4.5% this year and further build on them (albeit at slower rates) next year. We forecast resales of 11,400 units in 2011 and 11,700 units in 2012 in Saskatchewan, and 13,800 units and 13,900 units, respectively, in Manitoba. Levels will thus move closer to all-time highs next year for both provinces. Both provincial markets will benefit from strong growth in their economies and continued positive demographic fundamentals.

After displaying a fair degree of resilience in the past two years, we project home resales to decline slightly in **Quebec** to 77,600 units this

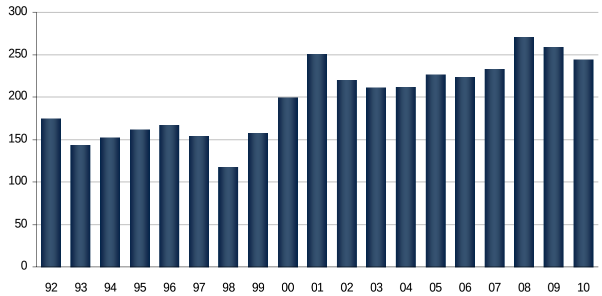






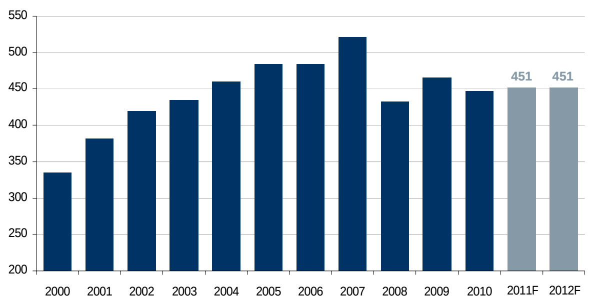


Net international migration into Canada
Thousands



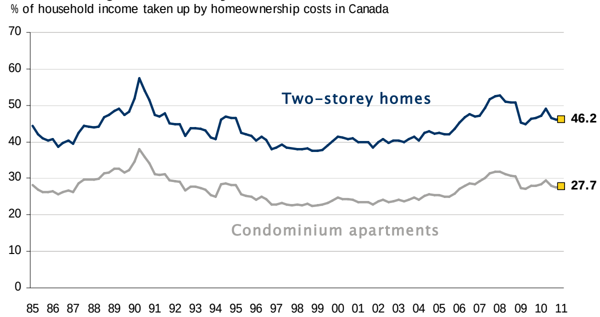
Source : Statistics Canada, RBC Economics Research

Existing home sales in Canada
Thousand units



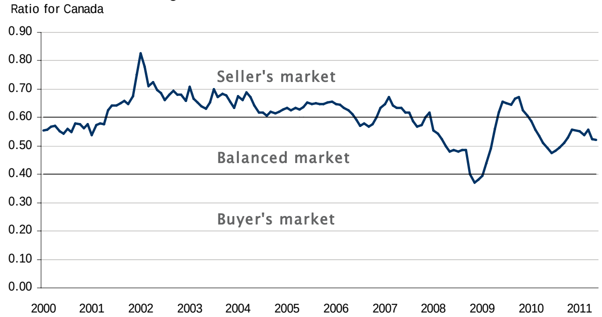
Source: CREA, RBC Economics Research

RBC Housing Affordability Measures
% of household income taken up by homeownership costs in Canada



Source: Statistics Canada, Royal LePage, RBC Economics Research

Sales-to-new listings ratio
Ratio for Canada



Source: CREA, RBC Economics Research

year (-3.5%) and 77,000 units next year (-0.8%). Quebec was one of only two provincial markets (the other being Manitoba) where resales actually rose last year (on an annual basis). In fact, at 80,400 units, Quebec's existing home sales in 2010 were the closest (off just 0.8%) to their all-time high (80,600 units reached in 2007) among the provinces. Higher interest rates and deteriorating housing affordability will dampen housing demand in the province in the period ahead.

We expect activity in **Ontario** and the **Atlantic Provinces** to be mainly flat in 2011 relative to 2010 with some weakness emerging next year. Ontario resales have been quite robust so far in this year although they moderated just a tad in the spring. We believe that rising interest rates will weigh on the province's first-time homebuyers (who are more vulnerable to Ontario's elevated home prices than buyers in most other provinces) starting later this year. We project that 195,300 existing housing units will be sold in Ontario in 2011, little changed from 195,600 units in 2010, but that the tally will edge lower to 193,700 units in 2012, the second-lowest level since 2003. In the Atlantic Provinces, we expect resales to rise marginally to 22,700 units in 2011 from 22,500 units in 2010 before softening a little to 22,400 units in 2012.

A rebound in activity in the second half of 2010 set the **British Columbia** market up for a good start to 2011 in terms of resales; however, quickly deteriorating affordability in key markets such as Vancouver contributed to a slowing since then. We believe that the first quarter of 2011 will prove to be the high point this year and that the provincial market will operate on a lower plane for the remaining months. Nonetheless, the initial strength will be enough to lift annual resales by 3.1% to 76,900 units in 2011. The softening of activity will show up next year with the number of units forecasted to drop 1.3% to 75,900.

Affordability measures suggest some mild market tension presently

Much concern has been expressed about Canada's lofty home price levels. It is easy to understand why given that property values have roughly doubled in the past decade and rebounded quickly to new record-high levels following the 2008 market downturn (in stark contrast to developments in U.S. and other international markets where home prices have yet to bounce back). While there is no question that housing is indeed expensive in Canada—e.g., metrics such as the price-to-household income ratio and price-to-rent ratio indicate some degree of over-valuation—we do not believe that prices, generally, are in a zone that foretells an imminent downward correction of major significance. In our opinion, the best measure of stress on the market is housing affordability, and this generally suggests that current property values currently exert just a little more tension than has been the case, on average, historically (the Vancouver area is a major exception). Nonetheless, we expect such tension to intensify gradually as interest rates rise, which will limit any upside movement in prices in the period ahead.

The majority of Canadian markets are balanced at this point…

The recent generally contained pace of property appreciation has reflected a fairly balanced relationship between supply and demand in the majority of markets in the country. The sales-to-new listings ratio—and indicator that usually correlates quite closely with price movements—has oscillated between 0.52–0.56 since the start of 2011 (that is within the 0.40–0.60 range in which neither sellers nor buyers have the upper hand). The sales-to-new listings ratio most recently stood in the 'balanced zone' in 16 of 20 major census metropolitan areas—the remaining four (including the Toronto area) corresponded to a seller's market. Another measure at the national level is the number of months' supply (i.e., the number of months it would take to clear the total number of homes listed for sale on the Multiple Listing Service—MLS—systems at the current rate of sales) that rose to 6.0 months in June relative to the average of 5.0 months since 2004. Even at 6.0 months, however, this modest inventory overhang is much lower than U.S. levels in the past five years and previous peaks in Canada.

…and likely to remain so

Going forward, we expect that balanced market conditions will generally persist. Rising interest rates and deteriorating affordability will dampen demand growth, but we believe that supply will adjust in lockstep. Our base case macroeconomic scenario portends little that would lead to a significant rise, let alone a flood, of housing unit supply on the market—whether existing or new. On the existing homes side, continued growth in the economy and sustained job creation will contain the number of distressed sales from owners experiencing adverse circumstances. Despite elevated household debt levels, mortgage delinquencies are expected to remain low in Canada. On the new homes side, positive macroeconomic and demographic conditions will continue to support decent levels of household formation (which we forecast to average around 183,000 annually in the next few years). We project new home construction generally to track this with housing starts totalling 185,000 units this year and 181,000 units next year, thereby keeping the expansion of the housing stock in line with the demographic fundamentals.

Condo construction is strong but not excessive

High levels of multi-unit structures built recently or still under construction have raised concerns about excess supply of condominiums (particularly in areas such as Toronto). While it is true that the number of completed units in such structures still awaiting occupancy has risen significantly in absolute terms in the past three years (to the highest levels since the early 1990s), the increase has been less dramatic in proportion to the stock of multi-unit dwellings. On that score, the percentage of unoccupied units most recently remained below the long-term average since the early 1970s.

Condo unit investors help address tight rental markets

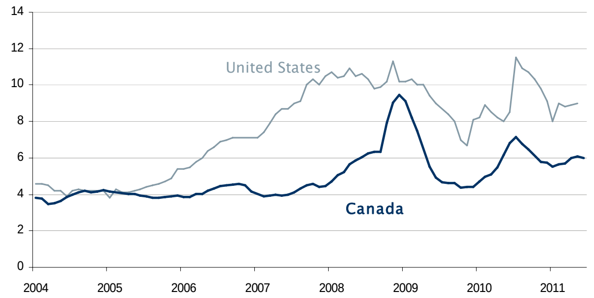
Concerns have also been raised about the growing number of investors fuelling the growth in condo sales in recent years. We believe that this phenomenon must be looked at in the context of relatively tight rental market conditions in large Canadian cities, from which investors aim to benefit. Condominium units fill a need in the rental market because few purpose-built apartment buildings have been initiated in the past two decades in markets such as Toronto (where about 20% of the condo stock is rented). To date, the flow of condominium units being directed to the rental pool has been absorbed by the market with rental vacancy rates remaining reasonably low. Nonetheless, the economics of investing in condo units will likely be tested going forward. The kind of rental rate increases in the market (usually directly or indirectly regulated by rent control) is unlikely to keep up with the rise in the breakeven rent levels that condo apartment 'landlords' will face once interest rates mount (which will boost condo investors' mortgage carrying costs). Moreover, changes to mortgage lending rules last year raised the minimum down payment (from 5% to 20%) required on government-insured mortgages on non-owner-occupied properties. We believe that the attractiveness of investing in condominiums will gradually diminish.

Home price increases will be minimal at best…

With markets generally maintaining a balance between supply and de-

Inventory of existing homes for sale

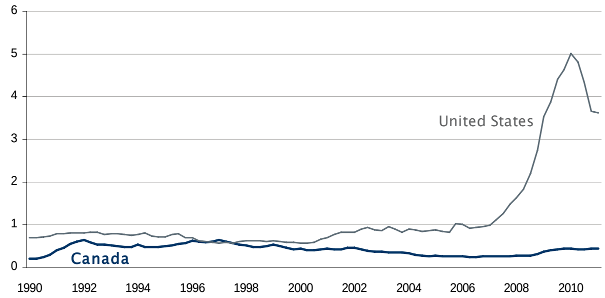
Number of months' supply, SA



Source: NAR, CREA, RBC Economics Research

Mortgage delinquencies

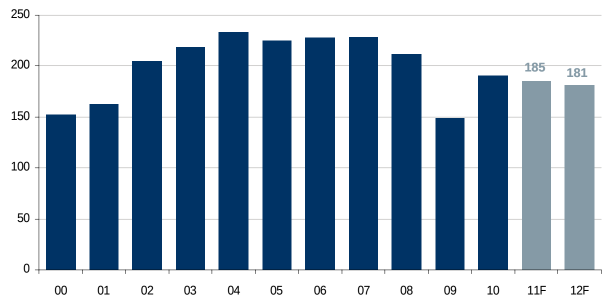
Mortgages 90+ days in arrears as a % of total mortgages



Source: Canadian Bankers' Association, Mortgage Bankers' Association, RBC Economics Research

Housing starts in Canada

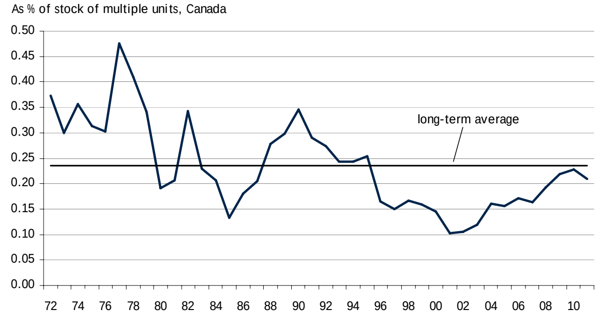
Thousand units



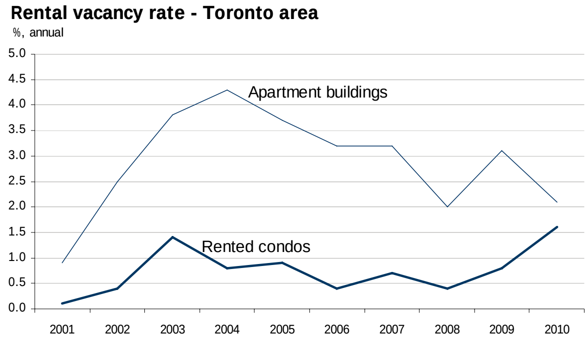
Source: CMHC, RBC Economics Research

Newly completed and unoccupied units - multiples

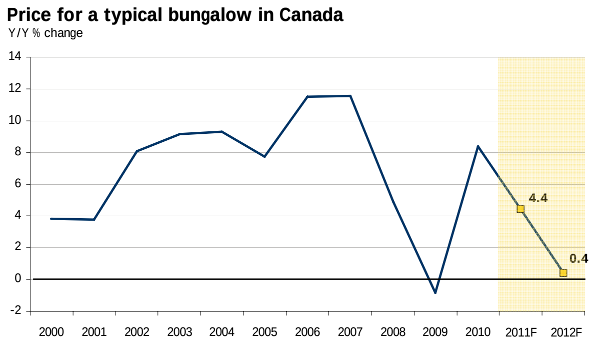
As % of stock of multiple units, Canada



Source: CMHC, Statistics Canada, RBC Economics Research



Source: CMHC, RBC Economics Research



Source: Royal LePage, RBC Economics Research

mand, we expect home price increases to be minimal at best in Canada this year and next. We forecast a gain of just 4.4% for the benchmark detached bungalow in 2011—the weakest increase in 10 years if we ignore the drop that occurred during the housing downturn in 2009 under extreme and unusual circumstances—and an even more meagre 0.4% advance in 2012—the smallest expansion-time appreciation in 15 years. These compare to an average of almost 9% from 2002 to 2008, just before the housing downturn. In effect, we expect a pricing environment that will be similar to what marked the latter part of the 1990s in Canada.

…with the B.C. property values expected to fall next year

Similarly moderating price trends are seen to prevail across the majority of provinces. Strong momentum in the early part of this year will translate into still vigorous price advances of 5.7% in British Columbia and 5.0% in Quebec in 2011, but we expect the quarter-to-quarter profile to weaken considerably in these and other markets going forward. Home prices in Alberta and Saskatchewan will be exceptions by increasing more strongly in 2012 (3.7% and 3.2%, respectively) than in 2011 (0.5% and 2.1%, respectively) due to the solid demand growth projected for these provinces. For all other provincial markets, price gains next year are forecasted to be at their weakest during a time of economic expansion since the mid to late 1990s. In the case of British Columbia, we expect that extremely poor affordability will cause a partial reversal of the recent substantial gains and forecast an absolute decline of 1.6% (on an annual basis) in 2012. Still, this would bring only minimal relief to local homebuyers as price levels in the area would remain by far the highest in Canada (68% above the national average).

Several downside risks to worry about…

Given the significant run it has had in the past decade or so, the Canadian housing market could easily be thought of as ‘priced to perfection’—not much needs to go wrong to cause a downward correction. And, with so much uncertainty lingering about globally and in Canada, there are plenty of downside risks to our housing market forecasts. We believe that the biggest risks are of a macroeconomic nature: either a spike in interest rates or unemployment would create significant disruptions. Even if the macroeconomic context evolves as anticipated, however, factors such as deteriorating affordability, high household indebtedness, or a substantial drop in investor interest could be the source of a retrenchment on the part of homebuyers, thereby causing property values to depreciate noticeably.

…but there are upside risks too

With so many dire predictions making the rounds, the focus has tended to highlight the vulnerability to a downward correction. Let us not forget that there are also upside risks, however. Canada’s housing market surprised us many times with its resiliency in the past few years, and there might be more left in the tank than we think. From a macroeconomic perspective, interest rates might not increase as much or as fast as we anticipate, and job creation and household income growth might be stronger than we forecast. Net immigration and household formation could also be stronger than we anticipate, or homeownership rates could rise further (we assume them to be flat at best in our base case scenario). Such developments would maintain a strong bid on residential properties in Canada.

Home resales forecast — units

	2007	2008	2009	2010	2011f	2012f
Canada*	521,100	431,800	465,100	447,000	451,200	451,300
	7.9	*-17.1*	*7.7*	*-3.9*	*0.9*	*0.0*
British Columbia	102,800	68,900	85,000	74,600	76,900	75,900
	6.3	*-33.0*	*23.4*	*-12.2*	*3.1*	*-1.3*
Alberta	71,000	56,000	57,500	49,700	53,200	56,500
	-4.1	*-21.1*	*2.7*	*-13.6*	*7.0*	*6.2*
Saskatchewan	12,500	10,500	11,100	10,900	11,400	11,700
	31.6	*-16.0*	*5.7*	*-1.8*	*4.6*	*2.6*
Manitoba	13,900	13,500	13,100	13,200	13,800	13,900
	6.9	*-2.9*	*-3.0*	*0.8*	*4.5*	*0.7*
Ontario	213,400	181,000	195,800	195,600	195,300	193,700
	9.5	*-15.2*	*8.2*	*-0.1*	*-0.2*	*-0.8*
Quebec	80,600	76,800	79,100	80,400	77,600	77,000
	12.6	*-4.7*	*3.0*	*1.6*	*-3.5*	*-0.8*
Atlantic Canada	26,300	24,500	22,800	22,500	22,700	22,400
	14.8	*-6.8*	*-6.9*	*-1.3*	*0.9*	*-1.3*

* Includes sales in the Territories.

Annual percent changes are in italics.

Source: Canadian Real Estate Association, RBC Economics Research

Home price forecast — annual average value of a detached bungalow

	2007	2008	2009	2010	2011f	2012f
Canada*	290,300	304,500	302,000	327,300	341,600	342,900
	11.6	*4.9*	*-0.8*	*8.4*	*4.4*	*0.4*
British Columbia	474,700	507,500	494,400	554,200	586,000	576,700
	11.8	*6.9*	*-2.6*	*12.1*	*5.7*	*-1.6*
Alberta	376,400	354,200	330,500	338,900	340,500	353,000
	30.5	*-5.9*	*-6.7*	*2.5*	*0.5*	*3.7*
Saskatchewan	240,100	299,100	293,600	311,900	318,600	328,800
	46.0	*24.6*	*-1.8*	*6.2*	*2.1*	*3.2*
Manitoba	201,600	217,200	227,000	250,500	262,400	268,000
	7.6	*7.7*	*4.5*	*10.4*	*4.8*	*2.1*
Ontario	303,300	319,500	316,300	340,500	355,600	357,000
	6.8	*5.3*	*-1.0*	*7.7*	*4.4*	*0.4*
Quebec	183,800	193,700	201,800	221,200	232,200	232,800
	6.4	*5.4*	*4.2*	*9.6*	*5.0*	*0.3*
Atlantic Canada	167,300	180,000	188,300	196,900	205,900	207,000
	9.8	*7.6*	*4.6*	*4.6*	*4.6*	*0.5*

* Weighted average, using provincial population as weights.

Annual percent changes are in italics.

Source: Royal LePage, RBC Economics Research