



The Bottom Line

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The Bubble Debate in Canadian Housing

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With the release of the transcripts from the 2006 meetings of the U.S. Federal Reserve policymaking committee meetings, the media is having a field day highlighting the laxity and imprudence with which the FOMC dealt with the biggest housing bubble in U.S. history. The Fed was totally blind-sided. Apparently, no one fully predicted the repercussions of the excessive leverage and overbuilding in housing. When Alan Greenspan retired in early 2006, he was lauded as the Maestro who shepherded the U.S. economy through its greatest boom. Greenspan even in 2007 remained sanguine about the housing boom, suggesting that average housing prices would not decline nationally and that the underlying fundamentals for housing remained sound—low interest rates, low unemployment and high potential growth of the U.S. economy.

Does this have eerily similar portent for Canada? Some are now wondering if Canadian policymakers and bankers might not be too sanguine about the housing strength in Canada, specifically in Toronto and Vancouver. While the Canadian situation is far different from the U.S. of 2006, the continued surge in condo construction and overall home prices to levels that are not consistent with the growth in domestic income is certainly raising questions about its sustainability and the fallout if it were to unwind.

Subprime lending and mortgage-backed bond creation—the helium in the U.S. housing bubble—play a negligible role in Canada. Although, credit terms were eased by CMHC in 2006, allowing for 30-year, then 35-year and, finally, 40-year amortizations with no down payment, there was nowhere near the laxity in mortgage qualifications rampant in the U.S. where, by 2006, many mortgages were made to borrowers with no money down, little income or assets and no documentation.

But bells were ringing last year as Governor Carney warned of the record level of Canadian household debt relative to income. CMHC substantially tightened its standards and banks have as well. Nevertheless, though many have warned for years that interest rates are likely to rise, mortgage rates continue to fall to their lowest level in history. Certainly, low interest rates make housing more affordable, boosting sales and prices—but the elevated supply of condominiums in Toronto (and, earlier, in Vancouver) is raising issues of overbuilding and future excess supply if interest rates were to rise. As well, foreign capital inflow has supported the Toronto and Vancouver housing markets for years. That factor has apparently been on a significant uptrend in Toronto in recent years. The outlook for that flow is uncertain, although arguably, Toronto will remain an attractive safe haven for foreign money. But how stable that money is remains a question.

In addition, the investment or speculative component of the condo market is vulnerable to higher mortgage rates and/or economic downturn. For now, our baseline economic

forecast is consistent with more moderate strength in Toronto housing—slowing the rate of price appreciation this year. Nevertheless, we are analysing the market in great detail, keeping a watchful eye on risks. One exogenous factor that could have meaningful impact is a potential work stoppage of inside city workers. The contracts of 6,000 outside city workers and 23,000 inside workers expired Dec. 31. This would impact every stage of condo construction in Toronto, delaying the approval and inspection processes and delaying move-in dates, which would raise the costs of funding these projects for developers and builders. It would also negatively impact, at least temporarily, the rest of the real estate sector and all of its retail spinoffs.

Bottom Line: We are keeping a watchful eye on real estate developments in Toronto and Vancouver. Price appreciation has been slowing, which is a good thing. The general level of housing starts and permits has returned to historical norms for the country as a whole, which is also good. Although household debt in Canada is at record highs, it is not out of line for most households given the sharp decline in interest rates over the past three decades. Nevertheless, mortgage rates have nowhere to go but up... eventually. Investment activity and foreign purchases in the condo market are not fully understood or predictable. Corrections in housing do occur and they can occur suddenly, so while this is not a red alert, we are not flashing green, either. Further analysis is warranted and will be forthcoming.

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