

Canada's Housing Correction: Halfway Home

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The Canadian housing downturn is more than a year old, a relative youngster compared with the nearly three-year long rout stateside. From lofty peaks in 2007, sales and starts have plunged over 40% and average resale prices have tumbled 13%. Is the correction almost over or only beginning?

Housing demand has fallen sharply in the past year, though the rate of decline appears to be slowing. Existing home sales were down 37% y/y in January to 10-year lows. Adjusted for the size of the adult population, home sales during the recent boom exceeded the peaks of the late 1980s, and would need to fall moderately further to match previous lows (*Chart 1*). Still, sales remain below long-run norms, suggesting room to recover once the economy improves.

For six years, sellers ruled the roost, but not any longer. New listings of existing homes out-numbered sales 2.7 to 1 in January compared with a long-run norm of 2.0 and an average 1.5 from 2002 to 2007 (*Chart 2*). The current ratio of listings to sales is still below the 1990 peak of 3.6 and has steadied recently amid a pullback in listings. The moderate overhang of unsold existing homes means buyers will retain the upper hand this year, keeping a damper on prices and new construction.

The downturn in sales and a tightening in credit have moved homebuilders into the basement. Starts were down 46% y/y in February to eight-year lows. That's not as bad as the U.S. debacle where homebuilding has collapsed by three-quarters from peak levels to record lows. The former red-hot Western Provinces have led the downdraft, though Central Canada isn't far behind. Though below rates of household formation, starts are likely to drop moderately further and remain depressed for a while to absorb the overhang built-up at the tail end of the boom (*Chart 3*). Consequently, residential construction could reduce GDP growth by one percentage point this year, aggravating the downturn. More than 100,000 construction workers (one-in-ten) could lose their jobs, on top of the 86,000 already laid-off since November, given

CHART 1
BUYERS ON STRIKE

Canada (units per 1000 population age 15 and older : s.a.)

Existing Home Sales

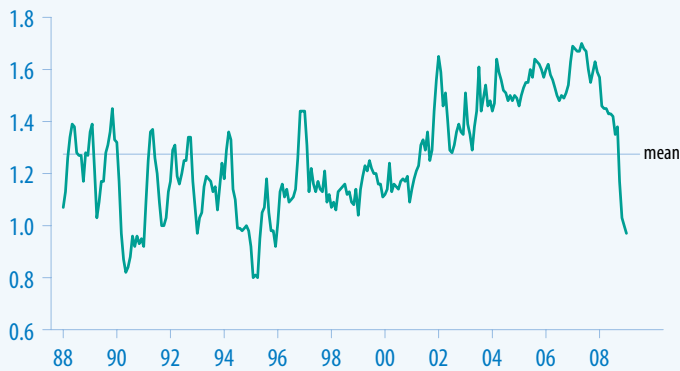
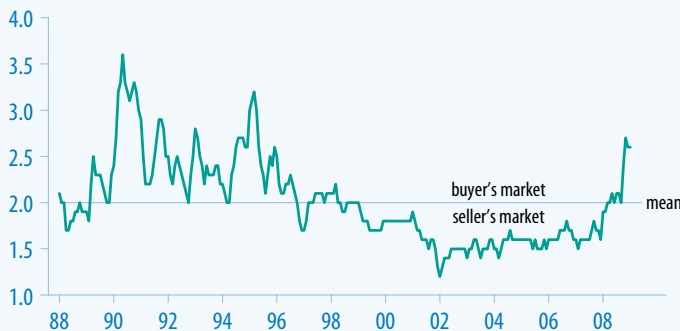


CHART 2
BUYER'S MARKET

Canada (ratio)

New Listings per Existing Home Sale



Source: Canadian Real Estate Association

CHART 3
DECONSTRUCTION ZONE

Canada (000s : annual rate)

Housing Starts vs. Household Formation



* Source: Census Housing Starts = (4-qtr m.a.)

CHART 4

HISSSSSSSSS

Canada (\$000s : s.a.)

Average Price of Existing Home

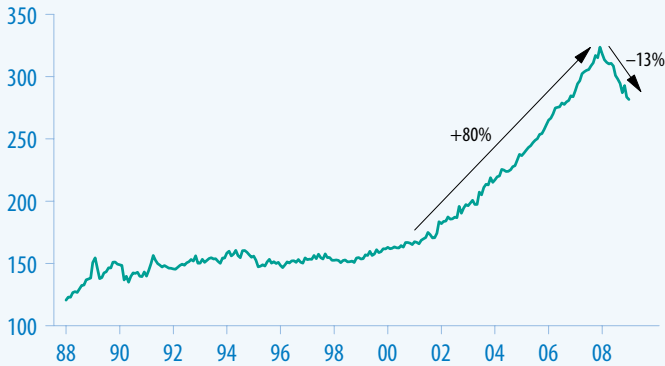


CHART 5

LOTS OF SKIN IN THE GAME

(% of real estate values)

Homeowner Equity

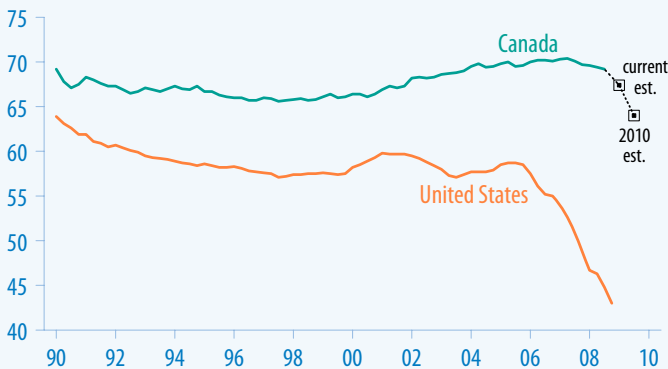


CHART 6

NOT CHEAP BUT AFFORDABLE

Canada (January 1988 = 100)

Affordability Index *



* Equals per-capita personal disposable income divided by mortgage payment. Mortgage payment is based on average price of an existing home, an average 20% downpayment, and an average of the 1-year and 5-year conventional fixed mortgage rate. Rebased to January 1988 = 100.

the still-high construction share of total employment. Unlike sales, where the correction appears well advanced, starts are likely to remain in the cellar this year.

The housing boom started and ended later in Canada than in most major countries, and the adjustment in prices so far hasn't been as severe. The average price of an existing home is down 13% from its peak, a moderate payback from the 80% surge from 2002 to late 2007 (Chart 4). This compares with a 27% slide in U.S. prices, after doubling from 2000 to 2006. The "typical" house price has fallen closer to 6%, as the decline in average prices has been skewed by fewer sales in high-priced regions of the country, notably Alberta and B.C. Still, prices should remain under pressure due to the moderate overhang of unsold homes and expected further job losses. Another 10% slide in prices would restore their normal relationship with income.

Even if prices fall moderately further, owners should retain significant equity in their homes. A 10% price decline would reduce homeowner equity to about 64% from an estimated 67% in Q1; below average, but miles above the 43% figure for the U.S. (Chart 5).

Falling home prices, combined with a two-percentage-point drop in mortgage rates (based on the average of 1-year and 5-year conventional fixed rates), have slashed monthly payments by one-third since late 2007—a savings of about \$600 per month. With an assist from higher incomes, affordability has returned to long-run norms and should remain good so long as interest rates stay low, a reasonable bet this year (Chart 6).

Bottom Line: A comparison of recent trends in housing indicators with historical benchmarks suggests the year-long correction in Canada's housing market is around the halfway mark. Growing job losses and an overhang of unsold homes will continue to depress activity and prices this year. However, barring a long recession, the improvement in affordability will support demand, which in turn should stabilize prices and anchor a modest recovery in homebuilding next year.

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