

Canadian Housing: Booming Rebound, No Bubble

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Canadian existing home sales have surged 63% from their January lows, the strongest eight-month performance since data started in 1980 (*Chart 1*). In September, existing home prices spiked 13.6% above year-ago levels, the second fastest clip in two decades. Topping \$330,000, the national average price has now surpassed its prior peak. Meanwhile, around the world, accelerating house prices are becoming a bother for some central banks. They were one of the reasons for Norway's recent rate rise and are flashing warning signs for several Asian authorities. Against this backdrop, Canada's resale market metrics are prodding the question: Are low interest rates pumping a domestic housing bubble? Some market commentators are already jumping on the "yes" bandwagon. We judge that not only is it too early to cast judgement, but the preliminary evidence on the ground is arguing "no".

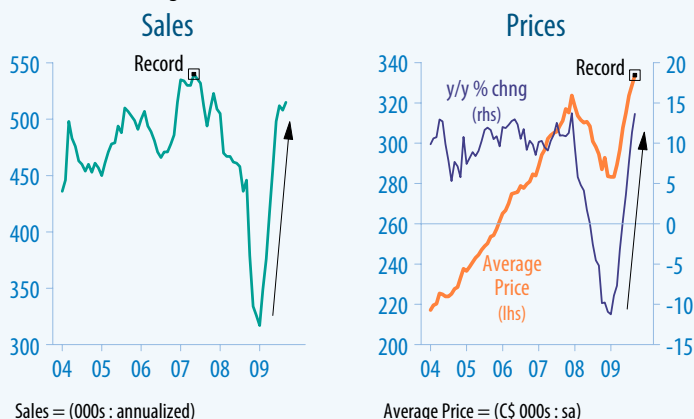
There are three characteristics common to all asset price bubbles, be they for houses, internet stocks or tulip bulbs. First, traditional valuation methods reveal high relative prices (e.g., homes prices relative to incomes or rents). Second, instead of dissuading demand, high and rising prices actually stimulate demand. Third, associated market turnover is aided and abetted by credit growth—increased borrowing against inflated asset values to buy even more assets or fund other types of spending. Specifically for Canadian housing, in addition to these three basic characteristics, bubble markers would include proof that the froth in the existing home segment is spilling over to new homes, and that the recent surge in resale volumes and prices is not justified by fundamental or technical factors.

To begin, the **record surge in resale volumes reflects unleashing pent-up demand**. From mid-2007 record highs (just before the global credit crisis began) to January lows, existing home sales plummeted 42%, with the majority of the decline occurring during the four months after Lehman Brothers' bankruptcy. In uncanny symmetry, the half year ended January represented the steepest sales slide in a couple of decades.

Discretionary and big-ticket purchases of all types were postponed in the post-Lehman panic, creating an abnormal amount of pent-up demand (on top of the "normal" amount created during recessions). Once the panic subsided, pent-up demand started to unwind, pulled by record-low mortgage rates (thank you Bank of Canada and CMHC's Insured Mortgage Purchase Program), cheaper home prices (around 9% on average), and an emerging sense among consumers that the worst of the recession was over. The current recovery in consumer confidence is rivaling the record rebound from the severe recession in the early 1980s.

Importantly, **existing home sales might already be starting to stabilize, and at levels below their past peaks**. There was only a fractional gain during August and September. Although the past year's total volume remains below the long-run trend (*Chart 2*), September's sales reading alone is about 7% above what the average monthly amount should be at trend. But, this is less than half what it was relative to trend at the pre-crisis peak. Resale activity has been rising steadily since the 1980s (2.3% per annum) reflecting population growth, internal migration and broadened home ownership.

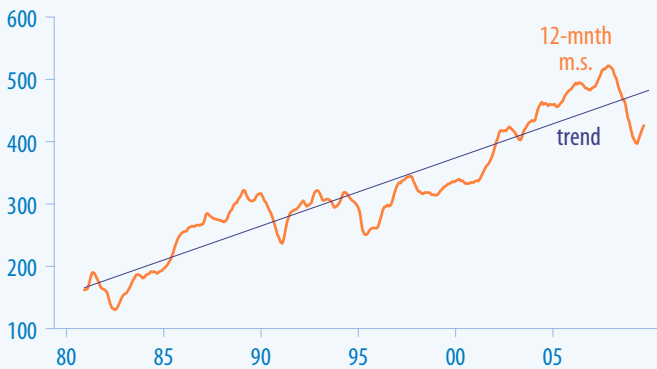
CHART 1
BUBBLE BAROMETERS?
Canada – Existing Homes



**CHART 2
HOMING IN ON TREND**

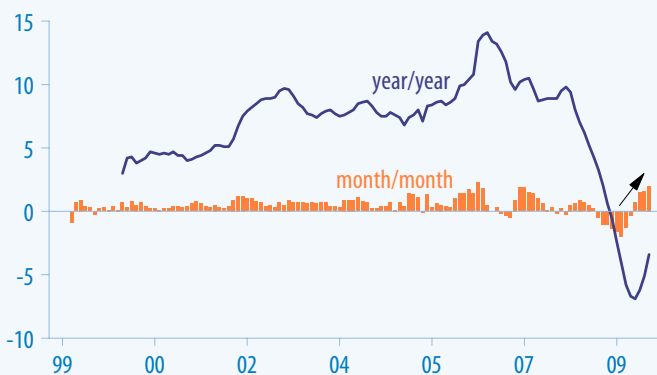
Canada (000s)

Existing Home Sales



**CHART 3
REPEAT-SALES PRICES PERK UP**

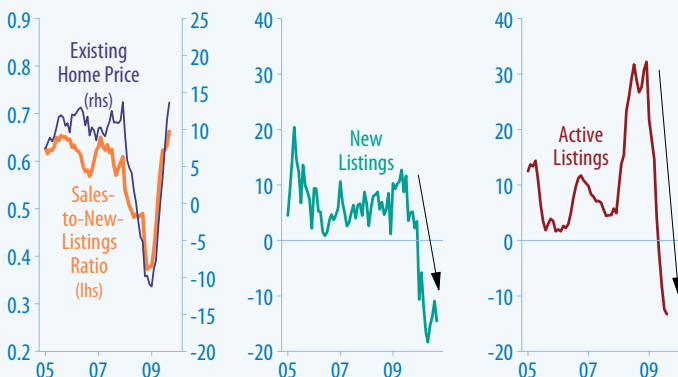
Canada (% chng)



Source: Teranet-NB House Price Index

**CHART 4
MARKET SLACK DRIVES HOME PRICES**

Canada



Existing Home Price, New Listings, Active Listings = (y/y % chng)

The **double-decade-extreme spike in prices is less of a concern because average existing home prices are a flawed measure.** Assuming home prices do not change at all across the country, the average price could still exhibit significant inflation to the extent transactions in higher-priced regions or properties are increasing their market shares. And, this is precisely what's been happening. For example, Vancouver is Canada's highest-priced real estate market and sales volumes have doubled in the past year. Keeping provincial market shares constant, measured home price inflation slowed to 9.3% y/y from 13.6%, but the data aren't readily available to account for shifts in the share of higher-price properties (anecdotal evidence suggests that sales of higher-priced properties tend to be more cyclical than those of more affordable homes).

A relatively new house price metric addresses both these biases; the Teranet-NB House Price Index is constructed using a repeat-sales methodology (the same one used by the S&P/Case-Shiller home price indices in the U.S.). Although coverage is for only six cities (Vancouver, Calgary, Toronto, Ottawa, Montreal and Halifax), this still covers more than half the value of Canada's real estate market. The Teranet-NB metric confirms that home prices have been accelerating since April, by 6.0% through August, after falling 9.0% in the previous eight months (*Chart 3*). However, prices are still 3.4% below year-ago levels.

Furthermore, **technical factors appear to be exacerbating the acceleration in home prices.** The panic that caused buyers to stop buying also caused sellers to stop selling; many homes were de-listed from the market. However, the expected unleashing of "pent-up supply" has lagged demand. In April, new listings contracted a record 22% y/y and, in September, new listings fell to a near five-year low (*Chart 4*). The lack of new listings is draining the inventory of homes available for sale (active listings), and pushing up the sales-to-new-listings ratio. The latter is a measure of real estate market tightness and a key driver of home prices. As such, some of the price spike is due to the tightening of supply conditions, in which case, prices are behaving as they should, being bid up as a means to attract more sellers to the market. This is similar to the way that the 40%-to-50% spike in Alberta home prices during the initial phase of the past commodity boom helped mitigate the local housing shortage.

CHART 5
NEW HOME PRICES STILL SUBDUED

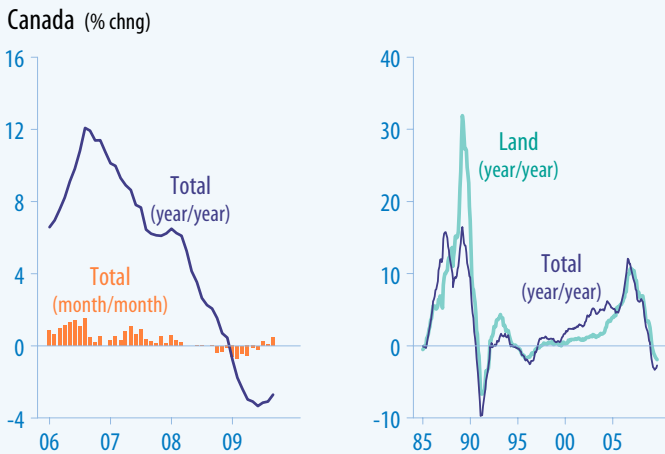


CHART 6
MORTGAGE CREDIT GROWTH MODERATING

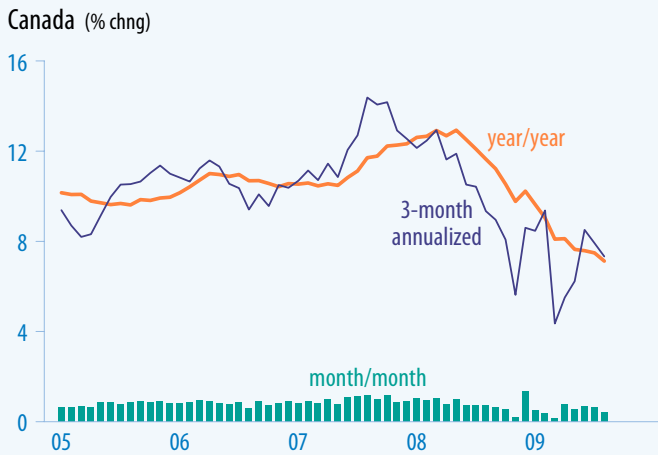
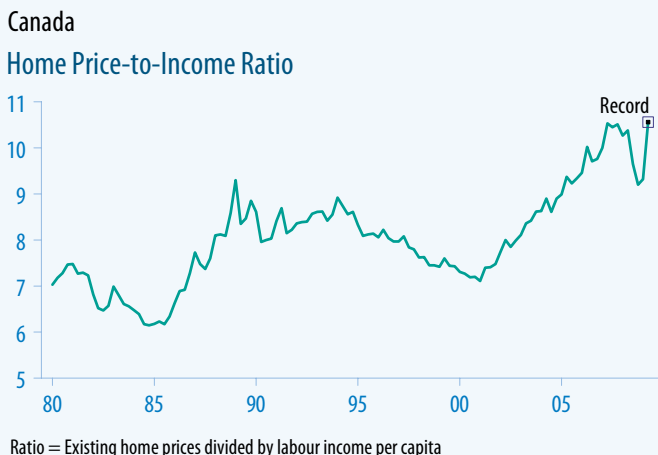


CHART 7
HOME PRICES OUTSTRIP INCOMES



New home prices tend to follow existing prices, and are a decent lagging indicator of housing boom, bust or bubble. **New home prices have begun to incrementally increase but they still remain 2.7% below year-ago levels** (Chart 5). Embedded in these prices are land prices, which separately remain similarly subdued. Land prices are a classic housing bubble marker, such as in the late 1980s.

Mortgage credit growth has also been decelerating, not accelerating, and remains well below pre-crisis double-digit peaks (Chart 6). Interestingly, monthly mortgage credit growth remained positive during the entire global credit crisis—a testament to the world-leading soundness of Canada’s banking system and the robustness of its mortgage market.

Thus, the **only truly concerning aspect of current conditions in the resale market is the level of prices**. Relative to even incomes, prices are now hitting record highs (Chart 7). For example, in Q2, the average price was 10.6 times the level of labour income per capita (the ratio has trended up over time as the proportion of two-income households has risen). The current lofty level reflects the impact of two forces, record-low mortgage rates and recession-ravaged incomes. Both of these forces are poised to reverse course. The concern is that current record-high home prices will not act to brake market activity by themselves, and that the coming income effect on housing demand will dominate the interest rate effect. This could potentially push home prices even higher, triggering a “must-buy-now-or-we’ll-never-be-able-to-afford-it” mentality, not to mention outright speculation. At this point, however, this is still just a risk.

Bottom line: Canada’s resale market metrics are stoking fears of a housing bubble, but the fears for the most part are unfounded. It’s not a bubble when a record sales rebound follows a massive sales collapse, owing to the vagaries of pent-up demand. It’s not a bubble when prices accelerate because growing demand is butting up against shrinking supply. It’s not a bubble simply because relative prices are at record highs. Furthermore, given that mortgage credit growth is moderating, and new home and land prices remain subdued, **the evidence on the ground argues against a housing bubble**.

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