

# Bubble Talk Bubbles Over

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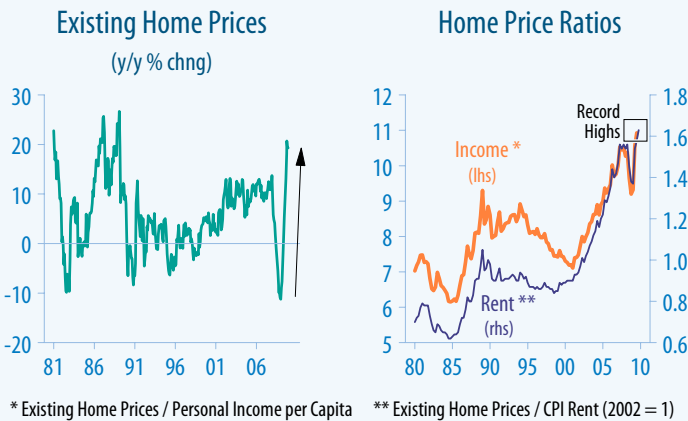
A story on a possible bubble in the Canadian housing market made the front page of the Wall Street Journal this week, stoking the domestic debate about whether a bubble actually exists. The problem is that “bubble”, like “beauty”, is in the eye of the beholder. In wading into this debate, we cast our eyes back to the market manias that dot financial history, and observe three characteristics common to all asset price bubbles, be they for houses, internet stocks or tulip bulbs. The bubble criteria are: (1) Prices rise rapidly to relatively high levels; (2) High and rising prices actually stimulate asset demand, instead of dissuading it; and (3) Price-pumping market turnover is aided and abetted by credit growth. The question: *Does Canada’s housing market satisfy these three bubble criterion?* The answer: *No, except for relatively high prices.*

On the surface, it does appear that Canadian home prices have risen rapidly to relatively high levels. The commonly-quoted average existing home price spiked 19.3% y/y in December, hitting the highest levels relative

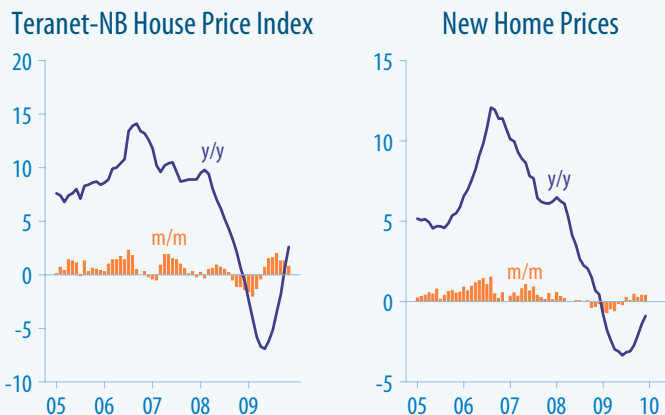
to incomes and rents since records began in 1980 (Chart 1). However, the average existing home price is a flawed metric, often skewed by shifts in the mix of real estate transactions. For example, a market share shift toward larger-sized homes or higher-priced regions pushes up the measured average price, even if no individual home price actually changed. In fact, these shifts have been heavily influencing existing home prices of late. The Teranet-NB House Price Index adjusts for both of these factors (admittedly covering only six cities), with prices up 2.6% y/y in November (Chart 2). Another measure, the New Housing Price Index, is a reliable lagging indicator of resale price trends. And, new home prices were down 0.9% y/y in December. For what it’s worth, these three home price metrics averaged around 7% y/y in the latest month, which, quite frankly, is as good a guess as any of “true” home price inflation.

Given the above, it’s not obvious that Canadian home prices are truly accelerating in bubble fashion, but it is obvious that relative home prices are historically high—perhaps too high (thus, bubble criterion #1 is partially satisfied). The persistent purchasing of potentially over-priced homes is causing relative debt levels among households to soar to historic highs as well, in turn, posing risks to financial stability (something the Bank of Canada has been worrying about). But this also poses a question: Why now do potentially over-priced homes continue to be purchased by potentially over-indebted households? If the primary motivation is the expectation of significantly higher home prices in the future, then this would be indicative of bubble behaviour, particularly given how strongly the demand for homes has rebounded.

**CHART 1**  
**BUBBLE BAROMETERS?**  
Canada



**CHART 2**  
**WHERE’S THE SPIKE?**  
Canada (% chng)



From their January 2009 lows during the depths of the global financial crisis, existing home sales ended last year up 78%, which is a record-paced rebound (*Chart 3*). The surge in sales followed one of the worst sales collapses on record (owing to the crisis), and its impact on prices was magnified by the slow response of new listings to the pick-up in activity. Nevertheless, the volume and price dynamics could still be indicative of bubble behaviour, if driven primarily by house price expectations. However, we argue that other non-price drivers have been behind the surge in sales (thus bubble criterion #2 is not satisfied).

The most important non-price driver is the current and expected cost of borrowing. Posted mortgage rates are currently the lowest they have ever been, even before any discounting. Meanwhile, mortgage rates are widely expected to increase in the not-too-distant future, say, after the Bank of Canada's conditional commitment to keep its policy rate unchanged expires after June 30<sup>th</sup>. These are powerful incentives to buy and borrow now rather than later.

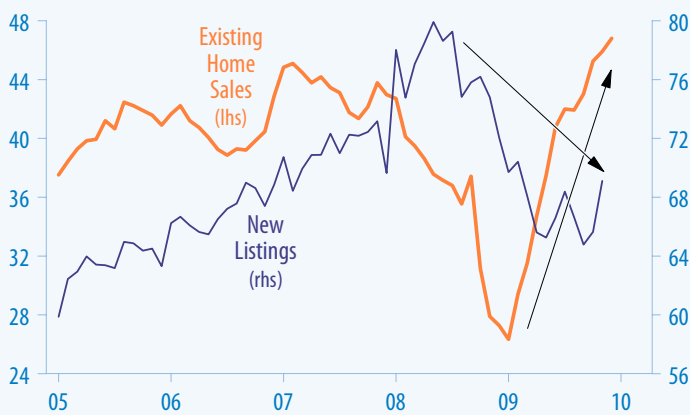
Another non-price driver is the certainty of higher taxes on real estate transactions in Ontario and British Columbia, effective July 1<sup>st</sup>, as these provinces harmonize their provincial sales tax with the federal goods

and services tax. Sales of higher-priced new homes and many transaction costs associated with the sale of both new and existing homes (of any price) will now incur higher taxes (an additional 7% in B.C. and 8% in Ontario). Both provinces' housing markets exhibited growth in unit sales and average prices that exceeded the rest of Canada (*Chart 4*), which biased up the national averages, but these regions also recorded much worse housing market conditions amid the financial crisis. Avoiding higher transaction costs could be a reason, at the margin, to pull home purchases forward. But the pull-forward effect is probably more profound for higher-priced new homes. Pressures in the new home market often migrate to the existing home segment; if potential new home buyers find the pickings too lean, they often turn to the resale market.

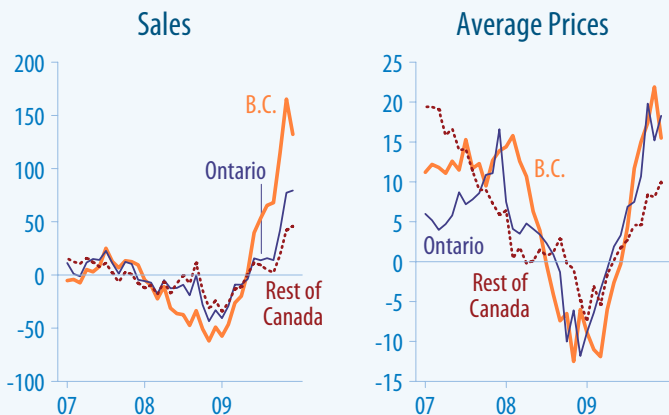
A more recent non-price driver is the potential for changes to mortgage insurance eligibility rules. The government last tightened these rules in 2008, by raising the minimum down payment to 5% from zero, shortening the maximum amortization period to 35 years from 40 years, and clarifying the credit adjudication process. There has been some speculation that these rules could be tightened again, particularly since the 2008 changes themselves were designed to mitigate the risks to financial stability posed by the laxer rules. And, these risks have continued to escalate, despite the changes.

*Table 1* shows how much the average down payment increases as the minimum amount moves from 5% to 10%

**CHART 3**  
**DEMAND DOESN'T ALWAYS CREATE SUPPLY**  
Canada (000s)



**CHART 4**  
**BEAT THE TAX**  
Existing Homes (y/y % chng)



(a commonly mentioned range of possible alternatives). Some households would be unable to hit these higher down payments, even if they could afford the associated mortgage carrying costs. For these prospective homebuyers, if they deemed the odds of this change happening sufficiently high, it would be rational for them to purchase sooner rather than later. *Table 1* also shows the monthly payment impact of shortening the amortization period from 35 years to 30 years (again, a commonly mentioned alternative). Interestingly, the payment jump would be comparable to about a 55 basis point rise in mortgage rates under existing amortization rules. This potential effective rate hike could be combining with generalized expectations of mortgage rate hikes to pull home purchases forward.

Arguably, the most important bubble criterion is the extent to which asset market turnover is being bolstered by credit creation—borrowing to buy assets or borrowing against what you already own to buy even more assets. In a housing bubble, as flipping and other speculative activity increases, this gets reflected in surging mortgage credit. However, Canadian mortgage credit growth is not surging (thus bubble criterion #3 is not satisfied). Although a bit choppy, the three-month and six-month annualized growth rates

continue to run in a range around 7% (*Chart 5*), in line with the one-year growth rate and, very interestingly, in line with the three-metric average of home price inflation. Admittedly, with mortgage debt increasing as a share of household income, even this moderate pace poses increasing risks to financial stability if sustained over the medium term. However, current mortgage growth is roughly half of what it was at its peak before the global financial crisis.

**The Bottom Line:** Apart from historically high relative home prices, Canada’s housing market is not emitting the classic bubble signals. In the months ahead, we look for new listings to catch up to sales activity, bringing the resale market back into better balance. Meantime, housing starts have been running at or above the 175,000 annualized pace for the past four months, a sign of emerging balance in the new home segment (in line with the rate of household formation). We’re not sure whether the Federal Budget on March 4<sup>th</sup> will contain any mortgage insurance changes. But the market betting is that at some point we’ll get at least some tightening tweaks to credit adjudication guidelines, possibly followed by a shortened maximum amortization period. After July 1<sup>st</sup>, any pre-HST froth in Ontario and B.C. should dissipate. Then, the Bank of Canada’s first policy announcement after midyear is on July 20<sup>th</sup> (and we’re pencilling in a 25 basis point rate hike). Add this all up, and we might only have to wait a few months more before all this bubble talk is put to rest.

**TABLE 1**
**CHANGES AFOOT?**

Average Mortgage Costs – Canada

Down Payments		Monthly Payments	
% Down	Payment	Amortization Years	Payment
5%	\$17,250	35	\$1,445
6%	\$20,700	30	\$1,559
7%	\$24,150	<i>difference</i>	<i>+\$114</i>
8%	\$27,600		
9%	\$31,050		
10%	\$34,500		

Assumes average Canadian home price (\$345,000)

Assumes average Canadian home price (\$345,000), 5% down payment, 4% mortgage rate

**CHART 5**
**FAST BUT NOT FURIOUS**

Residential Mortgage Credit – Canada (% chng)



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