

Is a real estate bubble on the horizon for Québec? Unlike in other provinces, recent price increases are not a concern

Even if we can dismiss the notion of a real estate bubble in Canada¹ for the time being, taking a closer look at Québec's real estate market seems timely. While prices barely fell across the province following the recession that ended last summer, it didn't take very long for the upward trend to bounce back. And since property prices are now higher than they were before the financial crisis triggered the economic decline, delving into the reasons behind these escalating prices seems worthwhile. Are the current prices sustainable? Are other increases on the horizon? Is there a major risk of a price correction in Québec's residential real estate market? This *Economic Viewpoint* will answer these questions and compare the situation with what is taking place in Canada overall and in other provinces.

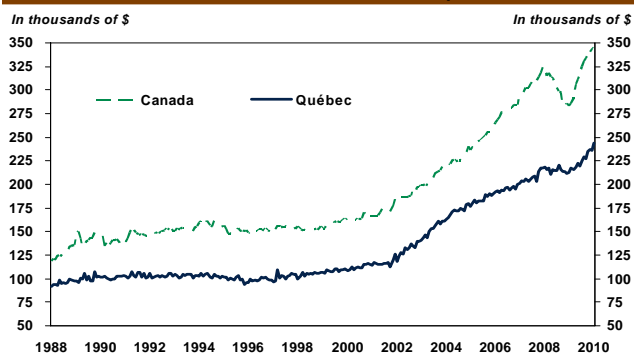
¹ See the *Economic Viewpoint* dated March 8, 2010, "The sudden rally in Canada's residential real estate market is surprising and troubling – However, this is not a bubble yet!" http://www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv100310.pdf

ARE PRICE INCREASES JUSTIFIED?

Much like the economy, the cyclical movements in property prices are usually less important in Québec. Recent developments in the residential market once again reflect this. In Canada, the average property price fell by 13% from the peak reached at the end of 2007 to the low point reached at the start of 2009. The speed with which the market snapped back surprised most observers (graph 1). Average prices had won back all lost ground, and they've been reaching new peaks

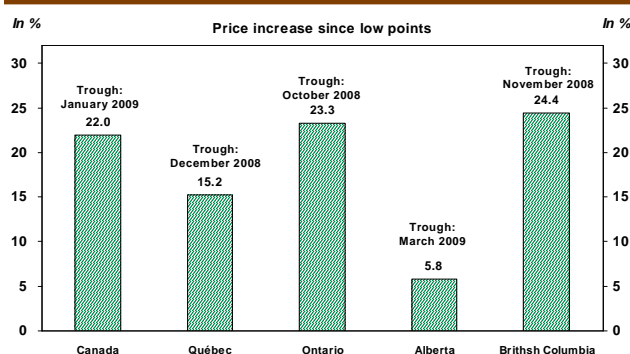
ever since. Prices are exceeding, by at least 20% on average, the cyclical trough that was reached across Canada in early 2009. Prices have rebounded sharply in Ontario and in British Columbia, while the price growth has been more modest in Québec (graph 2). And since the price increases were less spectacular before the recession, the damage was less severe. Prices that were barely dented during the recession started to trend upward again, however (box 1 on page 2).

Graph 1 – Residential real estate prices in Québec are also at a historical peak



Sources: Canadian Real Estate Association and Desjardins, Economic studies

Graph 2 – In Québec, price advances are generally weaker since low points reached during the recession



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

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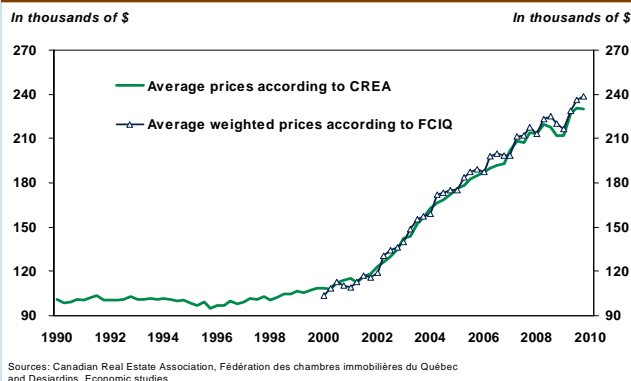
NOTE TO READERS: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

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Box 1
Price calculation method

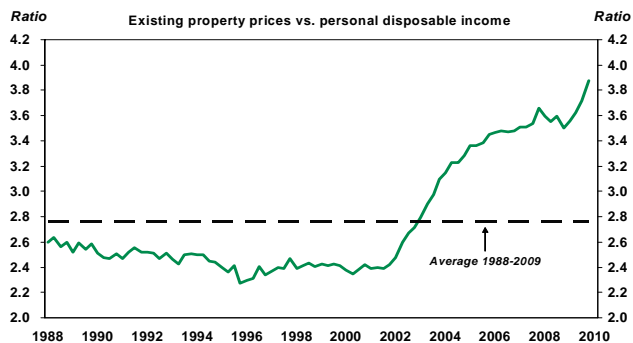
Two different price calculation methods were compared, but their movements are shifting in a similar pattern (graph 3). The average prices published by the Canadian Real Estate Association (CREA) have one drawback: they do not take the geographic breakdown of transactions into account. For example, stronger activity in Montréal can skew the average prices in Québec upwards. The data compiled by the Fédération des chambres immobilières du Québec (FCIQ) is by far more relevant. Prices are weighted by geographic breakdown and by property type, which eliminates any possible distortion. However, price changes as estimated by the FCIQ are comparable to the average prices set by CREA, which validates the conclusions of our analysis.

Graph 3 – Comparison of residential prices in Québec based on two different estimation methods



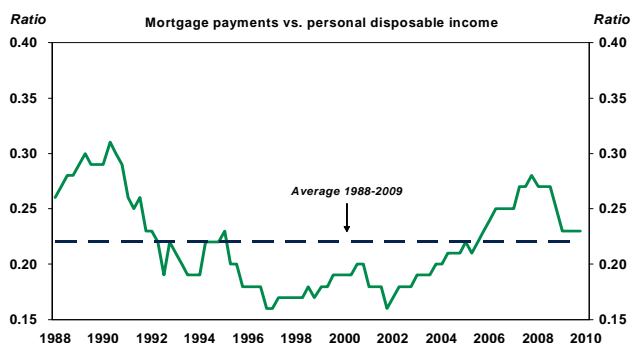
The recent price changes are raising concerns about the market's ability to sustain its current momentum. Could this high level compromise the residential sector's expansion period? One thing is certain, home prices have increased much faster than after-tax incomes since the start of the year 2000. In 10 years, property prices have increased by 112% while incomes have grown by only 33%. The residential market has therefore become excessively expensive over the past few years, as shown by the ratio of average property prices versus personal disposable income (graph 4). Lower interest rates have, however, saved the day. The weighting of mortgage

Graph 4 – Québec's real estate market is very expensive, historically



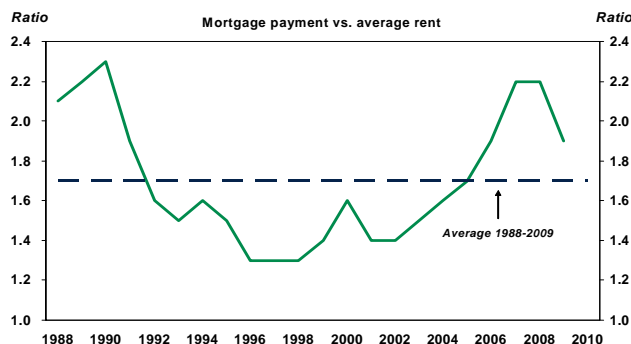
payments is still at a respectable level from a historical standpoint (graph 5) despite strong price advances. Incidentally, the alternative of buying a home instead of paying rent has again become a little more attractive recently, as shown by the decline in the ratio of the average mortgage payment

Graph 5 – Weight of average mortgage payments is closing in on Québec's historical average



vs. the average rent (graph 6) towards its historical average. Despite the sharp increase in property prices, mortgage payments are not exorbitant compared to current rents. Despite the appearances, the situation in Québec's residential sector does not seem to be critical, based on these indicators.

Graph 6 – The cost of a mortgage is not far from the average rent in Québec

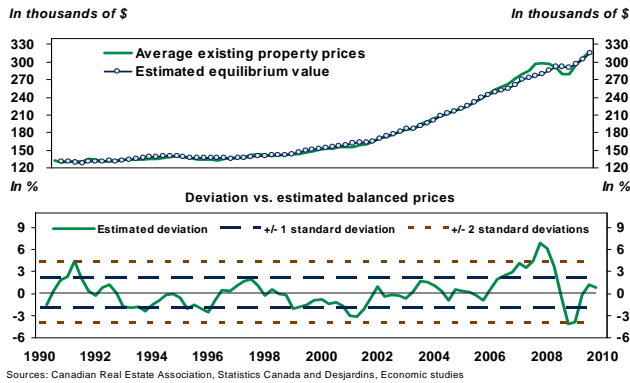


Box 2
Prices are overvalued in some provinces

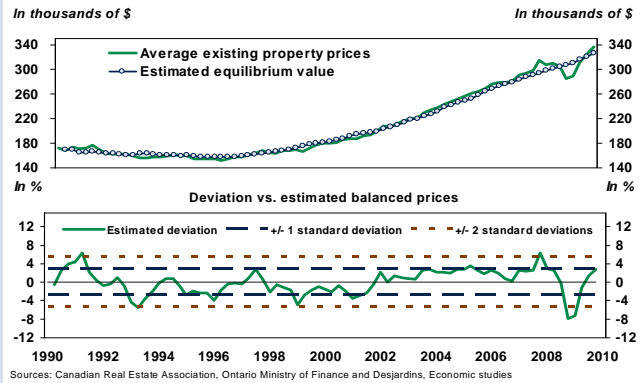
The analysis of the situation in Canada showed a slightly positive spread between average home prices and the estimated equilibrium value as per our model (graph 7). The market seems slightly overvalued in Canada overall and should be closely monitored to detect any potential for a real estate bubble. Now that we can dismiss any concerns about a bubble in Québec, we should determine which parts of the country are causing domestic prices to deviate from their fundamental trajectory. According to our calculations, current prices would be overvalued in Ontario and in British Columbia (graph 8 and 9). In both of these provinces, the difference between the current average price and that determined by fundamental factors is close to 3%, which corresponds to the standard deviation for the period studied. These results are not surprising given that property prices

have rebounded by almost 25% since their respective low points were reached. Moreover, the changes made to sales taxes in these two provinces that enter into effect on July 1 probably fuelled the rush to purchase property. The market of Alberta seems also be overvalued because the spread between the average price and the equilibrium value is close to 10% (graph 10). Elsewhere across the country, average prices are hovering around their equilibrium value (Atlantic provinces, Manitoba and Québec) whereas prices in Saskatchewan are shifting slightly below this key level. In short, only three provinces are grappling with overheated markets, since the difference between market prices and the equilibrium value has already reached its standard deviation. To detect the possibility of a real estate bubble, we would have to see a deviation that is equal to at least two standard deviations. This was the case in Canada at the end of 2007, just before the severe correction took place.

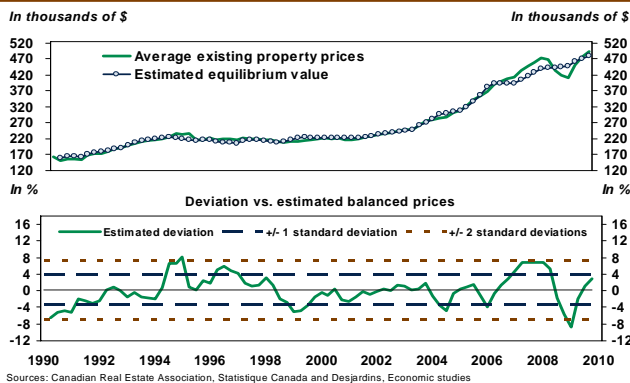
Graph 7 – In Canada, prices seem to be increasing too quickly against fundamental variables



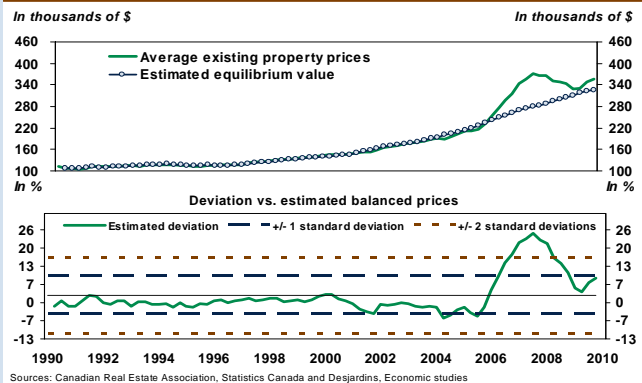
Graph 9 – The market in Ontario is already overvalued



Graph 8 – The market appears overheated in British Columbia

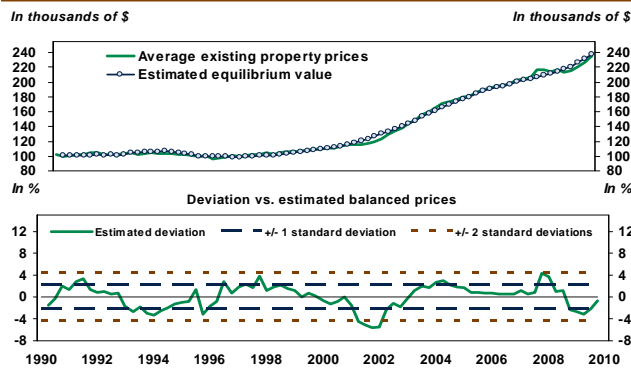


Graph 10 – In Alberta, prices seem to be increasing too much against equilibrium value



To determine if these price increases are sustainable, different factors must be considered. When we take mortgage rates and household income into account, it is possible to set a balanced price in the real estate market. In Québec, prices are hovering close to the estimated equilibrium value (graph 11). In fact, according to our estimation model, prices are near the value associated with fundamental factors, meaning that the situation in Québec is relatively healthier than in Canada and in some provinces (box 2 on page 3). Despite the almost uninterrupted ascension in prices since the start of the year 2000, the situation is therefore much less of a concern in Québec. It must be said that unlike previous recessions, personal incomes have not declined. If household incomes had fallen sharply, this diagnostic would be much different. Since the labour situation has been recovering for the past six months, the resulting advances in incomes mean that price increases are easier to absorb. One thing is certain however; the estimation model does not reveal the presence of a real estate bubble in Québec and does not point to the possibility of an emerging bubble in the near term.

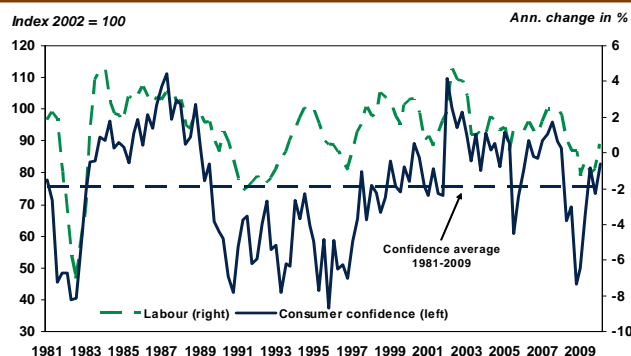
Graph 11 – Price increases in Québec are consistent with improvements in fundamental factors



Sources: Canadian Real Estate Association, Institut de la Statistique du Québec and Desjardins, Economic studies

Low interest rates and the positive impact of the economic recovery on household confidence and the labour market are underpinning the strength seen in the residential sector (graph 12). The effect of decisions turning into actions is also being

Graph 12 – Household confidence in Québec should rise as employment recovers



Sources: Conference Board, Statistics Canada and Desjardins, Economic studies

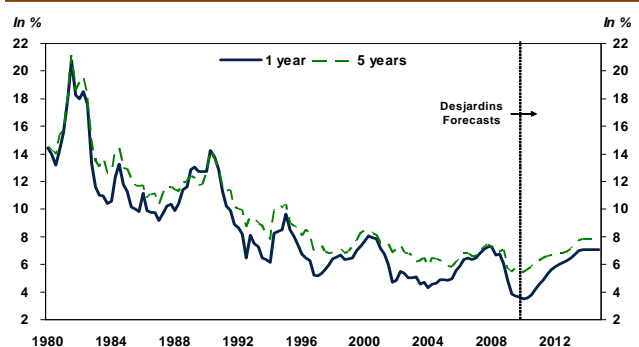
felt. Many households that toyed with the idea of buying property in the next year or two decided to jump into the market now before interest rates start to climb. At the same time, those who put their buying plans on hold during the recession are now setting them in motion. Since the labour market should continue to improve in 2010, the anticipated interest rate increases (expected by the end of summer or in the fall) will only slow down demand for housing and, by extension, price advances. In summary, favourable economic setting for property purchases stimulates the real estate market, which mitigates the risk of a price correction.

Even if the residential sector does not appear to be overvalued in Québec, it makes sense to question the capacity of households to support current prices. This is what the Desjardins Affordability Index (DAI) helps to determine. This index takes into account household income, mortgage rates, property prices and some of the fixed costs of home ownership like property taxes and heating costs. The DAI is calculated by drawing the ratio between average household income and the income needed to obtain a mortgage loan to purchase an average priced property. The higher the ratio, the more affordable the residential market is for households. When real estate activity is supported by favourable economic factors, the risk of a sudden price meltdown is extremely low. At the moment, the DAI is only slightly below its historical average, meaning that households still have a fairly good capacity to purchase property.

THE KEY: UPCOMING INTEREST RATE CHANGES

The risk associated with a major increase in interest rates is also worth examining. If the current situation does little to raise concerns in Québec, the projections carried out based on our expectations on interest rates are in fact a concern. The increase in borrowing costs which will take place before the end of 2010 and continue thereafter (graph 13) will gradually erode the capacity of households to purchase property. In less than five years, the level of affordability could close in on the low point seen during the recession at the beginning of

Graph 13 – Mortgage rates in Canada are at the lowest level in 30 years



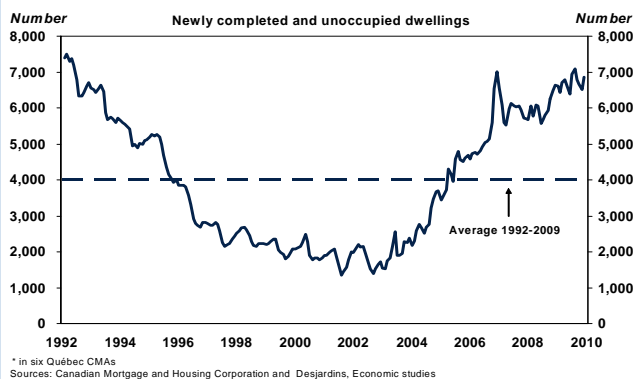
Sources: Datastream and Desjardins, Economic studies

Box 3

Despite appearances, inventory is low

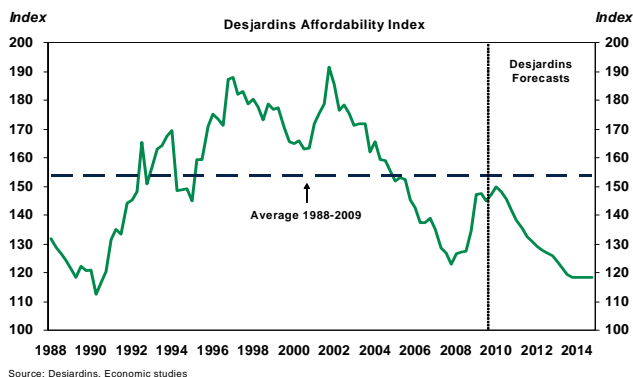
The inventory of recently completed new homes that haven't found any takers is high from a historical standpoint (graph 14). Strong demand will nevertheless see the stock of new homes sell fairly quickly. Other than inventory levels, the number of months needed to liquidate unoccupied dwellings is a better indicator, since it takes into account both the supply and demand for housing. For example, there are about 1,500 new condos in Montréal that remain unsold, according to the Canadian Housing and Mortgage Corporation (CMHC). However, the time-to-sell to liquidate the inventory of new unoccupied condos is approximately seven

Graph 14 – Inventory of new dwellings is high in Québec,* but time-to-sell is still respectable



the 1990s (graph 15). However, the assumption that property prices will rise in line with incomes was retained for this simulation.

Graph 15 – Anticipated mortgage rate increases will reduce affordability in Québec



months, in other words, not a big concern. In Québec City, the supply duration in this market segment is only six months, which is very respectable. At the beginning of the 1990s, more than one year was needed on average to sell the excess supply of new condos. Today's situation does not even compare to that nightmare. Despite the historically high inventory level, the relatively short time-to-sell helps dispel worries about excess condo construction. It remains to be seen how the many projects scheduled for completion this year will be absorbed by the market. If the number of units to liquidate was to exceed demand and the time-to-sell was stretched by several months, the risk of price declines would rise significantly.

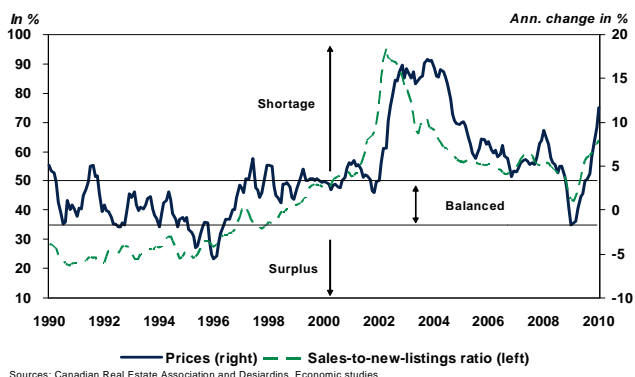
Incidentally, we should mention that the inventory of newly built conventional rental dwellings is almost nonexistent. The low vacancy rate for apartments and the difficulty in making new projects profitable (except for high-end projects), contribute to keeping the inventory at a low level. The senior residences' sector is currently showing a high vacancy rate, which is also inflating the inventory of new dwellings. The limited number of new housing starts since last year should allow excess construction to be gradually absorbed. All in all, even if the inventory of multiple-unit housing is high, the situation with condos and traditional rental dwellings is not a concern, and this eases the risks of excess construction. The threat of an oversupply of new housing can therefore be dismissed.

Twenty years ago the high level of mortgage interest rates—which climbed to above 10%—and mass layoffs due to the recession were such that demand for homes literally plummeted. The residential sector quickly reverted to a surplus situation which sparked off a long period of stagnating, and even declining, prices for some years. Given that it took a few years to absorb the excess supply of construction at the end of the 1980s, it took almost 10 years for the market to get out of its slump. The situation today is different on many fronts, however. The economic recovery seems to be well underway and the labour market has been healing for some time now. In terms of supply, housing developers and builders have learned from past mistakes and are exercising more caution (box 3). In this context, rising interest rates are the only risk to the residential sector. Even if Québec is not in the midst of a housing bubble and the probability of a price correction seems extremely remote in the near term, it remains to be seen how the market will react to gradual interest rate hikes.

SHORTAGES FUEL PRICE INCREASES

Price declines are certainly not on the radar anytime soon. Before any price contractions occur, the market would have to revert to a surplus situation as was the case through most of the 1990s. Sluggish demand and an oversupply of new dwellings had put downward pressure on prices. At the moment, new construction is not excessive. The resale market is currently dealing with a shortage as the number of properties for sale is insufficient to satisfy buyer demand. According to the CMHC, the existing market is balanced when the ratio between sales and the number of properties freshly put up for sale falls between 35 and 50 (graph 16). At this stage, price advances usually fall in line with the pace of inflation.

Graph 16 – Shortages in the real estate market favour price increases in Québec

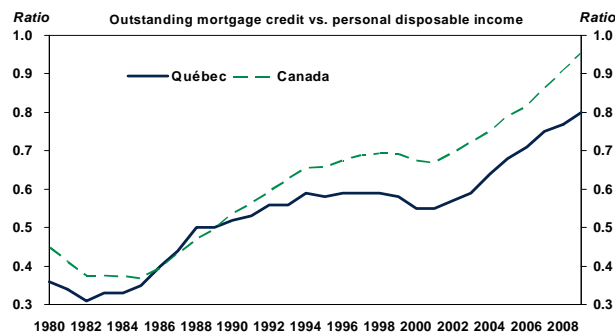


Another indicator of tension in the resale market, i.e. the number of sellers vs. the number of buyers, is even more telling and complete. It is in fact the ratio of total number of listings for sale (number of sellers) through real estate agents vs. the number of sales that have taken place in the same month (number of buyers). The market is considered balanced when there are 8 to 10 sellers for each buyer. Anything beyond this ratio is considered a surplus situation when downward pressures are exerted on prices. This was the case from the fall of 2008 until the spring of 2009 due to the drop in demand as a result of the recession in Québec. The market then returned to a balanced situation and since last fall, we seem to have a slight shortage on our hands. The market is still far from becoming overheated however, which is characterized by a ratio of fewer than five sellers per buyer.

The fact that sellers are now in a strong position will favour price increases that exceed the rate of inflation (1.5% expected in 2010 and 2.1% in 2011). Our forecasts call for residential

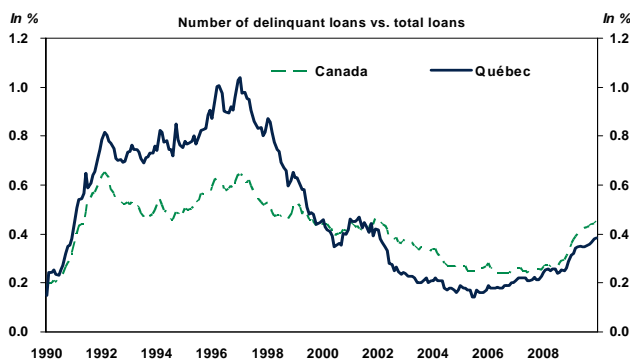
price advances of 5.5% this year and 2.5% in 2011. In the near term, the rate increases for mortgages will simply not be enough to throw the market completely off balance. Even if we end up with moderate rate hikes, as our forecasts call for, households should make sure they have some available leeway. For example, the posted rate for a five-year term, currently below 5.5%, could edge up to 8% by 2013. Access to property will be more difficult for first-time buyers while credit conditions will be less advantageous for those who need to renew their mortgages. The recent concerns raised by the Bank of Canada regarding household debt and the measures announced on February 16 by the federal Minister of Finance are, in a way, a call for caution. This observation also holds true for Québec since the level of mortgage debt is high (graph 17) and the ratio of delinquent mortgage loans has been rising for the past few months (graph 18). Tightening the rules used to grant mortgage loans is a good way to moderate the market. The risk associated with rising interest rates is very real in the property market, but it remains more of a medium-term issue.

Graph 17 – Mortgage credit has outpaced incomes in Québec, especially since 2000



Sources: Statistics Canada, Canadian Mortgage and Housing Corporation, Bank of Canada, Institut de la statistique du Québec and Desjardins, Economic studies

Graph 18 – The proportion of delinquent mortgage loans posts weak uptick in Québec



Sources: Canadian Bankers Association and Desjardins, Economic studies

Table 1 - Key indicators to assess the presence or formation of a real estate bubble in Québec

| | <i>Indicators</i> | <i>Criteria</i> | <i>Bubble</i> | <i>Characteristics</i> |
|-----|--|--|---------------|---|
| 1. | Ratio – average price/disposable income | Deviation vs. the historical average | Yes | Incomplete as it does not take borrowing costs into account. |
| 2. | Ratio – mortgage payments/disposable income | Deviation vs. the historical average | No | More complete than Point 1 as it takes into account the leeway attributable to mortgage rates. |
| 3. | Ratio – mortgage payment/average rent | Deviation vs. the historical average | No | Comparative indicator of property ownership and rental costs. |
| 4. | Price equilibrium value | Deviation in the average price vs. the estimated equilibrium value | No | Equilibrium price as calculated by the model based on long-term fundamental variables (relation between prices, income and mortgage rates). |
| 5. | Desjardins Affordability Index | Deviation vs. the historical average | No | Measures the financial capacity of households to purchase a property. Takes into account all costs and the qualification income required. |
| 6. | Sales-to-new-listings ratio | > 50 risk of overheating | Yes | Incomplete as it does not take into account all real estate agent listings. |
| 7. | Total listings-to-sales ratio (or ratio of sellers/buyers) | < 5 overheated | No | More complete than point 6 as it takes into account all properties for sale by real estate agents. |
| 8. | Number of completed and unoccupied dwellings (inventories) | Deviation vs. the historical average | Yes | Partial indicator. If inventories are high and demand is sustained, this is it not an issue. |
| 9. | Time-to-sell inventory (in months) | Deviation vs. the historical average | No | More complete than point 8 as it takes demand into account number of months to sell the inventory of new homes. |
| 10. | Household debt levels | Deviation vs. the historical average | Yes | Outstanding mortgage credit on personal disposable income. Incomplete as the financial weighting depends on the interest rate. |
| 11. | Proportion of delinquent mortgage loans | Deviation vs. the historical average | No | Indicator closely tied to movements in personal bankruptcies. |

Source: Desjardins, Economic studies

In the next year or two, the likelihood of price declines in the residential sector—due to falling demand as a result of higher borrowing costs—is very low. The likelihood of a sudden price correction, with no bubble on the horizon in Québec, is minimal (table 1). The changes to come in interest rates will be

a key factor in the current cycle. Interest rates, which will probably start rising by the end of summer or in the fall, could have an impact on the financial position of households in the next few years. This question will be examined further in an upcoming *Economic Viewpoint*.

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