



Canadian real estate market: Some regions could slow or even contract

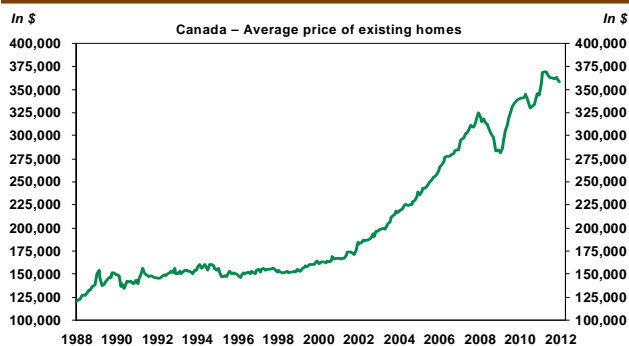
After several years of strong growth, Canada's real estate market is raising concerns. Most analysis measurements suggest that prices are not far from equilibrium levels. However, the Canadian figures are heavily influenced by the most active markets, such as Vancouver and Toronto, which interferes with the results. A regional approach, provides a more accurate idea of the health of Canada's real estate market. Although the chances the market will collapse remain relatively remote, a number of factors seem nevertheless to be in place for a gradual slowdown to materialize shortly. There are also growing signs of a decline in some markets.

A LITTLE HIGHER ... A LITTLE FURTHER ...

In March 2010, Desjardins Group's Economic Studies published an *Economic Viewpoint*¹ on the boom in the real estate market. At the time, existing home prices were oscillating just above equilibrium levels, but the spread was nowhere near the difference generally associated with a bubble. Much of the rise by prices could then be explained by the favourable factors prevailing at the time, such as low interest rates, an upswing by consumer confidence, the existence of pent-up demand from the recession, abundant mortgage credit and temporary blips associated with the introduction of new sales taxes in some provinces. In principle, the gradual disappearance of these factors was supposed to help the Canadian real estate market crest and even come down slightly, especially as, between July 2008 and January 2011, the federal government had announced three series of measures to limit access to mortgage credit. Among other things, the maximum amortization period was gradually reduced from 40 to 30 years, the minimum down payment went from 0% to 5%, and 20% for buildings not occupied by the owner, maximum refinancing was gradually reduced to 85% of the home's value (compared with 95% initially), and borrowers must now comply with the solvency criteria associated with a closed five-year mortgage, even if a shorter term is selected.

Just over 20 months have gone by since our spring 2010 *Economic Viewpoint* was released, and no convincing lull has materialized in the real estate market. In Canada, the average price for existing homes hit a peak of \$369,484 in March 2011, up 8.1% from the same period in 2010. We have seen a slight pullback in the last few months, but, at \$358,480 in December 2011, the average existing home price remains very elevated, up about 4% from last year (graph 1). What's more, the number of housing starts remains relatively high, at around 200,000 units in December, attesting to sustained activity in new home construction.

Graph 1 – Canadian housing prices continued to trend up in 2011



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

¹ Desjardins, Economic Studies, "The sudden rally in Canada's residential real estate market is surprising and troubling", March 10, 2010, www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv100310.pdf.

Some of the extended enthusiasm for the real estate market is no doubt due to the poor returns being delivered in the last

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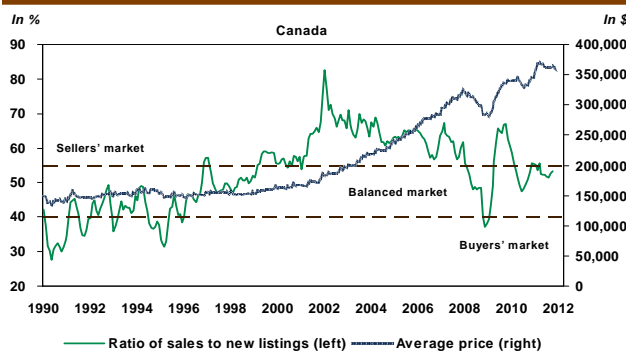
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few years by the various asset classes in the financial markets. The stock markets have seen some tough years, with the crash by tech stocks in the early 2000s and, more recently, the 2008-2009 recession and the financial crisis. Bond market yields have been positive, but their benefits have been offset by extremely low interest rates. Interest rates have also substantially reduced borrowing costs, favouring mortgage credit and, in turn, the real estate market. Given the major capital gains achieved in the real estate market in recent years, many households looking for another way to maximize their family assets clearly found investing in property a good idea. This observation of course raises fears of a resurgence by speculative transactions, a phenomenon that could increase the chances of a real estate bubble, especially in some segments of the market. Under these conditions, it is good to examine where the real estate market is in relation to equilibrium.

MARKET AT EQUILIBRIUM?

A number of indicators can be used to learn about the state of the real estate market. The most well-known indicator is the sales-to-new listings ratio. The slight drop by existing home sales since the start of 2011 combined with a fairly stable number of new listings has brought this ratio down slightly in the last few months. At 54.8 in December, it was within the zone in which the real estate market is deemed to be in equilibrium ² (graph 2). This means the upside and downside pressures on prices are relatively equal. According to this indicator, existing home prices should continue to increase moderately in the next few months, easing fears of an uncontrolled surge by prices. The ratio is also well above 40—below 40, home prices tend to decline—reducing the risk of a steep drop or correction by prices.

Graph 2 – The Canadian market is in the equilibrium zone

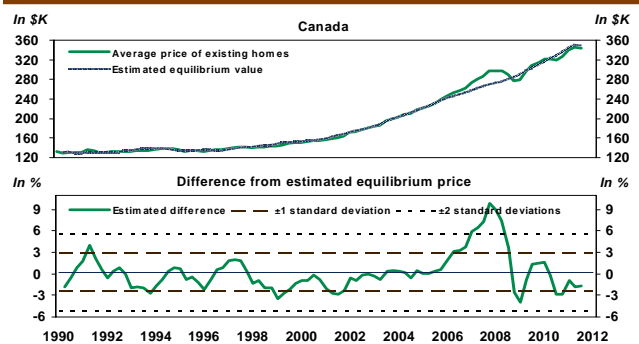


Sources: Canadian Real Estate Association and Desjardins, Economic Studies

² According to the Canada Mortgage and Housing Corporation, the resale market is deemed to be at equilibrium when the sales-to-new listings ratio is between 40 and 55.

Another way to assess the situation in the real estate market is using an equilibrium value estimated with an econometric model based on such things as income, the number of households and movement by interest rates. According to our estimates, the average price of properties in Canada would thus currently be just below its equilibrium value ³ (graph 3). At first glance, this situation may seem propitious for prices to keep rising over the next few months. That said, the gap may also be due to consumers being more cautious further to the recent deterioration by economic and financial conditions. Under these circumstances, Canada's real estate market could be considered as nearly at equilibrium.

Graph 3 – The average existing home price is just under its theoretical equilibrium value



Sources: Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies

However, the International Monetary Fund (IMF) recently issued a different opinion on the current condition of Canada's real estate market. Using an econometric model and explanatory variables slightly different than we did, the IMF finds that real estate prices are above equilibrium, primarily in Québec, Ontario and British Columbia. On average, prices would be about 10% above equilibrium value in Québec and Ontario, with the gap between 20% and 35% in British Columbia. That said, the imbalances are apparently mostly relatively limited in comparison with the situation prevailing a while ago in other parts of the world, especially the United States.

FIGURES THAT OBSCURE

The equilibrium value analysis's sensitivity to the various methods and variables used clearly show how confusing real

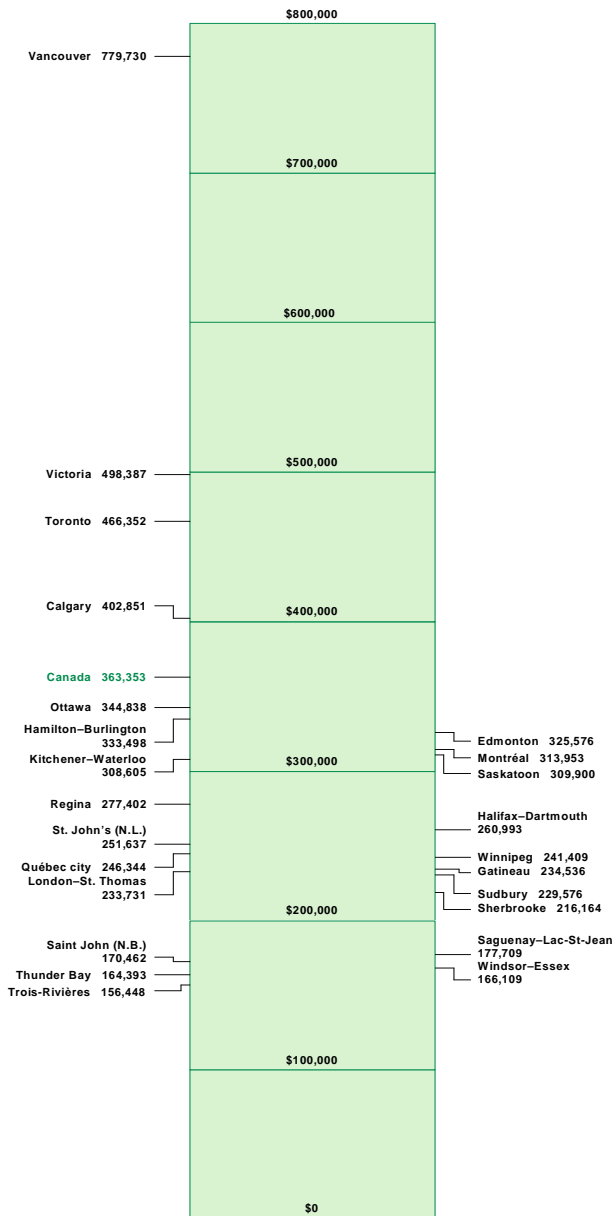
³ Strictly speaking, there are no criteria for defining a market that is booming or slightly out of balance, overheating, or a real estate bubble. For the purpose of our analysis, the gap between the average price recorded and the equilibrium price was calculated. This helped estimate the standard deviations in relation to equilibrium value. If we assume that the values seen are within one standard deviation, the market could be deemed to be slightly imbalanced. Between one and two standard deviations, the market would be overheating or substantially imbalanced. If the difference from the equilibrium price is greater than two standard deviations, it suggests that the risk of correction is growing.

estate market data can be. Much of this confusion is due to the fact that the prices generally used are derived from averages established using all of the transactions that occur during the reference month. However, those averages are somewhat skewed, especially when we consider the Canadian real estate market as a whole.

As graph 4 shows, there is a big disparity in home prices in Canada. In cities like Trois-Rivières and Windsor, the average price for 2011 is less than \$170,000. At the other end of

the spectrum, Vancouver tops the country with an average price of close to \$780,000. There is also a fairly big concentration of cities in which prices are between \$200,000 and \$350,000. Under these conditions, it may seem surprising that the average for Canada is above \$350,000, when the average price is above that level in just 4 of the country's 24 major cities. This is due to the way an average is calculated—it is heavily influenced by the extreme values. In this case, it is clear that prices in Vancouver, Victoria and, to a lesser extent, Toronto are putting very strong upside pressure on Canada's average home price. One way to fix this situation is to opt for the median in compiling the results (see the box on page 4). Unfortunately, the quality of the current data does not provide for an accurate assessment of the median price for Canada as a whole. However, some regional information is available, meaning we can put together a more disaggregated picture of Canada's real estate market. This approach has some obvious merits, as the factors that affect home prices in Vancouver are very different from the factors affecting prices in Halifax.

Graph 4 – The scale of existing home prices is very large in Canada

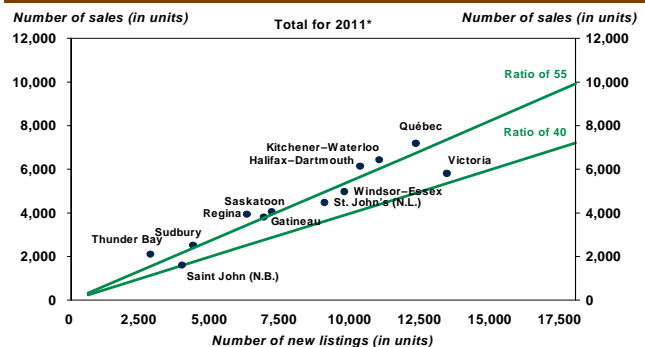


Average for 2011 except cities in Québec, for which the average is based on the first 11 months of the year. Sources: Canadian Real Estate Association, Québec Federation of Real Estate Boards and Desjardins, Economic Studies

REGIONAL ANALYSIS IS NEEDED

Given how many regions there are in the country, it is of course difficult to focus on each one. Initially, therefore, it could be useful to identify the regions that are in most danger of disequilibrium using the sales-to-new listings ratio. In graphs 5 to 7 (page 4), the zone between the two green lines corresponds to a situation that is generally considered to be equilibrium—a ratio ranging from 40 to 55. The regions between these two green lines therefore do not raise any red flags at the outset. The regions outside of this zone are generally considered to be more at risk of major price fluctuations. Some regions are far enough from the equilibrium zone that their situation is of concern. This is primarily the case with Winnipeg and Hamilton-Burlington, for the mid-size market category, and Toronto, for the large market category. Small markets do not seem to have any particular issue, to the point that no city drew our focus in this category.

Graph 5 – Relationship between sales and new listings in small markets



* Projections based on data from January to October for the cities of Québec and Gatineau. Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Average vs. median

Average and median are two statistical metrics that characterize the mid-point in a set of numerical values. The average is the value each of the elements would have if they were all equal, without changing the total of the whole. It is relatively simple to calculate. It involves dividing the sum of the elements by the total number of elements in the set. The median is the value that makes it possible to divide an ordered series of numbers (usually smallest to largest) in half, with each part having the same number of elements. Here is an example using fictitious existing home prices to illustrate the difference between the two metrics:

Assume a set of five homes with the following prices:

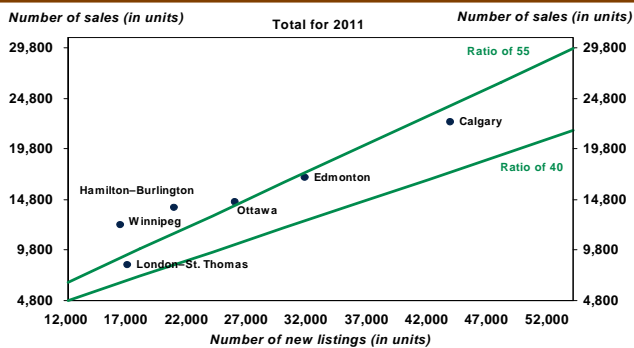
- Home A = \$125,000
- Home B = \$150,000
- Home C = \$175,000
- Home D = \$200,000
- Home E = \$500,000

The average is calculated as follows: $(\$125,000 + \$150,000 + \$175,000 + \$200,000 + \$500,000) / 5 = \$230,000$

The median is the mid-point in this orderly set, i.e. \$175,000 (Home C).

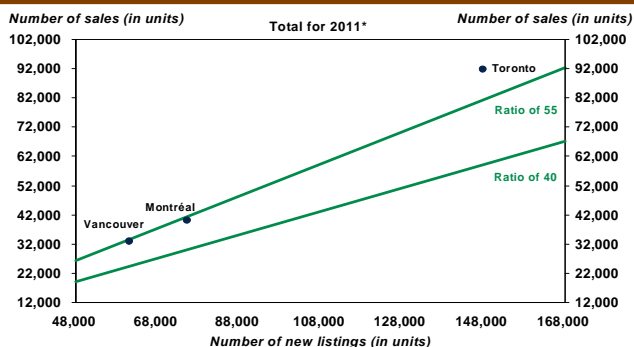
In this example, there is a gap of \$55,000 between the average and the median, more than a small difference. This shows how much influence the extreme value (\$500,000) has on the average.

Graph 6 – Relationship between sales and new listings in mid-size markets



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

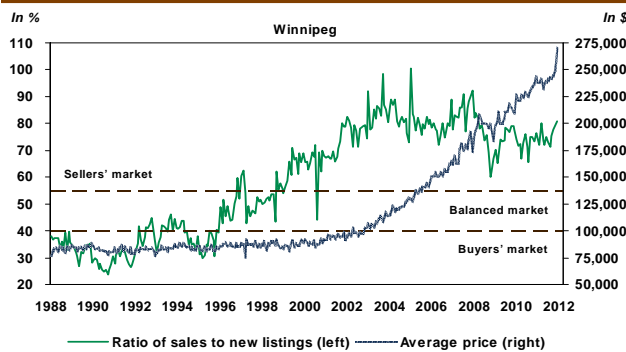
Graph 7 – Relationship between sales and new listings in large markets



* Projections based on data from January to October for Montréal.
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

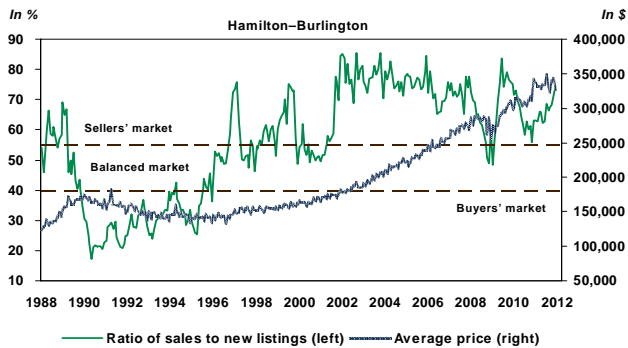
In Winnipeg and Hamilton–Burlington, there has been a major gap between sales and new listings for almost a decade. Prices there have thus gone up substantially since the early 2000s (graphs 8 and 9 [page 5]). In Winnipeg, for example, the average price has gone from about \$90,000 at the start of 2000 to almost \$270,000 in December 2011, for an annual gain of 9.5% per year during this period. Despite this strong growth, our equilibrium value estimates show that prices in Winnipeg and Hamilton–Burlington are not far from their optimal levels. The increases seen over the last few years are thus apparently justified by the normal adjustments between supply and demand (graphs 10 and 11 on page 5). The risks of a correction in these markets seem relatively low.

Graph 8 – The Winnipeg real estate market is in a zone favourable to price increases



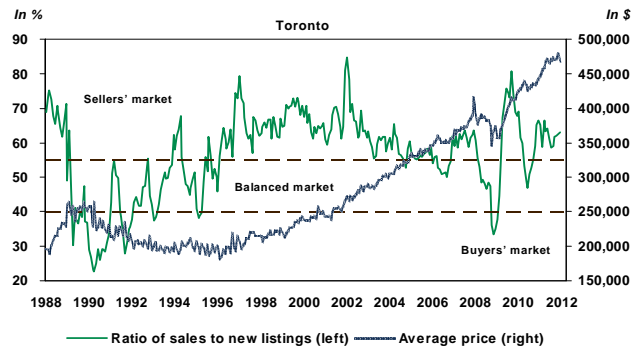
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Graph 9 – The Hamilton–Burlington real estate market is in a zone favourable to price increases



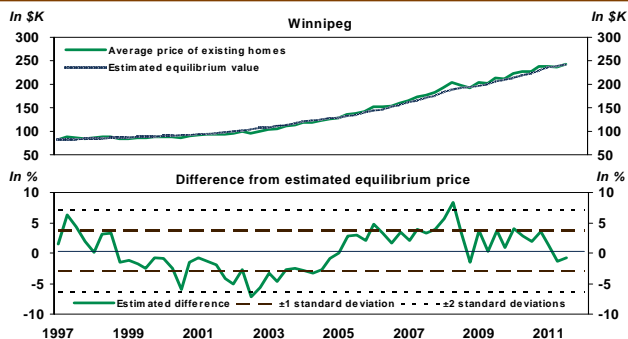
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Graph 12 – The Toronto real estate market is in a zone favourable to price increases



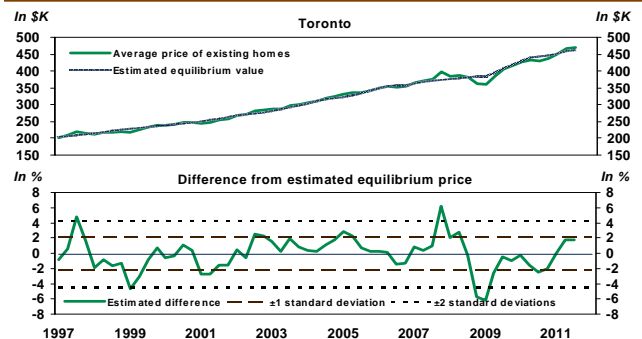
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Graph 10 – The real estate market apparently came back to equilibrium recently in Winnipeg



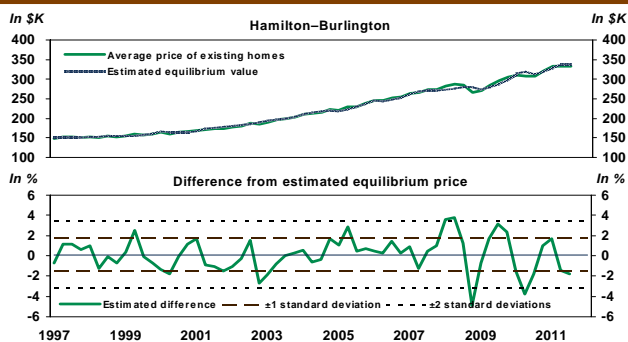
Sources: Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies

Graph 13 – In Toronto, prices are above equilibrium



Sources: Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies

Graph 11 – The existing home price is just under its equilibrium value in Hamilton–Burlington



Sources: Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies

In Toronto, except for a temporary dip during the last recession, existing home prices have gone up substantially since the end of the 1990s. Overall, the sales-to-new listings ratio has also held in sellers' market territory during this time (graph 12). According to our estimation model, the average existing home price is therefore above its equilibrium value in Toronto. The situation has not yet reached the critical threshold seen prior to the market's temporary dip in 2008, but the market is still at a level that is less and less sustainable

(graph 13). This of course opens the door to a potential correction characterized by dropping prices.

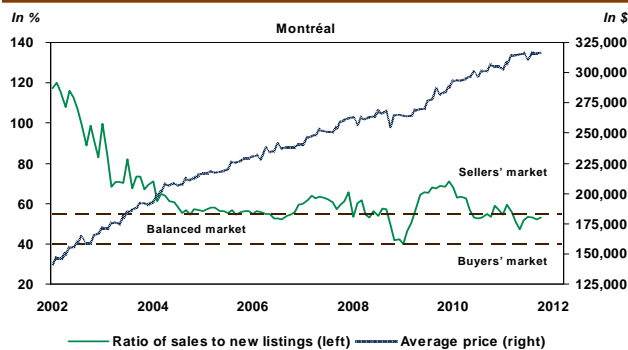
The biggest source of concern in the Toronto area is the condo sector. New construction has proliferated in recent years, and the number of existing units on the market remains elevated. The total condo supply has expanded substantially. The condo apartment vacancy rate has hit its highest level in 10 years. Despite this, prices continue to rise, posting a gain of about 9% in the third quarter of 2011 from the same period last year. Note that demand remains fairly strong. Among other things, the market seems to be getting a boost from the presence of many investors from Canada and abroad. Nearly 20% of Toronto area condos are not occupied by their owners; instead, they are rented out. This supply, intended for the rental market, is apparently filling a gap created by inadequate private investment in rental housing. However, some flagging is starting to materialize. For rental condos, the vacancy rate has increased in the last few months, indicating that demand is increasingly being met by the additional supply. Moreover, the new rules on mortgage credit instituted by the federal government (in April 2010) now stipulate a minimum down payment of 20% if the owner is not occupying the home. Such a change is of course likely to curb pur-

chases made for investment purposes. In the end, given the relatively high number of completed condo units that remain unsold, it seems likely that the market will eventually sag, a situation that should result in a decline in prices and sales in this market segment over the coming quarters.

WHAT'S HAPPENING IN MONTRÉAL AND VANCOUVER?

The regional picture of Canada's real estate market would not be complete without an overview of Montréal, the country's second largest market. Although less data are available, everything indicates that the Montréal market is close to equilibrium. The sales-to-new listings ratio is within the 40-to-55 zone, a situation propitious to moderate price growth (graph 14). According to the Fédération des chambres immobilières du Québec, the number of properties for sale in the metropolitan area has gone up substantially in the last few months. As supply rose faster than demand, conditions in the market have relaxed. In the third quarter of 2011, the number of sales was down 8% from the same time last year, attesting to a lull. Also note that, in the city of Québec and Gatineau, at first glance the market situation does not look very different from the situation in the greater Montréal area. As a result, the situation in the Québec real estate market is still relatively healthy.

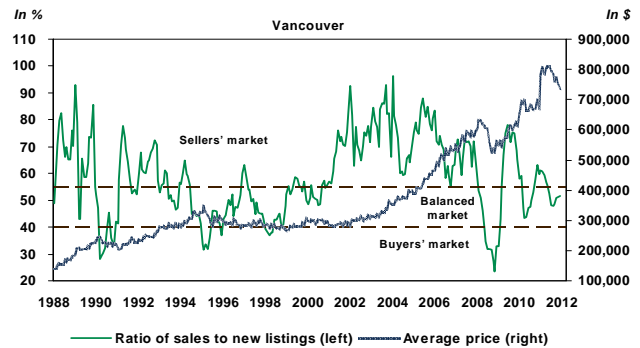
Graph 14 – Price pressures are relatively balanced in Montréal



Sources: Québec Federation of Real Estate Boards, Canadian Real Estate Association and Desjardins, Economic Studies

Lastly, although its sales-to-new listings ratio does not seem to be pointing to any problems, Vancouver's real estate market must also get close attention. It has been defying the laws of gravity for many years now, with prices hitting unthinkable levels. After peaking above \$810,000 in June, the average existing home price dropped to \$734,766 in December, down 9% in just six months. A rise in new listings and a drop by sales also helped bring the ratio back into equilibrium territory (graph 15). Is this the start of a lull in Vancouver's real estate market? Nothing could be further from certain. A similar decline occurred in the last recession, which did not stop the euphoria from returning once the recovery began. In fact, although it is not very conclusive as it is highly vola-

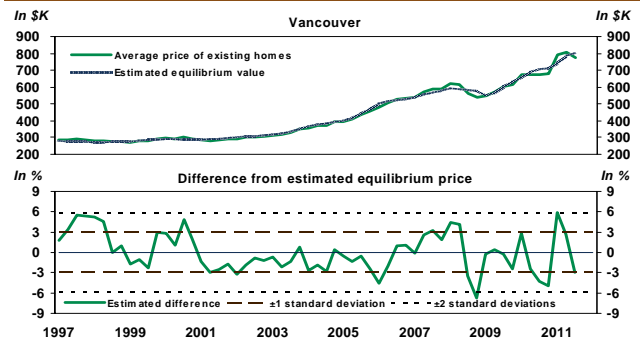
Graph 15 – The sales-to-new listings ratio has just returned to the equilibrium zone in Vancouver



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

tile, a look at our equilibrium value intimates that the average existing home price in Vancouver is below its equilibrium value, suggesting prices will start to rise again in the fairly near future (graph 16).

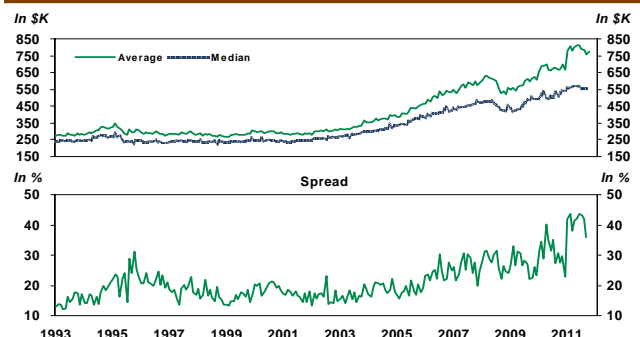
Graph 16 – Vancouver's existing home prices may recently have dropped below equilibrium



Sources: Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies

In the Vancouver market, there is a great deal of disparity among the different regions, which no doubt muddies the waters. As graph 17 shows, the gap between the median price and average price is currently almost 40%. Clearly, the price

Graph 17 – The gap between the median and average existing home price widened in Vancouver



Sources: Canadian Real Estate Association, Toronto Real Estate Board, Statistics Canada and Desjardins, Economic Studies

average is heavily influenced by the extreme values noted in some very sought-after neighbourhoods.⁴ In the early 2000s, the gap between the two measurements was below 20%. This demonstrates the degree to which the extreme values are gaining more and more weight in the figures usually put forward for the Vancouver area. The general picture of the Vancouver real estate market after the extreme values are excluded is therefore not as disproportionate as one may think at first. For example, the gap between the average prices in Vancouver and Toronto is nearly \$305,000 (or 65%). This gap is much smaller once we look at the median prices, at \$160,000 (or 40%), a difference that is easier to ascribe to the two markets' different characteristics. Among other things, demand for housing is apparently inflated in Vancouver due to the presence of many foreign investors (particularly from Asia). However, the recent deterioration in global economic conditions could make many international investors more cautious, reducing demand in the Vancouver real estate market. Under these conditions, the Vancouver real estate market seems especially fragile, as prior price increases have substantially decreased affordability for the region's households. As in the last few months, Vancouver is likely to see an ongoing decline in prices and sales over the next few quarters. That said, given the excesses noted in some market segments, we could see a steeper correction.

ARE WE ON THE VERGE OF A LASTING SLOWDOWN?

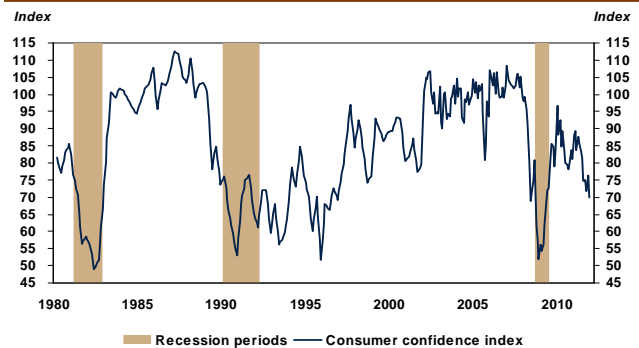
All in all, there are few places in Canada where the real estate market situation raises real concerns. In Toronto, the condo sector could become a worry, but some signs suggest that market conditions are gradually cooling. In Vancouver, the big disparities muddy the picture. Without them, conditions are not nearly as dramatic, even though eroding global economic conditions could fuel the current slowdown. In other words, the data do not indicate a true bubble in Canada's real estate market.

That said, everything suggests that Canada's real estate market is heading for a gradual and orderly pullback. A number of signs of flagging materialized recently. In Vancouver, the number of transactions and prices have been declining for several months. The market is also cresting in several regions, including Calgary, Edmonton, St. John (N.B.), Saskatoon and St. Catharines.

A variety of factors lean toward some moderation by Canada's real estate market. Following a sustained economic recovery that, among other things, allowed the employment market to

fully recoup the jobs lost during the recession, economic conditions have worsened recently. As Canada's economy is very open to foreign trade, the problems in Europe and concerns about international financial markets have a big impact here. Movement by the job market has been more erratic in the last few months, and the outlook for job creation has clearly come down. Consumer confidence has also deteriorated since last spring (graph 18).

Graph 18 – Canadian consumer confidence has declined in the last few months



Sources: Conference Board of Canada and Desjardins, Economic Studies

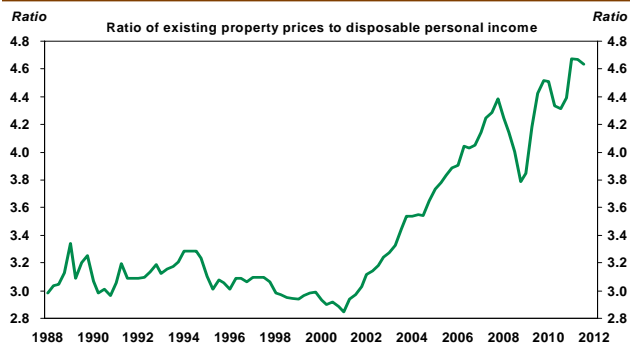
Wage growth has also slowed recently. The annual variation for average weekly wages slid from 4.5% in January to 2.2% in November. If we factor in the 2.9% total annual inflation rate, wage growth in real terms is in slightly negative territory. This means Canadian workers' purchasing power has deteriorated somewhat during this time. This situation is not good for consumer spending or residential investment.

The increase in property prices over the last few years is, on its own, becoming a growing curb on the real estate market. Despite a slight dip in the third quarter of 2011, the ratio between the average existing home price and households' disposable income remains very high, historically speaking (graph 19 on page 8). Clearly, buying a house is becoming less and less affordable. That said, interest rates remain exceptionally low, historically speaking, which is limiting the deterioration by the Canadian real estate market's affordability, for now. The affordability index compiled by Desjardins Group's Economic Studies is currently just below its historic average (graph 20 on page 8). In the next few years, however, interest rates could be higher, which should erode affordability.

In closing, the financial situation of Canadian households could increasingly hurt the real estate market. The magnitude of consumer debt is going from record high to record high, and the sharp rise in mortgage credit that accompanied the real estate euphoria of the last few years is largely responsible for that. The situation is not too worrisome for

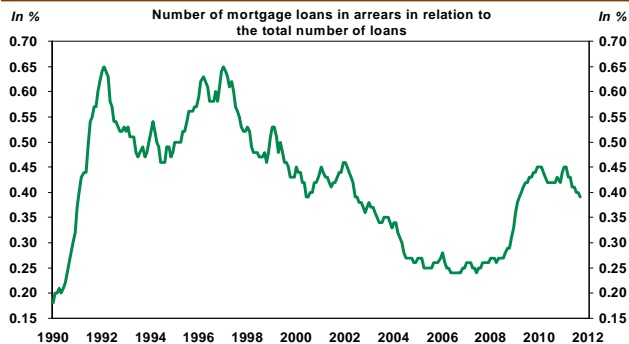
⁴ For example, the price of a typical single-family home in Vancouver West (close to downtown) was \$2,008,702 in October, compared with \$444,862 in the Maple Ridge region (eastern suburb).

Graph 19 – Real estate prices are very high compared with household income



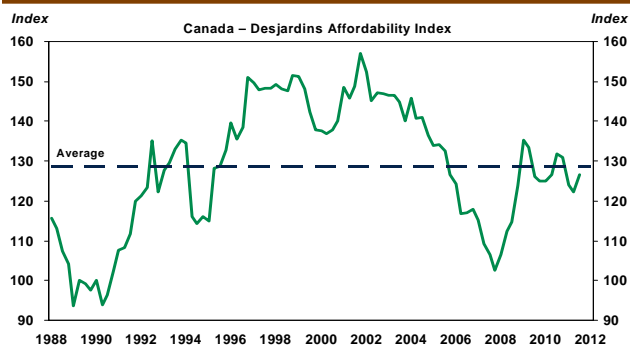
Sources: Canadian Real Estate Association, Statistics Canada and Desjardins, Economic Studies

Graph 22 – Delinquent mortgage loans remain relatively low in Canada



Sources: Canadian Bankers Association and Desjardins, Economic Studies

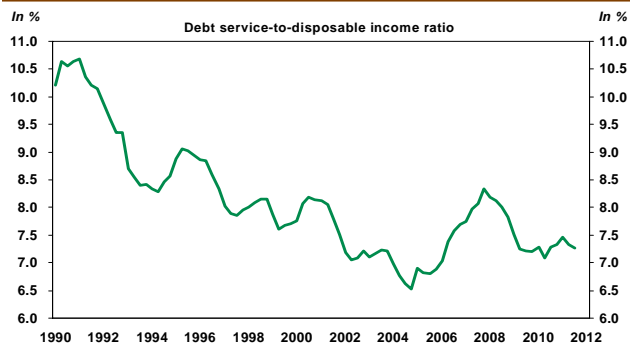
Graph 20 – The affordability index is just below its historic average



Source: Desjardins, Economic Studies

now, as interest rates remain very low. Household debt service has been holding under 7.5% since 2009 (graph 21), with the number of loans in arrears relatively low (graph 22). That said, as interest rates are close to a floor, they will have to go up at some point. Even though most studies try to be reassuring, some households could have a harder time meeting their financial obligations once interest rates start to go up. A number of stakeholders have begun to warn Canadians about overly high debt loads, including Bank of Canada and federal

Graph 21 – Despite the rise in debt, debt service is under control thanks to low interest rates



Sources: Statistics Canada and Desjardins, Economic Studies

government leaders. We can hope this message is increasingly getting across and more prudence will materialize. Slowing household debt, however, necessarily comes with slower growth by the real estate market.

For these reasons, it seems likely that we will see the real estate market slow in the coming quarters. A gradual, controlled drop in prices and sales could be recorded in the next few years, especially in areas with larger imbalances, such as Toronto and Vancouver.

That said, an economy's adjustments often happen more quickly than initially anticipated. We can therefore not rule out the possibility of a sharper correction by the real estate market, especially if Canada's economy is hit with a major shock, such as a steep drop in commodity prices or a substantial decline in earnings and employment resulting from heavier erosion of economic conditions. Although the risks of sharp corrections primarily affect Toronto and Vancouver, these two markets could potentially generate a negative spillover effect that could impact the entire Canadian real estate market.

Of course, a real estate market correction could have major repercussions for Canada's economy. In addition to direct impacts on the real estate sector, such as revenues from property transfers and home building, the deterioration in the value of household assets could also rein in consumer spending growth. For example, a recent IMF study showed that each permanent one-dollar drop in the value of Canadians' real estate assets would prompt a reduction of about \$4.30 in consumer spending. Thus, a 25% decline in the current value of real estate assets would result in a pullback of about \$7B in consumer spending, representing an additional drop of 0.7% in the nominal GDP over one year.

The real estate market's movement is clearly a leading issue for Canada's economy. As we said earlier, the government



has already made three attempts to curb the real estate market's advance by tightening mortgage lending conditions. The goal is of course to find the right mix to slow the market without making it collapse. However, the third series of measures was announced nearly a year ago now, and we must conclude that the tightening introduced to date has not slowed the market enough. Under these conditions, it is likely, and perhaps even desirable, that the federal government will shortly announce a fourth series of measures to further limit mortgage credit. Among other things, the government could be tempted to once again raise the minimum down payment on new loans (it went from 0% to 5% in October 2008).

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