



## Far from widespread, prices for residential housing will continue to fall in some regions across the country

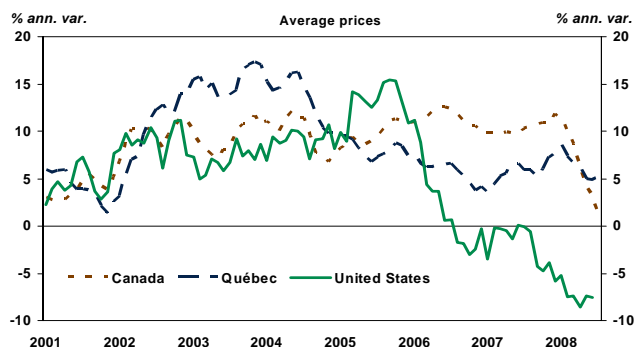
Until very recently, Canada's housing market showed exceptional strength, appearing impervious to the meltdown currently taking place in the United States. And while the downturn took some time to affect Canada, it now has the country firmly in its grip. The landing will probably be more brutal in some parts of the country, especially in certain western Canada cities where the overheated housing market has been more intense these past few years. Where prices have already started to fall in some populated areas, the question can be heard: Is this the start of a downward market in Canada? Is Québec, which up to now seems to have resisted this downward trend better than other parts of the country (graph 1), still able to withstand a more widespread drop in prices? In an environment where residential housing is at a turning point, now is the time to pinpoint the locations and niche markets that are most at risk.

### NO U.S.-STYLE DEBACLE IN CANADA

Since the summer of 2007, setbacks in the U.S. real estate market keep making the headlines. Increased borrowing costs, and the start of the liquidity and credit crises sparked a meltdown in the construction of new homes and a broad drop in home prices. Since reaching their peak in January 2006, housing starts have fallen by about 60%, and existing home prices have depreciated by about 20%. While the worst of this deterioration now seems to be behind us, there are no clear signs of price stabilization on the horizon. Faced with enormous difficulties, some of the financial corporations involved in providing subprime mortgage loans were forced into bankruptcy while Fannie Mae and Freddie Mac were placed under the control of the U.S. government at the beginning of September. These actions indicate that this tidal wave of bad news is unlikely to be over. Access to credit remains difficult and the residential sector hasn't hit the bottom of the barrel yet. Could Canada's market, which has resisted the turmoil until now, tumble as well?

Many factors are at the root of the real estate meltdown in the U.S. The effervescence of the early 2000 was magnified by the increasing number of high-risk loans—financing granted to borrowers with weak solvency ratings. In 2006, before the bubble exploded, these products represented 22% of all new mortgage loans granted in the United States vs. less than 5% in Canada. Lenders proved to be much more rigorous in their

Graph 1 – Québec's real estate market resisting headwinds, as shown by price gains



Sources: Census Bureau, Canadian Real Estate Association and Desjardins, Economic Studies

lending practices on this side of the border. In addition, the requirement in Canada to take out mortgage loan insurance when the down payment is less than 20% of the property's value is another protection for financial institutions in case borrowers default on their payments (see box on page 2). The potential for mortgage loans to default in this country is almost nonexistent since the financial position of lending institutions is relatively sound overall. Moreover, borrowers' strict selection criteria further reduce the risk of defaulting on payments. In this context, we can ask ourselves this question: Are we protected from a widespread decline in real estate prices?

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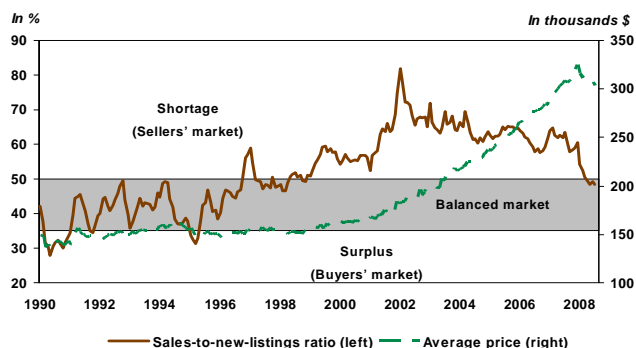
**THE RETURN OF STRICTER REGULATIONS**

The current real estate cycle was extended as a result of softened rules on mortgage insurance. In 2006, several measures were implemented to make it easier to purchase property across the country. Amortization periods were extended beyond the standard 25 years—to up to 40 years even—with the possibility of getting mortgage insurance while making interest-only payments for 10 years with no down payment. Even though the market had been barely affordable these past few years, these measures delayed the slowdown. In July 2008, the Department of Finance announced that it would apply federal restrictions when granting mortgage loans. The maximum amortization period for new mortgage loans would be reduced to 35 years as of October 2008, with principal and interest reimbursed as of the first year. The minimum down payment would have to be equal to at least 5% of the value of the loan in order to secure insurance. This return to somewhat more balanced borrowing should restrict access to property slightly in the coming months, which will further cool down the residential market.

**THE MARKET AT A TURNING POINT**

Even if demand for housing was not artificially inflated in Canada, the signs of a weakening market have been swirling around us for a few months now. New construction began to shift downward while home prices peaked due to the downturn in western Canada. This gradual slowdown is most welcome and signals a return to a balanced market after several years of overheating (graph 2). In fact, soaring real estate prices set off a mechanism that stabilized the market.

**Graph 2 – Return to a balanced market in Canada puts an end to strong price advances**

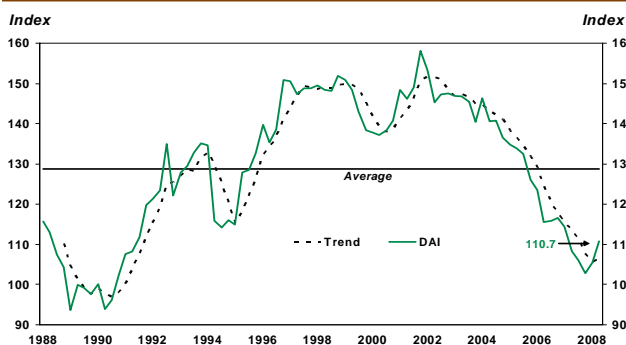


Sources: Canadian Real Estate Association and Desjardins, Economic Studies

Until very recently, this decade has been characterized by a shortage prompted by the economic boom and weak mortgage rates. The number of properties for sale was insufficient to satisfy the strong demand for housing. This sellers' market led to quick price hikes and, in some cases, bidding wars.

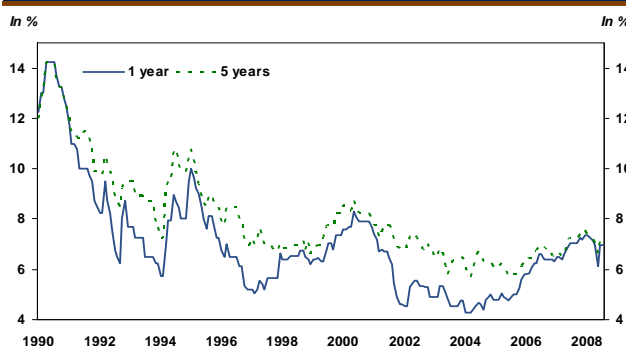
These increases made it much more expensive to buy a home on average in Canada. The Desjardins Affordability Index (graph 3), which evaluates the financial capacity of households to purchase a home, is in fact approaching the low point reached in the 1990s. At this time, soaring interest rates (graph 4), designed to fight inflation and public deficits, finally led to a recession that saw the real estate bubble burst. At that time, the fight against inflation was also heating up, which led to higher borrowing costs. It took about 10 years before another growth period began.

**Graph 3 – Desjardins Affordability Index near 1990 low point in Canada: The housing market is barely affordable**



Source: Desjardins, Economic Studies

**Graph 4 – Mortgage rates won't collapse the market like in 1990**



Sources: Statistics Canada and Desjardins, Economic Studies

This time, however, it's the high price levels that are curbing enthusiasm. Price advances had been supported by fundamentals—strong employment and low interest rates—not softening credit conditions. Canada's real estate market is therefore not overvalued, a finding confirmed through a recent study published by the IMF<sup>1</sup>. In fact, Canada and Austria are the only countries that have been spared from the real estate bubble that has affected most major industrialized countries. As such, Canada should avoid any widespread declines in

home prices, even if certain markets post price drops. While Canada's economy is on the verge of a recession, the deterioration of the labour market is far less pronounced than what we saw in the early 1990s. Unless Canada posts significant job losses in the coming months, the slowdown in the real estate market will be gradual overall. That said, any substantial deterioration in the financial environment on a global scale could indeed further undermine financial institutions, which would only see a further tightening of credit conditions. Canada's real estate market would then be subjected to the dreaded contagion we have heard so much about. The current financial crisis could have some surprises in store.

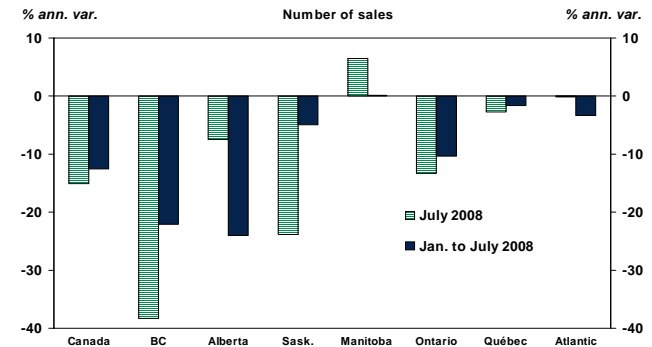
**PRICES FALLING IN WESTERN CANADA**

For the moment, the market in Canada is nowhere near the widespread market surplus we are seeing in the United States. After several years of booming activity that even led to a shortage of housing, we are gradually returning to balanced conditions. The key indicator that assesses the resale market, the sales-to-new-listings ratio, allows us to gauge how the supply of properties is satisfying demand. According to the CMHC, a balanced market is achieved when this ratio ranges between 35 and 50.

In a balanced market, price advances are usually in line with inflation. Since the start of 2008, prices have increased by 2.7% across the country. Major regional discrepancies in some markets came to light quite quickly, however. Some markets are inching toward a surplus situation, especially in Alberta and British Columbia (graph 5). Property sales in these two provinces tumbled by approximately 25% since the start of the year (graph 6). And since prices rose to stratospheric levels over the past few years in those markets, the breaking point was reached that much sooner, meaning that the landing will be that much harder.

Since 2001, prices have more than doubled in British Columbia, Alberta and Saskatchewan (graph 7), with that pro-

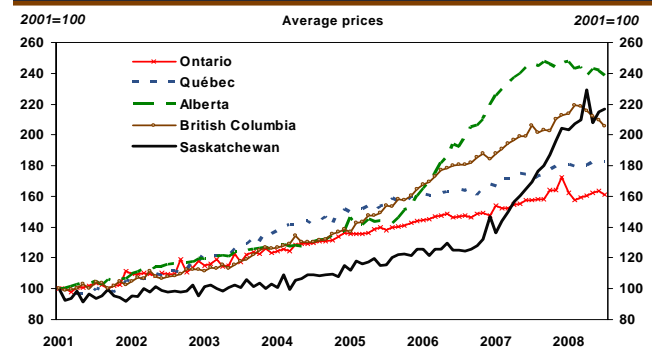
**Graph 6 – Sharp drop in property sales in some regions across Canada**



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

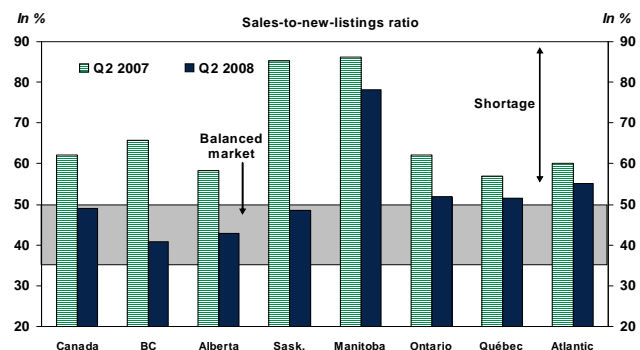
vince posting the highest price increases since the start of 2008. Saskatchewan's figure (\$223,630) has now surpassed that of Québec (\$212,578). According to the CMHC, speculators who are selling properties purchased in 2007 have been contributing to the strong increase in the number of properties available in Saskatchewan. This would explain the sudden return to a balanced market in the second quarter, which could be fleeting however. The year-over-year price increases of more than 25% in July reflect a market that is in full swing (graph 8). Since the start of the decade, prices have

**Graph 7 – Prices falling in the West, where they advanced the most**



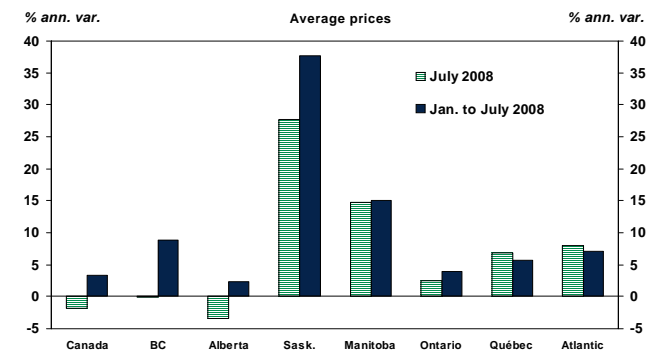
Sources: Canadian Real Estate Association and Desjardins, Economic Studies

**Graph 5 – Most markets are returning to balanced conditions, some are even approaching surplus**



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

**Graph 8 – Only Manitoba and Saskatchewan show sharp price increases**



Sources: Canadian Real Estate Association and Desjardins, Economic Studies

advanced more slowly in Québec (+82%) and in Ontario (+60%). While sales have retreated slightly in eastern and central Canada, prices continue to post modest increases. The slower price advances of the past few years and the return to a more balanced market will prevent any major price declines in both of these provinces.

**SOME CITIES PULLING CANADIAN PRICES DOWN LOWER**

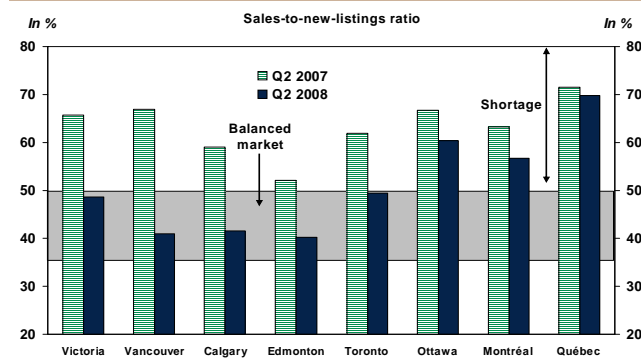
In June, year-over-year prices showed a drop in Canada. This shift began a few months earlier in the population clusters of Calgary, Edmonton and Windsor, Ontario (heavily affected by the decline of the automobile industry). Vancouver and Victoria were added to the mix over the months, bringing the total number of major urban centres showing price declines to five. In contrast, prices continued to advance in 20 of the 25 main centres across Canada last month. Right now, the markets in Vancouver, Calgary and Edmonton are not as tight as those in other major cities (graph 9). In August, prices weakened by 5% and more vs. prices seen a year ago (graph 10). And since properties are very expensive in Vancouver and Calgary, i.e. \$557,000 and \$390,000 respectively, and the number of sales is slipping, this contributes to reducing average prices across the country. Price declines are not widespread but contained in several western Canada cities.

And since these same cities had carved the path to soaring home values and their weighting in the volume of sales had increased over the years, the downward shift in prices is enough to slash average home prices across the board in Canada.

And yet the market is reaching a turning point. If the economic environment is slow to improve and demand weakens further, price declines could spread to other cities. More markets would have to reach a surplus situation to get to that point, which seems unlikely in the short term but it could happen. According to the sales-to-new-listings ratio, Toronto poses the greatest risk. For the moment, the market in Toronto has just reached equilibrium. The market would have to deteriorate significantly to see prices shift further downwards in some major markets. Montréal, Québec and Ottawa, where slight shortages have been recorded, seem to be sheltered from any possible depreciation.

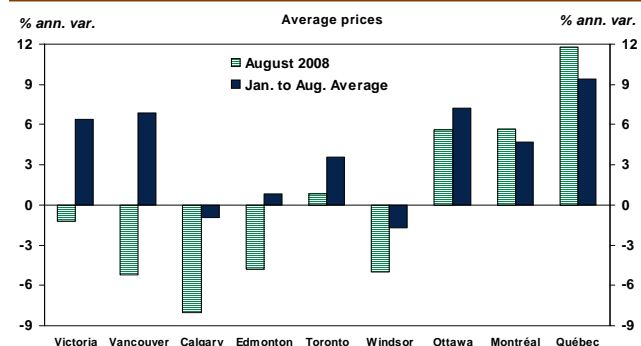
Despite the recent change in the direction of home prices in Canada, the advances recorded in the first half of the year will still allow us to post an increase of between 2.0% and 2.5% by the end of 2008. A drop seems almost inevitable in 2009, possibly even up to 5%. Demand will be slow to pick up and the price corrections we are already seeing in some cities will broaden. The more modest increases anticipated in the east central part of the country will be insufficient to offset price declines. In addition, stricter rules for granting mortgage loans, especially the end of the 40-year amortization period, will further limit the pool of potential home buyers. This option proved most popular for a large part of the market in western Canada due to higher property prices. The pullback will be even more pronounced.

**Graph 9 – Three Western cities to show surplus soon**



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

**Graph 10 – Prices in some major markets continue to fall**



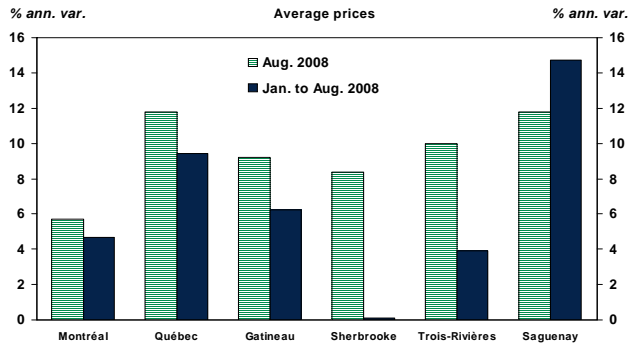
Sources: Canadian Real Estate Association, Québec Federation of Real Estate Boards and Desjardins, Economic Studies

**QUÉBEC HOLDING ITS OWN AGAINST HEADWINDS**

In Québec, the residential sector seems light years away from the debacle taking place in the U.S. While price advances have slowed since the start of 2008, annual increases still exceed 5%. This is in stark contrast to the meltdown in home values taking place in the U.S. and the stabilization taking hold in Canada's market. The market in Québec is gradually becoming more balanced, such that we are not about to see any surplus-related price drops anytime soon. We therefore anticipate market advances of 4.5% this year and 2.7% next year.

Up to now, none of Québec's six metropolitan regions has posted price declines (graph 11). The market in Sherbrooke has been stable since the beginning of the year—it's the most relaxed market in Québec, in fact. The sharpest increase, almost 15%, occurred in Saguenay, where the number of homes for sale is insufficient to satisfy demand. Prices are increasing by about 10% in Québec and 5% in Montréal, with Gatineau falling somewhere in between. In Trois-Rivières, prices have

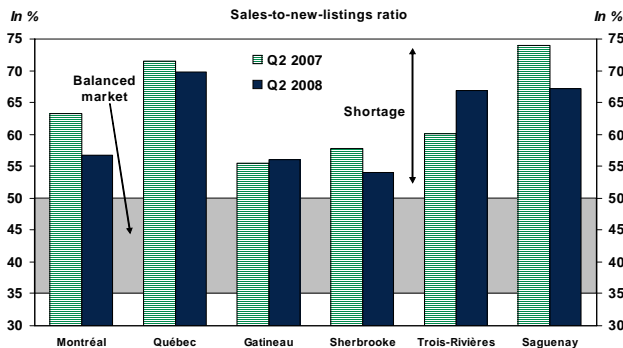
Graph 11 – Price increases in Québec are sustained



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

increased by close to 4% since the start of the year. In short, besides the brief period of stagnation in the Estrie region, Québec's main cities are far from showing the price declines we are seeing in other regions across the country. And since the sales-to-new-listings ratio shows that we are far from a surplus situation (graph 12), the odds of prices falling are almost zero at the moment. The only things that could possibly change this scenario would be a major shift in the labour market, soaring interest rates or a tightening of credit conditions.

Graph 12 – Major markets in Québec still show some shortages



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

### A CLOSER LOOK AT MONTRÉAL

In Greater Montréal, the market has softened somewhat recently but the shortage situation hasn't been completely eliminated. Even if sellers still have the upper hand during negotiations, buyers are in a better position to demand fair prices. This situation bodes well for overall price increases of approximately 5%.

Demand is toning down on the Island of Montréal, as reflected in the year-over-year drop of 10% recorded. The more affordable properties are still the most popular which favours some areas over others. On the island, demand remains strong

in Rosemont, St-Léonard and in LaSalle, where prices are rising at a faster rate, i.e. 7% to 8%. In these areas, the average price for a single-family home is 30% less than overall prices on the Island of Montréal<sup>2</sup>. In the more expensive neighbourhoods such as the Town of Mount Royal, Westmount and Outremont, prices seem to have levelled off above the \$700,000 mark for a single-family home. Demand is slowing significantly across the board in the high-end market, which is more vulnerable to price declines.

Prices that reached stratospheric levels these past few years led to a shift in demand for housing in different areas of the city, and high prices have enhanced the appeal of semi-detached homes, row houses and condominiums to the detriment of single-family homes. In the Montréal CMA, the price difference between a condo and a single-family home is approximately \$50,000. On the Island of Montréal however, the price difference can reach \$125,000 and climb up to \$400,000 in the areas around the downtown core. As such, the market is very strong in the eastern part of the island where condo sales have jumped by 20% since last year. It costs on average \$160,000 to purchase a condominium in this area vs. \$250,000 for a condo on the island, which explains the growing popularity of housing in this area.

A market running on two speeds is a good way to describe the current slowdown. Demand is still strong for affordable homes, while the more expensive homes are suffering a decline. Single-family homes no longer rule among buyers. New construction is also showing a similar trend throughout the province. In the first half of 2008, housing starts for single-family homes fell by 5.9% vs. the same period last year whereas sales of semi-detached and row houses jumped by more than 10% due to the lower prices for these homes. For example, in the Montréal CMA, the construction cost for a new single-family home is approximately \$325,000 compared to \$230,000 for a semi-detached home.

Condo construction saw the sharpest increase, i.e. 23% in the first half of 2008. After posting declines for three consecutive years, condominiums are enjoying newfound growth. This type of product not only appeals to baby-boomers with changing lifestyles, condos are attracting first-time buyers with limited leeway. The number of new condos that remain unsold is low and units are liquidated quite quickly, i.e. in eight months in Québec, Montréal and Gatineau. The state of downtown Montréal's real estate market was a concern at the start of 2007 since it took on average two years to liquidate all available condo units. By the end of the year, the situation had improved with most units taking eight months to liquidate. By now, however, a bit more time may be required. Condo construction is far from being over-abundant given that most units find takers during the pre-sale phase.

### NO WIDESPREAD PRICE DECLINES

In short, even if the resale market is approaching equilibrium in Canada, surpluses are beginning to creep up in some parts of the country, which pushes prices downward. This is the start of a bearish market that will take hold in a few cities that are ripe for a correction. The soaring prices of the past few years are behind this sagging market. While prices are dropping in 5 of the 25 major markets, the risks of contagion across the country are there, but are limited for the time being. The price reductions we are seeing in some locations will become more widespread in the coming months, which will result in more marked declines in average prices in Canada. Next year, the drop could reach 5% even if it is limited to some markets out West only. These past years' overheated conditions, combined with speculation in some areas, will unfortunately intensify the return of the pendulum.

In these circumstances, Québec and Ontario (except for some areas affected by the troubles in the automobile sector), should do fairly well. A market that is running on two speeds is an apt way of describing the current slowdown. We will continue to see shifts in favour of more affordable housing to the detriment of single-family homes. We may see prices for up-market homes fall as well. This market niche is usually the first to suffer

from a slowdown in demand, and this will be case again this time. Québec should continue to resist the headwinds and come out of this in better shape than the rest of the country overall. The possibility of prices falling in Québec is extremely weak at the moment. However, if the current financial crisis continues to unravel, the real estate market in Québec—much like the rest of the country—could suffer a backlash, in which case the landing would be far more brutal than expected.

### WEALTH EFFECT STALLS IN WESTERN CANADA

In the past few years, rising prices for residential real estate were a major contributor to household wealth. This sudden reversal, especially in some western Canada cities, means that real estate will no longer be able to support household spending as it has. In eastern and central Canada, the wealth effect related to rising real estate values will continue to solidify the financial position of households. This is an asset for Québec's economy and one less risk for Québec's consumers to worry about.

**Hélène Bégin**  
Senior Economist

<sup>1</sup> International Monetary Fund (IMF), World Economic Outlook, April 2008.

<sup>2</sup> Greater Montréal Real Estate Board and the Canada Mortgage and Housing Corporation (CMHC), Resale Market Analysis, Q2 2008.