

## **ALTHOUGH THERE IS NO REAL ESTATE BUBBLE IN CANADA, REGIONAL DISPARITIES ARE GENERATING SOME CONCERNS**

### Summary

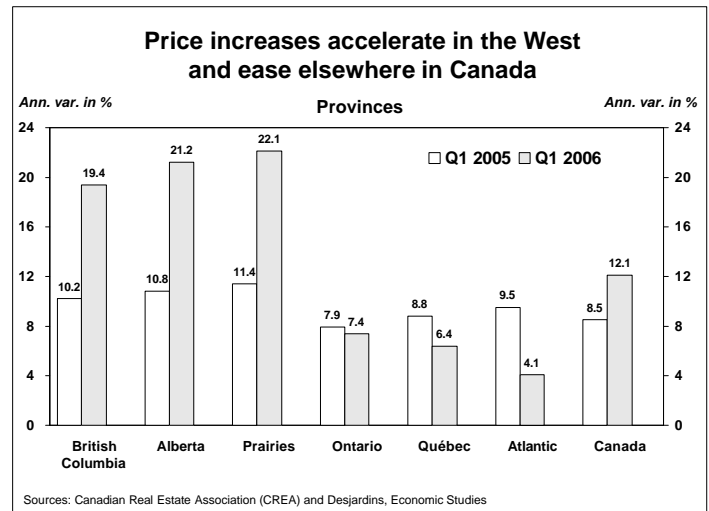
Even though the fears of a wide-spread real estate bubble can be dismissed at the national level<sup>1</sup>, the market's recent evolution is raising some concerns in some parts of the country. On one hand, price increases have been easing in Ontario and Québec for the last year, while they are speeding up in western Canada. Just like the Canadian economy, the real estate market is operating at two different speeds, and regional disparities have even intensified lately. Behind this lightning-quick property appreciation, a number of elements indicate that fundamental factors justify this booming market, although some cities, such as Vancouver, and some segments, like the condo market, are more at risk. The condo apartment market, which is also much more vulnerable to a price decrease resulting from pronounced cyclical movements, will be the subject of in-depth analysis here.

At the provincial level, the risks of a brutal drop in prices like the one seen at the start of the 90s are slight. The various market indicators presented in this section suggest instead that price increases will continue in the short term, though their magnitude will vary from one end of the country to the other. As a real estate bubble is often confined to a few cities, it is still important to go beyond a national or provincial diagnosis.

### Overheating intensifies in the west

While resale markets in central and eastern Canada are almost back at equilibrium following the boom in the first half of the decade, pressure in the west is only intensifying. It is so strong that the entire Canadian market remains tight, and price increases are accelerating steadily. In the first quarter of 2006, the annual change was in the neighbourhood of 20% in British Columbia, Alberta and the Prairie provinces. This is twice as fast as a year ago, and reflects greater tension in the country's western markets. Conversely, the tension is easing in the central provinces, so that price increases above 10%, as seen in Québec from 2002 to 2004, are now a thing of the past. The disparities between the country's largest cities are even more striking. The Vancouver and Calgary markets are clearly overheating, with price increases over 20%, in contrast to annual increases of about 5% in Toronto and Montréal in the first quarter of 2006.

To determine the market's cyclical position and, as a result, the short-term trajectory for prices, we must first accurately gauge the evolution of supply in relation to demand. The ratio of sales to new listings helps determine whether it is a seller's market, a buyer's market, or whether the market is at



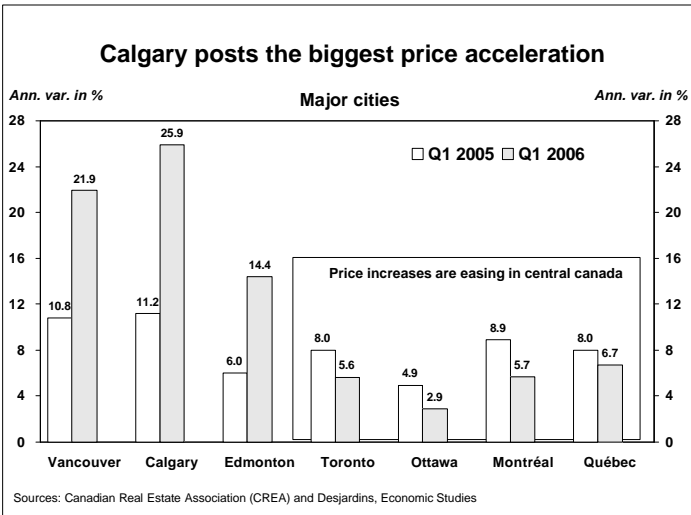
equilibrium. Here, this ratio represents the number of properties sold in a quarter compared to the number of homes that were newly listed for sale with real estate agents. According to the Canada Mortgage and Housing Corporation (CMHC), a sales/new listings ratio of 35% to 50% is symptomatic of market equilibrium.

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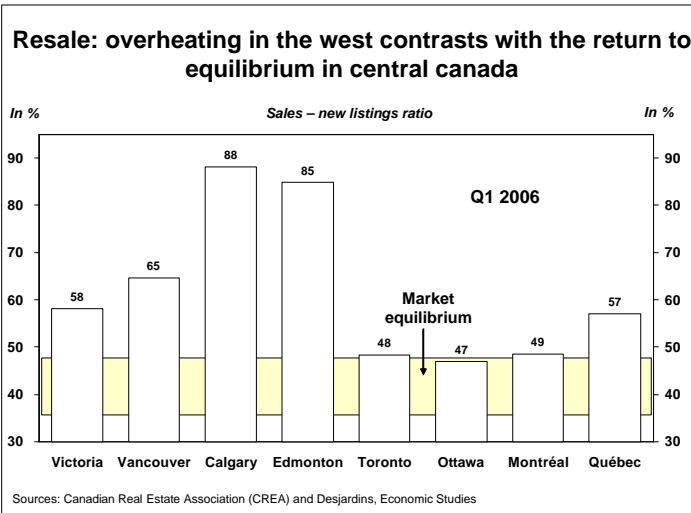
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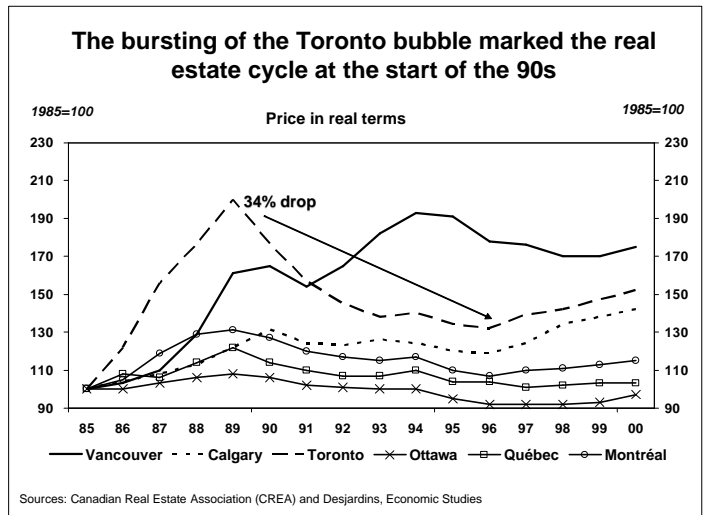
**Prices will continue to rise**

In central and eastern Canada, the market is tending toward equilibrium, meaning that the increase in prices will slowly move toward inflation. A stabilization or decline in prices only occurs when it is a seller's market, i.e. a ratio below 35. This was the situation nationwide at the start of the 90s, after the real estate bubble burst. The current ratio, around 55, dismisses any possibility of a generalized decline by prices in Canada, for the moment. The market still remains very tight in western Canada, with a sales/new listings ratio well above 50, which will continue to fuel price growth in the short term. In fact, price increases will exceed inflation as long as sellers have the upper hand. In the near term, unless an economic shock such as a recession or escalating interest rates causes demand to plummet, no generalized decline in prices is on the radar at the provincial level.



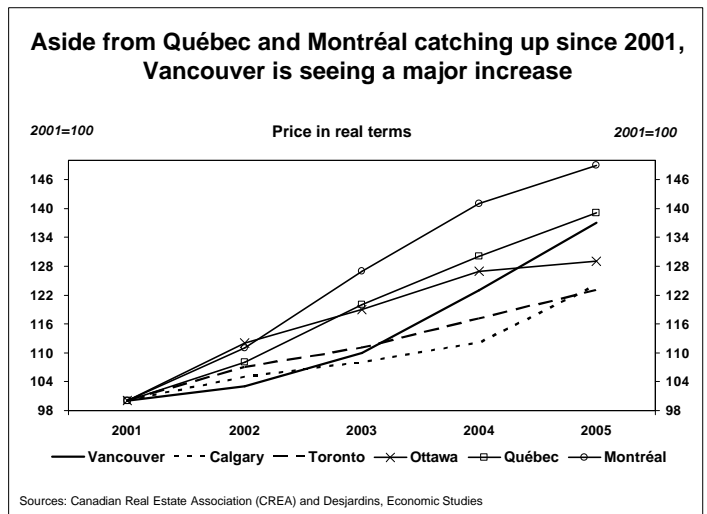
**Are there any similarities with the end of the 80s?**

Although the recent analysis of the resale market sheds some light on how prices are going to evolve, we need further analysis to assess the risks of a collapse. Here, the parallel with the end of the 80s, when the boom ended abruptly when the bubble burst, helps us to establish some points for comparison. As a real estate bubble is often confined to a few cities, it is still important to go beyond a national or provincial diagnosis.



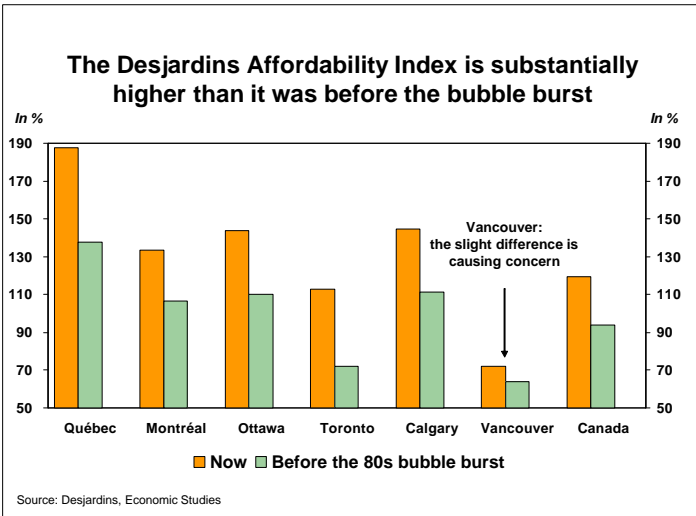
At the end of the 80s, Toronto was seeing the fastest price increases—they doubled in real terms between 1985 and 1989. Of Canada's six biggest cities, Vancouver has also stood out, with an increase of over 65% in five years. These two cities subsequently saw a major decline in prices at the start of the 90s. The bursting of the bubble therefore mainly affected Toronto and, to a lesser degree, Vancouver. Elsewhere, the price increases were small and the first half of the 90s was characterized by a period of stagnation.

The real recovery emerged at the start of the millennium, with Montréal and Québec in the lead this time. Although impressive, this increase is in fact due to the catching up that follows a long period of lethargy, since prices fell in real terms in the province during the 90s. In this context, it is Vancouver's price increase that has been the focus for a few years now. Of Canada's six largest cities, this coastal city consequently seems to be the most vulnerable to a real estate bubble. This is a very arbitrary assessment, however, since price increases alone are not enough to detect the risk of collapse, which is why it is important to round out the diagnosis with other indicators.



**Are the price increases justified?**

To assess whether the price increases are based on fundamental factors, not on speculation, Desjardins Economic Studies created an *Affordability Index*<sup>2</sup>. It simultaneously considers household income, mortgage interest rates, property prices and some ownership costs. This tool therefore allows us to properly gauge households' financial capacity for buying a home. A ratio of 150 means that the average household income is 50% higher than the income needed to obtain a loan for an average-priced residence. A high affordability index means that favourable economic factors underpin the expansion of the real estate cycle, thus banishing the risk of a sudden collapse by the market.



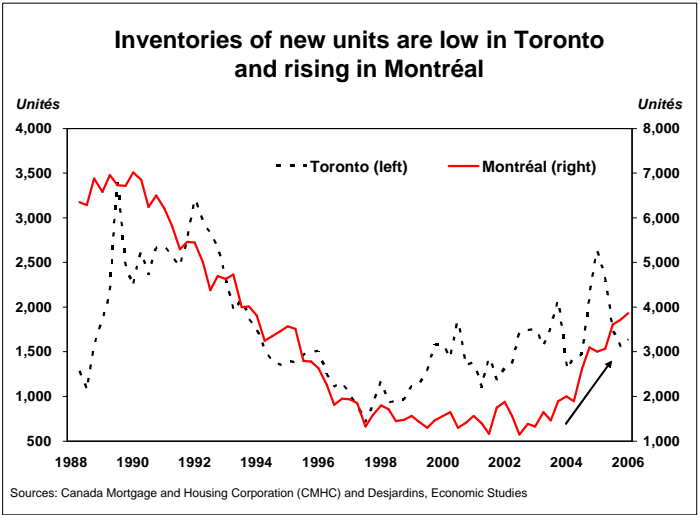
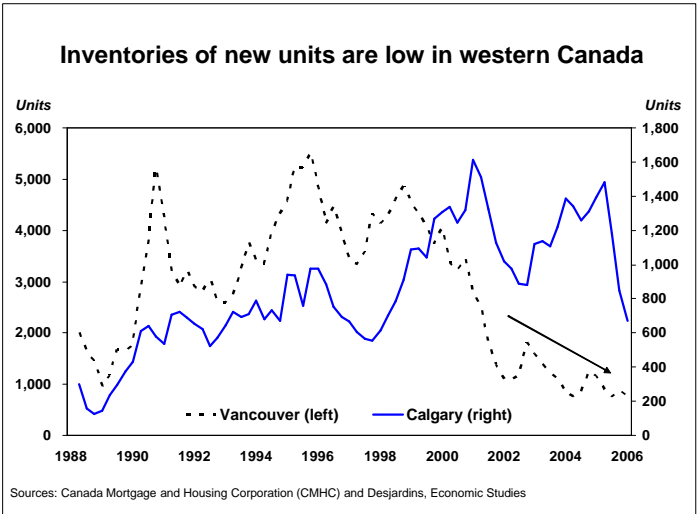
Although the Desjardins Affordability Index is slightly below the historical average in most major Canadian cities, it is at a relatively comfortable level. In fact, the current situation is substantially better than the one that prevailed before the bubble burst as the 90s opened, even in Toronto. Fundamental factors therefore appear to underlie current real estate expansion and ease concerns. Vancouver's case is still worrisome, since the Affordability Index is almost at the low level it was at in 1990, just before the price downturn. The boom of recent years would thus be based on more fragile foundations in this coastal city, increasing the likelihood of a price correction.

**No sign of overbuilding, except in Montréal**

Even though the resale market appears healthy in most major cities in Canada, the inventory of new units must also be considered. When the resale market is overheating, there is a risk of overbuilding. As the new and existing markets are interconnected, a major increase in new unmoved units can quickly propagate to the resale market and amplify potential price decreases.

However, inventories are very low in Canada at this time. In western Canada, supply is not meeting demand as a result of the labour shortage, the high cost of materials, and the scarcity of land, especially in Vancouver. In Toronto, the inventory of new units is close to its historic level, which does not give rise to any concerns in the short term.

In fact, only Montréal's case is worrisome since unsold units are up sharply in the last two years, even greatly surpassing the long-term average. However, the build-up in no way compares to the end of the 80s, when speculative building was going at full throttle. Over half of the units that have not found takers are condos, and the existing market is already showing signs of saturation. So, although the Montréal market seems to be resting on solid foundations in terms of the advance by prices and affordability, the increase in inventories, if it hangs on, could trigger somewhat of a correction by prices on the resale market, particularly in the condo sector. Elsewhere in Canada, the risks of overbuilding are practically nonexistent, which limits the likelihood that properties will depreciate.



## Condo market: are the concerns justified?

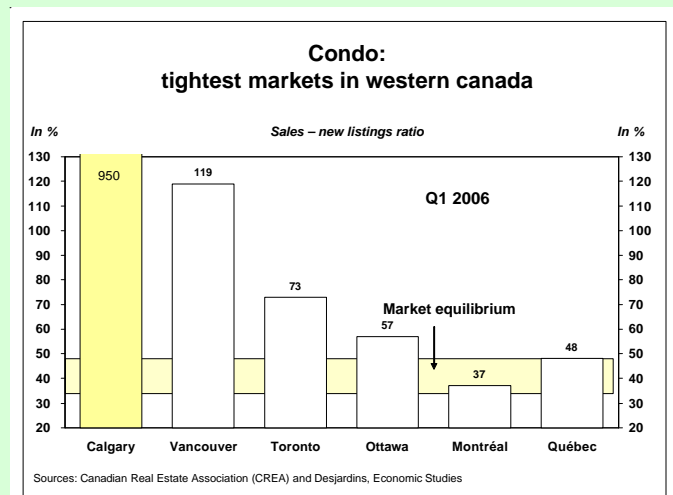
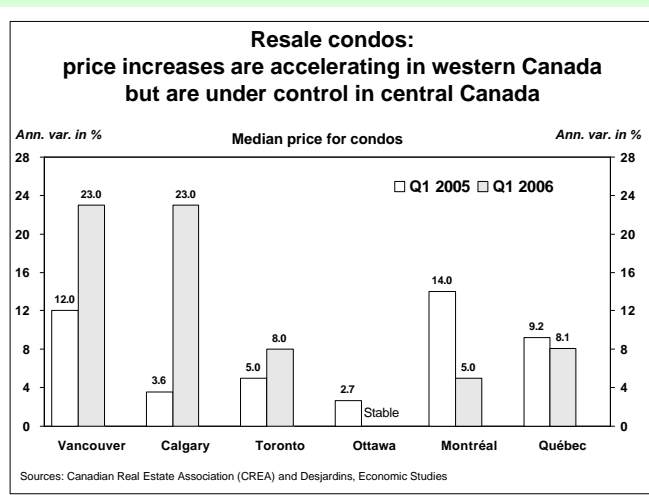
Due to its pronounced cyclical movements, the condo market is much more vulnerable to a decline in prices. This type of housing has been booming since the end of the 80s, and investors' concerns about a potential bubble have intensified lately. There are very clear signs of speculation in Vancouver and Calgary, where some condominiums are resold more than once a year. New construction is not keeping up with demand, increasing tension on the resale market.

Price growth has accelerated at a lively pace in the last year, particularly in Calgary and Vancouver: price growth was close to 25% in the first quarter. In Toronto, the increase is holding at between 5% and 10%, whereas Montréal is seeing a net slowdown. Annual increases above 10% have given way to a more moderate pace of about 5%. The evolution of the sales/new listings ratio also indicates that Montréal's condo market has come back to equilibrium. In Toronto, the situation has also relaxed, but the market is still overheating. Finally, Vancouver and Calgary stand out—ratios this high can only confirm the presence of speculation.

Incidentally, it is in western Canada that construction has expanded the most. Condo starts now represent close to 70% of total starts in Vancouver, compared to 45% in 1989. In Calgary, about 30% of new construction is occurring in condominium apartments, whereas there was almost none at the end of the 80s. This market has more than doubled in Montréal during this time, to its current 35%. It is therefore not surprising that the creation of a real estate bubble in this sector is concerning more and more investors.

However, the boom in starts still cannot keep up with demand, as shown by the few units that remain on the market. Unsold new condos are even well below the historical average in Vancouver, Calgary, Toronto and Ottawa. In a context in which supply is too small to meet demand in both the new and existing markets, the risks of a correction by condo prices are very low in western Canada and Ontario.

The situation is very different in Québec. At a time when the condo resale market is running out of steam, new construction is taking its time adjusting. In this case, the overly fast increase in the supply of new condos could spread to the secondary market, triggering a small price correction. In Montréal, the difficulties in moving new condos are a concern. The current inventory of over 2,000 units is twice as big as the historical average. The situation is of particular concern in downtown Montréal. In March 2006, the CMHC assessed that 225 new units were vacant while 2,200 others were under construction. As 730 downtown condos found takers last year, the CMHC estimates that it will take at least two years to move the units being built and current inventories, if no other project is started. In this context, the condo resale market, which is already at equilibrium, should continue to slow and a slight price correction could even occur in Montréal in the short term.



## Should we be worried about falling prices in some parts of the country?

All in all, although there are some signs of overheating in the resale market in western Canada, solid fundamental factors and low inventories of new units attenuate the risks that the market will collapse. Unlike the end of the 80s, Toronto is not the main source of concern. This time, Vancouver seems to be the most vulnerable city, Vancouver's price growth in recent years is disconcerting and, in particular, the Affordability Index is very low. Since it is almost where it was before the bubble burst at the beginning of the 90s, this coastal city is not completely safe from a potential price correction. However, as long as western Canada's economy and demographics continue to support sustained demand, the probability of price decreases in the residential sector remains low.

Conversely, the slowdown phase is already underway in Québec and Ontario. The price ascent of recent years was also based on solid foundations, which attenuates the risks of a drastic tumble by prices. Demand is beginning to wane, however, so that any overly fast increase in supply could destabilize the market. In Ontario, the low inventory of new units puts this out of the question, but the major surge in Québec is causing some concerns. In Montréal, a slight price correction is not out of the question since the surplus of new units, particularly in the condo market, could spread to the existing market. The resale market, which is already tending toward equilibrium, could end up in a surplus situation and put downward pressure on prices.

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<sup>1</sup> See the *Economic Viewpoint* titled: "The evolution of house prices in Canada reflects the improvement in market fundamentals"

<sup>2</sup> The official launch for the Desjardins Affordability Index will occur this fall, in the form of a press release.