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Special Report
Canadian Housing

Canada's Housing Outlook — Hot Markets Beginning To Cool

National home sales and prices in Canada have cooled in the first half of 2012, with resales easing back toward the decade average of around 460,000 annualized units and prices generally flat. Record prices combined with incremental regulatory tightening are reducing affordability and the housing market's earlier momentum, notwithstanding the lowest borrowing costs on record. Pent-up demand has been effectively exhausted after a decade-long housing boom, with Canadian home ownership at record levels.

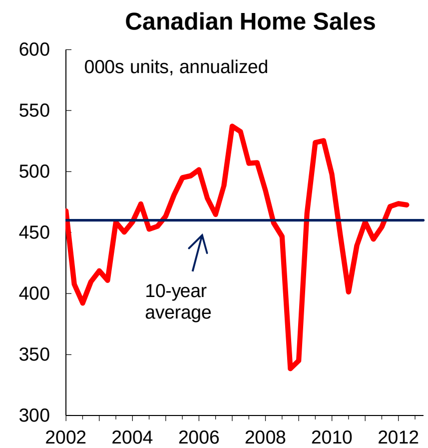
Canada's housing market is expected to avoid the sharp downturn witnessed in the United States and Europe. However, the downside risks to domestic housing activity are increasing. The full impact of the slowdown may not become fully visible until mid-decade.

Affordability will be increasingly strained for existing and potential homeowners when mortgage rates eventually drift up. Historically low interest rates are currently maintaining affordability in the face of record home prices and rising home operating costs.

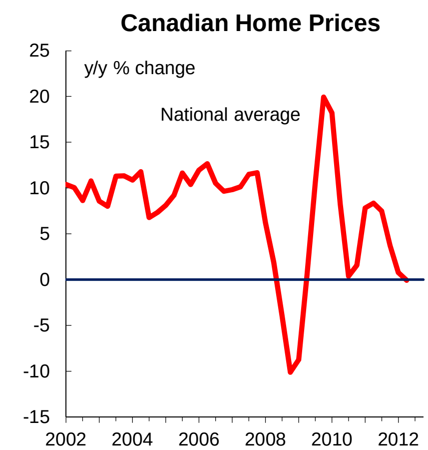
Moreover, the global outlook has become much more challenging. Intensifying debt strains in Europe are aggravating the slowdowns in the United States and many of the larger emerging markets, with negative implications for Canadian export earnings. A steeper reduction in trade and commodity prices would severely impact domestic jobs and investments, leading to a sharper retrenchment in Canadian housing activity.

Canadian household balance sheets remain in reasonably good shape, with homeowners' equity in real estate assets averaging 67% compared with 41% in the United States. Mortgage delinquency rates are currently low and falling. Nonetheless, high personal debt loads — household credit liabilities as a share of disposable income climbed to a record 152% in Q1 — and balance sheets heavily skewed to real estate leave Canadians vulnerable to an adverse shock, including a sharp rise in unemployment and/or a sharp drop in home prices.

Meanwhile, federal policy relating to housing markets has become increasingly cautious. Regulatory standards for mortgage and home equity financing have been tightened, oversight provided by the Office of the Superintendent of Financial Institutions (OSFI) has been detailed, and the government's role in residential



Source: CREA, Scotia Economics



Source: CREA, Scotia Economics

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mortgage insurance has been capped. Longer-term, these policy adjustments should reinforce the solid foundations of Canada's mortgage market. However, unlike earlier rounds of regulatory tightening, the latest changes are occurring against a backdrop of flat to moderately higher mortgage rates as opposed to falling rates.

In this environment, we expect average Canadian home prices will eventually decline a cumulative 10% over the next 2-3 years, as housing demand softens and buyers' market conditions re-emerge for the first time in over a decade. The correction will be concentrated in the Toronto and Vancouver markets, where supply risks and affordability pressures have the potential to trigger larger price adjustments. In contrast, we continue to anticipate relatively more favourable demand and pricing in many other regional markets facing more balanced conditions.

The combination of lower home prices and reduced sales volumes points to a further moderation in household credit growth. An extended, even if gradual, slowdown in the housing sector also entails large negative spillover effects to the broader economy, including consumer durables spending, renovation activity and employment. Canada's construction sector (residential and non-residential) has generated roughly 425,000 net new jobs over the past decade, or close to one in five new positions, more than double its share of total payrolls.

Even beyond mid-decade, Canada's housing sector faces the likelihood of a prolonged period of relatively modest sales and price gains. Historically, long cycles of rising home prices have been followed by extended periods of persistent softness, allowing affordability to be gradually restored and generating renewed pent-up demand. The downturns that followed Canada's major housing booms of the 1970s and 1980s — defined by having flat or negative real price growth — lasted 8 and 9 years, respectively.

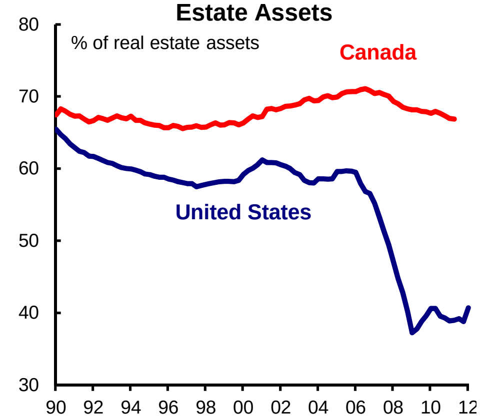
Canadian Housing Activity In Transition

Housing activity in Canada is moderating. The lure of ultra-low borrowing costs is being tempered by more moderate job growth, the cumulative tightening in mortgage insurance rules since 2008, and an exhaustion of pent-up housing demand. National sales are running only slightly above long-term trends, while supply conditions have become more balanced and prices have stabilized at record high levels.

Notwithstanding these developments, there is a widespread consensus that average home prices in Canada have overshot their longer-term fundamental values. The most common adjustment mechanism would be an extended period of relatively flat nominal home prices that over a period of several years gradually restores affordability. Canadian household incomes should continue to rise, albeit at a relatively moderate pace.

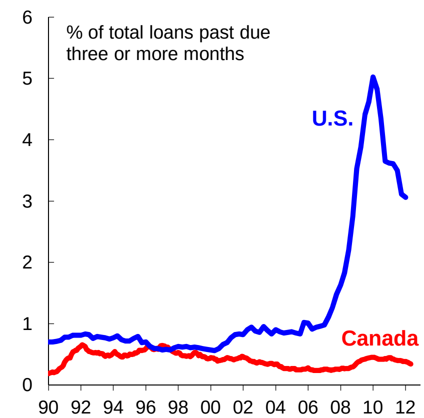
However, two factors point to an outcome with greater downside risks. First, the global economy has lost considerable momentum. Most of the developed economies are locked into a prolonged period of sub-par growth to redress significant debt burdens, while prospects in emerging nations are being tempered by domestic adjustments. Many countries have limited policy flexibility to foster faster growth. Canadian job and income gains will be pressured by the less buoyant global outlook coupled with domestic fiscal restraint.

Homeowners' Equity In Real Estate Assets



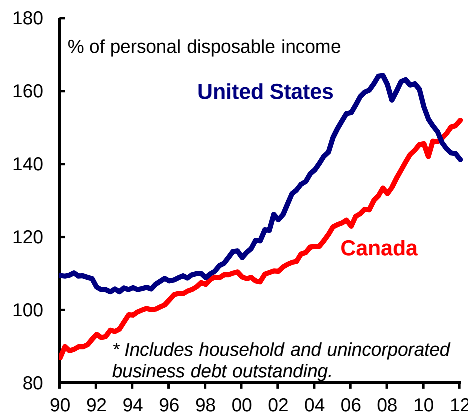
Source: U.S. Federal Reserve, Statistics Canada, Scotia Economics.

Mortgage Delinquencies



Source: MBA, CBA, Scotia Economics.

Household Debt*



* Includes household and unincorporated business debt outstanding.

Source: U.S. Federal Reserve, Statistics Canada, Scotia Economics.

And second, there are important regional distinctions behind the relatively stable national picture. Toronto continues to post sizeable house price gains, especially for single-detached homes, supported by strong demand (sales are running about 10% above the decade average) and a shortage of single-family listings. This is beginning to present affordability challenges, and raises the risk of a bigger price correction down the road. In the new home market, a rising condo inventory, fuelled in part by strong investor demand, represents additional downside risk.

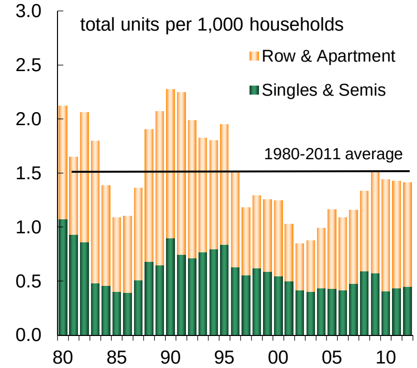
Affordability strains are a growing challenge in Vancouver, where housing demand has fallen 20% below its long-term trend. Elevated prices are only now beginning to adjust lower. Combined with excess new and resale supply, home prices could shift lower. In addition, the Vancouver housing market, particularly the luxury segment, is vulnerable to shifts in offshore investor sentiment.

From a supply perspective, Canada's overall housing stock is not notably overbuilt. The inventory of unsold new homes is above its long-term average but appears to be leveling off well below the peaks of the early 1990s. Taking into account growth in the number of private households, housing inventory is actually a bit below its historical trend.

Nonetheless, the current pace of housing starts, averaging close to 220,000 units in the first half of 2012, is exceeding underlying demographic requirements. We estimate Canada's sustainable annual level of housing starts is around 185,000-190,000 based on household formation of 175,000-180,000 plus an additional 10,000 units of replacement demand (i.e. infill construction). Activity will likely gradually move down toward this level over the next several years.

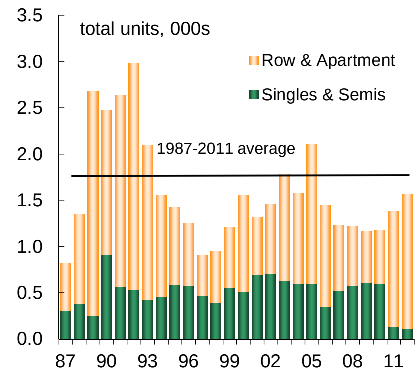
Yet certain market segments are at risk of oversupply, including the expanding condominium markets in several of Canada's largest centres, notably Toronto and Vancouver. In Toronto, condominium starts this year are on track to exceed the 22,000 unit high-water mark set in 2008. There are currently over 40,000 condo units under construction, which will gradually come onto the market over the next several years. In contrast, low-rise construction is well below historical norms, while the inventory of unabsorbed single-family units is at a record low.

Unsold New Homes - Canada



Source: Statistics Canada, CMHC, Scotia Economics.

Unsold New Homes - Toronto



Source: CMHC, Scotia Economics.

Current high-rise projects are being supported by strong demand. However, the ongoing high level of condominium construction underway combined with an elevated level of unsold units in the pipeline raises the risk of a sharper price correction to any weakening in demand. Given typical timelines between project openings and construction completions, supply could continue to build into 2014-15.

Moderating resale price appreciation and upward pressure on rental vacancy rates as new completions come to market should dampen investor demand. This in turn should slow new product launches. As the resale market cools, the incentive for builders to add additional housing stock will decline.

There are already signs that Toronto's condo market is beginning to self-correct. According to Urbanation, a condominium market research firm, sales of new Toronto condos, a sizeable share of which are purchased by investors, fell sharply in the second quarter of 2012. Combined with a record inventory of unsold units (including those in pre-construction phase), we anticipate increasing project delays and/or cancellations by developers unable to secure adequate pre-sales.

The multi-year rise in home prices in Canada has pushed housing valuations to record levels, whether measured by the ratio of national house prices to household disposable income or by a house price-to-rent ratio. Both measures may be in the process of plateauing, but are unlikely to decline until house prices and unit sales move decisively lower. Household income gains will remain moderate in a slow growth environment, while the upward bias in rents will be restrained by the increase in the supply of rental units — rental apartments and condominiums — coming onto the market over the next few years. However, a more dramatic correction that rivals the downturns in either the United States or in a number of European countries is unlikely. The vast majority of Canadian households should be able to absorb a gradual rise in borrowing costs over the medium term without a major adjustment since roughly two-thirds of residential mortgages are at fixed rates. Canadian housing activity should also be supported by immigration, the strength in selected regional markets such as Alberta and Saskatchewan, and the shift toward a more balanced housing market in other areas across Canada.

Furthermore, mortgage market fundamentals are sound. Canada lacks the weak lending practices and high-risk mortgages that felled the U.S. housing sector, and its subprime market is relatively small. The majority of mortgages are held on-balance sheet, promoting sound underwriting standards. The tightening in insured mortgage rules since late 2008 has reinforced cautious lending.

Impact Of The Latest Policy Adjustments

Finance Canada has tightened the standards for mortgage lending and home equity lines of credit (HELOCs) three times since the recession to restrain the surge in Canada's housing market and household debt. The latest changes were introduced in June and effective July 9. Ottawa also wishes to reinforce Canadian financial institutions' solid domestic lending framework and restrict, over time, the federal government's expanded role in Canadian housing finance.

To this end, recent policy adjustments include OSFI's guideline for residential mortgage underwriting practices released in June, OSFI's expanded responsibility to oversee CMHC's commercial operations, freezes for the foreseeable future on the mortgage insurance ceilings of CMHC and Canada's two private insurers of $600 billion and $300 billion, respectively, a provision in the covered bond legislation prohibiting insured residential mortgages as collateral, and the implementation of Basel III. The risk is that the interaction among the various policy changes will result in a more negative cumulative impact than anticipated.

Canadian Macroprudential Rules Are Clamping Down
• After sharply easing mortgage lending standards in 2006-07, the federal government has since reversed its position
• October 2008: Max 35 year amortization for insured mortgages; minimum 5% down for insured mortgages; consistent minimum credit score; new loan doc standards for property value and incomes
• February 2010: Qualify at 5 year posted rate instead of 3 year; lower refinancing ceiling to 90% from 95%; min 20% down required to get mortgage insurance on non-owner occupied properties
• January 2011: Max 30 year amortization for insured mortgages; refinancing ceiling for primary occupancy homes dropped to 85% from 90%; withdraw government insurance on HELOCs.
• November 2011: Accounting changes to hold more on balance sheet
• 2012-13 Federal Budget: OSFI oversight of CMHC
• Spring 2012: Insurance lifted from covered bonds; portfolio caps at the CMHC; new OSFI lending guidelines to banks
• June 2012: Max 25 year amortization for insured mortgages; insurance dropped for mortgages on homes valued over $1 million (i.e. now minimum 25% down); refinancing ceiling dropped to 80% from 85%; mortgage payments and total debt payments capped at 39% and 44% of income respectively
• January 2013: Basel III

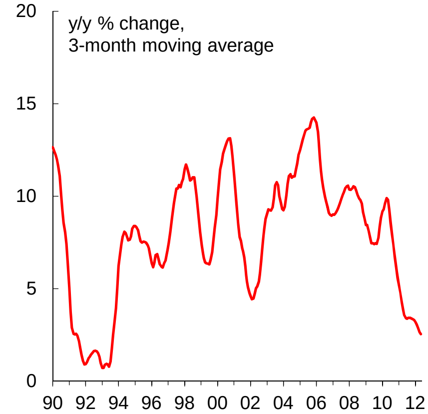
Ottawa is capping its dominant role in Canada's residential mortgage insurance industry that includes CMHC's major market share as well as backstopping 90% of the two private-sector firms' residential mortgage insurance-in-force. Mindful of its $600 billion cap, and the rise in its insurance outstanding to $570 billion as of March 31st, CMHC is planning to limit access to its low-ratio portfolio insurance as necessary in order to safeguard the availability of mortgage insurance for high-ratio homeowner loans and multi-unit properties.

The impact of the oversight and mortgage insurance adjustments is difficult to estimate, but the effect of shortened amortization periods can be more easily assessed. The incremental impact of a change in amortization from 30 years to 25 is modest at about a $178 increase in monthly payments for the buyer of an average-priced Canadian home ($370,000), and represents an imputed interest rate shock of about 85 basis points.

However, the cumulative impact of going from 40 years to 25 is sharper yet. In less than four years, 15 years have been shaved off maximum amortizations that have driven large shares of new mortgage originations. The monthly payment for today's buyer of an average-priced home with a 4% 5-year fixed mortgage rate and the minimum 5% downpayment has gone up by $387 (from $1,462 to $1,849) via compressed amortizations from 40 years to 25. This represents a 26% increase in monthly payments.

The cumulative effects of policy tightening present a downside risk to housing and the consumer sector. They take us into a markedly different environment compared to the sharp easing in mortgage lending standards in 2006-07, and the housing stimulus introduced during the downturn to shore up local employment. As the recession deepened, the federal and provincial governments introduced a wide array of housing market incentives including renovation tax credits offered by both Ottawa and Quebec, stepped-up first-time homebuyer assistance, expanded social housing investment, low-cost loans to municipalities for housing-related infrastructure, and the Insured Mortgage Purchase Program and other measures to assure financial institutions' liquidity and ability to lend. Combined with the Bank of Canada cutting its overnight rate to 0.25%, the result was heating up an already-strong housing market.

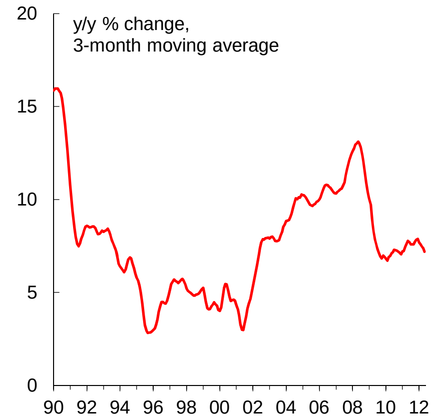
Consumer Credit



Source: Bank of Canada, Scotia Economics.

This latest round of policy tightening is being imposed when Canadian housing and consumer markets are operating at all-time leveraged peaks across most variables, and as slowing growth in household debt signals waning momentum due to stretched balance sheets. Past efforts to tighten mortgage rules occurred during a period of falling mortgage rates that partially insulated the impact upon house prices. They also occurred when Canada was bouncing back toward pre-crisis levels of employment via rapid job growth.

Residential Mortgages



Source: Bank of Canada, Scotia Economics.

Household credit demand is already trending sharply lower, with y/y growth slowing to 5.6% in May. Mortgage growth has slowed to 7% y/y, about one-third of the pace prior to the crisis and back to the rates of growth of a decade ago before the housing boom really kicked into high gear. Advances in consumer credit (i.e. excluding mortgages) have sharply decelerated since mid-2010 to just 2.6% y/y, suggesting that households are heeding warnings to slow their overall pace of debt accumulation.

Strained affordability for homeowners going forward will likely prompt provincial governments to carve out a limited role assisting households stretched by their mortgage debt. In many jurisdictions, rising property tax rates and power costs will add to the higher mortgage debt service eventually anticipated. Among the provinces, British Columbia is advanced on homeownership affordability measures, with its Home Owner Grant to partially offset the property tax burden a key program. Yet these initiatives, for most Provinces, are likely to be constrained by the challenge of each government's balanced budget targets in a slower global growth environment.