



CURRENT ANALYSIS

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Fears of a Canadian housing market crash overblown

Summary

- The sharp decline in housing resale activity since the beginning of the year has ignited fears that the Canadian market has started to crash.
- In large part, such concerns are based on the belief that the spectacular run-up in prices in the past several years reflected bubble-like conditions, which will inevitably end up in a gut-wrenching correction.
- While we agree that housing prices are currently historically elevated, we do not believe that any major slump will necessarily ensue.
- **Housing affordability** – the best indicator of underlying market tensions, in our view – has deteriorated in recent quarters but remains much better than it was in the late 1980s and early 1990s when bubbles clearly caused the Canadian market to meltdown in the years that followed.
- The further expected modest erosion of affordability in the period ahead is seen to **cool housing demand not deep-freeze it.**
- **Home prices, overall, are generally expected to stay above water in Canada,** although there are some local markets, such as such as Vancouver and, possibly, Montreal, where very poor affordability could well lead to declines to correct these imbalances.

Details

The 30% drop in seasonally-adjusted monthly housing resales in the first seven months of this year has raised fears that a full-blown slump is in the works for Canada. Last year's spectacular rally, which not only contrasted sharply to the moribund state of housing in most other parts of the developed world but also heated up conditions to even greater levels than those which prevailed in 2007, are perceived by some as evidence of a bubble threatening to burst anytime.

Such fears are rooted in the significant price gains since 2001 that far exceeded household income growth in Canada. Home prices nearly doubled nationally during that period, while disposable income grew by less than 50%. The ease with which the Canadian market recovered the losses incurred during the (short-lived) downturn of the latter part of 2008 and early 2009 and with which prices surpassed previous record highs during the rally only feed the notion that the Canadian market is being driven by irrational behaviour.

However, we find little compelling evidence of irrationality or bubbles in the overall Canadian market relative to historical patterns. The best measure of underlying stress – housing affordability – does not flag any major misalignment with respect to prices. At most, it points to a moderate degree of overstretching on the part of Canadian households – something that can be righted in time without causing a significant disruption in the market.

A natural benchmark to gauge the market's vulnerability to a severe downturn is the level of affordability that prevailed in the late 1980s and up to early 1990, the last time that the Canadian housing market was widely viewed as being in a 'bubble', which was a period during which speculative activity was a prominent phenomenon and prices skyrocketed to irrational highs. The bursting of the bubble in late 1990 and its aftermath weighed of the Canadian market for the better part of the 1990s.

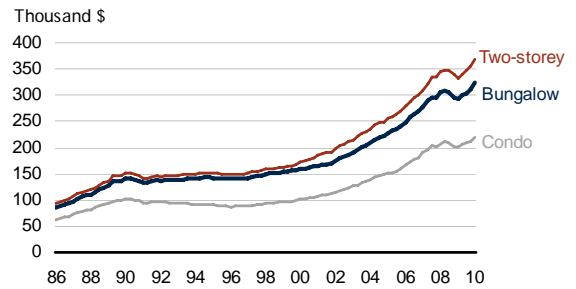
While housing affordability has been on a deteriorating trend again since the middle of last year – after improving significantly in 2008 and early 2009 – levels still remain much better than those in 1990. In the first quarter of this year, RBC's affordability measure for a typical bungalow in Canada was 41.1% compared with 54.2% in the second quarter of 1990 (the higher it is, the less affordable homeownership is); nonetheless, this was modestly above the long-term average of 38.9%, suggesting some greater than usual underlying tension at present.

Exceptionally low mortgage rates are a key factor that have kept homeownership costs from spiralling out of households' reach. These low rates are also a key reason why affordability metrics cause much less alarm than valuation measures such as the price-to-income ratio or the price-to-rent ratio, both at or near record levels presently. Home prices are indeed elevated, but the monthly mortgage payments (i.e., the cash flows associated with those prices) are still well below dangerous levels.

The risk, then, is that as interest rates rise, affordability will deteriorate further. We have looked into the issue and simulated where affordability measures would be under more 'normal' mortgage rates – defined as the long-term real rate plus an inflation premium of 2 percentage points. We found that affordability in Canada would currently be about as poor as it was in early 2008 (more than 46% for the typical bungalow) but still significantly better than at the worst point in 1990. (The normal rate used in the simulation is approximately 150-basis points higher than the mortgage rates prevailing at present.)

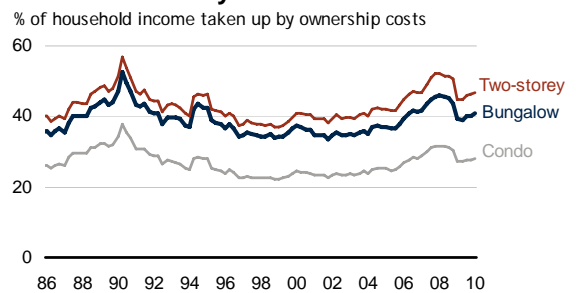
Canada

Prices

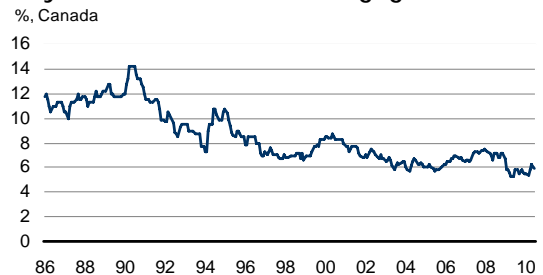


Canada

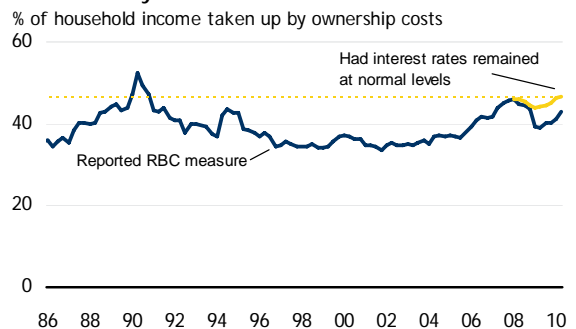
RBC Affordability Measures



5-year conventional mortgage rate



Affordability* - Canada



* Based on the purchase of a typical detached bungalow.

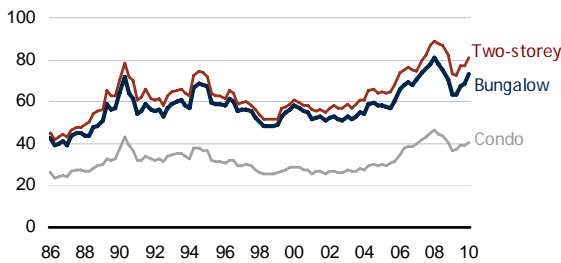
5-year bond yield - Canada



Vancouver

RBC Affordability Measures

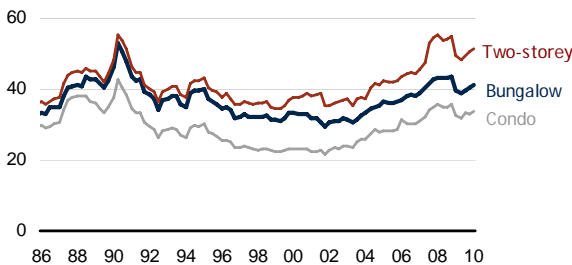
% of household income taken up by ownership costs



Montreal

RBC Affordability Measures

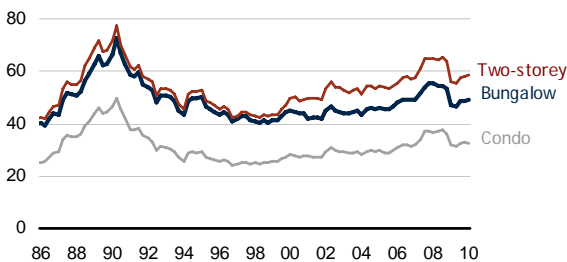
% of household income taken up by ownership costs



Toronto

RBC Affordability Measures

% of household income taken up by ownership costs



Since the monetary policy renormalization is expected to take place during the next 12 to 18 months, the effect of rising interest rates on affordability will be gradual and, therefore, will not constitute a sudden shock to the housing market. Meanwhile, an expanding economy will spur household income growth, which will provide some offset. Consequently, underlying pressure is unlikely to erupt and devastate the Canadian housing market.

In our view, the expected path of affordability will work to continue to cool demand for housing in Canada from its recent red-hot pace. We do not believe demand will go into a deep freeze. The implications for home prices are that, overall, they are generally expected to stay above water because supply will adjust in response to weakening demand.

It must be noted that this assessment focused on the overall market in Canada. Naturally, there are regional differences. Affordability measures flag more intense pressures than evident nationally in areas such as Vancouver where homeownership costs are still near record-high levels and far above anywhere else in the country. Montreal also has seen a notable erosion in recent years although affordability remains attractive relative to Canada's other major cities. In the case of Toronto, measures point to modestly worse than average affordability (historically), but the situation continues to be significantly healthier than it was in the late 1980s and early 1990s.

With demand more at risk of falling off substantially in Vancouver and, perhaps, Montreal, some sustained price declines could take place in those areas.

Bottom line

Affordability measures suggest that housing market fundamentals are comparatively stronger than those that prevailed in 1990, thereby minimizing the risk that a 1990s-style crash will occur. Nonetheless, because the cost of homeownership is likely to remain higher than average, a slower pace of housing market activity and more subdued pricing environment than we have experienced from 2002 to 2008 and again during the second half of last year should be expected.

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