TD Bank Financial Group

Resale Housing Outlook

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HIGHLIGHTS

- The Canadian resale housing market has held up to its 'first in – first out' (FIFO) billing in this recession. Its downturn and recovery were also as V-shaped as can be. Sales and average prices have more than recovered. As of October, each stood 5% higher than its prior peak established in late 2007.
- Viewing this sharp two-year cycle as a 'blip' is misleading. The 12% price adjustment seen in the downturn was partly warranted by fundamentals, which leaves the current market in a state of mild over-valuation similar to that of late 2007.
- While current price levels are not worrisome, the current market momentum has the potential to lead to significant price overshoot.
- 2010 should mark a transition from tight to balanced markets. Current price growth will elicit a positive supply response, while demand will ease as a result of the ongoing erosion of home affordability. By 2011, housing and the overall economy will experience a role reversal. While the economy will strengthen, resale housing market conditions will weaken.

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CANADIAN HOUSING: FIRST IN, FIRST OUT, BUT WHERE TO FROM HERE?

Of late, the Canadian housing market has been the focus of a lot of attention from the media and analysts alike, and for good reason. TD Economics has itself commented on these developments in two recent pieces[1], providing its residential real estate forecast and highlighting the potential monetary policy implications of various scenarios. The objective of the current note is twofold. Firstly, we update the outlook to incorporate data made available since our last report. Secondly, we expand on specific concerns that have arisen in the current housing market context.

Through the ringer – as sharp as ever

Existing home sales and prices, as provided by the Canadian Real Estate Association (CREA), went through a sharp downturn last year, falling by 40% and 12% respectively from their peak of late 2007. Just as quickly and sharply, a phenomenal rebound kicked off early this year and was still going strong early in the fourth quarter. From their trough sales had surged by 74% as of October, while the average price was 20% higher.

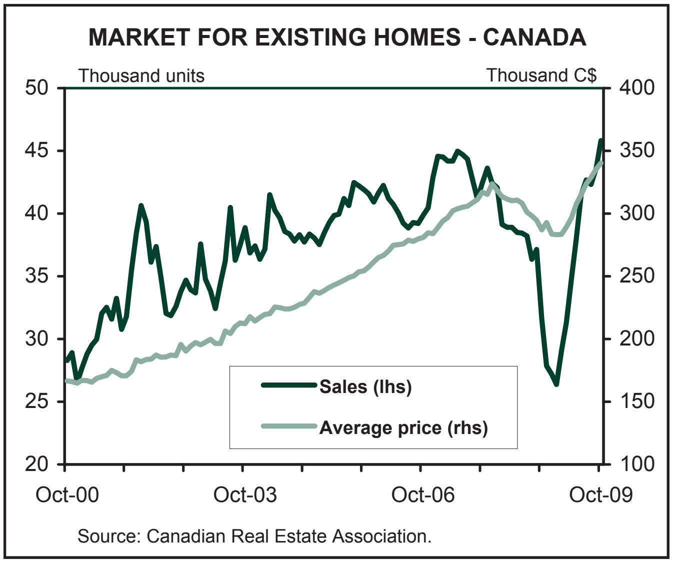
In this extremely sharp two-year cycle, the housing market has undeniably held up to its 'first-in, first out' (FIFO) historical billing. The downturn in existing home sales and prices (Q1/2008) preceded the start of the technical recession (dated Q4/2008) by three quarters. On the flip side, the strong recovery in existing home sales and prices that started in earnest in Q1/2009 led the end of the technical recession (dated Q3/2009) and the start of the overall economic recovery by at least two quarters.

Furthermore, the Canadian resale housing market downturn and recovery was as V-shaped as can be. A quick glance at the chart at the top of the next page shows sales and the average price could make a calligrapher green with envy. The length of each leg of this cycle was also nearly symmetric with the downturn lasting roughly all of 2008 and the ensuing recovery spanning all of this year.

While in the thick of a recession, the strongest countervailing force that set the stage for the mother of all rebounds, apart from lower prices, was lower interest rates. Recall that the Bank of Canada began easing its monetary policy back in late 2007, when it was becoming clear that the U.S. economy was tilting into recession and would surely drag Canada along with it. By the time the recession officially hit in Canada a full year later, the overnight rate had already been slashed from 4.50% to 2.25%, more than halfway en route to its all-time low of 0.25% by April 2009.

All said, the housing market has gone beyond retracing its steps and fully recovering from the end of 2007 – which had marked the peak of a half-decade long boom, concentrated in Western Canada. As of October 2009, national sales were running at a blistering 550K annual pace and the average price was $340K.

1. See "Real estate trends could impact future path of Canadian monetary policy", October 6th 2009, at http://www.td.com/economics/special/ca1009_housing.pdf and resale housing outlook, "Housing markets rebound sharply, sidestepping the worst", October 7th 2009, at http://www.td.com/economics/special/pg1009_rhousing.pdf



Seasonally-adjusted monthly sales hit all-time record volumes for 3 of the last 4 months, and are on track to continue this record-setting pace over the next few months. As of October, both sales and the average price stood 5% higher than their respective 2007 peak. Extrapolating this trend echoes Buzz Lightyear's mantra "to infinity, and beyond!".

Back here on earth, however, this latest housing cycle raises a number of concerns. For one, was the whole two-year cycle just a blip? A second, related question would be: is the recovery sustainable or was it all too much, too fast in the midst of a recession and early stages of recovery? Digging into the pace and magnitude of the rebound, more technical questions arise, such as: how much of the rebound was simply the unleashing of pent-up demand? Alternatively, how many of the current sales are simply being brought forward on the expectation that interest rates must eventually rise, in effect stealing from future demand? Last but not least, is a bubble brewing in Canadian housing?

Just a blip?

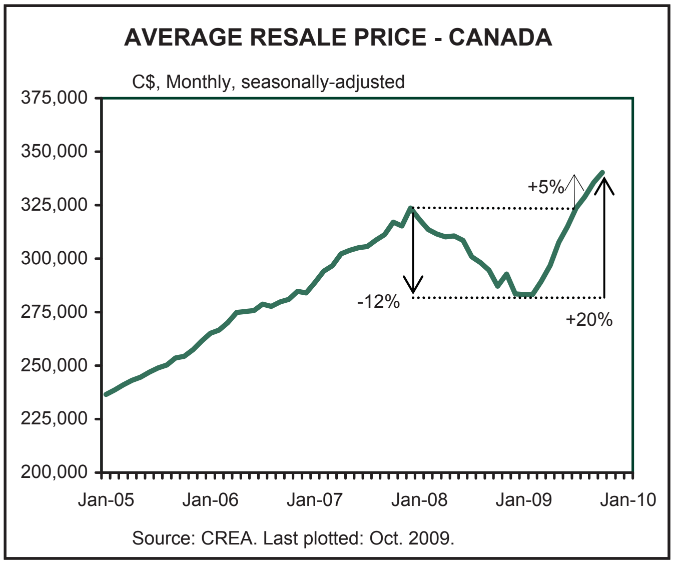
The accompanying chart showing sales and the average price suggests the recent cycle was just a blip. Affordability, as measured by typical mortgage payment as a percentage of average household market income, is also reverting back to where it stood before the downturn. After improving from 32.4% to 26.2% in 2008, it was back up to 29.5% in Q3/2009. We forecast this measure will have climbed right back to 32.6% by Q4/2011, thus erasing all of the improvement in affordability seen during the downturn.

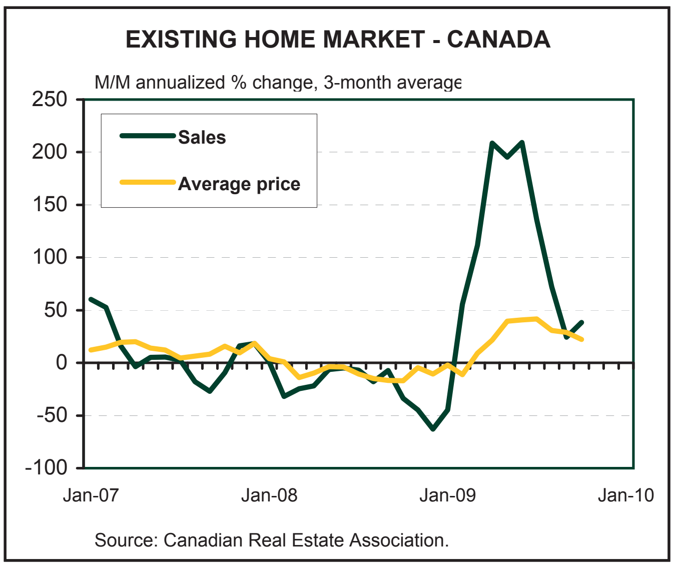
The 'blip' story goes something like this. The downturn in 2008 was that of a housing market being just an innocent by-stander getting unfairly sideswiped by fears of a U.S.-style downturn and rock bottom consumer confidence in the midst of an extreme financial crisis. As these fears abated and the worst of the financial crisis passed, the doom and gloom headlines became more nuanced and some modicum of confidence was restored, whereas little existed before. As a consequence, the housing market navigated rough waters and made it through the storm relatively unscathed.

This narrative is not wrong per se, but its implicit conclusion is that all is back to 'normal', whatever that may be. It also suggests that it will be smooth sailing from now on. In other words, the volatility in sales and prices has shaken out, and the expectation from here onward is a steady uptrend. As a result, we see two problems with calling this cycle a blip. Both arise from near-sightedness. First, it fails to think about where the market stood pre-downturn. Second, it neglects the fact that the current uptrend is too steep and that the resulting erosion in affordability will come back to bite into future demand.

To expand, the first problem is that the 'blip' notion fails to take a longer-term perspective on home values. If the Canadian housing boom (roughly 2002-2007) resulted in modestly overvalued residential real estate, which we estimate was roughly 10% [2] on a national scale at the 2007 peak, the downturn had just about set things right from a value perspective, with a peak-to-tough price adjustment of -12% [3] . For a number of reasons, we never forecasted a U.S.-style crash in Canadian housing. On the other hand, the adjustment that took place in 2008 looked warranted from a fundamental value perspective. The resulting improvement in affordability that came from more modest prices was encouraging and sustainable from a macro-financial perspective. From their trough, the most sustainable path for Canadian home prices would have been a gradual and modest uptrend aligned with nominal income growth. But now that home values are already past their previous peak in such short order, we estimate that the typical home remains overvalued by 12% at the national level. Unfortunately, sheer momentum suggests that this overvaluation is likely to increase over the course of the next few quarters, peaking at 13-15% in H1/2010.

2. Based on economic fundamentals such as incomes, interest rates, and wages. See "Overpriced and Overbuilt: Canadian Housing Returns to Fundamentals", TD Economics, April 7, 2009. In separate research, the IMF came to a very similar assessment of Canadian home values. See Tsounta, E. "Is the Canadian Housing Market Overvalued? A Post-Crisis Assessment", IMF Working Paper 09-235, October 2009.
3. A similar price adjustment was observable when using the monthly composite Teranet-NB home price index, which declined by 9% from peak-to-trough.





The misalignment of home prices with their fundamental drivers, such as demographics and income, cannot last. That much is known. What is less clear is the exact timing of when and precise channel by which the two will eventually realign. Because a necessary realignment has been erased so quickly without support from income growth, another adjustment must take place – although it could take many forms. As of our writing this note, early signs of market cooling are emerging and our analysis still suggests the most likely outcome is a soft landing and relative stagnation of home values in real-terms along with a resumption of stronger income growth over the 2011-13 time frame. Turn to our forecast section for the specific profile projected over the next couple of years.

The second problem with the 'blip' characterization is that fails to look forward to the eventual resetting of interest rates – what happens when the sturdy trampoline of rock-bottom policy interest rate that continues to fuel the sharp market rebound is taken away? Changes in affordability that rest solely on lower interest rates are inherently cyclical in nature, as opposed to those that arise from household income or homes prices.

Call this housing cycle a blip if you like. But we feel that is misleading, especially because of what this suggests for the future. While the market looks remarkably unperturbed from start to end of this sharp cycle, existing home sales and prices cannot sustainably stay on their current path. (See accompanying chart for 3-month trend in M/M annualized % change price). Markets are currently very tight and favour sellers, as evidenced by multiple competing offers and bidding wars, but we expect them to rebalance over the course of 2010. As the central bank begins to hint at a tightening monetary policy cycle in the second half of next year, sales could well see a last gasp of strenght. Moreover, by that time, the availability of units on the supply side should provide a relief valve helping to cool price growth. And, by 2011, while the overall economy will have improved significantly, housing markets will be losing momentum

Repaying the past, stealing from the future

On the issue of pent-up demand, we had calculated that, on a nationwide basis, at most 53,000 existing home sales that would normally have occurred in Q4/2008 and Q1/2009 did not occur because of the crisis of confidence resulting from the financial market turmoil. This figure is established on the basis of a continuation of the pre-recession downtrend in sales, which actual sales undershot significantly. Since Q2/2009, however, sales have overshot that trend by a wide margin. In our previous piece, we estimated that 50-60% of that pent-up had been released as of August. With two more months of data now available, we calculate that 75-100% of this pent-up demand would have been absorbed by October. Sales have been tracking our near-term expectations well and we continue to judge that any remaining pent-up demand will have likely been exhausted by November. At the very latest, by year-end this source of demand will have completely dried up.

The full absorption of pent-up demand by itself should help to slow overall sales in the first half of 2010 compared to their recent pace, which has already begun to cool on a 3-month trend basis. (See accompanying chart). Over the course of Q2/2009 and Q3/2009, up to one in five sales (monthly seasonally-adjusted units) could reasonably have been attributed to those that had previously been delayed (pent-up) because of sheer uncertainty.

While an important factor, this is clearly not the single or most important factor fueling overall demand. Demand has mostly been supported by attractive financing rates which have more than offset the headwind created by weak labour markets. As this is not expected to change much in the near-term, we do not anticipate sales to simply drop by a fifth come January – which is what would happen if other supporting factors were lacking. Nonetheless, it serves as a useful gauge of underlying drivers separate from displaced demand coming back online. In our view, any sales observed from January 2010 onward will originate not from past displacements of demand, but from traditional real estate drivers. This should enable us to get a much better reading of the underlying strength of demand after transient factors have washed out.

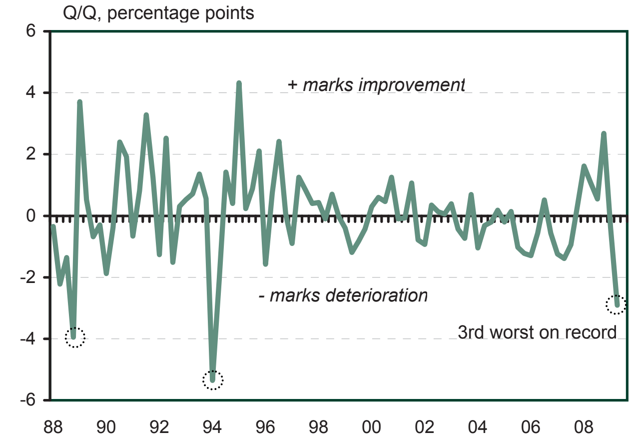
A more difficult issue relates to how much of the current demand is simply being brought forward, i.e purchases in recent months that advanced sales to take advantage of low rates, which raises the risk of a dip in ensuing quarters. Because the pool of potential buyers is not fixed and itself depends on affordability, it is not possible to satisfactorily address this issue in a precise quantitative fashion with the current data available. There is little doubt as to the direction of this effect, however. The prevailing 'now or never' mentality will weigh on future demand.

Too much, too fast?

The speed and magnitude of recovery has been a surprise to all. After all, it occurred in the midst of a recession during which unemployment rose significantly. Incomes also took a hit, particularly those tied to slumping commodity prices. The combination of declining home prices and lower interest rates dramatically improved home affordability over the course of 2008. And while affordability has no longer been improving since Q2/2009, the impact of past improvements in affordability is still rippling through resale markets and helping to spur sales.

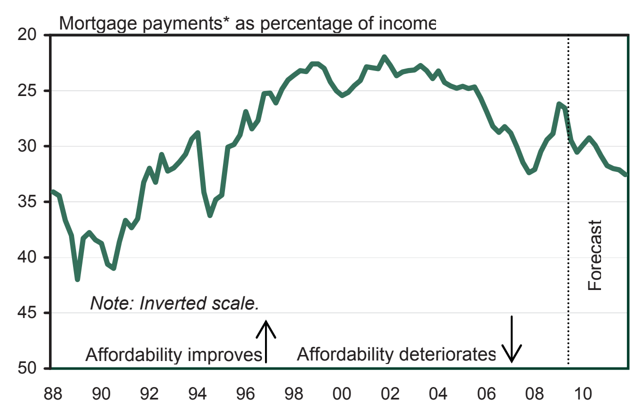
On the home price front, any answer to the sustainability question must distinguish between current levels and current momentum. While current price levels are above what we estimate to be long run fundamental values, they do not appear so dramatically out of line as to warrant a sharp correction in the near-term. Such corrections are typically triggered by a macro-financial event such as we saw when yields spiked in 1994 or during the financial turmoil unleashed in the fall of 2008. This risk of corrections always lurks, but a stabilization of prices around current levels

CHANGE IN HOME AFFORDABILITY



Source: Bank of Canada, Statistics Canada, CREA, TD Economics

EXISTING HOME AFFORDABILITY



* For the average price home using a conventional 25-year amortization, 75% LTV ratio, 5-year fixed rate. Source: CREA, Statistics Canada, TD Economics (Forecast as of Nov. 2009).

could be sustained, as affordability would remain decent.

As for price momentum, it is more clearly unsustainable. On a 3-month average M/M annualized percent change, average home price growth was 22% in October, but has been declining since peaking at over 40% in July. We expect double-digit growth by this measure to wash out after Q1/2010. Recall that every price increase that is not matched by a commensurate income gain increases the overvaluation gap. Second, more supply should come online in the first half of 2010 in the form of new home and condo completions. While the number of units under construction remains much lower than a year prior in most urban markets, they near an all-time high in the Toronto area, which will provide a supply relief valve in Canada's single largest market. In reaction to the recent price gains, we also expect a positive supply response on the existing home front, although it must be said that we make a prudent projection on this front as this uptrend has yet to materialize. Lastly, sometime in the second half of next year it will become evident that interest rates must rise, which is expected to dampen sales considerably in 2011-12 when compared to sales expected for 2010.

Bottom line – housing outlook 2010-13

All said, it looks to us as if the rebound was a tad overdone, but it is not so much the current level of prices which raises concerns. What raises eyebrows is where the current market momentum will bring prices next year. The current market tightness, as measured by the sales-to-listings ratio (see accompanying chart), while expected to ease gradually over the course of 2010, will not turn on a dime. As a consequence, it will be supportive of price growth in 2010 that is stronger than fundamentals can support over the long haul. After climbing by an estimated 4-5% on an annual basis this year, the average existing home price is expected to gain another 9-10% in 2010 as sales climb to 475K.

But the current momentum is not expected to last beyond the next 6-10 months. Were it to continue into 2011, there would be more credence to the view that a bubble has formed. But the brakes are currently being applied in the background, which should prevent a bubble from forming between now and then. Measured in terms of affordability, Q3/2009 marked the third worst deterioration on record – which dates back to Q1/1988. Previous historical episodes (in 1989 an 1994) caution that the market could stall in upcoming quarters. While interest rates may rise, they are unlikely to spike as they did back then, which provides the market with better shock absorbers than in the past. Nonetheless, as supporting factors wane and affordability erosions weaken sales by over 10% in 2011, prices will struggle to keep up with CPI inflation.

As interest rates continue to normalize to higher levels in 2012 and the economic backdrop continues to improve 2012-13, sales are expected to climb only modestly during those two years to reach 450K by 2013. A larger supply in the form of new and existing units should weigh down on nominal price growth to the point were we expect real prices (adjusted for inflation) to stagnate as incomes are finally allowed to catch up to home values. Assuming annual nominal income growth of 4-5%, home overvaluation would wind down to 4-8% by Q4/2011 and would essentially vanish by Q4/2012 under this forecast profile.

In closing, we note that the most important downside risk to our near-term forecast is not that the market cools more than we anticipate. While this risk certainly exists, it would not cause significant market disruptions, and it would ensure that affordability does not continue to erode at the current pace. The risk is rather that the market remains as hot as it currently is for too long, eventually running head-on into monetary policy tightening (and longer term bond yields rising). There is more than adequate time for the housing market to cool before then, but history suggests that if it fails to do so, the ensuing adjustment would be a rude awakening.

Longer term, Canadian households also need to ease debt growth to bolster net worth when asset price growth moderates. Debt-servicing costs will undoubtedly rise over the next few years. While most households can handle this rebalancing act, those already overstretched or getting into homeownership on the margins of affordability would do well to plan ahead by building up equity and saving through other means. We will also be examining these issues in detail in a forthcoming paper.

MARKET FOR EXISTING HOMES - CANADA

		2008	2009e	2010f	2011f	2012f	2013f
Sales	'000 units	434.5	462.6	475.0	421.2	430.0	450.0
	% chg.	-17.1	6.5	2.7	-11.3	2.1	4.7
Average price	'000 C$	303.6	316.3	346.1	351.6	356.2	363.3
	% chg.	-0.7	4.2	9.4	1.6	1.3	2.0

Source: CREA; e: estimate, f: forecast, TD Economics, Nov. 2009