

RELAX: IT'S JUST ANOTHER HOUSING MARKET CYCLE

SUMMARY

- Canadian home prices are unlikely to undergo U.S.-style correction.
- As part of a normal demand-driven housing market cycle, the price to income ratio reverts from its peak to its long-term average by way of income growth and stable prices.
- Homes purchased by retirees with accumulated wealth, not financed with income, may be upwardly skewing the British Columbia and national price to income ratio.
- Based on the longer-term relationship between price and income, the national price to income ratio will soon revert to its long-term average via increases in income, not sharp price declines.
- Warnings of a U.S.-style correction in Canadian home prices ignore solid Canadian mortgage market trends.
- Mortgage holders in Canada have borrowed conservatively and are accelerating mortgage repayment, providing options for the small proportion of homeowners that may face financial difficulty when their mortgage is renewed at a higher interest rate.
- Canada will avoid a massive oversupply of homes and a sharp drop in housing demand, so a U.S.-style correction in home prices is unlikely.

May 26, 2010

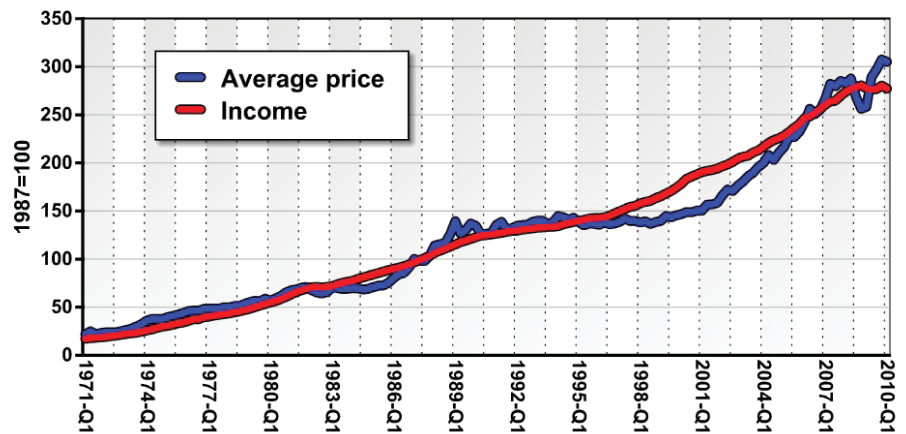
Based on the relationship between average home prices and incomes, and their outlook, Canadian home prices are unlikely to undergo a U.S.-style correction. Warnings of a U.S.-style home price correction in Canada are unfounded. Such warnings are typically based on a limited analysis of the historical relationship between national average home prices and income which ignores Canadian housing market cycle dynamics.

STICKY PRICES

Average price and income are charted in Exhibit 1. History shows that the national average home price experiences periods of stability while income grows, and periods when home prices grow by more than incomes. In economics classes, home prices and hourly wages are held up as classic examples of 'sticky prices'. Exhibit 1 confirms the "downward stickiness" of Canadian home prices.

Exhibit 1:

**Canadian home price & labour income
(indexed)**



Source: Statistics Canada, Conference Board of Canada, CREA

CONTACT

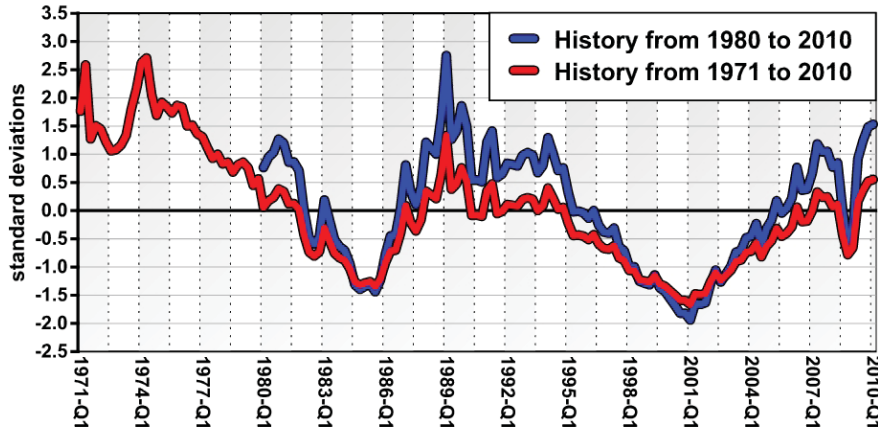
Gregory Klump
Chief Economist
(613) 237-7111

WAVY RATIO

The dynamics between the national average price and income cause the ratio of the two to rise and fall over time as part of a normal housing market cycle. The ratio of price to income compared to the historical average and variation (standard deviation) is charted in Exhibit 2:

Exhibit 2:

Canadian home price to income ratio (standardized)



Source: Statistics Canada, Conference Board of Canada, CREA

The current value of the price to income ratio compared to its long-term average is of less cause for concern

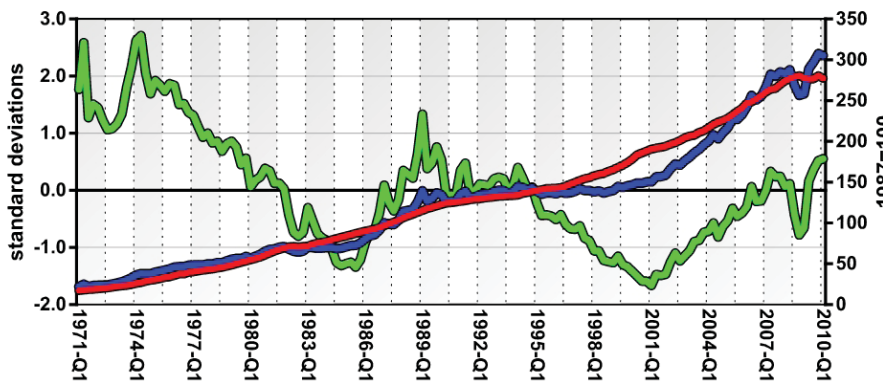
A longer-term history for the standardized ratio of price to income shows the current value for the ratio as less a cause for concern than suggested by analyses based on a shorter sample from 1980 onward.

RATIO REVERSION: INCOME, NOT PRICE

History suggests that the national average price to income ratio reverts from its peak to its long term average (i.e. mean reversion) by way of an increase in income and stable prices over time – not via significant price declines (Exhibit 3).

Exhibit 3:

Average price, income & price to income ratio



— Standardized ratio (L) — National average price (R) — Income (R)

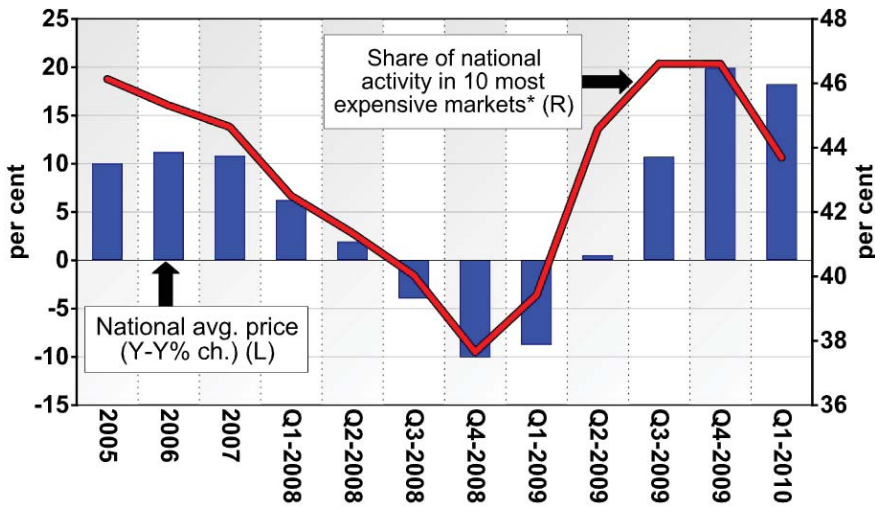
Source: Statistics Canada, CREA

History shows the price to income ratio reverts to its long-term average as prices remain stable and income grows

SKWEDED PRICE

The cause for the sudden decline in the national average price in late 2008 and its sharp rebound are well documented. At the depth of the recession, a dramatic decrease in higher priced transactions and housing markets skewed average prices downward. The subsequent rebound in activity disproportionately benefited this price segment, skewing average price upward. In early 2010, widespread average price increases across Canada further boosted the national average price. The downwardly skewed average price at the depth of the recent housing recession in late 2008 and early 2009 and the upwardly skewed average price evident during the subsequent recovery amplified year-over-year comparisons in average price in late 2009 and early 2010 (Exhibit 4).

Exhibit 4:



Recent increases in average prices are skewed by changes in activity among higher priced homes and markets

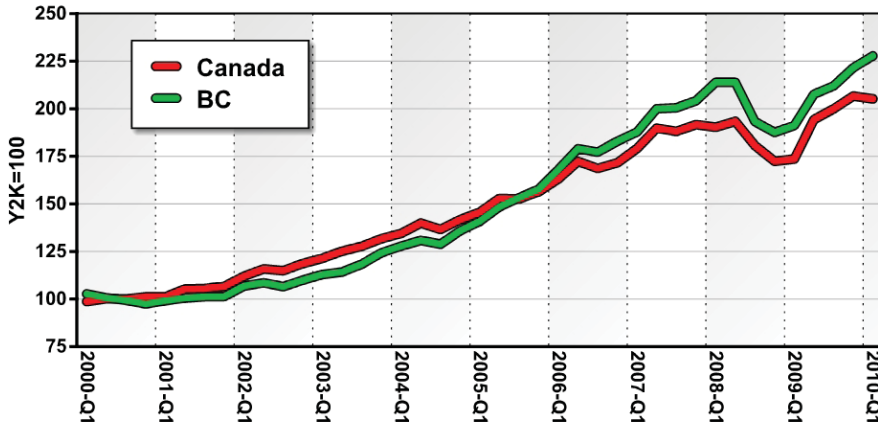
*Aggregate of sales in Canada's 10 most expensive markets as a percentage of national sales. Based on the 10 markets with the highest annual average price in 2009: Vancouver BC, Fort McMurray AB, Victoria BC, Oakville-Milton ON, Fraser Valley BC, Toronto ON, Calgary AB, Okanagan-Mainline BC, Muskoka & Haliburton ON, and Edmonton AB.

WEST COAST SKEW

The national price has been skewed upward recently by price increases in British Columbia (Exhibit 5), while national income since the year 2000 has been growing at a slightly faster pace compared to the province.

Exhibit 5:

Average home price: Canada & British Columbia (indexed)



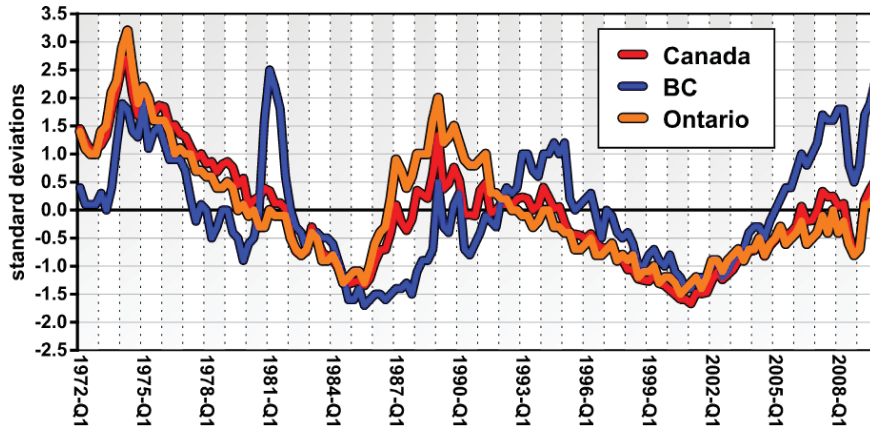
Source: CREA

The national price has been skewed upward recently by price increases in British Columbia

As a result, the price to income ratio for British Columbia has deviated considerably further from its provincial long-term average compared to the national ratio (Exhibit 6)

Exhibit 6:

Canadian home price to income ratio standardized: Canada, British Columbia and Ontario



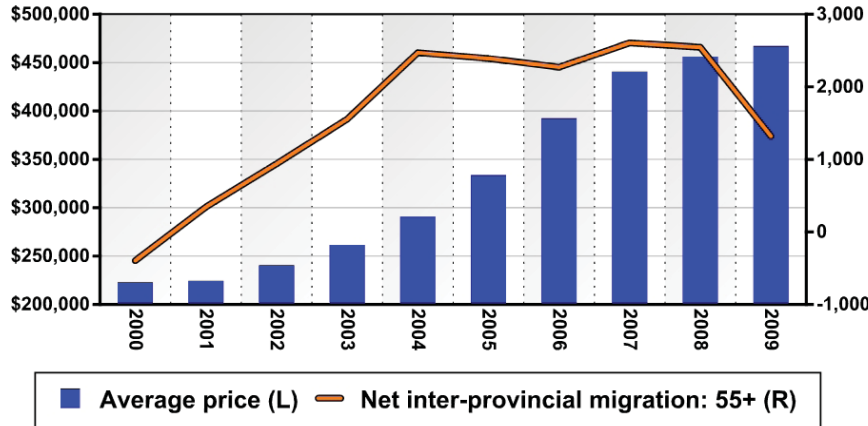
Source: Statistics Canada, Conference Board of Canada, CREA

However, the relationship between average home price and income in British Columbia may have changed in recent years due to international immigration and positive net inter-provincial migration. Much of the migration to the province from elsewhere in Canada reflects moves by people aged 55 and over (Exhibit 7). An increase in higher-priced home sales in recent years purchased using wealth,

not income, would cause the average price to be skewed upward. This may have caused the price to income ratio in recent years to rise significantly above its long-term average.

Exhibit 7:

**Average price & net inter-provincial net migration
British Columbia**



Source: Statistics Canada, CREA

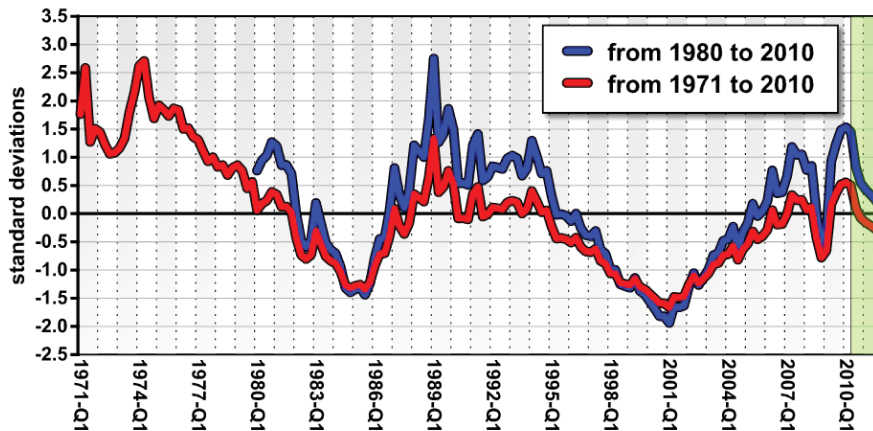
In recent years, homes purchased with wealth, not income, may have changed the relationship between average price and income in British Columbia

RATIO REVERSION OUTLOOK

CREA and other organizations are forecasting that national sales activity will decline in 2011, and the national average price will sag marginally. Private sector forecasts point to income growth.

Exhibit 8:

**Canadian home price to income ratio
(standardized)**



Source: Statistics Canada, Conference Board of Canada, CREA

Reversion of price to income ratio to its long-term average is confirmed by forecasts for incomes and average price

Based on the long-term relationship between the national average price and income, combined with forecasts for a marginal decline in national average price and continuing income growth, the price to income ratio will soon revert to its long-term average (Exhibit 8).

OVERWROUGHT WARNINGS

Warnings of a U.S.-style correction in Canadian home prices are based on the view that the price to income ratio will revert to its long-term average by way of significant price declines. Central to this view is the expectation that interest rate increases will cause the supply of homes to surge due to a wave of mortgage defaults or distress sales, and cause housing demand to plummet.

The supply side of this position fails to recognize solid Canadian mortgage market trends. Recent reports published by the Canadian Association of Accredited Mortgage Professionals (CAAMP)¹ and CIBC World Markets² indicate that:

- The vast majority of mortgage holders have borrowed less than they could otherwise have qualified for.
- Most mortgages (66%) have terms of at least five years.
- A substantial percentage of mortgage holders have been converting (“locking-in”) their variable rate mortgage to a fixed mortgage interest rate, giving mortgage holders more time to pay down principal and benefit from rising incomes.
- Mortgages with variable interest rates are focused in higher income groups.
- Homebuyers are becoming increasingly cautious about extending amortization periods. Over the past 12 months, most new mortgages (64 per cent) have amortization periods of 25 years or less. This is an increase compared to 54 per cent one year ago.
- A significant percentage (25%) of mortgage holders recently increased their home equity via lump sum payments against the principal and/or by increasing the amount of their mortgage payments above their scheduled payment.
- Most mortgage holders (77%) have a home equity position of at least 25%.
- Many will face lower mortgage interest rates when renewing.
- Very few mortgage holders are at risk of unaffordable increases in mortgage payments.
- Job losses incurred during the recent recession are the primary cause of the recent rise in mortgage arrears. With employment having stabilized, the arrears rate has likely reached its cyclical peak.

Concerns about a massive wave of mortgage defaults for those with amortizations of greater than 35 years and no down payment are equally uninformed. Mortgage default insurance (MDI) was available for these mortgages beginning in December 2006 and discontinued in October 2008. To qualify for MDI, borrowers were required to have higher beacon scores compared to other types of qualified mortgages. Borrowers financing their home purchase using a variable mortgage interest rate were also required to qualify using the three-year conventional mortgage rate. During the period over which these mortgages were available, the three-year mortgage interest rate reached a low of 6.15 per cent in May 2008. This is significantly greater than variable mortgage interest rates available more recently. Because variable rate mortgage holders with no down payment and 40 year amortizations were qualified for MDI at interest rates higher than their contract rate, potentially higher mortgage payments due to anticipated interest rates increases should be manageable.

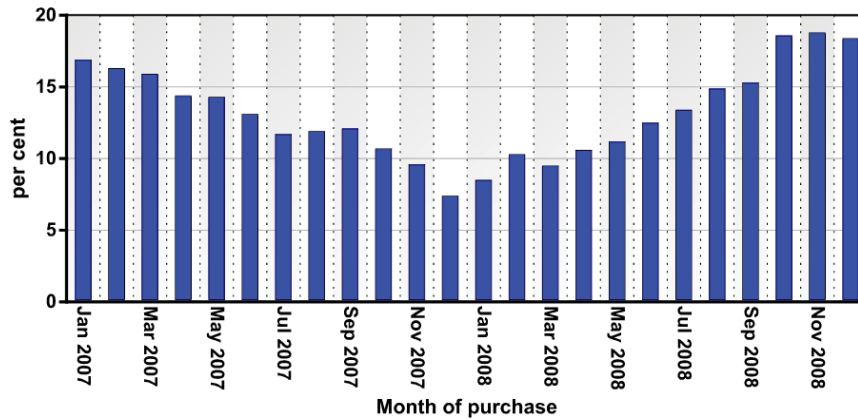
¹ See: “Revisiting the Canadian Mortgage Market – Risk is Small and Contained” (January 2010), and “Prudence Paying Off for Canadian Mortgage Borrowers” (CAAMP, May 2010).

² See “Canadian Mortgage Debt – A Closer Look” (CIBC World Markets, December 2009).

Homebuyers who bought using a mortgage with zero down and 40 year amortizations have accumulated equity. Exhibit 9 shows that, for purchases made between 2007 and 2008, equity as a percentage of average home value as of April 2010 ranges from a minimum of 7.3 per cent (for purchases made in December 2007) to over 18 per cent (for purchases made during the fourth quarter of 2008).

Exhibit 9:

Equity as a share of home value in April 2010
By month of purchase

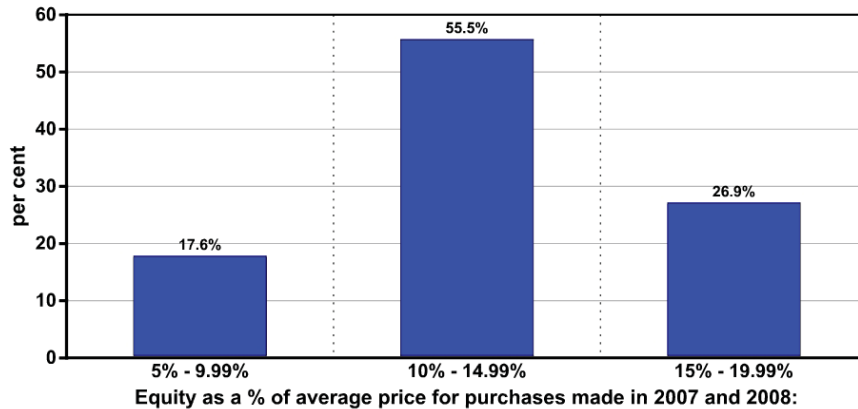


Source: Statistics Canada, CREA

The distribution of accumulated home equity for homes purchased in 2007 and 2008 using a mortgage with zero down and 40 year amortizations is shown in Exhibit 10. As of April 2010, equity as a percentage of average price ranges between 10 per cent to 15 per cent more than half of these home purchases.

Exhibit 10:

Home equity for purchases using 0 down & 40 year amortization
As of April 2010



Source: Statistics Canada, CREA

A sharp decline in housing demand due to expected interest rate increases is not supported by economic forecasts. The consensus among private sector forecasters points to further job and income growth, and a measured rise in interest rates. Job growth and rising home equity will prevent the pool of potential buyers from dropping sharply.

Based on the consensus of private sector forecasts, the five-year conventional mortgage interest rate will rise, but home financing will remain within reach for many new and repeat homebuyers over the next few years. Jitters about a repeat of the credit crunch that caused interest rates to spike and precipitated the recent global economic recession are understandable. While an unexpected jump in interest rates is always possible, the more likely scenario is that Canadian interest rates will rise slowly and marginally. Inflation expectations remain well anchored; while interest rates are expected to rise, they will remain at stimulative levels in support of economic growth as an era of fiscal restraint follows the expiry of temporary government stimulus spending aimed at combating the recession.

FINAL THOUGHTS

Canada is widely believed to soon enter a typical demand-driven housing downturn due to recent price increases and an expected rise in interest rates. While an unexpected spike in interest rates is always possible, rates are most likely to rise at a measured pace during a new era of fiscal restraint.

The prevalence of mortgages with longer-term interest rates insulates the overwhelming majority of Canadian mortgage holders from short-term interest rate volatility. Mortgage lenders have remained conservative in their lending practices throughout the recent Canadian housing market cycle, and mortgage holders have borrowed conservatively and are accelerating mortgage repayment. This provides options for the small proportion of mortgage holders that may face financial difficulty when their mortgage is renewed at a higher interest rate. Canada will avoid a massive oversupply of homes and a sharp drop in housing demand.

In keeping with the return of a balanced housing market and the dynamics of a typical demand-driven housing market cycle, prices are expected to remain stable. The national price to income ratio will soon revert to its long-term average as a result of stable home prices and rising income. Canada's solid mortgage market trends, conservative lending practices, and prudent borrowing by homebuyers means that Canada will avoid a U.S.-style housing price correction.

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