

HOUSING MARKET FROTH FINALLY EVAPORATING

May 2008

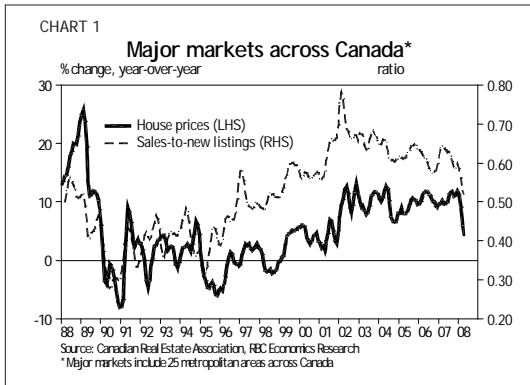


CHART 2
City resale markets
% change, year-over-year, April

	Prices	Sales	Listings
Major markets	3.2	-6.1	17.7
Regina**	64.6	14.6	49.0
Saskatoon**	31.2	12.8	120.8
St. John's	17.2	27.3	-6.8
Sudbury	16.8	-6.9	18.8
Saint John	14.4	18.1	7.7
Thunder Bay	9.7	15.8	-4.1
Vancouver	9.0	-5.0	25.9
Hamilton	6.9	2.2	17.8
Ottawa	6.7	0.7	16.2
Kitchener	6.1	-3.0	-2.3
Halifax	6.0	-1.4	6.4
Toronto	5.2	-7.3	18.3
Quebec*	4.7	-7.7	-5.6
Victoria	4.5	-14.2	4.0
London	3.2	-8.6	19.9
Windsor	-0.6	-2.8	15.5
St. Catharines	-0.7	3.0	21.7
Calgary	-1.6	-31.2	17.1
Edmonton	-2.0	-25.4	35.6

* Data for cities in Quebec are currently unavailable. Provincial numbers for March have been used as a proxy.
** Preliminary estimates

After another blockbuster year for Canada's housing markets in 2007, the much-anticipated housing market slowdown has arrived. The delayed arrival can be partly attributed to recent mortgage innovation that has seeped into the Canadian market during the last two years. Higher loan-to-value ratios and longer amortization periods (now extending up to 40-years) prolonged the housing cycle by opening up the market to a wider range of prospective homeowners. The near-term effects mean more manageable affordability conditions, while the longer-term effects of higher leverage heighten the risk of default. The effects of mortgage innovation will cushion, but not prevent, Canada's housing markets from cooling off as the current housing cycle gears down.

Tide turns in 2008

Last year, major markets delivered a sixth consecutive year of 10% house price gains, sales-to-listings ratios held firmly in seller's territory, and housing starts held above 220,000 units for a fourth year running as excess demand in the resale market spilled over into the new home market. But, housing markets are now on a clear cooling path and April's housing statistics supported this view. In April, major markets across Canada saw resale activity fall 6% on a year-over-year basis; listings jumped 18%; and price gains moderated further into the low single-digit range, hitting 3%.

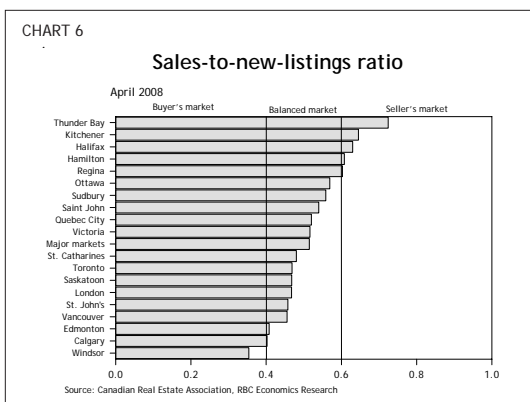
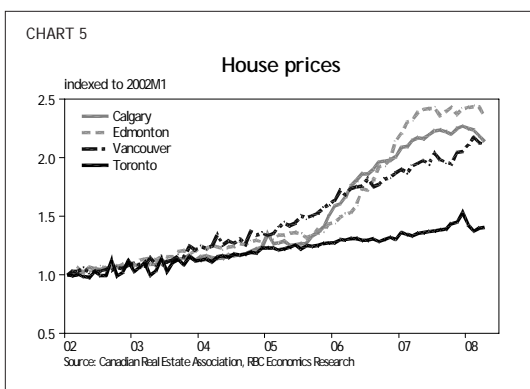
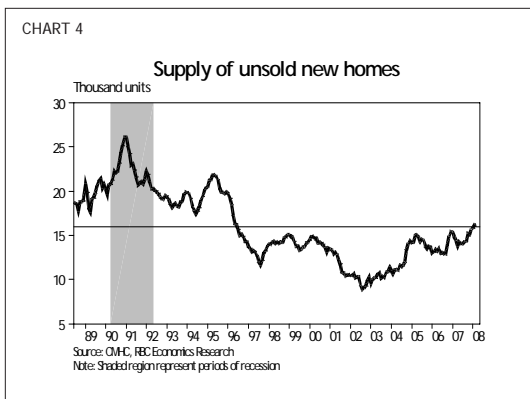
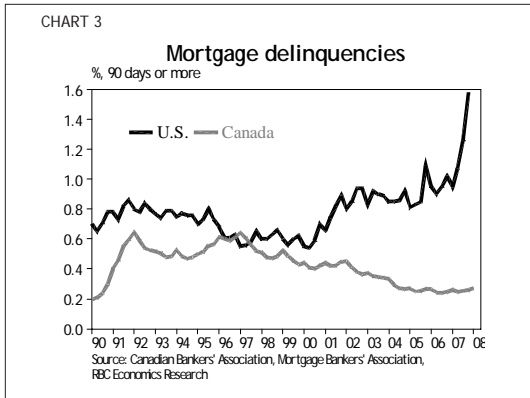
The slowdown is not shared evenly. Markets that soared well above their underlying economic fundamentals are the very ones with the most downside potential. Calgary and Edmonton have moved from chart-toppers to bottom-of-the heap in only a matter of months on a range of key housing market indicators, including house prices and sales (chart 2). Saskatchewan jumped into the spotlight in 2007 as a commodity-led expansion attracted migrants, which led to a major housing market boom. Regina and Saskatoon continue to clock annual price gains that are several multiples above the pace of their local wage growth. This lends evidence that current momentum is unsustainable, with a similar fate to Alberta's likely for both of these cities in a year's time.

Many of the middle-of-the-pack markets — like Toronto, Ottawa and Montreal — are maintaining their slow and steady cruising speed. House prices across much of central and eastern Canada are rising between 5% and 10% year-over-year. More moderation is in the cards this year as resale volumes slow, prices continue to cool, and new home construction activity tapers down from extremely elevated levels.

No U.S. style correction

Canada's housing market is on much firmer footing than the U.S. market. Although the arrival of slipping house prices in markets like Calgary and Edmonton are raising concern that Canada might be headed for a U.S.-style correction, the recent softening in house prices is part of a natural end-of-cycle slowdown that is expected to take hold through 2008. Several factors support our view that Canada's market is simmering down but still in healthy shape, including

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Canada's more conservative lending practices, healthy household finances, tight labour markets and a manageable inventory situation.

More conservative lending practices

Canada's lending practices in this past cycle were much more conservative than in the United States. Mortgage credit was extended, on average, to more capable buyers in Canada, leaving household balance sheets in better shape with mortgage quality strong and delinquency rates well below past cyclical peaks (chart 3). Also, while U.S. sub-prime mortgages account for roughly 14% of the market, Canada's sub-prime mortgage market is negligible — the highest estimates show only a 5% share. Speculative investing is also much tamer in Canada as investor-owned mortgages account for roughly 2% of the market compared to about 10% in the United States and the United Kingdom.

Labour markets are tight

A strong labour market is a critical underpinning to healthy housing markets. Canada's unemployment rate is holding at a 33-year low and average wages are outpacing inflation, meaning that homeowners are still realizing real increases in their monthly wages. Unemployment rates remain the lowest out west in Victoria (3%), Calgary (3.1%), and Saskatoon (3.3%) but are sitting at or near historical lows in most major markets across the country. Some slack in labour markets is expected as the economy cools, but outright job declines are unlikely as service sector gains are more than offsetting manufacturing sector losses.

Inventory overhang manageable

The inventory situation is largely in check with unabsorbed inventories inching up but still comfortably below levels hit in the late 1980s housing market bubble (chart 4). Again, there are some outliers with Edmonton's inventory situation rising at the fastest pace in the country. On balance, however, inventories are expected to continue to creep up as markets gradually return to more balanced supply and demand conditions.

Some markets more vulnerable than others

Sound housing market fundamentals leave little room for concern about a significant nationwide correction. However, there are different stories unfolding, with the west cooling sharply while central and eastern Canada remain in remarkably stable and balanced territory. A look back at the gains clocked since the cycle began gaining momentum in 2002 demonstrates the regional disparities in home price valuation (chart 5). Western Canada clearly takes the cake and is now coping with the aftermath of such a rapid run-up in house prices.

Bottom line – Sellers to lose some bargaining power

As housing markets move onto a softer growth path, sellers will gradually lose their negotiating power, but with significant regional variation. Sales-to-new-listings ratios have largely moved out of seller's territory in most markets and are likely to stabilize in the soft end of a balanced market by year-end. A declining sales-to-listings ratio points to the risk of further price cooling ahead, but the risk of significant price declines is still low, and Canada's housing market is expected to eke out modest price gains in 2008.

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