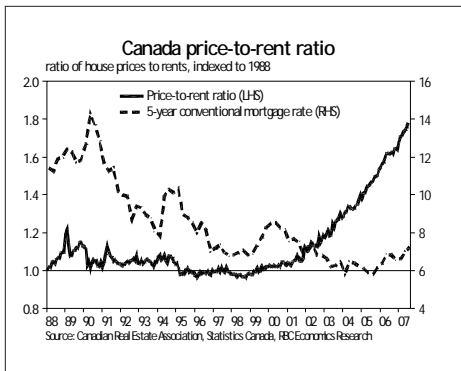
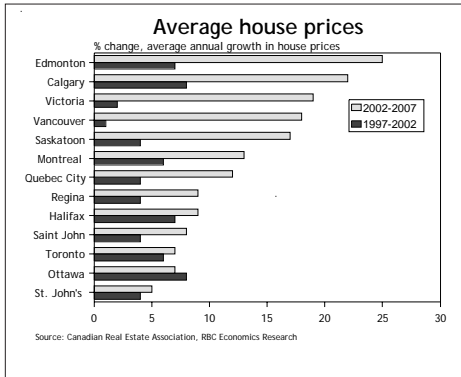


## HOUSING VALUATIONS POINT TO FROTHY MARKETS IN MAJOR WESTERN CITIES

September 2007



Canada’s housing market has been on a bull run for five years running. From 2002 to 2007, major markets across the country saw average annual price growth of 11%. Western cities were significantly above the average, while much of central and eastern Canada came in well below the average. In the prior five-year period from 1997 to 2002, average annual growth was a more moderate 4% with very little regional disparity as most major cities hugged close to the national average. The recent resilience of Canada’s housing markets has begged the question about the sustainability of the current housing cycle. A fundamental factor affecting housing demand is relative house prices. Raw price trends are misleading because they are not adjusted for inflationary pressures and because real estate is priced locally and differs vastly across markets. A rapid run-up in house prices is not necessarily a sign of an overvalued market. By looking at an alternative housing valuation measure using the asset-pricing approach, we attempt to shed some light on factors driving markets in major cities and to evaluate those that are starting to look frothy by this measure.

### A look beyond our standard affordability measure

Our latest housing affordability calculations showed one of the largest and most broadly based quarterly deteriorations in affordability in the current housing cycle stretching back to the mid-1990s. While the deterioration spanned every major city, it was the western markets that warranted caution because of the speed and depth of the deterioration. Our affordability measure provides a rough depiction of trends in wages, the cost of capital, energy prices and tax rates, but it has limitations, but it does not directly address whether or not house prices are high today by historical standards and how they compare to local rental options, nor does it account for recent financial innovation, which has altered the dynamics of the housing market through the introduction of products like extended amortization mortgages.

Another measure that provides an indication of an over- or undervalued market is the price-to-rent ratio — akin to a price-to-dividend ratio in the stock market — that compares house prices to rental costs using the rent component in the consumer price index. The price-to-rent ratio also has limitations. First, rents can be artificially depressed because of rent controls and a surge of new condos coming to market. Second, as momentum in a housing cycle picks up so does the value of expected future returns on housing investments and can lead to a rising price-to-rent ratio. There are also regional variations on the expected future returns, and therefore price-to-rent ratios, that are likely skewed sharply to the hot western markets. Third, the model assumes efficient markets, but real estate markets are plagued by many inefficiencies including high transaction costs and information barriers. While insufficient on their own to predict market valuations, these two measures taken together can help assess whether housing markets are inflated. For example, while financial market trends help explain some of the increase in price-to-rent ratios in central and eastern Canada, they do not fully explain the increases out west. The housing affordability measure together with the price-to-rent ratios point to evidence of overvalued markets in the west, while markets from Manitoba eastward appear, on balance, to be fairly valued.

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## Rising price-to-rent ratios partly justified

The unanimous trend of rising price-to-rent ratios in every major city in the current housing cycle can be partly attributed to recent financial market developments and innovation. The combination of historically low interest rates and significant financial innovation has been a key support in the current housing cycle. There is a significant discount rate story at play. Interest rates were on a downtrend through much of the 1990s and have held at very low levels since the start of the decade, helping to fuel housing demand. Financial innovation has also helped to make the market more liquid through extended mortgage amortizations, higher accepted loan-to-value ratios and securitization. Longer amortization products now dominate new mortgages in the insured market and comprise about 25% of total new mortgages in Canada, making housing markets more accessible. They are expected to extend the current housing cycle longer than would otherwise have been the case.

## Regional disparities behind soaring price-to-rent ratios

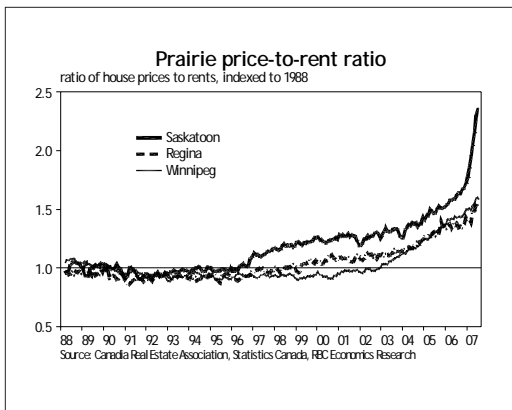
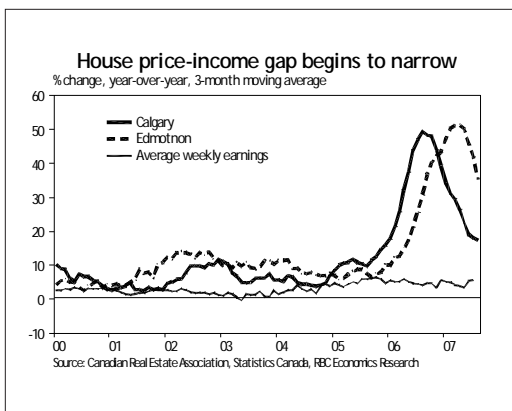
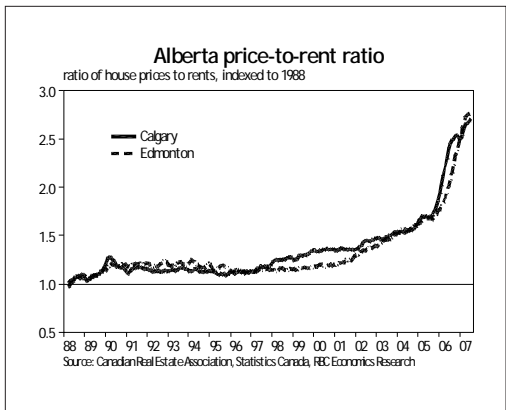
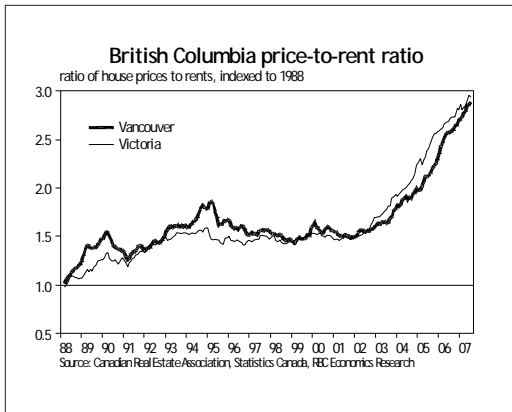
National price-to-rent ratios were remarkably stable through the 1990s indicating a relative indifference between buying versus renting a home. The result was a significant improvement in affordability right across the country. The tide turned at the start of the current decade and price-to-rent ratios have since increased by roughly 80% nationally. A rising ratio means that house prices are outpacing rental costs. These trends are not a consistent cross-provincial phenomenon. To understand local markets, we look at how the ratios have behaved across major cities. Part of the increase in the ratios is attributable to what has become an overheated market out west. However, part is also due to changing market dynamics that have made housing more affordable and accessible to lower-income segments.

## Highest price-rent ratios in Victoria and Vancouver

Victoria and Vancouver have the highest price-to-rent ratios and are widely regarded as the most expensive real estate markets in the country with average house prices roughly 45% above the national average. Going against the norm, the ratios were already on a mild upward trajectory through the early 1990 and accelerated at an even faster pace in the last five years. The ratios are now three times what they were in 1988. These dynamics have fed into a significant erosion to affordability conditions right across British Columbia. As the lagged effects of stressed affordability conditions filter through, they are expected to continue to dampen demand — a trend that is already evident. Both Victoria and Vancouver have gradually moved back into more balanced supply and demand conditions, indicating that the markets are expected to moderate from their recent peaks during the coming year.

## Moderation in the cards for Calgary and Edmonton

Housing markets in Calgary and Edmonton have been on fire. Although down from last year's 40% pace, Calgary is averaging annual growth in house prices of 23% so far this year, and Edmonton is averaging annual growth of 45%. While current conditions are still far more affordable than in neighbouring British Columbia, price-to-rent ratios show that valuations have accelerated at a pace comparable to Vancouver and Victoria. The chief distinction is that the acceleration was more concentrated in the last three years. With house prices sharply outpacing both rent and incomes for three consecutive years, there is now substantial evidence of an overvalued market. Fundamentals are still supportive of an overall healthy market going forward, particularly with oil breaking new highs, but the steep acceleration in the ratio is signalling a market ripe for moderation in the coming years. Similar to trends in British Columbia, markets in Alberta have already started to show some signs of more moderate activity compared to its blockbuster year in 2006.



## Saskatoon the lone Prairie outlier

Housing markets across major cities in the Prairies have long been the most affordable in the country. But, the recent pick-up in Saskatoon's market has quickly changed conditions. Regina and Winnipeg have seen their price-to-rent ratios move up during the last few years after very stable valuations through the 1990s but are still at modest levels. The bigger story is Saskatoon where the recent pick-up has caused price-to-rent ratios to soar. In contrast to Calgary, Edmonton and Vancouver, the pick-up in Saskatoon has been very concentrated in just the last year. The sudden and steep acceleration in price-to-rent ratios coincides with the sharpest deterioration in affordability on record. More expensive conditions already appear to be pricing people out of the market. Fifty-percent price gains are starting to weigh on demand and softer demand should feed through to cooler price gains ahead.

## Stability in Toronto and Ottawa

Ottawa and Toronto have both participated in the bull run in housing markets since the start of the decade but clocked most of the sharpest gains in the first few years. In the last few years, these markets have shown signs of moderation with price gains slowing from double-digit growth down to the 4%-5% range. What distinguishes these markets from the western markets, however, is that conditions are not out of whack with the underlying fundamentals. After the bursting of the housing bubble in the late 1980s, these markets went through a decade-long adjustment period and actually saw declining price-to-rent ratios until about 1996 when they bottomed out. The trend has since reversed as the cost of home ownership compared to renting gradually increased as markets recovered from a significant correction.

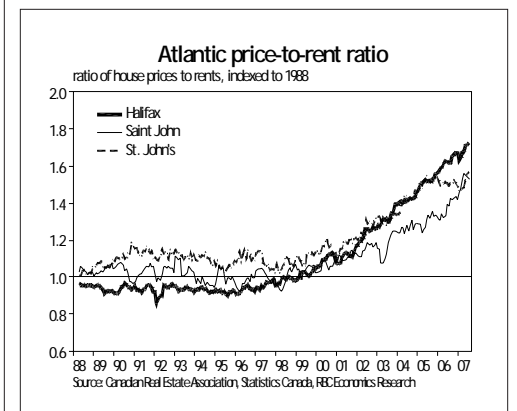
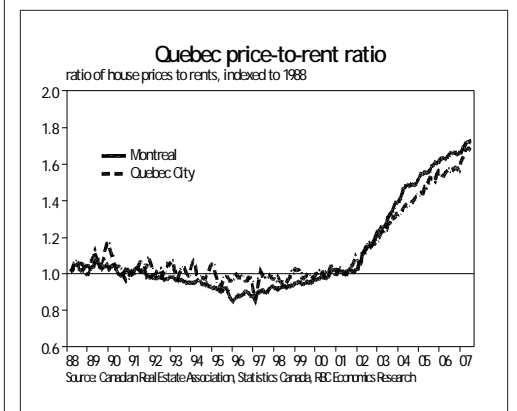
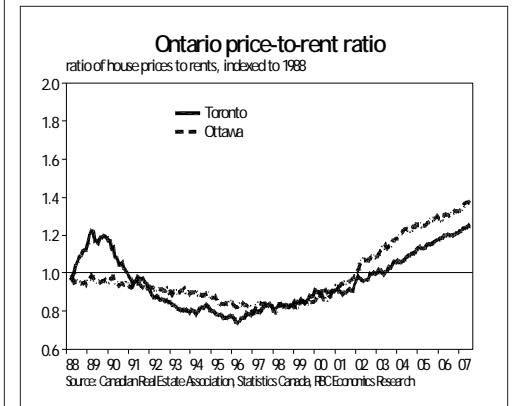
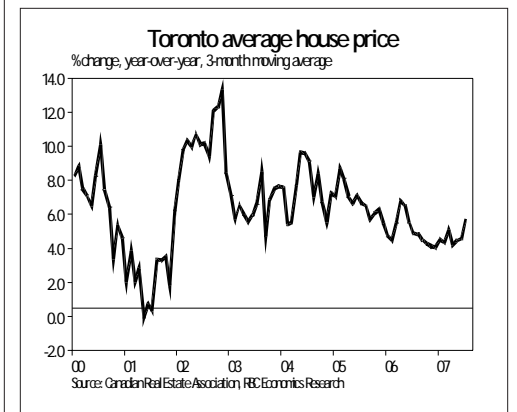
The price-to-rent ratios show that valuations in Toronto have returned to the levels that prevailed in the late 1980s while Ottawa has moved further above its late 1980s levels, but both are still well below valuations in the west. Some of the rise in ratios can be explained by innovation in financial markets since overall affordability conditions remain in check. Housing markets are expected to remain stable and healthy through the next year.

## Quebec's price-to-rent ratios pushed higher

A strict interpretation of rising price-to-rent ratios in Montreal and Quebec City points to markets being a renters haven. After stable ratios through the 1990s, markets have been on a significant upswing since 2002. However, a less dramatic picture emerges when affordability variables such as incomes and property taxes are taken into consideration. Income growth has been quite healthy and has kept affordability well below its late 1980s peaks. So, while markets are elevated, they do not appear to be out of line with underlying fundamentals in the economy. A tight job market and relatively stable affordability points to a healthy housing market.

## Atlantic Canada markets re-balancing

Similar to Quebec, price-to-rent ratios across cities in Atlantic Canada have also pushed higher in the current housing cycle. However, these ratios also need to be put in the context of not only the changing dynamics in the housing market but also in relation to incomes and overall affordability conditions. Underlying fundamentals across the Atlantic are not out of line with price gains. The market has actually started to show signs of cooling as deteriorating affordability conditions feed through into more moderate demand. Markets are in the midst of a re-balancing act and do not appear overvalued relative to fundamentals.



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