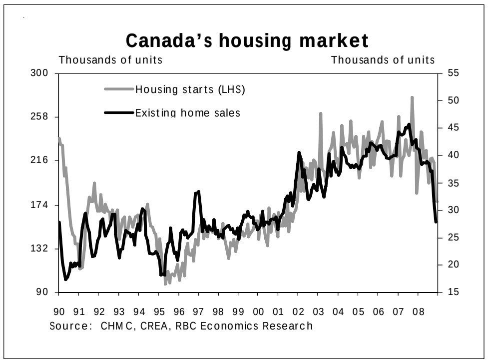
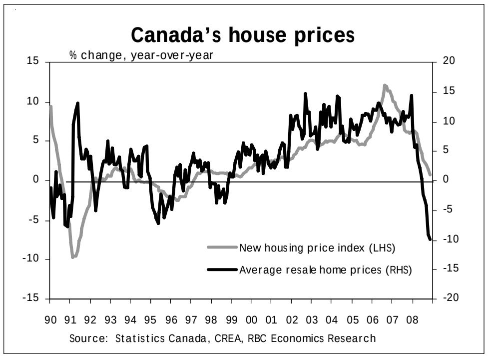
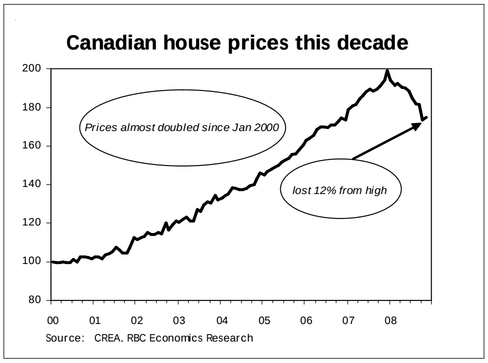
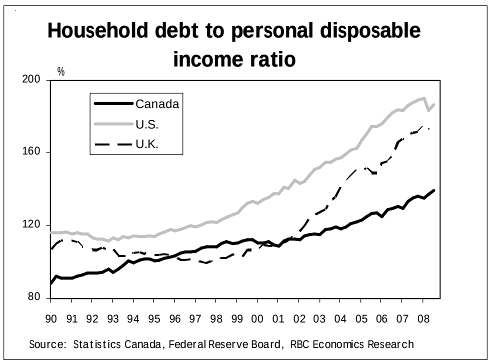
CURRENT ANALYSIS

February 2009









Dawn Desjardins
Assistant Chief Economist
416-974-6919
dawn.desjardins@rbc.com

The good and bad news for Canada's housing market

Canada's housing market sagged in late 2008 with sales falling and prices dropping below year-earlier levels. The Canadian Real Estate Association's data showed that the number of units sold fell steadily from May 2007's record pace and that the pace of decline picked up significantly in the fourth quarter of last year. Prices peaked in December 2007 and were off 13% from that peak a year later.

Activity is slower in all regions, but British Columbia stands out as the market that has come under the most significant downward pressure, with unit sales running 58% below their peak pace as of December 2008 and prices off about 16%. Ontario's housing market has also slowed significantly, with sales running at 37% below the July 2007 peak and prices off 11.7% from their December 2007 high. The slowdown in activity and price declines have awakened concerns that Canada is headed for a U.S.or U.K. housing market slump. While we expect Canada's housing market to soften some more, we see limited scope for the correction to mirror the record-breaking housing slump in these other economies.

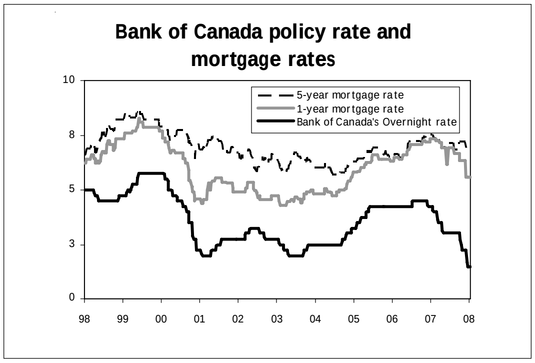
The bad news

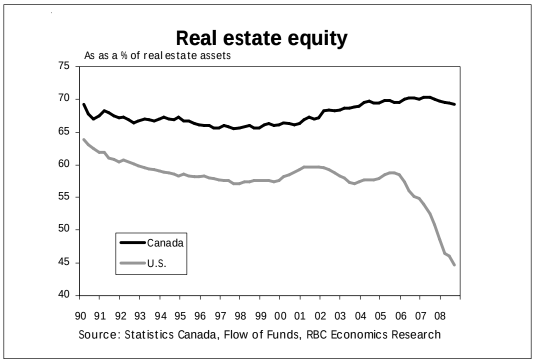
To be sure, some of the arguments favouring a continued deterioration in Canada's housing market are compelling. The economy is in recession with significant pockets of weakness, including Ontario, where slumping U.S. demand is hurting exports and a weakening labour market paints a picture of stunted growth. Consumer confidence is at an all-time low and, after a sustained period of robust job growth, the labour market is easing, with a record-breaking 129,000 jobs lost in January alone. In addition, the aggressive easing by the Bank of Canada has not fully translated into lower mortgage rates as high funding rates keep pressure on credit spreads.

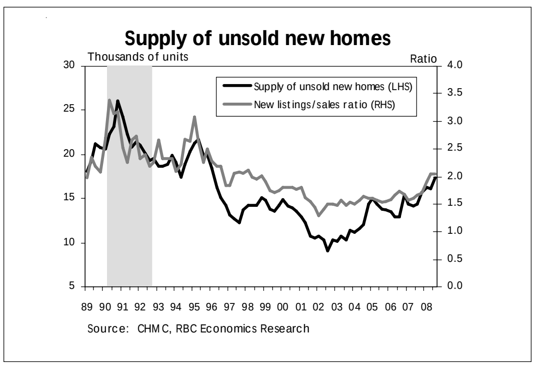
At the same time, households have been acquiring debt at a rapid pace and the recent trouncing in financial asset values and, to a lesser extent, real estate values pushed the debt-to-asset ratio to 18.8% in the third quarter of 2008, above the peak of 18.4% reached during the past recession. As a percentage of personal disposable income, Canadians are carrying the largest debt load on records back to 1990.

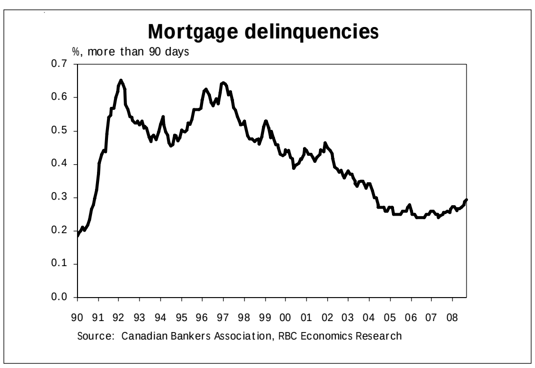
The good news

Despite the rapid pace of debt accumulation, Canada's debt-to-disposable income ratio stands at a much lower level than in either the United States or the United Kingdom. And, while the debt load has increased, the cost to service that debt has started to decline — the debt-service ratio edged down to 7.8% in the third quarter of 2008 from a recent peak of 8.1% three quarters earlier thanks to lower interest rates. Even without the recent declines, this ratio stands well below the 10%-plus rates evident during the early 1990s recession. The prospect that mortgage rates will continue to decline as credit markets stabilize and spreads narrow sets up for debt service costs to continue to ease in 2009.









The Bank of Canada's aggressive easing campaign has resulted in the overnight funding rate falling to 50-year low and extremely low levels for government bond yields. While the uncertainty in financial markets produced significantly wider credit spreads, policy actions by central banks to increase liquidity are starting to have traction and there is evidence of a moderate improvement in credit markets. Importantly, the spread between the three-month LIBOR rate and the expected policy rate has eased and, although still above its long-term average, is well below recent peak levels. This signifies that credit market conditions are improving, which bodes well for credit spreads to narrow over time, including those affecting mortgage rates.

Canadians have significant equity in their homes with the real estate equity-to-asset ratio standing at 69.2%, down from a record of 70.4% in June 2007, but still near historical highs. This compares favourably to the United States where households have 44.7% equity in their homes, down from a recent high of 58.8% in mid-2005.

The supply of unsold homes is up but still well below levels of past recession. The supply of existing and new unsold homes rose in recent months, which is likely to keep downward pressure on prices in the near-term. Still, the overhang is running between 58% and 60% of the level of the early 1990s and the number of new listings of existing properties declined in the latter part of 2008 after running higher mid-year.

The percentage of mortgages in arrears, meaning payment is late by three or more months, stands at 0.29% of all mortgages outstanding, higher than the recent low of 0.24% but below the average for this decade of 0.32% and the 1990s average of 0.5%.

Is there room for conditions to worsen?

While the good news appears to outweigh the bad in our list of factors, we still see room for Canada's housing market to slow in 2009. The weakened sales pace and falling prices are only adding to the anxiety Canadians are feeling about the economy and construction has already started to soften as indicated by the sharply lower level of housing starts in November through January.

RBC's base-case scenario for the economy is that the 2008-09 recession will be relatively short-lived, with accommodative monetary policy getting more traction once credit markets stabilize. There is also a healthy dose of fiscal stimulus on the way. With both fiscal and monetary policy support and a financial system that is weathering the current credit crisis better than many other economies, we expect a return to positive economic growth in the second half of 2009, which will limit the damage to labour markets and likely act as a balm to consumers' frayed nerves. The risk of a deeper and more prolonged global recession, however, cannot be discounted and this raises downside risk to our projection of a moderate, cyclical downturn in Canada's housing market in 2009 and modest recovery in 2010.