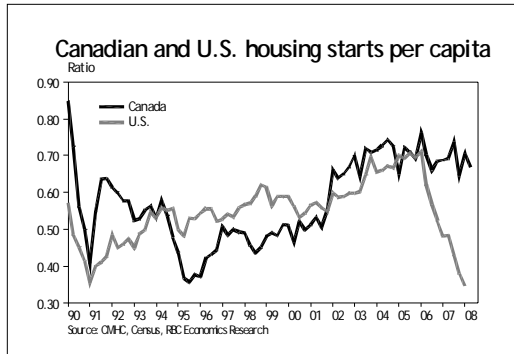
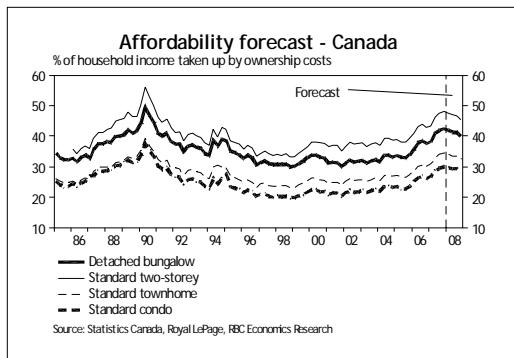
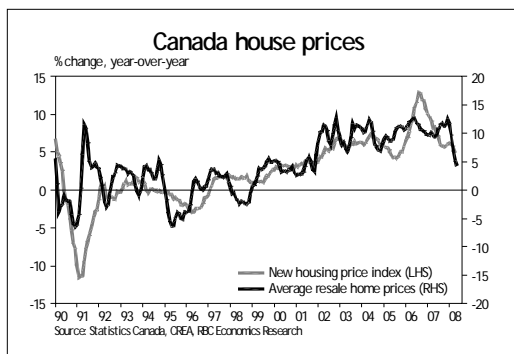
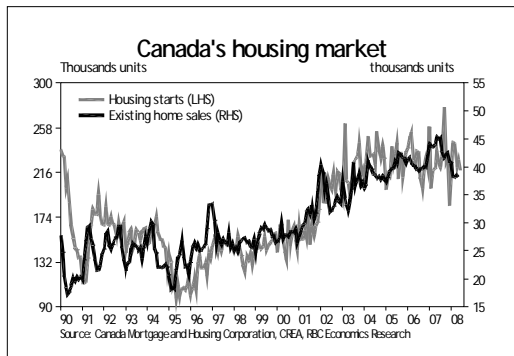


CURRENT ANALYSIS

July 2008



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

Housing market losing its edge, but no U.S.-style crash ahead

Canada's housing market is showing signs of coming off the boil after a period of unprecedented strength when resale home sales hit record highs, prices racked up double-digit gains and housing starts ran at a faster than 200,000-unit pace for six consecutive years. Recent reports showing that sales and prices are starting to slow have raised concerns that Canada's housing market boom is set to bust, mirroring the slump in the United States. To be sure, conditions are softening, but there continue to be many factors that point to Canada's housing market avoiding a U.S.-style crash landing.

Signs of cooling in resale market

Canada's resale housing market showed signs of slowing in the second half of last year with sales on track to post the fourth consecutive quarterly decline in the second quarter of 2008. Even at this more moderate level of activity, however, sales continue to run above the average pace of the past 20 years with 38,133 units sold in May 2008 (Chart 1). Since 2002, the strong demand for housing supported annual average price gains of about 10% each year from 2002 to 2007 for existing homes, with this pace slowing to 3% as of May. New house price gains have also slowed from 12.1% in August 2006 to 4.1% in May.

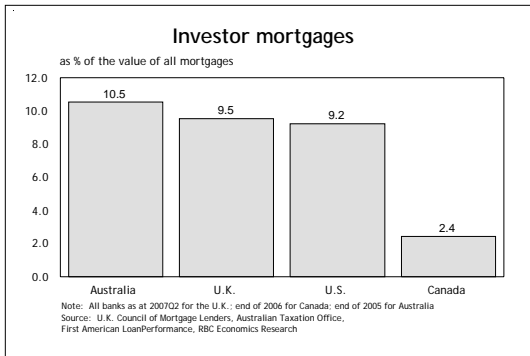
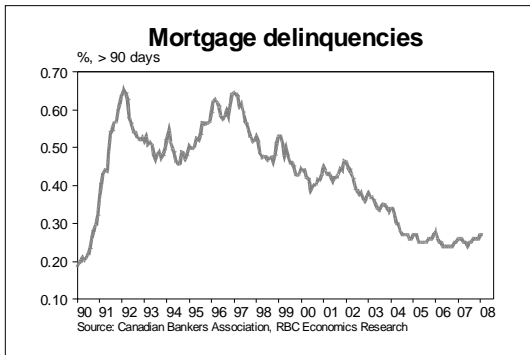
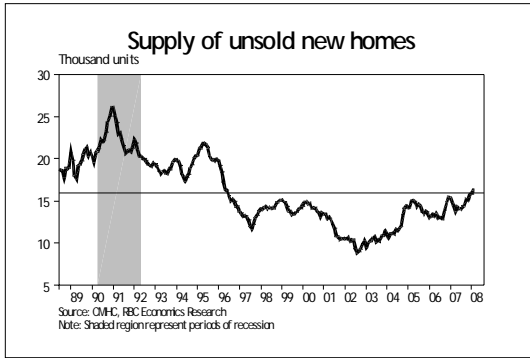
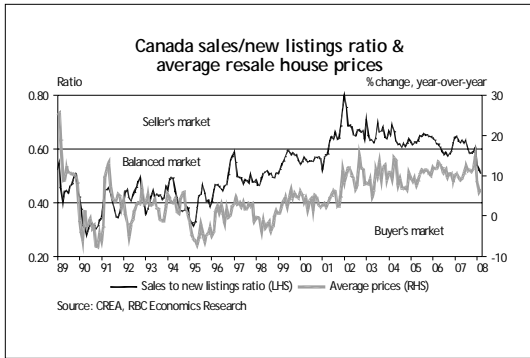
The slowing in the housing market was expected and, to some degree desired, as affordability became increasingly strained throughout 2007. RBC's Affordability Index, which tracks the proportion of household income required to finance home ownership, deteriorated steadily throughout 2007, with most major markets seeing affordability levels weaken to their worst levels since the early 1990s.

Price gains justified by fundamentals

The steady run of double-digit increases has pushed the inflation-adjusted price of Canadian homes up by a cumulative 46% in the past 6-1/2 years. Despite this massive increase, Canada is still considered to be one of the countries where the housing market is least overvalued according to international studies by agencies such as the IMF whose metrics indicate that price increases in Canada have been largely justified by fundamental factors.

Rebalancing act

On the supply-side, the high level of demand supported construction activity with housing starts running at an historically fast rate. Starts exceeded 200,000 units each year from 2002 to 2007, and continued to run at a blistering 228,000-unit average pace in the first half of 2008. Some of the "uber-hot" markets in the west, like Alberta, have started to cool, although other provincial markets, such as Saskatchewan's, have started to take off. The intense run-up in supply backfilled the pent-up demand from the early 1990s when the pace of starts was running well



below the pace of households being formed, resulting in per capita starts slumping. New listings have been gently rising during the past six years but jumped in April and May and were 13.8% higher than in the same two-month period a year earlier, nudging the market into a more balanced position after a sustained period of being a seller's market.

Low speculative and sub-prime exposure leave Canada in good shape

From a structural perspective, conditions in Canada's housing market are markedly different from the U.S. market, with very limited sub-prime mortgage activity, a relatively small speculative sector and no significant supply overhang despite the robust construction activity. In addition, affordability is forecast to improve this year with the Bank of Canada having cut the overnight rate by 150 basis points since December, mortgage rate spreads showing some signs of narrowing and the pace of house price gains slowing.

More conservative lending practices stand Canadian banks in good stead

Canada engaged in much more conservative lending practices during this past cycle compared to the United States. Mortgage credit was extended, on average, to more capable buyers, leaving household balance sheets in good shape with mortgage quality strong and delinquency rates well below past cyclical peaks. The sub-prime mortgage market in Canada accounts for about 5% of outstanding mortgages, while, in the United States, sub-prime mortgages account for roughly 14% of the outstanding mortgage market. Speculative investing is also much tamer in Canada. Investor-owned mortgages account for roughly 2% of all mortgages in Canada compared to about 10% in the United States and the United Kingdom.

Outlook this year

Current conditions in Canada's housing market point to a year of slower activity, although both starts and sales are likely to remain elevated by historical standards. Price gains are likely to slow but, with market conditions having shifted away from a seller's market and into balance, we anticipate gains to average in the low single-digits, a far cry from the double-digit decline posted in the United States.

The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.

