OBSERVATION

TD Economics

July 17, 2015

RATE CUT NOT A GAME CHANGER FOR CANADA'S HOUSING MARKET

Highlights

- TD Economics has upgraded its housing market forecast for 2015 and 2016 due to the knock-on effects on housing demand from the large decline in mortgage rates that occurred over the January to April period.
- The Bank of Canada rate cut on July 15th is unlikely to be a game changer for the Canadian housing market. There is narrow scope for bond yields to head lower to a degree that would prompt a surge in new housing demand. The Bank of Canada interest rate cut was intended to guard against the downside risks to an economy that has serially underperformed expectations outside of the housing market.

The Bank of Canada's decision to cut the overnight rate by 25 basis points on July 15th sparked some concern as to whether this will only add more fuel to an already hot housing market. The policy decision is unlikely to be a game changer for housing demand. Although TD Economics has upgraded its housing outlook for 2015 and 2016 (Table 1), this is a function of the knock-on effects to demand from the large decline in mortgage rates over the January to April period. The Bank of Canada's surprise 25 basis point cut to the overnight rate back in January was outdone by an outsized 55 basis point drop in the 5-year mortgage rate through to April. This parallelled the fall in the Government of Canada 5-year bond yield (Chart 1), which reflected a global move lower in yields related to economic growth concerns and deflation prospects in Europe.

Based on historical experience, mortgage rate changes of this magnitude can boost demand for housing by 10% to 15% over a 6-month period. Since existing home sales are up only 6% year-to-date as of June, the past decline in mortgage rates are likely to feed through to demand for several more months. In particular, pent-up housing demand has been consistently underestimated over the last few years, and we cannot exclude the possibility that a significant pool of homebuyers and investors are still waiting in the wings to jump into a market supported by a low rate environment.

Since 2009, housing demand has shown bursts of strength through the spring and summer, followed by winter lulls. This is occurring to a greater degree than suggested by past seasonal patterns. We expect housing activity to follow a similar pattern this year, but the slowdown in the winter months could be more sustained than in the past.

There are several reasons for this. First, 5-year government bond yields remain little changed today from April's level, in spite

Table 1: TD Economics Canadian Housing Market Outlook

	Current Forecast		Forecast as of February	
	2015	2016	2015	2016
Existing Home Sales (Y/Y%)	5.1	-3.4	-2.0	1.0
Existing Home Prices (Y/Y%)	7.1	1.4	1.5	1.0
Housing Starts (000's of units)	187.4	191.7	177.0	176.9

Source: Canadian Real Estate Association. F. by TD Economics as of July 2015

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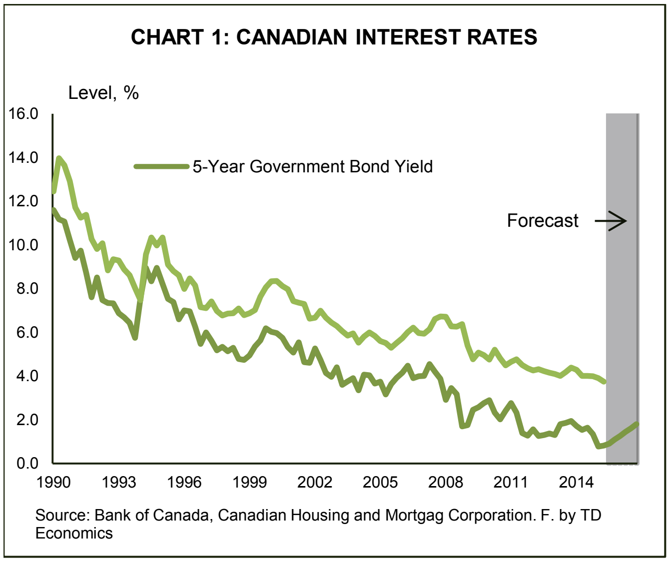

of a brief run-up in yields over the spring months. Although the variable mortgage rate edged lower alongside the Bank of Canada's cut on Wednesday, it is the five-year fixed posted mortgage rate that is the most important for housing activity. It is the rate that borrowers must be income tested against to qualify for a mortgage, and it most closely follows the 5-year government bond yield. Based on historical experience, this rate would have to come down by 40 to 50 basis points to meaningfully stoke home sales and prices. However, bond yields are influenced by global economic developments, as well as the Bank of Canada policy rate. With the 5-year yield sitting at roughly 70 basis points, another large leg down is unlikely. In fact, we think global forces will pull Canadian bond yields slightly higher as the year rolls forward, as rate hikes in the U.S. draw closer and global conditions improve.

A second argument for a cooling in the aggregate housing market later in the year surrounds the fact that the current pace of activity is simply unsustainable. Average existing home prices are still growing at twice the pace of average household incomes, and housing affordability is eroding due to this price appreciation despite record low interest rates (Chart 2). Sustaining this relationship will become even more difficult as the economic weakness over the first half of this year feeds into a key lagging indicator – the labour market. This will likely result in a period of weak employment and a modest uptick in the unemployment rate. All these forces should collide to constrain housing demand towards the tail end of this year and into 2016. Some key markets, such as Toronto and Vancouver, are more exposed on the downside after having already achieved double-digit growth in both home prices and sales this year. While low interest rates have helped stabilize housing activity in commodity-dependent markets such as Calgary and Edmonton, an anticipated acceleration in job losses through the second half of the year could lead to a further leg down in housing activity in those regions over the rest of 2015. In contrast, markets where the impact of low interest rates could offer more upside potential include Ottawa, Montreal, Quebec City and Halifax, where economic conditions are expected to improve and markets have already shed excesses through a multi-year soft landing. For more regional details, please see tables 2 and 3.

The natural question to ask is that if we don't expect the Bank of Canada's recent rate cut to have a large impact on lowering bond yields and stoking new housing demand, then what was the point of lowering rates in the first place? The central bank cut interest rates to maintain stimulative financial conditions to guard against the downside risks within an economy that has persistently underperformed expectations and likely contracted in the first half of the year. The drag feeding through to investment from low commodity prices has been longer and deeper than expected. Meanwhile, the rotation of economic growth towards the non-energy export sector is taking significantly longer alongside a favourable backdrop of stronger U.S. demand and a weaker Canadian dollar. The housing market was never in need of resuscitation. Growth in existing home prices and sales is forecast to clock in at 7% this year due to the sharp gains in housing activity already registered through the first half of this year. The Bank of Canada's commitment to a stimulative financial setting should help the housing market cool in an orderly fashion with time.

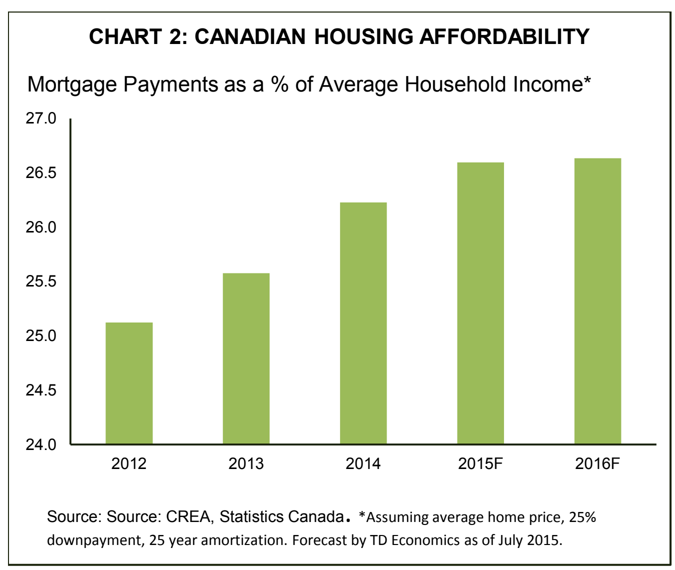

TABLE 2: EXISTING HOME SALES											
	000's of units						Annual per cent change				
	2012	2013	2014	2015F	2016F		2012	2013F	2014	2015F	2016F
CANADA	454.3	457.6	481.2	505.8	488.6	**CANADA**	-1.1	0.7	5.1	5.1	-3.4
N. & L.	4.7	4.3	4.1	3.8	3.6	**N. & L.**	3.8	-7.5	-4.7	-6.7	-5.9
St. John's*	--	--	--	--	--	St. John's*	--	--	--	--	--
P.E.I.	1.6	1.4	1.4	1.7	1.9	**P.E.I.**	6.1	-11.7	-3.2	21.9	11.4
N.S.	10.4	9.2	8.8	7.6	7.3	**N.S.**	1.3	-12.4	-3.6	-13.7	-4.6
Halifax	6.2	5.2	4.9	4.3	4.2	Halifax	2.0	-16.9	-6.5	-11.2	-2.2
N.B.	6.4	6.3	6.3	6.6	6.9	**N.B.**	-3.0	-1.9	-0.1	5.5	4.0
Saint John	1.6	1.6	1.6	1.8	2.0	Saint John	2.2	-1.3	0.2	11.6	10.4
Québec	77.4	71.2	70.7	75.5	74.7	**Québec**	0.3	-8.0	-0.7	6.8	-1.1
Québec City	7.2	6.3	6.5	6.6	6.5	Québec City	-0.3	-13.1	3.2	2.3	-1.1
Montréal	40.1	36.5	35.8	39.2	37.8	Montréal	-0.7	-9.0	-2.0	9.6	-3.6
Ontario	196.8	197.4	204.7	225.5	220.0	**Ontario**	-2.0	0.3	3.7	10.2	-2.4
Ottawa	14.5	14.1	14.1	14.2	13.4	Ottawa	-0.4	-3.1	0.3	1.0	-5.7
Toronto	88.2	88.9	93.3	102.9	97.4	Toronto	-3.9	0.9	4.9	10.3	-5.3
Hamilton	13.0	13.5	14.3	16.7	16.0	Hamilton	-6.4	3.3	6.3	16.5	-3.9
Manitoba	13.9	13.7	13.8	13.8	13.6	**Manitoba**	0.2	-1.2	0.3	0.0	-1.1
Winnipeg	12.1	12.1	12.1	12.1	11.9	Winnipeg	-1.7	0.0	0.5	-0.4	-1.6
Sask.	13.9	13.5	13.9	12.4	12.6	**Sask.**	5.7	-2.4	2.5	-10.7	1.3
Regina	4.0	3.7	3.7	3.5	3.7	Regina	1.4	-6.6	1.0	-5.9	4.6
Saskatoon	5.4	5.5	6.0	5.1	5.0	Saskatoon	4.1	2.7	8.2	-14.8	-1.9
Alberta	60.4	66.1	71.8	58.0	57.3	**Alberta**	12.3	9.5	8.6	-19.2	-1.3
Calgary	26.6	30.0	33.6	25.3	25.7	Calgary	18.6	12.5	12.2	-24.7	1.7
Edmonton	18.6	20.3	20.5	18.5	17.6	Edmonton	5.5	9.3	1.1	-10.0	-5.1
B.C.	67.6	72.9	84.0	100.0	90.8	**B.C.**	-11.8	7.8	15.2	19.0	-9.2
Vancouver	25.4	29.0	33.7	41.8	36.7	Vancouver	-22.7	13.9	16.2	24.2	-12.3
Victoria	5.5	5.7	6.4	7.6	6.5	Victoria	-5.5	4.3	11.9	20.0	-14.8

F. By TD Economics as of July 15

*Insufficient Data

Source: Canadian Real Estate Association

TABLE 3: AVERAGE EXISTING HOME PRICE											
Canadian $, 000's						Annual per cent change					
	2012	2013	2014	2015F	2016F		2012	2013	2014	2015F	2016F
CANADA	361.5	381.7	407.0	436.0	442.1	**CANADA**	0.3	5.6	6.6	7.1	1.4
N. & L.	269.2	283.7	284.3	278.3	278.3	**N. & L.**	7.6	5.4	0.2	-2.1	0.0
St. John's*	--	--	--	--	--	St. John's*	--	--	--	--	--
P.E.I.	152.7	155.1	165.1	164.3	164.9	**P.E.I.**	3.7	1.6	6.4	-0.5	0.4
N.S.	218.2	216.3	213.7	221.3	228.8	**N.S.**	2.8	-0.9	-1.2	3.5	3.4
Halifax	269.3	274.2	275.3	284.0	293.8	Halifax	3.6	1.8	0.4	3.2	3.5
N.B.	159.4	161.4	161.1	157.1	157.7	**N.B.**	0.2	1.3	-0.2	-2.5	0.4
Saint John	166.6	172.1	169.8	159.7	160.0	Saint John	-1.9	3.3	-1.3	-5.9	0.2
Québec	264.6	267.7	271.4	275.4	278.1	**Québec**	4.1	1.2	1.4	1.5	1.0
Québec City	258.1	267.2	265.3	268.6	275.7	Québec City	5.2	3.5	-0.7	1.3	2.6
Montréal	322.1	324.1	331.8	338.5	348.1	Montréal	4.1	0.6	2.4	2.0	2.8
Ontario	381.7	401.2	429.2	461.1	473.5	**Ontario**	5.0	5.1	7.0	7.4	2.7
Ottawa	351.0	356.4	360.7	373.7	389.3	Ottawa	2.3	1.6	1.2	3.6	4.2
Toronto	495.0	521.8	563.5	615.8	642.1	Toronto	6.8	5.4	8.0	9.3	4.3
Hamilton	358.1	381.2	404.5	441.0	463.7	Hamilton	7.8	6.5	6.1	9.0	5.2
Manitoba	246.6	260.7	264.7	268.0	274.9	**Manitoba**	4.9	5.7	1.5	1.3	2.6
Winnipeg	254.0	268.5	271.9	276.6	285.1	Winnipeg	5.3	5.7	1.3	1.7	3.1
Sask.	275.2	287.5	297.9	296.9	298.7	**Sask.**	6.4	4.5	3.6	-0.3	0.6
Regina	301.0	310.9	314.7	311.4	313.1	Regina	8.9	3.3	1.2	-1.1	0.6
Saskatoon	319.3	331.0	340.8	345.9	348.2	Saskatoon	6.1	3.7	2.9	1.5	0.7
Alberta	362.0	380.2	399.8	392.8	394.4	**Alberta**	2.6	5.0	5.2	-1.8	0.4
Calgary	410.8	436.6	459.5	451.6	453.6	Calgary	2.2	6.3	5.2	-1.7	0.4
Edmonton	333.2	343.6	361.3	366.8	365.7	Edmonton	2.9	3.1	5.2	1.5	-0.3
B.C.	512.9	537.6	570.2	627.7	644.4	**B.C.**	-7.9	4.8	6.1	10.1	2.7
Vancouver	725.6	767.4	813.2	899.1	936.4	Vancouver	-6.1	5.8	6.0	10.6	4.1
Victoria	482.0	476.7	495.4	516.7	535.7	Victoria	-2.9	-1.1	3.9	4.3	3.7

F. By TD Economics as of July 15

*Insufficient Data

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