TD Bank Financial Group

Observation

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TD Economics
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STRENGTH IN RENOVATION SPENDING RUNNING ON BORROWED DEMAND

HIGHLIGHTS

- **The renovation tax incentive is estimated to have bolstered renovation activity by an additional $4-4.3 billion over the life span of the tax credit (January 2009-January 2010) – providing a 0.3% boost to real GDP.**
- **The fiscal stimulus may have borrowed $3 billion from future demand. So, while strong momentum in late 2009 and early 2010 will likely drive a 1% annual gain in renovation investment this year, the pace of growth will diminish over the course of the year and into 2011 as payback from the tax credit occurs.**
- **In 2011, renovation activity will face some further challenges, as interest rates start to creep back towards more normal levels, housing market activity cools, and household spending growth moderates.**

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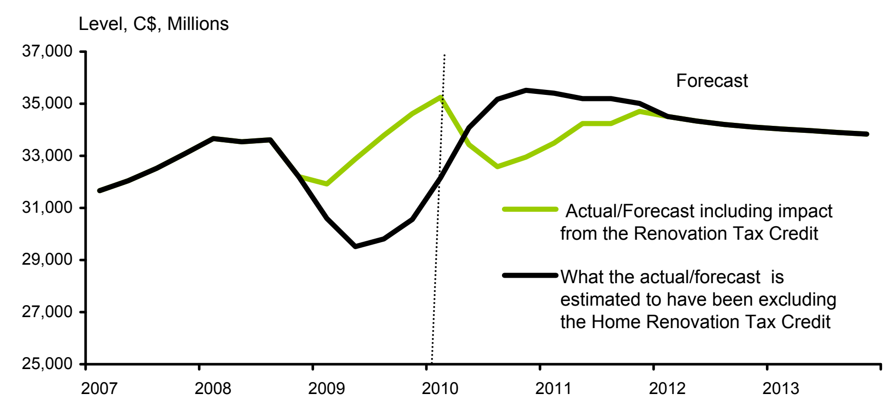
The popular federal home renovation tax credit gave Canadian homeowners an offer they could not refuse. We estimate that the tax credit likely bolstered renovation activity by an additional $4.3 billion above what it would have been over January 2009 to January 2010 – which represents a 0.3% boost to real GDP. As a result, renovation investment was one of the first components of the Canadian economy to fully bounce back from the economic downturn. Now that the tax credit expired at the end of January, one might ask what the future holds for renovation activity.

We believe that the stimulus measure likely borrowed $3 billion of demand from the future – as those with future plans for renovations undertook the spending in 2009, rather than waiting until later years. So, while a strong hand-off from the end of 2009 will likely drive a 1% annual gain in renovation activity in 2010, the pace of growth will diminish over the course of the year as payback from the tax credit occurs, and on a Q4/Q4 basis, renovation spending will likely decline by 5.3%. The payback from the renovation tax credit will be partially offset by favourable borrowing conditions and the pick up in the existing home market that began in the spring of last year– as buyers renovate their new purchases, and sellers attempt to add value in preparation to put their homes on the market. By 2011, a cooling in the housing market will also act as a drag on renovations, which are expected to grow a tepid 1.5%. Beyond 2011, renovation spending will be affected by a broad-based moderation in household spending.

CANADIAN RENOVATION SPENDING: ACTUAL VS. ESTIMATE OF EX. STIMULUS CASE



Source: Statistics Canada, Haver Analytics, Forecast by TD Economics as of February 2010

In this report, references to the impact of the federal home renovation tax credit are made in nominal terms, while references to renovation investment are in real 2002 Canadian dollars. In other words, the volume of renovations, excluding the impact of changes in prices. We focus on the implications for the volume of renovation investment because this real measure is what directly impacts economic growth.

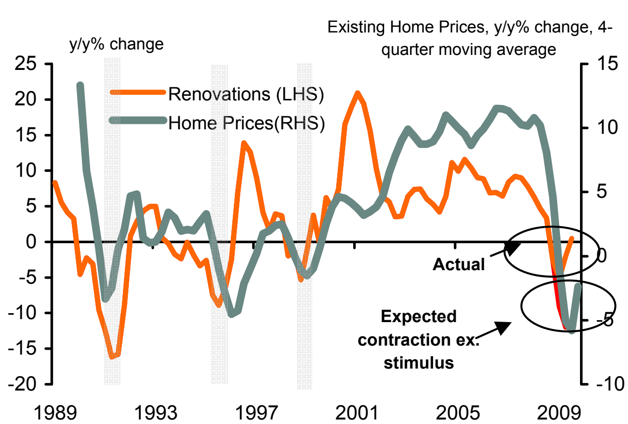
Impact from the Federal Home Renovation Tax Credit

Growth in renovation activity rebounded in the second quarter of 2009. This was hard to reconcile with the macroeconomic backdrop at that time. Looking back, consumer confidence was close to a 20-year low, real estate and equity markets had endured a massive price correction, employment losses were grave, and many were expecting the unemployment rate to climb above 10%. This suggests that something other than economic fundamentals was boosting renovations.

A tax credit of up to $1350, coupled with record low interest rates, was enough to entice homeowners to invest in their homes despite the economic uncertainty. The program has been very successful. According to the Canadian Revenue Agency(CRA), 3.5 million people inquired about the program details – that's 10% of Canada's population who looked into doing a renovation on account of the credit. Thanks to the extraordinary stimulative stance of fiscal and monetary policy, the financial conditions could not have been better for a renovation than it was in 2009. Not only would the government pay for up to 13.5% (depending on how much was spent) for renovations worth up to $10,000, the Bank of Canada cut interest rates by 4 percentage points since the beginning of 2008 and that brought the cost of borrowing to remarkably low levels.

Over the first three quarters of 2009 renovation activity totaled $30 billion, taking into account preliminary data for the fourth quarter and our estimate for January 2010, we believe that the tally for the life span of the renovation tax credit may have reached $43 billion by the end of January 2010 (when the tax credit expired). Part of this demand is derived from those who would have done a renovation in the year, regardless of whether there was a tax credit or not. Part of it also came from new demand for renovations on account of the credit. It is very difficult to differentiate between these two sources of demand, however, in the absence of hard facts, we can use economic relationships to estimate the impact. Renovation spending is largely driven by interest rates, existing home prices, and employment. Given the performance of these economic variables over 2009, we believe that renovation spending should have fallen by $3 billion from year ago levels. For instance, the accompanying chart indicates that typically when there is a sharp drop in existing home prices, renovation spending falls by a larger degree. This did not happen this time around, and renovation investment grew by $1 billion from 2008 levels. There are only two years in history where renovation growth significantly outpaced housing market activity – in 1996 and 2000. These large spikes in renovation spending were driven by strong gains in Canadian household net worth – something that is also missing from the current economic landscape. This leads us to believe that the total boost from the renovation tax credit was in the range of $4-4.5 billion over its life span (January 2009-January 2010).

CANADIAN RENOVATION SPENDING VS. EXISTING HOME PRICES



Source: Statistics Canada, Haver Analytics, CREA

Expect Payback

In 2010, the economic and financial backdrop for renovations will remain favourable, but growth in renovation activity is expected to wane, with the federal home tenovation tax credit expired as of February 1, 2010. We can break down renovations spending generated by the tax credit into two subcomponents. First, there is purely new demand – those who did a renovation because of the tax credit. Second, there are those homeowners who already had some desire or need for a renovation over the next few years, but rushed to get it done in between January 27, 2009 and February 1, 2010 to take advantage of the free money. We estimate that the combination of the tax credit and low interest rates has made the cost of $10,000 in renovation spending in 2009 16-19% lower when compared to the projected cost in 2010 and 2011. The cost of doing a renovation in 2009 may have been even lower because some homebuilding and supply stores offered incentives parallel to the fiscal tax credit on purchases. The decrease in current costs relative to future spending gives households an incentive to bring forward such expenditures rather than wait until next year. The latter steals from future demand, and would cause a drop off in demand as the tax credit expires.

It is impossible to be precise about the amount of demand brought forward by the tax incentive. Economic research shows that a high percentage of the impact from a temporary tax incentive comes from borrowed demand from the future. We've assumed 75% was brought forward by the tax incentive

Implications for Real Economic Growth

There should be no surprise that there will be a future payback. The tax and interest rate stimulus measure borrowed from future demand so that the contraction during the economic downturn was not as significant as it would have been absent of any government support. Had the tax credit not been introduced, renovation investment may have declined almost 9.4%. Thanks to the contribution from the stimulus measure, renovation investment likely grew 1.8% in 2009. This, in turn, has helped to promote real economic growth at a time when most other areas of the economy were weak. But, as is the case with monetary and fiscal stabilization policies, near-term support came at the expense of future demand, and growth in 2010 will not be as pronounced as it would have been had there been no payback for the strength in 2009. In 2010 and 2011, other areas of the economy, such as export, and business investment should strengthen and offer greater support to overall economic health in Canada.

It should be noted that even though the federal home renovation tax credit expired at the end of January, favourable borrowing conditions combined with strengthening economic fundamentals and robust home sales will still offer support to renovation activity. The pick up in the existing home market related to the low interest rate environment that began in the spring of last year will remain supportive to renovation activity as homebuyers will want to renovate their purchases of existing homes and potential sellers will renovate their homes to add value before putting them on the market. Typically, growth in renovation investment moves in tandem with home price growth with a four quarter lag. However, the renovation tax credit likely shortened this lag. This suggests that the renovation component may have already absorbed a majority of the additional demand from the recent strength in the housing market that would have normally been generated over the next four quarters.

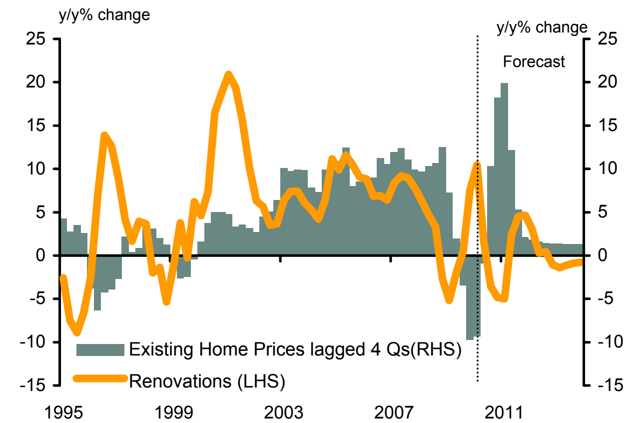
This leads us to believe that the majority of the payback from the tax credit will likely occur over the next four quarters. However, households likely have a 1-2 year planning horizon for large expenditures like renovations, and we could continue to witness payback within the next two years. As such, we have assumed that 80% of the $3 billion in payback happens in the four quarters after the credit expires, and 20% of it occurs in the following year. Combined with strengthening economic fundamentals, expected home price growth in 2010 would normally suggest growth in real renovation activity of 13% during the year. However, because of the hang-over from the expiry of the tax incentive, we are expecting renovation spending to only grow by 1% in 2010.

By 2011, the remaining 20% of the payback from the renovation tax credit, and a cooling in the housing market will act as a drag on renovation activity. In a recent special report *Canadian Housing: First in, First Out, But Where to Go from Here?* TD economics has argued that the current momentum in the housing market will not last. We argue that 2009's strong home price growth that resulted from exceptionally low interest rates means existing homes are anywhere from 10% to 15% overvalued. In 2010, a significant increase in new listings is anticipated and this should cool real estate activity. In the fourth quarter of 2010, the Bank of Canada is also expected to begin raising interest rates, and the tightening of monetary policy is expected to continue gradually over 2011. These trends, combined with weaker affordability, are expected to moderate demand for real estate and renovations. As conditions in the housing market move back in line with economic fundamentals, home price growth will cool significantly to an average of 1.6% in 2011. As such, renovation investment is expected to grow by a tepid 1.5% in the year. Had it not been for the payback from the prior tax credit, renovations would have been expected to grow by 3% in the year.

Looking beyond the Tax Credit

Beyond 2011, as the economic backdrop improves significantly, renovation activity (and overall housing activity) will also be affected by a broader economic trend at hand.

CANADIAN RENOVATION SPENDING VS. EXISTING HOME PRICES



Source: Statistics Canada, Haver Analytics, CREA, Forecast by TD Economics as of February 2010

RENOVATION INVESTMENT OUTLOOK

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

	2008				2009				2010				2011				2012				2013			
	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real 2002 C$	7.1	-1.4	0.8	-15.8	-3.5	12.5	11.5	12.6	8.2	-21.3	-9.7	4.6	5.9	9.3	0.1	5.5	-1.5	-2.0	-1.6	-1.2	-0.8	0.4	0.0	0.8
Nominal, C$	4.4	6.9	10.3	-8.9	-8.9	12.5	10.4	14.8	10.4	-19.7	-7.9	6.7	8.0	11.5	2.1	7.6	0.5	0.0	0.4	0.8	1.2	2.4	2.0	2.8

	Annual Average						4th Qtr/4th Qtr					
	08	09F	10F	11F	12F	13F	08	09F	10F	11F	12F	13F
Real 2002 C$	2.9	0.3	0.8	1.5	0.5	-0.6	-2.7	8.1	-5.3	5.1	-1.6	0.1
Nominal, C$	5.9	1.9	2.3	3.5	2.6	1.4	2.9	6.8	-3.4	7.3	0.4	2.1

F: Forecast by TD Economics as at February 2009
Source: Statistics Canada, Haver Analytics

As policy makers continue to unwind stimulus, economic fundamentals will strengthen. Employment and income growth will pick up, and the unemployment rate will begin to fall. These are all positives for renovation growth. However, Canadian household debt accumulation has been remarkable given the severity of the recession. In the past year, personal lines of credit – which are often used for renovations – have increased at almost double the annual growth rate of the five years leading up to the recession. As a result, household indebtedness hit a historical high of 140% of income in 2009. This level of borrowing can't be sustained if households want to accumulate wealth in the coming years. Since, asset price growth over the coming decade is projected to be slower relative to the period prior to the recession, growth in net worth will be constrained unless households ease the pace of borrowing, and increase savings. Moreover, the rapid rate of debt accumulation over the downturn in response to record low interest rates has likely left Canadian households more sensitive to rising interest rates. As such, an expected rise in short term interest rates of a full 3 percentage points from their current level by the end of 2011 will likely result in a broad-based moderation in household spending and investment – renovations included.

Conclusion

Were it not for government economic stimulus, renovation investment would have been materially weaker in 2009. Extremely stimulative monetary policy and tax incentives helped to avoid a significant decline in this sector of the economy. This, in turn, has helped to promote economic growth. And the renovation stimulus measure helped to support a Canadian economic recovery through increasing demand for housing-related goods and services at a time when most other areas of the economy remain weak. As is the case with monetary and fiscal stabilization policies, near-term support comes at the expense of future demand. As such, the pace of growth will diminish over the course of 2010 and 2011 as payback from the tax credit occurs. Even though the Federal renovation tax credit expired as planned at the end of January, favourable borrowing conditions combined with robust home sales will likely continue to support renovation activity, but growth will be significantly slower than it would have been without the hang-over from the tax incentive. In 2011, renovation activity will face some further challenges as interest rates start to creep back to more normal levels, housing market activity simmers down, and household spending growth moderates. As a result, we expect renovation activity to be relatively flat for the next three years, as current strength erodes future prospects. This will be offset by improving conditions in other areas of the economy, such as export growth and business investment that will strengthen and offer support to overall economic health in Canada.