TD Bank Financial Group

Observation

March 15, 2010

TD Economics
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HIGHLIGHTS

- Canadian household net worth, in market value, increased to $5.9 trillion in the fourth quarter of 2009.
- However, net worth growth was constrained over 2009 by a high rate of household debt accumulation, and net worth remains 1.8% below its mid-2008 peak – despite a full recovery in total household assets
- As asset price growth moderates going forward, households will have to scale back debt growth in order to bolster net worth

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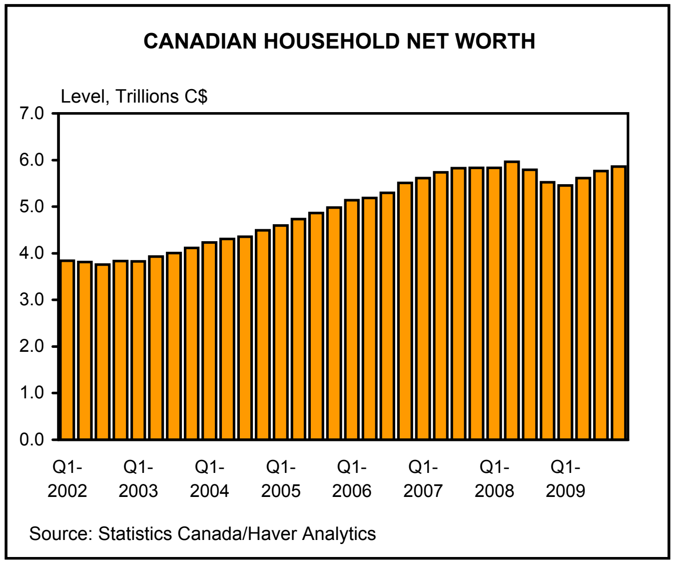
HOUSEHOLD BALANCE SHEET IMPROVES, BUT DEBT GROWTH CONSTRAINS NET WORTH

Canadian household net worth, in market value, increased to $5.9 trillion in the fourth quarter of 2009, up $9.3 billion from the previous quarter. After tumbling 8.6% through the last three quarters of 2008, net worth has made a vibrant come-back over 2009, as both equity and existing home prices recovered through the year. However, net worth growth was constrained over 2009 by a high rate of household debt accumulation, and net worth remains 1.8% below its mid-2008 peak – despite the fact that the value of total household assets has risen above its pre-recession peak. Unless households moderate the pace at which they accumulate debt, household liability growth could continue to constrain the rate at which households build their net worth over the medium term.



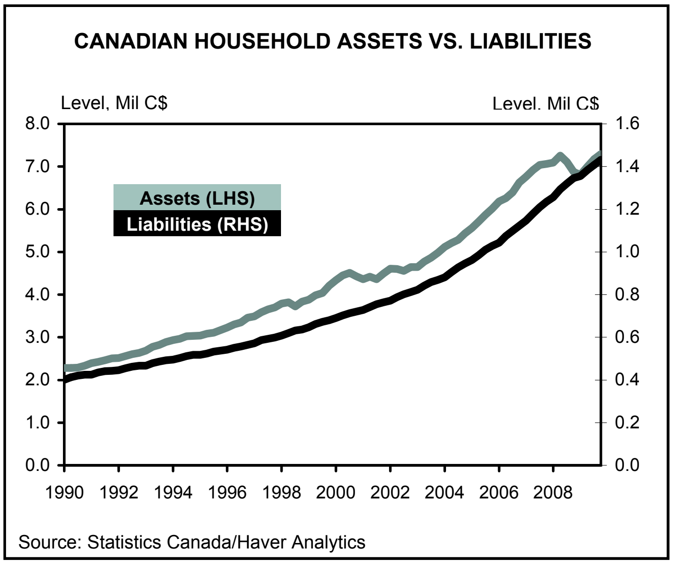
Assets Rebound

The first annual decline on record for Canadian household assets occurred in 2008 (-2.7%). However, total household assets have now more than recouped the losses that occurred over the last half of the year. The fast and furious rebound that has taken place in the Canadian housing market since the spring of 2009 played a large role in helping to rebuild the household balance sheet, as real estate assets have risen almost 2% above their mid-2008 peak.

Meanwhile, financial assets have risen 10.6% above the trough experienced in the first quarter of 2009, and remain only 1.9% below their 2008 peak. The strong bounce in financial assets is due to the rally in stock markets that occurred over the last half of 2009, as the majority of household financial wealth is held in assets that are highly correlated to equity price movements. However, the appreciation of the Canadian dollar has provided an offset by reducing the value of foreign investments.

Liability Growth Remained Strong

The combination of declining equity and real estate markets in late 2008, along with job market uncertainty, prompted households to slow the rate at which



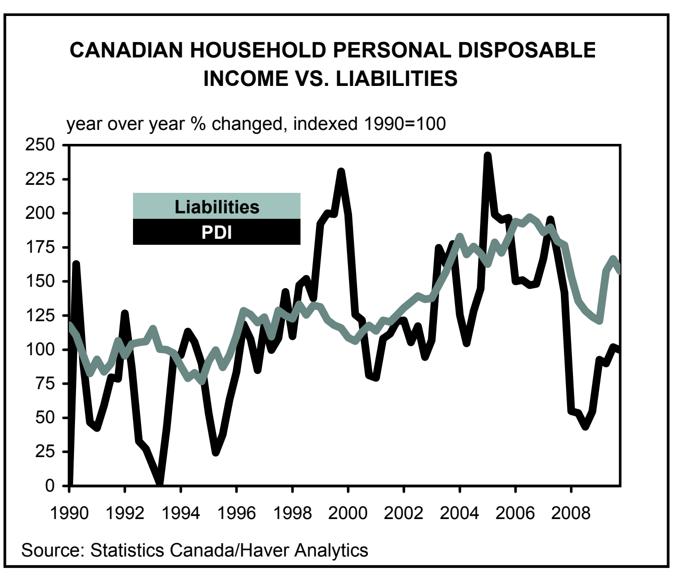
they accumulated debt, but not by much. Indeed, liability growth over the recession has been rather remarkable given the degree to which household net worth and personal disposable income were impacted. During the last year and a half, household liabilities have grown 10.6% above their pre-recession level, to $1.4 trillion.

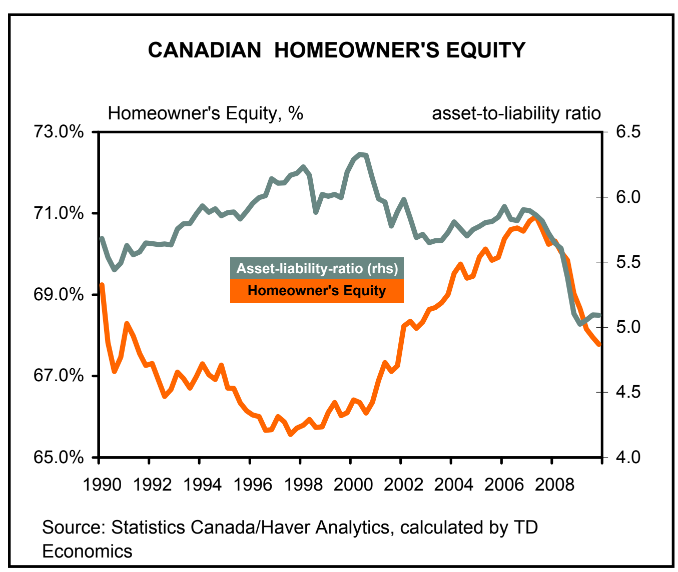
Measures of Financial Well-Being

There are typically three ratios that are used to study the overall health of the household balance sheet – and all three suggest that the high level of household debt is putting slightly more strain on the financial well-being of Canadians. The most closely watched is the ratio for household indebtedness, measured as debt as a percent of personal disposable income. This measure has risen to 146% – an all time high. Over time, this measure has trended upwards, with liabilities growing 1.5-2 percentage points above income. However, liabilities during 2009 increased 4 percentage points faster than income. Such a high level of household indebtedness raises the concern that households may have become more sensitive to future interest rate hikes. Indeed, while the household debt-service ratio (interest payments as a percent of personal income) remains below 2007 and 2008 levels due to record low interest rates, this ratio remains elevated when compared to levels experienced over the years of 2000-2006, despite the extraordinarily stimulative stance of monetary policy in Canada.

A second measure of financial well-being is the household asset-liability ratio. Prior to the recession, households held $5.6-5.8 worth of assets, for every $1 of debt. Currently, households are holding a record low $5.1 of assets for every $1 of debt – suggesting that a household financial rebalancing is in order.

The third ratio is the homeowner's equity ratio – the value of a property owned by the homeowner (not leveraged). Some types of debt are better than others, and the majority of liability growth over the recession has been driven by mortgage lending, and personal lines of credit – the latter was likely used to finance the purchase of homes and investment through renovation activity. Therefore, debt is being used to fund wealth accumulation through investment in real estate, which is traditionally viewed as more financially desirable than the accumulation of debt for purely consumption purposes. That being said, homeowner's equity has declined to a 7 year low by the end of 2009 despite improving real estate values. This ratio has been on a downward trend since 2006, which may likely be a reflection of a greater share of first-time new homebuyers





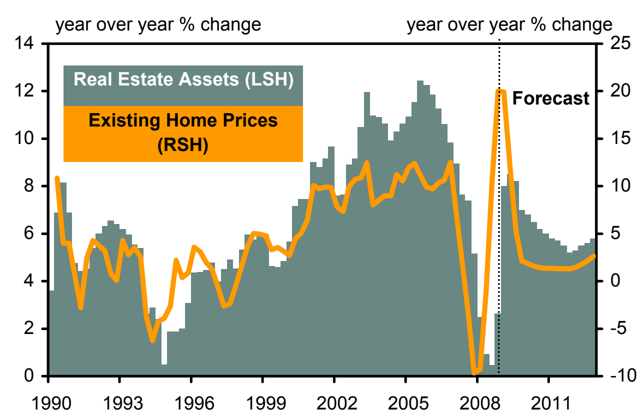
entering the market, rather than one that current households are over leveraging their homes.

Household Financial Rebalancing is in Order

All said, household net worth is recovering from the decline during the recession, and improving asset values suggests that household net worth will at least return to its pre-recession peak in the first quarter of 2010. However, looking beyond the near-term, the deterioration in all three measures of financial well-being suggest that a household rebalancing in balance sheets in order. Households cannot continue to accumulate debt at the current pace without impairing growth in net worth.

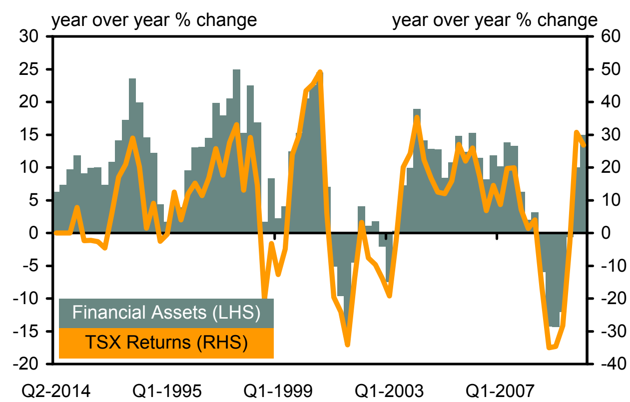
The rate of increase in equity and home prices will begin to moderate, and household asset price growth over the coming decade is projected to be slower than the previous five years. The Canadian resale housing market is undergoing a soft landing, and fundamentals in the housing market suggest that home price growth will slow to a mere 3.8% over the next five years, while the outlook for corporate profits suggests that equities could provide a return of 8%. Combined, the average household portfolio is expected to have an average return of 6%, significantly slower than the 11% annual return experienced in the five years leading up to the recession. As such, in order for net worth to grow at least at its long-run average of 6%, liability growth will have to advance at roughly 6% per year, down from the almost 9% annual average pace between 2003-2008. Since household total assets are 5 times the level of liabilities, household net worth can continue to rise at an annual rate of 6%, even as assets and liabilities grow at roughly the same pace. Nonetheless, since consumer spending is partially funded through debt, the slower rate of debt accumulation will likely result in a moderation of consumer spending. The slower rate of liability growth is consistent with growth in consumer spending at an annual average of 2.7% per year over the next five years, with durable spending growing at a soft 4.1% – both slightly slower than the average pace of 3.5% and 5.7% experienced over the five years leading into the recession.

REAL ESTATE ASSETS VS. EXISTING HOME PRICES



Source: Statistics Canada/Haver Analytics, Forecasted by TD Economics as of March 2010

FINANCIAL ASSETS VS. TSX PRICES



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