TD Bank Financial Group

TD Economics

Special Report

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CRASH AVOIDANCE: TORONTO CONDO MARKET PULLING OFF A TURBULENT LANDING

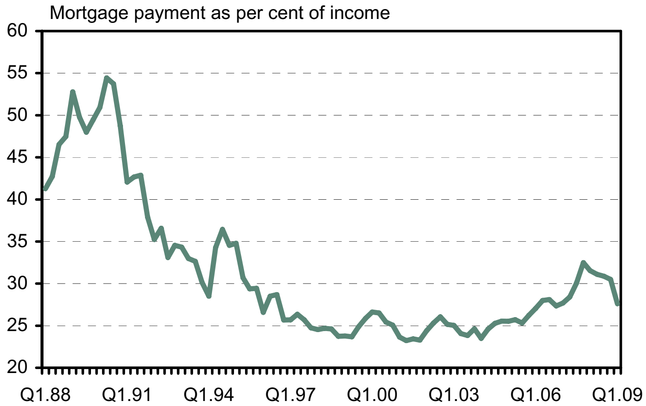
Is the Toronto condo market either experiencing or headed for a crash? Our short answer would be no. Many conditions present in shattered markets are thankfully lacking in Toronto, from a massive prior run-up in prices to excessive overbuilding and inventories, to unsound mortgage financing practices. While a crash scenario can never be dismissed entirely, our main conclusion is that the Greater Toronto Area's (GTA) condo market is in the midst of a cyclical downturn rather than a drawn out structural downturn. Far from academic, we view the difference as crucial. Among other things, it speaks to whether the downturn is expected to be a medium-term affair, a cycle lasting say 2-3 years altogether, or a half-decade to a decade protracted unwind, akin to Toronto's boom-bust experience in the late 1980s / early 1990s. In this piece, we refer to the current 'cycle' as having started with Toronto's latest housing activity and prices peak in late 2007 - early 2008, followed by last year's downturn extending into this year, and taking into account our forecast for a stabilization during the course of this year and a gradual recovery after-

HIGHLIGHTS

- **After pulling off what could be best called a 'crunchy' or turbulent landing, but most importantly avoiding the worst-case crash scenario, the GTA condo market is expected to stay grounded until a sustained economic recovery takes hold.**
- **Buyer market conditions seemed entrenched as we entered into recession. However, while soft, resale market conditions have not deteriorated significantly over the last few months of available data. To the contrary, they have in fact improved, supporting our view that, …**
- **… as argued in a recent report[1], conditions are not expected to mirror those in the U.S., which were largely brought on by shaky mortgages built upon lax credit conditions and chronic overbuilding.**
- **Current inventories of unsold new condos are not worrisome, …**
- **… but a large pipeline of projects already under way will boost the supply of new units faster than demand can absorb them.**
- **On the flip side, the sharp downsizing in building intentions and starts will help mitigate the risk of structural overbuilding or a replay of the late 1980s scenario. While inventories of newly completed but unsold condos will no doubt be higher by year-end, we expect units to be absorbed at a decent pace once the economic recovery takes hold.**
- **The current ultra-low interest rate environment also contrasts sharply with that of the late 1980s. Affordability, a prime consideration for potential buyers which tends to favour condos vis-à-vis single-detached homes, is improving markedly, sowing the seeds of a recovery in sales.**

[1] "*Annex A: A U.S.-style Housing Crash?*", pages 19-20 of "*Overpriced and Overbuilt: Canadian Housing Market Returns to Fundamentals*", TD Economics, April 7, 2009, available at: http://www.td.com/economics/special/gb0409_housing.pdf

HOME AFFORDABILITY* IN TORONTO



*Of the average-priced home with an average household income under a 5-yr fixed rate, 25% downpayment, 25-yr amortization.
Source: CREA, Statistics Canada, Bank of Canada.

wards.

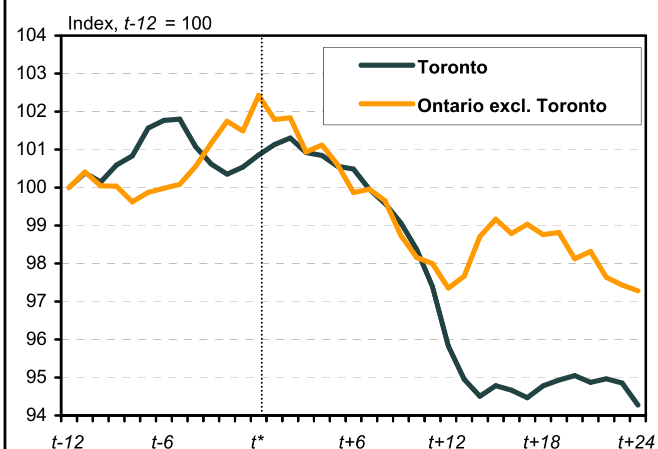
In the late 1980s, the affordability of homes[1] had eroded significantly, to the point where an average-earning household spent more than half their income on mortgage payments. In contrast, affordability in the GTA was much better entering the current cycle, with typical mortgage payments consuming less than a third of the typical household income. Buoyed by ultra-low interest rates, improving affordability is the dominant factor that will help smooth out the current cycle by putting a floor under the demand-side of the market. While it is still early days in the current recession, it is also worthwhile noting that, whereas the early 1990s recession left Toronto's labour market reeling, the current recession has hit the rest of Ontario much harder than the province's capital. All told, we expect 20% fewer existing condo units to change hands this year when compared to last year.

Aside from a generally longer or deeper recession than expected, which would not be a Toronto-specific event in the first place, the single most important risk looming over the local condo market lies on the supply-side. More condo apartments will come onto market in 2009-10 than can likely be absorbed in the midst of a severe recession. As a result of an elevated pace of condo starts in quarters past, reflected by a large number of units still under construction that will come online, we estimate that the inventory[2] of unsold new condos will increase to 3.5-4.0 months supply, albeit from a very low 1.7 months as at March. The recently announced transition to a single sales tax for Ontario by July 1, 2010, is likely to see a front-loading of new condo sales between now and then, in effect displacing some sales that would have otherwise occurred later in the cycle. Nonetheless, as a result of this increased availability of new units and a choppy resale market, we expect the median price of existing condos to stay grounded around its latest (March) level of $239,000, in the $230,000-$250,000 range over the next 12-18 months.

TORONTO'S ECONOMIC BACKDROP

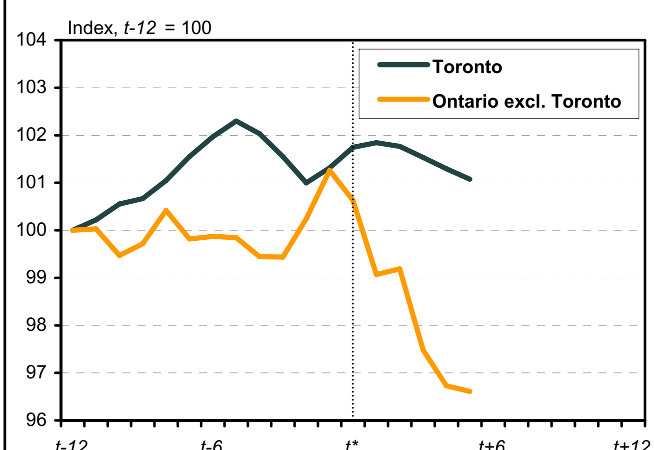
Already well under way, the current cyclical downturn in housing more or less aligns with the overall state of the economy, which is undoubtedly very weak. Furthermore, more weakness in terms or output, employment, income, and profits lies ahead for much of the rest of the year. However, the situation in Toronto has not deteriorated nearly as much as in the rest of the province. The most relevant illustration of this lies in the employment landscape.

EMPLOYMENT IN THE 1990-91 RECESSION



* *t* (month) marks start of recession. Source: Statistics Canada.

EMPLOYMENT IN CURRENT RECESSION



* *t* (month) marks start of recession. Source: Statistics Canada.

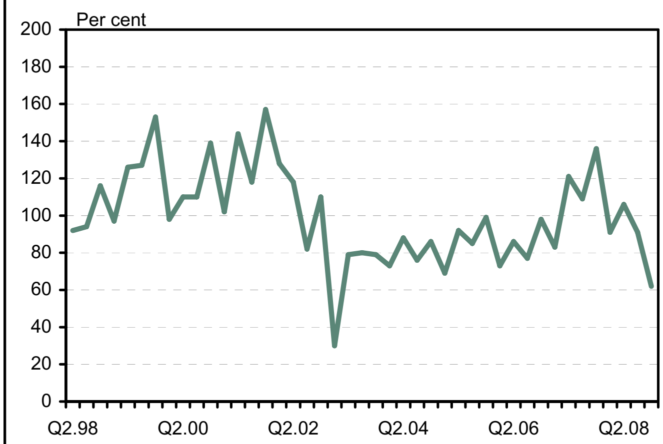
Since the advent of the current recession in November 2008, employment in Ontario when excluding Toronto has fallen by a whopping 4.0%. Meanwhile, the provincial unemployment rate has surged by 2 percentage points to 8.7% even as the labour force shrank by 0.4%. Digging down to the local level, however, reveals that net job losses have been much more acute in areas outside of Toronto such as Thunder Bay, Oshawa, Kitchener, and Windsor, as mining and manufacturing sector woes have hit these local economies hard. By comparison, employment in Toronto is down 0.7% during the same time period. Toronto's unemployment rate has nonetheless increased by a substantial 1.9 percentage points, to 8.8%, but this has largely resulted from strong labour force growth of 1.5% over the five months elapsed since October of last year. This is not to say that Toronto's economy will be left unscathed by the current recession, as more hardship surely lies yet ahead. However, recall that in the recession of the early 1990s, the city's employment fell off by nearly 6%, a scenario which looks unlikely to be repeated. We expect local employment to fall by roughly half of much, or 3%, this time around. Economic activity in the GTA should pick up before employment, however, towards the fourth quarter of this year and maybe as soon as the third quarter as financial markets anticipate a modest North American recovery for 2010.

RESALE MARKET CONDITIONS

The most encompassing measure of resale market conditions, provided by the sales-to-new listings ratio, reflects well the steep softening in market conditions that occurred throughout last year, and the subsequent firming up since then. The condo market itself was no different, and seemed to have gone through much of the above-mentioned trends, as its sales-to-listings ratio slumped in the second half of last year, and sales plunged by nearly 50% year-over-year in January. Sales did firm up slightly in February and March. However, condo apartment sales in the first quarter of this year were still 31% lower than the same period last year. This would be consistent with the trend observed in the monthly median[3] price series of condo apartments in the GTA, which saw the 6.1% year-over-year decline recorded in November 2008 ease to a 1.8% year-over-year decline in the first quarter.

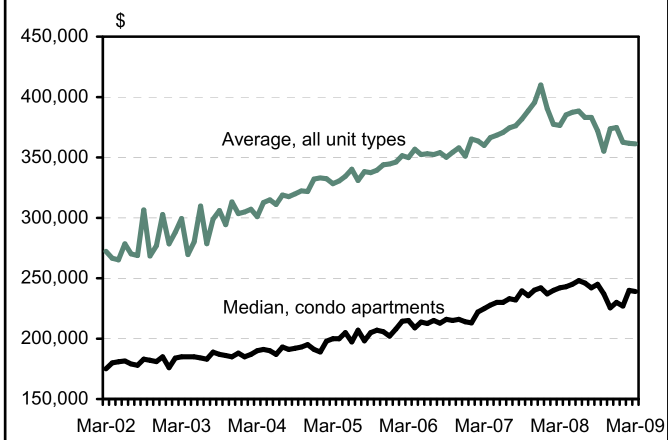
We expect markets to remain quite choppy between now and the end of the recession as two important forces run in opposite directions until then. On the one hand,

APARTMENT SALES-TO-LISTINGS - GTA



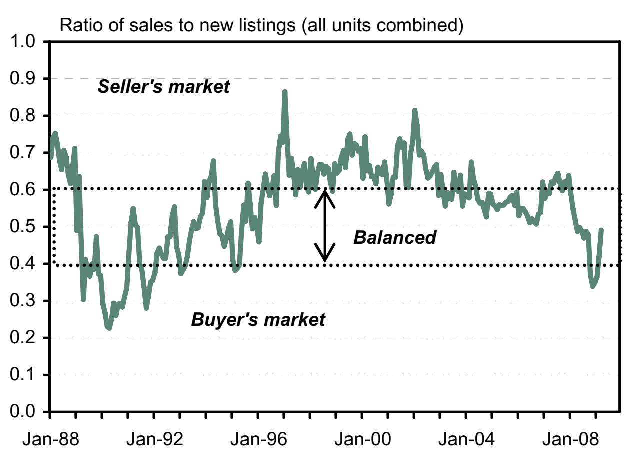
Source: CREA. Last data: Q4.2008.

EXISTING HOME PRICE - GTA

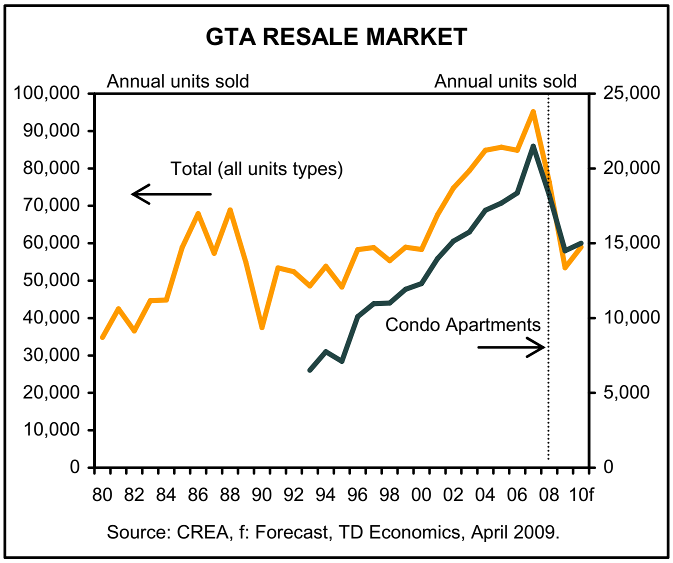


Source: CREA.

RESALE MARKET CONDITIONS - TORONTO



Source: CREA. Last: March 2009.



Source: CREA, f: Forecast, TD Economics, April 2009.

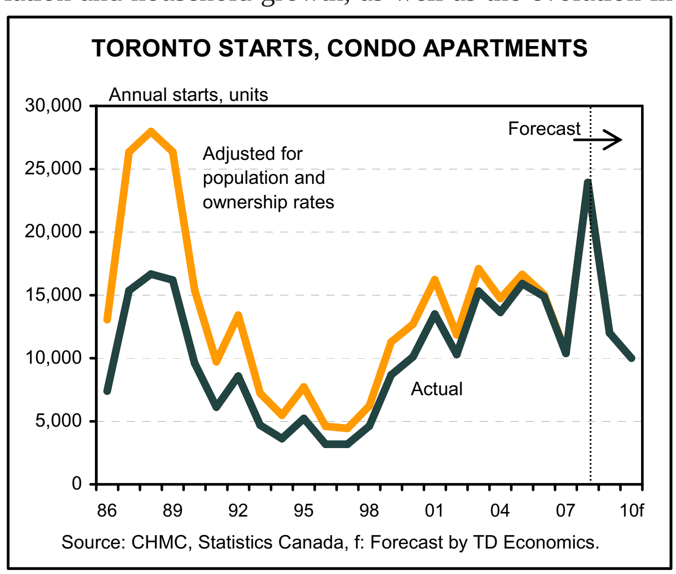
employment and incomes will continue to slump until the economy recovers next year, and this will weigh on home and condo demand directly as well as indirectly through overall consumer confidence. On the other hand, better affordability allows many homeowner households to upgrade and many potential new homebuyers to jump in. This is usually reflected in market conditions that hover back and forth between buyer conditions and balanced conditions as listings also respond with a lag to price trends. As seen in the chart below, when compared to the record sales levels registered in 2007, our forecast sales volumes for 2009-10 will be significantly lower. On the other hand, they are not expected to dip below 15,000 condo apartment units on a sustained basis. As a result of good availability of existing units, we expect the median price of existing condos to stay grounded around its latest (March) level of $239,000, in the $230,000-$250,000 range over the next 12-18 months. Note that by construction, because of the price distribution of units, the median price tends to be much lower and much less volatile than the average price. This fact holds true both on the upside and the downside. We do not have the average price for existing condo units, but the overall average price across all unit types –mainly condo apartments, row and townhouse units, single-detached and semi-detached homes – for the GTA is expected to hit a trough about 20% lower than its peak of $410,000 in December 2007. For existing GTA condo apartments, the median price is expected to hit a trough roughly 7% lower than its June 2008 peak of $248,000.

As sales stabilize later this year and eventually firm up in tandem with the overal economy, the demand-side of the market should be well supported. The challenge will most likely lie on the supply-side, specifically that for new units, to which we now turn our analysis.

NEW CONDOS – WHAT'S ON TAP?

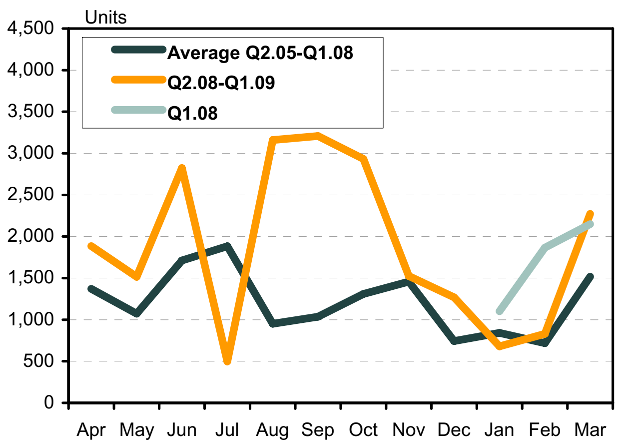
The Toronto condo market is often and anecdotally alleged to be a focal point of overbuilding. What does the available data say on this issue? Up until 2008, the pace of multiple unit starts seemed reasonable. Thus far, inventories of newly completed but unsold multiples have remained low relative to historical levels. While backward looking, this reflects the fact that most newly built condos coming onto the market have generally been absorbed, which is no surprise given the strength of past demand and that most projects can only obtain the go ahead if a large proportion of units are pre-sold.

However, a recent surge of building, reflected in a high number of units under construction, will likely tilt the new condo market balance more clearly in favour of buyers as many units come onto the market over the course of the year. The last twelve months of available data on starts of condo apartments, running from April 2008 to March 2009 show that the monthly pace of building has exceeded the average pace of 2005-07 by a significant 63% margin. Of particular concern is the third quarter (Aug-Oct) boom during which a total of 9,300 units were started. A longer-term first pass comparison of the annual number of apartment starts suggests that 2008 witnessed the largest scale of activity by far since the mid 1980s, but this is overstated. When looking at housing starts over extended periods of time, one has to adjust these levels to reflect population and household growth, as well as the evolution in



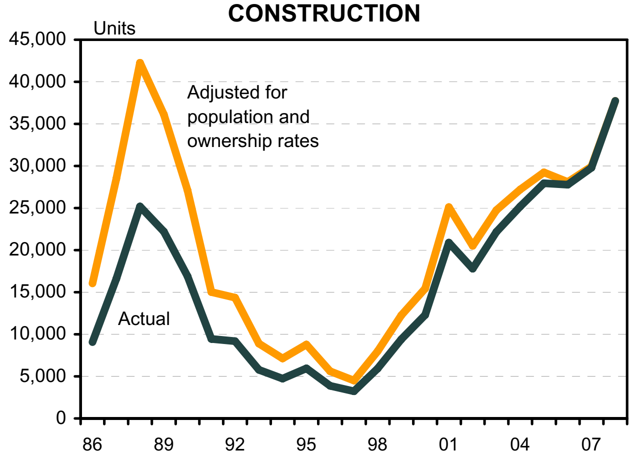
Source: CHMC, Statistics Canada, f: Forecast by TD Economics.

MONTHLY APARTMENT STARTS



Source: CMHC.

CONDO APARTMENTS UNDER CONSTRUCTION

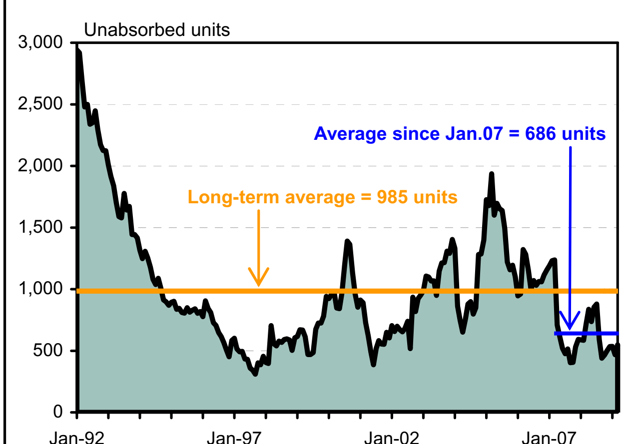


Source: CHMC, Statistics Canada, TD Economics.

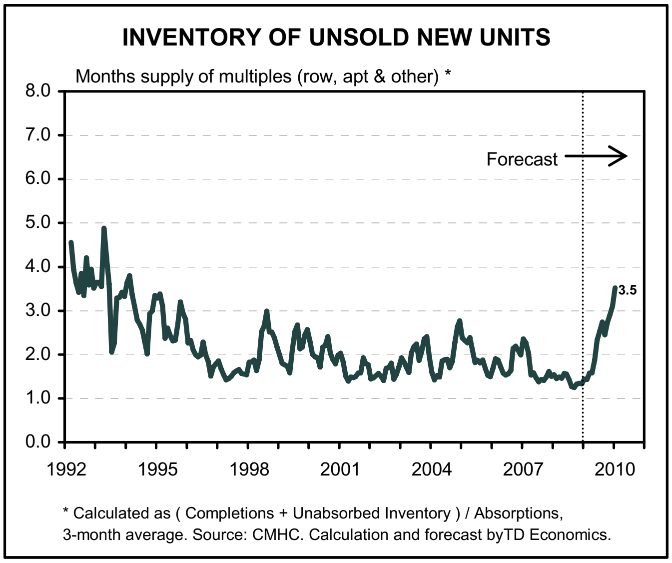
households' propensity to own a home as opposed to renting, a concept best approximated by actual ownership rates from Census data.[4] After this adjustment, we observe that the apartment building boom of the late 1980s was larger, but that 2008 came close to matching its 25,000 + units annually. The main difference is that over the 3-year span of 1987-89, the equivalent, in today's terms, of nearly 81,000 units were built. Meanwhile, during 2007-08, close to 35,000 units were built. Even if one assumes that condo building were to continue this year at the frantic pace of nearly 24,000 units set last year, this would imply a cumulative 59,000 units being built over the 3-year span of 2007-09, 28% fewer than in the late 1980s. Year-to-date, however, the 3,800 units pace of apartment starts established in the first quarter is 26% lower than that of the same period last year. A simple extrapolation into the remaining three quarters of this year would yield a total of nearly 18,000 units. This would still imply 35% fewer units built over 2007-09 when compared to 1987-89. To be clear, that simple extrapolation is used for illustrative purposes and does not constitute our forecast, which we would set at a significantly lower level of 11,000-13,000 units, roughly half as many units as last year. In particular, while the monthly series for apartments is highly volatile, we view the bounce back in March as a temporary blip that is not likely to extend into the second quarter or beyond. Admittedly, much can happen over the rest of the year, but most of the financial market and economic woes suggest more downside than upside risk.

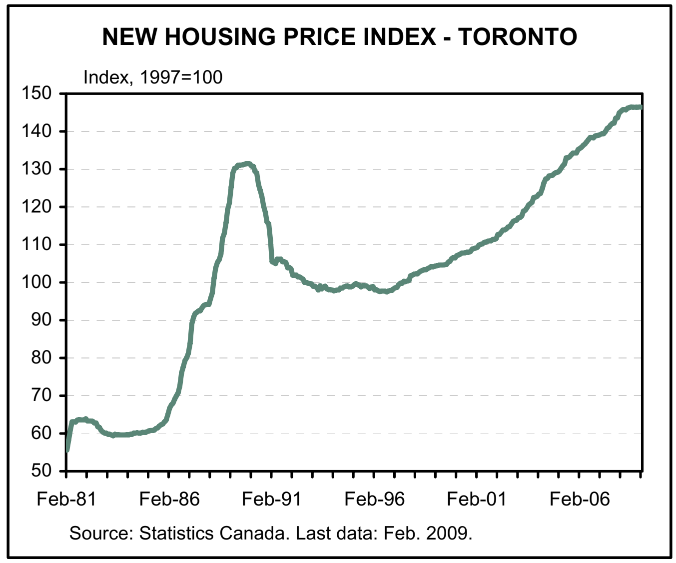
Using the number of condo apartment units currently under construction, our baseline forecast for starts, as well as prudent assumptions on the rate of completion of projects and the rate of absorption of new units, we estimate the path of new unsold condo inventories – as measured in months of supply – over the next twelve months. We find that the increase would be significant, from 1.7 months as of March to 3.5-4.0 months a year hence, but the actual level is not alarming. While we unfortunately do not have figures for what inventories were according to this measure in the late 1980s, we do know that the unsold inventory at the beginning of the series in January 1992, or a full two years after markets dipped, was still a hefty 3,000 units. This would roughly the equivalent of 5,000 units under today's market size, closer to 5 months of supply. The inventory peak could easily have been double that, and would occurred sometime around mid-1990 when sales hit bottom and construction had been plowing ahead at full steam

INVENTORY OF UNSOLD NEW MULTIPLES



Source: CMHC. Last data: March 2009.

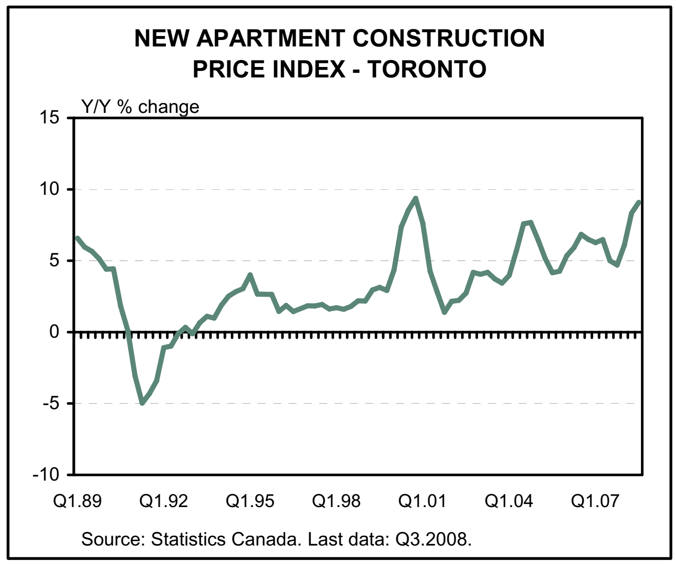




during the previous three years.

In the near-term, much will depend on how supportive sales are or not in keeping projects in the pre-construction phase on track. Whatever excess inventory builds up between now and the end of the current recession will certainly weigh down on prices for a while, but in and of itself does not, in our view, put the market at an elevated risk of a disorderly correction. The inventories would also pale in comparison to the pile-up witnessed stateside, where a surge in foreclosures has pushed the months' supply of inventory in double-digit territory and is, by far, the largest supply glut since the data was collected in the 1960s.

While it would weigh on current economic activity, the extent to which builders heed current market signals and pare back activity sharply would serve to minimize the risk of this cyclical downturn turning into something far more painful and protracted. The latter certainly has been known to happen, but does not currently appear to be the more likely outcome. Among other things, new housing price and apartment construction cost trends are simply not supportive of a continuation of the condo building boom. On the other hand, if builders ignore market and financial conditions, which we doubt they could, given the aforementioned incentives, and continue to build condos at an elevated pace, they would collectively be sowing the seeds of a structural overbuild in 2010 and beyond which would consequently take for more time to unwind.



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Endnotes

[1] Readily available price data by unit types, in our case of interest for condominium apartments, starts in 1993. To go back to the 1980s, we use the average price across all unit types, arguably without much loss of specificity with regards to affordability trends.

[2] Our measure differs from the CMHC measure, see accompanying chart for calculation. CMHC calculates months of inventory as the unabsorbed inventory divided by absorptions from this inventory, whereas we calculate this as the sum of completions and unabsorbed inventory divided by total absorptions. This is done in order to provide a more encompassing measure that keeps track of absorptions from the entire stock rather that just from the unabsorbed inventory, and is more readily comparable to U.S. measures.

[3] The price measurement reported by the Toronto Real Estate Board (TREB) – and in turn the Canadian Real Estate Association (CREA) – once we look at specific unit types (e.g. condos, single-detached) is the median price. The latter tends to be less volatile than the average price, which is more influenced by swings in sales volumes dispersed at the high and low end of the price spectrum.

[4] These are given every five years, which is the frequency of Census data. For simplicity in obtaining annual ownership rates for years in between Census years, we interpolated linearly.