TD Economics

Special Report

April 10, 2008

CANADA'S RED HOT REAL ESTATE MARKETS TO COOL

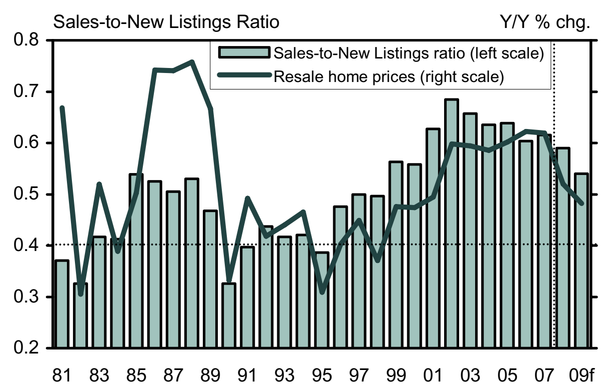
Canadian real estate markets have been a pillar of strength this decade. Strong domestic economic conditions and attractive financing rates sparked robust housing demand. This, in turn, fuelled vigorous resale home sales and new home construction. Despite rising supply coming from rapid residential building, real estate markets across the country have been generally characterized as seller's markets, resulting in very strong and sustained price growth.

Given this remarkable performance, it is natural to ask whether it can continue. The recent U.S. housing correction certainly highlights the risk that booms can rapidly turn into busts. For a variety of reasons that will be outlined below, TD Economics believes that Canada's major housing markets will experience cooler conditions over the course of 2008 and throughout 2009, with softer sales, construction and price growth from coast to coast. However, this moderation is not expected to lead to a housing downturn. Instead, the deterioration in housing affordability from the past outsized price gains combined with additional supply from new listings and continued elevated housing starts amid a weaker domestic economy should gradually let the heat out of real estate markets. The seller's market conditions are expected to give way to more balanced supply and demand, which is consistent with moderate price growth at a mid-single digit pace in most of Canada's major urban centres.

HIGHLIGHTS

- **Real estate delivered an outstanding performance over the past five years, with national home price growth averaging 10% annually.**
- **Cooler market conditions are anticipated over the course of 2008 and throughout 2009.**
- **This moderation will reflect the fact that the past rapid price appreciation has eroded affordability and has encouraged additional supply from new listings and new home construction. A weaker domestic economy will also contribute to the cooling.**
- **A soft-landing is anticipated. Indeed, with the Bank of Canada likely to cut interest rates further in 2008 and only gradually raise rates in late 2009, the risk of a significant or sustained correction in home prices is low.**

CANADIAN HOME PRICES & SUPPLY-DEMAND CONDITIONS



Source: CREA. f: Forecast by TD Economics as at April 2008.

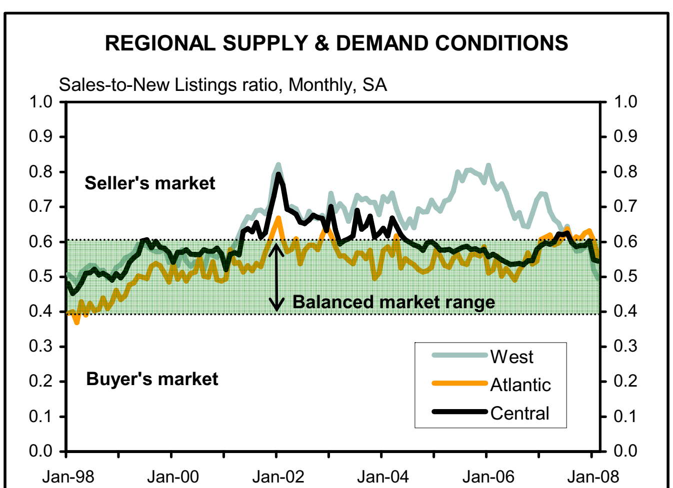
The 2K housing boom

In order to put the housing forecast in context, one needs an appreciation of the Canadian real estate boom this decade. Sales of existing homes started accelerating sharply early in the decade, rising from below 300,000 units in 2000 to above 500,000 units in 2007, while new home construction jumped from below 160,000 units to hover around the 220,000 mark over the past four years. This dramatic increase in activity fuelled rapid price growth, with national average home prices rising at a 10% annual pace over the past five years. The strength in the market was broadly based, as illustrated by the fact that since the start of the decade average home prices have risen in Atlantic Canada by 66%, in Central Canada by 74% and in Western Canada by a whopping 132%. This is not to dismiss the various regional performances. From 2002 to 2004, virtually all regions experienced high-single-digit or low-double-digit price gains. Beginning in mid-2005, the commodity-driven economic boom in Western Canada sparked a dramatic jump in housing activity and prices in that region, which contrasted with a cooling of real estate markets in the rest of the country. Over the course of 2007, however, these regional trends reversed, as deteriorating affordability and increased listings cooled conditions in the west (except in Saskatchewan), while housing markets once again picked up steam in Central and parts of Atlantic Canada.

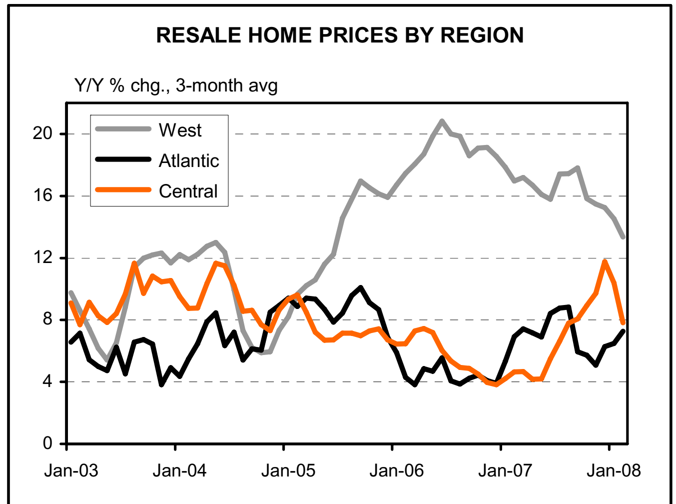
Economic and financial fundamentals were key

A number of key factors have contributed to the outstanding performance of real estate across the country.

First, the economic fundamentals have been extremely supportive. Since 2002, unemployment in Canada has fallen significantly, and is now hovering near a 33-year low. And, the decline in unemployment has been evident across the country and in most major metropolitan centers. This was accompanied by record employment rates and it occurred despite many additional Canadians entering the labour force. The tightness in labour markets has gradually fed through to higher personal income growth, which was further



Source: Canadian Real Estate Association (CREA).



Source: Canadian Real Estate Association, TD Economics

boosted by tax relief that contributed to solid gains in personal disposable income. The income growth significantly exceeded the rate of inflation, providing increased purchasing power. Plentiful jobs and rising income are powerful drivers for housing demand.

Second, home buying was boosted by a low interest rate environment and new financing options. The early stages of the housing boom were fuelled by aggressive interest rate cuts by the Bank of Canada in the wake of the 2001 tech collapse, which lowered financing costs. However, even when monetary policy became less simulative in 2005-06 and interest rates trended higher, the level of borrowing costs remained attractive to many potential homebuyers.

Third, new financing arrangements and easier credit conditions also attracted more home buyers into real estate markets. For example, home equity lines of credit became extremely popular in light of their increased flexibility provided to the borrower. The minimum down payment on a property without needing mortgage insurance was lowered to 20% and the Canadian Mortgage and Housing Corporation (CMHC) extended mortgage insurance to include the option of making purchases with no money down. Mortgage lenders also lengthened the available amortization period on loans out as far as 40 years, which greatly increased affordability – albeit at significantly higher borrowing costs over the life of the loan. These actions widened the pool of potential homebuyers and, in some cases, also encouraged existing homeowners to move up the property ladder.

Past price growth has eroded affordability

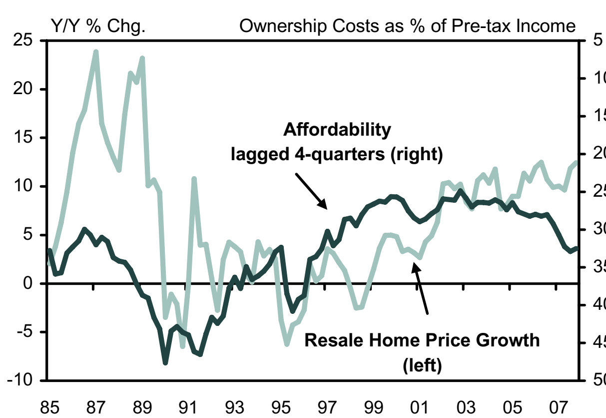
So, real estate activity has been phenomenally strong, but the current pace of sales and price growth cannot be sustained indefinitely. For example, home construction has significantly outpaced the demands needed from population growth. The implication is that there has been a shift away from renting and towards home ownership, while many homeowners have purchased secondary properties. Regardless of the reason why, the strength in residential building has created significant additional supply of new homes.

The rate of increase in prices has also exceeded the growth in household income, with the result that national housing affordability has deteriorated significantly. The share of personal income needed to finance mortgage interest and principal payments on a 5-year fixed mortgage with 15% down for an average priced home in 2004 was roughly 28%. Since then, the ratio has climbed to 38%. From a lender's point of view, a ratio greater than 32% for an individual household is viewed as undesirable.

While the share of personal income going to mortgage interest and principal payments has increased in virtually all regions, there are certain places that affordability has become extremely stretched. Specifically, the western centres of Vancouver, Victoria, Calgary, Saskatoon have experienced a shocking deterioration in affordability – particularly for detached bungalows.

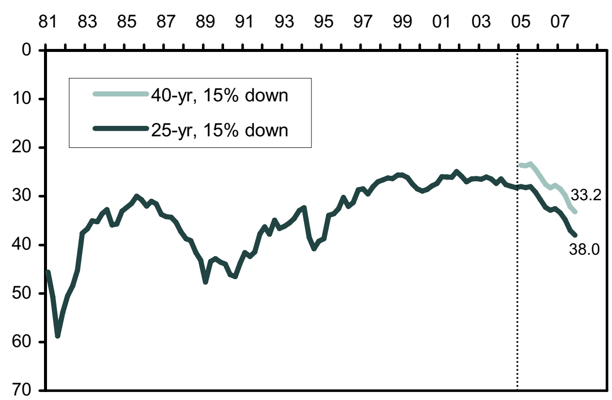
As the accompanying charts show, the weakening in affordability is not consistent with a continuation of the price and sales growth that was experienced in 2007. This raises the issue of why real estate conditions didn't cool sooner. In our opinion, some of the new financing arrangements may have delayed the impact. For example, shifting to a 40-year mortgage lowers the ratio by about 5 percentage points, and we know that a majority of first-time home buyers are opting for the long amortization mortgages. However, with rapid price growth, we have recently seen the 40-year affordability ratio breach the 32% mark. So, the weakening in affordability is a strong signal that it is only a matter of time before sales moderate and market conditions become more balanced. The only question is when.

AFFORDABILITY & RESALE HOME PRICES



Source: CREA, Statistics Canada, Bank of Canada, TD Economics.

HOME AFFORDABILITY MEASURES*



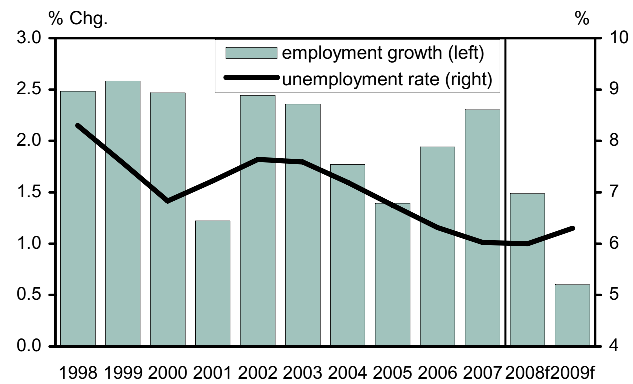
* Per cent of average market household income required to service mortgage carrying costs of the average-priced home. Source: CREA, Statistics Canada, Bank of Canada.

Real estate to cool over the course of 2008 and 2009

The latest data suggest that the cooling has started. Price growth in many western cities has already peaked. Indeed, there has been a sharp retreat of home price appreciation in Calgary, Edmonton and a moderation in Victoria and Vancouver. Saskatoon and Regina has been walking to a different beat, with price growth remaining dramatically high, but there too there are signs that price growth has peaked. In most markets, year-to-date (Jan.-Feb.) sales data were weak, but may have been distorted by poor weather conditions and the impact of the January 1st introduction of the land transfer tax in Toronto that could have pulled sales forward into the end of 2007. As a result, a rebound in the spring may be the cards, but then a renewed moderation should unfold.

The economic outlook is also signalling a cooling in real estate. Canada is in the midst of an economic slowdown. Economic growth slowed sharply at the end of 2007 to below an annualized 1% pace in the final three months of the year. Much of the weakness came from exports, which were hard hit by poorer U.S. demand and a strong Canadian dollar. Looking ahead, the challenge facing the export-oriented manufacturing sector will not abate. The U.S. economy looks to be in a mild recession and economic growth (excluding the temporary effects of tax rebate checks that will come mid-year) will remain soft until well into 2009. Up to this point, the domestic side of the Canadian economy has been resilient. Indeed, consumers went on a spending spree late last year, helping to drive robust domestic demand growth – which has also been supported by strong business investment. In our opinion, it is only a matter of time before the weak export performance tempers domestic economic conditions. The recent rally in commodity prices is also expected to run out of steam as slower U.S. consumer spending dampens global economic growth, and, in turn, demand for raw materials.

CANADIAN EMPLOYMENT GROWTH & UNEMPLOYMENT RATE

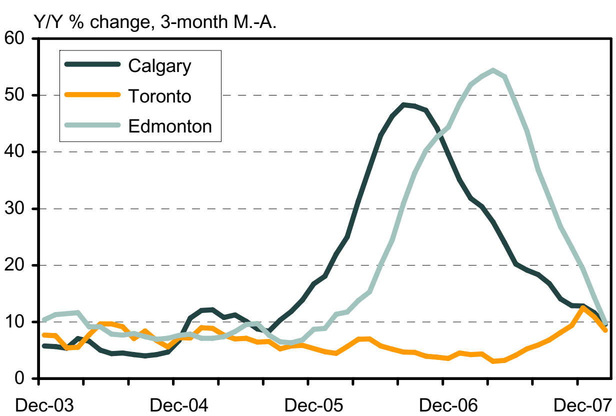


Source: Haver Analytics, f: forecast by TD Economics as at March 2008

The net result is that Canadian economic growth is expected to slow to a mere 1.1% in 2008 and then gradually recover when the U.S. economy starts to improve next year. There will be considerable regional variation, and this has implications for the real estate outlook. Western Canada will continue to post economic growth rates above the national average, supporting stronger relative housing demand fundamentals. Central Canada, and particularly Ontario, is more vulnerable than most other regions to the weakness south of the border.

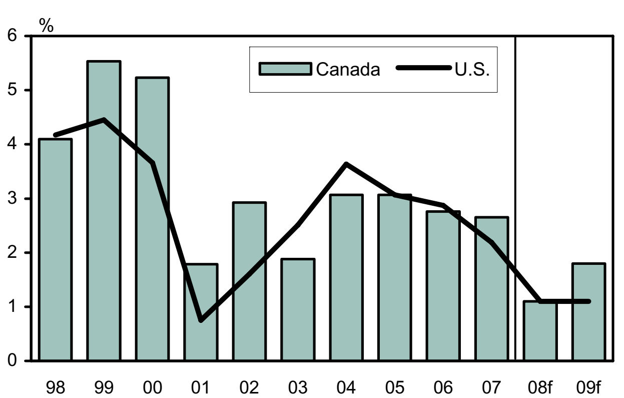
The macroeconomic outlook points to weaker labour market conditions, which tend to have a big impact on consumer confidence and the willingness to make big purchases – like homes. The pace of job creation in late 2007 and early 2008 was simply unsustainable and completely at odds with the pace of economic growth. The economy expanded by 2.7% last year, which should have supported no more than 1.7% employment growth – but the actual gain was 2.3%. Based on this outcome, productivity as measured by output per worker was virtually non-existent, which makes little sense and suggests that employers are unlikely to continue to add to staff the way they have recently. Moreover, much of the job creation was in the public sector, and given the prospects for tighter fiscal balances there is no reason to expect a repeat this year. The projected weak economic growth in 2008 implies that employment growth should slow to 1.5% this year and to 0.6% in 2009 – the delay in the labour market weakness highlights the fact that employment can often be a lagging indicator of

AVERAGE RESALE HOME PRICE



Last plotted: Feb. 2008; Source: Canadian Real Estate Association.

REAL GDP GROWTH



Source: Haver Analytics, f: forecast by TD Economics as at March 2008 economic conditions because firms may choose to initially hold off cutting staff. This is why the cooling in housing tends to lag behind the initial slowing in economic growth.

The good news is that unemployment will remain low, only edging up towards 6.3% over the forecast. That means labour markets will remain tight, but disposable income growth is still expected to slow from 5.6% in 2007 gradually down to 3.5% in 2009. This does not point to a major decline in housing demand, but it certainly does point to softer growth in home sales. Again, there is a regional disparity to the national trends. Labour markets in the west will remain quite tight, while the future weakness in employment is likely to be most evident in Ontario, and to a lesser extent in Quebec and parts of Atlantic Canada.

The weaker economic conditions will prompt the Bank of Canada to ease rates further and short-term rates are expected to come down by one and a half percentage points. That will reduce variable mortgage rates, but we are not expecting much decline in the 5-year fixed rates due to the lingering problems in credit markets. There is also a possibility that credit conditions will be modestly tighter than in past years – partly due to the inability, or at least a significantly weakened ability, to securitize loans. So, the degree of economic stimulus provided by the Bank rate cuts will likely prove more limited than in past easing cycles.

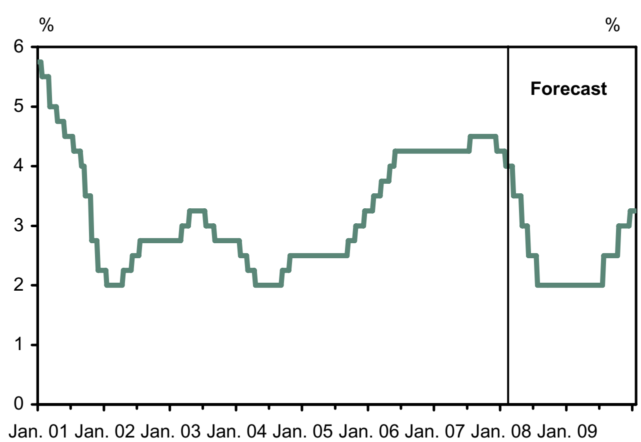
Boom-bust cycle can still be avoided

The main conclusion is that sales will moderate, leading to a sales-to-new listing ratio that is consistent with balanced markets and cause more moderate price growth. However, we still don't see a major housing correction for a number of reasons.

First, the parallels with the U.S. experience are limited. Much of the U.S. housing excess came from an inappropriate loosening of credit conditions that did not occur in Canada. In 2007, 32% of mortgage origination was subprime loans (i.e. to high risk borrowers) compared to an estimated 5% in Canada. Loans with no documentation for income, jobs or assets became common in the United States, while such practice was rare in Canada. Interest-only mortgages became popular in the U.S., but in Canada were less than 5% of mortgage originations. In the United States, many borrowers were qualified on the basis of the short-term interest rates, including the low introductory teaser rates or on their ability to make principal payments on no-interest loans. In Canada, the industry has qualified borrowers on the basis of the higher 3-year or 5-year posted interest rates, and there was no change in this practice in recent years. All of this means that Canadian housing loans had a significant lower risk profile than those Stateside.

Second, the similarities with the last Canadian housing bubble in 1989 are also limited. Affordability in 1989 deteriorated to 39% of personal income. Much of the new home building was done without the presales of today, and this led to a significant supply overhang in 1989 that is very unlikely to occur in the current market. The pace of home

BANK OF CANADA OVERNIGHT RATE



Actual data to March 5, 2008; Forecast by TD Economics as at Mar. 2008; Source: Bank of Canada

HOUSING INDICATORS IN CANADA: 1989 vs. 2007

	1989	2007
Housing Starts (thousand units)	215.2	227.6
New Home Inventories*	65,153	58,064
5-Year Mortgage Rate		
Nominal (%)	12.1	6.4
Real (%)**	7.8	4.3
Affordability ^	39.2	31.6
New Housing Price Index		
% change year/year	13.2	7.8
% chg. year/year (real**)	8.9	5.7
Average Resale House Price		
% change year/year	13.3	11.0
% chg. year/year (real**)	9.0	8.9
% growth rate 3-year avg.	16.1	10.7
Level (1989$ constant)****	146,965	216,037
Sales-to-New Listings ratio	0.47	0.62

* Completed and unabsorbed units for Canada's CMAs.
** Nominal rate adjusted for the change in the core CPI.
^ Percent of average household income taken up by mortgage payments. A decrease in this figure represents an improvement in affordability.
**** Deflated by Core CPI.
Source: CMHC, CREA, Statistics Canada, Haver Analytics, TD Economics.

price appreciation, after removing inflation, was significantly greater in the past. And, the housing fundamentals today are far superior, with lower unemployment and interest rates – although income growth was comparable.

Concern is often voiced on the risks from Canadian condo markets related to the fact that there has been particularly strong building in this sector in recent years. The accompanying table (top of page 5) shows that the number of completed but unabsorbed (i.e. un-purchased) units is still below the levels that existed in the first half of the 1990s. The main concern on the condo front is the extent to which the purchases are being made for speculative purposes, which would make them more vulnerable to price swings – but, there is no way to assess the vulnerability since there is no reliable data on this matter.

Third, and this is critical, both the latest U.S. housing bubble and the Canadian bubble of 1989 were pricked when the central bank tightened monetary policy significantly, causing speculators to scramble for the doors. However, the debate at the moment in Canada is how low rates will go – not how high they will climb. The weakness in the U.S. economy is coming at a time when the high-flying Canadian dollar is keeping inflation at check. This gives the Bank scope to lower rates. So, there is a window of opportunity for the erosion in affordability and the increase in housing supply to moderate Canadian real estate markets in a gradual fashion and avoid a boom bust cycle.

The key risk to monitor

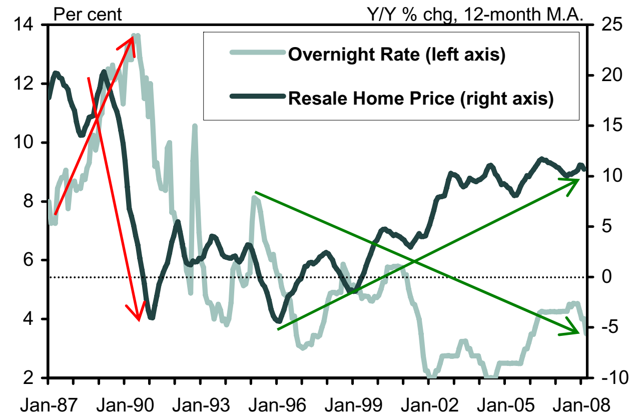
However, the risks of price corrections will increase if home price growth fails to slow, or worse yet accelerates. By late 2009, economic conditions are likely to be on the mend and the disinflationary impact of the strong Canadian dollar will largely have vanished. Given this backdrop, the Bank of Canada is expected to begin gradually raising interest rates. The initial tightening of monetary policy should not be too problematic for real estate markets. But, when the overnight rate returns to more neutral levels in the 4.50 to 5.00% range probably in 2010, it could create significant challenges for urban centres where affordability is still stretched for cities where speculation has remained strong.

Summarizing the outlook

A detailed national and provincial forecast is provided on the next page. To sum up, we look for national average home price growth to slow from a torrid 11% in 2007 to 6% in 2008 and down to a 4% pace in 2009. The moderation in housing activity will also be accompanied by weaker new home construction, but the level of building will remain quite strong. Housing starts are expected to edge down to 221,000 units and slip to 210,700 in 2009 – but this is still well above the pace of household formation (which is estimated at 175,000) and implies that new home supply will be a factor helping resale markets to cool.

By next year, the annual rate of resale home price growth in Atlantic Canada is expected to average between 2.5 and 5.4%, depending on the province. Quebec home prices are expected to advance by a modest 3% in 2009, while Ontario and Manitoba should post an increase close to 4%. Saskatchewan is forecast to see price growth decelerate dramatically from 30% in 2007 to around 7% in 2009, which is similar to the experience in Alberta where strong double digit price gains led to a significant drop in affordability and a major increase in listings. Indeed, Alberta home price growth has already slowed substantially and is expected to be around 3.5% in 2009, while B.C. is projected to post a gain of 5.6%. And, as interest rates rise in late 2009 and early 2010, a further cooling in real estate across the nation is anticipated, with the bulk of the moderation coming in the western markets.

INTEREST RATE ENVIRONMENT & HOME PRICES



Source: Haver Analytics, CREA

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HOUSING STARTS Thousands of units	2005	2006	2007	2008F	2009F
CANADA	**224.0**	**229.1**	**227.6**	**221.0**	**210.7**
N. & L.	2.6	2.3	2.6	2.8	2.7
P.E.I.	0.9	0.8	0.7	0.7	0.7
N.S.	4.7	5.2	4.7	5.0	4.4
N.B.	3.9	4.0	4.1	3.9	3.7
Quebec	50.9	48.0	48.5	47.0	46.1
Ontario	77.8	74.4	68.0	70.0	67.6
Manitoba	4.7	5.0	5.8	5.3	5.2
Sask.	3.3	3.7	5.9	6.0	5.5
Alberta	40.6	49.1	48.1	40.4	37.3
B.C.	34.5	36.6	39.2	40.0	37.6

F: Forecast by TD Economics as at April 2008
Source: Canada Mortgage and Housing Corporation

HOUSING STARTS Per cent change	2005	2006	2007	2008F	2009F
CANADA	**-3.7**	**2.3**	**-0.7**	**-2.9**	**-4.7**
N. & L.	-11.7	-10.7	14.9	4.4	-2.9
P.E.I.	3.7	-15.3	-13.8	0.7	-4.4
N.S.	-2.1	11.4	-9.6	5.8	-12.0
N.B.	2.6	3.6	2.3	-5.5	-5.1
Quebec	-13.0	-5.8	1.1	-3.2	-1.9
Ontario	-7.9	-4.4	-8.5	2.9	-3.5
Manitoba	6.2	6.7	15.1	-9.2	-1.0
Sask.	-11.6	12.8	58.3	1.6	-8.3
Alberta	12.1	20.9	-2.1	-16.0	-7.7
B.C.	5.1	6.0	7.0	2.2	-6.0

F: Forecast by TD Economics as at April 2008
Source: Canada Mortgage and Housing Corporation

RESALE UNITS Thousands of units	2005	2006	2007	2008F	2009F
CANADA	**483.9**	**484.0**	**520.8**	**491.1**	**478.9**
N. & L.	3.2	3.5	4.5	5.0	5.1
P.E.I.	1.4	1.5	1.8	1.7	1.7
N.S.	10.9	10.6	11.9	11.3	11.2
N.B.	6.8	7.1	8.2	7.7	7.4
Quebec	70.6	72.5	80.3	77.2	76.0
Ontario	197.0	194.8	213.4	204.7	199.8
Manitoba	12.8	13.0	13.9	14.1	14.3
Sask.	8.3	9.1	12.1	13.8	13.4
Alberta	65.9	74.4	71.4	58.4	55.7
B.C.	106.3	96.7	102.9	97.2	94.3

F: Forecast by TD Economics as at April 2008
Source: Canadian Real Estate Association

RESALE UNITS Per cent change	2005	2006	2007	2008F	2009F
CANADA	**5.0**	**0.0**	**7.6**	**-5.7**	**-2.5**
N. & L.	-1.7	10.2	26.4	11.3	2.2
P.E.I.	-3.4	3.0	18.6	-5.6	0.3
N.S.	23.1	-3.3	12.1	-4.3	-1.6
N.B.	14.3	4.2	14.5	-6.2	-3.9
Quebec	2.0	2.6	10.8	-3.9	-1.5
Ontario	-0.2	-1.1	9.5	-4.1	-2.4
Manitoba	5.5	2.0	7.0	1.5	1.4
Sask.	1.7	10.0	31.9	14.4	-3.1
Alberta	14.6	12.9	-3.9	-18.2	-4.6
B.C.	10.3	-9.1	6.4	-5.5	-3.0

F: Forecast by TD Economics as at April 2008
Source: Canadian Real Estate Association

AVERAGE RESALE HOME PRICE Thousand $	2005	2006	2007	2008F	2009F
CANADA	**249.2**	**276.9**	**307.3**	**325.7**	**339.1**
N. & L.	141.2	139.5	149.3	161.2	169.9
P.E.I.	117.2	125.4	133.5	142.0	147.1
N.S.	159.2	168.6	181.0	190.4	195.2
N.B.	120.6	126.9	136.6	145.2	150.0
Quebec	184.6	194.0	208.2	218.9	225.4
Ontario	262.9	278.4	299.5	312.7	325.5
Manitoba	133.9	150.2	169.2	175.3	182.1
Sask.	122.8	132.1	174.4	226.9	243.2
Alberta	218.3	285.4	356.2	374.0	387.1
B.C.	332.2	391.0	439.1	479.1	505.9

F: Forecast by TD Economics as at April 2008
Source: Canadian Real Estate Association

AVERAGE RESALE HOME PRICE Per cent change	2005	2006	2007	2008F	2009F
CANADA	**10.1**	**11.1**	**11.0**	**6.0**	**4.1**
N. & L.	7.4	-1.2	7.0	8.0	5.4
P.E.I.	5.8	7.0	6.4	6.4	3.6
N.S.	9.0	5.9	7.3	5.2	2.5
N.B.	6.8	5.2	7.7	6.3	3.3
Quebec	7.9	5.1	7.3	5.1	3.0
Ontario	7.2	5.9	7.6	4.4	4.1
Manitoba	12.3	12.2	12.6	3.6	3.9
Sask.	10.8	7.6	32.0	30.1	7.2
Alberta	12.1	30.8	24.8	5.0	3.5
B.C.	14.9	17.7	12.3	9.1	5.6

F: Forecast by TD Economics as at April 2008
Source: Canadian Real Estate Association