TD Bank Financial Group

TD Economics

Special Report

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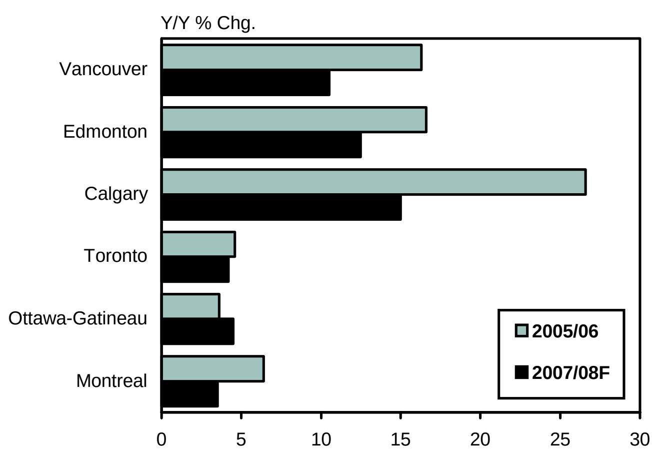
CONDOS TO REMAIN AN ATTRACTIVE OPTION FOR MANY HOME BUYERS

Canada's condo markets have delivered a strong performance in recent years, and the economic and financial outlook suggests a continued robust performance in 2007 and 2008. Like all real estate, the sales and price experience for condos will be heavily influenced by location. Since 2004, housing markets in central and eastern Canada have generally experienced a soft-landing, with activity moderating, but remaining at high levels, and with prices continuing to rise at a solid pace. The outlook is for more of the same over the next 24 months. In contrast, new and resale housing in the west has been on fire, but soaring prices have eroded affordability in many markets. In 2007/08, housing conditions are likely to cool in the west, but this need not lead to a boom-bust cycle if price growth slows as new supply comes on the market, demand eases and speculation becomes gradually less intense. So while the risks warrant close monitoring, the TD Economics base case projection is for a moderation in western housing activity, but with the price gains, home construction and resale activity all remaining at well above their historical averages. The regional condo markets are likely to be caught up and parallel these broad regional real estate trends, with the result that condo prices are expected to continue to post double digit gains in the west, but slower than that experienced in 2005/06, while prices in the rest of the country advance at a mid-single digit rate. Looking beyond the near-term outlook, there is fundamental support for condos in the major Canadian markets from structural economic trends, including the aging population and the continued urbanization of the country.

HIGHLIGHTS

- **Canada's major condo markets are expected to deliver a strong performance in 2007/08**
- **Some cooling expected in west, but from unsustainable strength, while markets elsewhere have experienced soft-landings that will support continued solid price gains**
- **Affordability to keep condos attractive, although past price gains are acting as a headwind in some markets**
- **Long-term outlook is positive. Demand for condos will be spurred by aging population, immigration and urbanization**

MAJOR MARKET RESALE CONDO PRICES



Source: Conference Board of Canada, Forecast by TD Economics

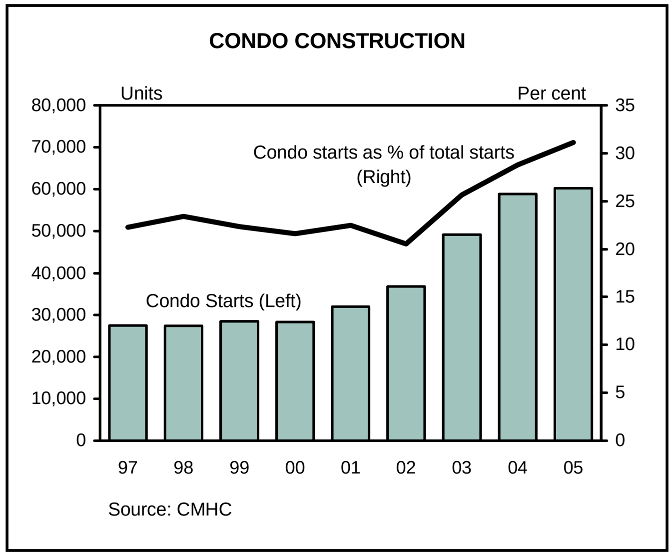
Condos attractive option for many buyers

In March, TD Bank Financial Group conducted a survey of Canadians aged 18 and over who were potential condo buyers. The findings confirmed that condos are viewed as an increasingly attractive option for many Canadians and the sentiments expressed suggest that demand for new and resale condos will remain strong. 39% of those surveyed said they were likely to consider buying a condominium as a principal residence and this ratio had risen by 4 percentage points from a similar survey done in June 2006. The top two reasons for preferring condos were lower maintenance costs and greater affordability, but there was more to the decision as well. The top three amenities were good building security, attractive design and environmentally friendly/energy efficiency. The last item is of particular interest, since the outcome could be interpreted in two different ways. It might reflect increased environmental awareness, which is consistent with the fact that concerns about the environment are ranking at the top of many public opinion polls. Alternatively, it could reflect a desire to keep monthly expenses on utilities as low as possible. Proximity to public transit, retail outlets and entertainment were also deemed to be attractive to potential buyers.

Surveys can provide interesting anecdotal evidence of changing consumer preferences and tastes, but they can also be misleading at times. So, the natural question is how do the survey results stack up against the current trends and the outlook for condos in Canada?

Condos have delivered a strong performance

The attractiveness of condos is evident in the recent strong activity recorded in the major markets across Canada. From 2001 to 2005, condo starts have posted an average annual increase of more than 16%. And, condos have climbed from close to one-fifth of all new home construction to almost one-third over the past ten years. Despite the strong supply coming on the market, robust demand has quickly absorbed the additional units. Indeed, with the exception of Montreal, conditions have been consistent with characteristics of a sellers' market. This can be seen by the fact that sales-to-new listing ratios on apartments, which are dominated by condos, have been well above the 0.55 mark that is traditionally thought of as being the threshold been balanced markets and sellers' markets. Consequently, the demand-supply balance has supported solid or strong price gains. There has been a significant regional dimension, with the west posting double digit condo resale price increases over the past few years, whereas price growth has tended to be in the single digits elsewhere.



RECENT MAJOR CONDO MARKETS INDICATORS

	Starts			Completed & Purchased			Average resale price, $			
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2007/08F*
Vancouver	12,647	13,084	12,419	7,604	10,419	11,599	214,031	247,192	289,344	319,725
% change	41.7	3.5	-5.1	20.4	37.0	11.3	16.5	15.5	17.1	10.5
Edmonton	3,317	4,256	4,539	3,248	3,159	4,048	134,068	140,532	180,367	202,913
% change	-20.7	28.3	6.6	33.9	-2.7	28.1	7.8	4.8	28.3	12.5
Calgary	4,558	4,112	5,226	3,869	3,827	3,466	166,517	183,995	262,456	301,824
% change	6.2	-9.8	27.1	-4.6	-1.1	-9.4	6.2	10.5	42.6	15.0
Toronto	14,022	16,178	15,432	10,697	13,852	16,631	219,147	228,437	239,816	249,888
% change	-3.1	15.4	-4.6	-4.3	29.5	20.1	3.4	4.2	5.0	4.2
Ottawa	2,259	1,219	1,646	1,538	1,797	1,538	165,263	172,475	177,267	185,244
% change	196.5	-46.0	35.0	628.2	16.8	-14.4	7.2	4.4	2.8	4.5
Montréal	10,053	8,758	7,219	7,300	8,564	7,178	150,229	161,771	169,899	175,845
% change	27.4	3.5	-5.1	31.2	17.3	-16.2	11.3	7.7	5.0	3.5

* Forecast is the average annual growth rate and average annual prices over the two year period 2007/08

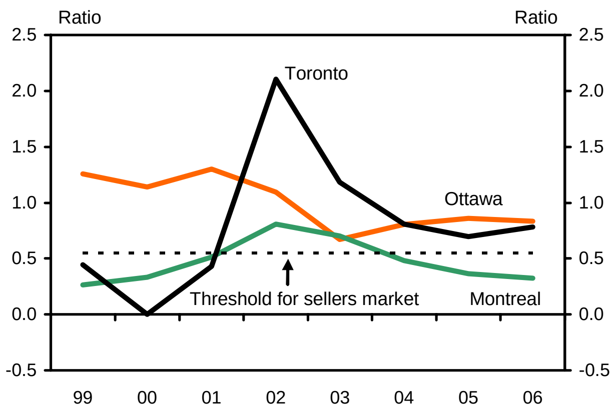
Source: CMHC, Forecast by TD Economics

Looking ahead, there is every reason to expect that the level of activity will remain strong and that prices will continue to advance, but some cooling will likely be evident in regions where affordability is being eroded by price growth.

Low unemployment and stable interest rates are supportive

The key short-term drivers for housing demand are labour market conditions and the level of interest rates. On these two fronts, the outlook is favourable. Employment growth in Canada is expected to slip from 2.0% in 2006 to 1.8% in 2007 and 1.3% in 2008. However, this continued job creation is expected to keep the national unemployment rate at close to a 30-year low and maintain an employment-to-population ratio at a record level. The plentiful jobs augur well for personal income, which is expected

SALES-TO-NEW LISTINGS: APARTMENTS



Source: CMHC

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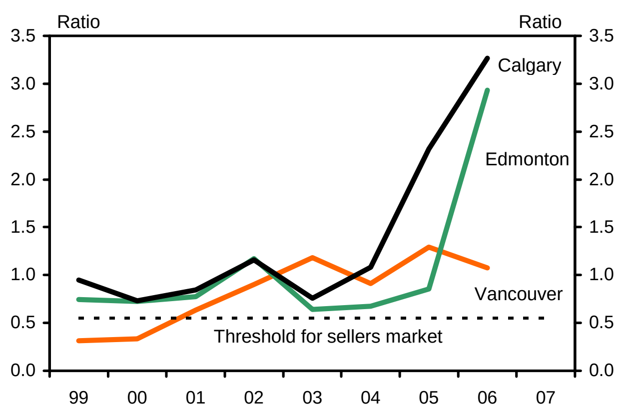
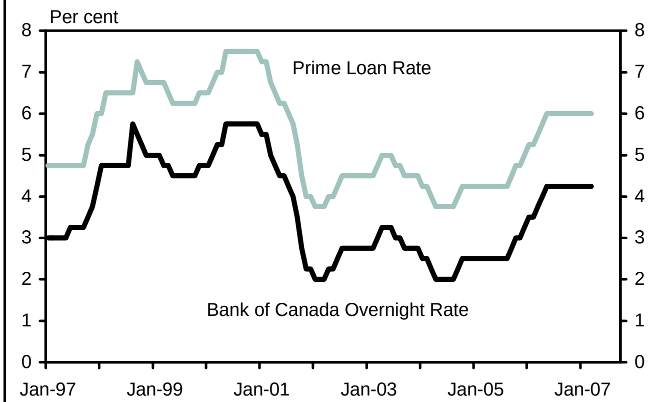


Source: CMHC

BANK OF CANADA OVERNIGHT RATE AND PRIME LENDING RATE



Last plotted: March 2007; Source: Bank of Canada/Haver Analytics

to rise at roughly 4% per annum over the next two years, but it is also positive for consumer confidence. There will be a regional dimension, with the lowest unemployment and greatest income gains in the west, but labour market conditions will remain generally solid in central and Atlantic Canada as well, and there is upside potential in these regions when exports to the U.S. firm, which is expected to occur in 2008.

The interest rate outlook suggests that mortgage borrowing costs will remain stable and low by historical standards. The prospects for variable mortgage rates are tied to developments in the prime lending rate, which is, in turn, determined by changes in the Bank of Canada overnight rate (see chart above).

The Canadian economy is delivering a sub-par pace of economic growth, but it is also operating at virtually full capacity. In this environment, the Bank is expected to leave monetary policy unchanged. A stable overnight rate would imply no change in the prime lending rate.

However, there are risks on both the upside and the downside to this outlook. If inflation accelerates, the unemployment declines further or the domestic economy proves stronger than anticipated, the Bank of Canada could decide to raise rates. On the flip side, if the U.S. housing market correction leads to a U.S. recession, the negative impact on the Canadian economy might force the Bank to cut rates.

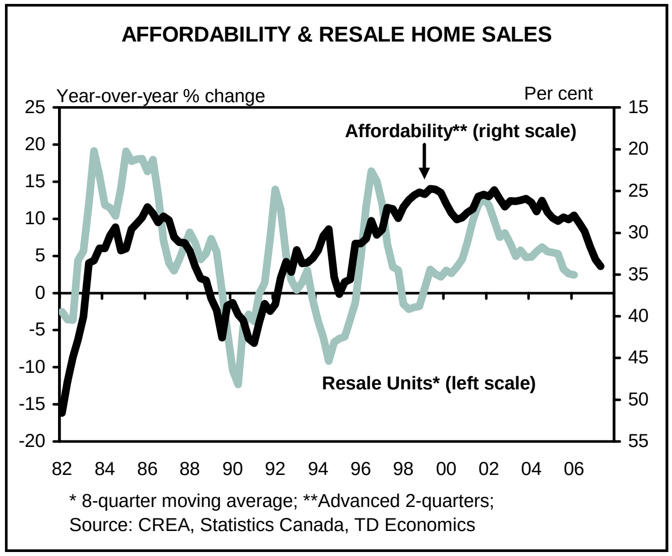
On balance, the recent economic data suggest that the odds of rate hikes are greater than rate cuts, but the main issue for housing markets is that the extent of any change in monetary policy from current levels is likely to prove limited because inflation is unlikely to get out of hand, while any unexpected headwinds from U.S. weakness will only gradually diminish the tightness in Canadian labour markets.

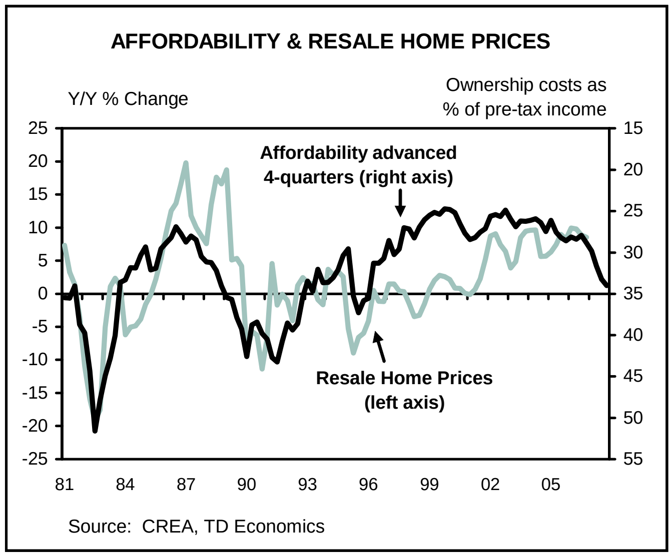
With respect to long-term borrowing costs, the 5-year fixed mortgage rate tracks changes in 5-year government bond yields quite closely (see chart below). Bond markets have fully priced our expectation of soft national economic growth in the near term, but improving in 2008, and the continuation of relatively subdued inflation. Accordingly, bond yields are expected to remain near current levels and rise only modestly in 2008. For example, the yield on the 5-year federal government bond is projected to rise only 50 basis point (half a percentage point) over the next 18 months, suggesting a similar increase in mortgage rates. Again, there are risks on both sides of the forecast, but the scope for either interest rate increases or decreases appears limited. As a result, the level of borrowing costs should remain favourable for real estate.

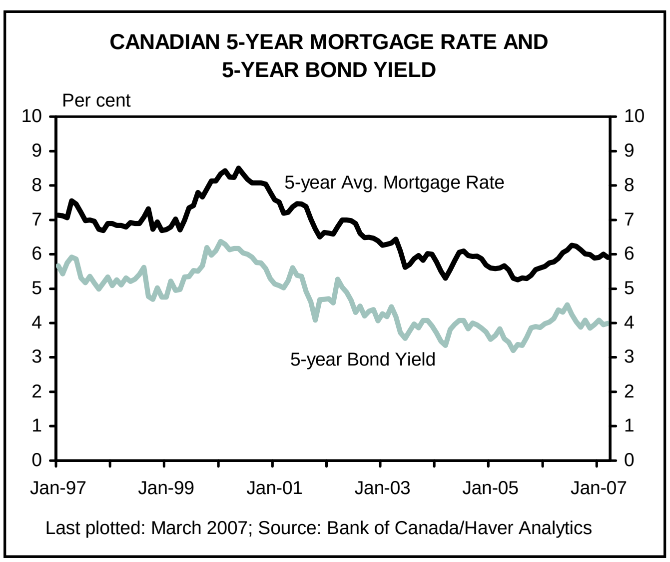
Declining affordability will cool some regional markets

While the economic and financial fundamentals are expected to be supportive, declining affordability is expected to pose a headwind in some cities.

From a national point of view, housing affordability has deteriorated over the past couple of years, reflecting the solid price gains that have outstripped personal income growth. As the accompanying charts show, housing affordability does impact home sales, but there is a lag. The implication is that buyer demand is eventually damped, and this ultimately leads to slower price growth, but the impact takes as much as a year to be fully felt.







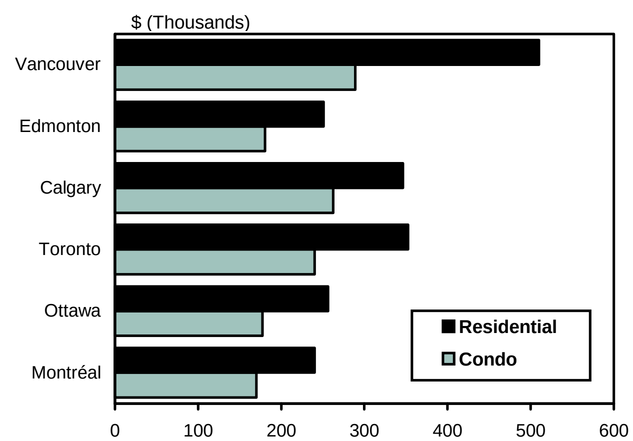
The current level of affordability is not a major problem, but the recent erosion does point to softer price growth ahead. Indeed, the current share of personal income going to home ownership costs points to a slowing in national average resales and a moderation in price growth from 10% to approximately a 5.5% pace over the next year. As one might expect, the erosion in affordability has been most pronounced in the western markets that have experienced the strongest price gains. So, we anticipate that the bulk of the cooling in prices will occur in these markets

The performance of condos is likely to be influenced by the general trends in real estate. The pace of condo starts is expected to decline by close to 6% over the next 18 months and resale price growth should cool in the west, but remain quite elevated. Consequently, price growth in Calgary is expected to drop from 26.6% in 2005/06 to 15.0% in 2007/08, while Edmonton slips from 16.6% to 12.5% and Vancouver goes from 16.3% to 10.5% over the same time frame. In central and eastern Canada, the markets are already much more balanced and the level of activity and price growth is far more sustainable, suggesting little reason for major market changes. Accordingly, Toronto condo prices are projected to average 4.2% growth in 2007/08, little changed from the 4.6% in 2005/06. Ottawa price gains are expected to rise slightly from 3.6% to 4.5%, while Montreal price growth softens from 6.4% to 3.5%.

Condo affordability remains superior

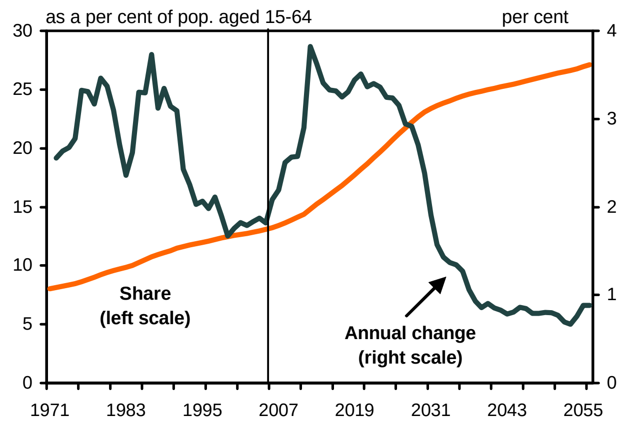
One should also stress that while the erosion in affordability in some major markets will act as a constraint, condos are significantly more affordable than alternative real estate options. To illustrate, condo prices are almost half of the average price of detached bungalows in Vancouver. They are a roughly one-third less than the average price in Calgary and Toronto. Obviously, one must factor in the financial burden of condo fees when making comparisons, but the fees often cover items that homeowners would have to pay themselves in non-condo dwellings. So, the conclusion is still that condos tend to be much more affordable than detached dwellings in most cities. And, given the rapid price increases in detached dwellings sustained over the last few years, condos may be the only option for some potential homeowners – and many first time buyers – in selected markets. So, while affordability may temper market performance, the drag should prove less of an obstacle for condos. The TD survey clearly indicates that potential condo buyers are acutely aware of the lower price tag associated with these dwellings.

AVERAGE RESIDENTIAL PRICES VS. CONDO PRICES - 2006



Source: Canadian Mortgage & Housing Corporation

CANADIAN POPULATION AGED 65 +



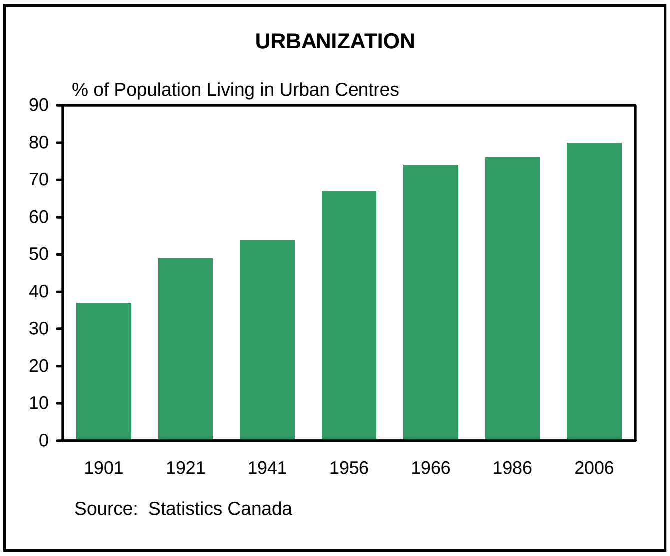
Source: Statistics Canada

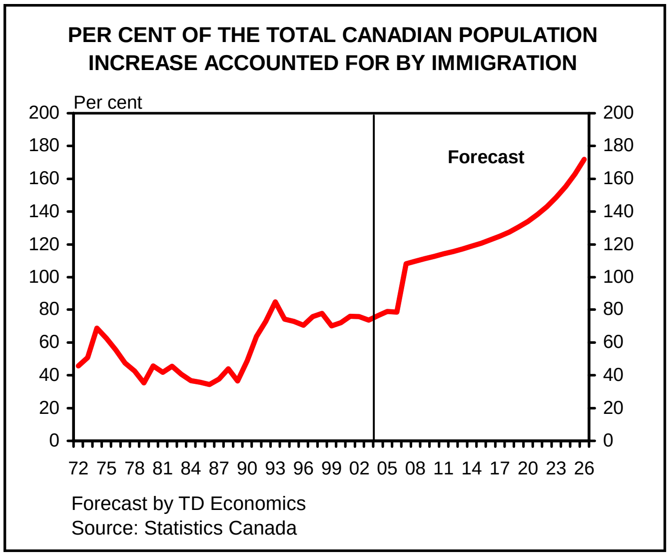
Condos to benefit from long-term structural trends

Looking beyond the near-term outlook, the prospects also look good for condos over the long haul due to a number of structural trends.

Canada has an aging population, associated with the graying of the baby boom generation. The median age in Canada was 37 in 2001 and it is projected to climb to between 45 and 50 years of age by 2056. This could create headwinds for real estate, which is influenced by demographic demand for housing, but the aging population could prove positive for condos. First, Canadians are living longer, healthier lives with the result that homeownership rates amongst older individuals is rising, as they are staying in their homes longer. Second, older Canadians might have a preference for condos, as some homeowners downsize in favour of properties with less maintenance costs.

While the changing demographic profile points to slower population growth, it is also evident that cities will continue to expand faster than rural communities. As an illustration of how dramatic this trend has been, in 1901 37% of Canadians lived in urban centres. By 1951, the ratio had climbed to 62%. In 2006, it reached 80%. However, land scarcity is becoming a more pressing issue is some urban areas. Commute times have been rising in recent years, but are reaching a breaking point in some cities, as traffic densities have surged. This is contributing to an urban





renewal, which is expected to intensify in the years to come. While condos are not solely located in cities, as evidenced by their presense in some resort settings, the bulk of condos are concentrated in urban centres, making them highly likely to benefit from the urbanization trend.

Immigration will play an increasingly important role in terms of contributing to population growth, and this could also prove favourable for condos. New arrivals, which are a growing share of first time home buyers, do not spread themselves equally across the country. For example, 88% of immigrants in 2004 settled in Ontario, Quebec and British Columbia. And, 80% of the immigrants to Ontario took up residency in the Greater Toronto Area. In fact, 72% of all immigrants were destined for Toronto, Montreal and Vancouver. Since these cities are also the largest condo markets, demand for this type of dwelling is likely to remain well supported over the coming decades.

Conclusions

The bottom line is that the TD condo survey appears to correspond well with the economic trends. Condos are an attractive alternative to buying a detached dwelling and affordability is often far greater. Some cooling is expected in Canada's major condo markets, but conditions should remain healthy and the level of activity will be high. The moderation will be concentrated in the west, but this represents a retreat from unsustainable levels. Having said all of this, some risks are present. The explosive price growth and the presence of speculation in the west have been sending off warning signals. But, if price growth moderates as new supply comes on the market and as eroding affordability dampens demand, a boom-bust cycle can be avoided. Meanwhile, there is significant additional supply in the pipeline for Toronto from projects that are already underway, but are not yet completed. This could impact price growth, but so long as employment remains solid and interest rates do not rise significantly from current levels, there should be no problem absorbing the additional units. So, the risks do not outweigh the short-term and long-term drivers for condos that all look to remain supportive.

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