TD Bank Financial Group

TD Economics

Special Report

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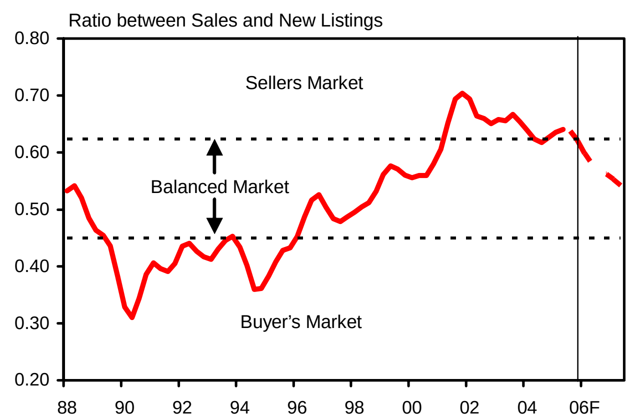
WHAT TO EXPECT FROM A SOFT LANDING IN CANADA'S HOUSING MARKET

After another stellar year that saw home prices continue to climb and sales of existing homes smash one record after another, there seems to be little disagreement among economists, builders and real estate execs that Canada's hot housing market is finally due for a protracted slowdown in 2006. But amidst widespread reports of a bursting housing bubble south of the border, many homeowners and potential homebuyers in this country are wondering exactly what the nature of an impending slowdown in Canada will be? In particular, will house prices tumble like many high-flying technology stocks did back in the year 2000?

Fortunately, the answer is a resounding "no". That's because fundamental factors like solid affordability, and strong job and income growth have been responsible for much of the robust housing activity on this side of the border, in contrast to the excessive speculative buying evident in many major U.S. markets. This is a key reason why national home price gains of around 9 per cent in Canada, have been much slower than the double-digit gains seen in the United States. It is also a key reason why a "correction" in Canada's housing market will not be necessary.

Instead, housing demand in Canada is likely to gradually cool down to a more sustainable pace in 2006. That's partly because borrowing costs are expected to only gently rise this year but remain low from an historical perspective. Meanwhile, high levels of immigration and net migration into major urban centers of Canada are expected to continue strongly supporting new homebuilding. So while housing starts are expected to simmer down from 223,900 units in 2005 to about 195,000 in 2006, they will still be at very robust levels relative to their long-term average of about 175,000 units per year.

RESALE HOUSING MARKET CONDITIONS

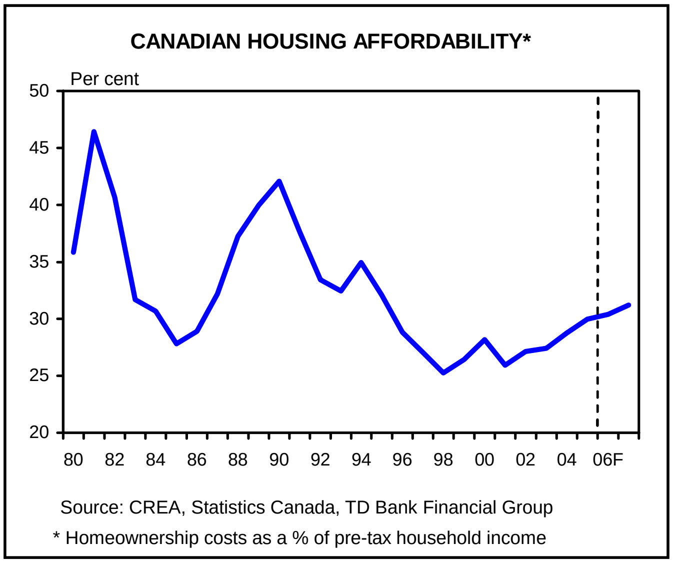


Source: CREA, TD Economics

Slightly softer housing demand together with a relative improvement in the supply of available homes should also help to unwind the generally tight conditions underscoring most Canadian housing markets in the last few years. This improved balance between supply and demand will ultimately mean that the growth of home prices will cool down to a more sustainable pace – around the low- to mid-single-digits over the next two years. In short, although Canada's housing market is poised to come off its peak in 2006, the slowdown will simply amount to what economists deem a "soft landing."

Is it still a good time to buy?

Whether they are looking to buy for the first time, or they are looking to trade up, many potential homebuyers may be wondering whether 2006 will still be a good time to buy a home. Of course, the answer typically depends on a host of factors including one's personal financial and



lifestyle situation. But generally speaking, a soft landing in the housing market should result in favourable conditions for prospective homebuyers for two reasons. First, although borrowing costs are expected to move slightly higher this year, their impact will be partly offset by healthy disposable income growth along with a slower rate of home price appreciation. As a result, housing affordability will still remain extremely attractive from an historical basis. For example, the percentage of household income needed to service the costs of home ownership is expected to mildly erode to about 30.4 per cent this year from about 29.9 per cent in 2005, but that is still considerably better than the average rate of 32 per cent over the 1990's.

Second, a better balance between buyers and sellers in 2006 means that prospective homebuyers will find themselves in a stronger position to negotiate on prices compared to the past few years. That's because buyers will have a bigger and more varied selection of homes from which to choose from given the greater number of available listings coming onto the market in 2006. Consequently, buyers will have the luxury of taking more time to find a home that is right for their needs, without fear of either losing out to another buyer due to a potential bidding war or simply being priced out of the market because they waited a little while longer to make a decision.

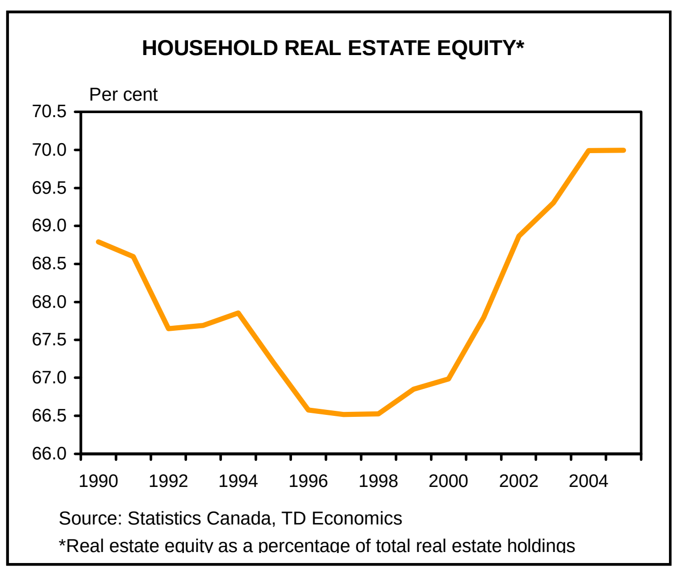
Homeowner wealth will remain intact

Over the last few years, the swift pace in which house values have risen has far outstripped the pace at which mortgage debt has been growing. As a result, the amount of equity that most Canadians have built up in their homes, defined as the market value of their residences minus their mortgages, has grown for five straight years after trending downward over most of the 1990's. Correspondingly, rising home prices have been a big reason why the net worth, or wealth, of Canadian households has grown by over 20 per cent during the same period.

Given this development, it is not surprising that many people believe a house is one of the best investments they'll ever make. Over a lifetime, they would probably be right especially since every penny made on a principal home can be pocketed as these gains are not taxed when they are realized. That said, many long-time homeowners who have experienced previous housing cycles can also tell a story or two about how a home can also be the most expensive mistake one could make, should a homeowner be forced to sell when prices are down.

The good news is that as Canada's housing market slows this year, the wealth that existing homeowners have recently accumulated should remain as safe as the foundations on which their homes are built on. As we noted above, that's because the expected slowdown in housing activity should merely result in a better balance between supply and demand. As a result, house price gains can be expected to slow to a more sustainable rate, with the likelihood of outright prices declines very slim in most major markets of the country.

But while the short-term situation for housing prices still looks favourable, what about the longer term? In particular, some observers have expressed concerns that as the leading edge of the large baby boom generation ap-



proaches retirement, housing prices could collapse as this group increasingly unloads their family homes to a smaller pool of younger buyers. While no one can forecast the longer-term with complete accuracy, it is important to keep in mind that not all baby boomers will be retiring at the same time. That's because this demographic group currently spans in age from just above sixty, down to forty years old. So while many older boomers may be pondering retirement in the next few years, their younger counterparts with growing families will still be looking to trade-up to larger homes. This should help to keep the housing market broadly in balance and therefore keep prices stable over the next decade.

It is also important to note that even as older boomers start to retire, they will not give up on homeownership right away. In fact, the fastest growing segments for homeownership are those above 65 and boomers will certainly not reverse this trend given their high levels of wealth. Consequently, aging boomers are likely to only reshape the types of housing that is in demand over the next two decades but they are unlikely to cause a deep contraction in overall home prices.

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