

OVERPRICED AND OVERBUILT: CANADIAN HOUSING MARKET RETURNS TO FUNDAMENTALS

Executive Summary

During Canada's "Housing Boom", which ran roughly from 2002 to 2008, unsustainable price increases drove unsustainable levels of building. Our view is that house prices exceeded the value of housing that was justified by fundamentals by approximately 9% nationwide. This overpricing compelled a level of residential construction that exceeded its fundamental-justified level by approximately 12%, an excess that was exaggerated in the past three years.

By "overpricing" we mean that prices detached from their fundamentals, as witnessed by a steep erosion of affordability. The current unwinding of house prices reflects both a cyclical downturn and a return of house prices to fundamentally justified levels.

We consider "overbuilding" of two forms: "demand-driven" where homebuyers buy up too many houses and that this demand cannot be sustained; and "supply-driven" where builders accumulate excessive inventories. Although there is evidence of both types, we contend that Canada's "overbuilding" was mainly of the first type, where homebuyers pushed homebuilding to an unsustainable pitch that is now being rapidly reined in.

While most markets won't face U.S.-style overhangs, the construction of too many new homes over the boom means a deepened slump. This overbuilding will likely weigh on markets over the next few years. Even as Canada recovers from the cyclical downturn, house price growth will remain choppy and new residential construction will be dampened, owing to this structural weakness. Construction is now undershooting fundamentals and we expect this to persist over 2009 to 2011. We anticipate that nationwide residential construction will fall further to around 125,000 starts over 2009 with a trough around 115,000 units in the fourth quarter.

To quantify the degree of overpricing and overbuilding, we first develop an empirical model, based on long-run fundamentals of house prices and housing starts in each province. Affordability is the key concept behind home values since house prices should track incomes over the long-run. Since homebuilders build to meet demand, we regard housing prices and household formation as the drivers of residential construction.

To examine the degree of overbuilding, we employ a "counter-factual," asking what level of residential construction would have occurred if housing had been priced optimally. We find that actual homebuilding exceeded this fundamental-justified level by about 12%. Although new units were being absorbed, homebuyers simply bought too many houses at prices that exceeded fundamentals.

Regionally, we see the greatest strains on the Prairies, where housing demand will further contract under waning population inflows. Saskatoon, Calgary and Edmonton are already witnessing surges in their unsold new homes at the very time that the resale market has swung into strong buyers' territory. Homebuilding in the Atlantic provinces has been relatively balanced but, while not plagued by structural weakness, will be singed by the downturn nonetheless. Québec shows signs of strain – especially given the strange accumulation of unabsorbed multiples on l'Île de Montréal – but recent building has been relatively balanced, given the province's history of under-building and low ownership rates. While Ontario homebuilding will reel from a cyclical downturn, the degree of structural weakness appears limited – with the important exception of the Toronto condo market. Both in Toronto and Vancouver, historically high levels of apartment-style units presently under construction mean that record numbers of condos will reach completion during 2009. If absorption rates fall, as cyclical factors would indicate, condo inventories could spike severely – particularly in Vancouver. However, while residential construction in B.C. will definitely droop, we anticipate that the West Coast will continue to benefit from inter-provincial and international migration over the coming years, which, along with improvements in affordability, will alleviate some of the pressure from overbuilding.

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