TD Bank Financial Group

TD Economics

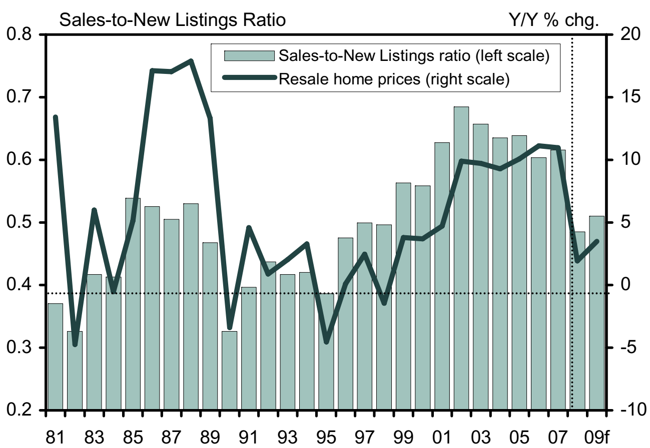
Special Report

June 26, 2008

CANADA'S HOUSING BOOM COMES TO AN END

Over the past couple of years, TD Economics has repeatedly forecast that Canada's major real estate markets would experience a significant cooling. In fact, housing remained stronger for longer than we had anticipated, largely due to increased affordability through new financing options, such as no money down or extended amortizations. Regional economic strength related to the commodity boom also helped to fuel unsustainably elevated home price growth in the west. Nevertheless, our last Special Report on Canada's housing market, *Canada's Red Hot Real Estate Markets to Cool* (April 10, 2008), stressed that there would be a significant adjustment in real estate activity in 2008-09, with national average home price growth slowing sharply from the 11% posted in 2007 to a low single digit pace. There is now clear evidence that this slowdown has taken hold. The year-over-year price growth for existing homes in Canada's major markets fell to only 1.1% in May, down from 8.6% just four months earlier. The trend has been broadly based, but it has been particularly sharp in some of the markets that had experienced the most dramatic price growth. Calgary and Edmonton home prices in April and May fell to below year-earlier levels. The combination of significantly higher listings, reflecting the desire of homeowners to take advantage of the past increase in prices, and weaker demand, due to the past erosion in

CANADIAN HOUSING MARKET



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

HIGHLIGHTS

- **The long awaited end of the Canadian housing boom has occurred, reflecting more moderate demand and increased supply of properties for sale**
- **Most of Canada's major housing markets have moved out of seller's territory to more balanced markets**
- **TD Economics forecasts modest national average price growth of 2.0% this year and 3.5% next year, down substantially from the 10% annual pace of the last six years**
- **Sales are significantly lower than in the banner year that was 2007, but they are returning to 2004-06 levels, held up by solid economic and financial fundamentals**
- **Past erosions in affordability are the main factor behind weaker sales, but affordability is now set to improve**
- **Additional supply of homes for sale is booming out west and new listings must be absorbed at more conservative prices before demand can lift prices again. After a pullback over the next 12 months, Alberta's major markets will stabilize and post mild prices gains thereafter**
- **Saskatchewan is bucking the national cooling trend, but price growth will come back down to earth next year**

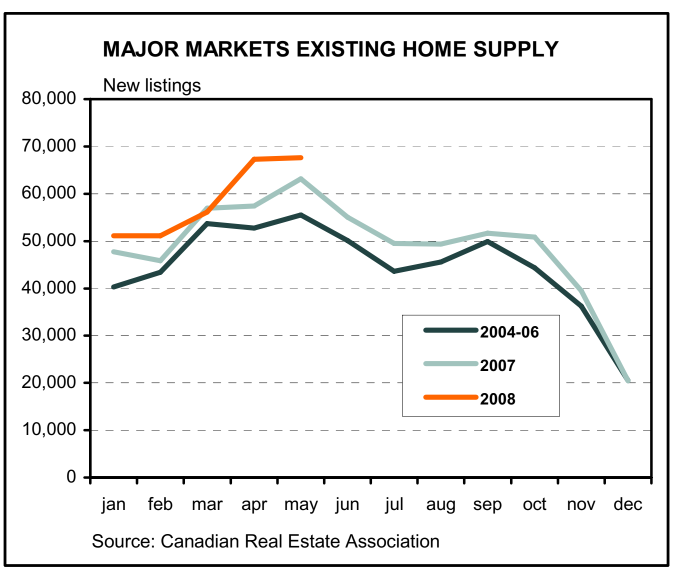
affordability, are leading to declining sales and softer price performance across the country, but particularly in the west.

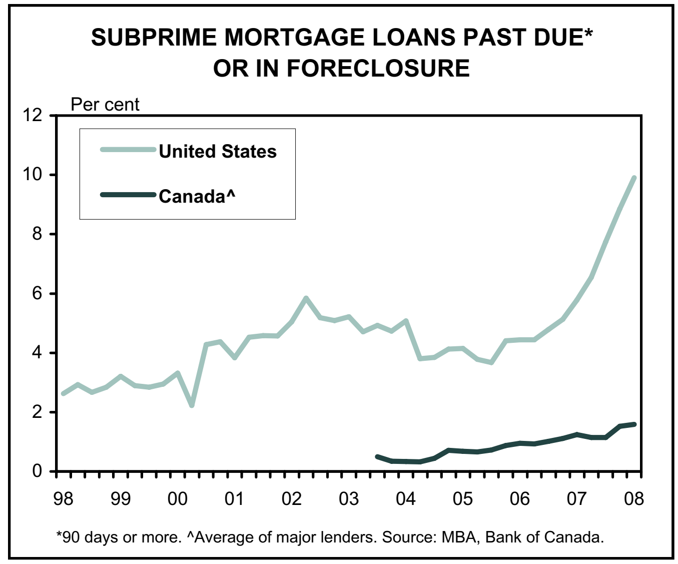
The key question is how far the recent trends will extend and whether Canada will experience a broad based housing correction. In our opinion, sales are likely to continue to decline in the coming quarters and price growth will slip to 2% on a national average basis in 2008 and rise only to 3.5% in 2009. However, this national average will mask very different regional price trends. Most markets will see low to mid single-digit gains, but Saskatchewan and Manitoba will continue to post double-digit gains in the near term followed by a significant cooling in 2009 – with the risk of a mild price correction in the major cities that have recently experienced extraordinary price growth. Alberta will have further weakness in the near term, as Calgary and Edmonton will likely see prices continue to fall for another 3 or 4 quarters, dropping 8% to 10% from their peak, after which prices should stabilize and start rising at a low single-digit pace.

Cashing in, not foreclosing

From an economic perspective, the recent behaviour of Canada's real estate markets and the outlook for 2008/09 can be best explained in terms of the trends in supply and demand – the interaction between which determines prices.

On the supply side, past price performance has strongly encouraged additional supply in both the new and existing home markets. Housing starts averaged a strong 234,000 units in the first quarter. While we expect new home construction activity to remain robust, starts should gradually





edge down to a lower level of around 200,000 units over the course of the next 18 months.

We had anticipated an increase in new listings as a result of solid price gains in the last couple of years, but the recent surge in new listings has been far greater than anticipated. The jump in supply of homes for sale is assuredly an attempt to take advantage of the past home price appreciation on the part of homeowners and real estate investors.

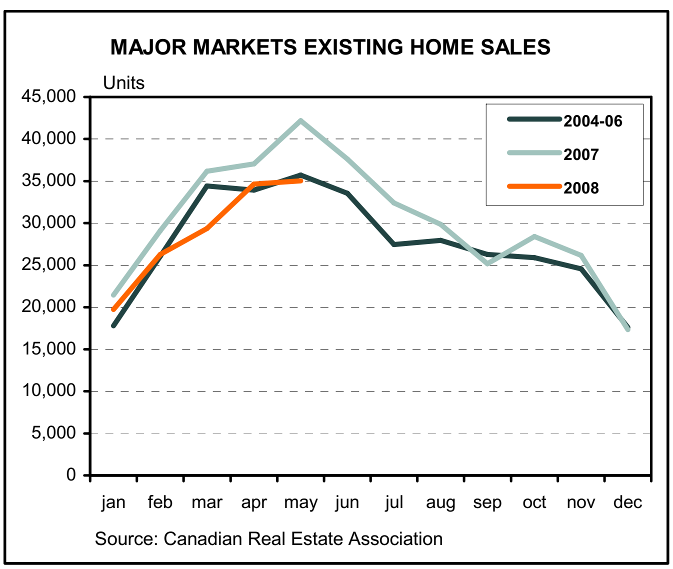
It should be stressed that the rise in listings does not reflect homeowners of principal dwellings desperate to sell, and this is the dominant difference between the Canadian and U.S. experience. Indeed, the U.S. has been characterized by an abnormal rise in delinquencies and foreclosures or large negative equity positions. In Canada, speculators may be quickly dumping properties on the market to get out while the times are good, but individuals that have a principal dwelling are not under financial duress. This distinction is crucial to evaluating the impact of weaker home price performance on personal wealth and consumption. Canadian consumers are also nowhere nearly as leveraged through their home equity as American consumers are.

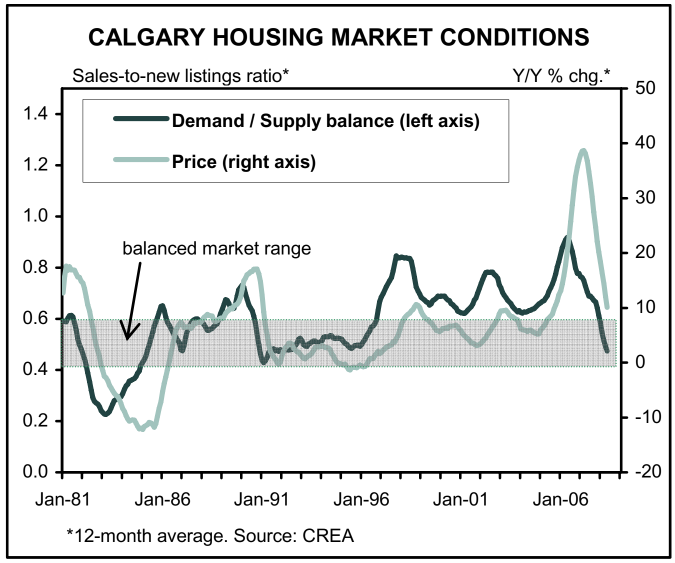
A few more important distinctions also bear noting as the U.S. housing bust struggles to find a bottom, which naturally arouses fears that a similar unwinding could take place in Canada.

First off, many of the seeds that sowed the current U.S. housing bust were never planted in Canada. Interest rates and mortgage rates were significantly lower for significantly longer in the U.S., especially in the case of adjustable-rate mortgages (ARMs) with low initial teaser rates. The bulk of surging delinquencies on mortgage loans occurs precisely when the rate adjusts to a higher level. ARMs never took hold in Canada. No spike in mortgage payments means no spike in delinquencies. As economic conditions will be weaker over the forecast horizon than they were in 2007 and mortgage rates likely modestly higher, delinquencies in Canada will only rise to reflect domestic economic conditions. A surge to high levels is nowhere on the horizon.

Furthermore, it wasn't just that borrowing costs were lower in the U.S. than in Canada. Overall lending conditions in the U.S. had eased to the point of becoming much too lax, introducing a systemic default risk, which is now a reality. Subprime mortgages were a significant chunk of originations in 2006-07. Not so in Canada, where they peaked at 5% in 2006 before vanishing. In the U.S., the additional supply of homes for sale as a result of 'involuntary' listings and / or foreclosures more often than not reflect desperate households trying to minimize their loss. In Canada, voluntary sellers are trying to maximize their capital gains. The difference is far from trivial.

It is also telling that the run-up in prices in the U.S. was, for many large markets, not supported by economic fundamentals. As per Nevada, Arizona, California, and Florida, it seemed to be driven much more by speculative activity. In Canada, markets whose economies have been booming are those whose housing markets caught fire. Witness the experience of Calgary, then Edmonton, and now Regina and Saskatoon. Valuations in these markets also started below national levels and arguably had some catching up to do, contrary to the hottest U.S. markets during the run-up which were already higher than the U.S. average.





Finally, financing and economic conditions are largely more supportive of local demand in Canada. Lending has not tightened nearly as much as it has in the U.S. And, as noted above, lending never became as lax. For example, the vast majority of mortgage applicants in Canada were income-tested on the basis of the 3-year or 5-year posted rates; whereas in the U.S. it was common to either dispense with income testing or test on the basis of the low introductory teaser rate. Furthermore, the credit crunch has hit U.S. lenders' balance sheets harder. The bulk of mortgage origination in Canada is sourced at well capitalized financial institutions. Homes currently being listed in Canada, if priced reasonably, will find buyers who can finance their purchase. In the U.S., despite much lower prices, financing is often hard to obtain, even for creditworthy potential buyers. The recent Federal Reserve cuts to the policy rate by a full 3¼ percentage points have had little traction into relief on mortgage rates. Clearing the large inventory overhang is all that more difficult in such circumstances that are simply not present in Canada.

The main conclusion is that there has been an increase in supply (i.e. new listings and new home construction) in Canada . That will act to dampen home price appreciation and create a pullback in prices in selected cities where markets went too far, too fast. However, the increase in supply in Canada will pale in comparison to the dramatic surge experienced in the U.S. that caused the worst American housing correction since the Great Depression.

Decaffeinated sales

On the demand front, the dominant theme is that the past price appreciation in Canada has eroded affordability, reducing demand for new and existing homes. Nowhere is this truer than in Alberta and British Columbia. National sales did remain elevated for longer than expected, but are now pulling back more sharply than even our spring forecast due to reduced affordability and greater supply. The year-to-date (as of May data) percentage drop in sales for Canada's major markets seems dramatic at -12.5%, but sales are in fact simply returning to the solid levels typically experienced in the three years (2004-06) prior the 2007 sales boom. (See sales charts for some major markets at the end of this report.)

Just as Calgary and Edmonton led the way up in sales growth, they are now leading the way down. Home sales in these two cities were down 34% and 30%, respectively, year-to-date as of May. However, Edmonton resale activity is tracking close to 2005 levels, while sales in Calgary are faring worse and look likely to revert back to 2004 levels, near 26,000 units. Our base-case scenario for Alberta home sales for the remainder of 2008 builds in an even greater decline in sales in the near term before levelling off late in the year for a net annual sales drop of 40%. As a result, after two years of percolating over 70,000 units sold, Alberta is more likely to record sales volumes in the 40,000-50,000 unit range this year and next.

The return to norm in resale activity is not confined to Alberta, and nor did we expect it to be. Our April forecast had sales declines for all provinces, except three (Saskatchewan, Manitoba, and Newfoundland & Labrador) that represent only 5% of the national total sales. Only Manitoba is disappointing our April forecast. Sales in Winnipeg are down by an unexpected 3.5% year-to-date, implying a likely sales decline of about 4% in Manitoba in 2008 – but this is only a shift from marginal sales growth to a marginal sales drop.

Sales are also weaker in other parts of the country, with British Columbia and Ontario sales down by more than 10%. Softer demand is therefore not an Alberta-specific theme. While affordability had not eroded to the same degree in other markets, it also had not improved for most markets, on a quarterly basis, since late 2006. Affordability remains at challenging levels for many potential buyers in Vancouver specifically, but also Toronto. Resale activity in Vancouver is tracking significantly below last year's levels and we expect sales for 2008 as a whole to end up almost 20% lower than 2007. Toronto is expected to experience 10% lower sales.

EXISTING HOME SALES
Thousands of units

	2005	2006	2007	2008F	2009F
CANADA	**483.9**	**484.0**	**520.8**	**443.7**	**457.1**
ex Alta	418.1	409.7	449.4	401.0	412.4
N. & L.	3.2	3.5	4.5	5.1	5.0
P.E.I.	1.4	1.5	1.8	1.6	1.6
N.S.	10.9	10.6	11.9	11.2	11.4
N.B.	6.8	7.1	8.2	7.6	7.9
Quebec	70.6	72.5	80.3	76.7	79.5
Ontario	197.0	194.8	213.4	186.6	197.3
Manitoba	12.8	13.0	13.9	13.3	13.8
Sask.	8.3	9.1	12.1	13.9	13.5
Alberta	65.9	74.4	71.4	42.7	44.7
B.C.	106.3	96.7	102.9	85.0	82.4

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

EXISTING HOME SALES
Per cent change

	2005	2006	2007	2008F	2009F
CANADA	**5.0**	**0.0**	**7.6**	**-14.8**	**3.0**
ex Alta	3.7	-2.0	9.7	-10.8	2.8
N. & L.	-1.7	10.2	26.4	13.4	-2.2
P.E.I.	-3.4	3.0	18.6	-8.6	0.3
N.S.	23.1	-3.3	12.1	-5.3	1.6
N.B.	14.3	4.2	14.5	-7.2	3.8
Quebec	2.0	2.6	10.8	-4.5	3.6
Ontario	-0.2	-1.1	9.5	-12.5	5.7
Manitoba	5.5	2.0	7.0	-4.4	4.0
Sask.	1.7	10.0	31.9	15.2	-3.1
Alberta	14.6	12.9	-3.9	-40.2	4.6
B.C.	10.3	-9.1	6.4	-17.4	-3.0

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

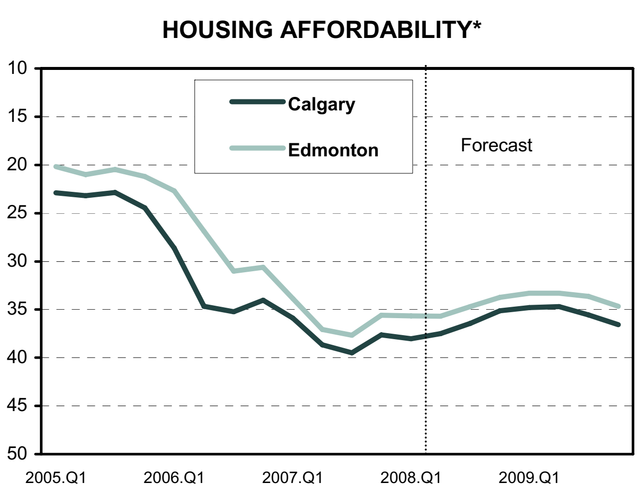
Affordability to improve

Based on our assessments of supply and demand, what are the prospects for the next 6-12 months? Over this time span, both sides of the market are unambiguously pointing to softer price growth in most major markets. Just how soft, is a matter of location. For Canada as whole, we expect existing homes to appreciate by only 2% this year, a downward revision from our last forecast of 6%. Slower price growth – or declines in certain cities – but still solid underlying economic fundamentals will lead to an improvement in affordability. However, the relatively high prices in many markets will remain a key factor crimping demand.

Looking beyond the next 12 months, as affordability improves in some markets or stabilizes in others, and demand slowly absorbs homes being listed, we expect demand to start pulling prices forward at a slightly quicker pace in the second half of 2009. However, because the current rebalancing has abruptly shifted conditions from seller's market territory to balanced market conditions in many cities, the price weakness will probably extend into next year. As a result, while prices will improve in 2009, the annual average resale price growth will still be modest at around 3.5%.

Turning to a regional perspective, Saskatchewan's major markets offer an exception to the cooling trend on an annual basis, but this is mostly a question of timing. The price surge above 30% growth came late last year and much of that momentum is being carried into this year. But if Regina and Saskatoon follow the path just recently threaded by Calgary and later Edmonton – and we think they will – Saskatchewan's price growth will have come back down to earth by early next year. We are looking for 2-3% price growth in 2009, with a risk of a mild price correction.

On the flip side, every other province, except Newfoundland & Labrador, and most notably the four largest provinces in the country, will experience significantly weaker home appreciation this year compared to last. Alberta will most likely experience a slight depreciation of 1-2% in home values on an annual basis. This correction will be concentrated in its largest urban markets of Calgary and Edmonton, where prices are expected to fall by 2-3%, with the rest of the province faring better. After stunning cumulative price gains of 45-65% in the last two years in those markets, our base-case forecast builds in a peak-to-trough correction of 8-10%. Our expectation is that monthly data will show year-over-year price declines for another 2-3 quarters of data (the typical duration of home price corrections in Canada), out to the first quarter of 2009. Alberta prices should then start growing again, albeit modestly at 1-2%, on a year-over-year basis.



*Percent of median market household income required to service mortgage carrying costs of the median-priced home. Source: CREA, Statistics Canada.

Affordability has been a key issue in Canada's most expensive market, Vancouver. Outside Alberta, where sales are down about 30% year-to-date, British Columbia is experiencing the largest percentage drop in sales year-to-date at close to 15%. This is not surprising given how strong sales (over 35,000 units) had been over the last six years. Vancouver has recorded a surge in listings since March, enough to bring the supply/demand relationship into balanced territory. Vancouver had not been balanced, by this measure, since late 2000. We therefore expect price growth to be subdued in the next 12-18 months. As a result of higher-than-expected listings, we now forecast 5% home price growth for the province as a whole this year (down from our spring forecast of 9%) and a similar outing next year – both a far cry from the 15% annual average home appreciation recorded over the last 3 years.

Ontario and Québec homes have appreciated at a steady 6-7% rate over the last three years. Both provinces are expected to record only about half as much (3-4%) home price growth over the forecast horizon. Options have improved for potential homebuyers in Québec due to more listings, making the slowdown mostly a supply story. Meanwhile, the softer price growth in Ontario's existing home market will be most closely related to a cooling in demand, resulting in weaker sales due to challenging affordability, particularly in the Greater Toronto Area.

Bottom line

Between 2005 and 2007, Alberta was skewing the national existing home market figures to the upside. Late in 2007 and early in 2008, Alberta home price growth came back down to earth, converging with national figures. The latest provincial real estate data show that Alberta is now more than a percentage point below the country's average in terms of home price growth. In the past, we presented figures excluding Alberta to measure the impact of this particular market. As an example, Alberta boosted the national price figure by as much as 2½ percentage points in 2006. The distinction became irrelevant once Alberta had cooled back down to the national pace.

This exercise is once again relevant, and we are re-introducing these 'ex. Alberta' measures. Outside Alberta, we expect existing home to appreciate by about 3% this year. Including Alberta – which we think will record a 1.5% price decline – brings the national forecast down by nearly a full percentage point to 2%. For 2009, Alberta's expected home price growth of 2% will not differ enough from the rest of the country to pull down significantly our forecast 3.5% for the nation as a whole.

The demand side of the home market is behaving largely as we forecast in the spring. Sales are down from the banner year that was 2007, but they are back to the average levels experience in 2000-05 in Calgary and Edmonton. Toronto sales have cooled, but they are still on pace with with elevated 2004-06 levels. Vancouver sales are one of the few cities where sales have dropped well below the levels experienced earlier this decade, and one cannot help but notice that this is also the market where affordability had become the most problematic.

Meanwhile, the supply-side is booming. This is helping to rebalance markets that had been in seller's territory for an extended period of time, which is favourable to affordability and future demand. Recall that since 2002, Canadian resale home prices grew at an annual average rate of 10.2%, so a softer price performance in 2008-09 should not be too surprising. It is also a positive development that markets are cooling before the Bank of Canada embarks on another cycle of interest rate hikes. In our spring report, we highlighted the risk of a still hot housing market running into a monetary policy tightening cycle. It is currently not financing conditions which are causing demand to cool, but slowing economic conditions overall along with the lagged impact of past erosions in affordability caused by price surges in specific markets. History suggests that when a tightening of monetary policy cuts through a hot market, things can unwind in a disorderly fashion. Canadians will remember the bust of the late 1980s as a prime example. Cooling home markets also help to alleviate inflationary pressures which in turn diminish the need for further interest rate hikes. We do not expect the Bank of Canada to start hiking interest rates before economic growth ratchets back up towards 3% in the second half of 2009. Canadian housing markets should be cruising at a healthier, more sustainable pace by then.

AVERAGE EXISTING HOME PRICE
Thousand $

	2005	2006	2007	2008F	2009F
CANADA	**249.2**	**276.9**	**307.3**	**313.3**	**324.2**
ex. Alta (E)	251.1	275.1	298.8	307.2	318.3
N. & L.	141.2	139.5	149.3	161.4	170.1
P.E.I.	117.2	125.4	133.5	142.1	147.2
N.S.	159.2	168.6	181.0	190.5	199.0
N.B.	120.6	126.9	136.6	145.3	151.1
Quebec	184.6	194.0	208.2	215.6	224.0
Ontario	262.9	278.4	299.5	308.4	319.1
Manitoba	133.9	150.2	169.2	191.9	207.3
Sask.	122.8	132.1	174.4	238.0	243.4
Alberta	218.3	285.4	356.2	350.9	357.9
B.C.	332.2	391.0	439.1	461.3	473.2

E: Estimate. F: Forecast by TD Economics as at June 2008
Source: Canadian Real Estate Association

AVERAGE EXISTING HOME PRICE
Per cent change

	2005	2006	2007	2008F	2009F
CANADA	**10.1**	**11.1**	**11.0**	**2.0**	**3.5**
ex. Alta (E)	8.7	9.5	8.6	2.8	3.6
N. & L.	7.4	-1.2	7.0	8.1	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	4.5
N.B.	6.8	5.2	7.7	6.3	4.0
Quebec	7.9	5.1	7.3	3.5	3.9
Ontario	7.2	5.9	7.6	2.9	3.5
Manitoba	12.3	12.2	12.6	13.4	8.0
Sask.	10.8	7.6	32.0	36.4	2.3
Alberta	12.1	30.8	24.8	-1.5	2.0
B.C.	14.9	17.7	12.3	5.0	2.6

E: Estimate. F: Forecast by TD Economics as at June 2008
Source: Canadian Real Estate Association

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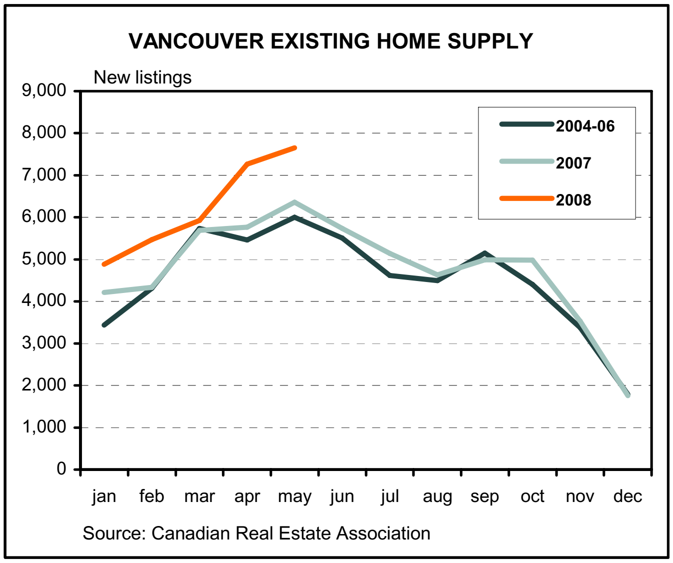
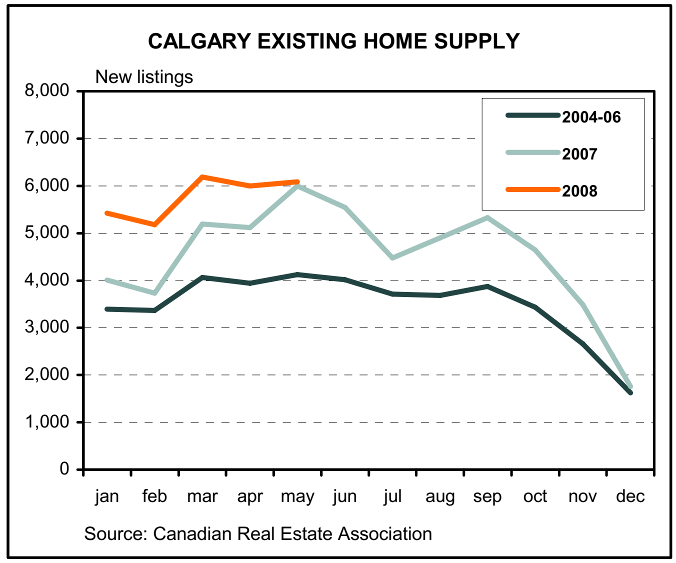
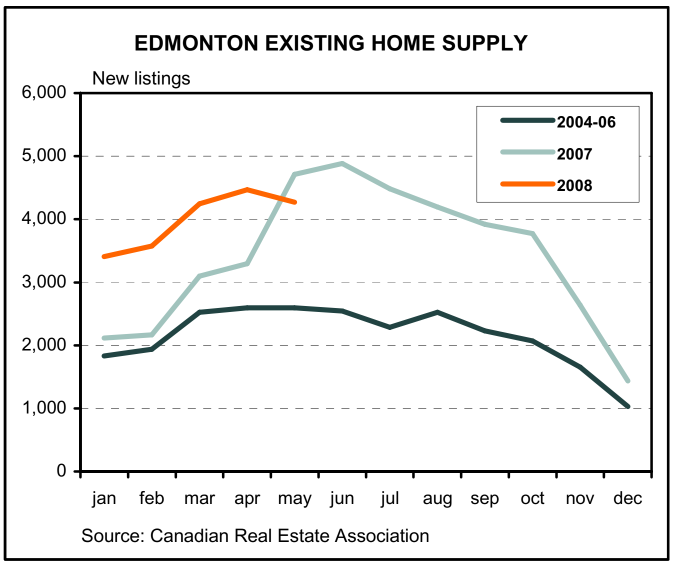
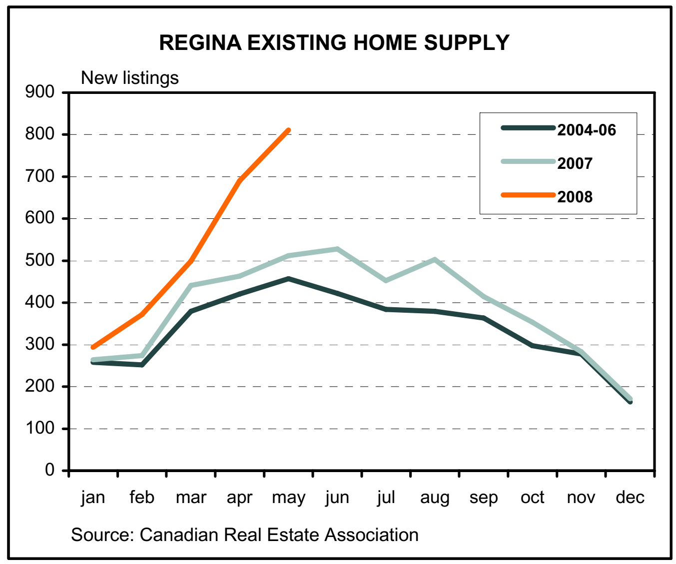

VANCOUVER EXISTING HOME SUPPLY
New listings
9,000
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
2004-06
2007
2008
jan feb mar apr may jun jul aug sep oct nov dec
Source: Canadian Real Estate Association


CALGARY EXISTING HOME SUPPLY
New listings
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
2004-06
2007
2008
jan feb mar apr may jun jul aug sep oct nov dec
Source: Canadian Real Estate Association


EDMONTON EXISTING HOME SUPPLY
New listings
6,000
5,000
4,000
3,000
2,000
1,000
0
2004-06
2007
2008
jan feb mar apr may jun jul aug sep oct nov dec
Source: Canadian Real Estate Association


REGINA EXISTING HOME SUPPLY
New listings
900
800
700
600
500
400
300
200
100
0
2004-06
2007
2008
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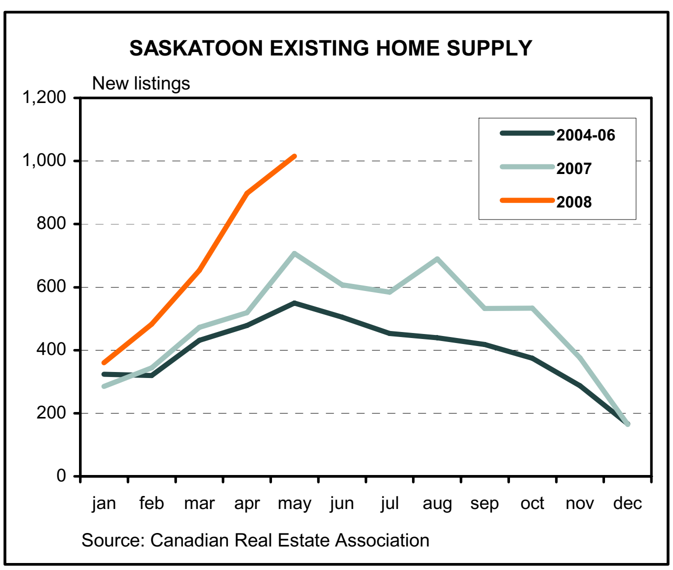
Source: Canadian Real Estate Association


SASKATOON EXISTING HOME SUPPLY
New listings
1,200
1,000
800
600
400
200
0
2004-06
2007
2008
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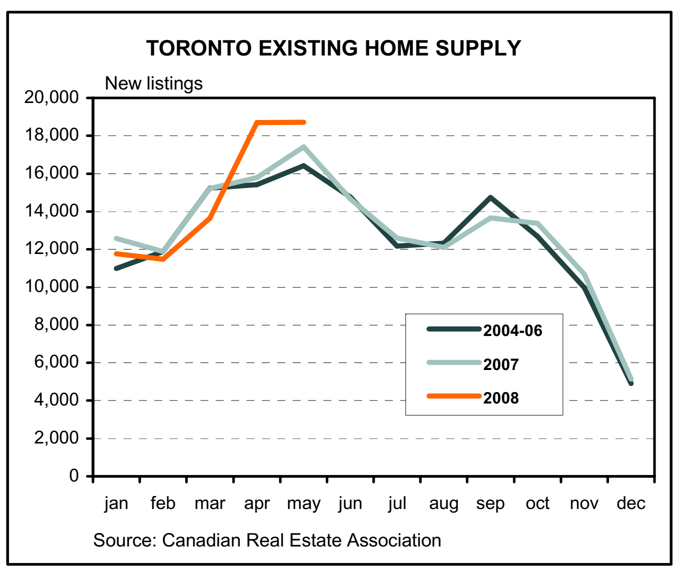
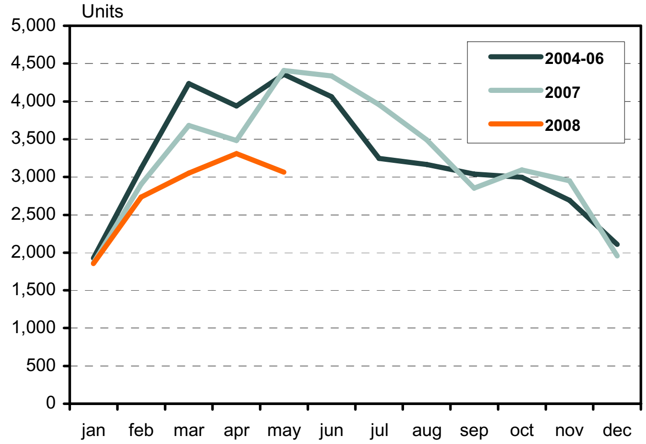
Source: Canadian Real Estate Association

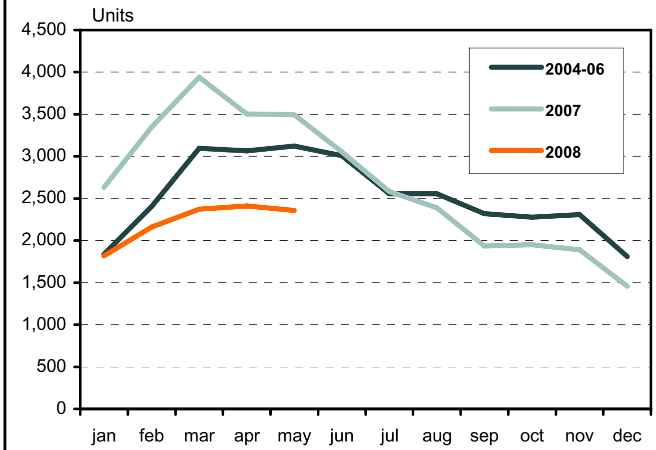

TORONTO EXISTING HOME SUPPLY
New listings
20,000
18,000
16,000
14,000
12,000
10,000
8,000
6,000
4,000
2,000
0
2004-06
2007
2008
jan feb mar apr may jun jul aug sep oct nov dec
Source: Canadian Real Estate Association

VANCOUVER EXISTING HOME SALES



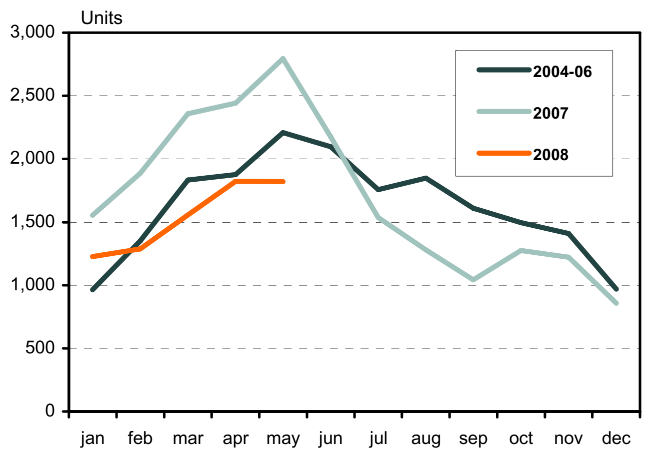
Source: Canadian Real Estate Association

CALGARY EXISTING HOME SALES



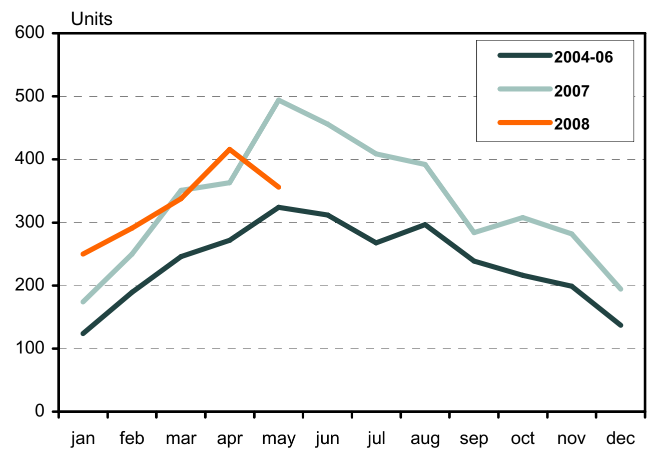
Source: Canadian Real Estate Association

EDMONTON EXISTING HOME SALES



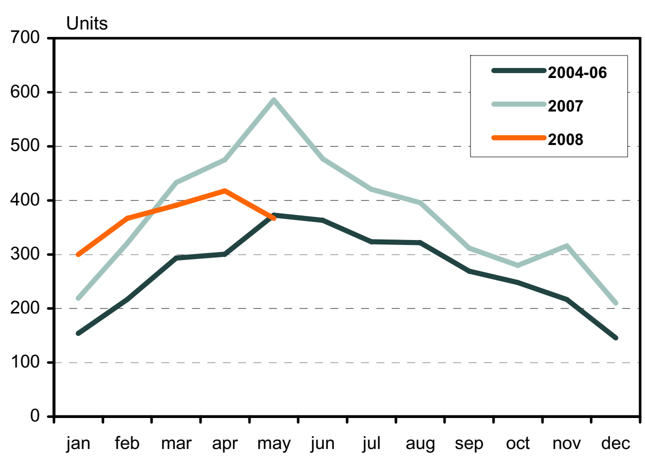
Source: Canadian Real Estate Association

REGINA EXISTING HOME SALES



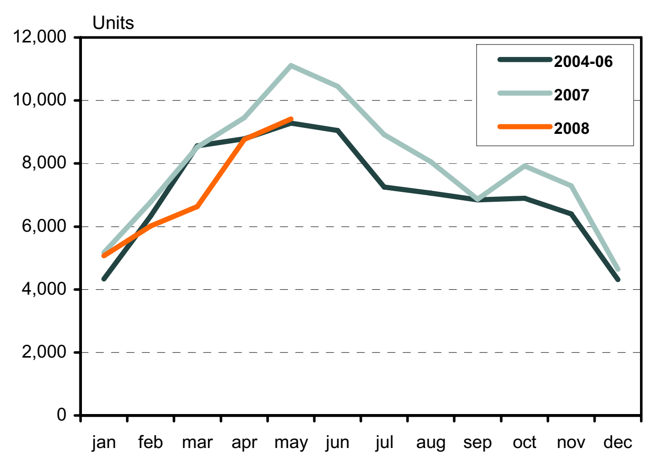
Source: Canadian Real Estate Association

SASKATOON EXISTING HOME SALES



Source: Canadian Real Estate Association

TORONTO EXISTING HOME SALES



Source: Canadian Real Estate Association