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MANY RISKS IN CANADA'S HOUSING MARKET ARE EXAGERRATED, SAY TD ECONOMISTS

- Concerns about a housing bubble are overblown, as speculative buying is not behind today's strong market.
- Other fears including overly leveraged homeowners, excessive building in the condo market and a possible demographically inspired crash in home prices in the future are also exaggerated.
- As such, housing should still be considered a solid long-term investment

TORONTO – Although there is little evidence of a housing bubble in Canada, concern about the prospects for Canada's real estate market abounds. But in a topic paper entitled *Bursting Aspects of the Housing Bubble Myth,* TD economists show that four of these specific fears are largely exaggerated. The report is available at www.td.com/economics. "Canada's red-hot housing market is on a solid foundation because there is very little evidence of speculative activity," remarked Carl Gomez, economist with TD Bank Financial Group. "But while a modest cooling is in the cards this year and next, there are a number of misconceptions about the state of this housing market and where it's going."

Most homeowners will not be hurt when interest rates rise

A major misconception is that recent homeowners, lured into the market by low interest rates will be deeply hurt when rates rise. But the TD report indicates that despite the growing popularity of variable rate mortgages, longer term fixed rate mortgages remain the most frequently used financing option for most homeowners in Canada. As such, most homeowners are already insured to some extent against the risk of rising rates since their mortgage payments would remain fixed over the term of their mortgage. Moreover, even when the Bank of Canada resumes tightening monetary policy, fixed mortgage rates are unlikely to rise as much as short-term rates.

And while most variable rate mortgage holders could simply lock into a fixed rate mortgage if rates headed higher, there is little incentive to do so immediately because payments on most variable rate mortgages would not change in the initial stages of a rising interest rate

environment. “What changes first is the proportion of money that goes toward interest and principal,” said Gomez. “So rates would have to rise substantially before most variable rate mortgage holders would see an increase in their monthly payments.” Nevertheless, the TD report explains that the risk of a substantial increase in rates is not likely in the current economic environment. “Inflation is not the monster that it was in the late 1980’s and that means that rates should only rise at a measured pace once the Bank of Canada begins its tightening cycle.”

A strong economic rationale for surging condo development

Despite recent fears that the condo market in Toronto and Vancouver could become overbuilt, the TD report notes that there are sound economic reasons supporting the development of this type of product. A popular argument is that condo living has become more appealing to potential homeowners given the growing trend towards smaller households. But the potentially bigger factor is that rising prices for highly accessible land in urban centres require more intense usage through higher residential densities to keep housing costs accessible. “Higher land prices in places like downtown Toronto and Vancouver put a premium on the price of single detached housing in these areas,” Gomez said. “But condos keep homeownership accessible to many potential buyers like younger people and recent immigrants who are drawn to the urban regions of Toronto and Vancouver, but who are the most constrained by affordability.”

The TD report also notes that while condo developments can result in a volatile pattern of over and under building, the homebuilding industry has instituted a number of risk management techniques like pre-selling dwellings prior to construction. “As a result, today’s backlog of complete and unoccupied condos remains broadly manageable in Toronto and down-right tight in Vancouver,” noted Gomez. “So even if demand suddenly cooled, the risk of a supply overhang would not be as great as previous cycles.”

Retiring baby boomers will continue to support home prices

As the leading edge of the large baby boom generation approaches retirement, a frequently heard myth is that home prices will collapse as this group increasingly unloads their family homes to a smaller pool of younger buyers. However the TD report counters that not all baby boomers will be retiring at the same time, “This demographic group currently spans in age from 60 all the way down to 39,” Gomez pointed out. “So while older boomers may be pondering retirement, 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." But the TD report also notes that even as older boomers retire, they will not give up on homeownership just yet, "The fastest growing segment for homeownership are those above 65 and the boomers will certainly not reverse this trend given their high levels of wealth," said Gomez. "Consequently, aging boomers are likely to reshape the types of housing that will be in demand over the next two decades but they are unlikely to cause a deep correction in prices."

However, the TD report concedes that an aging population could be responsible for mild price declines in one small segment of the housing market over the next few years. "Smaller 'shoebox' condos recently sprouting up in parts of Canada as result of the current housing boom could face some difficulty when they come back up for sale on the existing home market," warned Gomez. "That's because these condos are designed mostly for young first time buyers whose numbers will make-up a smaller percentage of potential buyers in the future."

Homeownership remains a sound investment

Given that there is no coming crash in real estate markets, only a modest cooling, housing should remain a sound investment. Assuming that the market remains fairly balanced and the economy grows moderately, the TD report expects home prices to grow at an average annual pace of about three per cent over the next decade. Though this does not seem like much, the report argues that the expected after-tax return is closer to six per cent given that there are no capital gain taxes on the sale of a principal residence. Furthermore, the growth of home prices tends to be more stable than other investments like stocks, "The return per unit of risk in housing has actually been better than in the topsy-turvy world of stock markets," Gomez said. "That's reassuring given that land and structures account for more than a third of households' total assets."

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Bursting Aspects of the Housing Bubble Myth (including charts and detailed tables), is available in PDF format on TD Economics' Home Page at: www.td.com/economics.