TD Bank Financial Group

TD Economics

Topic Paper

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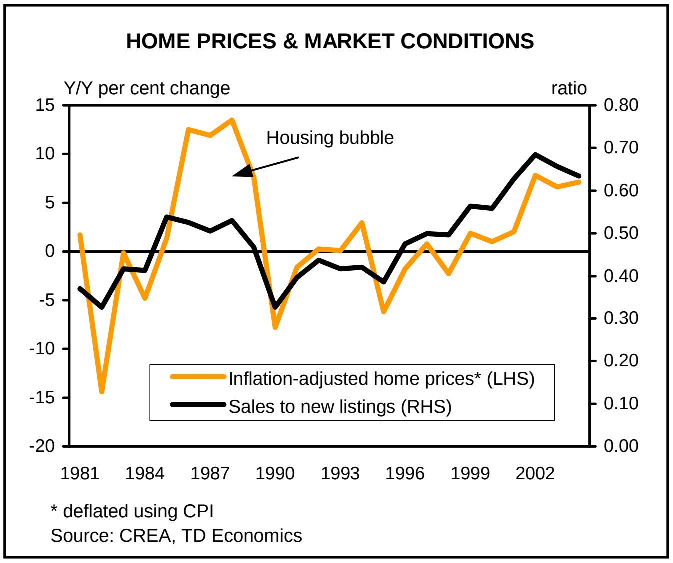
BURSTING ASPECTS OF THE HOUSING BUBBLE MYTH

For nearly four years, the housing market has continued to defy gravity, charting its way to one of the longest cyclical booms in recent history. What is also unique about this extended cycle is that it has shown sustained strength from coast to coast, providing a significant amount of support to local economies and a sizeable boost to personal wealth. But while a modest cooling of the housing market is expected this year and next, the current pace of outsized activity continues to elicit a chorus of chants warning of the risks from the fallout of a housing bubble.

We don't subscribe to those fears. That's because one of the key tenets of a housing bubble –speculative buying – is simply not behind the current red-hot market save for a few isolated occurrences. Support for this conclusion largely comes from the recent rise in homeownership rates to about 67 per cent from 65.8 per cent in 2001, which broadly indicates that home sales are not being fuelled by speculative purchases of investment properties.

But an inspection of overall market conditions also shows that the underlying forces of supply and demand are the main catalysts behind today's annualized real price gains of about 7 per cent, not speculation. For example, CMHC characterizes a housing market as balanced when the ratio of sales to new listings is roughly between 0.40 and 0.60. Based on historical observations, a balanced market will correspondingly see inflation-adjusted house price gains of about 1 per cent. However, when the ratio between sales and new listings moves higher than 0.60, a seller's market develops and stronger real price gains are warranted. Given today's solid affordability, which has helped to boost demand beyond existing supply, the sales to new listings ratio continues to reside north of 0.60, indicating a housing market favouring sellers and warranting strong price gains.



In contrast, the sales to new listings ratio during the late 1980's housing bubble remained near a fairly balanced level of about 0.50. But the hyper-inflated price gains of about 15 per cent during that period vastly exceeded what underlying market conditions could justify and suggested that prices were largely being driven by speculation. Consequently, it was not surprising to see speculators flushed out of the market when mortgage rates rose dramatically by the early 1990's. The result was a sharp price correction that lingered on for several years after that.

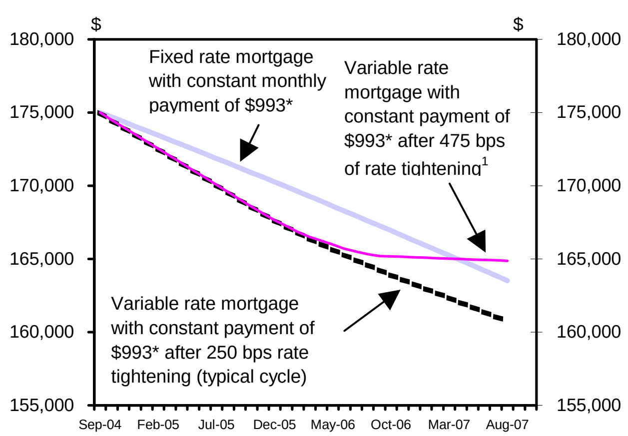
But while we can confidently refute the notion of a bubble forming for today's overall housing market, other specific risks perceived to be the *result* of a bubble continue to be raised simply because of this market's high levels of activity. In the rest of this topic paper, we will directly address four of these concerns and in doing so, show that even these peripheral risks are exaggerated.

1. As interest rates rise, homeowners will be hurt

An often heard concern surrounding today's housing market is that recent homebuyers, lured into the market by historically low mortgage rates, will ultimately be hurt when rates eventually rise. The foundation for this concern is largely due to the perception that homebuyers have increasingly taken out floating variable rate mortgages and over exposed themselves to interest rate risk. While it is true that variable rate mortgages have enjoyed increasing popularity in recent years, fixed rate mortgages continue to be the most frequently used financing option for more than half all homeowners in Canada, with the five year fixed rate having been the most popular term. On this basis, these homeowners are already insured to some extent against rising rates because long-term fixed mortgage rates are unlikely to rise as much as short-term rates. And even if they did, the mortgage payments under a fixed rate would not change during the term of the loan (i.e., five years).

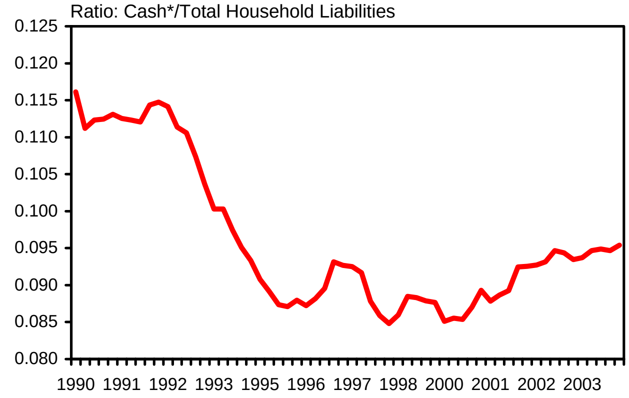
As for homeowners who have enjoyed the luxury of saving a considerable amount on interest costs in recent years thanks to their variable rate mortgages, most could simply take the option of locking into a fixed rate mortgage if rates headed higher. However, hardly any of these mortgage holders would do this. That's because even if rates rose, payments on most variable rate mortgages would not change right away. What would change is the proportion of money that goes towards interest and principal. And since most variable rate holders must qualify for this type of mortgage based on a three year fixed rate, short term rates would have to rise by as much as 475 basis points before these mortgage holders would begin owing more than they would have under a fixed rate.[1]

BALANCE OF PRINCIPAL ON A $175K MORTGAGE



*Monthly payments based on a 3 year fixed rate of 4.70% amortized over 25 years beginning in September 2004.

HOUSEHOLD LIQUIDITY



*Dollar deposits at banks, credit unions and trusts, plus money market assets plus currency holdings
Source: Statistics Canada, Bank of Canada, IFIC, TD Economics

Nevertheless, even if the economy were to suffer an intense interest rate shock, improved household liquidity over the past few years would provide consumers with a buffer. Whether it has been because of heightened uncertainty or a lack of risk taking, consumers have been building up a sizeable stockpile of cash sitting in their bank accounts, money market funds and direct currency holdings over the past few years. If need be, they could deploy these cashable assets to meet their debt obligations in the short term.

It is worth noting, however, that the risk of an intense interest rate shock is quite low given Canada's currently benign inflation environment. Indeed, core consumer prices, which exclude the volatile effects of food and energy prices, continue to sit just below the midpoint of the Bank of Canada's inflation target and inflation expectations remain well contained. Thus, inflation is not the monster that it was in the late 1980's (i.e., the only time in the past 20 years that the Bank of Canada actually engaged in a tightening cycle as steep as 475 basis points). Consequently, interest rates should only rise at a measured pace over the next few years, with the risks of an early 1990's spike nowhere on the horizon.

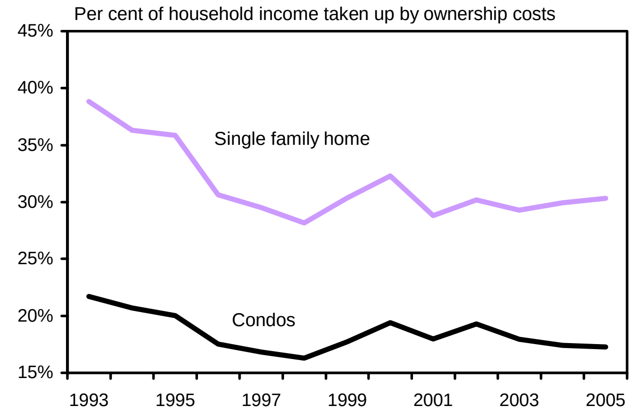
2. The condo market is becoming overbuilt, particularly in Toronto and Vancouver

Some concerns have been expressed during this housing cycle that the condominium market, especially in the large urban areas of Toronto and Vancouver, is becoming overbuilt. This concern generally stems from the belief that condos cater to a largely speculative investment market and that this housing type has begun to account for a greater share of new homebuilding in comparison to traditional ground-oriented homes.

While it is true that most potential homeowners would prefer ground-oriented dwellings like a single family home, there is solid economic justification to support condominium development, especially in large urban areas that are experiencing strong population growth. The main demand side argument is that condo living has become more appealing to potential homeowners thanks to the growing trend of smaller households together with the lure of numerous amenities found in the "bright lights of the big city," and savvy marketing efforts have increasingly tapping into this trend. Indeed, recent surveys suggest that homeowners are largely driving today's condo market while investors make up only about 20 per cent of Toronto's market compared to nearly 40 per cent in the late 1980s.

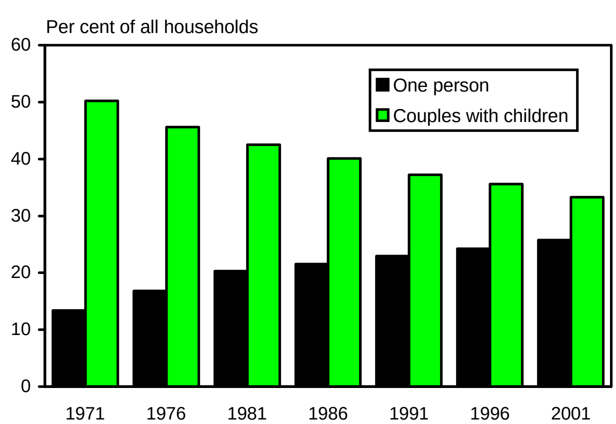
However, it is the supply side that provides the more compelling reason for condo development, especially over the longer-term. As competition for scarce but highly accessible land intensifies, it typically drives up the price of these desirable sites. This ensures that it will be used more intensively, specifically through higher residential densities like condos. The efficient use of higher densities thereby helps to keep housing costs affordable for prospective homebuyers wishing to remain within close proximity to urban centres. In contrast, low density forms of housing such as single family developments will increasingly be pushed out to less accessible sites (i.e., the suburbs) where land prices are not as high. While local municipalities can strengthen the process of higher densities if they seek to gentrify their urban cores, increasing multifamily development would also become a more viable option in suburban locations if zoning restrictions compromise the lower comparable land prices in those areas.

TORONTO AFFORDABILITY* BY HOME TYPE



*Percentage of household income taken up by housing costs
Source: Statistics Canada, CREA, TD Economics

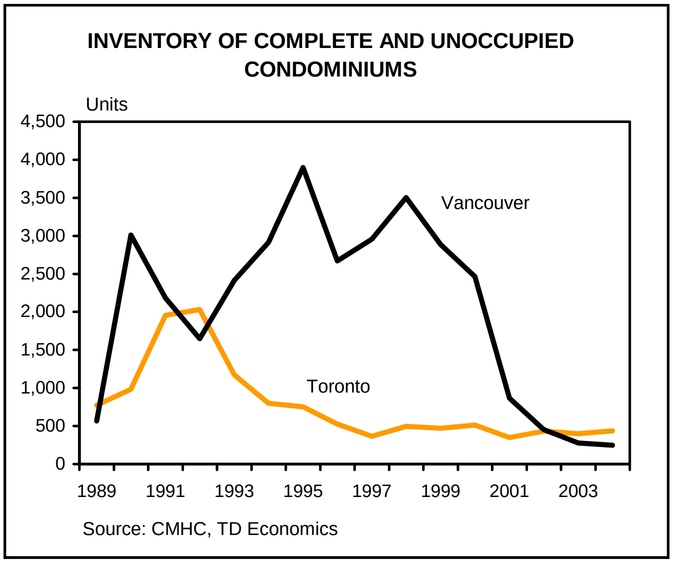
HOUSEHOLDS BY TYPE



Source: Statistics Canada, CMHC

This sound economic rationale for development has indeed allowed the condo market to remain significantly more affordable to potential buyers in Toronto and especially in Vancouver, where the shorter supply of single detached housing has resulted in considerable price premiums. That's good news for recent immigrants and younger people – those potential buyers that are typically drawn to the urban regions of Toronto and Vancouver, but are also most constrained by affordability.

But has the exuberance of the building industry in this cycle now resulted in too many condo units? Given the long construction period for condos there is always a lag between the planning and occupancy phases and as a result, the condominium market (and most multifamily housing types) operate on a relatively volatile pattern of over and under building. In fact, this pattern ultimately resulted



in an over supply of condos when housing demand cooled during the early 1990's in Toronto and during the mid-1990's in Vancouver.

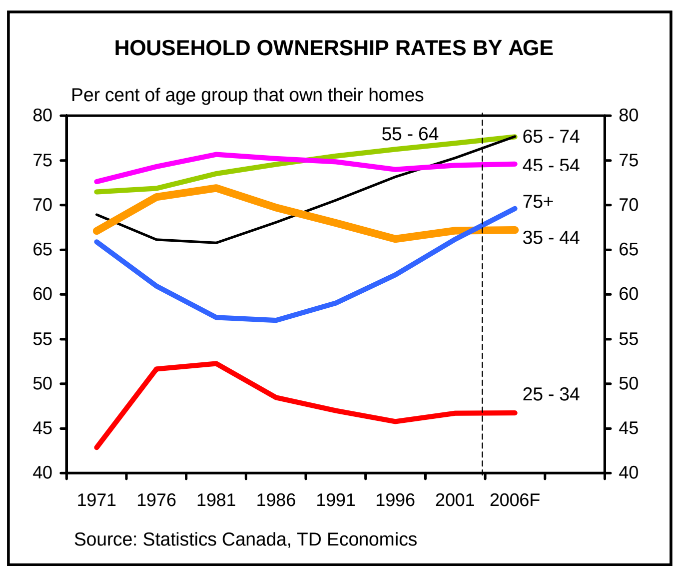
So in order to minimize this volatility over a housing cycle, the property development industry has since instituted a number of risk management techniques. In particular, the practice of pre-selling dwellings prior to construction has become more prevalent. Furthermore, lenders have established targets for a specified number of pre-sales as a pre-requisite for providing construction financing to builders. As a result, today's inventories of complete but unoccupied condos remain broadly manageable in Toronto and are down right tight in Vancouver, implying that if demand suddenly cooled, the risk of a supply overhang would not be as great as in previous cycles.

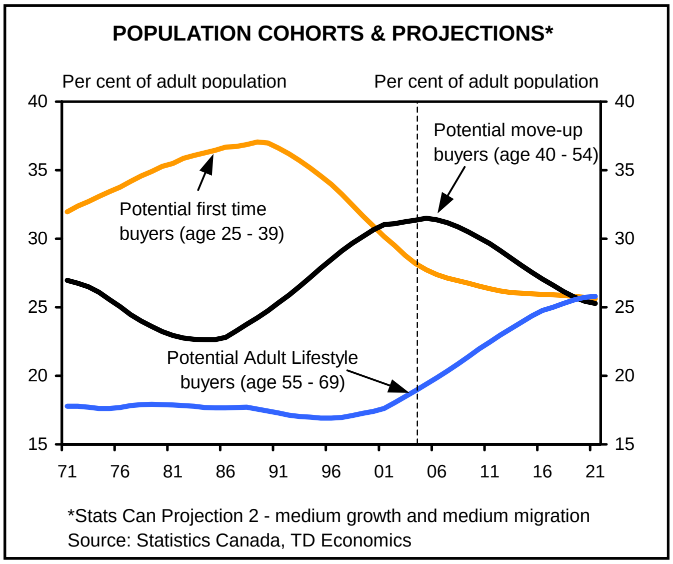
3. House prices will eventually collapse as the boomers retire

The outsized pace of today's housing market has resulted in some concern that future housing demand has been severely exhausted. In particular, a frequently heard myth is that home prices will ultimately collapse in the next decade as the huge baby boom generation approaches retirement and begins to flood the marketplace with their large family homes given the comparatively smaller pool of younger potential buyers that they are preceding.

There are two big problems with this assertion. First and perhaps most obvious, not all boomers are of the same age. In fact, this large cohort currently spans in age from 60 all the way down to 39. So while the leading edge of the boomers may be pondering retirement, there are just as many younger boomers with growing families that are still thinking about trading up to larger homes and who are not even thinking about retiring until around 2020. Second, there is no reason to believe that the two age cohorts showing the fastest growth in homeownership (65 – 74 years olds and the 75+ category) will reverse course in the future. In fact, given that senior boomers will continue to see some of the fastest growth in wealth and disposable income than any other age group together with potentially longer lifespans, the 65 – 74 year old category should easily become the peak age group for homeownership in the next few years.

On balance, this trend suggests that most retiring boomers are likely to stay put in their current homes for many more years to come. But while some might decide to trade down and bank the equity they've accumulated in their houses, many leading-edge boomers are actually showing a tendency to do just the opposite. Thanks to high levels of income and wealth, they have sought to "buy more home" either through increased renovations on their existing home or buying smaller homes like townhouses and two bedroom condos, but with more luxurious amenities. Moreover, an increasing number of them are showing an interest in purchasing secondary homes and recreational properties. To that end, the senior boomers will only reshape the types of housing that will broadly be in demand over the next two decades, but in doing so, they should continue to have a supportive influence on overall housing prices.



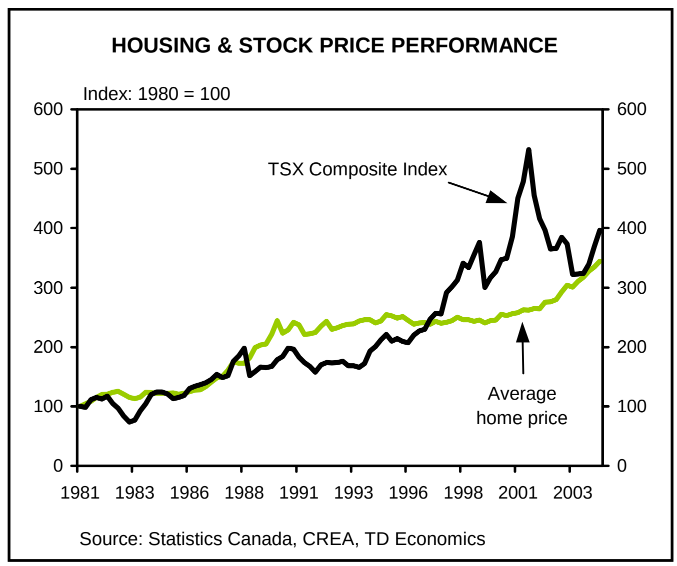


But what about today's declining pool of potential first-time buyers? If this pool nears depletion because of the today's outsized level of housing activity, couldn't that also spell trouble for house prices? Not necessarily. Today's first time buyer pool may be even deeper than what is implied by demographics because of the pent-up housing demand accumulated during the Canadian economy's soft patch in the mid-1990s. This factor, along with today's solid affordability has kept housing demand elevated and has helped to drive today's home price gains. And while its true that the pool of potential first time buyers aged 25-39 will continue to steadily decline from its peak in the late 1980's, the group will still represent a larger share of the adult population than retiring boomers for at least another 15 years. Consequently, even if the leading edge of the baby boom generation begins to increasingly unload their family homes over the next decade, there will still be a great many more first time and move-up buyers competing for their homes.

However, it should be noted that a declining pool of potential first time buyers does warrant a slower rate of new construction in the future. That's because fewer buyers in their primary household formation years suggest that fewer *additional* housing units will be required for the existing housing stock. As long as the property development industry remains cognizant of this demographic trend, then the housing market should remain broadly in balance between potential demand and supply, keeping overall home prices well supported. In this regard, one segment of the market that could potentially see a mild price correction in the near-future are the smaller "shoe box" condos that have sprouted up in parts of Toronto as result of the current housing boom. Since these housing projects cater mostly to young first time buyers and appeal less broadly to other types of potential buyers, these units could be viewed as an inferior housing type once they come up for resale in the existing home market in the next several years.

4. Home ownership is a risky investment

Those who believe that housing is a risky investment largely fear that home prices will crash because of a bubble. But as we have broadly pointed out, there is no imminent collapse expected for the housing market, only a moderate cooling. Assuming that the housing market remains fairly balanced and the economy continues to grow moderately during the next decade, after-inflation average home prices should rise by roughly 1 per cent a year.



HOUSING AND STOCK PERFORMANCE 1980 - 2004

Average annualized return (reward)	
Housing	5.4%
Stocks	7.6%
Standard deviation (risk)[2]	
Housing	7.2%
Stocks	18.6%
Reward to risk ratio	
Housing	0.8
Stocks	0.4

And with inflation expected to remain near the Bank of Canada's 2 per cent target, the average annual return on housing should be about 3 per cent. That doesn't sound like much, but given that there are no capital gain taxes on the sale of a principal residence, the expected after tax return is equivalent to a pre-tax return of slightly less than 6 per cent on an investment taxed at the average marginal tax rate.

Furthermore, even though home price appreciation has been historically slower than other investments like stocks, its risk-adjusted return has been better because home prices have been more stable. For example, the average annual return for stocks has been 7.6 per cent while it has been 5.4 per cent for the average home in Canada. But as the table shows, when this return is standardized for the variability of prices,[2] the reward to risk ratio of housing is slightly better. Since land and structures account for more than a third of households' total assets, the stability of this investment is assuring. Lastly, it is important to note that looking at housing as an investment is only one way to characterize its value. That's because housing provides certain other intangible benefits that no other investment can match, the most notable of which is shelter.

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Endnotes:

[1] This assumes that the mortgage was initiated in September 2004, and that the Bank of Canada began its tightening cycle in the fourth quarter of this year.

[2] The standard deviation is a measure of the dispersion of a set of returns from its average. The more spread apart the returns are, the higher the deviation. In investment analysis, the standard deviation is applied to the annual rate of return of an investment to measure the investment's volatility (risk).