

Where's the Trigger for a Canadian House Price Crash?

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Every dollar drop in the value of Canadian real estate elevates the level of anxiety about a US-style housing meltdown in Canada. To be sure, house prices in Canada will continue to ease in the coming months. But the triggers that led to a freefall in Canadian real estate markets in the early 1990s and today in US markets are nowhere to be found.

Buyer's Market?

In six short months, the Canadian real estate market was transformed from a confident seller's market to a more muted balanced market. And at this rate of growth in unit sales and new listings, by early next year the Canadian housing market will turn, for the first time since 1995, to a buyer's market (Chart 1).

Direction is important, but so is magnitude. A quick glance at Chart 2 reveals that when measured against income, the Canadian real estate market has indeed overshot. But a mere 5-7% drop in prices from current levels should bring the national average back to equilibrium. That's a fraction of the 25% overshooting seen in the US by mid-2006.

Location, Location, Location

While the national housing market is still in a balanced position, the overall picture is far from uniform. Calgary

and Edmonton, where until recently homeowners doubled the value of their real estate during the course of breakfast, are now seeing close to two and a half new house listings for every unit sold (Chart 3). Consequently, average home prices in these markets fell by 8.5% and 4.6%, respectively, during the year-ending July 2008.

The trigger for the current slowing in these markets is a sharp deterioration in affordability. With house prices in Alberta doubling since 2004, housing affordability has deteriorated to levels not seen since the early 1990s (Chart 4).

But a second glance at Chart 4 also reveals that affordability in other key markets such as Ontario and Québec did not worsen so rapidly. In fact, from a national perspective, it is now 20% more affordable to carry a house than it was after Governor Crow took interest rates to double-digit territory in 1990. Put differently, to bring national affordability back to the levels that triggered the real estate correction of 1990, current mortgage rates would have to double.

US Minus Subprime = Canada

US housing prices have been falling for two years with a cumulative decline of 18% to date—on their way to an eventual correction of 25%. Having started the housing boom roughly at the same time (around 1997), the Canadian housing market is now lagging the US market by roughly two years.

Chart 1

Cdn Real Estate: Getting Closer to a Buyers' Market

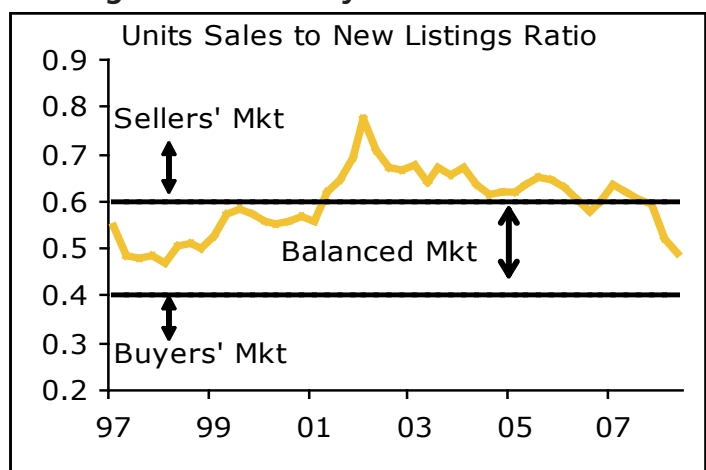


Chart 2

Cdn House Prices—Some Overshooting

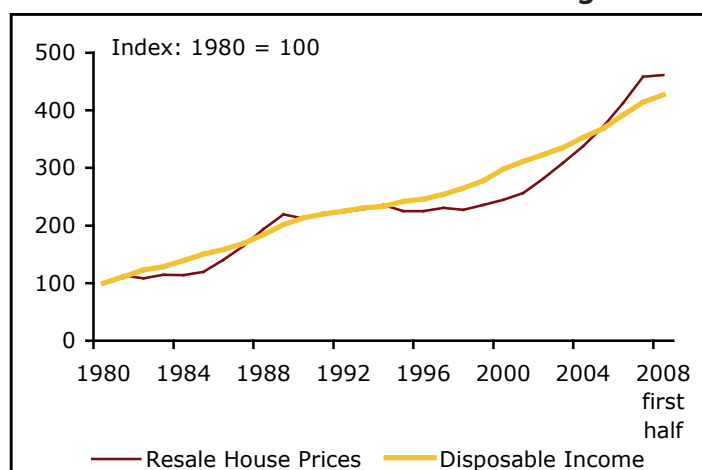
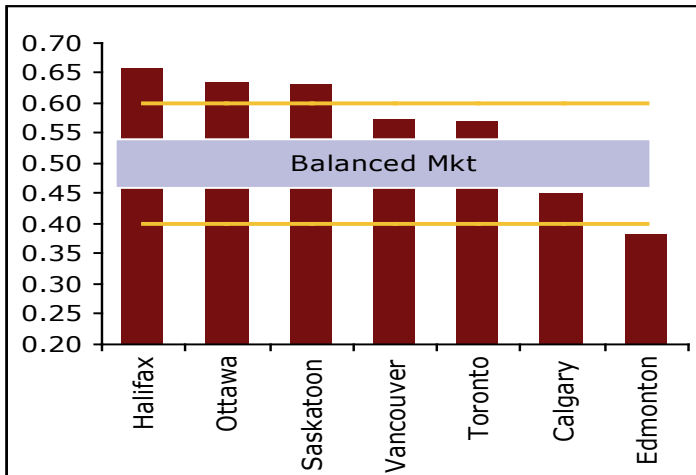


Chart 3

Unit Sales Per New Listing



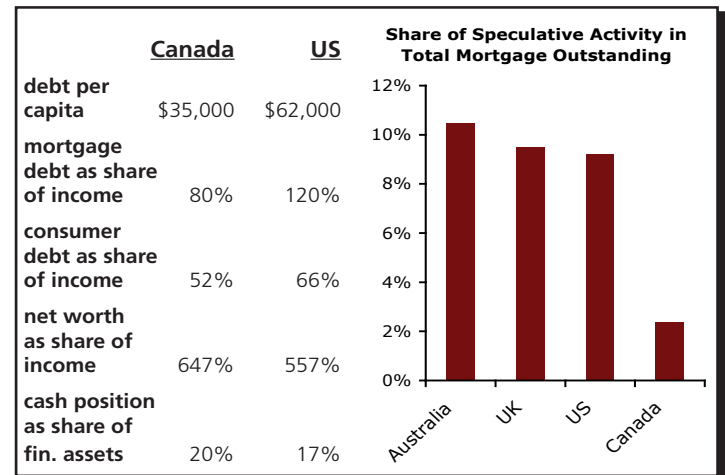
But that's where the similarity ends. By almost any measure, American households entered the current housing crisis from a more vulnerable position relative to their Canadian counterparts—carrying a heavier debt load and a much lighter net worth position (Chart 5, left). And when it comes to real estate speculation, Canada was not really a player (Chart 5, right).

But even more important than the absolute and relative level of debt is the distribution of debt. At the peak of the cycle, subprime and Alt-A mortgages accounted for no less than 33% of originations in the US market. In Canada we estimate that at the peak, non-conforming mortgages reached 5.4% of originations.

And at its core, the US meltdown is a subprime story. A glance at Chart 6 tells the tale. Average house prices

Chart 5

Canada vs US: Spot the Difference



in cities with above-average subprime exposure fell by more than 25% from the June 2006 peak—notably more than the 10% decline in cities with below average exposure (Chart 6, left). And in today's US market, below-average subprime exposure does not necessarily mean low exposure, as this category includes cities such as Dallas and San Diego with well over 20% in subprime exposure. In fact, house prices in cities with 10-19% subprime exposure fell by only 8% since the 2006 peak, and markets with single-digit exposure fell by an inconsequential 5% (Chart 6, right).

Eradicate subprime from the US housing market and, instead of the most severe house price meltdown since the great depression, you get a trivial moderate cyclical slowing—something along the line of what we are currently experiencing in Canada.

Chart 4

Affordability: West vs the Rest

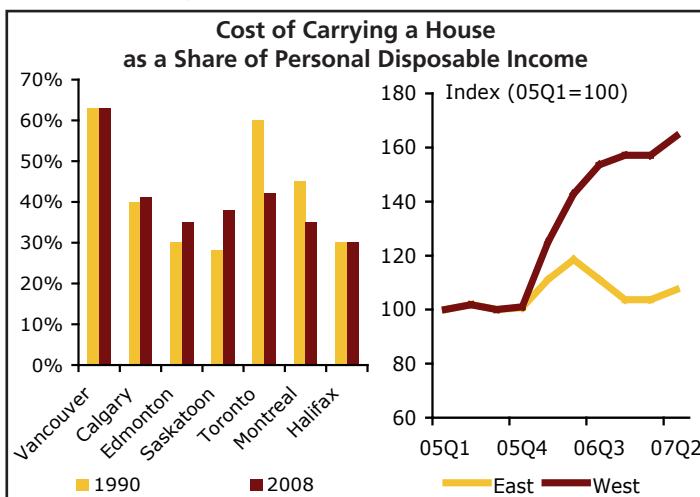


Chart 5

US House Prices by Subprime Exposure

