

## Canadian Housing: Behind The Headlines

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*"Lies, damned lies, and statistics." ~ Mark Twain*

In economics underlying details are often more important than headlines. And that is certainly the case when it comes to the highly debated ascent in household debt and the health of the Canadian residential real estate market. In both cases, any statement based on headline figures or average numbers can be hugely misleading. The truth is buried in the details—and there the picture is still not pretty, but much less alarming.

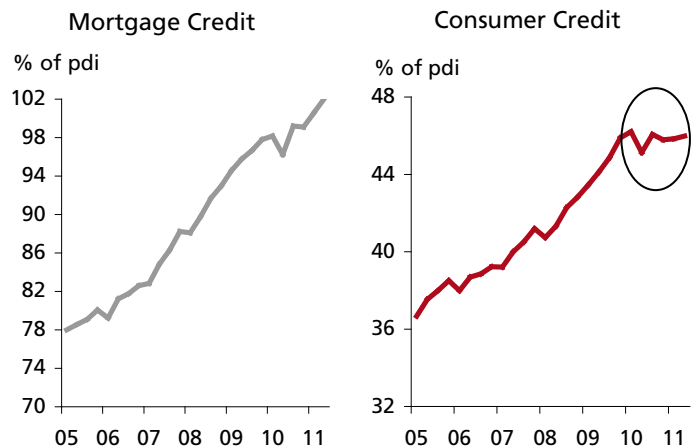
### HOUSEHOLD DEBT—A CLOSER LOOK

The debt-to-income ratio, which measures total household debt as a proportion of personal disposable income in the economy as a whole, is one of the most popular statistics quoted in any discussion regarding household debt. But like many other economic statistics, the cost of simplicity is high. No economist worth his or her salt would use this ratio at face value. After all, comparing the stock of total debt outstanding to the flow of annual income makes very little sense. Accordingly, the actual value of this ratio (a record-high 150% as of June 2011) is, in many respects, meaningless. Much more consequential, however, is the change in this measure. That is, to what extent growth in credit outpaces growth in income. Since early 2010 this ratio has been rising by an average of 0.5 percentage points per quarter—a much softer pace than the average increase of more than 1.2 percentage points per quarter observed since the early 2000s.

The main catalyst behind the reduced speed of indebtedness among households is the drastic deceleration

in the pace of growth in consumer (non-mortgage) debt. Adjusted for inflation, consumer credit is now growing at the slowest pace since the early 1990s. In fact, the ratio of consumer debt to disposable income has been relatively stable over the past year. And this trend is mostly due to demand factors, as there are no indications that lenders have cut accessibility in that space in any meaningful way. So the growing household debt problem in Canada is really a mortgage debt problem (Chart 1). And mortgage outstandings are rising by 7% on a year-over-year basis—much slower than the 12% rate before the recession, but still more than 5 percentage points faster than income.

Chart 1  
**Household Credit**



Source: Statistics Canada, CIBC.

### THE HOUSING MARKET—BE AWARE OF THE AVERAGE

The still healthy pace of growth in mortgage outstandings is a reflection of a housing market that defies gravity. The average price of a house has risen by 28% since reaching its recent cyclical low in January 2009, and it is now close to 50% above the level seen before the recession.

This highly quoted average house price masks highly segmented markets with strong activity in relatively expensive markets, such as Vancouver and Toronto, skewing the average number materially. Zooming in on the high-profile Vancouver market, we see that the gap between average and median prices is approaching an

*Canadian household debt and the housing market are less alarming than headlines would suggest. Canada does not have a generalized consumer debt problem.*

all-time high—indicating a highly skewed market. In fact, removing properties that are above the \$1 million mark reveals a much more moderate price appreciation and reduces the average sale price by \$220,000 to just over \$590,000. So what makes Vancouver abnormal is the high end of its property market.

And in this context, many including Governor Carney, suggest that foreign wealth – mainly from Asia – is the driver here. Our analysis of the data in the high-end market of the city suggests that direct foreign buying, along with foreign buying on behalf of children or other local proxies, has reached an estimated 40%-50% of transactions in specific parts of the city, such as Richmond and the West Side.

So looking beyond the average price numbers reveals a highly segmented and multi-dimensional market that is probably influenced by different forces. But even a multi-dimensional market can overshoot—and the likelihood is that prices in the Canadian market and its sub-segments are higher than what can be explained by factors such as income growth, rent, and household formation.

### IS IT A BUBBLE?

A casual look at supply and demand conditions in the housing market can provide us with a false sense of comfort. The ratio of sales to new units is currently well within a range that is believed to be a balanced market. But the recent experience in the US and the 1991 housing market meltdown in Canada suggest that this relatively calm picture can change overnight with a balanced market turning into a buyers' market within a few short months with little warning.

However, the fact that prices are overvalued today does not necessarily mean that they will crash tomorrow. After all, a violent market correction needs a trigger such as the sub-prime crisis, which ignited the US real estate meltdown, and/or abnormally high interest rates, as was the case during the 1991 property crash in Canada.

Despite some mitigating factors such as an increased

proportion of households that accelerate their mortgage payment, the reality is that home owners are currently more sensitive to higher interest rates since the early 1990s. The recent rush to variable mortgage rates (currently a record-high of 30% of originations), the near 40% increase

in average mortgage size since 2005 and the 15% average annual increase in home equity lines of credit during the same period are clear indications of this trend. Fortunately, a rapid rate hike is not on the horizon this time around. An array of limiting factors, including

a strong dollar, the end of fiscal stimulus, a slower pace of economic activity in the US, and a more rate-sensitive household sector, suggest that rates will remain unchanged in the coming two years or so.

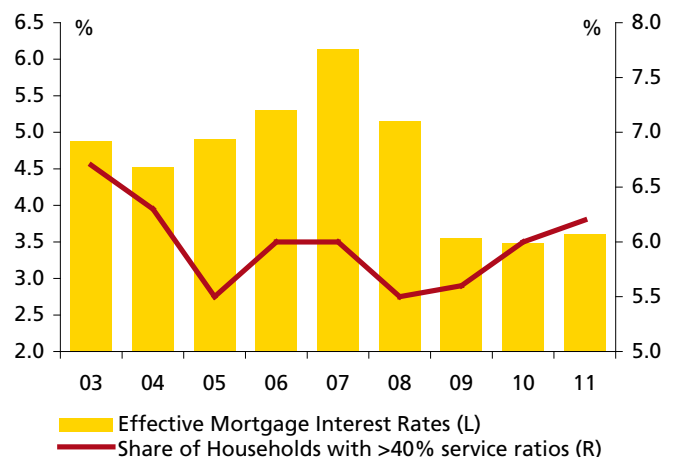
What about the risk profile of the Canadian mortgage space? We zoom in on two sub-segments of the mortgage market that traditionally accounted for most defaults: mortgage holders that carry a debt-service ratio of more than 40% and those with less than 20% equity on their house.

As illustrated in Chart 2, just over 6% of households have a debt service ratio of more than 40%—a number that has risen by a full percentage point since 2008. Note, however, that this ratio is still well below the ratio seen in

*Adjusted for inflation, consumer credit is now growing at the slowest pace since the 1990s. Mortgage debt is growing at a much slower rate than before the recession but still faster than income, and with a backdrop of potentially overshooting house-price appreciation.*

Chart 2

### Number of Stretched Households on the Rise – But Not in the Sky



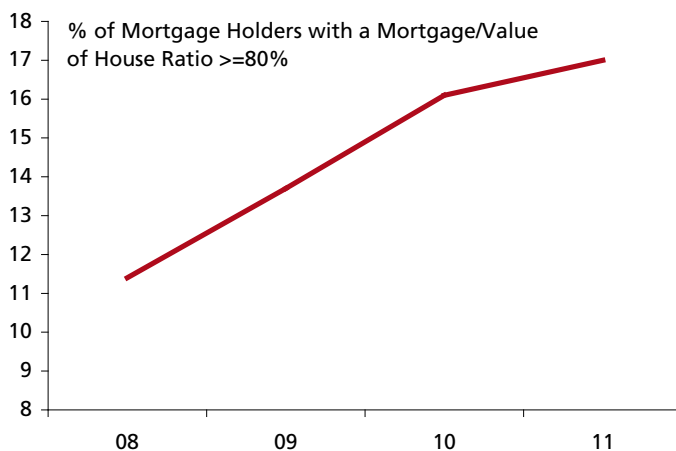
Source: The Financial Monitor, CIBC.

2003, when the effective interest rate on debt was more than a full percentage point higher, and no correction in house prices ensued. All other things being equal, even a 300-basis-points rate hike by the Bank of Canada would take this ratio to only just over 8%. Not surprisingly, Vancouver has the highest ratio of households with high debt-service ratio, followed by Toronto.

Moving on to the equity position, just over 17% of the Canadian residential real estate pool consists of properties with less than a 20% equity position (Chart 3). Note that this number has been rising over the past few years and, again, Vancouver and Toronto lead the way. Not surprisingly, more than 80% of households with less than 20% equity position are first-time buyers.

Chart 3

### High Ratio Mortgages on the Rise



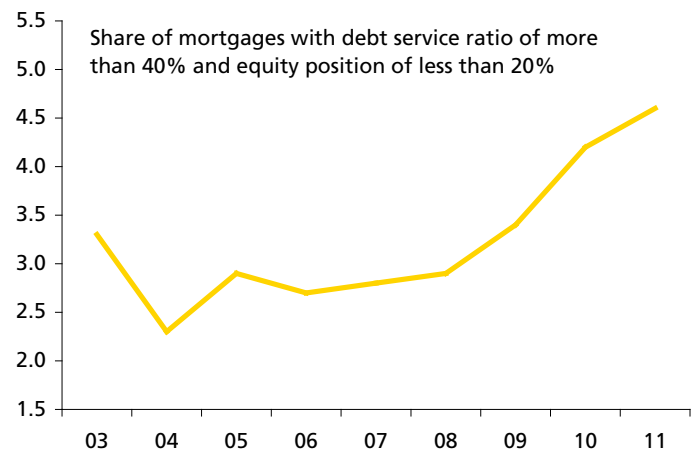
Source: The Financial Monitor, CIBC.

Digging deeper and looking at the households with both low equity positions and high debt-service ratios, we found that this fragile segment of the market accounts for only 4.5% of total mortgages—a number that has been on an upward trend over the past few years (Chart 4). Historically, even in that group, the default rate has been well below 1%. Thus, short of a huge macro shock, there does not appear to be the risk of large-scale forced selling that would typically be the trigger for a precipitous plunge in the national average house price.

*Short of a huge macro shock, the risk is small that in the near term a large-scale forced selling materializes and triggers a precipitous plunge in house prices.*

Chart 4

### The High Risk Segment of the Mortgage Market



Source: The Financial Monitor, CIBC.

Accordingly, while we do not see house prices crashing, we do believe that house prices in Canada will level off in the coming year or two. Further out, the most likely scenario is that the eventual increase in interest rates will lead to a modest decline in prices (probably in the magnitude of 10%-15%). But given the current balanced affordability position, the more significant adjustment will be in housing market fundamentals that are likely to catch up with prices in the coming years—paving the way for a healthier housing market later in the decade.

Indeed a flattening in house prices in the next year or so is a necessary condition for such a soft-landing scenario. If the pace of house price increases accelerates during that period, then a year or two from now the likelihood of a violent price correction will be higher than it is now.