

No bubble in Canadian house prices study

Jacqueline Thorpe

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The U.S. housing market may be rolling over but virtually all Canadian cities remain undervalued and could see annual price increases of 4.2% on average through 2010, a new study from Merrill Lynch says.

The study runs contrary to current wisdom that Canada's housing market is boiling over. For example, despite the oil boom, house prices in Calgary are 16% undervalued compared with average historical valuations. Ottawa's market is 13% undervalued, Halifax 12% and Toronto 17%. Merrill found only Victoria to be overvalued.

"The two most important fundamentals from my perspective and just about any housing economist you talk to is how much can people afford -- what are people's incomes and what are the interest rates charged on the debt," said David Wolf, Canadian economist and strategist for Merrill. He based his study on a new valuation that takes into account how much potential homeowners can afford.

"Rates have gone way down and incomes have gone way up and prices, broadly speaking, have only just recently started to keep pace with that," Mr. Wolf said.

Figures from Royal LePage Real Estate Services yesterday show the Canadian market did in fact heat up in the first quarter.

The average price of a detached bungalow rose 11% to \$282,059 over the first quarter of 2005, the price of a standard two-storey property rose 9.2% to \$340,956, while a standard condominium rose 8.8% to \$195,909.

That contrasts sharply with the United States where both existing home sales and prices have been declining in recent months.

Despite the sizzling start to the year, Mr. Wolf believes Canadian prices will continue to push ahead based on his estimate of "potential" house prices, or the price an average family could buy given standard mortgage terms and current interest rates and household incomes.

This is the reverse of the commonly used affordability index that compares what kind of income is needed to buy the median house at standard mortgage rates and terms.

Applying his measure, Mr. Wolf found most cities in Canada are posting below-potential prices as recent increases have only partially eroded the setbacks of the 1990s.

Mr. Wolf refined his measure further to take into account the fact that some cities -- for reasons of size, geography, climate, etc -- will always be pricier than others. Vancouver, for example, will always be more expensive than Thunder Bay.

And he compared current potential prices with average prices going back to 1980.

"Victoria B.C., is the only Canadian city we estimate to currently be overvalued based on this metric," Mr. Wolf said in his study. "Even with the rapid house price gains of recent quarters, both Alberta cities [Calgary and Edmonton] still come out as somewhat undervalued based on this metric."

To test his metric, Mr. Wolf did the same for several U.S. cities and found most were overvalued -- San Diego was the worst at 44% overvalued.

The analysis also revealed that Canadian markets were much more frothy than U.S. markets in 1990. For example, in 1990 Toronto was the most overvalued (54%) of all Canadian and U.S. cities.

"While cities in Ontario were most stretched in 1990, we note that every major Canadian city in our sample comes out as overvalued, to contrast with the current estimated broad undervaluation," Mr. Wolf noted.

Since 1990, actual prices in Toronto have only risen an aggregate 32% -- and are still lower in inflation-adjusted terms than they were 15 years ago -- while household incomes have risen 43% and five-year mortgages are barely half of what they were.

"Relative to both its own history, and the U.S. benchmark, then, we don't think Canada's [current] housing market looks frothy," Mr. Wolf wrote.

Given the current and historic potential valuations, Mr. Wolf calculates house prices should increase an annualized 4.2% on average through 2010.

"[But] if rates spike and incomes stagnate, we will surely not see those real 4.2% gains come to fruition," Mr. Wolf said.