Canada's hot housing market to cool down: BMO report

BY KIM COVERT, FINANCIAL POST MARCH 3, 2011

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Photograph by: Norm Betts/Bloomberg, Norm Betts/Bloomberg

Canada's hot housing market should cool down somewhat this year, according to a new report from BMO Capital Markets, which says the kind of correction some observers have been warning about is unlikely — though not impossible, given the right circumstances.

The question of a correction comes down to whether increases in household incomes can keep up with rising home prices. If price rises outpace incomes, said BMO senior economist Sal Guatieri, "a correction would be inevitable."

While incomes and average home prices kept pace with each other over most of the last three decades, both rising 5.7% a year, Guatieri said in the report that prices more than doubled in the decade to late 2007, and grew twice as fast as incomes from 2002 to 2007.

“Even after sliding 13% through the recession, prices quickly rebounded and are now 10% above their 2007 peak,” Guatieri said. “The ratio of average resale prices to personal incomes is currently 14% above its long-run mean, suggesting the national market is moderately overvalued.”

BMO expects gains in income to outpace advances in housing prices for the next 18 months — during which time the bank expects interest rates to rise by two percentage points.

“If incomes climb eight per cent and prices stabilize, as we expect, the current over-valuations would fall to six per cent, hardly the stuff of corrections.”

Growing incomes are also expected to offset costs associated with rising interest rates.

While new homebuyers are told housing costs — such as mortgage, taxes, insurance and heating — shouldn’t consume more than 32% of household income, Guatieri said the current rate is about 35%, and if incomes and interest rise as expected, affordability would “deteriorate” to 40% of disposable income. That alone would not trigger a correction, Guatieri said, noting that during corrections in 1989 and 2008, affordability exceeded 45%.

“The risk of a correction would increase, however, if prices rose alongside rates and incomes (that is, by eight per cent) — in which case the affordability measure would reach 43% and approach the threshold of prior corrections.”

Currently, the housing market is relatively balanced, according to Guatieri. New-home construction has fallen back and there are about two new listings for every sale. Average resale prices rose five per cent over the past year, but excluding Vancouver that increase would have been less than two per cent, and new home prices rose just two per cent, while land sales are flat, Guatieri added.

Tighter mortgage rules, which come into effect March 18, along with higher interest rates, lower affordability and elevated household debt, “should keep house prices on a tight leash,” Guatieri said.

According to the bank’s calculations, housing markets could be considered pricey in six provinces: Saskatchewan, Newfoundland and Labrador, British Columbia, Manitoba, Quebec andNova Scotia. Guatieri notes that unlike many other regions, Alberta could see an increase in house prices this year “in response to solid economic growth, high oil prices and in-migration.”