TD Bank Financial Group

TD Economics

Special Report

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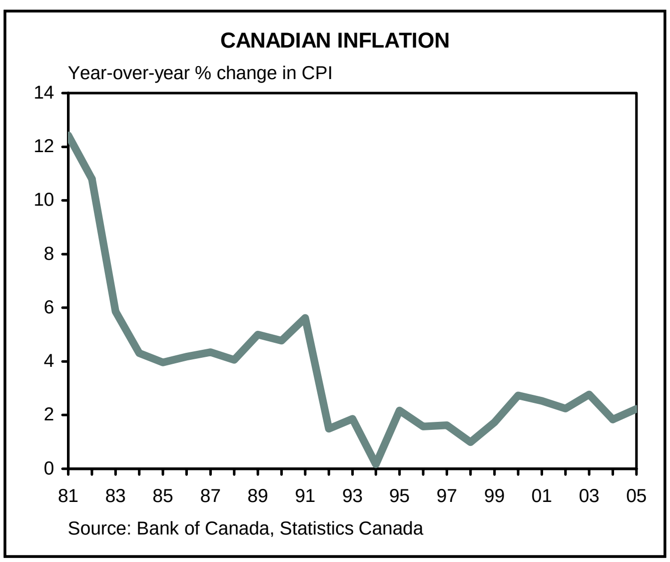
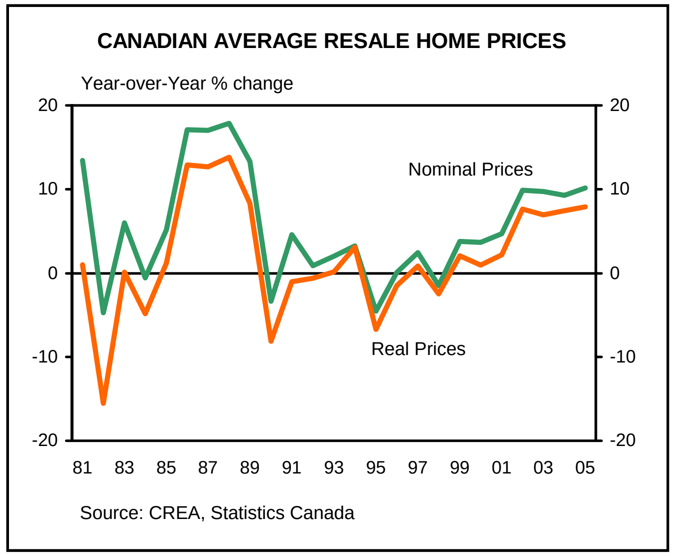
LONG-TERM OUTLOOK FOR CANADIAN HOME PRICES

Real estate is usually the single biggest financial asset most individuals own. It is estimated that more than 70 per cent of Canadian families are currently homeowners. The total value of residences exceeds $1 trillion and land and housing together account for one-third of all personal assets. Given this importance, the future value of a home should be included in the financial plans of Canadians. However, while it is relatively easy to assess the current value of a property, gauging the future value is far more challenging.

In the following sections, we examine past trends in home prices and consider how factors like a sustained low inflation environment and the aging population might impact prices going forward. The main conclusion is that the national average of home prices is expected to rise at close to a 4% average annual rate over the next 25 years, but with considerable variation at the individual city or neighbourhood level and with significant volatility from year to year.



Source: Bank of Canada, Statistics Canada



Source: CREA, Statistics Canada

History as a guide

Over the past two and a half decades, the average annual increase in resale home prices has been 5.6% per annum. Given that this time frame encompasses several business cycles (i.e. long-term economic fluctuations), one might be inclined to believe that a similar performance would be delivered in the future. This assessment, however, fails to take into account the declining trend in inflation over the past several decades. Like any financial asset, the return on real estate must compensate the investor for the declining purchasing power of money from rising prices. Over the past 25 years the average annual rate of inflation has been 3.7%, implying that the after-inflation (real) increase in home prices has been 1.9%.

Since the mid-90s the Bank of Canada has been remarkably successful in keeping inflation under wraps. Indeed, the average rate of inflation from January 1995 to December 2005 was 2%, which is bang on the Bank of Canada target. There is every reason to believe that the

Bank will deliver a similar track record in the future. If this assumption is correct, the historical trend in real resale home prices combined with the outlook for inflation suggests that national average home prices will rise at close to 4% per year over the long term.

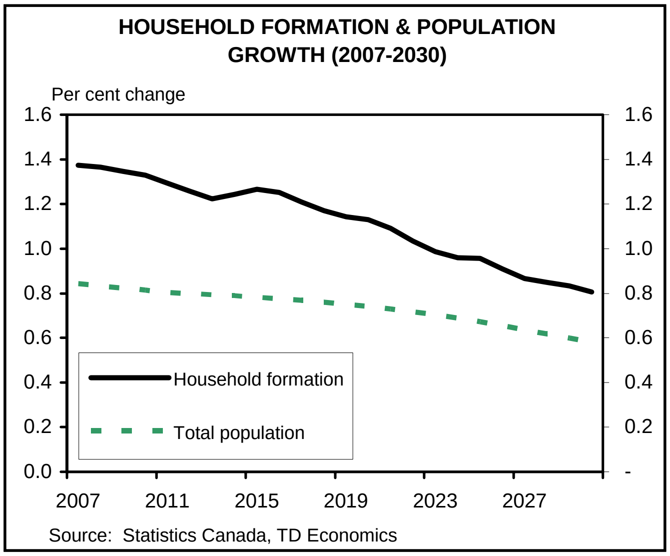
Key determinants of home prices

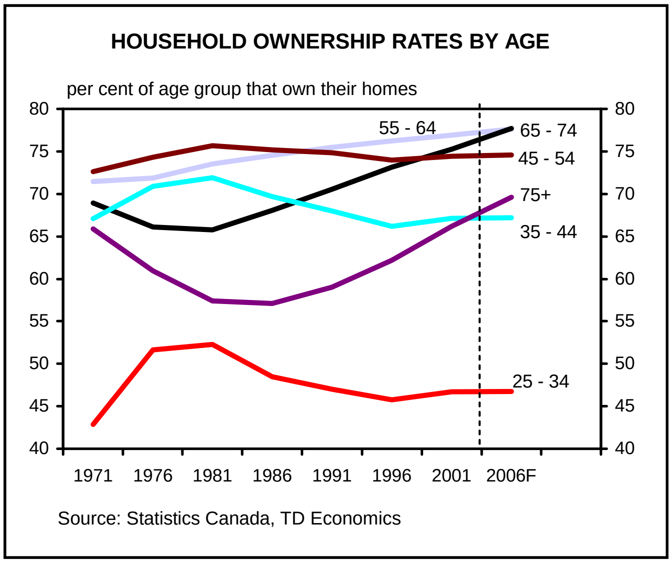
This expectation may be erroneous if there are major structural changes in the economy that impact home prices. An alternative approach is to examine the main drivers behind resale prices and consider their future trends. Various analytical studies have suggested that the key determinants of home prices include: demographics, labour markets conditions and the level of interest rates.

Aging population could constrain price growth

Demography is the major driver of demand for housing over the long haul and the aging of Canada's population is likely to act as a constraint on home price growth in the years ahead. Statistics Canada provides a medium growth, medium immigration projection that is a good benchmark. It shows population growth slowing to a 0.6% pace in 2030, down from the 1.0% average in the last decade. This aggregate view masks the changing age distribution of the population. Demand for residences is driven by the rate of net household formation, which will decline in response to an aging population. Household formation growth is expected to slow from 1.4% in 2007 to 0.8% in 2030.

Furthermore, the increasing reliance on immigration for population growth could impact demand for housing. At least initially, immigrants overwhelmingly go into rental





accommodation, and they will increasingly account for a rising share of household formation.

All of this points to weaker demand growth for housing and more modest price gains than in the past.

A number of offsets will be present

However, fears that baby boomers will depress housing markets as they sell their properties and move into retirement homes are likely overblown. Individuals are living longer, healthier lives. The aging population could actually lead to a modest rise in the national home ownership rate. The implication is that slower household formation may temper home price growth, but the impact should be gradual and only moderate.

The aging population could also create an offsetting increase in personal income by creating tighter labour market conditions. A study on determinants of house prices by the Federal Reserve of Boston found that the entry of baby boomers into the labour market temporarily depressed wages and salaries growth. Conversely, we can speculate that the exit of baby boomers may lead to a structural decline in unemployment rates and a higher trend rate of wages and salary growth, particularly for highly skilled workers. This would lead personal income to rise as a share of total income in the economy (i.e. nominal GDP) -- reversing the recent trend where corporate profits have taken up a larger share of GDP.

The impact of demographics on home prices may also be limited by more modest construction of new homes. In other words, weaker demand could be offset by more limited supply. For example, the demographically supported rate of housing starts could fall from the current annual level of around 175,000 to 125,000 by 2030.

Rate changes should wash out over the long-run

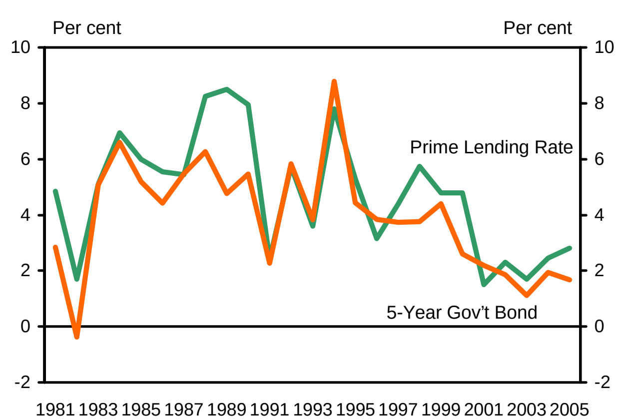
What about the impact of interest rates? Borrowing costs influence home prices both in terms of the supply of homes and demand for homes. Lower interest rates encourage construction by reducing financing costs for builders, but also raise demand by lowering the financing costs for buyers. It should be noted that it is real (after-inflation) interest rates that matter. While increasing supply is negative for prices, empirical studies show that the dominant effect from lower interest rates is on raising demand, with the result that the net impact of lower rates is positive for prices.

In the 1990s, real interest rates trended lower, reflecting the adjustment to a low and sustained inflation environment and the increased credibility of central banks at maintaining relative price stability going forward that reduced the inflation-risk premium demanded by lenders. This likely contributed to strong housing markets in the late 1990s and first half of this decade, but the adjustment process is now complete. While real interest rates will fluctuate in the coming years, rising in strong economic times and falling in weaker ones, there is unlikely to be a major long-term structural trend either higher or lower. As a result, the outlook for interest rates should not impact the long-term prospects for home prices.

National average annual price gains of 4%

Putting it all together, the combination of weaker demographic demand for housing is likely to be offset by

CANADA: REAL INTEREST RATES



Source: Bank of Canada, Statistics Canada

AVERAGE ANNUAL RESALE HOME PRICES (1981-2005)

	Nominal	Real
Vancouver	6.8	2.9
Victoria	6.8	2.9
Toronto	6.7	2.8
Montreal	6.0	2.4
Ottawa-Carleton	5.8	2.0
Halifax-Dartmouth	5.3	1.6
Quebec City*	4.8	2.1
Calgary	4.2	0.6
Saint John	4.1	0.6
St. John's	4.1	0.7
Regina	3.9	0.4
Winnipeg**	3.8	0.2
Saskatoon	3.6	0.2
Edmonton	3.5	-0.1

*No data avaliable from 1982-1983; **No data avaliable for 2005
1980-1984 - Real prices are inflation adjusted using the CMA Total CPI
1985-2005 - Real prices are inflation adjusted using the provincial CPI X-Shelter (NA prior to 1985)

rising home ownership rates, rising personal income, a modestly lower long-term rate of unemployment and more modest construction of new homes. Meanwhile, the level of interest rates should have little impact over the long-haul. So, the assumption that national home prices will rise at an average annual pace of 4% (after-inflation increase of 2%) over the next decade and a half seems reasonable, but as the demographic pressures build particularly after 2025 there is a risk that the trend rate of price growth could slow into a 3 to 3.5% range.

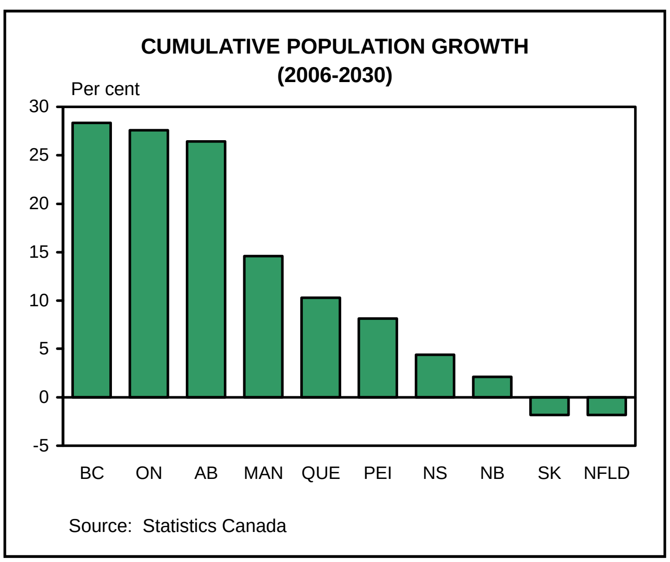
Location, location, location

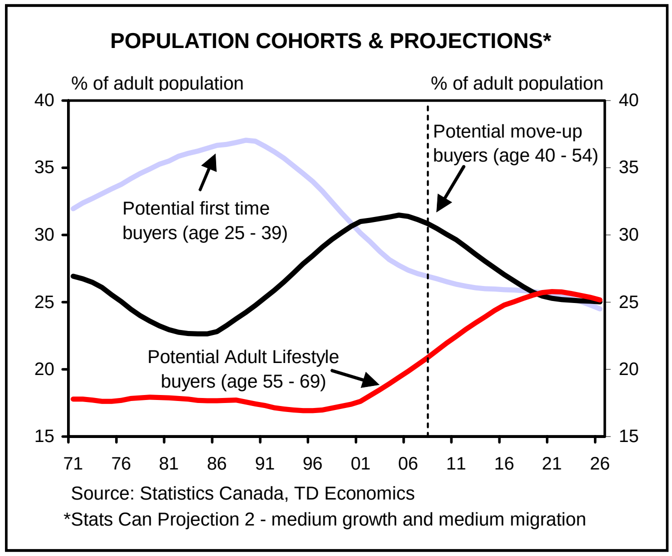
One should recognize that the national perspective is a gross simplification. There is an old adage that real estate is all about location, location, location. There is no national housing market. Instead there are hundreds of local markets, each with their own characteristics and prospects for demographics and labour markets. The table above shows the average annual performance of home prices of selected major cities in Canada from 1981 to 2005. Real average annual home price gains have ranged from 0 to 3%. If this performance repeated itself, the future increase in home prices would be roughly 2 to 5% when inflation is factored in.

Historical experience shows that larger cities (where land scarcity and demand for housing is the strongest) have tended to have the greatest price gains. This is why Vancouver, Victoria, Toronto and Montreal have had the most rapid price gains over the last two decades. Over the next 25 years these cities are likely to continue to experience price gains above the national average, with Toronto and Vancouver benefiting from their attraction to immigrants, who will play a greater role in the pace of Canadian population growth going forward.

Two cities that are likely to break away from their historical performance are Calgary and Edmonton. Home prices after removing the impact of inflation in these urban centres averaged close to a flat performance from 1981 to 2005. However, this is extremely unlikely to be repeated in the coming decades, as the past weakness likely reflected the secular decline in oil prices in the 1980s and 1990s. While energy prices will prove volatile in the years ahead, the level of energy prices is expected to remain well above their historical averages. Alberta also has the

RESALE HOME PRICES FOR SELECTED CITIES Average Annual Change in Prices 2007-2030	
Above Average (+4% per annum)	
Calgary	Toronto
Durham	Vancouver
Edmonton	Victoria
Montreal	
Average (3-4 % per annum)	
Halifax/Dartmouth	Ottawa/Gatineau
Hamilton	Quebec City
Kitchener/Waterloo	St. Catharines
London/St. Thomas	Sudbury
Below Average (2-3% per annum)	
Regina	Thunder Bay
Saint John	Windsor-Essex
Saskatoon	Winnipeg
St. John's	Most rural areas
Forecast by TD Economics	





advantage of lower tax rates, stronger projected population growth and a younger population than many other provinces. Thus, all of the stars are aligned for Calgary and Edmonton to experience above average price growth in the future. However, it should be stressed that the recent pace of price gains in these markets have been completely unsustainable and will eventually come back to earth when the housing markets become more balanced.

Conversely, a number of cities in Canada will experience slower than average home price growth, reflecting less supportive demographic and labour market conditions.

Type of housing matters as well

Finally, the changing demographics could significantly influence the price performance of various types of dwellings. As the chart above shows, demand for entry level homes will moderate, while demand for housing more suited to older Canadians will increase (e.g. condos, ranch-style homes and perhaps smaller size properties). However, support for entry level homes could come from the immigration front. Unless immigrants are better integrated into the labour force, a trend we deeply hope will take place, their demand for homes will be greatest for more modest dwellings. So, the largest impact from the shifting population may prove to be on the high-end, largest square footage properties.

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