

Homes in Edmonton, Saskatoon most overvalued

ROMA LUCIW

Globe and Mail Update

September 13, 2007 at 1:10 PM EDT

House prices in Edmonton and Saskatoon, traditionally sleepier enclaves of Canada's real estate market, have overshot their long-term trends and are at the greatest risk of an eventual softening, a report predicted Thursday.

The report, written by Bank of Nova Scotia economist Adrienne Warren, looked at 15 cities across the country and calculated the percentage that real house prices have deviated from their historical averages. It found that in all markets, with the exception of St. John's, current inflation-adjusted price levels are well above their long-term trend.

The average deviation across the country was about 8 per cent, but with wide regional variations. Edmonton, where the oil boom has spurred a massive jump in housing sales, starts and prices, led the pack, with a deviation of 25 per cent. Saskatoon, another Western city that has climbed aboard the resource price rally, has deviated 21 per cent.

“The further domestic home prices climb above underlying economic fundamentals, the greater the risk of an eventual correction,” the report said.

Ms. Warren said the two cities have traditionally seen small year-over-year home price increases. Historical precedent suggests that with supply-demand conditions tightening, the sharp increases in Edmonton and Saskatoon will slow. However, the price of oil hit a record \$80.20 (U.S.) on Thursday and if commodity prices remain high, the housing market could outperform its long-term trends.

“Historically, these areas have not had long-term strength,” Ms. Warren said in an interview. “Assuming we don't see a commodity bust this time around, then the long-term trends might improve from what these statistical estimates suggest. Perhaps these valuations are more reasonable now.”

In Ottawa, the price deviation was just 1 per cent while in Toronto it was 2 per cent. That is because these two cities have experienced larger sustained gains in house prices over the last two decades.

To be clear, Ms. Warren is not predicting a Canadian housing collapse, but rather a cooling in price gains. Nationally, she expects prices will rise 10 per cent this year, slow to the “high single digits” next year, and eventually fall back in line with the rate of inflation, which would put them between 2 and 2.5 per cent.

A rise in the number of extended-amortization mortgages, which lengthen the time it takes to repay a home loan to 30, 35 or 40 years from the traditional 25, have bolstered the recent strength of Canada's housing market, Ms. Warren said. These mortgages are stretching affordability for first-time home buyers, but because they are seldom combined with zero-down or interest-only structures, she does not see them as particularly risky.

“I don't think this is a major risk, though it is supporting the housing boom more and we probably would have seen things level off this year instead of reaching a new peak,” Ms. Warren said.

The current Canadian housing boom, which began nine years ago, has been the longest of the post-war era, with cumulative price gains of more than 60 per cent, the Scotiabank report said. And although the housing fundamentals are solid in Canada because of low unemployment, high immigration and tight apartment vacancies, years of relentless house price increases mean affordability is waning just as risks to the economy mount.

“There is little doubt that current trends are unsustainable,” Ms. Warren said.

“Affordability is becoming increasingly stretched for many would-be buyers after almost a decade of rising home prices. More recently, economic risks have increased in the wake of the intensifying financial market turmoil stemming from the U.S. subprime mortgage problems.”

Companies are already feeling the pinch. Toronto-based Xceed Mortgage Corp. on Thursday froze its dividend payments as turmoil in the U.S. subprime market sparked a drop in quarterly profit. “For the duration of this period, it is going to be a difficult and challenging time for our industry, Xceed, and our investors,” warned Ivan Wahl, chairman and chief executive officer.

Speculative buying is rare and subprime mortgage loans account for just 5 per cent of the market in Canada – much lower than the 20-per-cent market share in the U.S. And Ms. Warren stressed that Canada ranks relatively low in the degree of overvaluation relative to other developed nations.

“There is an indirect correlation in that volatility in lending markets could lead to a tightening in lending conditions, could lead to erosion in consumer confidence or slower growth in Canada as we see some softening in U.S. demand spilling over. But at the same time, it looks like interest rates here will be lower and that will support our market.”

Still, she's not the only one raising the red flag. Canada's housing affordability saw “one of the largest and most broadly based quarterly deteriorations since the mid-1990s,” said Derek Holt, assistant chief economist at the Royal Bank of Canada, in a report Wednesday.

A standard two-storey home now eats up about 46 per cent of pre-tax household income, with all types of homes experiencing a slide in affordability.

The Canadian economy is increasingly vulnerable to any decrease in housing prices because home-ownership rate is sitting at the highest level on record, national census data showed Wednesday.

For now, prices continue to rise at a healthy clip, though that pace is slowing. National prices were, on average, 7.7 per cent higher in July from a year ago, though the rate of increases has been decelerating for almost a year.

With a file from Tavia Grant.