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THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE

ECONOMIC WINTER

The Developing Canadian Housing Crisis

New Mortgage Rules Apply the Brakes to Rising House Prices

Last July 9th. Finance Canada announced changes to the Canadian mortgage market which included a reduction in the maximum amortization period for insured mortgages to 25 years from 30 years; as well as a reduction in the home mortgage loan to value ratio to 65% from 80%. Not only, did it represent the fourth intervention in the rules governing the Canadian mortgage market in as many years, but also, these were the changes which had the biggest market impact. Potential first-time home buyers, who in a typical housing market comprise one-third to one-half of all home buyers, felt the change almost immediately. For example, the Toronto Real Estate Board reported the volume of home sales in Toronto declined by 21% in September on a year-over-year basis, while home sales in the Greater Toronto Area fell to 5,879 from 7,422 on a comparable basis. Phil Soper, President of Royal LePage commented: “Fewer homes trading hands typically precedes a period of softening house prices; and where there is reduced demand, home sellers reduce their asking price to stimulate interest. While hard-hit in the short term, first time home buyers will adjust to tougher mortgage qualifications. The dream of home ownership is very much alive among young Canadians. While they may remain renters for some time as they save; some will opt for less desirable neighbourhoods and some will purchase smaller homes.” Robert Kavcic, an economist at BMO Nesbitt Burns in Toronto, noted: “With new listings up by 4% on a year-over-year basis, against a backdrop of declining sales and with a plentiful supply of potential resale condos adding to inventory over the next year, Toronto is rapidly heading for buyers’ market territory.”

Canada’s Housing Bubble Begins to Burst

As recently catalogued in the Globe and Mail, although there is some truth to the oft-repeated idea that Canada regulates its banking industry fairly conservatively, there is more than just circumstantial evidence that the generally conservative outlook in the mortgage market has not prevented a housing bubble from forming. Housing prices have doubled across Canada over the past 10 years, despite broadly flat wage levels. While higher house prices in markets such as Calgary, Edmonton or Fort McMurray could possibly be explained by an influx of workers related to the energy industry, combined with a shortage of housing inventory; it’s difficult to comprehend why house prices in Toronto and Vancouver should be three or four times higher than average house prices in the United States and more than double their historical average price ratios. If Canadians are fortunate enough to witness an orderly decline in house prices in the coming months, unlike the recent experience in the United States, the impact on household budgets could prove manageable. However, when the prevailing level of interest rates start rising off their current historic lows, a sizeable number of Canadians would soon discover their inability to meet their debt and mortgage obligations.

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Canadian Housing Starts Decline in September

According to Canada Mortgage and Housing Corp. (CMHC) data, the nation's housing starts declined to a seasonally adjusted annualized pace of 220,215 in September, down from 225,328 units in August, resultant from slower construction activity in condos and apartment buildings. Mathieu Laberge, CMHC's deputy chief economist commented: "As expected, the number of multiples starts in Ontario, particularly in Toronto, reverted back to a level more in line with the average price of activity over the last six months. Following a period of elevated housing starts activity due to strong volumes of multi-family unit pre-sales in 2010 and 2011, the pace of housing starts is expected to moderate." Since a prolonged advance in Canadian house prices and a condominium building boom in Toronto and Vancouver have initiated some concern of a housing bubble, recently the International Monetary Fund (IMF) has specified Canada's housing boom as a factor to monitor. Moreover, in a research note, Francis Fong, an economist with TD Economics, stated: "In our view, Canada still has overbuilding concerns. The level of household formation does not support the level of construction activity that we are seeing each month. However, given the low interest rate environment … we anticipate a slow moderation in both new sales and construction activity towards their long-term trend levels over the next few years."

New home construction in the Inspiration Community project by developers Tribute Communities in Richmond Hill Source: Moe Doiron / Globe and Mail

Canadian Home Sales Register a Steep Drop in September

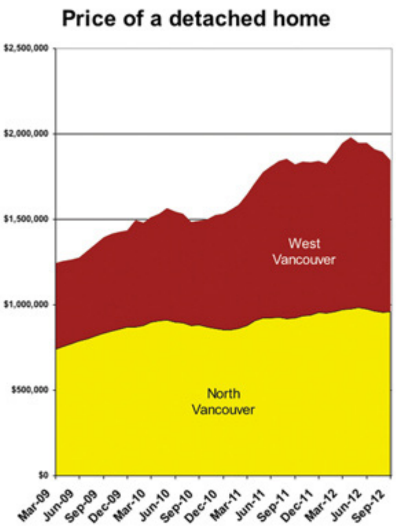
The Canadian Real Estate Association (CREA) reported national home sales declined by 15.1% in September on a year-over-year basis, citing sales in more than half of the country's local markets fell by at least 10%. According to the Real Estate Board of Greater Vancouver, there were 1,516 sales in September, down 8.1% from the 1,649 sales in August. In an interview with the Globe and Mail, CREA Chief Economist Gregory Klump observed: "The recent mortgage insurance changes are working, since they are cooling off the market and home sales have ratcheted down compared to a year ago. We do anticipate that house sales are going to remain below year-ago levels for the rest of the year and maybe even into the spring." In a research note to clients, Bank of Montreal economists related: "While the underlying trend in home sales is likely not as dire as the headline yearly drop would suggest, there is little doubt that home sales have taken a step back in recent months. September marked the second full month under more strict mortgage rules which took effect on July 9th. In the past three months, combined home sales are down by about 7% from year-ago levels, compared with an increase of nearly 5% on a year-over-year basis in the first six months of the year."

Warning Issued on CMHC Home Valuations

Copies of confidential statements and documents recently supplied to the Globe and Mail from banks, appraisers and mortgage insurers, indicate an increasing concern over the usage of a database operated by Canada Mortgage and Housing Corp. The documents suggest that the data are flawed and have helped fuel inflation in home prices. Introduced in 1996 as a method for CMHC, banks and other mortgagees to quickly and inexpensively determine how much money could be loaned against a residential property, the database (known as Emili) may be too heavily relied upon. Emili is an automated system which uses figures – such as recent sales of nearby homes – to gauge values, without sending an actual appraiser to the address. For banks, it could mean the collateral they have against the mortgage is not worth as much as perceived. CMHC is the largest mortgage insurer in the country. The documents, from last May, were part of a process by the Office of the Superintendent of Financial Institutions (OSFI) – the federal banking regulator – to determine whether Canada's mortgage lending rules needed to be tightened. This summer, OSFI advised banks to take a closer look at how they determine housing values and to make more of an effort to perform more in-person appraisals. However, when the new mortgage guidelines were announced, there was no indication to the extent of the concerns raised in private by the industry and the heightened level of concern over the accuracy of Emili data. Known as an automated value model (AVM), Emili is used to estimate whether a mortgage or a refinancing is risky or not. When mortgage lenders use Emili, they submit a proposed residential valuation to the database, which then responds by determining whether the value fits within the range for that community or not. However, the database cannot determine whether the actual property is worth that much. The documents also suggest that blunt estimates on home valuations may have resulted in higher CMHC premiums paid by consumers on insured mortgages.

High End Vancouver Home Prices Sliding

According to the North Shore News, after three years of jaw-dropping gains, house prices in West Vancouver and other wealthy Lower Mainland enclaves appear to be in retreat. According to the Real Estate Board of Greater Vancouver, since April, the price of a typical West Vancouver single-family home has declined by 6.6%. The slide marks an end to a spectacular streak for the community's housing market, which saw the price of a detached residence – as measured by the Multiple Listing Service (MLS) Home Price Index – rise by about 60% in three years to almost \$2 million (CAD). In a press release, board president Eugene Klein stated: "While prices in the region remain relatively stable overall, we do see some price reductions in the areas which had experienced some of the largest price increases over the last couple of years." West Vancouver home sales have been more than 30% below the previous year's in every month since March. In September, 57 properties changed hands – a year-over-year decline of 33% – and the lowest total for the month since 2008. According to real estate board figures, a similar boom-bust pattern has occurred in other well-heeled municipalities within the Lower Mainland – notably in Richmond and the Vancouver West-End – while the trend has been less pronounced in more modestly priced areas. The North Shore housing market rebounded from the 2008 correction with the rest of the region beginning in the spring of 2009, but prices in West Vancouver and other high-end areas quickly advanced. Although there are few statistics available on the issue, it was widely reported at the time that the upward price trend was the result of a surge in investment in very high-end homes by foreign buyers, mostly from China.

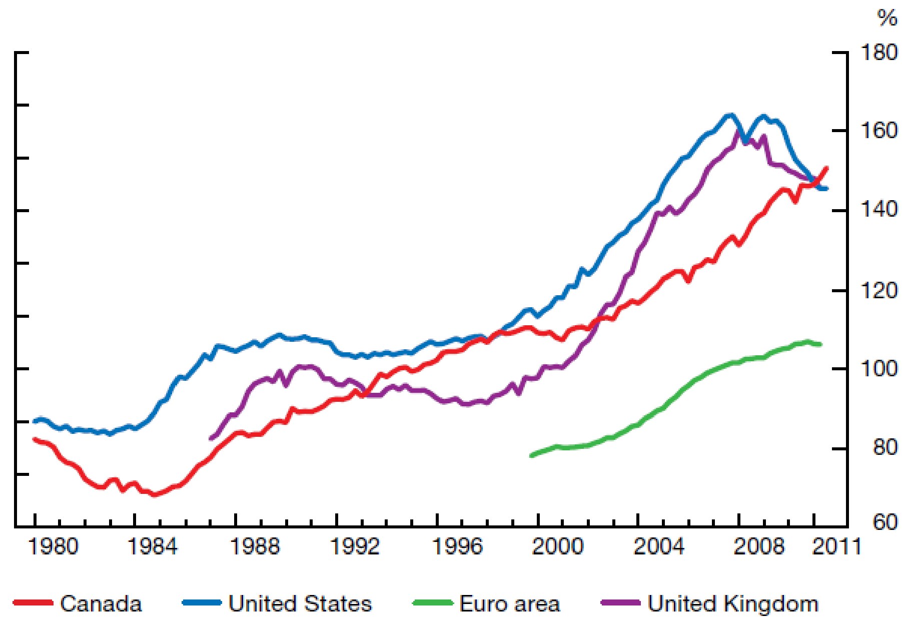


Source: North Shore News

Canadian Household Debt Level Soars to New High

Canadians have entered the debt danger zone that helped ignite the real estate crashes in Britain and the United States in 2007. According to Statscan, the ratio of Canadian household debt to income reached 163.4% in the 2nd. quarter, up from 161.7% at the end of 2011. As reported in the Globe and Mail, the much higher debt ratio is the result of revisions by Statscan for 2011, aimed at bringing its estimates of key economic data in line with international norms. The new methodology added about 11 percentage points to the 2011 debt ratio, previously estimated at 150.6%. Households are also wealthier, due in part to higher home values. Statscan revised its estimate of household net worth to $6.6 trillion (CAD) in 2011 from $6.3 trillion (CAD) and which has continued to increase this year to $6.9 trillion (CAD) to the end of June. Some economists are concerned about the similarities to the United States, where excessive debt to income ratios were a prelude to a huge housing crash. However, Toronto-Dominion Bank economist Francis Fong argues: "A gradual increase in interest rates by the Bank of Canada over the medium term will ultimately be required to ensure a more sustainable picture for household balance sheets. With mortgage rates at record low levels, there is still a big incentive for borrowing to resume acceleration."

Chart 1: Ratio of household debt to personal disposable income



Sources: Statistics Canada, U.S. Federal Reserve, Bank for International Settlements and U.K. Office for National Statistics

Last observations: Canada, United Kingdom and United States: 2011Q3; euro area: 2011Q2

Bank of Canada Vows Greater Monetary Policy Transparency

Following a speech in Nanaimo, B.C. Bank of Canada Governor Mark Carney stated: "Efforts by Finance Minister Jim Flaherty and the Office of the Superintendent of Financial Institutions (OSFI) to deter new mortgages are still having an impact on the housing market. We are watching with great interest the sum of those policies and their effect on the evolution of household debt. Raising interest rates to deflate a household debt bubble would be a last line of defence. However, if we were to lean against emerging imbalances in household debt, we would clearly declare that we were doing so and indicate how long we expect it would take for inflation to return to the 2% target range."

In Spain's Housing Crisis, Deep Discounts Attract Buyers

As recently reported in the New York Times, Spanish banks, which have been carrying a huge inventory of real estate assets – or listing them at only slight discounts – are beginning to slash prices, eager to exit the business of being landlords. Spaniards who remain employed are lining up to partake of the bargains. Certainly, no one expects Spain's housing backlog to disappear soon, given that the country has in excess of 1.2 million unsold new homes. While Spain is still far from getting its financial house in order, many Spaniards have not lost their passion for buying property at the right price. Many experts see the fire sale prices as the beginning of what will probably be a long untangling of Spain's real estate excesses. In the heady days of the construction boom, banks lent liberally to developers and homeowners alike, which resulted in billions of euros of bad loans when the economic crisis struck in 2008. Initially, the banks did everything they could to disguise the losses, including retaining property off the market, in order that its diminishing value could not be recorded. Even after numerous audits, note the true extent of the bad loans remains unclear as the recession continues. Last month, the Bank of Spain reported 9.9% of the country's bank loans were in arrears, up from 9.4% in August.

Most of these discounts are for apartments in huge developments in overbuilt tourist destinations or distant suburbs. Outside Madrid, Sesena, one of the country's most famous ghost towns, had stood virtually empty since the crash of 2008. However, several months ago, Santander, which owned 500 units, began to slash the prices. By January, the bank was advertising the last remaining units for sale at a third of their original price. More recently, the bank Banesto listed 1,800 units on its website at discounts of up to 80%, promising homes at prices not seen for two decades. The housing units were scattered nationwide. Everyone agrees that there are still Spaniards willing to invest in real estate as a way to safeguard their money. Rafael Valderrabano of Basico Homes noted: "The very rich have taken their money out of the country, but the average person still feels that property is a safe thing." Carlos Bode Vallespin, director of Banco Sabadell's real estate division Solvia, cited: "Even if they don't all pay, many of them will pay. Also, they will pay the taxes and maintain the property. Sabadell is eager to move quickly because its officials believe other banks will soon follow suit, competing for buyers in hard times. We need to be there first because demand is limited."

Why the Outlook Has Brightened for U.K. House Builders

"There is resilient and underlying demand for property" Source: U.K.Telegraph Media Group

In an article for the U.K. Telegraph, Bellway Group Chief Executive Officer John Watson writes: 'Amongst a backdrop of economic uncertainty, we at Bellway believe that the positive news of our third year of consecutive growth in volume, average selling price and operating margin I a promising signal that underlying confidence in the house building industry is starting to show its face. This confidence is thanks to a number of contributing factors that are driving the market. There is a resilient and underlying demand for property. As an industry, we are still building too few homes (output last year was only 120,000) in an environment where there is a trend away from apartments to houses with the larger family homes supporting growth in the average selling prices across the sector.

The Government appreciates that for the GDP to grow, it needs the construction sector to play its role; we are seeing support from the Government materialize in the release of surplus land and further allocation of funds for the First Buy scheme. This will help people who have previously been priced out of the marketplace to take their first steps on the housing ladder. Bellway has displayed a consistent financial performance throughout the financial crisis and is sticking with its strategy of growth in volume, average selling price and margin via a combination of changes in its product mix together with increasing completions on higher margin land. Given our geographic spread, our hands on approach to buying land, robust balance sheet and market share, we believe that Bellway is well placed to take advantage of the current environment and deliver continued growth for our shareholders and quality housing for our customers.

Summation

In this Economic Winter, we focus on the potential for a housing correction in our native country of Canada. Predictably, with housing prices doubling across Canada over the past decade, supported by record low mortgage rates and an influx of foreign buying, the country's housing market was rapidly outpacing the reach of the first-time buyer. Indeed, within this writer's community of West Vancouver, our real estate industry contacts confirmed that buyers from China were a major factor in pushing the local housing market to frothy levels. A housing bubble can represent a real threat to the Canadian economy.

Accordingly, we alert our domestic subscribers that the Bank of Canada and the Office of the Superintendent of Financial Institutions (OSFI) continue to monitor Canadian's household debt situation closely. Since the ratio of household debt to personal disposable income has reached a high of 163.4% as of the end of June, the central bank may initiate a monetary policy change to increase administered interest rates, notwithstanding the offsetting effect of a higher premium to the Canadian dollar, currently 101.92 cents (U.S.), and its potential negative impact on the country's exports within a weakening global economy.

We also highlight the current real estate trends in Spain, where dramatic price discounts have attracted buyers after four years of a virtually frozen housing market and in the United Kingdom, as seen from the perspective of a leading house building firm whose operations literally run the length and breadth of the country.

Subscribers and Canadians in particular, should remain cognizant of the fact that within the realm of global economic cycles, the world economy is still in the grip of the Kondratieff economic winter cycle. Ergo, no meaningful resumption of global economic growth can occur until the mantle of private and public debt has been expunged, or at the least, significantly reduced. Given the daunting challenges of the European sovereign debt crisis, the looming American 'fiscal cliff' crisis and not forgetting the U.S. statutory debt mountain now in excess of $16 trillion (U.S.); these economic headwinds will continue to consume several years of the forward calendar.

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"Those who cannot remember the past are condemned to repeat it." Santayana