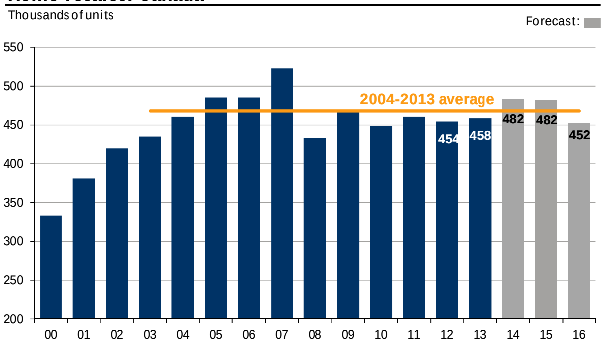
CANADIAN HOUSING FORECAST

January 15, 2015

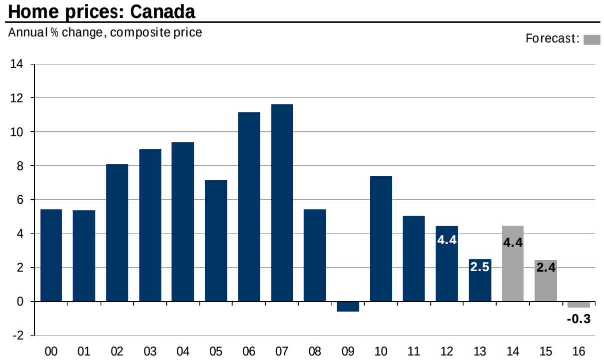
Opposing forces to keep Canada's housing market afloat in 2015 but downside risks mount

Home resales: Canada



Source: Canadian Real Estate Association, RBC Economics Research

Home prices: Canada



Source: Royal LePage, RBC Economics Research

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- We have updated our housing forecasts for Canada and the provinces to reflect recent changes to our outlook for the national and provincial economies, interest rates and oil prices. These changes include substantial downward revisions to oil price assumptions—to US$65 per barrel in 2015 and US$74 in 2016 (WTI, annual average basis)—a realignment of provincial economic growth (favouring Central Canada and BC at the expense of Alberta), and a lower path for longer-term interest rates (although they are still expected to rise).
- The factor having the biggest effect on our housing forecasts at the national level is the later-expected start to, and more subdued pace of, the increase in longer-term interest rates. This results in higher levels of home resales in Canada and slightly stronger price increases than we previously anticipated for 2015.
- Significantly lower assumed oil prices alter the provincial composition of forecasted housing market activity across Canada but have limited impact overall. We have downgraded our projections for home resales and prices in Alberta and Saskatchewan—similar adjustments in Newfoundland are not readily apparent in Atlantic Canada's aggregate numbers—however, we have also boosted projections in net oil-consuming provinces, including Ontario, Quebec and BC.
- Despite changes to underlying assumptions, our base-case scenario for Canada's housing market remains largely unchanged: we believe that rising interest rates and increasingly strained affordability will bring about a moderation of overall activity. On an annual basis, we expect this moderation to translate first into a levelling off of resales nationwide in 2015 before becoming an outright decline in 2016.
- Our base-case scenario projects fairly sizable resale declines in Alberta and Saskatchewan starting in 2015, although such would unlikely qualify as market 'crashes'. In fact, we expect home prices to continue to rise in Alberta in 2015, albeit at a much slower pace than in 2014.
- We anticipate that any softening in oil industry-sensitive markets will be offset by gains elsewhere in the country in 2015. More specifically, we believe that resales in BC, Ontario and Quebec have more room to increase before higher interest rates exert a significant cooling effect (more likely to take place in 2016). Accordingly, we expect home prices to rise at a decent clip in Ontario and BC in 2015 (price increases in Quebec will be restrained by plentiful supply).
- We continue to point to 2016 as a period most likely to prove challenging for Canada's housing market. Our scenario for interest rates shows a substantial cumulative rise by then, which we believe will cause resales to decline in all provinces that year. We also expect small drops in prices in the majority of provinces.
- Risks facing Canada's housing sector are significant, both on the downside and upside. Downside risks include a severe slump in the energy sector that would far exceed gains in other parts of the economy or any other event causing widespread job losses. Upside risks include lower-than-expected interest rates and a stronger-than-expected economy .

Forecast assumptions

%,

	2014	2015f	2016f
BoC overnight rate (year-end)	1.00	1.50	2.75
5-year bond yield (year-end)	1.34	2.30	3.20
Population growth (y/y)	1.1	1.0	1.0
Oil prices (WTI, avg. US$/bbl)	93	65	74
Unemployment rate			
Canada	6.9	6.4	6.3
British Columbia	6.0	5.7	5.7
Alberta	4.7	4.5	4.9
Saskatchewan	3.7	3.9	4.1
Manitoba	5.4	5.1	5.0
Ontario	7.2	6.6	6.3
Quebec	7.7	7.4	7.2
Atlantic	9.9	9.7	9.7

Elements of our macroeconomic outlook have changed since our previous housing forecast report,…

Our view continues to be that the overall Canadian economy will grow at a rate of 2.7% in 2015 (unchanged from our previous housing forecast report published in August 2014); however, we recently made changes to a number of key economic variables that have implications for our outlook for housing markets across Canada. Of note are sharply downwardly revised oil price assumptions for 2015 and 2016 (US$65 and US$74 per WTI barrel, respectively) that reset the forecasted provincial economic growth rankings. We no longer expect Alberta and Saskatchewan to lead the country in real GDP growth but rather see Ontario, BC and Manitoba taking the helm. More importantly, we have revised the timing and magnitude of the expected interest rate increases. Our current assumptions are that the Bank of Canada will start raising its overnight rate in Q3/15 (was Q2/15 previously) and that five-year bond yields (a key driver of fixed mortgage rates) will follow a more measured upward path—reaching 2.30% by Q4/15 and 3.20% by Q4/16—than the rapid climb to 3.30% by Q4/15 that we anticipated in August.

...requiring some adjustments to our housing scenario but not a wholesale re-thinking

We have altered our housing scenario in light of these revised assumptions to show 1) a downgraded housing outlook in Alberta and Saskatchewan (and in Newfoundland, although it is not readily apparent in the aggregate numbers for the Atlantic region), and 2) a modestly upgraded outlook for other provinces, including Ontario, BC and Quebec. Our updated housing scenario moreover takes stock of the greater-than-expected strength in market activity in the latter half of 2014 that owed in large part to an easing in mortgage rates. With mortgage rates still near generational lows as 2015 begins, we believe that the majority of Canada's housing markets will sustain higher levels of activity in the near term than we projected previously. That being said, the revisions to our forecasts represent a recalibration rather than a wholesale re-thinking of our scenario.

We continue to expect moderation in resale activity in Canada

The core of our scenario remains that it will be rising interest rates and increasingly strained affordability that will set the direction of the majority of markets across Canada. We expect these factors to cool homebuyer demand and moderate home resale activity, thereby causing the pace of home price increases to slow down nation-wide. We expect that above-potential growth in the Canadian economy will prompt the Bank of Canada to start removing monetary stimulus later this year and that longer term rates will begin to rise well before then. As interest rates normalize, affordability issues—already flaring up in some markets—will become greater obstacles to home ownership. Growth in household income will provide some offset, however.

Support persists for housing demand

While we expect Canada's housing market to face increasing headwinds, it will continue to be carried by tailwinds as well. Housing demand will continue to find support in factors such as demographics (e.g. fairly steady immigration) and reasonably upbeat economic conditions (including improving employment prospects) in most parts of the country, as well as still-low interest rates despite their projected rise. We expect these factors to keep pumping fuel into the market and smooth the transition toward lower levels of activity.

Home resales to level off in 2015

For 2015, we project the number of homes sold in Canada to be little changed (-0.1%) from 2014 at 481,500 units, and prices to rise by 2.5%, both marking substantial moderation from gains of 5.3% and 4.4%, respectively, in 2014. On a provincial basis, however, we project a fairly sizable 6.5% decline in resales in Alberta and 5.8% drop in Saskatchewan, where the effects of lower oil prices are likely to reverberate significantly on housing demand. Close to a full offset will come from modest forecasted gains in BC, Ontario and Quebec, however.

Alberta market expected to be down but not out

A drop of 6.5% in home resales no doubt would serve a blow to the Alberta market; yet, this would unlikely result in a knock-out punch. Markets such as Calgary and Edmonton start from very strong positions, whereby demand currently exceeds supply—both clearly were sellers' market in the late stages of 2014. If anything, the cooling effect on homebuyer demand from oil prices averaging US$65 in 2015 would contribute to re-balancing demand-supply equations in the province in the near term. Under such conditions, we expect further price increases in Alberta in 2015, albeit at a much slower pace (1.7%) than in 2014 (5.7%). We will monitor closely a recent surge in new listings in Calgary for any signs of a loss of confidence. The steep fall in oil prices below our assumption for the year clearly raises downside risks in Alberta.

Saskatchewan market more vulnerable

Compared to Alberta, there is much less of a buffer in Saskatchewan because the supply of homes available for sale is quite plentiful at the present time. In fact, home prices already began to decline in 2014, including in markets such as Regina. We project prices to drop by 2.0% overall in Saskatchewan in 2015.

Ontario, BC, Quebec markets likely to keep marching forward

A lower expected flight path for interest rates, sharply weaker oil prices and accelerating economic growth bode well for markets in Central Canada and BC to advance further in 2015. We forecast home resales to rise modestly to historically-high levels in Ontario (209,200 units) and BC (84,900 units), supporting the stronger price gains (3.5% and 3.1%, respectively) in Canada. We also project a modest increase in resales in Quebec, although to a level (72,300 units) that would remain below the 10-year average in the province (75,300 units). Substantial supply—particularly for condominium apartments—will restrain price rises to just 1.8% this year overall in the Quebec market.

Markets in Manitoba and Atlantic Canada to remain mostly static

We expect renewed vigour in Manitoba's economy in 2015 fuelled by a resurgent manufacturing sector to be positive for housing demand and support elevated resale activity in the province; however, with the number of homes sold having reached a record-high in 2014, we see little scope for a further gain this year. We project Manitoba resales to stay unchanged at an all-time high of 13,900 units in 2015, strong enough to support a price increase of 2.2%. In Atlantic Canada, weak demographics—population is declining in New Brunswick and Newfoundland and Labrador, and barely rising in Nova Scotia—will continue to weigh on housing market activity. We expect a third-consecutive annual decline in resales (-1.9%) in the region in 2015. Sharply lower oil prices are likely to add downward pressure in the Newfoundland market. We project home prices in the region to rise just slightly by 0.9%.

2016 looks more challenging

Our interest rate scenario shows a material cumulative rise in longer term rates by 2016, and we believe that this will pose increasing challenges for affordability and homebuyer demand across Canada. We expect resales to fall in all provincial markets next year as a consequence. In the aggregate, we forecast a fall of 6.2% to 451,700 units overall in 2016, the largest drop since 2008 (17.1%). That being said, the level would be only 4% below the 10-year average, hardly consistent with a deep slump. Even in Alberta, where we project a second-straight sizable decrease in resales (-9.0%), the level of activity would still be above what it was in 2012 in the province, which would unlikely qualify as a 'crash'. We expect cooler demand to drive prices down in many provinces in 2016—including BC, Ontario and Quebec—thereby causing prices at the national level to dip by 0.3%. It is important to note that pricing conditions in 2016 are likely to vary substantially not only across provincial and local markets but also across segments within these markets. For instance, we would expect prices for single family homes to show more resilience than prices for condo apartments in Ontario.

There are downside risks arising from the oil price slide…

The plunge in oil prices poses significant downside risk to the outlook for housing markets where the oil industry has a strong presence like Alberta. Our base-case housing scenario shows a moderate hit in Alberta—and to a less extent, Saskatchewan—from US$65-$74 oil; however, things could get a lot more challenging should oil prices linger at much lower levels than we assume for an extended period of time. Persistence of oil prices in the US$40 to US$50 range (WTI), for example, eventually could lead to a material fall in property values in Alberta if it causes its economy to tumble. That being said, it is important to note that the transmission channel is far from direct between oil prices and home prices, and that possibly a year or two would elapse before the market would be most affected. Moreover, we would expect any risk of contagion to other markets to be mitigated by the attendant economic benefits of lower oil prices in provinces that are net oil consumers. Therefore, we believe that so long as the Canadian economy continues to grow, the sharp drop in oil prices, on its own, is unlikely to become a trigger for a widespread housing meltdown in Canada, even if it is more severe than we anticipate.

...and vulnerability to other types of unexpected negative shocks

Still, Canada's housing market is in a delicate position to withstand a sharp deterioration in the economy. Household indebtedness is near record-high, property valuations are stretched in many markets, there has been a lot of new units built (and still under construction) and interest rates have limited room to drop to provide help. Any economic developments causing widespread employment losses, for instance, would put the health of the household sector at risk and threaten the stability of Canada's housing sector.

There are upside risks too!

Canada’s housing market defied many predictions of corrections in recent years and it could do the same again during 2015-2016. Interest rates may not rise as much—or at all—as we assume, and continue to stimulate growth in homebuyer demand. Stronger-than-expected growth in the Canadian economy (fuelled by a booming US economy, for example) or rapid increases in net migration also may support further housing gains.

Home resales forecast (units)

	2008	2009	2010	2011	2012	2013	2014f	2015f	2016f
Canada*	433,100	466,200	447,900	459,800	454,300	457,800	482,200	481,500	451,700
	-17.1	*7.6*	*-3.9*	*2.7*	*-1.2*	*0.8*	*5.3*	*-0.1*	*-6.2*
British Columbia	68,900	85,000	74,600	76,700	67,600	72,900	83,600	84,900	79,600
	-33.0	*23.4*	*-12.2*	*2.8*	*-11.9*	*7.8*	*14.7*	*1.6*	*-6.2*
Alberta	56,000	57,500	49,700	53,800	60,400	66,100	72,300	67,600	61,500
	-21.1	*2.7*	*-13.6*	*8.2*	*12.3*	*9.4*	*9.4*	*-6.5*	*-9.0*
Saskatchewan	10,500	11,100	10,900	13,100	13,900	13,500	13,800	13,000	12,700
	-16.0	*5.7*	*-1.8*	*20.2*	*6.1*	*-2.9*	*2.2*	*-5.8*	*-2.3*
Manitoba	13,400	13,100	13,100	13,900	13,900	13,700	13,900	13,900	13,400
	-3.6	*-2.2*	*0.0*	*6.1*	*0.0*	*-1.4*	*1.5*	*0.0*	*-3.6*
Ontario	182,300	197,000	196,700	201,800	197,600	198,700	206,300	209,200	195,600
	-15.1	*8.1*	*-0.2*	*2.6*	*-2.1*	*0.6*	*3.8*	*1.4*	*-6.5*
Quebec	76,800	79,100	80,000	77,200	77,400	71,200	71,200	72,300	68,400
	-4.7	*3.0*	*1.1*	*-3.5*	*0.3*	*-8.0*	*0.0*	*1.5*	*-5.4*
Atlantic Canada	24,500	22,800	22,500	22,900	23,100	21,200	20,600	20,200	19,900
	-6.8	*-6.9*	*-1.3*	*1.8*	*0.9*	*-8.2*	*-2.8*	*-1.9*	*-1.5*

* Includes sales in the Territories.

Annual percent changes are in italics.

Source: Canadian Real Estate Association, RBC Economics Research

Home price forecast

Composite price	2008	2009	2010	2011	2012	2013	2014f	2015f	2016f
Canada*	299,600	297,800	319,800	336,000	350,900	359,500	375,400	384,600	383,300
	5.5	*-0.6*	*7.4*	*5.1*	*4.4*	*2.5*	*4.4*	*2.5*	*-0.3*
British Columbia	457,100	447,000	493,000	525,100	528,200	524,100	546,700	563,400	553,100
	7.6	*-2.2*	*10.3*	*6.5*	*0.6*	*-0.8*	*4.3*	*3.1*	*-1.8*
Alberta	346,800	324,400	330,500	330,100	339,600	353,000	373,000	379,500	379,800
	-6.3	*-6.5*	*1.9*	*-0.1*	*2.9*	*3.9*	*5.7*	*1.7*	*0.1*
Saskatchewan	295,300	288,800	307,700	321,600	341,400	355,100	353,800	346,900	346,400
	24.6	*-2.2*	*6.5*	*4.5*	*6.2*	*4.0*	*-0.4*	*-2.0*	*-0.1*
Manitoba	220,600	232,800	254,900	268,700	286,000	299,800	305,700	312,500	315,600
	9.8	*5.5*	*9.5*	*5.4*	*6.4*	*4.8*	*2.0*	*2.2*	*1.0*
Ontario	314,900	313,100	337,400	355,600	379,000	393,400	417,200	431,700	431,200
	6.1	*-0.6*	*7.8*	*5.4*	*6.6*	*3.8*	*6.0*	*3.5*	*-0.1*
Quebec	210,000	216,800	231,900	245,200	255,300	259,500	267,600	272,300	271,100
	6.1	*3.2*	*7.0*	*5.7*	*4.1*	*1.6*	*3.1*	*1.8*	*-0.4*
Atlantic Canada	187,200	194,200	203,600	213,300	223,200	227,800	230,600	232,600	233,100
	8.5	*3.7*	*4.8*	*4.8*	*4.6*	*2.1*	*1.2*	*0.9*	*0.2*

* Weighted average, using provincial population as weights.

Annual percent changes are in italics.

Source: Royal LePage, Statistics Canada, RBC Economics Research