

The Canadian Housing Industry Economic Update



Monthly Report

January 2011

Looking Back

This time a year ago we were optimistic on Canada's economic prospects and were calling for a good year for Canada's new home builders in 2010. Back then we had downgraded the risk of a double-dip recession into the remote category and housing starts were projected to increase in 2010 by about 23% to an annual total of 175,000 units. Such a possible construction outcome was described as respectable performance by past historical standards.

The risks that we saw a year ago for Canada's economy were expected to come later in 2010 and also in 2011, when government fiscal stimulus would be winding down; when another stock market decline might occur; and when households would be facing elevated levels of debt.

Earlier Housing Bubble Worries

There was much concern a year ago about a housing bubble. We were warned that houses were over-priced by 15% to 35% relative to normal relationships with rents and incomes. However in our view, these relationships were misleading. In addition, prices for new homes told a different story as we began 2010. In western Canada, most major cities were showing significant yr/yr declines. Looking at central and Atlantic Canada, the same message came through. The only major city showing more than a 2% yr/yr increase was Quebec City. Looking more closely at Ontario, there was no sign of excessive new house price increases anywhere.

The Scorecard

We were too pessimistic a year ago in our 2010 housing outlook. As we begin 2011, we can say that the housing market is in a healthy balance. Existing home sales are running at sustainable levels. Bubble worries are a thing of the past. Starts have been stronger than anticipated. In 2010, they ran at an annualized rate either in excess of, or close to 190,000 units for 10 out of 11 months. December estimates are not available yet. Media reports were misleading as initial monthly starts reports were consistently revised upwards. The revisions never received much attention though.

December 2010 starts figures will not be released until the New Year, but it is safe to say that housing starts in 2010 will end up totaling around 192,000 units - well above our beginning of the year forecast. It is an increase of 29% from the 2009 actual, which is now shown to be 149,081 units.

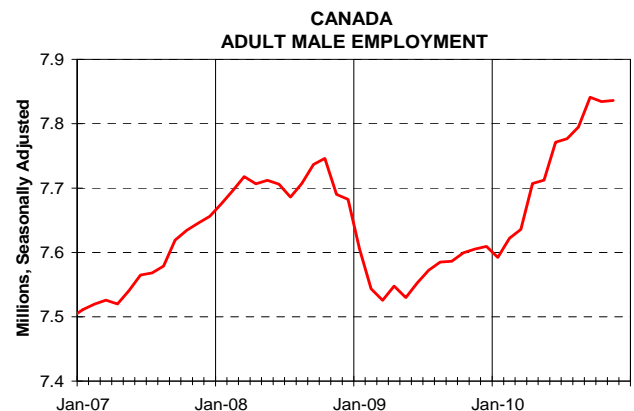
Mortgage Rates

We finished the year with better economic fundamentals than had been expected. Mortgage interest rates remained remarkably stable at historically low levels.

The Bank of Canada increased its overnight target rate three times but mortgage rates were not affected. The year 2010 began with special offer rates on 1-year and 5-year mortgages at 3.00% and 4.19%, respectively. They show very little change since then. The 1-year rate is currently 3.05% and the 5-year rate is 4.24%. Mortgage rates will continue to be very "housing friendly" through the home builders' 2011 spring selling season. A significantly higher mortgage rate environment is unlikely until 2012.

Job Creation

Canada has experienced substantial full-time job creation. The latest figures show that there have been 318,000 jobs created in Canada over the 12 months ending in November 2010. Of this amount, 192,000 or 60% have been full-time jobs. The gains in adult male employment since early 2010 have been particularly impressive. Adult male employment is a key indicator for both housing and renovation demand. Adult male employment has increased by 231,000 over the 12 months ending November, and 97% of these jobs have been for full-time work.



Don't be confused by media statements that all or most of Canada's employment job growth is in part-time jobs. The confusion is caused by looking at yr/yr percent changes which show part-time employment up by 4.0% and full-time by 1.4% over the past 12 months. This comparison misleads because it neglects the size of the base. Full-time employment is a much larger number and a 1.4% yr/yr increase gives a much larger actual employment increase than a 4.0% yr/yr increase does for part-time work.

Looking Ahead

Be sure to check the date stamp on the label for any economic forecast for next year. The U.S. economy appears

to have advanced at an above-potential rate in the final quarter of 2010 and the outlook for 2011 is now much better as a result of the December U.S. fiscal stimulus package. It will keep the U.S. growing at an above-potential rate in 2011.

The compromise 2010 Tax Relief Act does more than extend Bush era tax cuts. It provides a wide range of tax cuts and benefit extensions going beyond a mere extension of the tax regime already in place. It will combine with the second round of quantitative easing. The Fed will purchase \$600 billion of longer dated U.S. Treasury securities by June 2011. This all amounts to a large amount of additional economic stimulus. The U.S. economy now seems capable of real GDP growth of almost 4.0% in 2011.

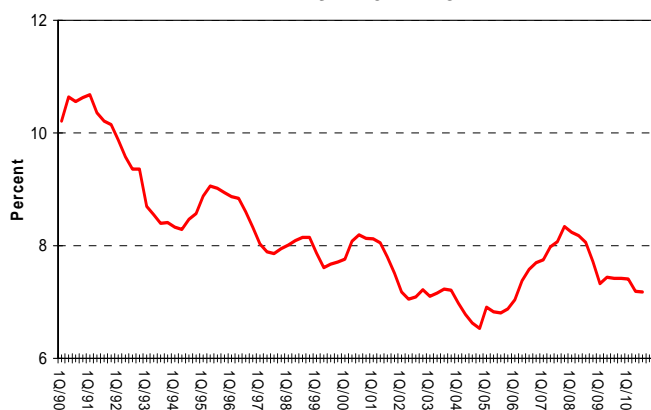
Canada's Economy in 2011

With Canada's best customer shifting into an above-potential growth rate in 2011, Canada's export performance will improve. This has been the weak link in Canada's economy. There has been plenty of domestic demand in Canada – real consumption has been growing at almost a 4% rate and plant & equipment has been showing double digit growth. However, there was a big import drain in 2010 and exports slumped. Looking ahead, Canadian exports will be helped by accelerating economic activity in the United States. We expect Canada to at least match and perhaps show a growth premium over the United States in 2011 as a new global commodity cycle takes hold. Canada did not suffer as much financial damage as the U.S. during the crisis.

Household Finances

Canada's household debt levels are making headlines and undoubtedly will put its economy and Canada's housing sector in a vulnerable position when the next recession inevitably arrives. However, this is not in our short-term planning horizon of the next two years. For now, it is the cost of servicing debt that matters, not the actual level of debt.

CANADA DEBT SERVICE RATIO

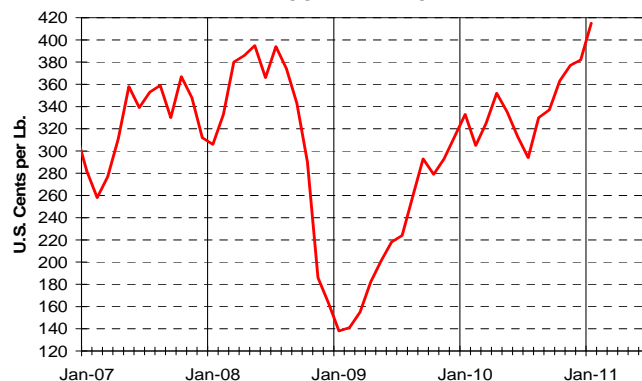


The reality is that households can afford to carry their debt. The share of disposable income taken up by debt payments is close to a historic low and is on a downtrend. In addition, asset values have been increasing as fast as debt. The ratio of debt to household net worth has been moving sideways. The debt story will not be a problem until the debt service ratio is much higher than it is today.

Costs and Prices

Above potential growth in the U.S. will reinforce our forecast that the global economy has already begun a new commodity cycle. Energy, base metals and lumber prices are expected to continue to rise. The exception will be natural gas where the market is expected to be over-supplied through mid-decade.

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An upturn in residential construction in the U.S. is expected to add to capacity pressures in building materials markets. We are forecasting U.S. housing starts to recover to 800,000 units in 2011 and expect them to reach 1.15 million units by 2012. This would be the first time in four years that U.S. starts have exceeded 1.0 million units. Our recovery outlook for U.S. housing starts is based on our expectation that the U.S. unemployment rate will begin to move down sharply starting next summer. Canadian new home builders can therefore expect continuing increases in lumber prices as well as a range of other building materials prices. Elevated levels of non-residential construction will also put some categories of construction workers in short supply.

Residential Renovation

The Home Renovation Tax Credit (HRTC) applied to work performed, or goods acquired before February 1, 2010. Its impact was concentrated in Q4/2009 and Q1/2010. Since then renovation activity has declined but it is still running at a rate that is 10.9% above its 2009 annual level in price-adjusted terms. Given the recent gains in resale housing activity and the positive outlook for the stock market, we expect a near double digit growth rate in 2011.

FORECAST SUMMARY

		2Q10	3Q10	4Q10	2010	2011
CPI	(% ch. from yr. ago)	1.7	1.8	2.4	1.9	2.0
PRIME RATE	(end of period)	2.50	3.00	3.00	3.00	3.75
HOUSING STARTS	(000's annualized)	198.5	190.4	180.0	192.0	180.0