

The Canadian Housing Industry Economic Update



Monthly Report

June 2010

No Interest Rate Overkill

The basic message is that inflation is not a problem at present and that Bank of Canada rate increases are unlikely to be large enough to produce interest rate overkill for Canada's new home builders. The BOC is not shifting to a tightening mode. Instead, it is merely moving away from the emergency rate settings of 2008 and 2009 now that the economy is showing that it is strong enough to expand without the aid of such extreme policy support.

Low Inflation Risk

Consumer prices rose by 1.8% yr/yr in April but most of the acceleration reflected energy prices. Excluding energy, the yr/yr increase in the CPI was only 1.1% in April. The Bank of Canada's preferred core inflation measure, which excludes the 8 most volatile items from the index, showed a 1.9% yr/yr April increase, following a 1.7% gain in March.

Headline inflation will be pushed higher by a bit more than half of one percent because of the harmonization of the GST and provincial sales taxes in Ontario and B.C. on July 1st. However, this will be a temporary bounce which will soon fade. The BOC will look through the jump in inflation caused by the HST to the underlying trends in costs and prices in Canada, which are expected to remain stable.

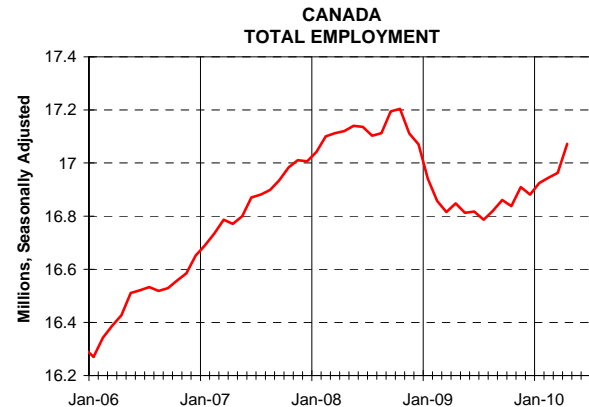
Strength in Consumer Spending

The latest retail sales report is very strong. The value of retail sales showed the largest monthly increase in five years. The gain in February was also revised upwards from the initial estimate a month ago. In price-adjusted volume terms, sales surged by 2.2% (a 30% annual rate) between February and March. This means a strong 1st Quarter GDP advance, supporting our prediction of a Canadian V-shaped recovery.

The latest employment news suggests that strong growth momentum in consumer spending and GDP has continued in Canada into the 2nd Quarter. The 109,000 increase in total employment between March and April was the largest monthly advance since 2002. All of the increase was in the private sector. A large share of the employment gain was among adult males (aged 25 and over). Since the upturn in the job market began last August, job-creation has been concentrated in full-time work.

Good News for Housing

Strong employment gains are good news for both new home builders and renovators. They are an essential prerequisite for personal income growth and consumer confidence. Canadians are showing the willingness to make big-ticket durable goods purchases and this is spilling over to housing.



The spring selling season is now coming to an end and looking ahead, the employment recovery points to a resumption of active new home sales activity in the fall. One thing that could go wrong, however, would be an economic shock from Europe's sovereign debt crisis. The linkage would be through the stock market. A decline of several thousand points in the Dow Jones Industrial Average or the S&P/TSX would definitely disrupt home buying and renovation plans. This would only happen, however, if investors lose confidence in the effectiveness of the EU/IMF emergency bail-out package for Europe.

The European Debt Crisis

Europe's fiscal statistics are alarming and Greece's debt load appears to be overwhelming. There is a high probability of another European recession, even with the EU/IMF emergency bailout package. It is not a long-term solution and it must be supplemented by severe fiscal tightening and a coordinated European fiscal policy. There is no easy way out as the debt-burdened countries are unable to devalue their currencies. At this point it is unthinkable that even the weakest countries might abandon the euro.

They could conceivably be forced to renegotiate their debt. This would probably take the form of an extension in maturity rather than outright default on government bonds. Europe's crisis is therefore a threat to the global economic outlook. Even in a best case outcome, the IMF forecast of global real growth of over 4.0% in 2010 and 2011 could prove to be overly optimistic. However, if the European bail-out fails, or even appears shaky, and worries resurface about Greece's ability to meet its debt commitments, financial market turmoil could spread and pull everyone down again.

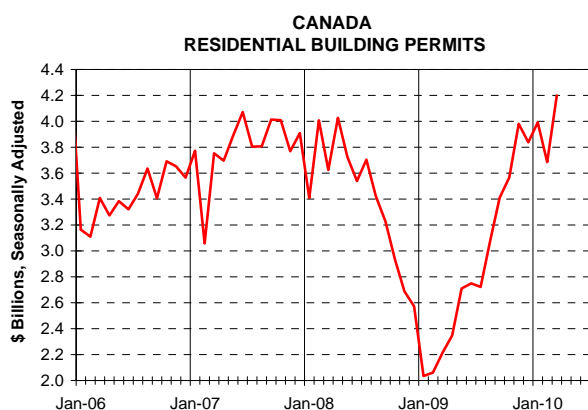
Canadian Dollar Volatility

The Canadian dollar is directly affected by the European crisis. It closed at a high for the year at 1.0012 USD on April 20th before the European crisis intensified.

It then plunged to a closing rate of 0.9365 on May 20th. Despite its strong banking system and its relatively healthy outlook for government budget deficits, the Canadian dollar has been pushed lower by developments in Europe. We can expect that any further bad news on Europe's government debt problems would push the CAD down even further.

Troubles in Europe are interpreted as a shock to the global economy. This is having a negative impact on confidence in commodity markets and hence the CAD. A backing away from parity with the USD is not in itself bad news for the Canadian economy and the housing industry, as a lower-valued CAD will be supportive for the employment rebound in Canada that is currently underway.

Housing Starts Have Momentum

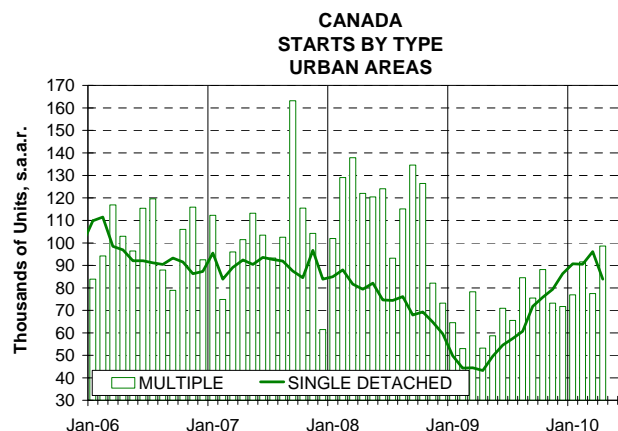


Building permits are a leading indicator for housing starts and they are currently telling us that we have not yet seen the peak in Canadian housing starts. Permits are indicating that the annualized housing start rate could reach 220,000 units this summer. The latest permit report shows a strong monthly increase, driven by a surge in the multi-family category to its highest level since the summer of 2008. This is good news as it indicates that high-rise condo projects that were postponed during the recession are now being started up. Ontario and British Columbia accounted for most of the increase in these multi-family building intentions in the latest month.

New Housing Forecast

Housing starts have been running higher than industry expectations for some time now. They moved up to 201,700 units s.a.a.r. in April from an upwardly revised 199,200 the month before. There was also an upward revision to 189,000 in January and 200,400 in February. As a result, starts averaged 196,000 units at annual rates in the 1st Quarter, up from 177,800 in the 4th Quarter of 2009. Housing start forecasts are still moving higher despite the BOC prediction of a marked weakening in the remainder of 2010.

We are now revising our forecast upwards to 210,000 starts in 2010. Previously we had been in a range of 190,000 to 210,000. A more optimistic outlook for high-rise multi-family construction has prompted us to move to the upper end of this range. High-rise condo developers are becoming more confident in the sustainability of Canada's economic expansion. This is being confirmed by Canada's remarkably strong employment recovery. In addition, they are experiencing an easing in credit conditions.



Housing-Friendly Mortgage Rates

Recent mortgage rate declines are also a positive factor for the housing outlook. Banks reduced mortgage rates twice in May. Special offer rates for 1-year mortgages are currently around 3.30% and for 5-year mortgages, around 4.60%. Even though the BOC will be raising rates, it is expected to be a gradual process. In addition, Europe's financial crisis is having the effect of supporting U.S. and Canadian government bond prices and keeping long-term interest rates low. It will in all likelihood stretch through all of this year and into 2010 as well. As a result, we are expecting a housing-friendly interest rate environment.

Tax Effects

The Home Renovation Tax credit was very successful in stimulating renovation. Worries that spending might have been brought forward and that there would be a big renovation slump after the program ended were valid fears but appear to have been over-done. Retail sales at building material dealers have been very strong going through the month of March, well after the end of the HRT credit.

The harmonized sales tax (HST) effect on new home sales remains uncertain. Some builders may have adjusted prices for the HST for homes selling above threshold price levels some time ago, thereby removing the possibility of a negative affordability effect after the HST starts on July 1st.

FORECAST SUMMARY

		4Q09	1Q10	2Q10	2009	2010
CPI	(% ch. from yr. ago)	0.8	1.6	1.8	0.3	2.6
PRIME RATE	(end of period)	2.25	2.25	2.50	2.25	3.25
HOUSING STARTS	(000's annualized)	178.4	198.9	202.0	149.1	210