

# The Canadian Housing Industry Economic Update



Monthly Report

March 2011

## A New Recovery Phase

The economic cycle in the U.S. and Canada is entering a new phase. After a year and a half of slow economic recovery, the North American economy is gaining traction and picking up speed. In the U.S., the pace of economic activity has accelerated to a 4.0% real growth rate in early 2011.

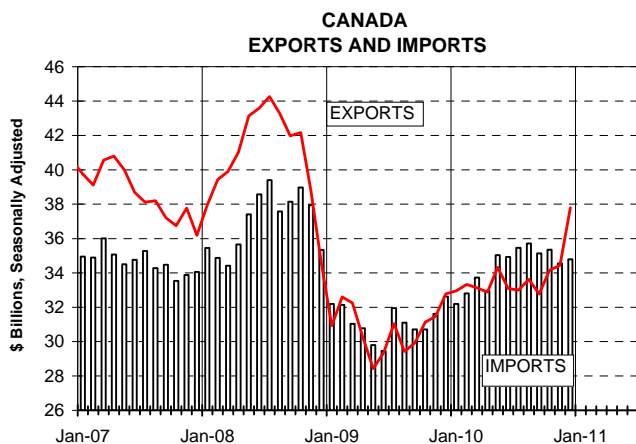
The recovery is now more broadly based and a self-reinforcing process is now underway. We expect that 2011 will be the first true recovery year in the U.S. and that a 4% real GDP growth rate can be maintained through to year-end.

As a result, Canada's economic prospects are looking better than they were just a month ago. The new home building and renovation industries in Canada will be supported by improving economic conditions this year. High levels of household debt are a valid concern as interest rates will inevitably move higher this decade, thereby increasing the cost of debt servicing. However, the key issue is timing.

For now, household interest payments as a share of disposable income are running close to record lows. In the aggregate, Canadians can afford to carry their debt. In addition, household sentiment will be on the rise as a result of employment and income gains. The problems facing new home builders and renovators in 2011 are more likely to be associated with cost pressures than a shortage of demand.

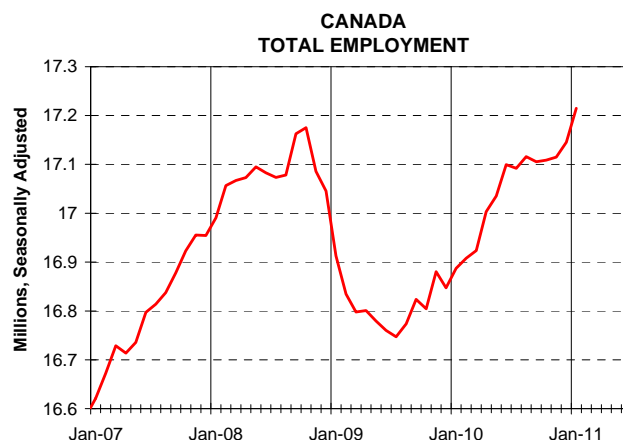
## Strong Export Growth

The recent surge in Canadian exports is a game-changer. This had been the missing link for Canada's economy. There was plenty of domestic demand last year but exports were stagnant for most of the year. This all changed in December. The monthly export increase was outstanding – the largest in almost 30 years. Energy exports accounted for over half of the advance with two-thirds of this reflecting volume gains.



There was widespread export strength elsewhere, with solid advances in metals, industrial goods, machinery, aircraft, wood pulp and wheat. This is a sign that Canada's trading partners have finally reached a recovery stage that will allow Canadian exports to make a serious economic contribution to employment, income and homebuyer sentiment.

## A Job-Creation Revival



After moving sideways through the summer and fall, employment is again showing strength. Total employment increased by 69,000 between December and January. This is a much larger increase than had been expected. Another good sign is the recent improvement in hiring in the manufacturing industries. Manufacturing employment showed an encouraging monthly increase of 66,000 in December and maintained this higher level in January.

A continuing employment uptrend is expected in the months ahead. Canada seems capable of matching the 4% real GDP growth rate in the U.S. and this will be strong enough to generate healthy employment gains. There has been a misconception that part-time work accounts for most of Canada's employment recovery. In fact, the exact opposite is true. Over the 12 months ending January, total employment increased by 327,000. Full-time employment increased by 236,000 over this period and accounted for 72% of the increase in total employment.

The confusion is caused by looking at percentage increases rather than the actual head-count. The number of full-time workers is much larger than the number of part-time workers. Given the larger base, an increase of 236,000 translates into a 1.7% 12-month increase. With a smaller starting point, a 91,000 increase in part-time employment reflects a 2.8% 12-month gain. Statistics can be confusing. The point is that there has been substantial full-time job growth and that it is big enough to support housing demand.

## The Inflation Outlook

Inflation is a controversial issue. Some economists think deflation is a continuing threat. More than 210 million people across the globe are unemployed. This is up by more than 30% from 2007, before the global recession began. The U.S. Federal Reserve is also concerned about the risk of deflation. That is why it began an extensive second round of quantitative easing (long-term bond buying) last November.

This monetary policy technique is intended to raise inflation expectations. Another objective is to boost stock prices and other asset prices. Lower bond yields push investors into riskier holdings. Risk-adjusted discount rates are also lowered, thereby increasing the present values of future dividend, earnings and rental income flows. This means higher stock prices and higher values for commercial real estate. It seems strange that the U.S. central bank has actually been trying to move inflation higher.

So far, quantitative easing has proved to be very good for the stock market. This is benefitting Canada's home builders. Higher equity prices have a positive effect on confidence and also help with the financing of home buying and renovation plans. Canada's major stock market index has tracked the rebound in the U.S. stock indexes. The Dow Jones Industrial Average has increased by 12% since the end of November, while Canada's S&P/TSX is up by over 9%.

## Commodity Inflation

Core CPI inflation remains very low in the United States. It moved from 0.6% yr/yr in October to 1.0% yr/yr in January. The latest figures show the Bank of Canada's measure of core inflation at 1.5%. With unemployment rates still high in both countries and aggregate wage inflation showing only subdued increases, there would not seem to be any reason for Canada's new home builders and renovators to worry about price and cost pressures.

This could be a dangerous conclusion, however. We are currently experiencing another commodity inflation shock. It is global in nature but also has aspects that are specific to North America. The upward price movement is widespread, affecting base metals, lumber and energy. A wide range of food and non-food agricultural commodities are also affected. Wheat, corn, soybean, cotton and rubber all show sharp price increases. Wheat prices are up by more than 80% in the past year. Such commodity price moves are affecting expectations and are fuelling the price surge.

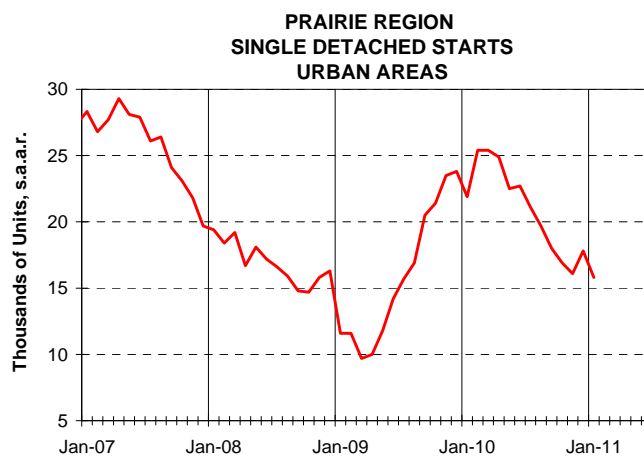
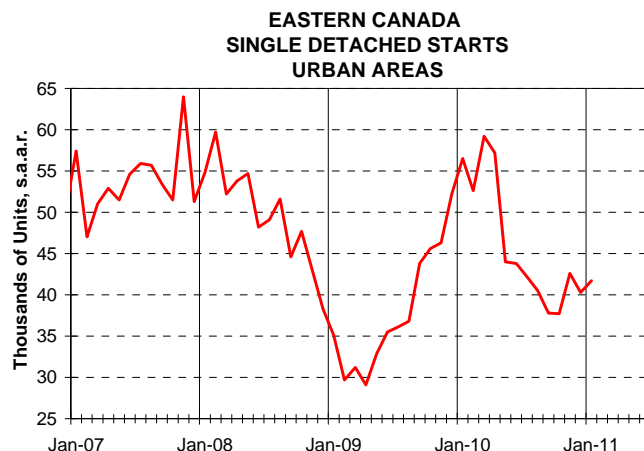
As the economy strengthens, there will be a tendency for manufacturers to attempt to pass through higher input costs into final prices. New home builders are at risk of continuing upward price pressure on lumber and a wide range of building materials and supplies.

## Interest Rates

Accelerating U.S. and Canadian economic growth, a revival in Canadian job-creation and the risk of a spill-over effect from commodity inflation are likely to advance the timing of the next Bank of Canada interest rate increases. It will probably begin to raise its overnight target rate again by the summer. Our guess would be at the July 19<sup>th</sup> interest rate announcement date. By then, the U.S. economy is expected to be generating an average of around 250,000 new payroll jobs per month. This will create expectations of future Fed interest rate increases and could dampen the effect of Bank of Canada rate increases on the Canadian dollar.

## Housing Starts

Single-detached housing starts have been on a pronounced downtrend at the national level that was partly offset by strength in high-rise condo construction starts. Single-detached starts in eastern Canada (Ontario, Quebec and the Atlantic Provinces) have recently stabilized and have moved higher, but the trend is still downward in the West.



### FORECAST SUMMARY

		3Q10	4Q10	1Q11	2010	2011
CPI	(% ch. from yr. ago)	1.8	2.3	2.3	1.8	2.3
PRIME RATE	(end of period)	3.00	3.00	3.00	3.00	3.75
HOUSING STARTS	(000's annualized)	191.5	178.7	173.0	189.9	178.0