

Housing Rebound in Canada Spurs Talk of a New Bubble

By PHRED DVORAK

TORONTO—Dominic Carrasco first tried to sell his studio apartment here in January 2009. The only offers the 42-year-old massage therapist got were well below the 166,900 Canadian dollars he'd paid for it five years earlier.

Last month, Mr. Carrasco tried again. The condominium was snapped up by the woman in charge of posting the information to the real-estate listing site, for C\$209,900, or US\$196,003, 40% more than the highest bid last year.

"I couldn't believe it," says Mr. Carrasco, who says he's both relieved and unsettled by his change in fortune. "If my condo can go up that much in one year, it doesn't make sense."

As the U.S. struggles to get out of its housing slump, its neighbor to the north faces a different challenge: Canada's housing recovery has been so rapid that some here are worrying about a bubble.

Last Wednesday, a housing-price index for Canada's six biggest cities posted its seventh straight monthly gain, showing home prices in November are now back to their prerecession peak. Another broader measure shows the average home price in 2009 hitting a record. Home building has picked up too, with housing starts in December jumping to their highest level since October 2008. Economists expect that growth to continue when January figures are released Monday.

Canada's finance officials say they're watching home prices carefully. The finance minister in December outlined steps he can take to cool things down, if needed. The central bank last month said it is watching the booming market with "vigilance, but not alarm."

Some observers foresee trouble. "It's a mania. It's going to end badly," says Garth Turner, a former cabinet member who just published a book predicting that prices of real estate and other assets will fall.

Several other nations have taken action over concerns that their real-estate markets are heating up too quickly. In China, a housing boom has been lifting property prices at a 20% annual rate, helping fuel economic expansion of more than 8% in 2009. As evidence of a Chinese real-estate bubble mounts, the government there has tightened controls on bank lending. In South Korea, record-low interest rates led to frenzied home

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buying, and the government last year lowered the maximum amount that would-be homeowners can borrow.

In Canada, nearly 40% of gross domestic product historically is generated by exports, mainly to the U.S., where economic weakness persists. To stimulate its economy, the government has focused on the domestic slice. In an effort to boost internal consumption, it has kept a key interest rate near zero—resulting in exceptionally low mortgages rates—and has offered various financial incentives and tax credits.

Consumers have responded. Average home prices in Canada have risen 23% from their trough in January 2009. Home-sales volumes are up 70% over the same period.

Canada never had the kind of bubble created by risky "subprime" home loans that the U.S. had, thanks in part to conservative lending practices. The S&P Case-Shiller index—a U.S. index of home prices in 20 cities—more than doubled between January 2000 and late 2006, then fell 33% during the economic slump. In Canada, a similar home-price index of six major cities rose 90% between 2000 and mid-2008, but fell only 9% during the slump.

Not everyone agrees that Canada's recent price increases are cause for concern. Bubble skeptics say they aren't yet seeing other symptoms of froth such as speculative buying, looser lending standards or a run-up in land prices. Canada's central bank and finance ministry say there isn't currently any reason for alarm.

But some economists who are concerned point out that home prices are rising far faster than other measures of economic health. The 2009 price increase of more than 20% came as personal income in Canada fell nearly 1% and total employment was 1.4% lower than the year earlier. In a December report, the Bank of Canada warned that household debt—largely mortgages—was 1.42 times disposable income during the second quarter of 2009, a record high.

Another possible danger: Because Canadian banks typically reset adjustable-rate mortgages every few years, those who are buying now at low rates will likely see increases soon. [Toronto-Dominion Bank](#) forecasts suggest that the rate to which many Canadian mortgages are pegged, the prime rate, could nearly double by the end of 2011. The Bank of Canada warned in its December report that if interest rates increase as expected, by mid-2012 about 9% of Canadian households could have so much debt that they'd be "financially vulnerable."

"This is exactly what happened in the U.S., when affordability had moved way out of whack with prices," says David Rosenberg, an economist who witnessed America's

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housing bubble at Merrill Lynch in New York, and now sees similar trends up north from his post at Toronto-based wealth-management firm Gluskin Sheff.

The Canadian housing market's roller-coaster ride began in September 2008 with the collapse of Lehman Brothers in the U.S. and the freeze in global credit markets.

Brad Lamb says his Toronto real-estate firm noticed a drop in buyers. Sales volume plummeted and the company lost money, he says. Heather Holmes, one of his top agents, says that at one point she was handling 17 sellers at the same time, but had only a trickle of offers, at well below asking prices. To supplement income, she started handling rentals. "There was a lot of fear," she recalls.

Vaughn Gray, one of her clients, had agreed to buy a one-bedroom apartment the week Lehman collapsed. As he was completing the paperwork, his mortgage agent called with a request to increase his down payment to 15% of the condo's value, from the 5% they'd discussed earlier. Mr. Gray couldn't produce the cash, and the deal fell through. "It was heartbreaking," recalls Mr. Gray, a concierge at a clothing retailer.

By December 2008, the average home price in Toronto was 9% below the year-earlier level, and sales volume was down 50%, the Toronto Real Estate Board reported

But Canada's housing slump didn't last long. In October 2008, the Bank of Canada made the first of a series of rate cuts that eventually lowered the target for its key overnight lending rate to 0.25%, which in turn reduced banks' prime rate—the basis for calculating variable-mortgage rates in Canada—to 2.25% by April 2009. In Canada, nearly all mortgages have rates that adjust at least every few years. Currently, rates on some loans have fallen to 2% or lower.

Canada never saw the wave of foreclosures that the U.S. did, and the balance sheets of Canadian banks stayed strong. As the global credit crunch began to ease at the end of 2008, Canada's big lenders, which handle the bulk of residential mortgages, started to market more aggressively.

Toronto-Dominion Bank boosted its mortgage sales force by 10%, says Tim Hockey, head of the Canadian banking operations. Don Peard, the [Royal Bank of Canada's](#) mortgage chief for Alberta, told his sales people to double the number of calls they made seeking mortgage referrals from real-estate agents and home builders.

Home sales started to rise again in February 2009. By midyear, Ms. Holmes, the Toronto real-estate agent, was seeing the kinds of bidding wars that were common in 2007.

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"It's all the people that would have bought during the slowdown," she says. In September, she says, one condominium she handled had 15 offers—her personal record.

The low interest rates and the eagerness of banks to lend attracted buyers such as Cindy Gerard of Red Deer, Alberta, who invests in residential real estate to supplement the money her husband earns as a welding inspector for the oil-and-gas industry.

Ms. Gerard has been buying and renting out apartments for years. In 2009, she went into overdrive, buying six units in six months, with mortgages at rates ranging from 2.45% to 3.95%. She says she "maxed out" on the last mortgage, which pushed the family's ratio of debt service to income into the mid-40% range—above the level many Canadian lenders are comfortable with.

Ms. Gerard says she bought all the properties for below the asking prices. "Money is growing on trees these days, lending rates are so low," Ms. Gerard wrote in December in an online forum for real-estate investors. "There are loads of properties to choose from, and the banks want to lend!"

Nevertheless, with housing prices rising, recent buyers are finding deals harder to come by. Ms. Holmes, the agent, explains that a few years ago monthly mortgage payments on downtown Toronto condos were far enough below rents that investors could count on making a profit. Now, she says, new investors are more commonly just breaking even.

Bryce Wilson, an elementary-school teacher in Toronto who bought two condominiums in December, says a 20% drop in the value of his mutual funds prompted him to shift money into real estate. He's planning to rent out one property—a one-bedroom apartment in a new condo building—for C\$1,500 a month, netting him C\$360 a month after mortgage and maintenance fees. He says he is prepared for his 2% mortgage rate to rise. "I've budgeted for the rate doubling," he says.

Economists at Toronto-Dominion Bank say they think current home prices are about 12% above where they should be based on income and interest trends—not enough for a bubble, they say, so long as future price increases are slowed by home building and rising mortgage rates.

Mr. Hockey, Toronto-Dominion's domestic banking chief, says housing prices are "of interest but not a concern." If the situation worsens, he says, the bank will consider steps like raising the hurdles for borrowers.

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The government is mulling action too. Finance Minister Jim Flaherty has said that if it's warranted, he would consider tightening the terms for home buyers seeking government-insured loans, shortening maximum mortgage lengths from their current 35 years, or raising minimum down payments from the current 5%.

But Canada's central bankers appear reluctant to take any steps that would hurt the economy. In a Jan. 11 speech, a representative of the Bank of Canada said: "If the Bank were to raise interest rates to cool the housing market now...we would, in essence, be dousing the entire Canadian economy with cold water, just as it emerges from recession."

For now, the housing boom shows no sign of abating.

Mr. Gray, the Toronto concierge whose home deal fell through at the end of 2008, is looking again for a condo, although he's had to increase his budget to around C\$350,000, from C\$250,000. Ms. Gerard, the housewife in Red Deer, says she hopes to buy a seventh unit in a few months—after she pays down enough of her credit-card debt to qualify for another mortgage.

Mr. Carrasco, the Toronto massage therapist whose condo rose in value by 40% in one year, says he's glad he sold when he did.

"I think we're in a housing bubble," he says. "I'm going to put stuff in storage, rent cheap and buy again when prices come down."