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Consumer Watch Canada

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Jeffrey Rubin	Avery Shenfeld	Benjamin Tal	Peter Buchanan	Warren Lovely	Leslie Preston
(416) 594-7357	(416) 594-7356	(416) 956-3698	(416) 594-7354	(416) 594-7359	(416) 956-3219

Loonie Boom

How The Soaring Dollar Is Sustaining The Canadian Housing Market

Benjamin Tal

At first glance, there should be little relationship between the value of the Canadian dollar and the housing market. But the reality is that over the past year, the soaring loonie was real estate's best friend. The dramatic appreciation of the dollar put the brakes on monetary tightening by the Bank of Canada and helped to keep long-term rates near historic lows. And with cheap credit being the life-blood of the housing market, real estate values continue to surge. This dollar-induced housing boost contributed directly to overall GDP growth through increased residential investment, but it also provided a significant financial lift to many households in 2004. This influx of cash came courtesy of the savings realized through variable-rate mortgages, a positive housing wealth effect, lower mortgage interest payments, due, in part, to a surge in renegotiating activity, and further borrowing against home equity.

The Dollar Is Doing The Bank of Canada's Job

By now there is no doubt that the 25% appreciation in the value of the Canadian dollar since 2003 is hurting the economy. Real exports have fallen by 4% (annual rate) over the past six months, while manufacturing activity is showing unmistakable signs of dollar-linked frailty. The Bank of Canada is paying attention, scaling back its 2005 GDP forecast by a full percentage point over the past nine months (Chart 1, left). Lower growth projections go hand in hand with a reduced need to remove liquidity from the economy by raising interest rates, as reflected in

Chart 1
Strong Dollar Slows Growth

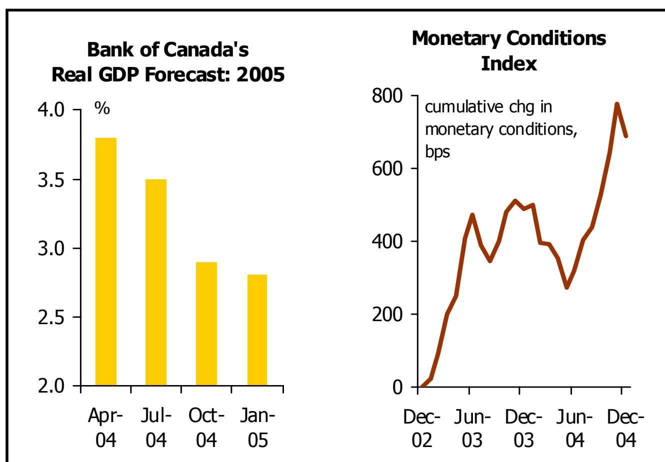
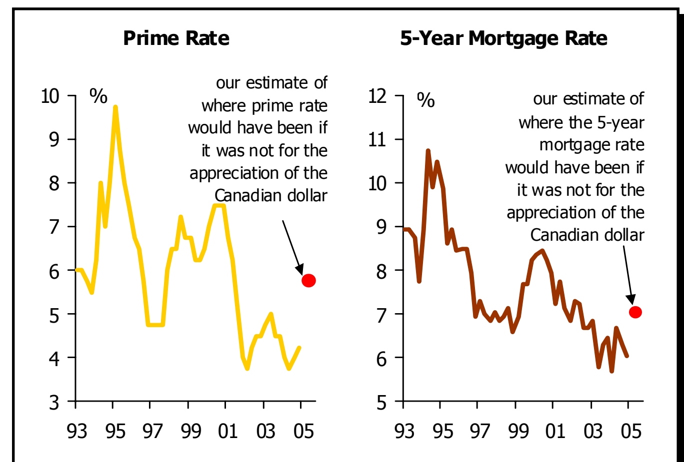


Chart 2
Where Interest Rates Might Have Been



the recent surge in the Bank of Canada's Monetary Conditions Index (Chart 1, right). In fact, we estimate that the dollar's appreciation single-handedly prevented a 150 basis point hike in short-term interest rates in 2004 and kept long-term rates 75-100 basis points below where they might have been (Chart 2).

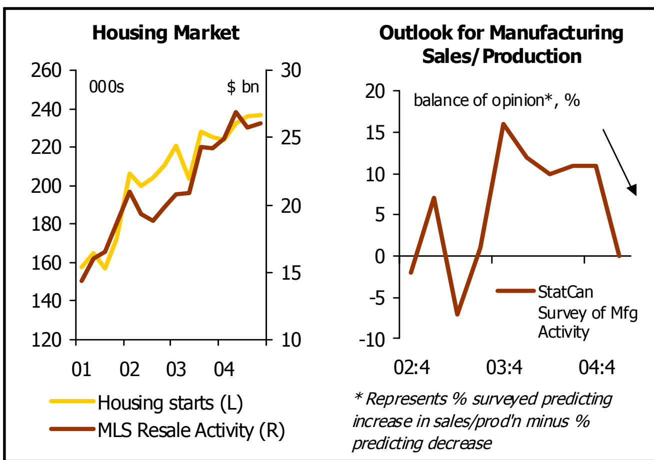
This dynamic, in which the dollar's appreciation provides all the economic drag needed to keep inflation at bay, has created a clear dichotomy between two major drivers of economic growth — the manufacturing sector and the housing market. The manufacturing sector is clearly the loser (Chart 3, right), while the housing market, thanks to the persistence of low interest rates, is probably the biggest winner (Chart 3, left).

Variable-rate mortgages: Choice or Necessity?

The persistence of low short-term rates in Canada allowed homeowners to continue to save with the adoption of variable-rate mortgages, which are tied to the prime rate. Currently, one in four Canadian mortgages is a variable-rate mortgage — roughly the same share seen in the US. And the use of variable-rate mortgages has paid off. Over the past five years, those homeowners who chose a variable-rate mortgage on $100,000 mortgage, which was amortized over 20 years, saved, on average, a cumulative $11,000 in interest payments. In fact, for 89.3% of the period from 1985 to 2004, a variable-rate mortgage offered savings compared to a five-year fixed-rate mortgage.

Chart 3

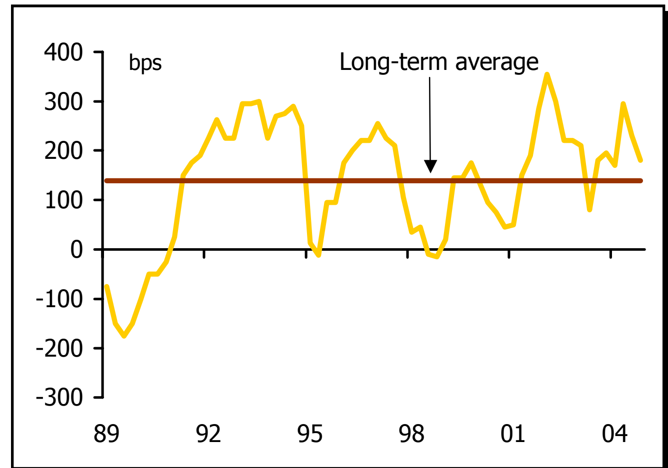
Strong Housing; Weak Manufacturing



Sources: CMHC, CREA, Statistics Canada

Chart 4

Spread: 5-Year Mortgage Rate Over Prime Rate

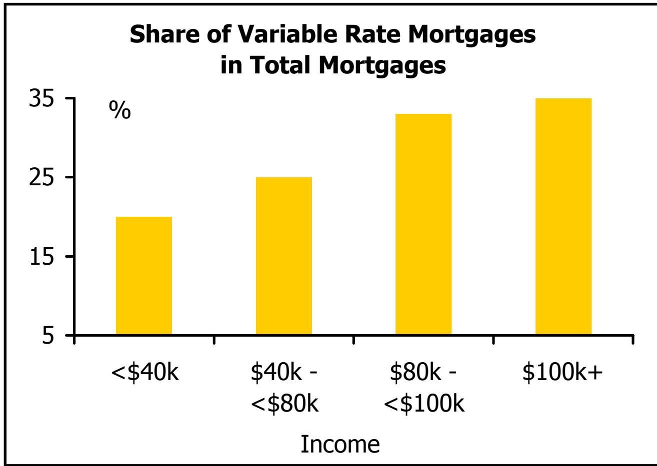


The main factor influencing the tendency to choose a variable-rate mortgage is the difference, or spread, between long- and short-term interest rates. A rising prime rate or falling long-term mortgage rates both work to reduce the attractiveness of variable-rate mortgages. While long-term mortgage rates have been trending downward over the past six months, the relative stability of short-term rates in Canada kept the spread between the five-year mortgage rate and the prime rate approximately 50 basis points above its long-term average (Chart 4). Here again, the strong Canadian dollar, which has kept short-term interest rates from rising, has had a hand in helping Canadian mortgaged homeowners save money.

But do people choose variable-rate mortgages because it's a good deal, or is it simply their only deal, since they cannot afford the more expensive fixed-term mortgages? Clearly, heavy reliance on variable-rate mortgages also means increased vulnerability to higher interest rates. In this sense, the distinction between choice and necessity is important. It is reassuring to note that variable-rate mortgages are more popular among higher income Canadians, who may be better able to deal with fluctuations in interest rates and may be more financially savvy. One in three high-income homeowners choose a variable-rate mortgage, compared to 20% of lower-income homeowners (Chart 5). But, of course, those homeowners on the lower end of the income scale are the ones who

Chart 5

Variable Rate Mortgages More Popular Among High Income Earners



need the cheaper borrowing most, since the annual carrying costs of their homes (relative to income) is more than double the carrying cost for higher-income homeowners (Chart 6). The reduced tendency among low-income households to choose variable-rate mortgages, despite their proven savings potential, might reflect a relatively higher level of risk aversion among this income group.

Note that the situation in the US is very different. The Adjustable Rate Mortgage (ARM) market south of the border may be over-utilized by those who can least afford a fluctuation in rates, leading to a delinquency rate among homeowners with ARMs that is double that seen among fixed-rate mortgage holders.

The Housing Wealth Effect — An Important Economic Driver

The strong dollar and its stabilizing impact on mortgage rates have helped boost record-high real estate prices by an additional 9% in 2004. Furthermore, both housing starts and resale activity advanced by 5%. Without the dollar's appreciation, house prices would likely have risen by only a fraction of that pace and we would probably have seen much slower housing starts and resale activity in the second half of 2004.

Furthermore, housing remains the primary source of wealth for most Canadians. With the increase in the value of their homes, Canadian homeowners are feeling richer and are spending accordingly — a phenomenon known as the "housing wealth effect". Using the Bank of Canada's estimates,[1] consumers spend 5.7-cents out of every dollar increase in the value of their homes. Note that this housing wealth effect is significantly more powerful than the wealth effect associated with rising stock prices. Housing wealth is much more broadly distributed across income levels than stock wealth and its impact on consumer spending is much more immediate. Consumers may be slower to spend when they realize stock market gains because they are cautious about making life style changes based on near-term movements in stock prices that may not be sustainable.

Compliments of the rising dollar, the appreciation in house prices in 2004 and the associated housing wealth effect have led to a record high of more than

Chart 6

Annual Home Carrying Cost

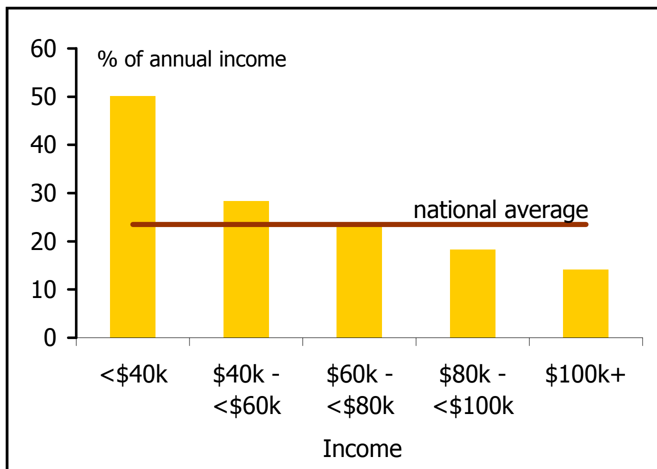
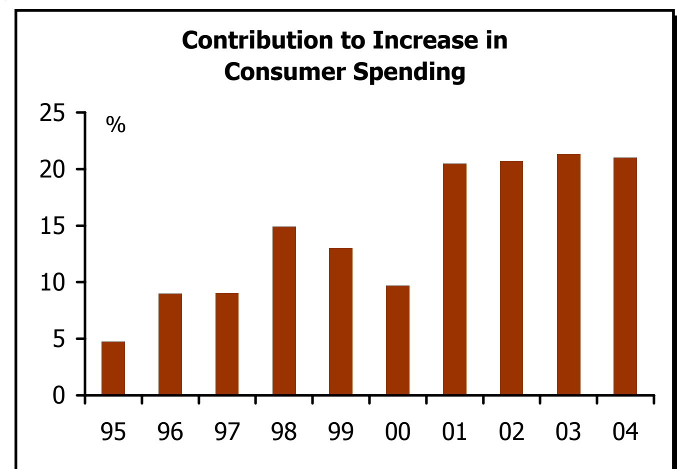


Chart 7

Housing Wealth Effect



$7 billion of extra spending last year. In fact, in the past three years, the housing wealth effect led to a cumulative $21 billion in additional household spending, contributing more than 20% to the total increase in consumer spending during this period (Chart 7).

Homeowners Are Saving Money By Renegotiating

In addition to providing Canadians with another reason to spend, the strong loonie, by keeping interest rates low, has helped put more dollars in the pockets of homeowners. Stable short-term mortgage rates and falling long-term rates during most of 2004 proved to be an irresistible combination for many homeowners. No less than one-third of mortgage holders renegotiated their mortgage in 2004, and more than half of them did so well before the mortgage term was up.

With Canadians obtaining new mortgages at very low interest rates and those who have mortgages renegotiating for a lower rate, the mortgage market is being reshaped. A whopping 60% of all Canadian mortgages were negotiated in the past two years[2] (Chart 8). Lower interest payments due to mortgage renegotiations saved the average household close to $1,900 in 2004 — the equivalent of a 3% increase in average household income, and roughly 10% of the annual carrying cost of a home. Lower income Canadians who renegotiated their mortgages in 2004 saw an even larger benefit relative to their income, tapping into annual savings equivalent to no less than an 8% pay increase. By renegotiating their mortgages last year, Canadian homeowners saved a total of $3 billion in interest payments. Taking a longer-term view, the low-interest rate environment enabled Canadian homeowners to save a cumulative $10 billion in mortgage interest payments over the past three years.

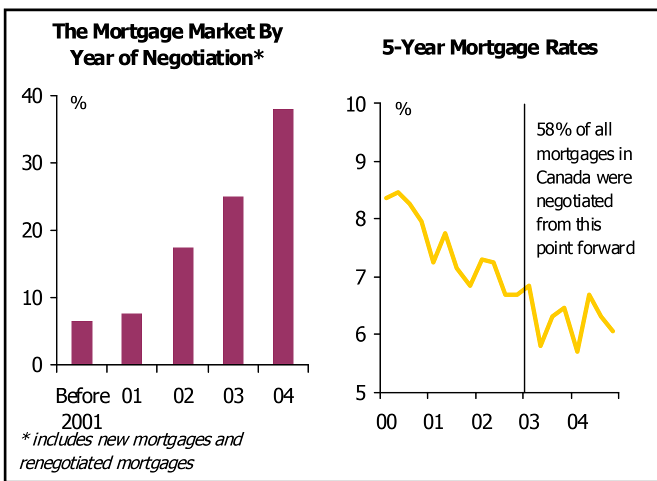
Given recent trends in interest rates, an estimated 20% of current mortgage holders can still renegotiate their mortgages profitably, despite the strong renegotiating activity in the past two years.

Interest rates impact not only house values, but also the ability of households to borrow and spend against the increase in the value of their homes. One in four homeowners who renegotiated their mortgage in 2004 also used the opportunity to increase their mortgage amount by an average of $30,000, or almost half of the average annual household income (Chart 9).

Canadians are also capitalizing on the rising value of their homes by increasing their use of home equity loans. Roughly half of all homeowners carry a line of credit, of which approximately one-third are secured against home equity. Last year alone, line of credit borrowing rose by 30%, adding an estimated $9 billion in cash to consumers' wallets. Looking at the past three years, this figure likely swells to $20 billion.

Chart 8

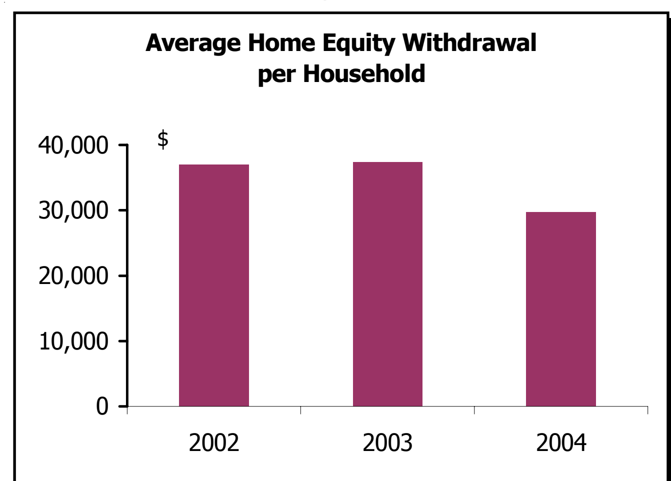
Close to 60% of Mortgages Were Negotiated in the Past Two Years



** includes new mortgages and renegotiated mortgages*

Chart 9

Cash Out Refinancing



What's more, despite the fact that interest mortgage payments in Canada are not tax deductible, as is the case in the US, Canadian households have shown the same appetite to borrow against home equity as their counterparts south of the border. We estimate that home equity withdrawals in Canada (refinancing, or increasing mortgage amounts upon renegotiation, and new home equity loans) amounted to a record-high $21 billion of extra cash for households last year. Cumulatively, over the past three years, home equity withdrawals reached $55 billion, a sum equivalent to more than 11% of the growth in total Canadian GDP during this period — only one percentage point shy of the rate seen in the US. The ability of Canadians to close the refinancing gap with American households reflects the fact that the increase in short-term interest rates in the US in 2004 has reduced the popularity of mortgage refinancing, which now accounts for less than 40% of total mortgage origination, down from 70% in 2003 (Chart 10). Canadian home equity withdrawals are moving in the opposite direction, reaching a new record high in 2004, facilitated by the strong dollar that kept a cap on interest rates.

Home Equity Withdrawals Help To Finance Renovation Boom

Much of the cash that is borrowed against home equity is finding its way back home. One-third of all the funds available to homeowners in 2004 through the combination of cash out mortgage refinancing and home equity loans was used to finance home renovations. And it seems that there is plenty to finance on this front. The home renovation market is booming. One in two homeowners in Canada took on home renovations in the past two years, spending, on average, $12,000 in the process. Spending on home renovations totaled a record high of $28 billion in 2004 and is projected to rise to $30 billion in 2005. Note that borrowing against home equity financed close to one-third of total spending on renovations over the past three years, clearly helping to sustain the ongoing boom in home renovation activity in Canada (Chart 11).

The Ripple Effects of a Strong Housing Market

The continued momentum in the housing market has played a significant role in the Canadian economic landscape. In addition to housing sales making direct and important contribution to the economy, each home purchased generates, on average, $7,500 in terms of move-related new spending, such as home inspection fees, legal fees and moving costs. This "housing multiplier" effect amounted to close to $10 billion in extra spending over the past three years. This additional spending was most noticeable in British Columbia, where one in four homeowners purchased their home in the past five years.

Highly Leveraged Homeowners

The strong increase in house prices, limited income growth and continued low interest rates have opened the door to further increases in real estate-

Chart 10
Rising Rates Slow Refi Activity in the US

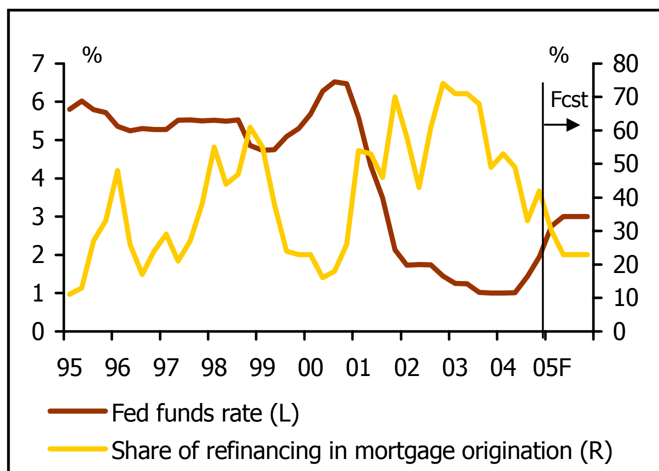
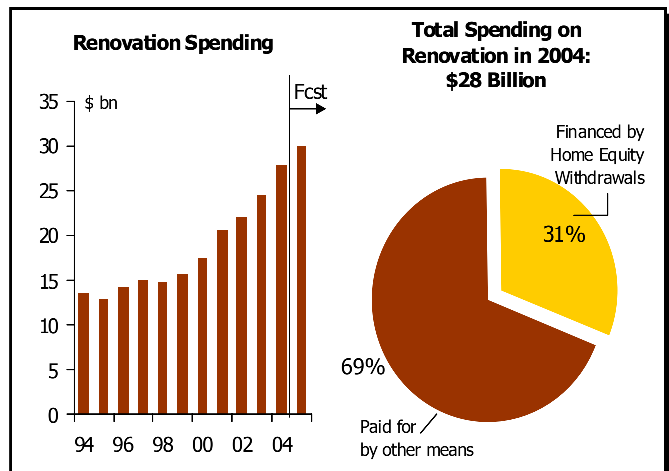


Chart 11
A Booming Home Renovation Market



backed borrowing. Not only did the average mortgage size increase by more than $20,000 since 2001, but there has also been an increase in high-ratio mortgages (in which the homeowner has less than a 25% down payment). In fact, while in the past a down payment of 10% or less was considered modest, now it's the norm — accounting for nearly half (47%) of all new mortgages in 2004 and 2005[3] (Chart 12). This trend makes homeownership an even more powerful leverage investment machine, with even a small percentage gain in home values generating a large return relative to the down payment invested in the house. But this reality also leaves homeowners who rely too heavily on low interest rates much more exposed to the risk of a substantial hike in interest rates and/ or other economic shocks.

Looking at the financial positions of homeowners a bit more closely, we find that the widely quoted national statistics regarding the level of indebtedness of Canadians masks significant discrepancies across the different regions. The debt to income ratio of homeowners[4], while not a perfect indicator, can provide us with a good benchmark for comparison. Note that based on this measure, British Columbian homeowners are the most indebted, with a ratio of debt to income of just under 130% — well over the national average of close to 90%. This is not surprising given that the average house price in the province is 27% higher than the national average. But even when we focus on the alternative measure of financial position — the debt to asset ratio (which takes into account the value of real estate and financial assets) British Columbian homeowners still emerge as the most indebted in the country (Chart 13). This, in part, reflects the fact that mortgage borrowing in the province over the past five years out paced the increase in home values.

In Quebec, despite leading the nation in the appreciation of home prices (70% since 1997), homeowners in the province are still the second most indebted in the country, with a debt to asset ratio of 21%, in large part reflecting the slow pace of asset accumulation during the pre-housing boom era. Homeowners in Ontario and Saskatchewan emerged as the least indebted, sharing a debt to asset ratio of 17%. The relatively favourable position of homeowners in Saskatchewan probably reflects the dominance of the farming sector in the province, with the value of farms working to offset rising debt. In Ontario, the 50% increase in home valuation since 1997, along with the recovery in the stock market in recent years, helped to offset the strong increase in homeowner borrowing.

A Look Ahead

In many respects, the strong Canadian dollar bought the real estate market some time, prolonging the housing boom and providing households with extra cash via the multiple channels described in this analysis. But as the damaging impact of the appreciating loonie elsewhere in the economy becomes painfully more visible, it will force the Bank of Canada to

Chart 12
Highly Leveraged Homeowners

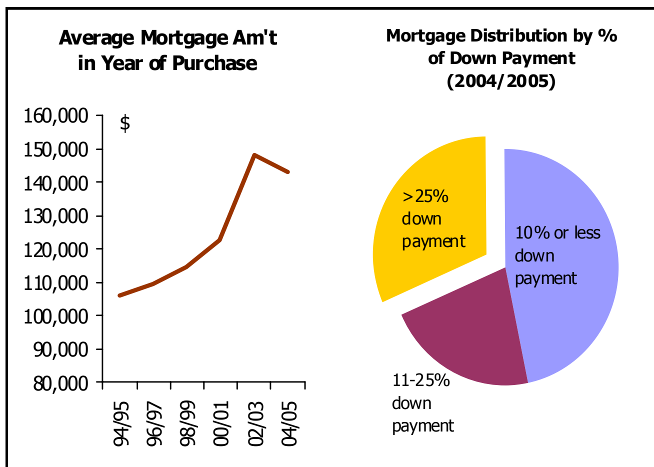
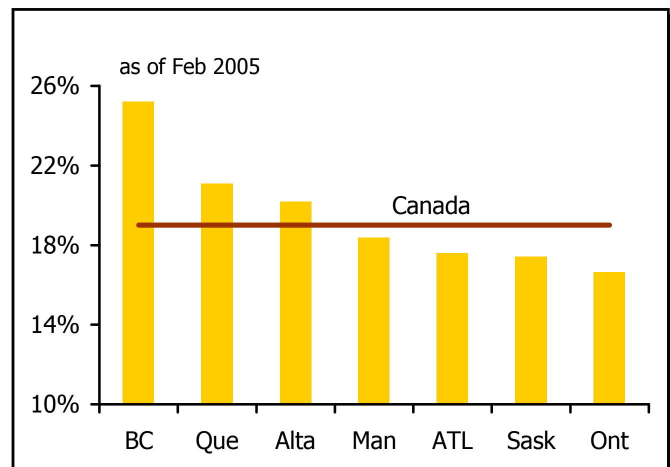


Chart 13
Debt to Asset Ratio of Canadian Homeowners



postpone any tightening plans it had in mind. In fact, the cumulative damage to the economy and its disinflationary effect could put additional downward pressure on interest rates — mainly in the long-end of the yield curve. And, as illustrated earlier, Canadian households have already demonstrated that they are highly responsive to lower rates. Accordingly, look for the real estate market to continue to benefit from low and potentially lower mortgage rates in 2005, with renegotiation activity continuing to surge, and borrowing against home equity financing another record-year in home renovations.

Notes:
(1) Lise Pichette and Dominique Tremblay, "Are Wealth Effects Important For Canada?" Bank of Canada Working Paper 2003-30.
(2) "Don't know/not stated" responses were excluded from this calculation.
(3) "Don't know/not stated" responses were excluded from this calculation.
(4) Source: The 2005 CIBC Homeownership Poll. The base here is homeowners with a mortgage. The focus here is on gross income.*

Data sources used in this study:
*2005 CIBC Homeownership Poll**
CIBC World Markets
Canadian Real Estate Association (CREA)
Canada Mortgage & Housing Corporation (CMHC)
Statistics Canada

** The 2005 CIBC Homeownership Poll was conducted by The Strategic Counsel between January 25th and February 1st, 2005 and was based on a randomly selected sample of 2,150 English and French speaking Canadian household decision-makers (2,003 current homeowners, 147 current renters who are potential homebuyers). With a sample of this size, the results are considered accurate to within ±2.11% percentage points, 19 times out of 20, of what they would have been had the entire Canadian adult population of homeowners and renters who are potential homebuyers been polled. The margin of error will be larger within regions, Census Metropolitan Areas, and for other sub-groupings of the survey population. The sample of household decision-makers is representative of the regional and age distribution produced by Statistics Canada. Percentages may not sum to one hundred due to rounding or the acceptance of multiple mentions.*

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