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Home prices approaching bubble territory

Home prices are approaching bubble territory, although a cool-off is expected.

OTTAWA - Canada's housing market is reaching the limits of sustainability and could tumble if there is no moderation, the Bank of Montreal says.

The bank notes Canada's hot housing market is still not in the red zone for prices, but it's getting there.

And unless there is some moderation in sales and prices, the market could be setting the stage for a major correction, it adds in the recently released report.

"While we do not expect a significant correction nationwide, the risk of such would increase, especially in some regions, if prices were to continue to outrun incomes or if interest rates were to increase rapidly," economist Sal Guatieri says.

He notes that after slowing last summer, Canadian home sales rebounded in the fall and house prices have kept rising.

On average, home prices rose five per cent in the past year to January, while in Vancouver they rocketed 20 per cent. On average, home prices are 10 per cent higher now than they were before the recession, when they were at an all-time high.

The problem is that the value of homes has increased much faster than incomes.

The bank says average home resale prices compared with personal incomes are 14 per cent above the long-run trend, up from last summer, although still below the 21 per cent peak that preceded the 1989 crash.

But that is not the case in all markets. Five provinces are currently in the danger zone, led by Saskatchewan, where the ratio is 39 per cent above historic norms.

Also well above the long-run levels is Newfoundland, 34 per cent higher; British Columbia and Manitoba, 31 per cent, and Quebec, 23 per cent above.

By comparison, in Ontario the price-to-income ratio is only 10 per cent higher than historic norms, suggesting prices are moderately overvalued but not in bubble territory.

What's made this possible have been historically low interest rates which have allowed Canadians to carry bigger mortgages. As a result, mortgage payments for the typical owner consume 35 per cent of disposable household income, about the same as the 23-year average of 34 per cent.

The bank says there should be no major correction if incomes increase faster than home prices in the future, as expected.

It says sales are expected to cool and prices stabilize this year in response to higher interest rates and tighter mortgage rules that go into effect later this month.

"The risk of a correction would increase, however, if prices rose alongside rates and incomes," the report cautions.

If prices don't stabilize, the report says it would put the Bank of Canada in a tight spot. It risks creating a housing bubble if it keeps rates super-low too long, or could precipitate a crash if it hikes rates too quickly.

The Bank of Montreal report is the latest to throw up caution flags about the seemingly unstoppable Canadian housing market.

Last month, Capital Economics warned the Canadian housing bubble was poised to burst, needing only the pinprick of rising interest rates to set off the collapse.

The economic consulting firm noted that by historical standards, almost all the key indicators around housing were at historic highs. It predicted prices could fall 25-35 per cent in the next three years once interest rates and mortgage upkeep costs begin rising.

Still, most private sector analysts see a soft landing rather than a crash, in part because the Bank of Canada is unlikely to raise rates sharply or quickly.