

The Canadian Housing Industry Economic Update



Monthly Report

January 2009

Recession Announcements

The Bank of Canada announced on December 9th that Canada is now entering a recession. Two days later, the official scorekeeper of U.S. business cycles, the National Bureau of Economic Research, announced that the U.S. economy actually peaked a year ago in December of 2007 and has been in a recession since then. The average U.S. recession since WW2 has lasted only 10 months but this one is expected to be at least twice as long.

A Need for Perspective

There is obviously plenty of bad news to talk about. However, Canada's new home builders and renovators should not be overwhelmed by the wave of pessimism that has descended on consumers, homebuyers and businesses. Canada's housing sector has gone through recessions before and there are several aspects of this one that are different from the rest. In previous downturns, demand was turned off by rising interest rates. This time around interest rates are going the other way. In addition, over-building and speculative price pressures have exacerbated previous Canadian housing downturns. These influences have arguably not been as apparent in recent experience.

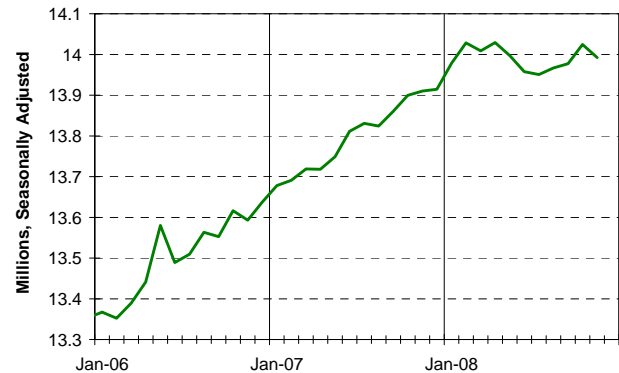
No Return to the 1930's

There are a number of factors at play that suggest that the outlook is not as bleak as the alarmists are claiming. First of all, the recession is not internally driven. There would not have been one in Canada had it not been for the financial system collapse in the United States. Furthermore, it seems to be a wild exaggeration to claim that we could be facing a re-run of the 1930's.

The U.S. economic policy response to the current crisis has been massive and fast-acting. The U.S. Treasury has directly injected about \$250 billion of capital into the U.S. banking system. The Fed is undertaking mammoth unorthodox steps to support financing activity. Excess bank reserves have soared from around \$1.5 billion to \$590 billion, with most of the increase over the past 3 months. The Fed has plans to buy mortgage-backed securities and even government and corporate bonds.

This is vastly different from the experience 80 years ago. Between 1929 and 1933, the Fed allowed the money supply, as measured by M2, to decline by about one-third. The downturn in the U.S. economy between August 1929 and March 1933 lasted 43 months. The current U.S. downturn has already lasted 12 months and is unlikely to stretch beyond the end of 2009.

CANADA
FULL-TIME EMPLOYMENT



Underlying Support for Canada

Canada's economy cannot avoid any serious recession in the U.S. but there is compelling evidence of underlying support for Canada's economy. Both individuals and businesses are on sounder financial footing in Canada.

Canadian households are far less levered than their U.S. counterparts. Debt as a share of total household assets is significantly lower in Canada. In addition, Canadian homeowners do not face the kind of mortgage resets being experienced in the United States. In Canada, those lucky enough to have variable rate mortgages are seeing big declines in their mortgage payments. In the U.S., mortgage resets are producing big increases in payments.

In addition, Canadian companies have entered the business downturn with a healthy level of profitability. In contrast to the downturn in U.S. profits, corporate profits in Canada increased sharply in both the 2nd and 3rd Quarters of 2008. As a share of GDP, profits were running at record high of almost 15% in Canada. This is far above the long-term average of 10% over the period 1984-2008. With profits this robust heading into the recession, many companies have healthy financial positions.

Employment Has Held Up Well

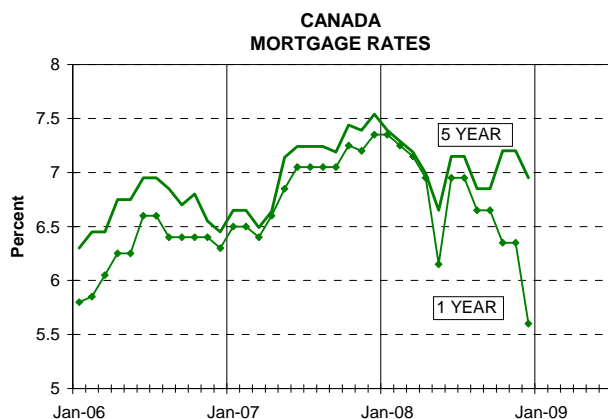
We can expect to see layoffs and rising unemployment in Canada in 2009. However, up to the end of 2008, employment in Canada had held up very well. There was a decline in November but it followed a big gain the month before. The chart at the top of the page shows the path of full-time employment. It has basically been moving sideways at a high level following big gains in 2006 and 2007. Employment is a key indicator for home sales. The relative stability in employment in Canada is in sharp contrast with the steady declines in the United States.

Canada's Banks

Canada's banks are in better shape than their U.S. counterparts. Their financial strength will be a positive factor for Canada's economy. This will give Canadian new home builders an advantage in 2009. We can expect Canada's banking system to be more supportive to home sales and residential construction.

As in past recessions, "cash is king". There has been hoarding of reserves by the Canadian banks but it is hopefully only temporary. Canada's banks are well capitalized. In addition, they have been assisted by the Bank of Canada's term lending programs, the federal government's mortgage purchase program and government loan guarantees. There has been a reluctance to lend, even to credit-worthy borrowers. However, we expect that this will subside as the financial panic begins to ease in the U.S. in early 2009.

Mortgage Rates



Mortgage rates are beginning to respond to Bank of Canada cuts in its overnight target rate. The 1-yr closed mortgage has declined to a posted rate of 5.60% and is available on a "special offer" basis at 4.35%. The posted 5-yr rate has not moved down as much. The posted rate for 5-years is 6.75% and the "special offer" rate is 5.69%. We expect Canadian mortgage rates to decline further in early 2009 to levels that will encourage home sales.

Oil Prices

The sharp decline in crude oil prices is an important development for Canada's new home builders. Energy is a major cost factor for a wide range of building materials. It is also a significant part of builders' and contractors' operating budgets. In addition, energy and gasoline costs are very important to home owners. The sharp declines in both over the last 6 months will gradually boost consumer finances and can be expected to support government stimulus efforts.

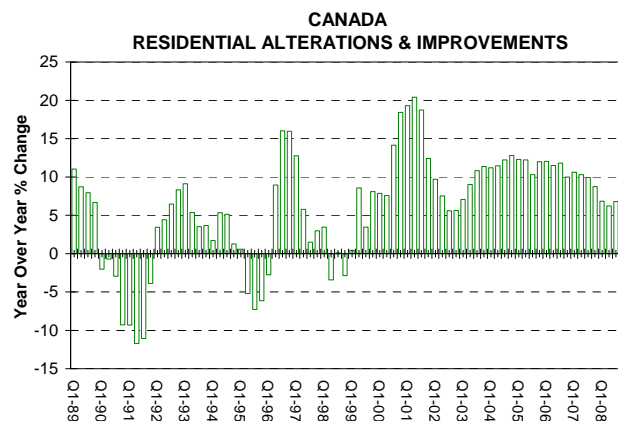
SPOT OIL PRICE - WEST TEXAS INTERMEDIATE (\$ U.S./BARREL)



OPEC production cuts have been unable to stabilize the price of oil. In fact, crude oil prices responded to OPEC's December announcement of a 2.46 million barrel per day production cut by moving below US\$40 per barrel. For now, weakness in world oil demand is more important than reductions in supply.

There have also been large declines in other commodity and basic materials prices such as copper, zinc and steel. Copper is an important building material. It peaked at almost \$US4.00 per pound this summer and the near-month futures price is currently down to US\$1.37 per pound. Construction wages in Canada have not yet responded to the economic downturn, probably because of work in progress on high-rise condos and ICI construction. However, construction wage costs will be much more negotiable in 2009.

Residential Renovation



Renovation is not recession-proof. There were hefty declines as a result of the 1990-91 recession. However, the sector has positive momentum going into 2009. The latest figures show almost a 7.0% yr/yr increase in the 3rd Quarter. Renovation feeds off previous years' home sales and there is a possible backlog of renovation work heading into 2009.

FORECAST SUMMARY

		1Q08	2Q08	3Q08	2008	2009
CPI	(% ch. from yr. ago)	1.8	2.3	3.4	2.4	0.9
PRIME RATE	(end of period)	5.25	4.75	4.75	3.25	2.25
HOUSING STARTS	(000's annualized)	234.4	220.1	209.5	214.0	160.0