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Weekly Market Insight

December 18, 2009

NORTH AMERICAN & INTERNATIONAL ECONOMIC HIGHLIGHTS

Canadian Mortgage Debt—A Closer Look

By Benjamin Tal

In a remarkable turnaround the Canadian housing market has swung from a buyers' market earlier in the year, back into today's sellers' market. With cheap credit fueling mortgage activity, the Bank of Canada is now fearing that this might be too much of a good thing. How big is the mortgage debt problem in Canada? Let us take a closer look.

House Prices—Some Overshooting

Over the past two years the degree of volatility observed in the Canadian housing market has been unprecedented. Within this short time frame, house prices fell by almost 13%, only to rebound by an impressive 21%[1]. Meanwhile, resale activity is now rising by close to 67% on a year-over-year basis after falling by close to 40% in 2008. Housing starts are presently 33% higher than in April 2009 despite dropping by more than 50% earlier in the recession. In fact, no other segment of the economy has rebounded as fast as the housing market, making it one of the real surprises of this recession.

This rapid uptick in housing activity, in the face of recessionary conditions elsewhere in the economy, raises concerns about its sustainability, and is causing some to wonder whether house prices are in fact rising too quickly given current economic fundamentals. Using a recent IMF housing valuation model[2] as a base, and updating it to reflect the most recently available Canadian data (November 2009), we estimate that the Canadian housing market as a whole is indeed beginning to overshoot its "fair value". At just under $350,000, the current average price of a home is estimated to be roughly 7% over what would be consistent with current housing market fundamentals such as interest rates, income growth, rents and demographics. However, that modest overshooting is far from uniform across the country. Those figures are skewed to western Canada, which has seen the most dramatic swings in house prices over the past 24 months. That market now appears to be overvalued by roughly 10-15%, suggesting that the imbalance in the rest of the country is much more modest.

Note, however, that overvaluation does not necessarily mean a bubble or a dramatic price correction. Given that the current overvaluation is occurring in a context of historically low interest rates, what we are most likely witnessing is a temporary period of exuberance that is "borrowing" activity from the future, as households take advantage of lower rates and accelerate their borrowing and home purchasing activities.

To the extent that current activity is simply a redistribution of sales from the future to the present, the housing market of tomorrow may be in store for a more muted level of activity. Housing starts will also catch up with the sudden spurt in demand, with the increase in supply helping to moderate price trends. Rather than plunging, house prices are more likely to stagnate in coming years (or fall modestly in the most overheated markets) as fundamentals catch up with a market that has gotten ahead of itself.

What Worries the Bank?

Rather than house prices, it is the accelerated pace of borrowing at very low rates that is beginning to raise some concerns at the Bank of Canada. For the first time in the post-war era, real household credit[3] continued to expand through a recession. In fact, mortgage credit is now rising at a year-over-year rate of more than 7%. This strong performance is a clear reflection of an extremely effective monetary policy in Canada. With Canadian consumer confidence only ten points below its pre-recession level (versus a 50% decline in the US), Canada is benefiting not only from properly functioning credit channels, but also from a household sector that is able and willing to take on new credit. Remember, low rates only work as an economic stimulus if Canadians take advantage of them.

The wave of borrowing does, however, have consequences in terms of consumer debt levels. The household debt-to-income ratio is now at a new all-time high of more than 140%. Despite a record low 4.4% effective mortgage rate, overall mortgage interest payments as a share of after tax income, are now at levels that in the past were consistent with a 6% effective mortgage rate. Since rates will no doubt at some point return to those higher levels, the Bank of Canada is worried that Canadians are making themselves increasingly more vulnerable in terms of their ability to continue to service these new, higher debt loads.

How Big is the Problem?

The relevant question, however, is just how serious a problem it is becoming, and here we have to dig a bit deeper to get the answers. Aside from an unlikely scenario of a 1970s-type stagflation, any future increase in interest rates will be in response to an improving economy. Thus any analysis of the potential impact of higher rates on the household sector in general, and the housing market in particular, should be done with tomorrow's healthier economy in mind.

After all, the reality is that in the past, interest rates have played only a minor role in driving mortgage default rates. Historically, it's clear that mortgage arrears rates are highly correlated with the unemployment rate, with little or no correlation with changes in interest rates. The same goes for the economy in general. Over the past three decades, personal bankruptcies have risen twice as fast in an environment of falling interest rates than in an environment of rising rates. And the logic here is obvious. Interest rates rise when the economy recovers, and the benefits to employment and incomes of an improving economy easily offset the sting of higher interest rates on debt service costs.

But the line of defense goes well beyond an improving economy. In its latest "*Financial System Review*" the Bank of Canada estimated that at present, 5.9% of all Canadian households are vulnerable to rising interest rates since their debt-service ratio (DSR) exceeds 40% (i.e. debt payments account for more than 40% of their household gross income). The Bank also estimated that the share of households with a 40%+ DSR would climb to 8.5% by 2012 if interest rates rise by 300 basis points.

However, focusing on a borrowers' debt-service ratio with no reference to the underlying asset that they hold can be misleading. In fact, many households with a DSR greater than 40% have already accumulated a significant amount of equity in their house, and therefore have the option to downsize and reduce their debt overhang if their mortgage payments stop becoming manageable. Out of the five million Canadian households who hold a mortgage, only an estimated 350,000 have a mortgage with a loan-to-value (LTV) ratio greater than 80% and a DSR greater than 40%. Add this number to the small number of renters with DSRs over 40% and the share of Canadian households that are "vulnerable" to a rate shock is less than 4.0%, notably below the 5.9% starting point estimated by the Bank of Canada[4].

A Few More Buffers

Another potential buffer is the fact that most Canadian financial institutions limit their variable rate customers to a mortgage that they would qualify for at today's 3-year fixed-term rate, well above current variable rates.

While all borrowers will face the impact of higher rates, most of them will therefore be able to absorb a 300 basis point rate hike and still remain within the qualification threshold. Only mortgages that were underwritten since early 2009 are vulnerable in this sense, as their new mortgage rate (prime + 300 basis points) will end up being higher than their qualifying rate.

But even this small group will not have to face the full magnitude of the tightening by the Bank of Canada, as they will have the option to switch to fixed rates in the early stages of the monetary tightening by the Bank of Canada. And if history is a guide, they will do it very quickly. Although fixed rates might also have risen by that point, they would still typically have sheltered themselves from the full rise in variable rates ahead.

Others in the supposedly "at risk" group have afforded themselves some protection from the initial impact of rising rates by having already locked in a fixed rate mortgage. Based on information obtained from CMHC, no less than 80% of households who took a mortgage in 2009 with an LTV greater than 80% and a DSR greater than 40% have a fixed rate mortgage. Also note that in general, low income Canadians tend to rely more heavily on fixed-rate mortgages—the complete opposite of the situation south of the border where low income Americans were heavy users of variable-rate mortgages. While even fixed-term mortgages will eventually be reset, the longer time frame for any hikes in their borrowing rates leaves them with more time to pay down principal and benefit from rising incomes before that hits.

Moreover, many Canadians have taken advantage of low mortgage rates to accelerate their mortgage payments. No less than 40% of mortgage holders now accelerate their payments by adding a full-month of extra interest payments each year[5]. On a $250,000 mortgage with 5% rate amortized over 30 years, that works out to a *de facto* shortening of the mortgage amortization period by 5 years. Translating years into basis points means that by simply switching from an accelerated payment plan to a regular one, these same borrowers can absorb the first 75 basis points on any rate increase by simply exercising their right to cease these prepayments.

Add it all up, the level of vulnerability in the mortgage market is not as high as suggested by the Bank of Canada, and even the most vulnerable borrowers have some flexibility to absorb higher interest rates. There is nothing in Canada akin to the huge excesses in lending that led up to the housing and mortgage crisis experienced in the US in the past few years.

That said, we share the Bank's view that it is time for both borrowers and lenders to exercise prudence in continuing to build up household debt loads to the point where they are overly reliant on today's low rates. Existing debt burdens appear to be manageable for the vast majority of Canadians given the buffers noted above, but care should be taken on how far these are extended in the next couple of years. An accelerated pace of credit growth, and the resulting upward pressure on home valuations could lead to adjustment problems down the road. Clearly, the current magnitude of the problem is not big enough to justify a premature tightening move by the Bank of Canada. While other adjustments to practices by participants in the mortgage market could be examined as a means of enhancing prudence, one should be careful to avoid excessively denting the health and flexibility of the housing market as a whole.

Notes:

1. *Note that when house prices are weighted by market size, the swings in house prices during this cycle were not as dramatic. For example, while in January 2009 the unweighted measure fell by 11% on a year-over-year basis, the weighted measure fell by only 6.2%. And as of November 2009, the unweighted measure rose by almost 20% (year-over-year) vs. a much more modest increase of 13% seen in the weighted measure.*
2. *IMF working paper 09/235 October 2009.*
3. *Using PCE deflator.*
4. *CIBC's calculations based on data obtained from CMHC's estimates regarding the homeowners population as well as Ipsos Reid's CFM for the six months ending October 2009.*
5. *Source: CMHC*

Market Snapshot

US	Current*	yesterday*	a week ago*	a month ago*	a year ago
TED SPREAD (bps)	21	21	22	23	148
10Y / 2Y SPREAD (bps)	272	275	272	265	139
2Y SWAP SPREAD (bps)	34	36	35	32	79
3M T-Bill (%)	0.04	0.04	0.03	0.03	0.02
LIBOR 1 MONTH (%)	0.23	0.23	0.23	0.24	0.47
LIBOR 3 MONTH (%)	0.25	0.25	0.25	0.26	1.50
2-YR BOND (%)	0.78	0.78	0.82	0.71	0.74
5-YR BOND (%)	2.25	2.26	2.26	2.16	1.36
10-YR BOND (%)	3.50	3.53	3.54	3.36	2.12
A Rated / 10Y TREASURY (bps)	167	177	175	174	428
B Rated / 10Y TREASURY (bps)	546	556	554	577	1281
BB Rated / 10Y TREASURY (bps)	441	456	456	472	937
CANADA					
PRIME / BA SPREAD (bps)	185	185	185	185	184
CDOR 3 MONTH (%)	0.47	0.47	0.47	0.50	2.30
CDOR 3 MONTH / 3M T-BILL SPREAD (bps)	28	27	27	28	151
10Y / 2Y SPREAD (bps)	209	206	216	214	155
2-YR BOND (%)	1.30	1.32	1.25	1.24	1.26
5-YR BOND (%)	2.55	2.56	2.55	2.56	1.85
10-YR BOND (%)	3.39	3.38	3.40	3.38	2.81
A Rated / 10Y TREASURY (bps)	111	115	113	124	346
BBB Rated / 10Y TREASURY (bps)	186	190	185	192	404
CAN Sovereign Agency / 10Y TREASURY (bps)	38	41	35	39	84
Provincial / 10Y TREASURY (bps)					
ALTA	61	65	62	61	166
BC	82	86	85	82	166
MAN	79	83	79	80	182
NB	77	82	81	78	177
PEI	108	111	108	106	185
NFLD	118	124	122	114	199
ONT	95	99	98	95	180
QUE	102	106	106	109	192
SASK	101	105	102	95	181
NS	89	94	91	93	191
COMMODITIES					
WTI CRUDE FUTURE (US$ / bbl.)	74.3	72.3	70.3	76.4	33.9
NATURAL GAS (US$ / MMBtu)	5.9	5.6	5.3	4.3	5.3
SILVER (US$ /t oz.)	17.2	17.4	17.3	18.3	10.8
GOLD (US$ / t oz.)	1107.2	1117.6	1126.7	1140.0	836.4
WHEAT (US¢ / bu.)	521.3	527.8	517.8	557.0	563.3
SOYBEANS (US¢ / bu.)	1026.3	1052.8	1037.5	1038.0	868.3
SUGAR (US¢ / lb.)	25.9	25.4	23.1	22.2	11.0
CORN (US¢ / bu.)	400.0	405.3	380.5	391.5	380.8
FX					
C$ / US$	1.064	1.069	1.053	1.071	1.215
US$ / EURO	1.435	1.437	1.465	1.486	1.391
C$/ EURO	1.526	1.535	1.543	1.591	1.693
YEN / US$	90.375	90.053	89.435	88.990	89.310
US$ / BRITISH POUND	1.618	1.614	1.623	1.651	1.492
SWISS FRANCS / US$	1.042	1.047	1.033	1.019	1.104

* As of 11:00 a.m.
Note: Data is for reference only.

International Stock Indexes

Thursday, December 17, 2009

			DAILY					52 WEEK			
					% Chg		YTD				3-yr
Index (Regiona/Country)	**High**	**Low**	**Close**	**Chg**	**-**	**+**	**% chg**	**High**	**Low**	**% Chg**	**% chg**
Global											
The Global Dow (World)	1979.55	1940.8	1942.74	-36.59	-1.85		27.3	1984.1	1139.9	26.3	-2.9
The Global Dow (Euro) (World)	1286.37	1274.08	1274.94	-3.39	-0.27		23.3	1278.33	849.42	27.4	-5.8
DJ Global Index (World)	225.9	221.8	222	-3.86	-1.71		29.1	227.46	130.29	29.2	-7.1
DJ Global ex U.S. (World)	200.45	195.84	196.2	-4.2	-2.1		33.7	203.58	111.8	31.4	-6.7
MSCI EAFE* (World)	n.a.	n.a.	1548.97	-35.9	-2.27		25.2	1617.99	911.39	22.5	-9.1
Asia Pacific											
DJ Asia-Pacific (Asia-Pacific)	122.58	120.89	121.04	-1.23	-1.01		29.3	124.27	73.76	29.2	-5.8
All Ordinaries (Australia)	4718.8	4667.7	4689.6	13.58		0.29	28.2	4862.5	3111.7	33.2	-5.5
S & P/ASX 200 (Australia)	4703.1	4649.2	4670.3	8.36		0.18	25.5	4859.9	3145.5	30.4	-5.7
DJ CBN China 600 (China)	29139.67	28253.94	28283.6	-702.26	-2.42		91.6	29890.92	14765.15	71.6	25
Dow Jones China 88 (China)	300.71	292.71	293.11	-5.55	-1.86		79.2	327.69	163.6	59.7	19.8
Shanghai Composite (China)	3272.98	3176.63	3179.08	-76.14	-2.34		74.6	3471.44	1820.81	57.7	11.8
Hang Seng (Hong Kong)	21665.79	21218.9	21347.63	-264.11	-1.22		48.4	22943.98	11344.58	37.7	3.8
Bombay Sensex (India)	16979.52	16826	16894.25	-18.52	-0.11		75.1	17326.01	8160.4	67.7	7.5
Jakarta Composite (Indonesia)	2542.5	2505.97	2509.58	-12.97	-0.51		85.2	2528.15	1256.11	85.7	11.9
Nikkei 300 (Japan)	183.43	181.91	181.91	-0.42	-0.23		3.9	196.39	140.76	6.2	-18.1
Nikkei Stock Avg (Japan)	10260.12	10163.8	10163.8	-13.61	-0.13		14.7	10639.71	7054.98	17.3	-15.6
Topix Index (Japan)	903.39	896.28	896.28	-2.01	-0.22		4.3	975.59	700.93	6.9	-18.5
Kuala Lumpur Composite (Malaysia)	1272.59	1265.58	1266.97	-2.06	-0.16		44.5	1279.95	838.39	43.9	5.2
NZSX-50 (New Zealand)	3139.7	3119.41	3122.92	-9.39	-0.3		15	3252.56	2417.95	15.3	-7.9
KSE 100 (Pakistan)	9382.44	9213.64	9227.18	-26.48	-0.29		57.3	9845.73	4815.34	18.5	-4.4
Manila Composite (Philippines)	3051.05	3032.78	3048.15	15.78		0.52	62.8	3119.96	1759.33	60.3	2.2
Straits Times (Singapore)	2827.91	2807.4	2813.27	-0.66	-0.02		59.7	2813.93	1456.95	56.4	-0.6
Kospi (South Korea)	1664.65	1647.66	1647.84	-16.4	-0.99		46.5	1718.88	1018.81	40.1	5
Colombo Stock Exchange (Sri Lanka)	3139.84	3089.45	3134.47	45.02		1.46	108.5	3139.73	1484.53	105.4	4.8
Weighted (Taiwan)	7836.43	7728.88	7742.17	-9.43	-0.12		68.6	7819.13	4242.61	64.9	0.9
SET (Thailand)	719.17	713.59	715.81	-0.2	-0.03		59.1	751.86	411.27	58.5	-0.9
Europe											
DJ Stoxx 600 (Europe)	249.98	246.93	247.18	-3.14	-1.26		25.5	251.34	157.97	25.3	-12.3
DJ Stoxx 50 (Europe)	2537.9	2505.51	2508.53	-33.98	-1.34		21.5	2546.37	1614.75	21.8	-12.4
DJ Euro Stoxx 50 (Euro zone)	2916.08	2882.82	2891.66	-34.86	-1.19		18	2950.82	1809.98	17.9	-11.3
DJ Euro Stoxx (Euro zone)	271	268.16	268.77	-2.92	-1.07		20.6	276.82	169.38	20.8	-12.1
ATX (Austria)	2482.36	2448.92	2451.52	-31.11	-1.25		40	2752.39	1411.95	42.9	-17.9
Bel-20 (Belgium)	2516.56	2490.69	2490.69	-36.98	-1.46		30.5	2606.93	1527.27	32.4	-16.9
PX 50 (Czech Republic)	1118.4	1112.4	1117.7	3.2		0.29	30.2	1195.7	628.5	34.1	-11.7
OMX Copenhagen (Denmark)	316.01	313.17	314.41	-1.06	-0.34		39	320.53	193.26	37.5	-9.3
OMX Helsinki (Finland)	6268.77	6188.44	6233.37	-33.94	-0.54		15.4	6632.35	4110.31	16.7	-13.4
CAC 40 (France)	3864.05	3820.88	3830.82	-45	-1.16		19	3892.36	2519.29	18.4	-11.6
DAX (Germany)	5891.37	5833.9	5844.44	-58.99	-1		21.5	5903.43	3666.41	22.9	-3.9
BUX (Hungary)	20723.5	20555.01	20643.79	-80.06	-0.39		68.6	21612.57	9461.29	64.1	-5.4
FTSE MIB (Italy)	22853.33	22601.56	22677.74	-211.85	-0.93		16.5	24425.98	12621	16	-18.2
AEX (Netherlands)	329.06	325.52	326.68	-1.93	-0.59		32.8	328.61	199.25	30.7	-12.9
All-Shares (Norway)	418.27	413.17	413.5	-4.77	-1.14		53	418.27	239.48	56.2	-5.6
WIG (Poland)	39872.91	39427.62	39553.33	-372.39	-0.93		45.3	40852.94	21274.28	44.4	-8.7
PSI 20 (Portugal)	8295.88	8168.24	8187.3	-114.68	-1.38		29.1	8882.69	5743.09	30.5	-9.7
DJ Russia Titans 10 (Russia)	5454.29	5450.93	5454.29	-112.63	-2.02		102	5566.92	2351.18	107.8	-5.2
RTS Index (Russia)	1452.98	1398.74	1400.91	-48.11	-3.32		121.7	1486.62	498.2	109.6	-8.9
IBEX 35 (Spain)	11820.5	11648.6	11696.9	-166.3	-1.4		27.2	12034.4	6817.4	26.3	-6.7
SX All Share (Sweden)	299.91	296.76	297.09	-3.38	-1.12		45.5	304.25	186.4	43.9	-7
Swiss Market (Switzerland)	6539.51	6476.05	6489.23	-43.09	-0.66		17.2	6532.32	4307.67	17.7	-9.6
Istanbul National 100 (Turkey)	50932.62	49693.83	49963.21	-854.04	-1.68		86	51380.65	23035.95	89.3	7.5
FTSE 100 (U.K.)	5320.3	5217.6	5217.61	-102.65	-1.93		17.7	5382.7	3512.1	20.5	-5.9
FTSE 250 (U.K.)	9141.42	9054.98	9057.4	-83.95	-0.92		42.4	9546.64	5769.79	41.7	-6.5
Americas											
DJ Americas (Americas)	294.39	289.97	290.29	-4.11	-1.4		28.4	294.97	172.41	31.1	-6.4
Merval (Argentina)	2228.03	2199.9	2225.48	-4.17	-0.19		106.1	2309.48	930.12	99.3	2.8
Sao Paulo Bovespa (Brazil)	68618.62	66791.95	67067.95	-1554.45	-2.27		78.6	69349.4	36234.69	69.6	15.4
S & P/TSX Comp (Canada)	11637.04	11473.06	11473.06	-163.98	-1.41		27.7	11779.73	7566.94	36.2	-3.8
Santiago IPSA (Chile)	3484.12	3456.61	3482.5	-0.61	-0.02		46.5	3483.11	2335.06	48.1	9.3
IPC All-Share (Mexico)	31958.28	31808.45	31948.41	-7.84	-0.02		42.8	32111.79	16929.8	43	7.4
Caracas General (Venezuela)	55145.51	54842.78	54890.23	-233.99	-0.42		57.2	55124.22	34318.05	59	6
Other Countries											
CASE 30 (Egypt)	6477.86	6424.38	6477.86	-7.09	-0.11		40.9	7249.55	3389.31	45.5	-1.4
Tel Aviv (Israel)	1114.02	1103.85	1105.34	-15.26	-1.36		68.8	1128.39	625.84	60.7	n.a.
Johannesburg All Share (South Africa)	27308.33	27089.43	27130.01	31.56		0.12	26.1	27489.24	18120.69	23.1	4

*Europe, Australia, Far East; U.S.-dollar terms. Three year percent change is annualized. Sources: Reuters; WSJ.com