TD Bank Financial Group

TD Economics

Housing Bubble Watch

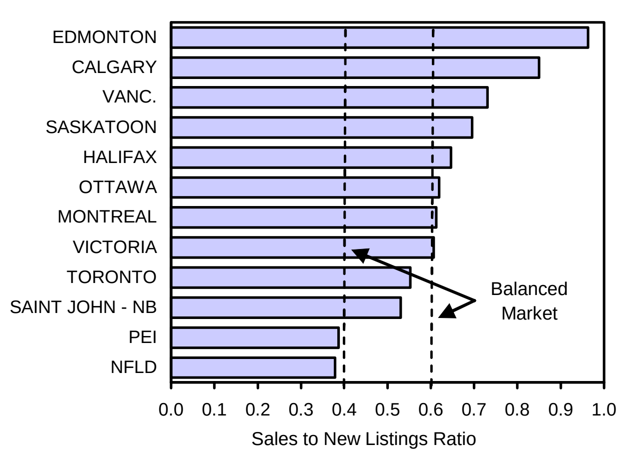
August 31, 2006

WARNING LIGHTS FLASH IN CALGARY, EDMONTON & VANCOUVER

This report monitors for the presence of a speculative housing bubble in local markets across Canada. In this regard, several indicators are used to look for generally agreed upon characteristics of bubble behaviour: i.e., whether the level of home prices are being bid up beyond what is consistent with underlying fundamentals and whether homebuyers are doing so with the expectations of future price increases. It is important to note, however, that it is, by definition, impossible to identify a bubble before it bursts, since rational investors would refuse to hold any asset whose price was certain to fall.

There are concrete signs that the U.S. housing market is falling back to earth and there is widespread recognition that this will severely dampen the performance of the U.S. economy. This has led to concerns that Canada might have a similar experience. There is no disputing that Canadian housing markets have been booming in recent years with extremely high levels of starts, sales and price gains in many markets. This has periodically fuelled concerns that a housing bubble might have formed. However, TD Economics has consistently argued that Canada's real estate markets have generally lacked the degree of speculation that dominated past boom-bust cycles and the excesses have been far less than those evident than in the United States. We still hold that overall view, but developments in a few Western cities are clearly flashing warning lights. There is no question that the recent dramatic price gains in Calgary and Vancouver are unsustainable and that these urban centres are vulnerable to significant moderation, including the possibility of a pullback in prices at some point in the future. Edmonton is also experiencing explosive price growth, but affordability remains high. In contrast, the other major Canadian real estate markets appear to be in much more balanced shape and housing activity in Central and Atlantic Canada has already cooled without prompting a price correction – supporting the view that a bubble never formed in these regions.

MARKET CONDITIONS IN 2006 Q2



Source: CREA, TD Economics

National perspective shows continued strength

At the national level, Canada's housing market is delivering a robust performance. Sales of existing homes are on track for another record year and strong demand has created upward pressure on prices. Resale home prices rose 12.9% in the second quarter of 2006 from a year earlier, which is marginally faster than the 12.0% gain posted in the first three months of the year and far exceeds the long-term national average of 5.6%.

The strength in resale markets has fed through to new home activity, with new home prices advancing at an 9.8% annual pace in June. This attests to the strong demand for housing, as inventories of unsold new homes are much lower than a year ago even though housing starts (i.e. new home supply coming to the market) have been at an elevated level for quite some time. Starts have dipped modestly since the start of the year, but the 236,500 units in June remain far above the sustainable 175,000 level that is consistent with current population growth and household formation.

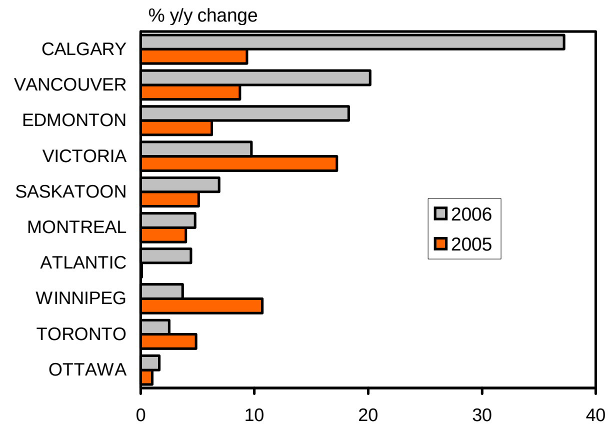
As often happens, the national story is masking major regional developments. Housing in Alberta has soared in the past three months, while activity in Vancouver continues to look excessive. Excluding Alberta and British Columbia, the average rise in resale home prices across the other provinces is a more moderate 7.3%. Alberta is also responsible for almost half of the gain in the national average of new home prices. Moreover, the dominant trends in housing markets outside of the West have been weaker unit sales, greater new listings and more moderate price growth – all of which point to more balanced market conditions and declining real estate risks.

Given that the national averages provide little understanding of the current underlying trends, let us turn our attention to the developments at the major city level, and we will frame the discussion from west to east.

Victoria cools, but remains relatively hot

Demand conditions are clearly softening in Victoria. Unit sales have fallen in five of the last seven months on a year-over-year basis. Reduced foreign interest in Victoria's real estate market in response to the strong Canadian dollar may have contributed to this trend. At the same time, new listings have been rising rapidly in the last few

INFLATION ADJUSTED RESALE HOME PRICES IN Q2



Source: Statistics Canada, CREA, TD Economics

months. The new home market appears to have stabilized, with relatively flat housing starts from January-July compared with a year ago. The net effect is that the Victoria housing market has become less of a sellers' market. This has been reflected in resale home prices, which slowed from a 17.5% year-over-year increase in the first quarter of 2006 to 12.7% in the second quarter, before strengthening to 14% in July. This suggests that the degree of speculation in the market is abating. However, with 50% of household income going to home ownership costs (mortgage interest, principal payments, property taxes and utilities), affordability is still a major issue. Price gains need to slow more in the months ahead to create a more sustainable market.

Vancouver still looks frothy

Demand for housing in Vancouver has been softening since the beginning of 2006. In six of the last seven months, unit sales have been virtually flat or negative

VICTORIA

2006	Unit Sales*	New Listings	Sales-to-Listings Ratio	Avg. Resale Price
Jan	3.6	47.8	0.48	15.9
Feb	-1.9	18.5	0.64	12.2
Mar	-10.7	26.5	0.62	22.9
Apr	-16.4	10.4	0.65	12.7
May	1.7	49.1	0.57	11.0
Jun	-7.9	16.0	0.60	13.9
Jul	-8.7	31.3	0.57	14.0

*Unless otherwise stated, listed as Y/Y % change
Source: CREA, TD Economics

VANCOUVER

2006	Unit Sales*	New Listings	Sales-to-Listings Ratio	Avg. Resale Price
Jan	12.8	2.4	0.55	21.3
Feb	-4.1	5.1	0.67	26.5
Mar	0.7	12.5	0.69	19.2
Apr	-17.7	-22.5	0.75	21.8
May	-4.4	13.7	0.73	23.7
Jun	-9.4	13.2	0.72	20.2
Jul	-26.7	4.7	0.62	20.3

*Unless otherwise stated, listed as Y/Y % change
Source: CREA, TD Economics

on a year-over-year basis. This may reflect the fact that the average resale house is now priced at over half a million dollars and home ownership costs have climbed to almost 50% of median household labour income.

Supply conditions have been more mixed. There have been substantially more new listings, with increases in six out of the last seven months on a year-over-year basis. As a result, the sales-to-new listing ratio has declined and now stands at only slightly above the 0.6 mark. This suggests that while it is still a seller's market, the balance between supply and demand has improved. However, there is still considerable tightness in the new home market. To illustrate, the inventory of unsold new homes stood at just 712 units in June – which is a record low.

There is welcome news that the rate of home price appreciation appears to have plateaued, but it has done so at an extremely elevated pace of around 20% year-over-year. Some of the market's strength is supported by fundamentals including lower unemployment, rising income, low interest rates and scarcity of land, but the substantial double digit price gains cannot last indefinitely and they will likely be brought back to earth by an increase in supply, particularly on the new home front.

The recent trend towards weaker unit sales and rising listings is a positive development that might augur for a soft-landing if it continues. Close monitoring of this market is clearly called for.

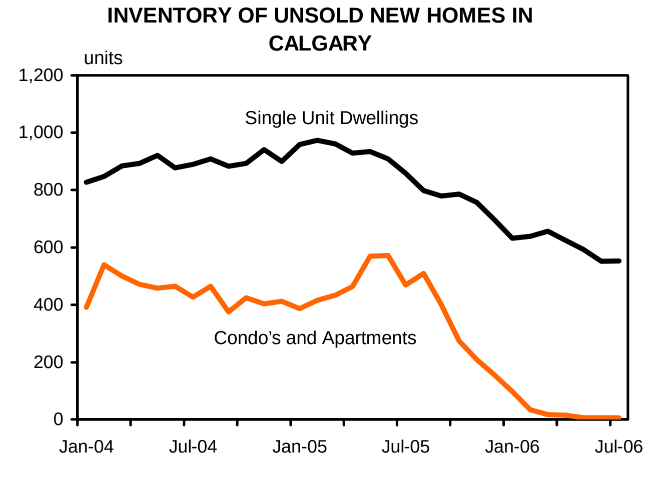
Calgary on fire

Demand for housing has softened a bit in Calgary over the last few months. After a booming start in 2006, unit sales have dropped from a dramatic 49% year-over-year increase in January to a 5.0% decline in July. Although the Calgary housing market is still very tight, it has begun to open up. After declining for most of 2005 and 2006,

CALGARY

2006	Unit Sales*	New Listings	Sales-to-Listings Ratio	Avg. Resale Price
Jan	49.3	-16.2	0.81	20.2
Feb	37.1	-6.9	0.95	26.2
Mar	17.9	-5.2	0.89	30.0
Apr	5.4	-15.5	0.95	37.1
May	11.9	-1.0	0.86	43.6
Jun	8.2	24.7	0.74	49.3
Jul	-5.0	41.2	0.58	45.6

*Unless otherwise stated, listed as Y/Y % change
Source: CREA, TD Economics



Source: Statistics Canada, TD Economics

new listings picked up substantially in June and July, rising 24.7% and 41.2% year-over-year respectively. This is likely a reflection of the dramatic increase in prices that has curtailed sales and boosted listings, but it has not yet tempered the explosive price gains.

As in Vancouver, the very low level of available new housing units is keeping the resale market very hot. There were only roughly 580 unsold new homes available in the April-July period. The last time inventories were this low in Calgary was in 1992. Even more amazing is that the total inventory of unsold new condos and lofts for sale from May to July stood at a mere six units.

This has resulted in a powerful sellers' market for new homes, and while the resale market has become more balanced it has only done so in the last couple of months.

As a result home price growth has been dramatic. Indeed, resale home prices jumped 25.5% year-over-year in the first quarter and accelerated to a 43.3% in the second quarter.

So, is there a bubble in the Calgary market? It may sound strange with the recent unbelievable price gains, but housing in Calgary remains surprisingly affordable and comparable to other major cities in Canada. Indeed, Calgary housing is still more affordable than Toronto or Montreal. In the second quarter of 2006, home ownership costs were only 24% of median household labour income in Calgary. This reflects the fact that resale home price gains in Calgary in the past have been more subdued than in many other urban centres and household income growth has been exceptionally strong in recent years. Also, much of the strong demand and drain on inventories is likely warranted by the robust population growth in Calgary and the rest of Alberta. In fact, Calgary has now hit the one million person mark and about 3,000 working-age men and women are arriving in the city every month.

Having said that, the speed of the rise in prices is troubling and cannot be sustained. If prices continue to rise at a close to 40% rate, affordability will quickly become a problem and fear of being priced out of the market may encourage hasty decisions. However, if the market becomes more balanced, the rate of price growth will eventually slow (although it will remain elevated for some time as the impact of additional supply will only gradually be felt), and we would argue that a price correction is not warranted. But the market is so overheated at the moment and new home supply so tight that a bubble may be forming, or could easily develop. Based on our bubble watch indicators, Calgary is the second urban centre that merits close attention.

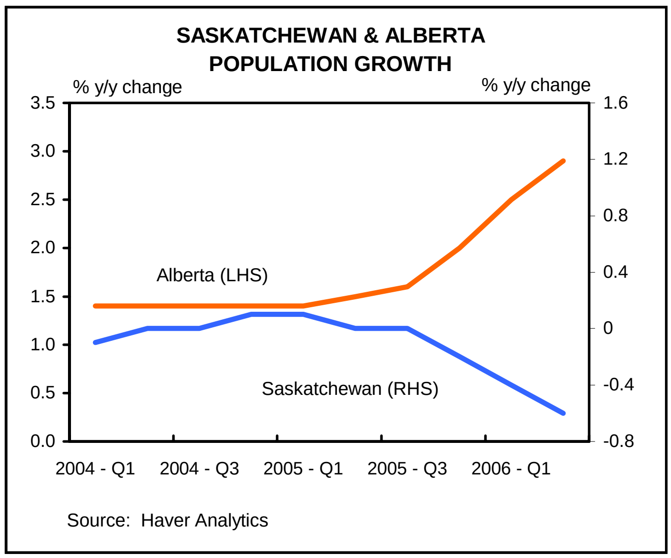
Edmonton also booming, but affordability remains good

Demand for housing in Edmonton is at its strongest in years, with unit sales up about 20% from the year before. Meanwhile, the supply-side of the Edmonton housing market remains very tight and has not kept up with demand. For example, there were more sales than new listings in May. We saw similar conditions in Calgary's housing market at the end of 2005. In Edmonton this has led to a 2-year low in the inventory of unsold new homes. The tight conditions in the housing market have fuelled a frenzy of housing starts (up 19% year-over-year in the Jan-July period). Meanwhile, the strong demand and tight supply has resulted in resale home prices soaring from 13.9% year-over-year in the first quarter to about 22.9% in the second quarter and reaching 31% in July.

While this explosive price growth is troubling, housing in Edmonton is still quite affordable. Housing-related costs were just 18% of median household labour income in the second quarter of this year. So, the message is the same as for Calgary. Much of the strength is supported by economic fundamentals, but prices cannot go up at this pace indefinitely. If the pace doesn't soften, a bubble could form. However, greater affordability and the scope for a future increase in supply lowers that risk and could lead to a soft-landing.

Saskatoon delivers strong performance

There hasn't been much change in the state of the Saskatoon housing market, which continues to deliver a robust performance. Unit sales have remained at roughly the same levels as a year ago and demand for housing has been fairly constant, as the outflow of workers to Alberta has largely been balanced by an influx of people from rural Saskatchewan. Supply has also been largely unchanged. As a result, inventories of unsold new homes and new list-



EDMONTON

2006	Unit Sales*	New Listings	Sales-to-Listings Ratio	Avg. Resale Price
Jan	32.6	-13.4	0.73	10.1
Feb	27.7	-7.4	0.87	15.5
Mar	20.0	-15.7	0.92	16.1
Apr	12.4	-22.3	0.93	18.2
May	22.3	-13.4	1.06	22.9
Jun	2.3	-3.1	0.89	27.5
Jul	21.3	2.2	0.88	31.0

*Unless otherwise stated, listed as Y/Y % change
Source: CREA, TD Economics

SASKATOON

2006	Unit Sales*	New Listings	Sales-to-Listings Ratio	Avg. Resale Price
Jan	27.2	12.9	0.49	16.0
Feb	4.2	-8.6	0.72	4.3
Mar	17.4	-3.7	0.73	9.7
Apr	-15.7	-19.4	0.65	6.1
May	2.7	4.9	0.69	11.5
Jun	9.4	1.2	0.75	14.9
Jul	-1.5	6.9	0.70	9.8

*Unless otherwise stated, listed as Y/Y % change
Source: CREA, TD Economics

ings are both around their 2005 levels, but this means the market is still fairly tight and home price growth remains strong, rising by 10.8% year-over-year in the second quarter, which is virtually unchanged from the 10% in the first quarter. However, there is good reason to believe that the market may open up in the months ahead, as housing starts are currently running about 34% higher than a year ago. With houses remaining reasonably affordable, the market should become more balanced and price growth should slow before long.

Winnipeg remains the most affordable

Although the Winnipeg housing market remains solid, demand for housing is likely softening. Population growth in Winnipeg decelerated substantially in 2006 to about 0.5% annualized, which is slower than the 1% observed over the last few years. As a result, the rate of increase in resale home prices slowed from 8.1% in the first quarter to 6.5% in the second quarter from a year ago. There may be some supply-side pressures, as there are still relatively few unsold new homes available, but housing starts are up about 9% year-over-year. With home ownership costs representing only about 14% of household income, Winnipeg remains one of the most affordable cities in the country to own a home.

Greater Toronto has cooled

There is clear evidence that the Greater Toronto housing market has cooled. While demand for housing remains robust in Toronto, unit sales appear to have reached a plateau in the past few months. At the same time, supply has increased slightly. There have been more new listings on the market and the inventory of unsold new homes was slightly higher in the second quarter versus the beginning of the year. Although starts rose in the second quarter, they were down from a year ago. As a result of these various trends, the Greater Toronto housing market has moved into a balanced position favouring neither sellers nor buyers. This has led to a slower pace of home price growth. After rising by 7.4% in 2005, resale prices moderated to a gain of 5.5% year-over-year in the second quarter of 2006 and down to 4.9% in July.

TORONTO

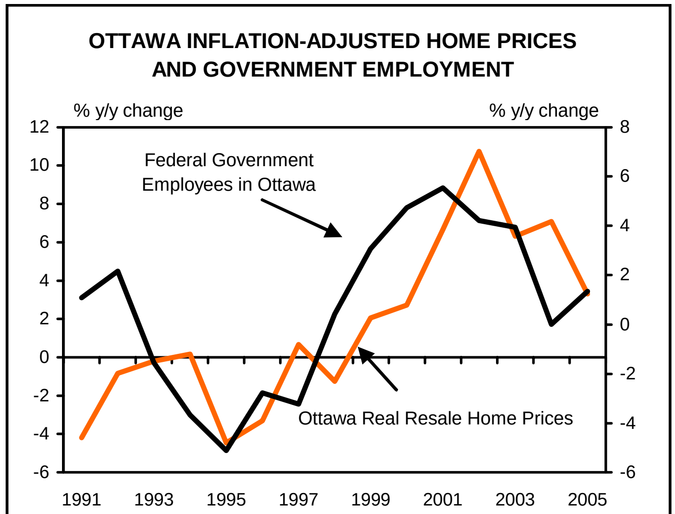
2006	Unit Sales*	New Listings	Sales-to-Listings Ratio	Avg. Resale Price
Jan	10.4	11.4	0.38	2.9
Feb	9.5	10.2	0.52	5.9
Mar	10.2	12.9	0.53	6.8
Apr	-5.4	-4.6	0.54	7.2
May	2.4	7.6	0.53	5.5
Jun	-4.6	2.8	0.58	3.8
Jul	-3.9	5.1	0.56	4.9

*Unless otherwise stated, listed as Y/Y % change
Source: CREA, TD Economics

OTTAWA

2006	Unit Sales*	New Listings	Sales-to-Listings Ratio	Avg. Resale Price
Jan	2.0	9.2	0.36	1.2
Feb	7.4	9.2	0.49	4.2
Mar	19.4	6.1	0.53	2.7
Apr	2.0	-8.3	0.58	6.2
May	7.6	8.0	0.58	4.7
Jun	8.7	-5.1	0.70	2.3
Jul	3.2	-5.3	0.65	1.4

*Unless otherwise stated, listed as Y/Y % change
Source: CREA, TD Economics



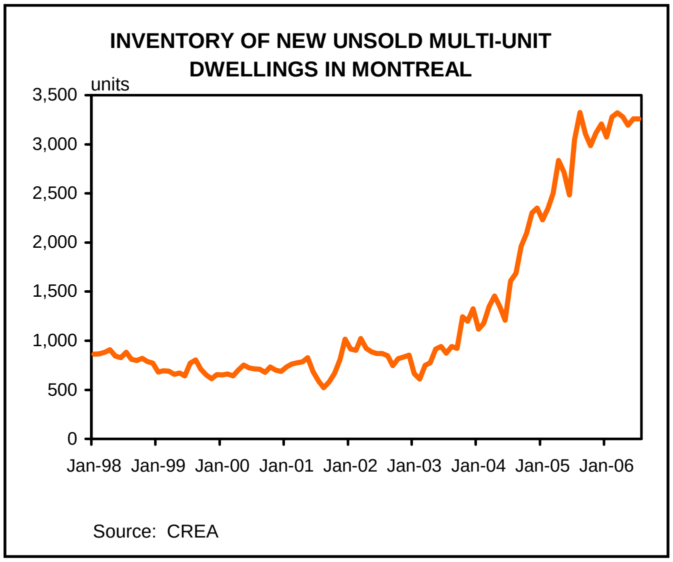
Source: Statistics Canada, CREA, TD Economics

Ottawa price growth slows in reaction to new supply

Over the past few months, unit sales growth have slowed, owing partly to a moderation in employment growth in the public sector. At the same time, new listings have declined, leading to a tightening in supply-demand conditions. In this situation one might expect to see an acceleration in the growth rate of resale home prices, but this hasn't happened. In fact, resale home price growth has slowed, dropping to an average increase of 2.8% year-over-year in the May-July period. This can be partly explained by an increase in new homes, which has

MONTREAL				
2006	Unit Sales*	New Listings	Sales-to-Listings Ratio	Avg. Resale Price
Jan	7.9	12.5	0.34	8.7
Feb	3.6	7.7	0.51	5.7
Mar	5.5	12.8	0.59	4.4
Apr	-2.7	2.1	0.62	7.9
May	5.3	4.1	0.63	8.2
Jun	3.6	9.3	0.59	5.8
Jul	0.3	7.0	0.46	8.5

*Unless otherwise stated, listed as Y/Y % change
Source: CREA, TD Economics



put a damper on prices. There are more unsold new homes than a year ago and housing starts in Jan-July are up by a substantial 21%.

Montreal market has become more balanced

Activity in the Montreal market has lost a bit of stream, but this has not led to significantly slower price growth. The rate of increase in unit sales and new listings have slackened over the past three months, with the ratio between the two statistics moving from 0.63 to 0.46, which is clearly a balanced market. Meanwhile, the number of unsold new homes has climbed significantly, reaching its highest recorded three-month average of 3,946 units in the May-July period. More than 80% of the unsold units have been in condos and lofts. The high inventories of properties available for sale have discouraged new starts, with the latter having fallen since the beginning of this year by 17% on a year-over-year basis. These trends are negative for home price growth, but their constraining influence has not yet been evident. Indeed, average resale prices in July were 8.5% higher than a year earlier. While this is strong, it does not imply that speculation is becoming a problem, and it is likely that the pace of home price growth will moderate in the second half of 2006.

Atlantic Canada cools over course of Q2

Housing market conditions in Atlantic Canada are healthy. In particular, the sales-to-new listings ratios for St. John's, Saint John, and PEI show relatively balanced markets. Conditions in Halifax are tipped slightly in favour of being a seller's market, but this is largely because growth in new listings has slowed faster than unit sales, with the direction of both being towards a cooling. However, this assessment is not apparent in the aggregate Atlantic statistics in the bubble watch indicators table on the next page. Just as the national housing data are being distorted by regional trends, so too is the Atlantic aggregation. Resale home prices in Halifax spiked temporarily higher by 48% in April from a year ago, dramatically lifting the price gains in the second quarter, but then price growth slowed in each of the next three months, dropping to a 3.5% pace in July. Similarly, price growth in PEI was extremely strong in the first quarter, but has been slowing steadily since February. As a result, Atlantic Canada is on track for robust price growth in 2006, but the trend is towards more moderate price growth. The tighter market conditions do suggest that Halifax may outperform the regional average in the months ahead, but the assessment is that the risks of a housing bubble remain low.

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BUBBLE WATCH INDICATORS - Second Quarter of Each Year (Unless Otherwise Stated)	Toronto	Van.	Victoria	Calgary	Edm.	Sask.	Winn.	Ottawa	Montreal	Atlantic
Average Price										
1989 (annual average)	253,599	208,616	140,977	111,819	88,711	75,811	84,182	137,362	109,042	86,864
1995 (annual average)	195,899	309,279	211,234	132,257	110,236	82,030	82,980	143,326	106,898	94,272
2005	334,173	401,694	351,704	239,997	187,515	139,899	129,732	244,789	198,825	154,961
2006	351,680	509,606	421,637	345,903	232,932	157,453	144,827	256,182	215,301	178,531
Real Annualized Price Gain										
1989 (annual average)	NA	24.8	13.4	6.2	2.9	-3.6	-2.2	1.9	1.1	-1.0
1995 (annual average)	-4.2	-1.0	-6.3	-3.0	-4.5	-1.8	-4.2	-4.5	-5.5	-2.3
2005	4.9	8.7	17.2	9.4	6.3	5.1	10.7	1.0	4.0	4.9
2006	2.5	20.2	9.7	37.2	18.3	6.9	3.7	1.6	4.8	9.2
Irrational Exuberance Indicator										
1989 (annual average)	NA	37.0	16.1	8.6	4.0	-9.1	-6.8	4.0	4.1	NA
1995 (annual average)	-8.4	-2.4	-12.0	-6.2	-10.8	-2.8	-11.5	-13.3	-21.7	-5.3
2005	8.4	10.6	21.1	11.8	8.4	7.6	13.5	1.8	6.3	8.8
2006	4.6	27.6	16.1	43.8	19.0	9.9	NA	2.6	7.9	16.5
P/E Ratio										
1989 (annual average)	14.4	11.6	NA	NA	8.5	NA	8.8	10.5	12.0	NA
1995 (annual average)	10.9	15.5	NA	NA	8.8	11.7	7.8	9.9	10.0	9.6
2005	12.4	17.5	NA	NA	10.4	NA	9.2	12.3	11.1	9.4
2006	12.9	19.9	NA	NA	13.3	NA	9.6	13.9	12.2	11.1
Own v. Rent Ratio										
1989 (annual average)	136.8	110.2	NA	NA	80.9	NA	83.5	100.3	114.3	NA
1995 (annual average)	83.8	119.3	NA	NA	67.8	88.5	59.9	75.7	76.5	73.7
2005	71.2	100.8	NA	NA	59.7	NA	53.0	70.8	63.5	53.8
2006	80.5	124.5	NA	NA	83.1	NA	60.1	87.0	76.1	69.2
Affordability (%)										
1989 (annual average)	48.6	33.6	32.1	21.6	15.7	19.4	20.4	20.4	28.3	21.1
1995 (annual average)	25.0	41.7	45.3	17.0	14.0	18.5	12.3	19.7	21.2	19.9
2005	24.4	39.3	45.8	15.5	13.9	17.6	12.5	17.8	22.0	17.8
2006	27.3	49.8	50.0	24.0	18.0	21.5	13.9	19.6	25.9	23.6
N/A = not available										

INDICATOR DEFINITIONS

Real Annualized Price Gain: The twelve-month increase in average home prices deflated by the consumer price index (CPI). Sources: Canadian Real Estate Association, Statistics Canada, TD Economics.

Price to Earnings (P/E) Ratio: This indicator measures the price of a benchmark property (townhouse) in relation to its expected future cash flow. For real estate, this is broadly thought to be the imputed rent yielded by the property. On this basis, imputed rents should theoretically reflect all fundamental factors affecting the property including expected economic conditions. An increase in the P/E ratio suggests that a property's price may have risen faster than what the underlying earnings of that property could generate, potentially implying some overvaluation. A standard townhouse is chosen as a benchmark property since it conceivably represents a median housing choice in the housing market (i.e., this property contains attributes that are similar to both condos and single-family homes). It is also a property type that is consistently found in most urban markets thereby allowing for regional comparisons. Source: Royal Lepage, Statistics Canada, TD Economics.

OWN vs. RENT Indicator: The ratio between the estimated monthly ownership costs of a benchmark townhouse and its imputed monthly rent. Ownership costs only consist of principal and interest payments for the property based on the current 5 year average mortgage rate and a 25 per cent down payment amortized over 25 years. The further the indicator moves above 100, the cheaper it is to rent that property type, all else equal. Sources: Royal LePage, Statistics Canada, TD Economics

Irrational Exuberance Indicator: The ratio between the twelve month percentage increase in inflation-adjusted average home prices and underlying supply and demand conditions. The latter term is estimated as the ratio between sales to new listings in the representative market. The Irrational Exuberance Indicator effectively suggests to what degree home prices are growing in relation to market conditions. For example, an indicator greater than 10, suggests that prices are growing faster than what market conditions would warrant, implying increasing risk of speculative activity. Conversely, an indicator less than –10 would suggest greater negative sentiment than the market would imply. Source: Canadian Real Estate Association, TD Economics.

Affordability Indicator: The percentage of household income needed to service the ownership costs of a benchmark property (townhouse). Ownership costs only consist of monthly principal and interest payments based on the current 5 year average mortgage rate and a 25 per cent down payment for the property amortized over 25 years. Household income is based on median total income for all economic family types. The greater this indicator, the more income it takes to service the costs of ownership. Source: Royal LePage, Statistics Canada, TD Economics