



## Consumer price inflation below 1%

B.C.'s inflation rate for the year ending March 2004 was 0.8%, according to the latest Consumer Price Index (CPI) from Statistics Canada. The latest month-over-month rise came in at 0.2%, down from February's 0.4% increase. Higher prices for fuel oil, gasoline, footwear and vegetables in March outpaced lower prices for children's clothing, coffee and tea.

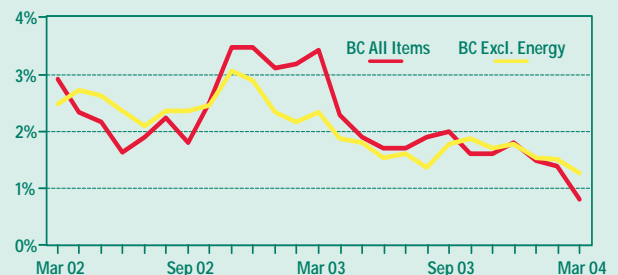
Excluding energy, B.C.'s inflation rate for the year ending March 2004 was 1.3%, down from February's 1.5% year-over-year rate. The latest month-over-month change was just under 0.2%, as the excluded energy prices, particularly gasoline and fuel oil, rose at above-average rates.

Near-term inflation is on a downward trend. The higher U.S.-Canada currency exchange rate is restraining some CPI component prices such as food. Continued low mortgage interest rates and weaker rental markets will contain shelter costs. Energy prices are a wild card and recent price gains put crude oil prices near their highest level since September 2002. The higher Loonie does provide some offset to imported crude, which is priced in U.S. dollars. OPEC pledged earlier this year to cut production, but demand will fall as the weather warms. However, the price for crude oil could well stay above \$30 U.S. per barrel.

Our forecast for B.C.'s average CPI inflation rate is 1.8% for this year and 2% next year. The B.C. provincial budget released in March forecasts 1.6% and 1.9%, respectively. CPI increased by 2.1% in 2003.

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B.C. Consumer Price Index (CPI)  
Year-over-Year Per Cent Change



Source: Statistics Canada.

## Housing market — correction, collapse or more upside?

More and more speculation is heard about a possible correction or collapse of the hot housing market. Housing prices are rising at a double-digit pace, listings are snapped up when they come on the market, with some selling above the asking price, and buyers are lining up overnight to buy downtown condos. These are obvious signs of a hot market, and possibly an overheated market. How much longer can prices go up? Is not a correction in the offing in a cyclical market such as housing?

It is not an insightful forecast to say that the housing market, or any market, will correct. Markets by their very nature find the over-supply point and will correct in response to imbalances. At some point, the housing market will indeed be over-supplied and prices will come down, but the real utility of such a forecast comes only when a time-line and a rationale for the correction is given.

Looking back in history, housing market corrections are almost always caused by negative changes in housing demand, usually sharp increases in mortgage rates or in unemployment — and sometimes in both. A population outflow can also occur when the local economy turns down, exacerbating the housing market correction. To see if a housing market correction is likely, we should examine the outlook for interest rates and the economy.

Obviously, pundits and commentators can have differing views on the interest rate and economic outlook. Those who foresee a large two or three percentage point increase in mortgage rates, which would push the five-year term posted rate to over 8% or 9% from its current 6.15% within the next 12 months, are right in predicting a negative impact on demand and on the overall market. But higher interest rates would only come about if the economy is stronger and inflation is a threat. Stronger economic growth would be accompanied by stronger employment and income growth, and that would provide some offset to those higher rates.

We see rates remaining generally low, with some upward drift in longer-term rates as inflation expectations rise. Volatility in financial markets will increase with the guessing game as to when the U.S. Federal Reserve will raise rates and how the Bank of Canada will react to the Fed's moves. Financial markets usually lead central banker's actions, sometimes correctly and sometimes prematurely. The recent up-tick in the five-year mortgage rate is viewed as temporary and will come down on economic news that inflation is not a threat. Interest rates will eventually move higher, particularly in the U.S., but the timing and extent of the rise will be more gradual and later than the market currently expects.

Most, if not all, forecasters are calling for a lower B.C. unemployment rate this year and next, accompanied by moderate economic growth. No economic recession is foreseen for B.C., Canada, or the global economy. If there is a problem, it might be that growth is too strong and cause interest rates to rise substantially.

If rates and the economy are not an imminent threat to the housing market, then perhaps these double-digit price increases by themselves will cause a market correction? Our forecast calls for 15% and 12% increases in the average sales price, this year and next, respectively. This is on top of a 10% increase in 2003 and an 8% increase in 2002, amounting to a near 50% increase in four years. The forecast risk is for these increases to be low, not high.

Higher prices could cause a market correction, but likely not a market collapse. In the later stages of a market upswing, higher prices will cause demand growth to subside due to an affordability squeeze, mainly affecting potential first-time buyers. Unit sales will ease, flatten out and possibly decline, but that will not be the basis of a major market correction, as sharp increases in mortgage rates or in unemployment would be.

The potential first-time buyer market is deep at these low rates. Rates would have to climb by two, three or more percentage points to make a significant cut into that buyer pool. There are over 500,000 renter households in B.C., and about 100,000 of them could afford to buy a home at February's average sales price of \$283,000, with a 5% mortgage rate and with a minimal down-payment. If the mortgage rate rose to 7%, the number of potential buyers would fall to about 60,000, a large decline that illustrates the importance of financing costs in determining affordability. To achieve the same negative impact through prices would require a price hike of about 25%, at a constant mortgage rate. A price-driven affordability squeeze is underway and is a mounting future market issue.

Speculation is likely increasing, as it does in any hot market. Some speculation serves a useful market purpose but not rampant speculation, which usually results in a misallocation of resources. The extent of speculative activity in the housing market is not precisely known, but we believe it is not widespread at this time. Most transactions are driven by the demand from principal owners and not from flippers. When speculative transactions become a larger part of the market, the market becomes more vulnerable to negative demand shocks.

So far, we have looked at demand, but we should not forget about supply. Under rising prices, supply will increase and help to temper price increases. New construction is rising but it takes time to bring new product onto the market, whereas supply of the existing stock comes onto the market much more quickly. In this market upswing, supply of the existing stock – represented by listings or units for sale – is higher but by less than usual thus far. However, this is starting to change and more existing supply will come onto the market, helping to ease price pressure.

The scenario foreseen is for lower price increases due to a combination of more supply and less demand growth. In other words, a 'soft landing' rather than a market correction or collapse is the most likely scenario for this year and next, barring the unexpected.

