



It may burst your bubble, but buy within your means

Patricia Lovett-Reid, Financial Post · Saturday, Jun. 26, 2010

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My daughter Carolyn just bought her first house. It was a bit of a stressful experience, as home buying can be. With terms like "housing bubble" making headlines almost every day, she was justifiably concerned about her chances of buying her dream home.

According to the Canadian Real Estate Association (CREA), the national average price of homes sold in May is up 8.5% year over year to \$346,881, the highest on record. It's no wonder my daughter, and many others like her, are anxious about the possibility of a housing bubble.

What I reminded her of was the importance of putting things into perspective. Home prices across the country have grown at an average annual pace of 4.7% over the past 22 years, or just 2.4% per year above inflation.

Residential home prices in the Greater Vancouver Area have appreciated by 54% over the past five years. That's over 9% a year compounded! In comparison, the average selling price in the Greater Toronto Area has risen at a compound rate of 5.2% per year over the same period.

I'll be the first to admit that finding good value is becoming increasingly difficult in certain markets. But just because homes are fully priced in many areas does not mean a bubble has formed.

I believe that the current pace of activity and the price gains may not be sustainable over the balance of 2010. Recent changes to the mortgage insurance rules, the upcoming implementation of the HST in Ontario and British Columbia, as well as the expectation of rising interest rates have resulted in a rush to get transactions booked in the first half of this year.

The combination of these changes along with the rise in home prices will impact housing affordability and help cool the market. Plus, the federal government, the Bank of Canada and financial institutions have already demonstrated their conservative approach to residential real estate and, in my opinion, will take all necessary measures to avoid a bubble. My colleagues in TD Economics forecast that after a 9% appreciation in average existing home prices in Canada in 2010, we could see a dip of 2.7% in 2011.

What is the impact on mortgage rates? After a bout of record-low interest rates, rising bond yields led lending institutions to raise rates on fixed mortgages. Five-year fixed rate mortgages are now higher than they were just three months ago. Variable rate mortgages are closely linked to the Bank of Canada's benchmark lending rate, as well as the cost of funds and market conditions. On June 1st, the Bank of Canada raised its rate by 25 basis points and lenders followed suit. Economists at TD Bank expect the Bank of Canada to raise rates from the current 0.5% to 1.5% by the end of 2010 and to 3% by 2011. You can expect variable mortgage rates to increase along the way.

At present, you can get a five-year fixed rate mortgage for approximately 4.6%, and the closed five-year variable rate mortgage is approximately 2.35%. When I bought my first house in the 1980s, I remember rates being stubbornly high and paying 18%. The question becomes, should you go fixed or variable?

The more stable your job, the higher the amount of equity in your home, the greater your financial liquidity and risk tolerance, the more suitable a variable mortgage may be for you.

On the other hand, fixed rate mortgages offer you the peace of mind of a set rate and a predetermined amortization schedule. The way I see things, it's actually pretty simple: Don't like risk? Then a fixed rate mortgage is for you.

Just like I told my daughter Carolyn: Buy within your means because it is not worth the sleepless nights.