

Transitioning to a slower growth environment

By current metrics, the finances of Canadian households are in good shape. From an *asset* perspective, household wealth has reached unprecedented highs, thanks to years of solid, uninterrupted economic growth accompanied by falling unemployment and rising home and stock prices. From a *liability* perspective, indicators of balance sheet leverage appear in line with past norms, even as historically low borrowing costs have fuelled a steady rise in debt loads. And from a *portfolio* perspective, household assets remain well diversified despite a shift in favour of real estate assets this decade.

However, this performance will be tested in the months ahead as the global economy moves to a slower growth trajectory, housing markets — at least east of the Prairies — cool off, and job growth moderates. In recent years, households have relied almost exclusively on outsized capital gains to build their wealth, a strategy that could have major implications for the aggregate consumer spending outlook. *Simply a return to a historical pace of asset price appreciation would remove much of the strong 'wealth effect' that has supported big-ticket consumer spending so far this decade. It would also force many households to raise their conventional level of saving to meet their long-term retirement goals.*

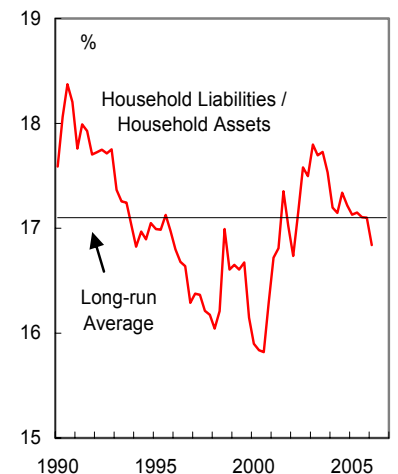
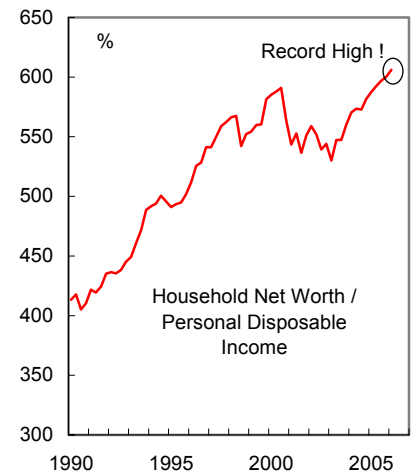
At the same time, the typical household investment portfolio has become both less liquid and more exposed to market risk than in the past, reflecting the more rapid growth in holdings of stocks, mutual funds and tax-sheltered pension vehicles relative to traditional cash and term deposits. This more aggressive investment strategy has been positive from a longer-term wealth-building standpoint. From a short-term cyclical perspective, however, it leaves households more exposed to adverse economic developments, such as a sharp correction in the buoyant housing market, increasing joblessness attributable to slower U.S. demand for Canadian exports, or increased financial market and interest rate volatility.

Among the major trends shaping Canadian balance sheets, five in particular stand out:

Canadians are wealthier than ever before

The collective net worth of Canadian households — the value of all assets minus liabilities — increased 10% in the most recent twelve-month period, to a record \$4.97 trillion. This brings the cumulative rise in household wealth in the past three years to an impressive 31%, or about 20% after adjusting for inflation and population growth. Given Canada's roughly 12 million households, this translates into an average net worth of almost \$400,000 per family (including roughly \$100,000 in accumulated employer pension plan benefits).

Statistically, *average* net worth estimates are heavily skewed by households at the top of the wealth distribution. Statistics Canada's 1999 *Survey of Financial Security* found that *average* net worth was roughly 2.3 times greater than *median* net worth — the latter being more representative of a 'typical' household. Assuming this ratio is



still a reasonable approximation today, the median net worth of Canadian households is probably closer to \$175,000 (including about \$50,000 in trustee pension fund assets).

Notably, wealth gains over the past several years have been broadly based by asset class, reflecting both the sustained nationwide housing boom that has pushed up home prices to record levels, as well as to the strong recovery in stock markets in the aftermath of the 2001 tech meltdown. The total market value of household real estate and financial assets has risen 26% and 34%, respectively, since the beginning of 2003.

Canadians have also been borrowing more, encouraged by their appreciating investments, historically low interest rates, and a consistently solid pace of job creation. Yet thanks to their asset gains, the ability to service this debt has not materially deteriorated. In fact, the ratio of total household liabilities (consumer credit and mortgages) to assets — a broad measure of household leverage — was slightly below its historical average in early 2006. In contrast, U.S. households, which have relied more heavily on home equity loans and mortgage refinancing in recent years, are facing record high debt leverage ratios.

Investors are altering their wealth accumulation behaviour

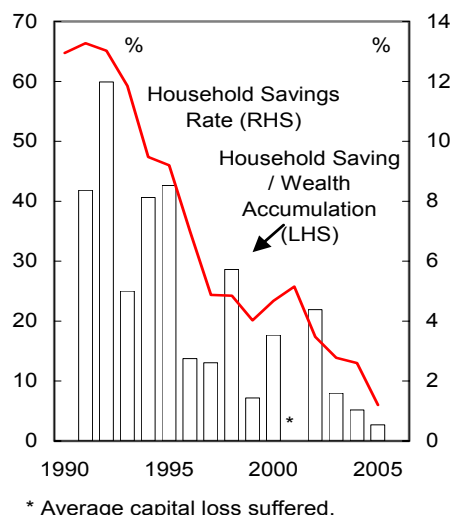
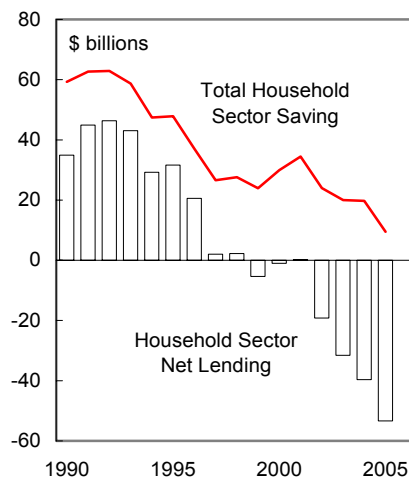
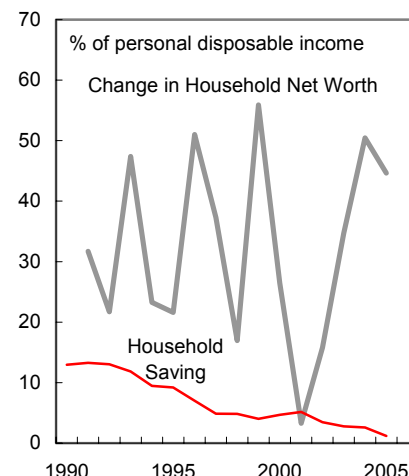
Canadians on average are saving less out of current income, instead relying on capital gains (both realized and unrealized) accruing from their real estate and equity holdings to build their wealth. The nation's official savings rate — the difference between current personal income and expenditures — has fallen steadily over the past decade and a half, from over 13% in 1990 to a record low 1% as of mid-2006. Conventional savings rate estimates exclude contributions to social insurance and employer pension plans, non-discretionary savings that are deducted directly from paycheques. Adding back these deductions would lift the measured savings rate above 8%, but the declining trend would still persist.

From an economy-wide perspective, the household sector in Canada is an increasingly large *net borrower* of funds, reversing its long-standing position as a *net lender*. We expect this trend to continue as retiring baby boomers gradually draw down their accumulated savings, including those from employer and private pension plans. In the meantime, Canadian corporations and governments have stepped up as net suppliers of investment funds, more than compensating for the decline in personal sector saving.

On its own, Canadians' decreased propensity to save out of current income is not a major cause for concern. Personal savings rates in most industrialized nations have been on a downward trend since the early 1990s, as rising wealth improved the overall financial position of many households. Solid economic growth and low and well-anchored inflation expectations may also have decreased the perceived need for a sizeable 'rainy day' fund.

As an asset-building strategy, however, the implications are dramatic. From 2000-2005, conventional saving by Canadians accounted for just 10% of personal sector wealth accumulation, compared with almost 30% in the 1990s. Last year, saving accounted for a mere 3% (\$9 billion, or roughly \$750 per household) of the aggregate \$351 billion increase in national household wealth — the lowest on records back to 1990. The remaining 97% stemmed from asset price appreciation.

Looking ahead, many households may need to revisit their investment strategies as the heady pace of home and equity price appreciation inevitably slows. Generating even modest wealth gains may require boosting traditional savings and/or reining in discretionary outlays. At a macroeconomic level, the impor-



tant 'wealth effect' underpinning consumer spending growth will likely diminish, reinforcing any economic slowdown already under way. Gains in real estate wealth are thought to be particularly powerful, as they are perceived as more permanent, and real estate is widely held.

Investment portfolios remain well diversified

Appreciating home prices, rising homeownership rates and a boom in renovation activity in recent years has shifted the composition of household wealth in favour of real assets — 80% of which represent real estate holdings. This is the reverse of the trend of the 1990s, when buoyant stock markets and an underperforming housing market consistently favoured financial asset investments. From either a historical or international perspective, however, the exposure of Canadian households to real estate markets is not unusually high. Real estate assets accounted for 33% of all household assets in the first quarter of 2006, up 4 percentage points from the start of the decade but in line with its long-term average.

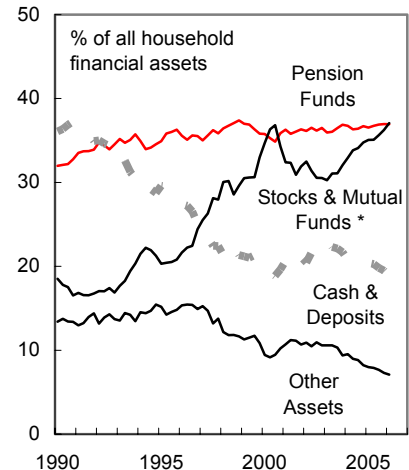
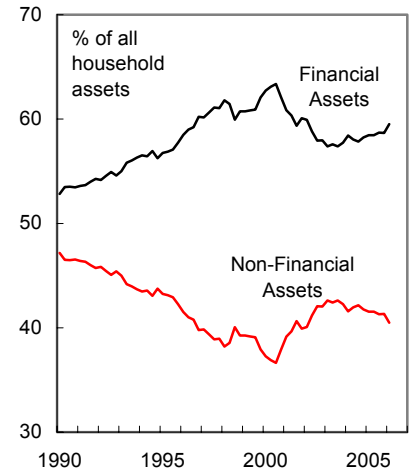
Again, average portfolio shares derived from aggregate balance sheet figures are not necessarily representative of a typical household. As real estate is much more widely held than equities, we expect it accounts for more than one-third of most households' total assets. The aggregate measures are nonetheless indicative of the exposure of the entire household sector to real estate and equity markets.

The reallocation between asset classes appears to have been driven more by cyclical considerations — pent-up housing demand, historically low borrowing costs and the steep equity market correction at the turn of the new millennium — than an underlying shift in investor mentality. Indeed, real estate's share of total household assets peaked almost two years ago amid the general recovery in stock markets globally. Longer-term, growing investor risk tolerance and sophistication, and the historically higher average returns to stocks over housing, should favour financial assets over real assets.

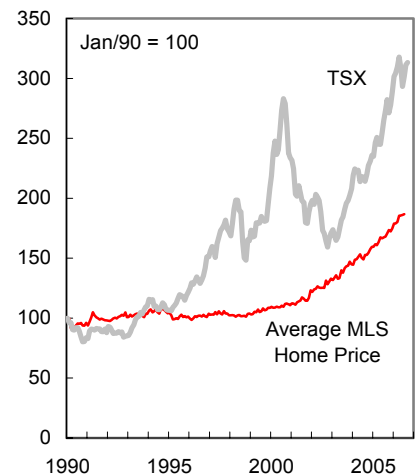
Demographic trends (i.e. an aging population) also favour financial assets. Younger households that are just beginning to establish themselves financially tend to focus on accumulating real assets such as durable goods and first homes, while older households focus on retiring mortgage debt and building their financial assets for retirement. Because households often trade up to larger, more expensive homes during their lifetime, however, the real estate share of most portfolios historically hasn't begun to decline until around age 45 — perhaps even later today given increased longevity and life expectancy.

Maintaining a diversified portfolio of assets is important to managing the inherent risk in any investment. Notwithstanding the recent strong gains in both housing and stock prices, the correlation between real estate and equity market performances historically is quite weak. For most of the 1990s, for example, rising stock prices compensated for largely stagnant home valuations. Adding real estate assets to financial holdings could lower the overall volatility of household net worth.

As an investment, however, housing is not without risk. It provides diversification compared with a portfolio consisting entirely of financial assets, and has a relatively lower risk of nominal price decline than for many other investments. But given the magnitude of the principal residence to total assets, and the high degree of leverage used to finance it, too heavy a focus on housing could leave a household highly exposed to regional house price developments.



* Includes tax-deferred vehicles.



Financial assets are becoming less liquid

The relative percentages allocated to various financial assets have also shifted, generally toward less liquid investments. Stocks and mutual funds, much of which are held in tax-sheltered retirement plans, accounted for 37% of all household financial assets in early 2006, double the share in 1990. Over the same period, the accumulated value of household life insurance and employer pension plan funds as a share of total financial assets increased 5 percentage points, also to 37%.

Meanwhile, Canadians have been steadily reducing their holdings of lower-yielding, lower risk cash and other short-term deposits, which now represent just 11% of household financial holdings, down from 19% in 1990. This reduction in liquidity is the natural outcome of an aging population and a low inflation environment. In the event of an unexpected economic downturn, however, it could leave many households with a limited savings cushion to draw on.

Households are taking on greater market risk

The rising share of household assets invested in real estate, stocks, mutual funds and pension funds, and the corresponding decline in holdings of cash, savings bonds and term deposits, has increased the exposure of Canadian investors to market risk. We estimate that roughly 21% of household assets at the end of 2005 were invested in high market risk holdings (i.e. stocks and mutual funds), more than double the comparable share in 1990. Meanwhile, investments in low risk savings vehicles (i.e. cash and term deposits, mortgages and savings bonds, and consumer durables) dropped from 35% to 21% of all financial assets. The remaining 56% could be categorized as medium risk (i.e. real estate, pension funds, and foreign and other investments).

Rising market risk does not imply that the overall financial health of Canadian households is unduly exposed. Indeed, households' rising net worth relative to income suggests a greater ability to weather increased market risk — and generate larger long-term investment returns. However, along with reduced liquidity and a shift to price-appreciation based wealth accumulation, short-run changes in wealth and consumer spending may ultimately prove more volatile than in the past.

