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Canadian home prices overinflated by 20 per cent: Fitch

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Ratings agency says new financial model suggests home prices overvalued, says doesn't expect prices to fall by same amount

Canadian home prices are overvalued by about 20 per cent, Fitch Ratings says.

The rating agency's estimate of how inflated prices are was included Monday in details of a new financial model that it is proposing to use to estimate the potential losses on pools of residential mortgages, which form the backbone of a number of securities that Fitch rates.

The agency said that, based on its sustainable home price model, it estimates "at the time of publication, that prices are overvalued by approximately 20 per cent in real terms across Canada, with regional variations."

But "because of the effects of inflation and price momentum, it is not expected that prices would drop by this amount," it added. "If growth halted and prices began to drop, it would be expected to take several years for home prices to revert to their sustainable values, depending on a number of factors such as government support and credit availability. With this timeframe, the actual observed decline in prices could be as low as 10 per cent."

The agency noted that prices have continued to climb, with small corrections, since 1996, "and specifically since 2008 have risen when underlying fundamentals suggest that growth is unsupportable."

"This story is similar throughout Canada," it added. Its estimates of the overvaluation in Ontario, Alberta, British Columbia and Quebec are 21 per cent, 15 per cent, 26 per cent, and 26 per cent respectively.

"Actual nominal [price] declines could range from the low single digits for Alberta, up to more than 15 per cent for B.C. and Quebec over the next several years assuming values start falling immediately and taking into account inflation and other market dynamics," it said.

Among the four largest provinces, Alberta is the least overvalued because it already went through a house price correction when crude oil prices fell in 2008, and prices have not returned to their 2007 peak. Prices in B.C., on the other hand, quickly rose to record highs after the global recession.

Generally, while low rates have kept payments down for all borrowers, higher home prices have led to larger mortgages, eroding much of the benefit for new buyers, Fitch said.

"Price-to-rent ratios are now 60 per cent higher than their 30-year averages," it added. And the average property price is now five times average disposable income, up from the long term average of 3.5 times.