



# Mortgage Rate Forecast

## LOWER FOR LONGER

### HIGHLIGHTS

- Unprecedented collapse in bond yields but no change in mortgage rates?
- Danger of Euro-credit crisis spreading
- Interest rates likely to stay lower for longer

### Mortgage Rate Forecast

Term	2011				2012			
	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
1-Year	3.50	3.62	3.50	3.40	3.40	3.50	3.75	4.00
5-Year	5.34	5.56	5.35	5.30	5.30	5.50	5.50	5.60

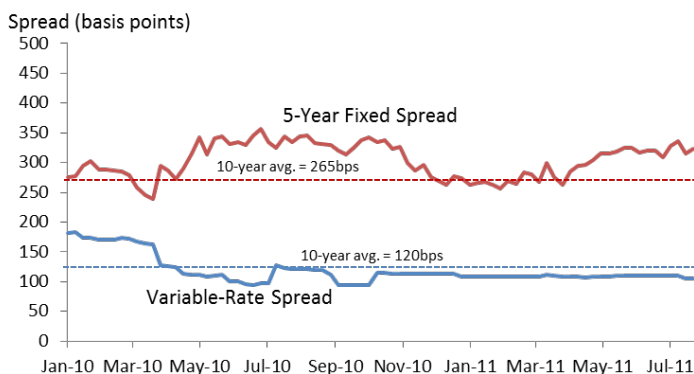
Source: BCREA, Bank of Canada

### Mortgage Rate Outlook

The third quarter saw a stunning collapse in government bond yields as markets digested weak US economic data and an increasingly serious debt crisis in the Euro-zone. The yield on five-year Government of Canada debt fell an incredible 150 basis points from its peak in the first quarter to 1.35 per cent, the lowest level on record.

The current level of bond-yields would normally prompt a dramatic fall in mortgage rates. However, there are a number of factors complicating the normal arithmetic. First, some lenders are offering deeper discounts for the most credit-worthy borrowers. This allows banks to provide competitive rates while also filtering out higher-risk borrowers. Second, the emerging potential of credit crisis in Europe has raised

#### Bank Profitability Being Squeezed by Low-Margin Variable Rate Mortgages



Note: The 5-year spread is the 5-year posted rate minus 5-year Govt. Bond Yield;  
Variable rate spread is Bank of Canada estimated variable rate minus 3-month Bankers Acceptance

Source: Bank of Canada

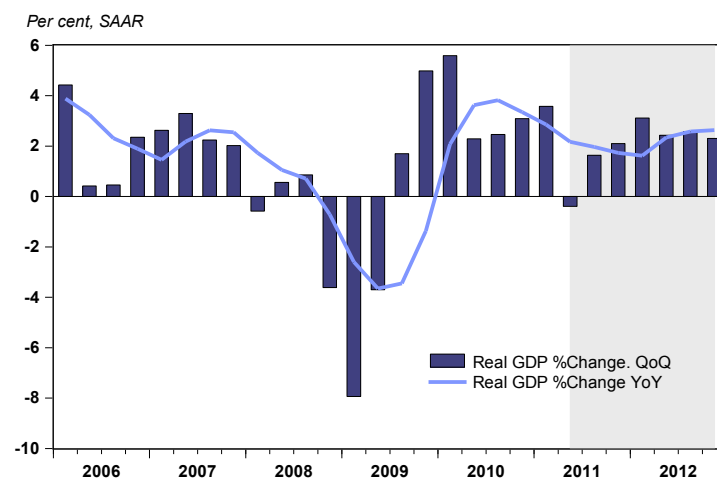
the short-term cost of funding for financial institutions worldwide, thereby squeezing profitability. Moreover, the increasing popularity of variable rate mortgages due to very low rates may be putting further strain on the profitability of mortgage portfolios. Nearly a third of mortgages in 2011 are variable rate compared with 25 per cent five years ago and just ten percent a decade ago. Since variable rate mortgages tend to carry lower profit margins, the shift in consumer preferences to variable rate mortgages is likely cutting into profits. Shrinking profit margins have even prompted some banks to increase their offered variable rates in absence of a change in the reference prime rate.

Our forecast for the remainder of 2011 assumes that very low bond yields will persist through the end of the year and will therefore lead eventually to a cut in mortgage rates. The five-year fixed rate has the potential to decline to its previous historical low of 5.19 per cent and will likely average around 5.3 per cent in the second half of 2011. The one-year rate is expected to average 3.5 per cent. Given current economic weakness and the almost certain delay in any monetary tightening by the Bank of Canada until as late as mid-2012, both long-term and short-term rates will likely stay very low for most of 2012. We expect that rates will move higher in the second half of next year, with the five-year rate hitting 5.6 per cent and the one-year rate reaching 4 per cent.

### Growth and Inflation Outlook

Canadian economic growth has sharply decelerated from the first quarter of 2011. Recent data shows that the Canadian economy actually contracted in the second quarter of the year by 0.4 per cent. While the very sluggish growth profile in the global economy means that a technical recession (two consecutive quarters of negative real GDP growth) cannot

#### Weak Growth Expected in Second Half and 2012



Latest Data Point: 2011Q1, \* Real GDP (chained 2002 dollars) growth at annualized rates

Source: Statistics Canada, BC Real Estate Association

be ruled out, our baseline forecast is for slow growth in the second half of 2011 and throughout 2012. We are forecasting real GDP growth of 2.5 per cent this year, falling to 2.2 per cent in 2012 and then rising to 2.9 per cent in 2013.

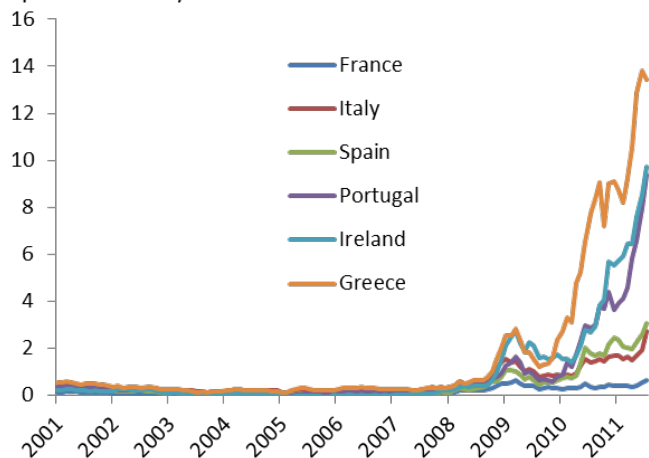
We anticipate that both total and core inflation will remain muted, particularly as energy prices stabilize and the impact of the HST is no longer present in year-over-year price-changes.

### Interest Rate Outlook

Market volatility over the summer and incoming data indicating very weak economic growth prompted an abrupt change in the policy stance at the Bank of Canada. Whereas just a few short weeks ago it was widely expected that interest rates were set to rise this fall, those rate hikes have been pushed out, possibly to as far as next summer. The major economies of the world are dangerously close to slipping into recession over the next 12 months. High European sovereign debt combined with short-sighted stabilization policy and misguided austerity measures are threatening to destabilize world credit markets. These fears can be observed in the spike in borrowing rates of the peripheral states of the Eurozone. Meanwhile, political acrimony in the United States is only further damaging an already deeply troubled economy.

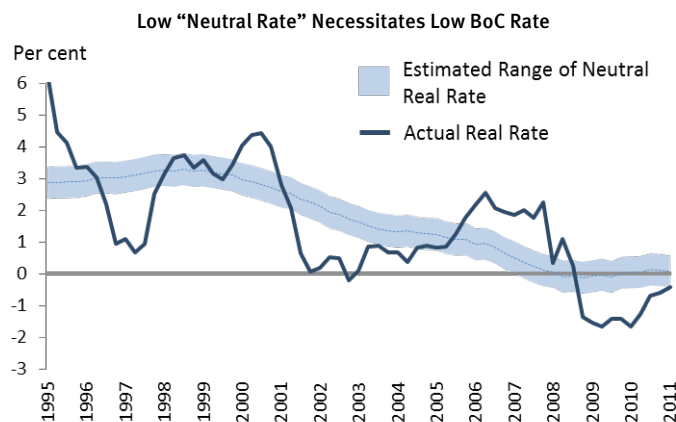
#### Financial Markets Very Worried about European Debt

Spread over 10-year German Govt. Yield



Source: European Central Bank

Once the economy sees its way through the current tempest, waters will calm and interest rates will need to normalize. Key to understanding the near-term path of interest rates is some idea of the destination that Bank of Canada has in mind. Economists tend to frame this question in terms of the neutral level of real (net of inflation) interest rates, or a rate that is neither stimulative nor contractionary. A popular short-hand is the level of interest rates prevailing when the economy is fully utilized.



Note: Range of neutral rate estimated with a Kalman Filter; Actual real rate is Bank of Canada overnight rate less core inflation

Over the long-term, the neutral real interest rate is determined by factors such as productivity, population growth and long-term saving preferences. However, in the short-run, the neutral real interest rate may deviate from its long-run level due to various disturbances or shocks that impact the economy.

Therefore, as the Bank of Canada recently signalled, a closing of the output gap does not necessarily have to coincide with interest rates being set to their long-term equilibrium. Given the magnitude of shocks to the global economy over the past three years, the neutral rate is very likely much lower than its long-term counterpart. Therefore, the Bank of Canada may need to keep rates very low while the economy stabilizes. In light of this, we have adjusted our forecast for the Bank of Canada's overnight rate to 1 per cent for the remainder of the year and through at least the first quarter of 2012. We then expect rates to increase, ending next year at between 1.75 and 2 per cent.

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