BRITISH COLUMBIA REAL ESTATE ASSOCIATION

Mortgage Rate Forecast

THE TRUMP EFFECT

HIGHLIGHTS

- Long-term bond yields jump following election of Donald Trump to President
- Canadian economy's strong third quarter probably will not last
- Bank of Canada on hold but bias may tilt toward rate cut

Mortgage Rate Forecast

	2016				2017			
Term	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F
1-Year	3.14	3.14	3.14	3.14	3.14	3.14	3.24	3.24
5-Year Qualifying Rate	4.64	4.64	4.64	4.64	4.74	4.79	4.79	4.84
5-Year Mortgage Rate	3.75	3.68	3.68	3.70	3.83	3.95	3.95	3.95

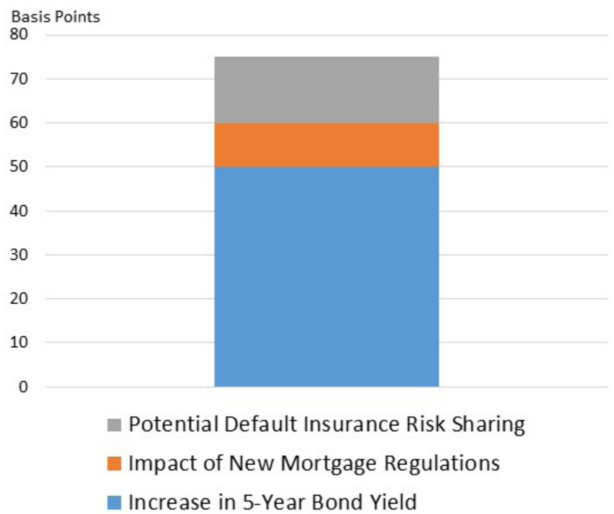
Source: Bank of Canada; BCREA Economics

Note: 5-Year Average Rate is the average residential mortgage rate contracted through Canadian lenders and reflects discounts from the qualifying rate

Mortgage Rate Outlook

What a difference a few months can make. Early in the fall the Federal government made sweeping changes to mortgage qualification rules, the most prominent being the requirement that all insured homebuyers qualify at the posted 5-year fixed rate. The change in qualification rules for homebuyers means that the posted 5-year rate has become much more binding and will now have a more immediate and impactful effect on mortgage demand than in the past. Additionally, less publicized changes such as eliminating the availability of insurance on mortgages with greater than 25-year amortizations or potential default insurance risk sharing, are putting upward pressure on rates offered by lenders.

Sources of Upward Pressure on Mortgage Rates



Sources Bank of Canada; OSFI; Mortgage Industry Estimates

In addition to a shake-up of mortgage rules, a shocking Presidential election in the United States could signal a major shift in the path of long-term interest rates. The ultimate economic impact of the election of Donald Trump to the Presidency is difficult to ascertain at this point, but the consequence for interest rates depends crucially on two things. First, the implementation of a budget consistent with his campaign promises to massively increase the deficit through large tax cuts and a huge (or is that "yuge"?) program of infrastructure spending. Secondly, that GOP lawmakers, who frequently obstructed such infrastructure spending plans by the previous administration, acquiesce with a Republican in the White House. If Trump's plans are more than just empty rhetoric, the US Treasury will need to dramatically increase borrowing in international bond markets. That means that the Canadian government, which has deficit plans of its own, will be forced to compete much harder for global capital by offering higher interest rates to investors.

The bond market response to the election thus far suggests that markets believe in Trump's campaign promises. Yields on five and ten-year government bonds in the US and Canada jumped close to 50 basis points since the election, marking the first time that the five-year bond yield has eclipsed 1 per cent in the past 12 months.

The posted 5-year qualifying has been remarkably steady in recent years and its new significance as a binding qualifying rate across all insured mortgages may lead to even less volatility if Banks's are hesitant to squeeze out potential borrowers. The 5-year qualifying rate could see a minor uptick in the next one to two quarter given the recent increase Canadian 5-year Government bond yields, though the fundamental change in the importance of the qualifying rate presents a challenge to forecasting. For that reason, we are now also forecasting the average contracted 5-year rate, which reflects discounts offered from the qualifying rate. We anticipate that as bond yields move higher in the next year and new mortgage regulations squeeze margins, banks will raise their current offered rates on 5-year mortgages by roughly 20 basis points to just under 4 per cent on average.

Economic Outlook

The Canadian economy expanded at a 3.5 per cent annual rate in the third quarter, a sharp rebound following a 1.3 per cent decline in the second quarter. Household consumption remained a significant driver of economic growth last quarter, aided by rising disposable incomes, while export growth posted a strong rebound after declining in the second quarter. A build up in business inventories suggests that growth will moderate closer to trend growth of 2 per cent in subsequent quarters. Overall, the Canadian economy is on pace to grow just 1.2 per cent in 2016.

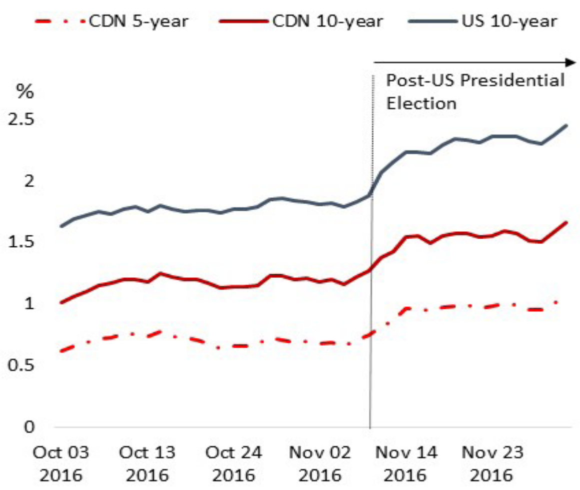
While there are clear downside risks to the Canadian economy over the next year, with the uncertainty introduced by the incoming Trump administration front and centre, we expect the Canadian economy to post stronger growth in 2017. The US economy is improving and could see a further short-term uptick in growth if Congress approves of incoming administration's more stimulative ideas. Moreover, higher oil prices will boost growth in Canadian exports and stabilize the economies of Canada's energy producing regions. Overall, we are forecasting growth of 2.1 per cent next year and 2.3 per cent in 2018.

Interest Rate Outlook

With long-term interest rates rising, the Bank of Canada is likely content to keep the short-end of the yield curve relatively flat and will therefore hold rates at 0.5 per cent until 2018. Inflation, as measured by the Consumer Price Index (CPI), has trended well below the Banks's 2 per cent target for the past year and there is little indication that trend will break anytime soon. Market expectations of long-run inflation have ticked modestly higher, but are still anchored below 2 per cent.

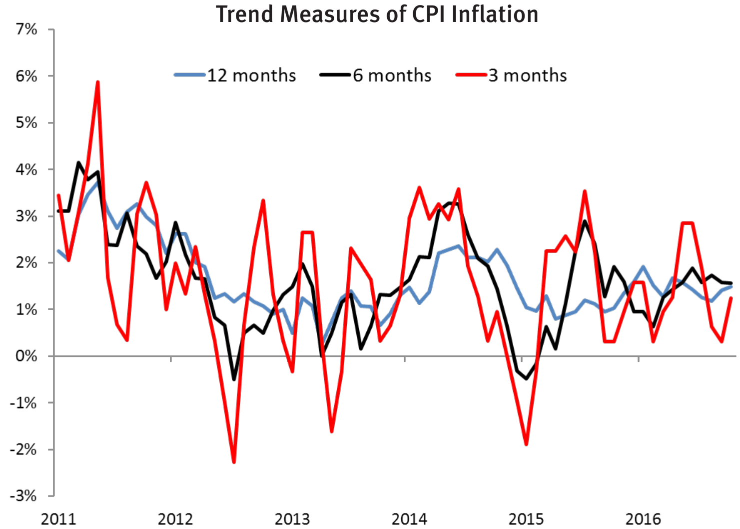
That said, the stark unpredictability of the incoming Trump administration on everything from trade to taxes to the ultimate impact on long-term interest rates means that risk in the economy is tilted to the downside. Therefore, there remains the potential for a rate-cut by the Bank of Canada, should economic conditions and the outlook for inflation deteriorate.

Government Bond Yields



Source: Statistics Canada; St. Louis Federal Reserve

Trend Measures of CPI Inflation



Soruce: Statistics Canada

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