



Mortgage Rate Forecast

MORTGAGE RATES LOW AND STEADY

HIGHLIGHTS

- Fixed mortgage rates steady in 2015 but could rise next year
- Canadian economic recovery underway
- Bank of Canada wary of the “zero lower bound” on interest rates

Mortgage Rate Forecast

	2015				2016			
Term	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
1-Year	2.89	2.89	2.89	2.89	2.89	2.89	2.89	3
5-Year	4.76	4.64	4.64	4.64	4.79	4.79	4.93	5.11

Note: Data is average of weekly rates

Source: Bank of Canada; BCREA Economics

Perhaps more importantly, US bond yields have risen in recent months as the US economy accelerates and the US Federal Reserve prepares to raise its target overnight for the first time since the 2008 financial crisis. Canadian yields have so far diverged from those in the US, but historically the correlation between the two is very strong, even when the two countries' normally in sync monetary policy is heading in different directions.

Therefore, whether the Fed opts to raise interest rates this year or next, it will have a meaningful impact on bond yields in Canada. In conjunction with what should be a recovering Canadian economy, we expect there to be some upward pressure on fixed mortgage rates by the middle of next year with five-year rates rising to just over 5 per cent.

Mortgage Rate Outlook

The current spread between fixed five-year mortgage rates and five-year government bond yields remains well above historical norms. Normally, this is suggestive of a coming decline in fixed rates. However, elevated risk in global financial markets and a tightening of credit among Canadian lenders reported in the most recent Bank of Canada Senior Loan Officer Survey has translated to fixed rates remaining steady in spite of falling bond yields.

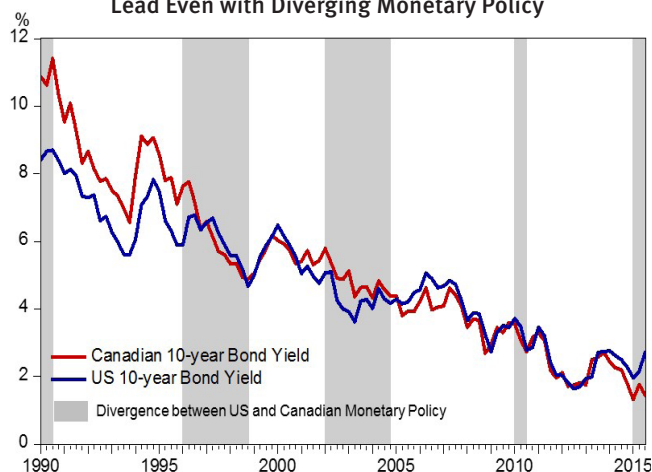
Economic Outlook

The Canadian economy contracted in the second quarter of 2015, declining 0.5 per cent on an annualized basis following a 0.8 per cent contraction in the first quarter. A second consecutive quarterly decline fits what some call the technical or statutory definition of a recession.

While some may quibble over whether the economy was in recession, technical or otherwise, economic growth was undeniably weak for the first five months of the year. However, the downturn was quite modest compared to the severe recessions of the early 1990s or the 2008 financial crisis.

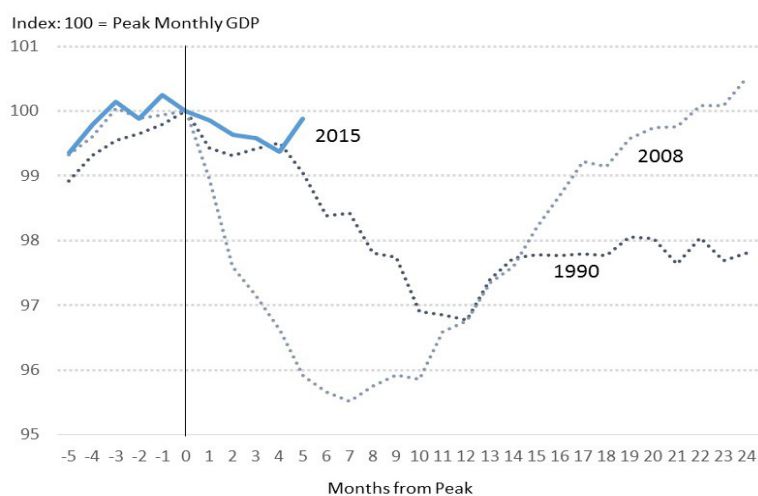
Moreover, it appears from available third quarter data that the economy is already rebounding and should post fairly robust growth for the remainder of the year. We expect that the Canadian economy will eke out growth of 1.1 per cent this year and 2.4 per cent growth next year.

Canadian Long-term Interest Rates Tend to Follow US Lead Even with Diverging Monetary Policy



Source: Bank of Canada; St. Louis Federal Reserve; BCREA Economics

Comparison of Recent Canadian Recessions



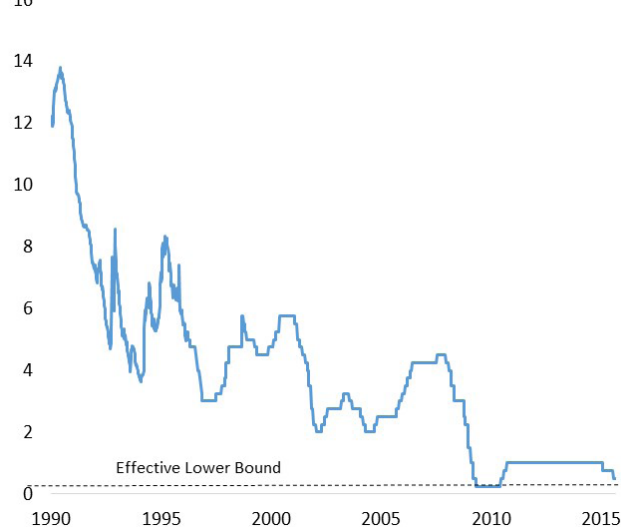
Source: Statistics Canada; BCREA Economics

it tends to get more and more ineffective, particularly when the usual channels for monetary policy to work, such as housing and consumer debt, are already somewhat clogged by high Canadian debt levels. If traditional monetary policy were exhausted, the Bank would have to resort to less conventional policies, including forward guidance or quantitative easing, to achieve its inflation targeting mandate.

In the absence of a crisis inducing economic or financial shock, the Bank would likely prefer not to test the lower bound on interest rates and may even begin to tighten rates by the end of next year if the economy resumes a healthy and sustainable rate of growth.

Bank of Canada Approaching “Zero Lower Bound”

% Bank of Canada Target for the Overnight Rate



Source: Bank of Canada

Interest Rate Outlook

The Bank of Canada once again finds itself in a delicate balancing act between supporting those regions of Canada adversely impacted by low oil prices while not tipping the balance of risk in the economy toward overly indebted Canadian households. Further complicating matters are the realities of conducting monetary policy so close to the so called “zero lower bound”. While in theory, the lower bound for interest rates is zero; in practice, transaction costs associated with short-term money markets make 25 basis points as low as the Bank can go while preserving a functioning market. With its target overnight rate at just 0.5 per cent, the Bank is risking returning to its effective lower bound of 25 basis points for the second time in six years. As monetary policy approaches that lower bound,

Send questions and comments about *Mortgage Rate Forecast* to:
Cameron Muir, Chief Economist, cmuir@bcrea.bc.ca; Brendon Ogmundson, Economist, bogmundson@bcrea.bc.ca.

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