



# Mortgage Rate Forecast

## MORTGAGE MARKET MANIA

### HIGHLIGHTS

- Frenzied competition pushes offered mortgage rates to all-time lows
- Pressure on mortgage funding costs rising
- Contagion risk in Europe reduced, but uncertainty remains

### Mortgage Rate Forecast

Term	2012				2013			
	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
1-Year	3.30	3.20	3.30	3.50	3.50	3.70	3.90	4.05
5-Year	5.25	5.25	5.35	5.50	5.50	5.75	5.75	5.80

Source: BCREA, Bank of Canada

### Mortgage Rate Outlook

While *posted* mortgage rates fluctuated modestly in the opening months of 2012 (even briefly falling to a record low of 5.14 per cent), a competitive frenzy was unleashed as lenders jostled for market share with headline grabbing promotional offers, such as a 2.99 per cent five-year fixed rate. However, as pressure on funding costs rose and already tight profit margins were squeezed, many of these temporary offers were withdrawn.

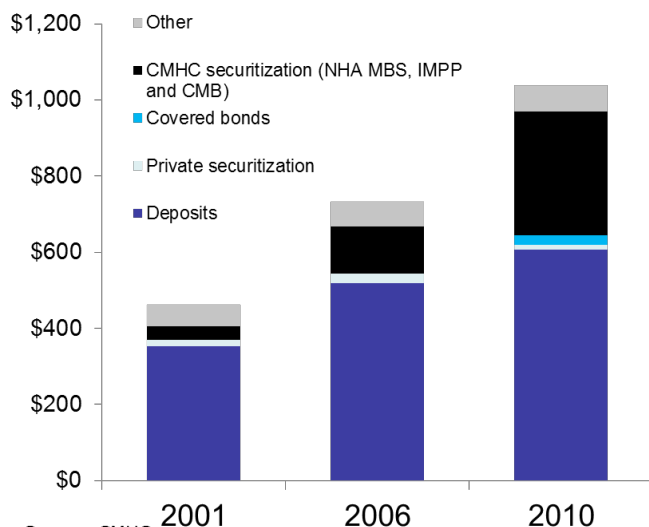
Upward pressure on bank funding costs is coming primarily from two sources. Signs of a stronger than expected US economic recovery are starting to drive bond yields off the lows reached at the start of 2012. In recent weeks, the yield on five-year government of Canada bonds (a key benchmark for mortgages) rose to a three month high of 1.5 per cent.

Furthermore, the Canada Mortgage and Housing Corporation (CMHC) has announced that it is nearing its \$600 billion ceiling on mortgage default insurance and as a result would be rationing its bulk insurance program for insurance on conventional (low-ratio) mortgages. Canadian banks have been increasingly purchasing bulk or portfolio insurance (as opposed to mandatory insurance on high-ratio mortgages) as part of prudent risk management and to lower capital costs through securitization of insured mortgages. However, as the CMHC approaches its ceiling, banks may be forced to find other, perhaps more costly, sources of financing which could put some pressure on mortgage rates and the availability of mortgage credit.

These funding pressures explain recent increases in posted five-year rates which we anticipate will level off unless economic growth or inflation is materially higher than currently expected. While banks recently raised posted five-year rates they also cut one-year rates by 30 basis points to 3.2 per cent, a mere 20 basis point premium over the average variable rate. We are forecasting the five-year posted rate to remain around 5.3 per cent for the first half of the year before rising slightly to 5.5 per cent by the end of 2012. While the one-year rate should remain anchored in a range of 3.2 to 3.5 per cent.

### Mortgage Credit Increasingly Relying on Securitization

Total Residential Credit Outstanding (\$billions)

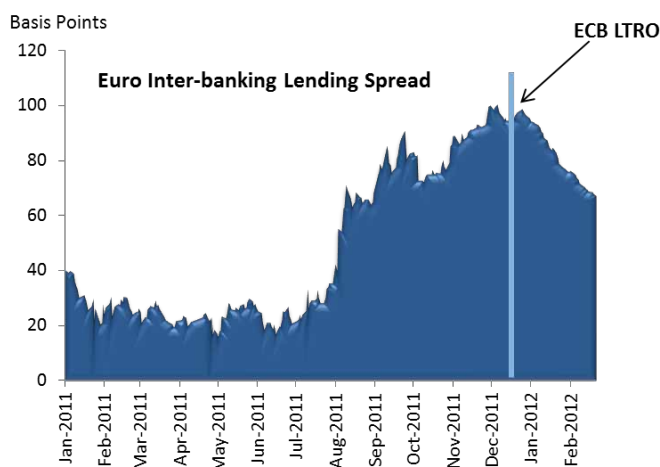


Source: CMHC

### Growth and Inflation Outlook

The Canadian economy is likely to face a number of headwinds in 2012, both externally from the Euro-debt saga and a still shaky US economy, and internally as recent drivers of growth threaten to fade. A possible slowdown in consumption growth, fiscal austerity and moderating residential construction could limit economic growth in 2012. This leaves private business investment to drive the economy, but given a murky demand outlook, it is far from certain that businesses will be in the mood to take on significant new projects.

## ECB Lending Eases Euro-Banking Pressure



Source: Bloomberg

Growth in the Eurozone has slowed significantly in 2012 and many important European economies have likely slipped into recession. While Canada has little direct exposure to Europe, exports to the EU are only about 2 per cent of GDP, uncertainty in financial markets stemming from the Euro-debt crisis does represent a risk to Canadian economic growth.

Fortunately, the European Central Bank, through its three-year and over \$1 trillion Long-Term Refinancing Operation, seems to have succeeded in alleviating growing strains in interbank lending markets. This action should help negate potential contagion effects from the most troubled economies of Europe. That said, significant uncertainty remains and this uncertainty will likely constrain growth in developed markets. We are forecasting Canadian economic growth to be 2.2 per cent in 2012 before rebounding modestly to 2.6 per cent in 2013. Muted economic growth and ongoing slack in labour markets should keep core inflation near 2 per cent, while rising oil-prices may push headline CPI inflation higher.

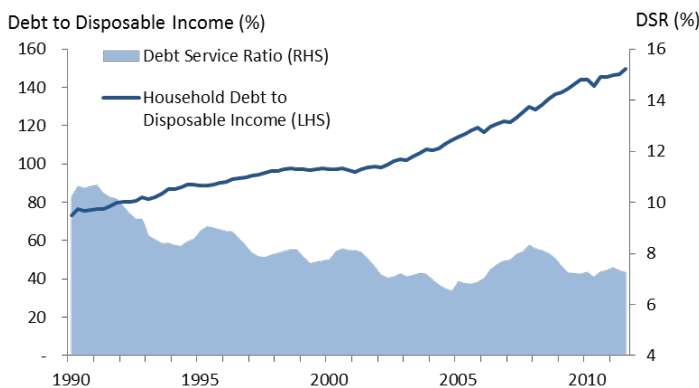
## Interest Rate Outlook

The Bank of Canada held its overnight rate steady at 1 per cent at its most recent meeting in January. This was the eleventh consecutive meeting that the Bank left interest rates unchanged.

The Bank of Canada has lately been stressing the word “flexibility” in reference to its inflation target which can be read to mean that it will tolerate inflation above 2 per cent, at least in the short-run. The situation in Europe along with concerns over rising Canadian household debt is obviously taking precedence over mild inflationary pressures in the minds of monetary policymakers.

Given recent weakness in Canadian labour markets and the extent of downside risks to the Canadian economy, it is unlikely that the Bank of Canada will move on interest rates in 2012. Moreover, long-term rates will likely remain at historically low levels until confidence is restored in the sovereign debt of Europe.

## Household Debt at Record High, but Low Rates Keep Debt-Service Low



Source: Statistics Canada

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