BRITISH COLUMBIA REAL ESTATE ASSOCIATION

# Mortgage Rate Forecast

## LOWER FOREVER?

### HIGHLIGHTS

- Mortgage rates may feel upward pressure in coming months
- Canadian economy set for a second half rebound
- Bank of Canada: lower for longer, but not forever

| Mortgage Rate Forecast | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2016 | | | | 2017 | | | |
| Term | Q1 | Q2 | Q3F | 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 | 4.64 | 4.64 | 4.70 | 4.74 | 4.74 | 4.79 | 4.89 | 5.00 |

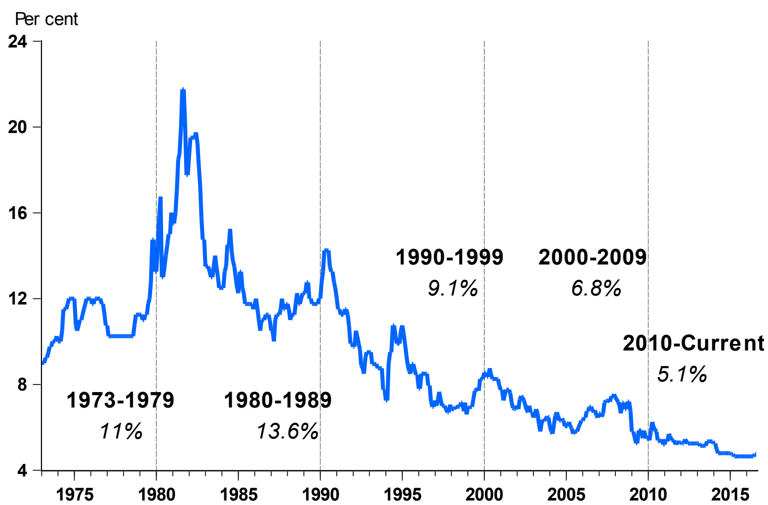
Note: Data is average of weekly rates

Source: Bank of Canada; BCREA Economics

### Mortgage Rate Outlook

The Canadian five-year qualifying mortgage rate briefly moved higher in the third quarter, rising by ten basis points to 4.74 per cent before swiftly falling back to its historical low of 4.64 per cent. There are currently two primary sources of upward pressure on mortgage rates in the near term. The most immediate remains the stance of US monetary policy. The US Federal Reserve remains determined to raise its overnight rate this year, possibly as soon as its next meeting in September. While the Fed's last rate increase had little impact on Canadian rates, the market may see a second tightening as a true shift in the Fed's view toward future tightening.

Five-Year Fixed Mortgage Rate




*Latest Data Point: 2016m9, Monthly Data, 5-Year Term Posted Mortgage Rate - Chartered Banks*

**Source: Statistics Canada, BC Real Estate Association**

In addition to pressure from potentially higher US rates, Canadian bank regulators have proposed stricter capital requirements to shift the burden of housing market risk away from taxpayers and onto financial institutions. That could in turn mean higher funding costs for banks and credit unions, which could be passed through to mortgage rates.

Overall, given those upward pressures, we anticipate that mortgage rates will rise from their current lows with the five-year qualifying rate reaching 5 per cent by the end of next year.

### Economic Outlook

Wildfires in Alberta were a major drag on the Canadian economy in the second quarter, prompting a 1.6 per cent contraction in real GDP, the largest decline since the second quarter of 2009. However, strong consumption growth in the second quarter and a 0.6 per cent rebound in growth in June means that the hand-off to third quarter growth should be very strong.

While some downside risks remain, particularly due to highly leveraged Canadian households, we expect Canadian economic growth will rebound sharply in the third and fourth quarter as oil production normalizes and the federal government's uptick in expenditures and tax credits impacts the economy. The Canadian economy is forecast to expand at an average of 2.5 per cent in the second half of 2016 and into 2017.

## Interest Rate Outlook

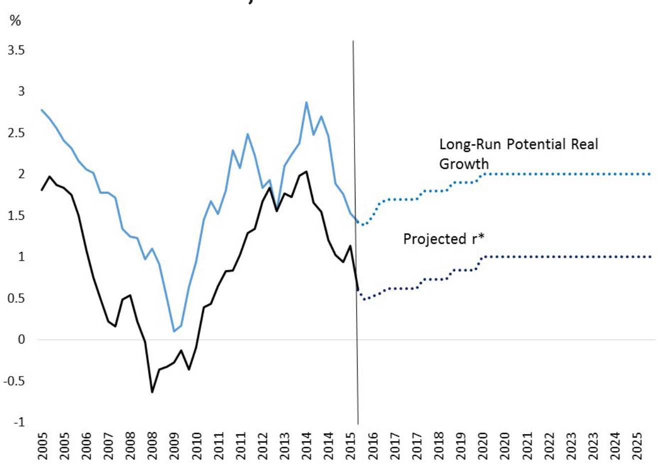
Almost ten years after the global financial crisis, interest rates remain not just below long-run averages, but lower than economists and financial market analysts ever thought possible. Unlike some countries, Canada has yet to see nominal interest rates fall below zero. However both short-term and long-term interest rates are at historical lows and show very little signs of moving materially higher.

When thinking about where interest rates will land in the long term, economists often use models of the so-called "natural rate of interest" (designated r* in the accompanying charts) usually defined as the level of real interest rates that would prevail when the economy is at full potential. Modern economic theory posits that when the Bank of Canada wants to stimulate the economy, it sets its overnight rate below the natural rate. Therefore, the lower the estimated natural rate, the lower the Bank's overnight rate must go to provide a boost to growth and inflation. One reason that interest rates have been so low for so long is that the potential growth rate, and therefore the natural rate of interest, in Canada has declined due to the aging of the Canadian workforce and the sharp decline in commodity prices. The latter has meant a dramatic scaling back in oil-sector capital investment and lower productivity growth, which in turn decreases Canada's growth potential. However, potential growth is expected to recover back to around 2 per cent as the impact of the 2014 oil shock fades.

Projecting the natural rate of interest as a function of potential growth, the natural rate is on a path to about 1 per cent in real terms, or 3 per cent in nominal terms given the Bank's 2 per cent inflation target. Based on historical averages of interest rate spreads, that implies that the five-year fixed mortgage rate would equal about 6 per cent once the Bank of Canada closes the gap between its overnight rate and the natural rate.

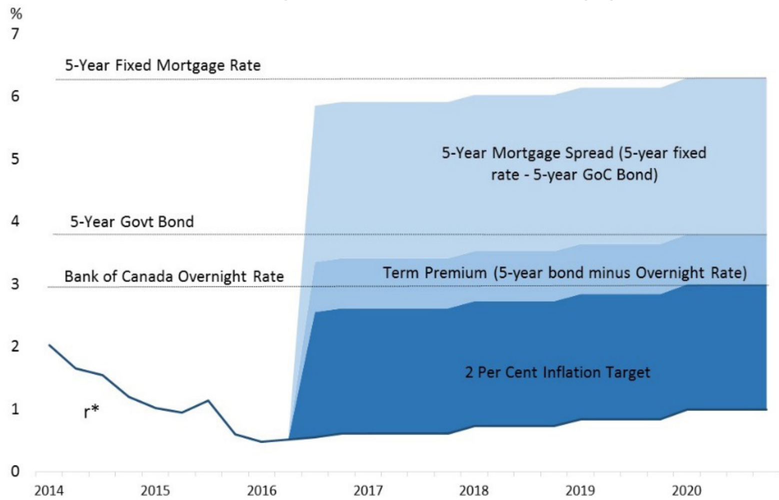
However, it could take quite some time to get there. Given the Bank's current forecast, the economy is not expected to reach its full-potential until 2018, at which time interest rates would be expected to rise, albeit slowly. So while today's low rates may not last forever, they are very likely to be around for the foreseeable future.

**Projected Natural Rate**




Note: Projection of Potential Real GDP Growth is an average of IMF, Bank of Canada and PBO estimates.
Source: IMF, PBO, Bank of Canda, BCREA Economics

**What Does a Rising Natural Rate Mean for Mortgage Rates?**




Source: BCREA Economics

Send questions and comments about *Mortgage Rate Forecast* to:
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