



Mortgage Rate Forecast

INTEREST RATE LIFT-OFF

HIGHLIGHTS

- 5-year fixed mortgage rates hit three-year high
- Rapid economic growth, but still no sign of inflation
- Bank of Canada tightening, but how quickly?

Mortgage Rate Outlook

Since our second quarter forecast, our projected rise in mortgage rates has occurred and accelerated, as the Bank of Canada—spurred by economic growth that far exceeded its outlook—turned suddenly hawkish. The Bank surprised with a 25-basis point increase in July and then again in September, taking its overnight rate back to 1 per cent, where it was before the precipitous drop in oil prices that shocked the Canadian economy in 2014. After the July interest rate hike, markets widely expected at least one additional rate increase in the fall, and so bond markets and lenders had already priced in the September increase by the time it occurred.

Over the past 12 months, the 5-year bond yield has risen 110 basis points to a three-year high of close to 1.8 per cent, prompting a 60-basis point increase in 5-year discounted mortgage rates to above 3 per cent for the first time since 2014. The 5-year qualifying rate has risen just 20 basis points to 4.84 per cent. The latter is an interesting development, because it is the first increase in the posted rate since stricter qualifying rules for insured mortgages were imposed last fall. Rising mortgage rates may complicate the introduction of further mortgage qualifying restrictions slated for October, this time tightening lending for uninsured mortgages.

We anticipate that the Bank of Canada will hold off on further rate increases this year and assess how higher rates are impacting the economic and inflation outlook. However, in the Bank's recent communications, it has very clearly left the door open for more aggressive tightening should the current torrid pace of economic growth continue. Our baseline forecast is for the 5-year fixed mortgage rate offered by lenders to average 3.15 over the fourth quarter, eventually rising to 3.44 by the end of 2018. The posted 5-year qualifying rate is forecast to reach 5.14 per cent by the end of next year.

Economic Outlook

The Canadian economy is forecast to post its best year of growth since 2013, propelled by 4 per cent average

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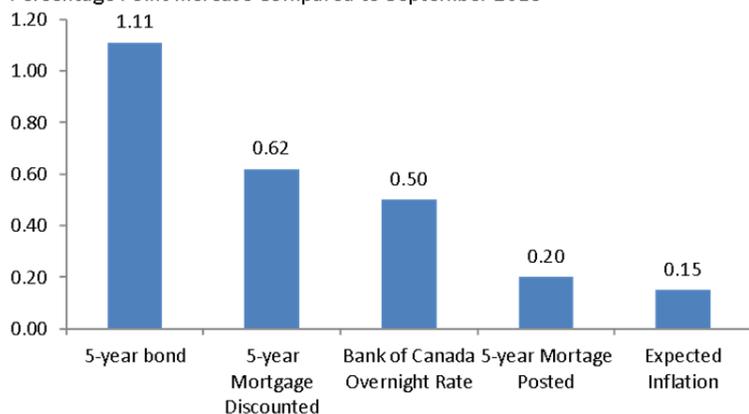
| Term | 2017 | | | | 2018 | | | |
|------------------------------|------|------|------|------|------|------|------|------|
| | Q1 | Q2 | Q3 | Q4F | Q1F | Q2F | Q3F | Q4F |
| 1-Year | 3.14 | 3.14 | 3.14 | 3.24 | 3.24 | 3.24 | 3.44 | 3.44 |
| 5-Year Qualifying Rate | 4.64 | 4.64 | 4.79 | 4.94 | 4.94 | 5.04 | 5.14 | 5.14 |
| Average 5-Year Mortgage Rate | 2.75 | 2.61 | 2.94 | 3.15 | 3.20 | 3.34 | 3.34 | 3.44 |

Source: Bank of Canada; BCREA Economics; Rate Spy

Note: Average 5-year discounted rate is the average rate available in the market, offered at a discount from the posted 5-year qualifying rate.

Rising Interest Rates; Muted Inflation Expectations

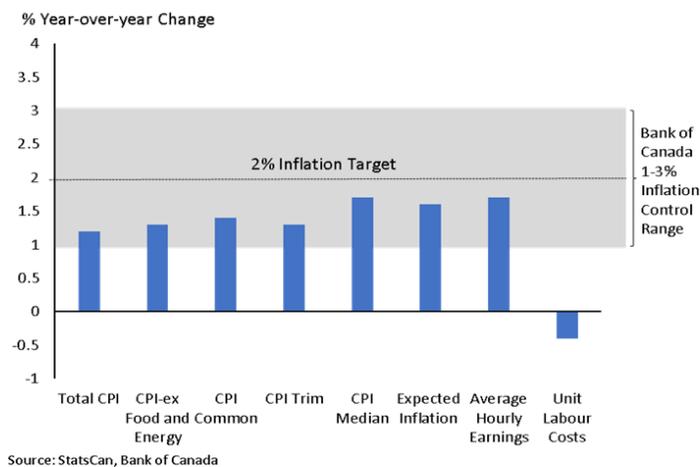
Percentage Point Increase Compared to September 2016



Source: Bank of Canada

quarterly growth in the first half of 2017. That accelerated pace of growth has meant that excess capacity in the economy, referred to by economists and central banks as the “output gap,” is rapidly being eliminated. The output gap is important because it is used by the Bank of Canada as a guide to future inflation. An economy operating above its potential, as the Canadian economy is on track to do, should be inflationary. Since monetary policy acts with long and variable lags, quelling expected future inflation would necessitate higher interest rates today. Significantly, all measures of inflation monitored by the Bank of Canada currently sit well below the Bank’s official 2 per cent target and, to date, show very little sign of accelerating. Changes to inflation will be key to future movements in interest rates.

Inflation Undershooting Target



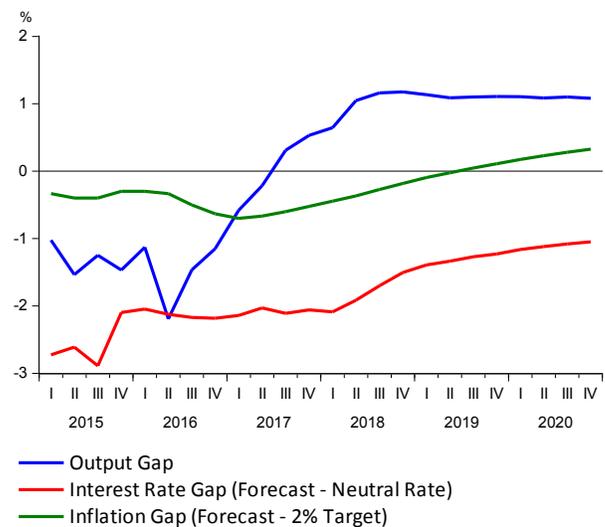
We expect the economy will continue to grow above trend in the third and fourth quarters, and will ultimately expand by 3.3 per cent for all of 2017 before slowing in 2018 to 2.3 per cent, as higher interest rates and a soaring loonie start to drag on the economy.

Interest Rate Outlook

Given the rapid expansion in the Canadian economy, it is clear the stimulus introduced to offset falling oil prices is no longer required. However, the policy direction going forward is less clear, given the chronic undershooting of the Bank’s inflation target over the past year.

If sustained economic growth and a closing of the current output gap bring higher inflation, the Bank will likely embark on a more sustained cycle of rate increases to close the wide gap between its current target rate and its estimate of the “neutral” rate at which the economy runs neither too hot nor too cold. The Bank itself estimates that neutral rate in a range of 3 per cent to 3.5 per cent, which means a further 200 to 250 basis points of tightening in the future. However, should inflation remain stubbornly low, the case for rate hikes loses some urgency. Our baseline forecast is for gradual rate increases over the next two years, with the Bank of Canada’s overnight rate ending 2018 at 1.5 per cent.

Output, Inflation and Interest Rate Gaps Closing



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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