June 2017

BRITISH COLUMBIA REAL ESTATE ASSOCIATION

Mortgage Rate Forecast

STRONG CANADIAN ECONOMY COULD SIGNAL CHANGE IN INTEREST RATES

HIGHLIGHTS

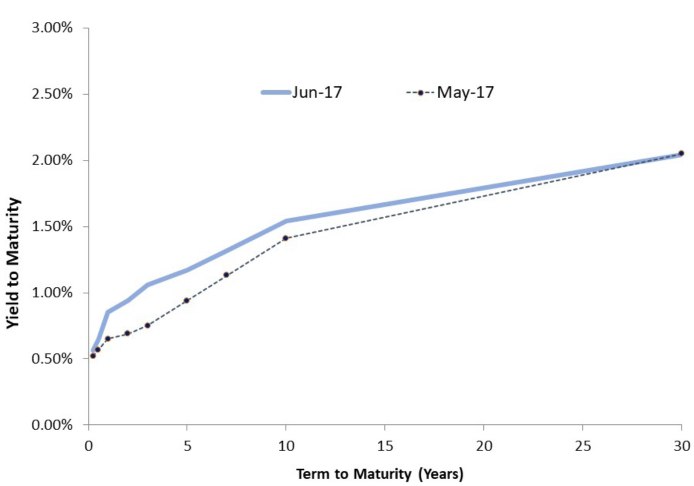
- Hawkish turn at the Bank of Canada?
- Canadian economy heating up
- Falling oil prices and low inflation may keep Bank on hold until 2018

Mortgage Rate Forecast								
	2017				2018			
Term	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
1-Year	3.14	3.14	3.14	3.24	3.34	3.34	3.44	3.54
5-Year Qualifying Rate	4.64	4.64	4.64	4.64	4.74	4.74	4.74	4.84
Average 5-Year Mortgage Rate	2.75	2.61	2.79	2.90	3.05	3.10	3.20	3.35

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.

Canadian Yield Curve



Source: Bank of Canada

Mortgage Rate Outlook

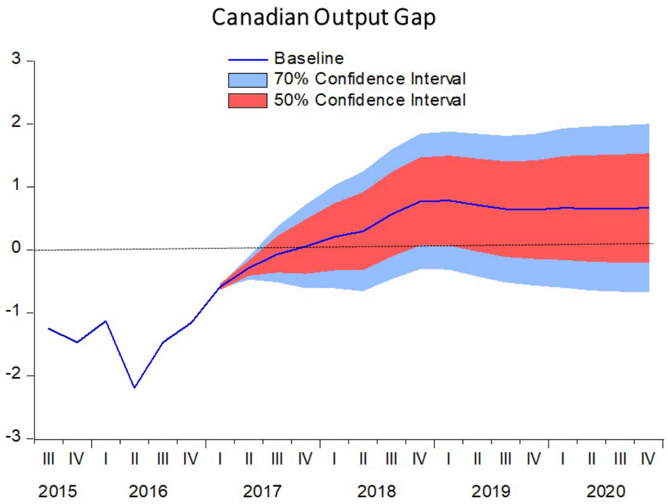
For the past six months, the relative calm in the Canadian economy meant that mortgage rates were guided more by external factors than domestic ones. Most prominent has been the quieting of previously bullish sentiment on US growth and inflation, as neither the trillion-dollar infrastructure plan nor tax cuts promised by the Trump administration have been proposed, never mind passed, despite one-party control of Congress. Bond markets have taken notice of this inaction, dramatically revising down expectations. Consequently, bond yield spent much of the last three months sliding back toward pre-election levels.

Pushing against this trend, the US Federal Reserve (the Fed) remains steadfast in its desire to normalize interest rates as the US economy pushes up against full employment. The Fed has now raised rates three time in seven months and continues to signal further rate hikes on the horizon. More importantly, the Bank of Canada, sensing a turn in the economy following three quarters of strong economic and job growth, has seemingly turned hawkish with recent speeches by key policymakers designed to prime markets for an approaching tightening cycle. Those factors seem to be gaining significant traction as rates across the short end of the Canadian yield curve, including the benchmark 5-year Government of Canada bond yield, have increased by about 25 basis points in a matter of weeks. The 5-year yield is now close to where it was at the start of 2017, when 5-year fixed rates were about 30 basis points higher.

Assuming the Canadian economy continues its current trend, the shift in the bond market means that the recent downtrend in 5-year fixed mortgage rates offered by banks and other lenders will likely reverse by the end of the summer. Overall, we expect that the posted rate will remain unchanged in 2017, while discount rates will gradually rise to just under 3 per cent by the end of the year.

Economic Outlook

The Canadian economy has finally returned to good health following the rapid and dramatic decline of oil prices in late 2014 and the consequences of wildfires in Alberta last year. Since the third quarter of 2016, the Canadian economy has expanded at an average rate of 3.5 per cent, well above the Bank of Canada's estimate of 1.7 per cent sustainable long-run growth. After posting nearly 4 per cent growth in the first quarter of this year, we expect that real GDP growth will slow slightly to around 2.4 per cent in the second quarter with the economy ultimately growing 2.5 per cent this year and 2 per cent in 2018. If the economy continues to accelerate, and growth in real GDP is higher than currently expected by the Bank, slack in the economy could be eliminated by as early as the end of this year, which could push up the timetable for monetary tightening.



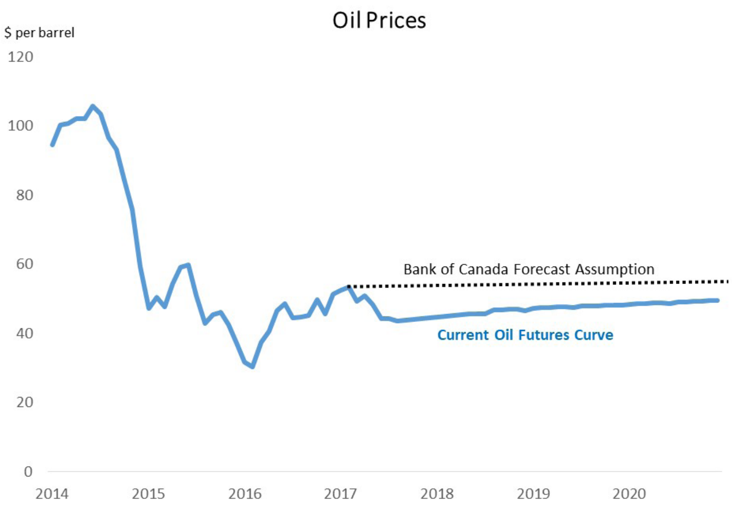
Source: BCREA Economics

Interest Rate Outlook

While the economy is currently very strong, Canada has had several false alarms when it comes to an imminent increase in interest rates. The case for Bank of Canada tightening this time around, however, may be stronger than in the past. Firstly, a rate increase of 25 basis points would mainly undo the rate cut made in 2015 to deal with the dramatic decline in oil prices. With the macroeconomic consequences of that oil shock dissipated, there is no longer a need to keep interest rates at their current level. Secondly, rapid growth in the Canadian economy means that slack in labour and products markets is being eliminated faster than expected, which should begin to put upward pressure on inflation, with a return to the Bank's 2 per cent inflation target sooner than currently projected. So far, higher inflation has failed to materialize. The most recent reading on both total CPI inflation and the Bank of Canada's preferred trend measure of inflation registered just 1.3 per cent.

Muddling the case for monetary tightening is the recent slide in oil prices. A glut of oil supply in global markets has once again pushed oil to the mid-$40 level with some expecting prices to test sub-$40 per barrel. If that occurs, it could take some wind out of the sails of the economy while also pushing inflation lower. Indeed, the oil futures curve has dipped below the assumption used by the Bank in their most recent forecast.

While the likelihood of the Bank raising its target rate by the end of 2017 has certainly increased, we still expect the Bank to hold off until early 2018, particularly if oil prices remain low and inflation fails to pick up.



Source: EIA, Bank of Canada, NYMEX

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