ECONOMICS
Mortgage Rate Forecast

June 2020

HIGHLIGHTS

- Mortgage rates fall to record low
- Canadian economy in recession, but is a recovery on the horizon?
- Bank of Canada hits its effective lower bound...again

Mortgage Rate Forecast								
	2020				2021			
Term	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Prime Rate	2.45	2.45	2.45	2.45	2.45	2.45	2.45	2.45
5-Year Qualifying Rate	5.04	4.94	4.94	4.94	4.94	4.94	5.05	5.05
5-Year Average Discounted Rate	2.80	2.49	2.49	2.49	2.49	2.49	2.65	2.65

Source: Bank of Canada; BCREA Economics; Rate Spy

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

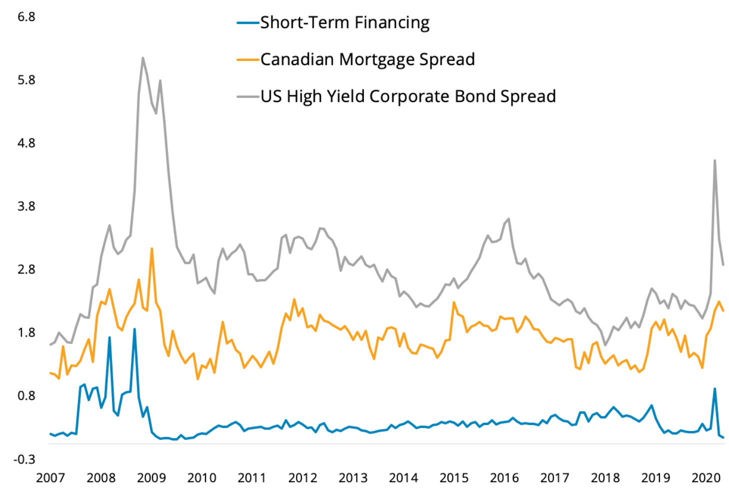
Mortgage Rate Outlook

The second quarter of 2020 will perhaps prove to be one of the most turbulent periods in Canadian economic history. The frightening spread of the COVID-19 pandemic and the subsequent shutdown of the economy have produced some truly startling economic data. As for Canadian mortgage rates, once-rising risk spreads have been quelled by swift and overwhelming action by the Bank of Canada to inject liquidity into the financial system. The Bank not only lowered its overnight lending rate to its effective lower bound of 25 basis points but also implemented a massive expansion of its balance sheet intended to prevent a rise in private sector borrowing costs. The Bank, along with the Canada Mortgage and Housing Corporation (CMHC), purchased billions in mortgage-backed securities, helping to reverse rising mortgage rates early in the crisis. The average Canadian 5-year fixed rate now sits at a record low of 2.49 per cent. Given the economic outlook, it may be some time before we see much movement in mortgage rates.

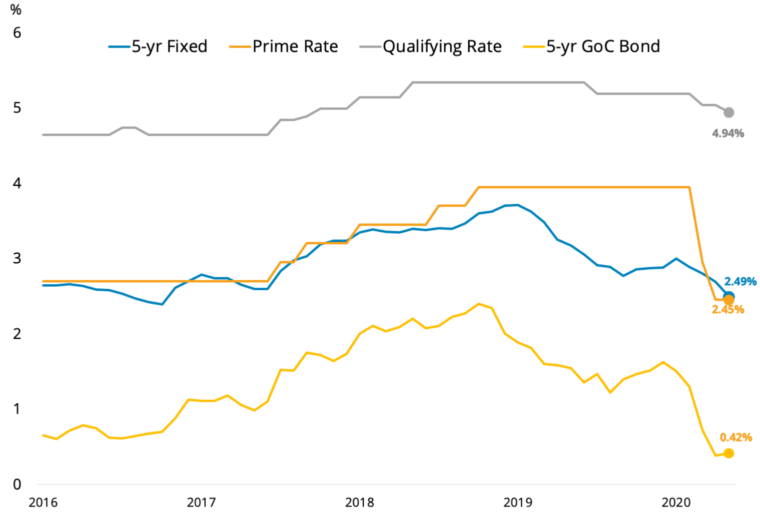
Unfortunately, not all government policy has been as helpful. At the beginning of the pandemic, the government shelved its plan to modify the insured stress test rate, a change that would have likely been applied to the B-20 uninsured stress test as well. Instead of a rate based on the 5-year posted rate of the largest Canadian banks, the new stress test rate would have changed to the average 5-year fixed rate plus a 200-basis point buffer. As of now, instead of 4.94 per cent, the qualifying rate would be 4.49 per cent, much more reflective of current market conditions.

Even more perplexing, CMHC decided to tighten mortgage credit in the middle of a historically deep recession, lowering the maximum gross and total debt service ratios,

Credit Spreads and Mortgage Rates



Source: Haver; US Federal Reserve



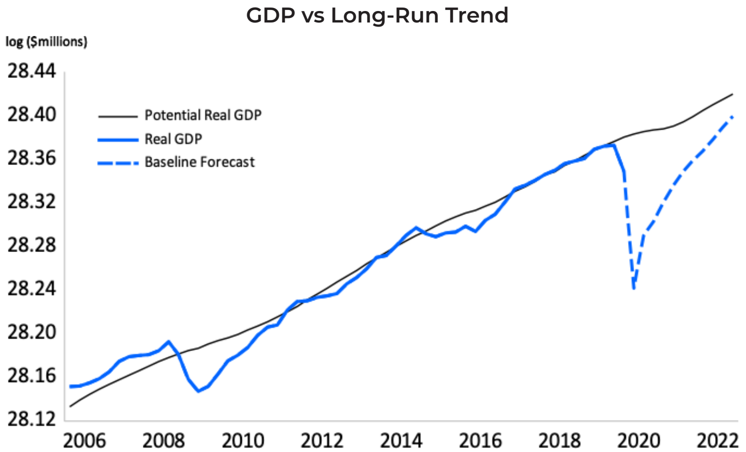
Source: Haver; RateSpy

increasing minimum credit scores and banning some sources of non-traditional down payments for insured borrowers. Private sector mortgage insurers, thankfully, have decided not to follow suit, which should mute the overall impact of CMHC's actions.

Economic Outlook

The Canadian economy contracted 8.2 per cent at a quarterly annualized rate in the first quarter of 2020, including a 7.2 per cent monthly decline in March following the paralysis of economic activity brought on by the COVID-19 pandemic. Household spending fell 2.3 per cent, the steepest drop ever recorded, while exports were down 3 per cent and government spending fell 1 per cent due to school closures and government curtailments. Total housing investment was down 0.1 per cent, with both renovation spending and ownership transfer costs falling. New home construction, however, rose 1.6 per cent.

Deep Recession Followed by Third Quarter Recovery



Source: Bank of Canada, BC Real Estate Association

Source: Statistics Canada; BCREA Economics

As dramatic as the first quarter decline appears, it will almost certainly be overshadowed by the potential 40 per cent or more annualized decline in the second quarter, when the impact of COVID-19 on the economy is expected to be the most severe. Note that those are annualized estimates. The actual peak-to-trough decline in Canadian real GDP is estimated at 10-15 per cent before things begin to normalize and growth rebounds in the third and fourth quarters of this year. Positive signs of recovery are emerging as of May, with a surprising turnaround in the labour market, solid new home construction and an uptick in consumer spending.

Even with a strong second-half recovery, this year will likely see the Canadian economy contract by more than 7 per cent while struggling with a double-digit unemployment rate. We are more optimistic about the outlook for 2021 as pent-up consumer demand, rock-bottom interest rates and, crucially, a successful vaccine help to push real GDP growth to 4 per cent.

Interest Rate Outlook

With the Bank of Canada already at its effective lower bound of 0.25 per cent (worries about the functioning of the short-term money market prevent the Bank from going any lower or into the negative), the only question for the outlook is when the Bank might consider moving off that lower bound. The last time the Bank was in this position, following the global financial crisis of 2008/2009, it was 14 months before the Bank began raising its overnight rate. Given the depth of the COVID-19 recession and the reliance of a full recovery on a vaccine, the Bank will likely be extra cautious this time around.

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