BCrea

# ECONOMICS

## Mortgage Rate Forecast

March 2022

### HIGHLIGHTS

- Long-term interest rates head back down on Russian invasion
- Elevated inflation set to stick around a little longer?
- It begins – the Bank of Canada is raising rates, but where will they stop?

**Mortgage Rate Outlook**

The last several months have seen a high degree of volatility in global bond markets as interest rates were whipsawed by the combatting forces of the Omicron variant, escalating inflation and, most recently, the Russian invasion of Ukraine. While the pandemic and global events are adding uncertainty to global financial markets, the driving force behind the longer-term rise in interest rates remains the elevated level of inflation across major world economies and global central banks' reaction to that inflation. Consumer price inflation reached a 30-year high in January at 5.1 per cent (year-over-year) and Canadians' expectations for the rate of inflation has more than doubled. The latter is particularly concerning for the Bank of Canada as expectations becoming unanchored from the 2 per cent inflation target risks a feedback loop from rising expecations to wage demands to current inflation that will be challenging to break. As a result, the Bank of Canada has adopted a more aggressive schedule of rate increases than was expected just six months ago.

Canadian fixed mortgage rates began increasing toward the end of 2021 and have now risen back to their pre-pandemic level of 3 per cent while variables rates, which move in lock-step with the Bank of Canada, are now also on the rise. Our view is that the Bank will continue to increase its overnight rate until it reaches the pre-pandemic level of 1.75 per cent, which implies a variable rate of 3.25 per cent by 2023.

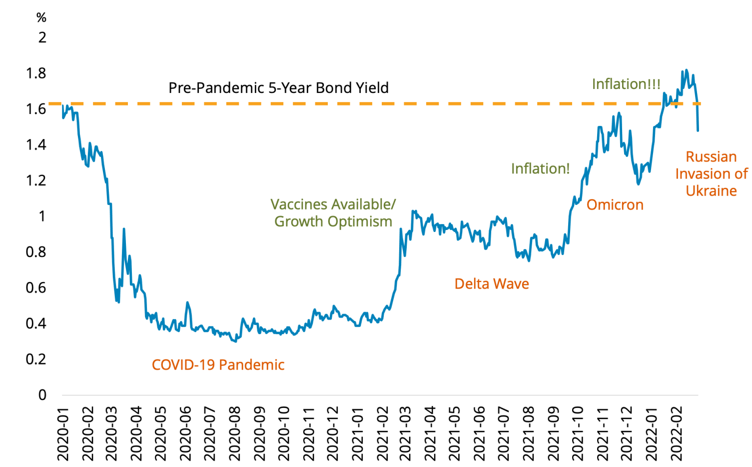
**Mortgage Rate Forecast**

| | 2022 | | | | 2023 | | | |
|---|---|---|---|---|---|---|---|---|
| Term | Q1 | Q2F | Q3F | Q4F | Q1F | Q2F | Q3F | Q4F |
| Prime Rate | 2.70 | 2.95 | 3.20 | 3.45 | 3.70 | 3.95 | 3.95 | 3.95 |
| 5-Year Qualifying Rate | 5.25 | 5.25 | 5.50 | 5.80 | 5.95 | 6.10 | 6.10 | 6.10 |
| 5-Year Average Discounted Rate | 2.99 | 3.25 | 3.50 | 3.80 | 3.95 | 4.10 | 4.10 | 4.10 |

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.

**What is Driving Rates?**



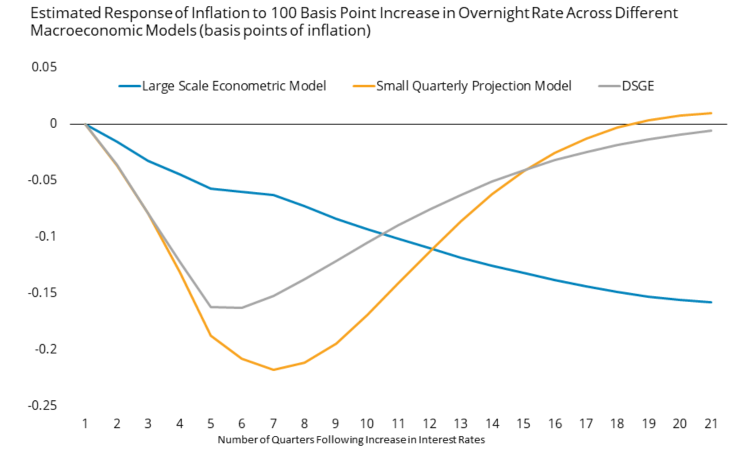

Source: Bank of Canada

We expect five-year fixed rates will rise to about 4 per cent over the next year and a half. However, uncertainty in global financial markets due to the Russian invasion of Ukraine could significantly delay Bank of Canada rate increases and may cause a reversal in the upward trend in long-term rates, a scenario we saw play out in the first week of the invasion with five-year bond yields falling 30 basis points.

### Growth Outlook

The Canadian economy finished 2021 with significant momentum, growing close to 7 per cent on an annualized basis in the fourth quarter and growth appears to be stronger than expected in the first quarter of 2022, tracking at close to 4 per cent. On its current trajectory, that growth would lead to slack in the Canadian economy being completely absorbed within the first six months of 2022 and a positive output gap (more demand than supply) developing over the year. Generally, a positive output gap is somewhat inflationary, though a healing supply chain may help attenuate shortages that have placed upward pressure on prices over the past year. Tightening monetary policy by the Bank of Canada should slow demand and help to bring inflation down, though that will take time. Rising oil and commodity prices caused by the Russian invasion of Ukraine also present a risk of high inflation persisting longer than expected.

## Monetary Policy Works with Long Lags



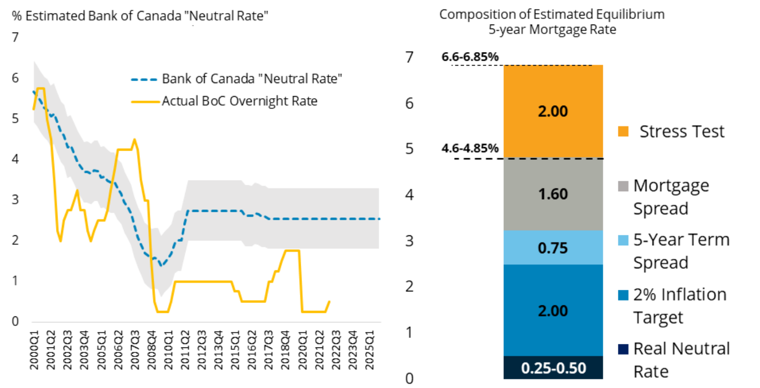

Source: Macroeconomic models database

### Bank of Canada Outlook

With the Bank of Canada embarking on its first rate-tightening cycle since 2018, it is important to ask: where is the Bank's policy rate headed?

When thinking about where interest rates will land in the long term, economists often use models of the so-called "neutral rate of interest," usually defined as the interest rates that would prevail when the economy is in its long-run equilibrium.

## Where is the Bank Headed?




Source: BCREA Economics; Estimated from Laubach and Williams Neutral Rate Model

Based on estimates from the standard model for the neutral rate of interest, the neutral rate is currently about 0.25 to 0.5 per cent in real terms, or 2.25 to 2.5 per cent in nominal terms given the Bank's 2 per cent inflation target. This aligns with the Bank of Canada's official estimate of 1.75 per cent to 2.75 per cent as a range for the neutral rate. That increase would ripple through other Canadian interest rates, which means a higher cost of borrowing for Canadian banks and lenders, and therefore higher mortgage rates. Under a scenario where the Bank of Canada returns its overnight rate to a neutral rate of 2.5 per cent, we can estimate a "neutral" five-year fixed mortgage rate by building up from the overnight rate using historical averages of interest rate spreads. Doing so implies a neutral five-year fixed mortgage rate of between 4 and 4.6 per cent, which would mean a qualifying rate of 6 to 6.6 per cent. Our baseline forecast is for the Bank to pause and re-assess its monetary stance after six rate increases, bringing its overnight rate to 1.75 per cent.

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