

June 2022

HIGHLIGHTS

- Bond markets expect very aggressive Bank of Canada
- Is Canada in a recession?
- Bank of Canada tightening aggressively now, only to cut rates in 2024?

Mortgage Rate Outlook

In BCREA's last Mortgage Rate Forecast, we anticipated Canadian 5-year fixed mortgage rates would reach 4 per cent later this year. Instead, rates have already sling-shotted to 4.69 per cent as elevated inflation continues to drive interest rate expectations.

Canadian bond markets – and Canadian mortgage rates in turn – have already priced in significant Bank of Canada tightening. The 2-year Canadian bond yield, a good indicator of where markets expect the overnight rate to be two years from now, is already well over 3 per cent. That is an indication that markets believe the Bank will have to be very aggressive in its current tightening cycle, raising the policy rate above the top end of the Bank's estimate of its neutral rate.

A steep trajectory for the overnight rate implies that the 5-year fixed mortgage rate could reach the 5 per cent level for the first time since 2009 while variable mortgage rates may rise to as high as 4.5 per cent. With the stress test for both insured and uninsured borrowers, prospective homebuyers are currently being qualified at a rate of 6.49 per cent with a strong possibility of qualifying at 7 per cent soon, a rate that has not been a reality in the Canadian mortgage market since the early 2000s.

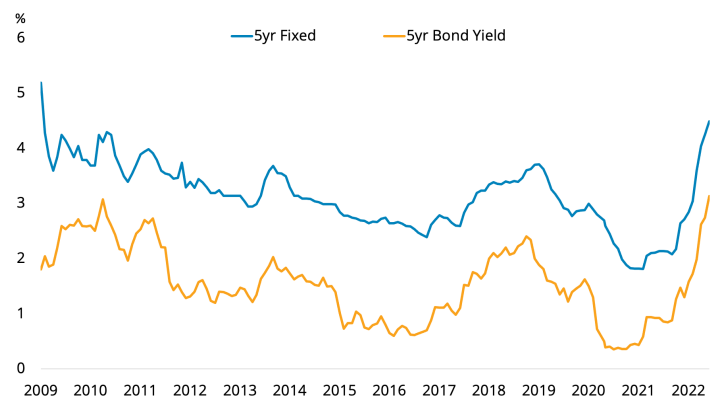
Given how aggressive markets expect the Bank of Canada to be, any good news on inflation, or any significant deterioration in the Canadian economy, could see a significant reversal in the most recent jump in Canadian bond yields.

Mortgage Rate Forecast								
	2022				2023			
Term	Q1	Q2	Q3F	Q4F	Q1F	Q2	Q3F	Q4F
Prime Rate	1.95	2.75	3.25	3.75	4.00	4.25	4.25	4.25
5-Year Qualifying Rate	5.25	6.49	6.69	6.75	7.05	7.05	7.05	7.05
5-Year Average Discounted Rate	2.99	4.49	4.79	4.85	5.05	5.05	5.05	5.05

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.

Radically Different Interest Rate Environment



Source: Bank of Canada

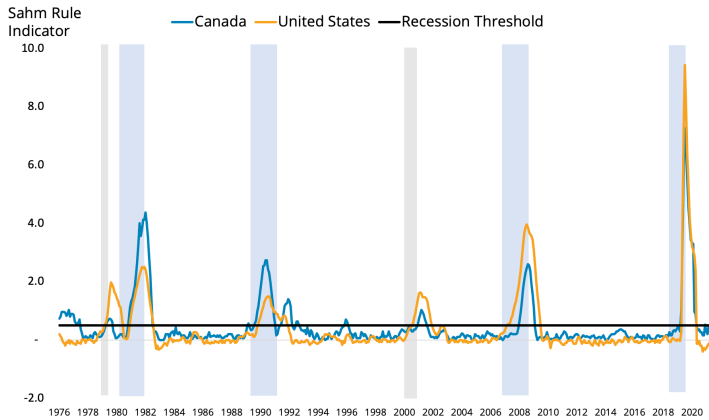
However, the baseline case for now is a Bank of Canada that is single-minded in its pursuit of lower inflation.

Economic Outlook

Growth in the first quarter of 2022 registered a solid 3.1 per cent at an annualized rate compared to the previous quarter. With Omicron lockdowns constraining activity in certain sectors during the start of 2022, performance was mixed across the economy.

The Canadian economy is expected to grow close to 4 per cent this year but is showing some early signs of slowing. That slowdown will likely continue as the Bank of Canada continues its tightening cycle, particularly in interest rate-sensitive sectors like housing.

Are We in a Recession Now? Sahn Rule Says No.



Note: Blue shaded bars are US & Canadian recessions. Grey shaded bars are US recessions only. Source: BCREA Economics; St. Louis Federal Reserve.

While the Canadian economy looked set to enjoy several years of strong economic growth as it recovered from the COVID-19 pandemic, expectations have rapidly shifted from one of successive boom years to growing concerns of a recession either this year or in 2023. Common recession forecasting tools like yield curve spreads are sending somewhat mixed signals. An inverted yield curve in which short-term interest rates are higher than long-term interest rates is often interpreted as a sign that the central bank will have to start lowering its policy rate due to a recession.

The difference between yields on the 10-year bond and the 3-month treasury bill remains positive while the 10-year spread over the 2-year bond, which takes into account expected rate hikes, has declined but has not turned negative for any significant period of time. The Sahn Rule, which is a contemporaneous indicator of recession based on the unemployment rate, and which

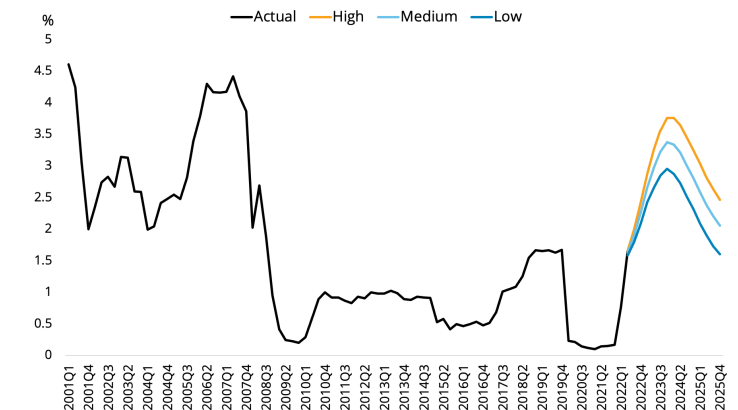
has a very good track record, is not signalling that the economy is currently in recession.

Bank of Canada Outlook

With a second consecutive 50 basis point increase, the Bank of Canada’s overnight rate is now within 25 basis points of its pre-pandemic level. Markets continue to anticipate at least another 100 basis points of tightening on the horizon. The ultimate destination for the overnight rate will depend on the trajectory of inflation over the next few months. While some see signs of inflation peaking, significant upward pressure on consumer prices remains from rising commodity prices and shortages.

The most interesting question for the Bank of Canada is whether cracks begin to show in the economy before it can bring its overnight rate back to a neutral range of 2-3 per cent. While bond markets have priced in a very aggressive Bank of Canada, it is worth noting that the Bank’s last tightening cycle stalled well before hitting the estimated neutral rate as growth began to falter. This cycle is much different than in 2018, especially with inflation reaching 30-year highs, but we could see the Bank backtracking on rate increases in 2024 or even sooner if recession fears are realized.

Aggressive Rate Tightening to Reverse in 2024?



Source: BCREA Economics

Send questions and comments about the *Mortgage Rate Forecast* to: Brendon Ogmundson, Chief Economist, bogmundson@bcrea.bc.ca; Ryan McLaughlin, Economist, rmlaughlin@bcrea.bc.ca.

Additional economics information is available on BCREA’s website at: www.bcrea.bc.ca. To sign up for BCREA news releases by email visit: www.bcrea.bc.ca/subscribe.