Economics

MORTGAGE RATE FORECAST

September 2024

HIGHLIGHTS

- Canadian bond yields falling as markets expect deep rate cuts by US Federal Reserve and the Bank of Canada.
- Economic growth slowed through the summer but will lower rates stimulate a second half recovery?
- The Bank of Canada is on a glide path to a 2.75 per cent policy rate.

Mortgage Rate Outlook

Canadian mortgage rates continue to fall, with the Bank of Canada in the early stages of what could be deep policy rate reductions and the US Federal Reserve on the verge of beginning its own cutting cycle.

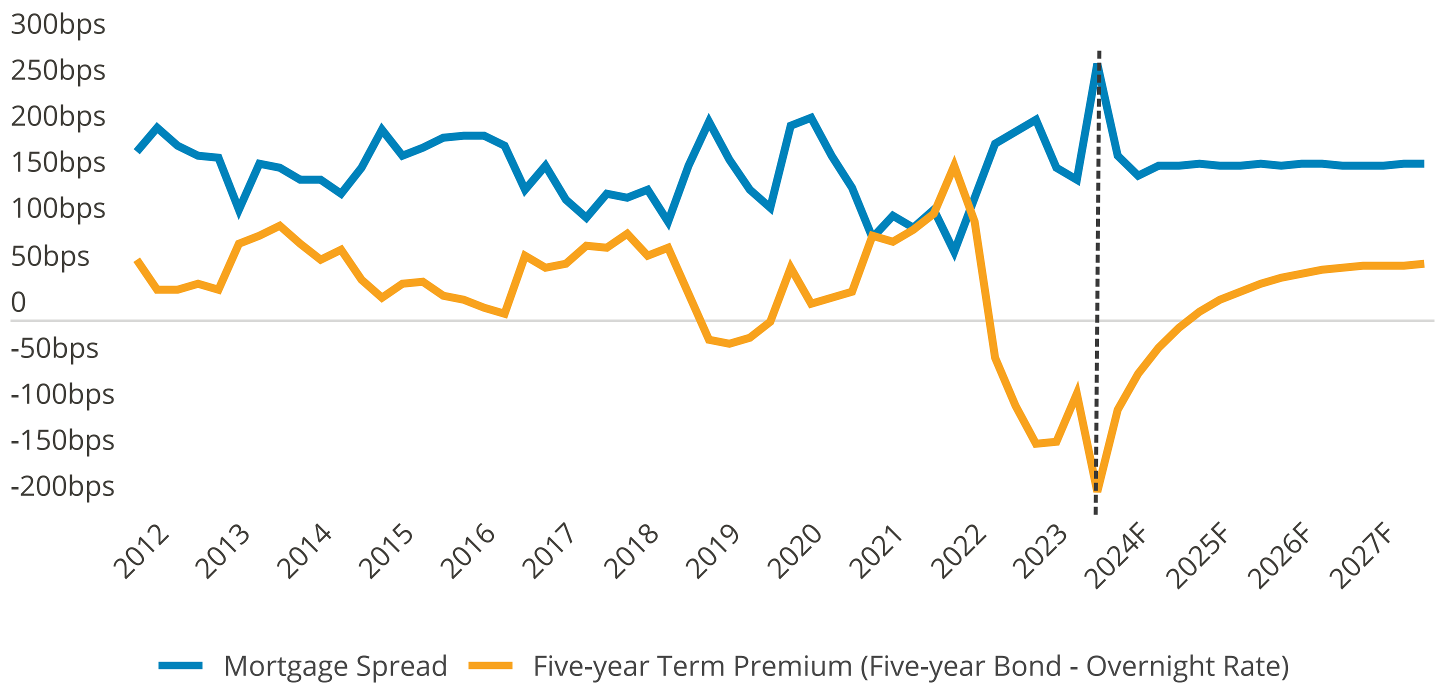
The key question for mortgage rates going forward is where the Bank of Canada is going to stop. If the destination for the overnight rate is 2.75 per cent, the midpoint of the Bank's "neutral range," historical data implies a five-year bond of about 3.25 per cent and a five-year mortgage rate of 4.85 per cent. However, that implies a five-year bond yield that regains its usual 50 basis point spread over the overnight lending rate, a significant increase from its current negative level.

Lingering fears of a weaker-than-expected US economy have pushed markets to expect a more aggressive cutting cycle in Canada and the United States. Consequently, Canadian bond yields have fallen to 2.75 per cent, implying that markets are currently pricing a Bank of Canada overnight rate of 2 to 2.25 per cent. While perhaps over-done, if not reversed, those expectations could drive Canadian fixed mortgage rates even lower, particularly if the economy shows signs of weakening into 2025 rather than rebounding as the Bank is currently forecasting.

Ultimately, we expect that the Bank's rate cuts will stimulate stronger economic activity, prompting the yield curve to normalize and five-year fixed mortgage rates to settle around 4.85 per cent.

Mortgage Rate Forecast								
	2024				2025			
Term	**Q1**	**Q2**	**Q3**	**Q4F**	**Q1F**	**Q2F**	**Q3F**	**Q4F**
Variable Rate	6.60	6.35	5.70	5.20	4.70	4.35	4.35	4.35
Five-Year Qualifying Rate	7.25	7.10	6.60	6.50	6.70	6.85	6.85	6.85
Five-Year Average Discounted Rate	5.25	5.10	4.60	4.50	4.70	4.85	4.85	4.85

Key Mortgage Rate Spreads Need to Normalize



Economic Outlook

Canadian economic growth surpassed the Bank of Canada's expectations in the second quarter but was largely driven by government spending while household consumption slowed. Monthly GDP growth in June slowed, and preliminary estimates for July show further weakness. Moreover, Canadian GDP per capita continues to struggle amidst rapid population growth. Employment has continued to soften from the previous quarter, with the unemployment rate hitting a three-year high of 6.6 per cent in August, as positive job growth has not been enough to keep up with an outsized pace of population growth.

A slowing economy comes in the context of continually improving inflation, which hit 2.5 per cent last month, although price appreciation is still being largely driven by high shelter costs due to pressures in the rental market and a jump in household mortgage costs over the past year. Core measures of inflation have also fallen under 3 per cent and should continue to move lower in the coming months.

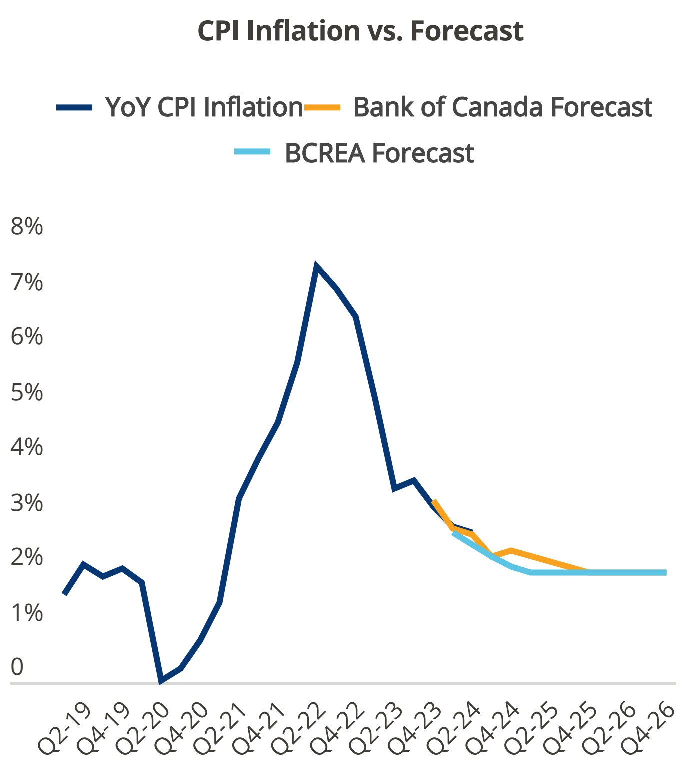
We expect the Canadian economy to eke out about 1 per cent growth in 2024 but head into 2025 with some falling interest rate-driven momentum. As such, we could see a somewhat Goldilocks-like Canadian economy in 2025 growing slightly above 2 per cent with inflation falling back to target.

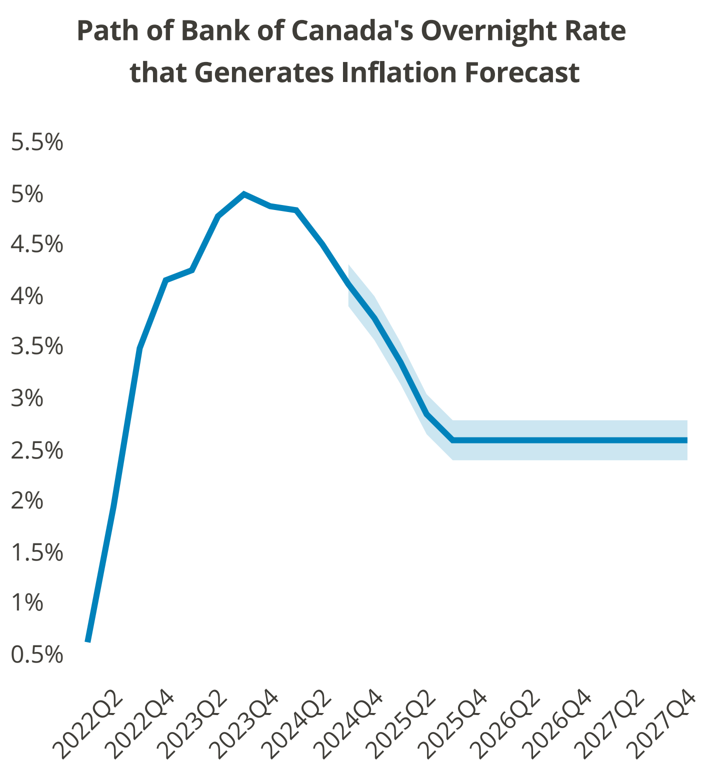
Bank of Canada Outlook

Following three consecutive rate cuts by the Bank of Canada, the focus for each interest rate decision going forward has shifted from whether the Bank will lower rates to how large those rate cuts should be, with some analysts even looking for larger 50 basis points cuts in the future. While the Canadian economy is certainly under-performing, particularly on a per-capita basis, its not clear that the Bank is ready to shift from the current gradual approach implied by the Bank's inflation forecast.

While the Bank publishes its forecasts for growth and inflation, it does not reveal the assumed path of interest rates that generate those forecasts. However, a comparison of the BCREA macromodel with the Bank of Canada's reveals a strikingly similar response of inflation to changes in the policy rate in both models. Given a similar inflation forecast from our model to that of the Bank's, we can get a pretty good sense of the Bank's thinking on the path of rates over the next year. What that shows is that as long as inflation isn't deviating from expectations, and employment is not significantly weaker, we should see continued rate cuts at an orderly 25 basis points pace until the Bank reaches its neutral range between 2.25 and 3.25 per cent in 2025 with a likely destination of 2.75 per cent by the end of 2025.

Gradual Rate Cuts Expected as Long as Inflation Stays on Course





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Send questions and comments about the Mortgage Rate Forecast to:

Brendon Ogmundson, Chief Economist
bogmundson@bcrea.bc.ca; 604.505.6793

Amit Sidhu, Economist
asidhu@bcrea.bc.ca; 604.677.9345

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Suite 1425, 1075 West Georgia Street, Vancouver, BC V6E 3C9 | Phone: 604.683.7702 | Email: bcrea@bcrea.bc.ca