

MORTGAGE RATES RELATIVELY STEADY IN 2019

HIGHLIGHTS

- Oil prices prompt plunging bond yields
- Canadian economy slowing down
- How high can they go? Is the Bank of Canada already finished with rate increases?

Mortgage Rate Outlook

Midway through 2018, everything seemed to be pointing to sharply higher mortgage rates. The Canadian economy was soaring, the Bank of Canada and its counterpart in the US were resoundingly hawkish and bond yields were testing multi-year highs. However, declining oil prices, the stronger than expected impact of the B20 mortgage stress test and generally soft economic data in recent weeks have prompted a swift change in market sentiment.

Since early November, the 5-year bond yield has dropped close to 50 basis points back to levels last seen in June, prior to two rate hikes by the Bank of Canada. Moreover, expectations for future rate increases have been scaled back even as the Bank itself has reinforced its desire for a 3 per cent policy rate. Slowing economic growth, particularly in light of mandated oil production cuts in Alberta, casts significant doubt on the Bank's ability to follow through on that desire.

The impact of the mortgage stress test is weighing heavily on traditional lenders' ability to grow their mortgage books, with growth in residential mortgages at its slowest pace in 17 years. So, even as funding costs were rising earlier this year, banks were hesitant to raise the 5-year qualifying rate.

The 5-year qualifying rate remains at just 5.34 per cent, up a mere 20 basis points on the year. On the other hand, bank lenders are currently pricing 5-year mortgages at 3.74 per cent, up about 40 basis points from the start of 2018. This means borrowers with more than 20 per cent down payments are largely being asked to qualify at 5.74 per cent due to the B20 mortgage stress test. It is unclear if borrowers can bear further mortgage rate increases, with growth in mortgage credit already approaching record lows.

Our forecast over the next year is that a slightly higher policy rate will be pushing against expectations of slower growth in both Canada and the United States. As a result, variable rates may rise modestly with a higher prime rate, while 5-year fixed rates will likely remain relatively flat and may even decline in the first quarter of 2019.

Mortgage Rate Forecast

Term	2018				2019			
	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F
Prime Rate	3.45	3.45	3.70	3.95	3.95	4.20	4.20	4.20
5-Year Qualifying Rate	5.14	5.27	5.34	5.34	5.34	5.54	5.54	5.54
5-Year Average Discounted Rate	3.39	3.38	3.43	3.74	3.64	3.74	3.74	3.74

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 Mortgage Credit
(% Year-over-Year)

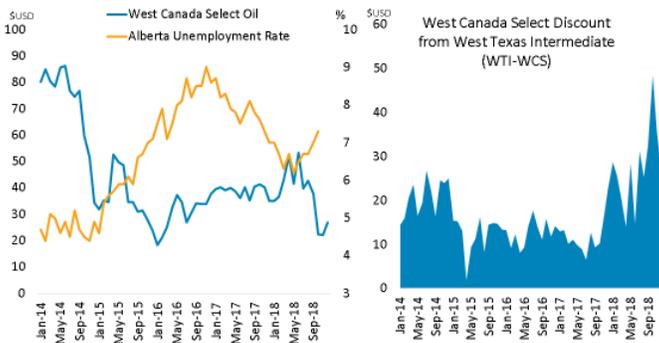


Note: Grey Bars are Canadian Recessions
Source: Statistics Canada

Economic Outlook

The most recent quarter of Canadian GDP data was, on the surface, relatively strong, showing that the economy expanded at a 2 per cent annual rate. However, the underlying data was far less encouraging. Household spending slowed, residential investment fell 1.5 per cent and business investment also declined following six consecutive quarterly increases.

Canadian Oil Prices and the Alberta Economy



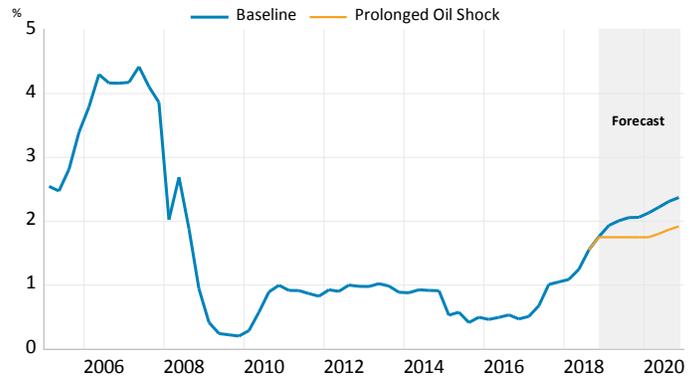
Source: Haver; Statistics Canada

One of the more problematic trends to emerge this year is the steep discount on Western Canada Select oil, the primary oil produced in Alberta. A lack of pipeline capacity has prompted a build-up of inventory, causing prices to decline much more than the West Texas Intermediate benchmark price. In turn, Alberta's economy has struggled with rising unemployment and an uncertain investment climate. In response, the Alberta government has adopted the drastic measure of mandatory cuts to Alberta oil production in hopes of stabilizing prices. Whether that gambit will work is uncertain, though the impact on economic growth due to scaled-back production will be negative in the short run. Early estimates have the scaled-back oil production subtracting over a point of Canadian real GDP growth in the first quarter of 2019.

Interest Rate Outlook

Given the Bank of Canada judges the economy to be at full capacity currently, and inflation is running slightly above its 2 per cent target, its bias remains tilted towards "normalizing" its policy rate back to its estimated neutral level of between 2.5 and 3.5 per cent. With that bias in place, the timing of rate increases, rather than their direction, is the more pertinent issue.

Bank of Canada Overnight Target Rate



Source: Statistics Canada; BCREA Economics

The deep discount for Western Canada Select oil, and the ramifications of limited Alberta oil production, is one reason to be skeptical that the Bank will accomplish its objective to return to a neutral 3 per cent rate over the medium term. However, other cracks in the economy are starting to appear as well, including the highly publicized closing to GM's Oshawa plant, which will have a material impact on growth in Ontario. Those factors, along with a slowing housing market across Canada and a potentially sharp slowdown in US economic growth next year, may give the Bank pause. For those reasons, our baseline forecast is that the Bank will only be able to bring its overnight rate to 2.5 per cent during this tightening cycle. However, if the disruption in the Alberta oil patch is more prolonged, it may prove very difficult for the Bank to return to a program of rate increases without a lengthy delay. As of now, we expect the Bank will at most be able to raise its policy rate twice next year, though we are leaning toward a single rate hike as the most likely outcome.



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