Mortgage Rate Forecast

MORTGAGE RATES HOLD STEADY FOR NOW

HIGHLIGHTS

- The path of Canadian inflation will determine mortgage rates over the next year
- Canadian economy slowed in the second half of 2017
- Bank of Canada to weigh impact of higher rates and mortgage rules before acting

Mortgage Rate Forecast								
	2018				2019			
Term	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
1-Year	3.34	3.34	3.54	3.80	4.05	4.24	4.44	4.64
5-Year Qualifying Rate	5.14	5.14	5.39	5.49	5.60	5.60	5.70	5.70
Average 5-Year Mortgage Rate	3.39	3.39	3.49	3.59	3.64	3.64	3.84	3.84

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.

Mortgage Rate Outlook

Canadian mortgage rates have continued 2017's upward trend. The five-year qualifying rate for insured mortgages bumped up 15 basis points to 5.14 per cent while discounted rates offered by lenders increased similarly to 3.39 per cent. The increases were driven by the earlier than expected rate increase by the Bank of Canada in January. The Bank has now raised interest rates three times since last summer, with its key policy rate sitting at 1.25 per cent.

The Bank's next move, and the impact on mortgage rates, hinges on how Canadian inflation evolves over the next two years. Our baseline forecast, which lines up similarly with the Bank of Canada's, assumes the Canadian economy will return to its full employment level this year. That would mean inflation returning to the Bank's 2 per cent target with the overnight target rate gradually rising to its neutral level of around 3 per cent over the next two years. However, it is important to also examine mortgage rates under alternative scenarios for inflation and the economy. One scenario could see core inflation overshooting the Bank's target as economic growth escalates above trend, putting extra pressure on wages and prices. In that scenario, the Bank would likely tighten rates much more aggressively. If inflation approaches the upper-end of the Bank's 1 to 3 per cent range, we would expect discounted mortgage rates to rise to about 4 per cent by the end of this year and to 4.5 per cent by 2019.

Alternatively, it is possible inflation will undershoot the Bank's target, as it has for the past several years, which would mean less urgency for tighter monetary policy. However, even with inflation undershooting the Bank's target and falling to near the bottom of the Bank's range, it is likely long-term interest rates will still rise due to other factors, including tightening by the US Federal Reserve and a general upward bias in rates as they normalize closer to their long-term average. If inflation undershoots the Bank's 2 per cent target, we expect that 5-year mortgage rates will be only 15 basis points higher by the end of 2018.

Under our baseline scenario for the economy, we expect that the 5-year qualifying rate will reach 5.5 per cent

Inflation Scenarios and Mortgage Rates

Source: BCREA Economics

by the end of this year and rise to 5.7 per cent in 2019. Likewise, the average discounted rate for 5-year fixed mortgages is forecast to rise to 3.65 per cent this year and 4 per cent in 2019. However, with the recent Canadian economic slowdown, the risk is tilted slightly toward a slight undershooting of the Bank's 2 per cent inflation target, translating into a more modest rise in mortgage rates.

Economic Outlook

The Canadian economy closed 2017 on a somewhat disappointing note, growing just 1.7 per cent in the fourth quarter. The consensus forecast of economists was for more than 2 per cent growth. The slowdown was primarily due to slower household spending, which posted its lowest growth rate in almost two years. However, the over 4 per cent growth in the first half of 2017 means that, even with the second half slowdown, Canadian real GDP grew at 3 per cent for the year, marking the strongest annual growth since 2011.

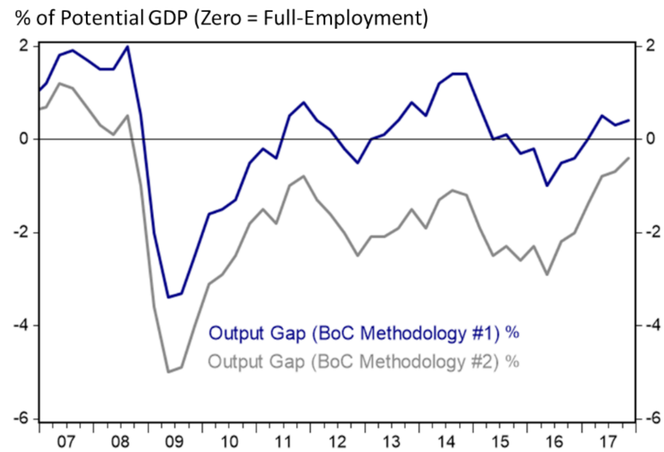
We do not expect 2017's stellar economic performance to be repeated in 2018. The Canadian housing sector and household spending will likely slow under the weight of higher mortgage rates and mortgage tightening measures implemented in January. Moreover, ongoing NAFTA negotiations will come to a head this year, with a distinct possibility of the agreement collapsing under the weight of unreasonable demands from our American counterparts. Indeed, recent ad-hoc policymaking on trade tariffs present a significant risk to Canadian steel and aluminum exports and further damage could be done by an escalating trade war. For those reasons, we anticipate Canadian economic growth to be around 2 per cent in 2018.

Interest Rate Outlook

The Canadian economy is at or very close to full-employment, meaning there is little room for Canadian firms to expand output without putting undue pressure on inflation. There are signs core inflation is already firming up. Two of the Bank's three core inflation measures are closing in on the Bank's 2 per cent target and all three measures have increased significantly in the past six months. Absent any unforeseen challenges to the Canadian economy, monetary policy will be biased in the direction of higher interest rates.

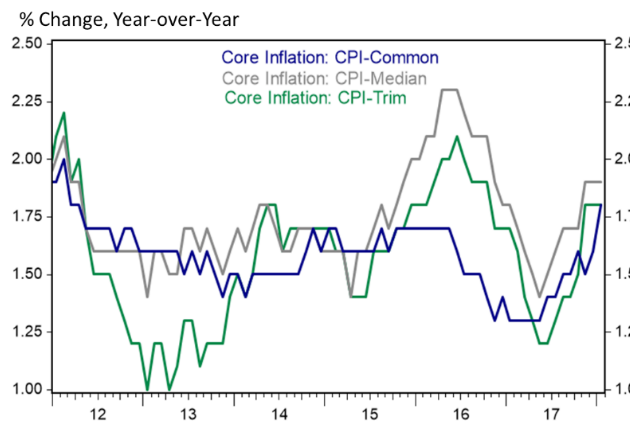
We are forecasting the Bank of Canada will follow up its January rate increase with at least one more rate increase in 2018. However, it will likely hold off until later in the year so policymakers can properly assess the impact not only of its own tightening over the past year, but also the impact of newly implemented B-20 guidelines on mortgage qualification rules and the heightened risk to Canadian exports from US trade policy.

Canadian Output Gap



Source: Bank of Canada/Haver Analytics

Canadian Core Inflation



Source: Statistics Canada/Haver Analytics

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