BCrea

ECONOMICS

Mortgage Rate Forecast

December 2021

HIGHLIGHTS

- Bond yields jump higher; fixed mortgage rates follow
- Canadian economic growth still constrained by supply shortages
- Bank of Canada – higher, faster?

Mortgage Rate Forecast								
	2021				2022			
Term	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F
Prime Rate	2.45	2.45	2.45	2.45	2.45	2.45	2.70	2.95
5-Year Qualifying Rate	4.79	5.25	5.25	5.25	5.25	5.25	5.25	5.25
5-Year Average Discounted Rate	2.05	2.10	2.10	2.70	2.75	2.80	2.95	3.10

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.

Mortgage Rate Outlook

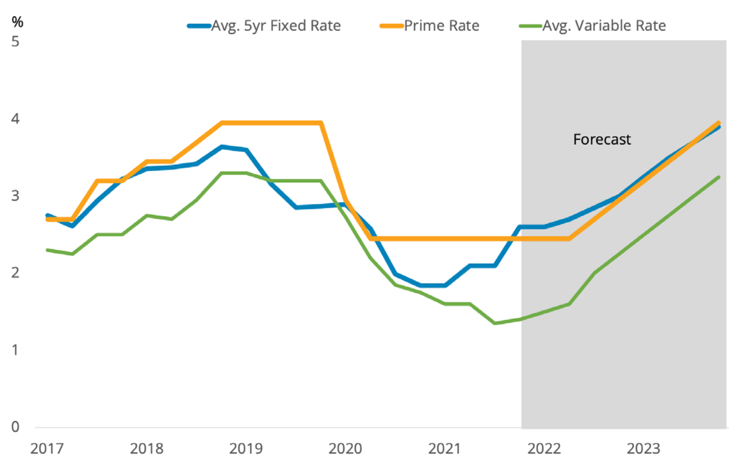
A lot has changed in the Canadian mortgage market in a very short period of time. The benchmark five-year government of Canada bond yield raced higher in October, nearly doubling in just under a month as financial markets and central banks once again pivoted their attention from the pandemic back to inflation. Indeed, a more hawkish-sounding Bank of Canada ended its Quantitative Easing program and signaled that its first rate increase may now occur in the middle of 2022, or about three-to-six months earlier than previously expected. These changes in the Bank's policy and language have prompted a dramatic market reassessment of both the timing and number of rate increases that may occur over the next year.

As a result of rising cost of capital for banks, Canadian fixed mortgages are also on the rise. The average five-year fixed rate increased from just over 2 per cent in September to 2.6 per cent currently. Based on our outlook for economic growth and inflation, as well as the Bank of Canada's new timetable for tightening monetary policy, we anticipate that the average five-year fixed rate will return to its pre-pandemic level of 3 per cent by the fourth quarter of 2022. Variable rates are forecast to rise along with the first Bank of Canada rate increase early in the third quarter of next year. The Bank considers its equilibrium overnight rate to be between 1.75 and 2.75 per cent. However, in Canada's last tightening cycle in 2018, the Bank was only able to bring its overnight rate to the lower end of that range before the economy showed signs of weakness. Two rate increases next year would bring the overnight rate to 0.75 per cent and implies a variable rate of about 2 per cent by the end of next year.

Sharp Rise in Canadian Bond Yields

Source: Bank of Canada

Mortgage Rate Forecast



Source: BCREA Economics; Bank of Canada; RateSpy

Economic Outlook

The global economic environment continues to be a confusing mix of booming demand, gummed-up supply chains and the ongoing COVID-19 pandemic. Against this backdrop, it is very difficult to get a read on the Canadian economic outlook. Perhaps there is no better example of this difficulty than the sudden upheaval in financial markets related to the emergence of the Omicron variant of COVID-19.

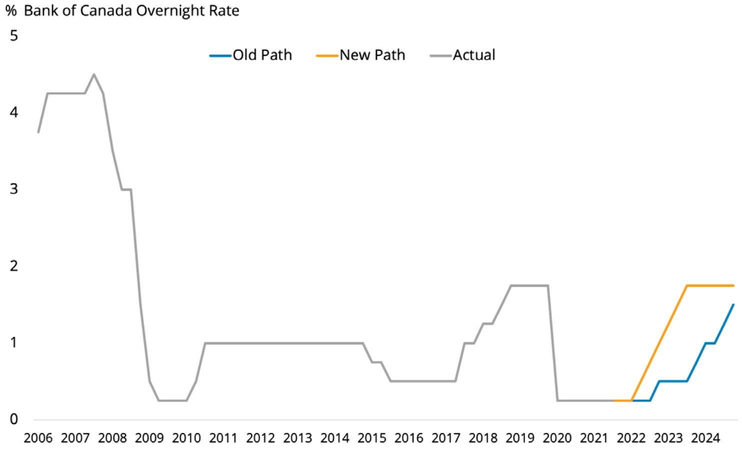
While uncertainty abounds, it appears that the Canadian economy is primed for strong growth. However, as a small open economy, that growth very much depends on the smooth functioning of global supply and demand. So long as supply chains remain challenged by a variety of causes (including the extensive flooding across BC and the resulting damage to transportation infrastructure), growth will continue to be impeded. Fortunately, these obstacles are resolvable with time. Even with choppy growth this year, the Canadian economy will expand close to 5 per cent in 2021 after contracting 5.3 per cent last year. We forecast that the economy will enjoy strong growth in 2022, with real GDP growth of 4 per cent.

Most of the factors that led to a decline in GDP over the second quarter were either one-time changes or due to what should be temporary supply chain disruptions. Data for June showed strong growth, but the pace of the recovery remains uncertain due to the pandemic and especially the Delta variant-driven rise in cases around the country. We anticipate that some of the expected acceleration of economic growth may now be pushed into the fourth quarter of 2021 and the first half of 2022.

Bank of Canada Outlook

The Bank is currently challenged by the highly abnormal circumstance of an economy that is in many ways booming, from retail spending to the housing market, but one that is also suffering through significant supply-side shocks from overwhelmed ports, global factory shutdowns, and labour market shortages. The optimal monetary policy for the current environment is far from clear.

Bank of Canada – Higher, Faster?



Source: Statistics Canada; BCREA Economics

In its last statement, the Bank signaled that it expects the output gap to close in the middle quarters of 2022. However, at least part of the work of closing the output gap is coming from a slowdown in the productive capacity of the Canadian economy rather than overheating demand. While raising interest rates is not a cure for an economy beset by supply shocks, the Bank is clearly nervous about inflation and needs to signal its willingness to keep price growth within its target range. Moreover, since monetary policy acts with long lags, raising rates in the middle of next year will have its peak impact sometime in 2023 when supply-side issues are hopefully resolved and the economy is once again operating close to full capacity.

We expect the Bank will raise its overnight rate two times next year, followed by quarterly increases in 2023, bringing the overnight rate back to its pre-pandemic level by the end of 2023. However, the realities and uncertainties of the pandemic are still very much a presence in the global economy and thwarting recoveries in other parts of the world. Consequently, it would not be surprising if the Bank of Canada had to delay its rate increases.

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

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