

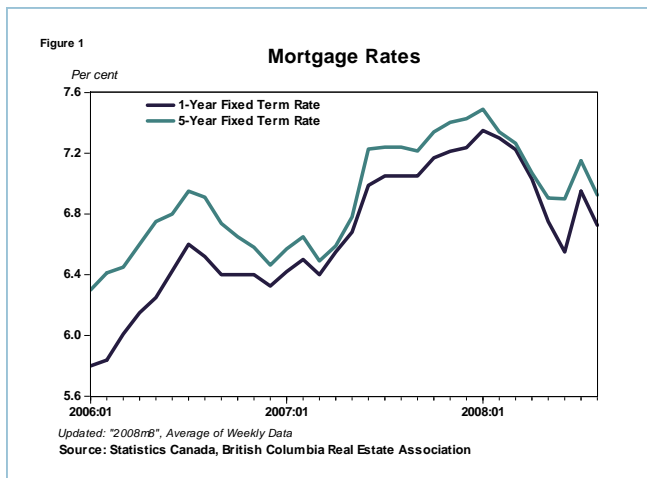
# MORTGAGE UPDATE

ECONOMICS SEPTEMBER 2008

## MORTGAGE RATES STEADY INTO 2009

Posted Canadian mortgage rates moved up in mid-June and July before settling lower in August. Borrowing costs on one-, three- and five-year fixed-rate mortgages fell during the second week of August by 30 basis point (bps) compared to a week earlier. This decline brought the average one- and five-year rates down to 6.7 and 6.9 per cent in August, 30 bps below the same month in 2007 (Figure 1).

BCREA forecasts mortgage rates to remain near current levels, albeit with a slight upward trend through to the end of 2008 into 2009.



In a move widely expected by economists, the Bank of Canada (BoC) held its trend-setting interest rate at 3 per cent on September 3. This move came despite the recent slide in prices for commodities such as crude oil, a weak US economy and the continued slowdown in the Canadian economy that calmed inflationary pressures and fuelled speculation that rates may be cut. Financial markets had priced in the potential that the BoC would cut rates by 25 bps leading into the decision.

BCREA expects the BoC will keep its trend-

setting overnight rate unchanged at 3 per cent through 2008 and into 2009 given BoC's statement that the "target for the overnight rate remains appropriately accommodative." BCREA expects an interest rate hike in the second half of 2009 in response to signs of a recovery in the US economy and higher US interest rates. The expectations of a future rate increase should provide upward pressure on Canadian mortgage rates as 2008 progresses.

However, BCREA anticipates improved credit market conditions to offset some of this increase. Tighter credit conditions have been the norm since August 2007 when the credit crunch drove up the cost of funds, including monies used to fund part of the mortgage loan market. This resulted in higher mortgage rates than would otherwise have been expected, given the historic relationships between mortgage rates and yields on financial instruments with similar maturities. A recovery in the US economy will likely coincide with an improvement in credit market conditions, resulting in lower risk premiums which should partly offset the impact of higher interest rate expectations in Canada.

Mortgage Rate Forecast <sup>1</sup>								
	2007		2008				2009	
Term	Q3	Q4	Q1	Q2	Q3F	Q4	Q1	2009 Avg
1-Year	7.05	7.20	7.30	6.80	<b>6.90</b>	<b>7.05</b>	<b>7.20</b>	7.2
5-Year	7.23	7.39	7.37	6.96	<b>7.05</b>	<b>7.15</b>	<b>7.30</b>	7.3

<sup>1</sup> Average of weekly data

Source: Bank of Canada, BCREA Forecast

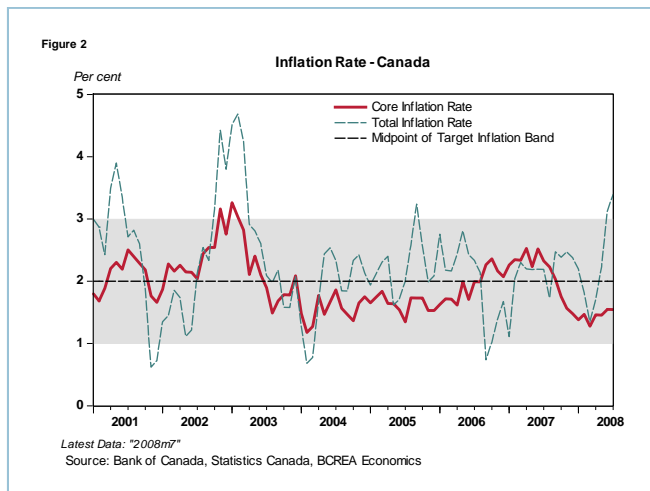
**Inflation Risk Tempered by Crude Price (Page 2)**

**Economy Remains Soft in Q2 (Page 2)**



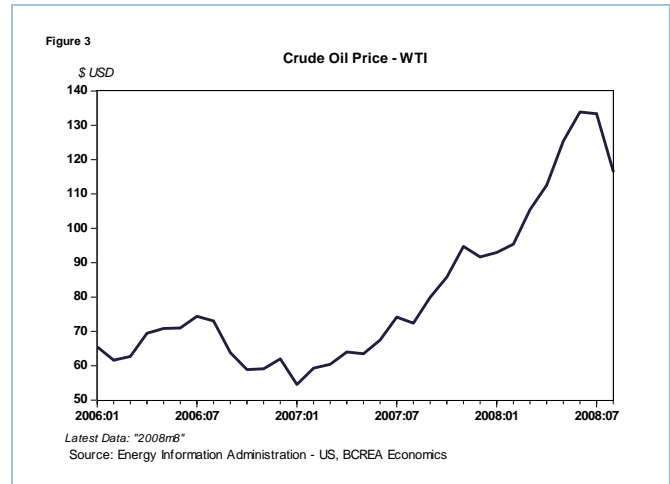
## Inflation Risk Tempered by Crude Price

The accelerating pace of inflation is likely to slow in the coming months as energy prices moderate. Recently, higher inflation has been a concern as July's total inflation breached 3 per cent for the second consecutive month and remained well above the BoC's target band of 1 to 3 per cent (Fig. 2). Despite a low core inflation rate, which excludes the most volatile items and is a good indicator of underlying inflation, the high headline rate fuelled speculation that rates could rise to stem inflationary pressures.



Rapid increases in energy prices have been the main contributor to higher inflation levels. The energy component of consumer price inflation increased by 21.1 per cent in July from a year earlier. Excluding energy, inflation amounted to only 1.6 per cent. However, after reaching \$145 per barrel on July 14, the spot price of crude oil has tumbled 25 per cent to \$109 at the beginning of September (Fig. 3). Crude futures for October delivery, the best indicator of future crude price, has fallen below \$105. This is well below the BoC's projection of \$140 assumed in its July Monetary Policy Update, and provides a cushion against upward inflation risk and interest rate hikes.

However, several factors may offset downward inflation pressure. The BoC noted volatility in commodity prices and global inflation in its September 3 communiqué. Additionally, while high crude prices have con-



tributed to a stronger Canadian dollar, a significant drop in the price of crude may have the opposite effect, resulting in higher import prices and inflation pressures. The Canadian dollar continues to be historically high, but its value compared to the US dollar has declined nearly 6 per cent since July.

## Economy Remains Soft in Q2

Canada's economy remained sluggish in the second quarter, expanding at an annualized rate of 0.3 per cent. This followed a first quarter decline of 0.8 per cent. A relatively high Canadian dollar and softer US and global demand has resulted in a slowdown in export activity. However, domestic demand has remained strong despite a moderate slowdown in the second quarter. Overall activity was deemed by the BoC to be near production capacity, reflecting solid economic conditions in Canada.

In its September 3 communiqué, the BoC found that its current trend-setting interest rate was "appropriately accommodative." The BoC expects total and core inflation will still converge to its target of 2 per cent by the second half of 2009. Given that the downside risks outlined in its Monetary Policy Update were realized, and the BoC still left rates unchanged, BCREA expects no change in the rate until mid-2009 when economic growth is expected to improve. However, future rate increases should be offset in part by lower risk premiums, yielding stable mortgage rates for consumers.

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