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ECONOMIC VIEWPOINT

The Policy Rate Has Started to Come Down

How Will This Affect Mortgage Rates?

By Hendrix Vachon, Principal Economist

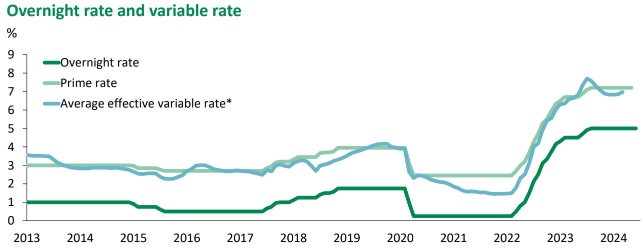
The Bank of Canada (BoC) has finally trimmed its policy rate, and additional cuts are on the horizon. Borrowers are certainly excited. But the truth is that retail rates won't all come down in step with the BoC's rate cuts. That's because retail rates are also influenced by factors such as US interest rate trends, the inverted yield curve and borrowing costs for financial institutions—not to mention the uncertainty surrounding the pace and amount of further policy rate cuts. The BoC's policy rate can only come down if inflation continues to move closer to the 2% target. Fortunately for borrowers, the markets have already priced in several rate cuts for the next few years. Because of the sharply inverted bond yield curve, longer-term fixed rates are already much lower than variable rates and very short-term fixed rates. This means that fixed rates, even for longer terms, are still worth considering, especially for risk-averse borrowers.

Policy Rate Cuts Only Have an Immediate Impact on Variable Rates

The BoC rate cut announced on June 5 will mainly benefit people with variable-rate loans, but these borrowers were also hit the hardest by soaring interest rates over the last two years. Variable rates are based on financial institutions' prime rate, which is usually adjusted in proportion to changes in the BoC's target for the overnight rate (graph 1). Most borrowers are able to get a variable mortgage rate that's lower than the prime rate. For example, the average effective variable rate obtained by borrowers in early 2022 was almost 100 basis points below prime. But for the last 10 years, the average difference was 30 points. Since that spread stays the same for the duration of the term, the variable rate only changes if the prime rate does.

In March 2022, when the policy rate hike cycle began, more than half of borrowers took out variable-rate mortgages (graph 2). This would suggest that a lot of people will get some relief from the recent policy rate cut.

Graph 1
Variable Interest Rates Tend to Move in Step with the Bank of Canada's Target for the Overnight Rate
Overnight rate and variable rate



* Mortgage rates on new insured loans.
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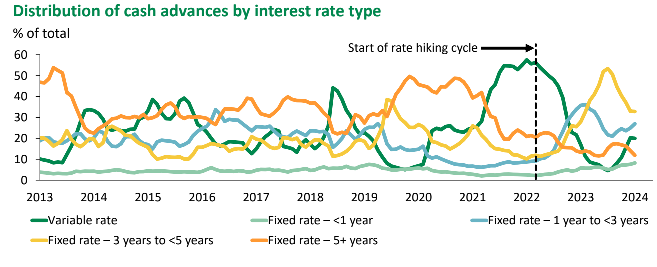
Graph 2
Before Rates Went Up, Most Borrowers Took Out Variable-Rate Mortgages
Distribution of cash advances by interest rate type



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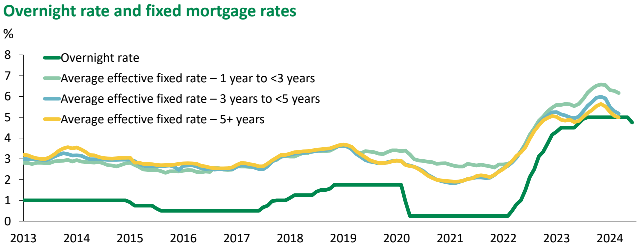
Fixed Rates Depend on Many More Factors

The BoC's recent rate trim doesn't affect borrowers with fixed-rate mortgages. They will keep their current rate until they renew. Fixed rates are currently higher than they were a few years ago, having been pushed up by the rising policy rate, but not to the same extent as variable rates (graph 3). Moreover, fixed rates had already started to edge down before the BoC's announcement on June 5.

Graph 3
Fixed Rates Haven't Gone Up as Much as the Overnight Rate, Especially for Longer Terms
Overnight rate and fixed mortgage rates



* Mortgage rates on new insured loans.
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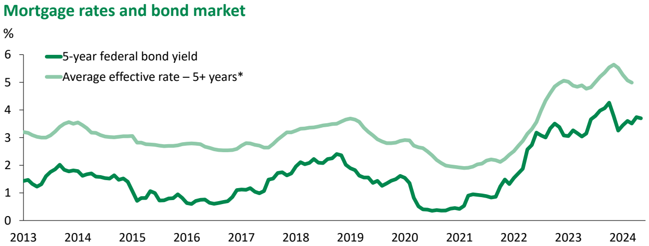
The mechanics behind fixed rates are more complex than with variable rates. Fixed interest rates are more closely tied to government bond market yields, which serve as a benchmark for low-risk loans (graph 4). The bond market certainly reacts to policy rate announcements, but it also tends to move in anticipation of central bank decisions.

Graph 4
Fixed Mortgage Rates Tend to Track Bond Yields
Mortgage rates and bond market



* Mortgage rates on new insured loans.
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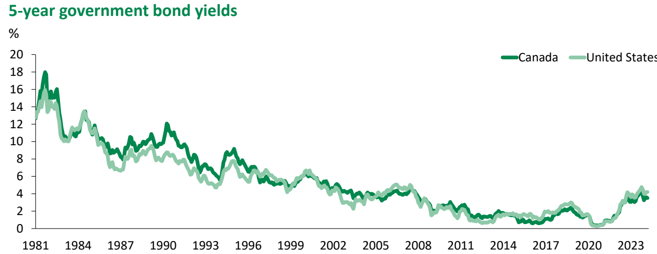
Other factors, like inflation, public deficits and government risk ratings, also influence the bond market. Bond yields can also be viewed as the rates required to maintain the balance between savings and credit. All other things being equal, an increase in available savings usually drives bond yields down, while stronger credit demand tends to push bond yields up. And to complicate things further, Canadian bond yields are influenced by what happens in both Canada and the United States. Historically, the relationship between Canadian and US bond yields has been quite strong (graph 5). The two countries can have diverging rates, but the spread needs to remain reasonable. Otherwise, investors will migrate toward whichever bond offers the better expected return, at equivalent risk.

Graph 5
Canadian and US Bond Yields Usually Move in Sync
5-year government bond yields



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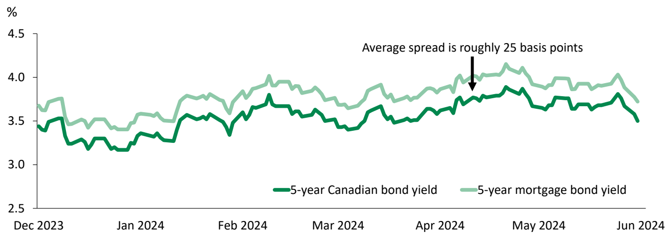
The spread between sovereign bond rates and mortgage rates boils down to financial institutions' borrowing costs and margins. Some of the money that financial institutions use for lending comes from customer deposits, but it's not enough. Financial institutions also need to borrow money on the financial markets, and the interest they pay on these loans is higher than the government's rate. These funding costs aren't fixed. For instance, they can rise and fall with the loan's risk level, as perceived by the investors who lend money to financial institutions. Another source of funds for financial institutions is securitization, a practice that involves pooling existing mortgages and transforming them into mortgage-backed securities. These securities can then be sold on the market or to the Canada Housing Trust, a CMHC entity that will, in exchange, issue mortgage bonds on the market. Ultimately, these transactions allow financial institutions to obtain funding at a competitive price. The yield on 5-year mortgage bonds is just 25 points higher than the 5-year Government of Canada bond yield (graph 6 on page 3). Even after accounting for the other costs associated with securitization, financial institutions are still able to obtain funds at a lower cost than in the traditional market.

Conditions Couldn't Be Much Better for Fixed Rates

When we look at the factors that influence fixed rates, we can see why they're still attractive. The first factor that has helped fixed rates is the sharply inverted yield curve. Long-term bond yields have been lower than short-term yields since the third

Graph 6
Canadian Mortgage Bond Yields Are Very Close to Federal Bond Yields

Comparison of 5-year yields



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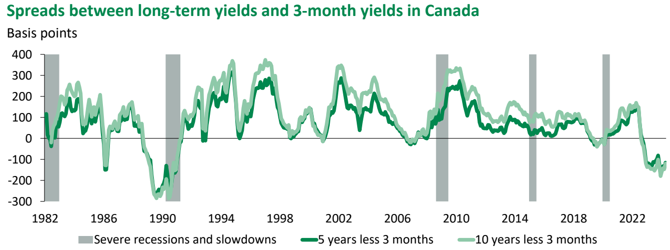
quarter of 2022. That's because of the market expectation that central banks will get inflation under control and eventually be able to gradually bring down key rates. We haven't seen a more inverted bond yield curve since the early 1990s (graph 7). As a result, financial institutions can obtain funds at a lower cost over the long term and offer better fixed rates to their customers. The inverted bond yield curve is the main reason we're seeing such a big spread between fixed and variable rates (graph 8).

Graph 7
The Yield Curve Has Been Sharply Inverted since Q3 2022

Spreads between long-term yields and 3-month yields in Canada



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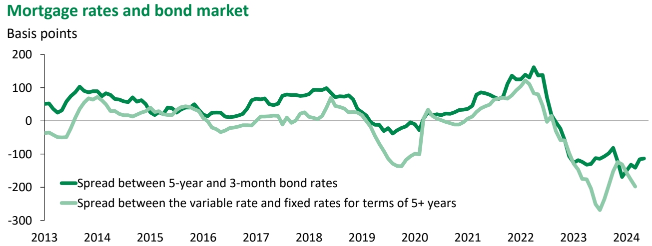
Graph 8
The Inverted Yield Curve Is Clearly behind the Spread between Fixed and Variable Interest Rates

Mortgage rates and bond market



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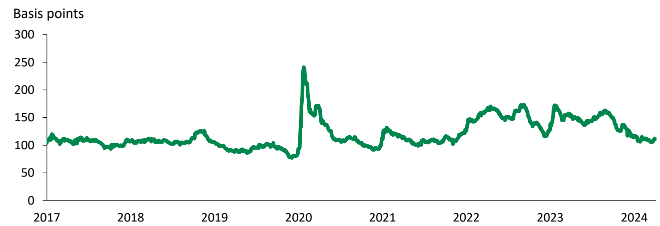
Fixed rates have also benefitted from the fact that financial institutions have seen their borrowing costs come down since the end of 2023 (graph 9). This has given them the ability to lower their mortgage rates. Even better rates are available for borrowers who take out CMHC-insured mortgages. Since these loans can be securitized, financial institutions can take advantage of lower financing costs through the Canada Mortgage Bond Program. Looking at 5-year fixed interest rates, there's about a 50-point spread between insured and uninsured mortgages (graph 10). The Government of Canada contributes to these favourable market conditions by [buying up to half of the mortgage bonds] issued through the CMHC.

Graph 9
Borrowing Costs for Financial Institutions Have Decreased since the End of 2023 and Are Now Close to Pre-pandemic Levels

Canada – Spread between federal and financial sector bond yields



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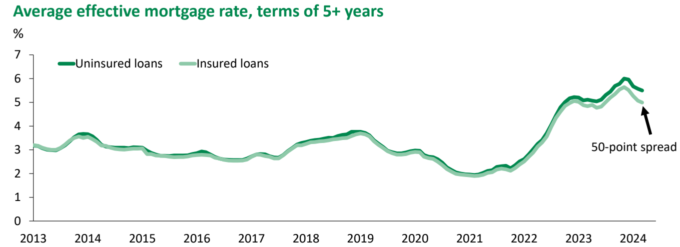
Graph 10
Market Conditions Are More Favourable for Insured Mortgages

Average effective mortgage rate, terms of 5+ years



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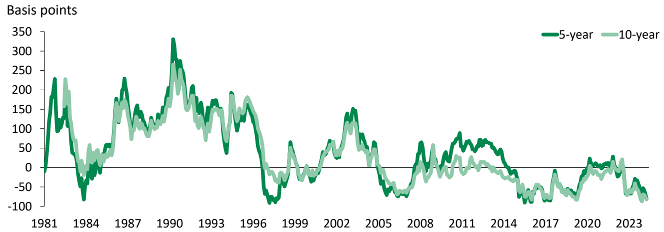
Finally, even though sticky inflation in the United States has created a less favourable environment for monetary policy rate cuts, Canadian bond yields still managed to edge down, which helped cool fixed mortgage rates on our side of the border. Canadian bond yields have rarely been weaker in relation to US bond yields (graph 11 on page 4). It's hard to imagine that conditions could get better than this, unless US bonds yields were to slide further in the coming months and thereby create more room for Canadian bond yields to continue trending downward.

Graph 11
Canadian Bond Yields Have Rarely Been So Low Relative to US Bonds

Canadian and US yield spreads



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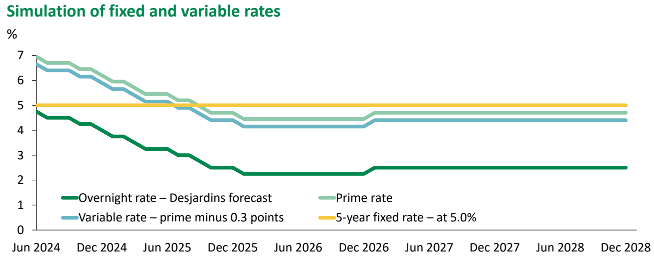
Several Rate Cuts Are Needed to Justify Variable Rates

Even though fixed rates are attractive from a market perspective, variable rates will likely become more appealing amid expectations of further overnight rate cuts. Our forecast has variable rates dropping by another 250 points by the start of 2026. Over a 5-year period, a variable interest rate at prime minus 30 basis points could offer a slightly better deal than a fixed interest rate of 5% (graph 12). Of course, this is just an example. There's a stronger argument for a variable rate if the borrower is able to get it at more than 30 basis points below prime. But there's also a chance that better fixed-rate offers could become available. That's why it's important for borrowers to meet with an advisor, crunch the numbers and assess the related risks.

Graph 12
Our Scenario Shows Variable Rates Falling Significantly by the End of 2025

Simulation of fixed and variable rates



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Our current forecasts are based on a number of assumptions and surrounded by plenty of uncertainty. Importantly, inflation needs to continue edging toward the 2% target in order for the policy rate to come down as expected. If inflation shows signs of stabilizing at an unacceptably high level, the BoC could decide to either hit the pause button on rate cuts or move ahead at a much slower pace than we anticipated. And if one thing's for sure, it's that upside inflationary risks abound. Inflation could be driven higher by stronger-than-expected growth or low productivity relative to wage growth and other rising costs for businesses. We also need to think about what's happening around the world. The global economy could improve and commodity prices could rise faster than expected. The unforeseen effects of geopolitical uncertainty could disrupt global supply chains and financial markets once again. On the other hand, there are also downside risks where the economy could weaken and inflation could come down faster.

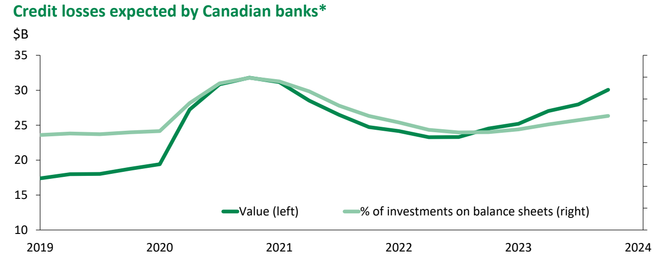
Shorter-Term Fixed Rates Also Come with Risk

Seeking a compromise, many borrowers have recently opted for fixed-rate mortgages with terms that are shorter than the traditional five years. They're hoping that mortgage rates will be lower by the time they renew. And while that certainly does seem likely, fixed rates probably won't ease all that much—and there are risks.

First, the yield curve isn't expected to stay inverted through to 2026. This major advantage for fixed rates will disappear in the next couple of years. It's also likely that Canadian rates will come closer into line with US rates. But there's also a possibility that US inflation could prove sticky and rates in that country might not come down as much as expected. Both of these factors could limit the downward movement of Canadian fixed mortgage rates. Potential changes in financial institutions' borrowing costs are another source of uncertainty. Market conditions are currently quite favourable, but they could deteriorate. Financial institutions have increased their credit loss reserves in anticipation of growing risks (graph 13). We also don't know if the federal government and the CMHC will maintain the same level of support for financial institution funding through the Canada Mortgage Bond Program.

Graph 13
Financial Institutions Have Increased Their Credit Loss Reserves, Reflecting an Increase in Risk

Credit losses expected by Canadian banks*



* Based on forward-looking information as defined by IFRS 9 regulations.
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In short, there are a lot of things to consider, even with shorter-term fixed interest rates. Once again, you've got to do the math and consider various scenarios. Obviously, if there's a special low-rate offer for a shorter term, that would make longer-term fixed rates less attractive. But if the lowest rate is the 5-year option, it may be worth considering. Rates might be even lower for insured loans, which could be helpful for first-time buyers since they often need to insure their mortgages.

The Takeaway: Mortgage Rates Will Probably Go Down, but Probably Not as Much as We'd Like

Clearly, there's a lot to consider when deciding between a fixed or variable interest rate. Borrowers with a variable mortgage rate will have the advantage of seeing their interest rate come down at the same pace as the policy rate. But this strategy isn't without risk. The BoC and other central banks could end up making fewer cuts. Or they could decide to spread them out over more time than currently anticipated. It's pretty clear that current market conditions, including the highly inverted yield curve, are making fixed rates more attractive. Of course, fixed rates are a lot higher now than they were between 2010 and 2019, and this has a lot of borrowers feeling frustrated. But the previous cycle was unique in that economic and financial conditions pushed interest rates to record lows. Then the pandemic made the situation even more unusual. The reality today is that inflation has once again become problematic, and unless there's a serious recession, it's unlikely that mortgage rates will fall significantly and approach the low levels we saw before.