

# ECONOMIC VIEWPOINT

## Canadian Mortgage Interest Rates Could Rise a Few Percentage Points in the Coming Years

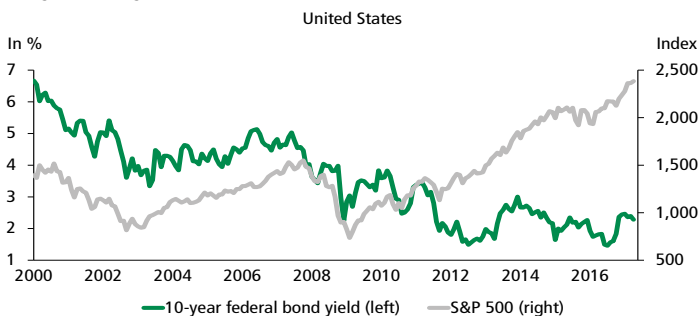
Despite the tightening of U.S. monetary policy, Canadian mortgage rates have remained very low up until now. However, the resilience of the bond markets has its limits, and a widespread increase in interest rates is to be expected over the next few years if the economic expansion continues in North America. The extent of the rise will depend primarily on how long it is before the next economic slowdown. The likelihood of mortgage rates skyrocketing is very low and our base scenario only suggests a slight increase. Borrowers should however make sure they can face an average increase of approximately 2% in mortgage rates over the medium term, something that could happen if the economic expansion continue for longer.

### Interest Rate Lows Appear to Be Behind Us

For several years now, consumers, businesses and governments worldwide have grown accustomed to seeing interest rates continue to fall. This has minimized interest charges despite a sharp rise in debt levels in the private and public sector. Maintaining a generally downward trend for interest rates in developed economies despite a long period of economic expansion may seem counterintuitive (graph 1). This can be explained in large part by low inflation and persistent excess production capacities, which has led central banks to implement increasingly aggressive monetary policies to support economic activity, including by lowering interest rates across the board.

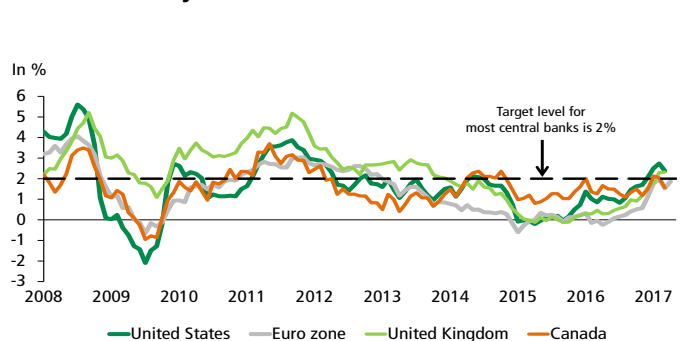
The steady drop in bond yields was however followed by a rebound in the final months of 2016. Donald Trump's election and his program focused on stimulating economic growth was a major catalyst for this rise in yields. However, the stage appears to have already been set for a new trend before the election. Most central banks seemed to have realized that ever-falling yields had a number of disadvantages and, more importantly, the outlook for global growth and inflation was beginning to improve. In particular, the significant hike in oil prices brought inflation very close to the level targeted by central banks (graph 2). This enabled the Federal Reserve (Fed) to raise its key interest rates by 0.25% in December 2016 and in March 2017. It is also considering to start shedding its bond holdings soon. Even

**GRAPH 1**  
**Unlike the stock markets, bond yields continued to decline until very recently**



Sources: Datastream and Desjardins, Economic Studies

**GRAPH 2**  
**Inflation recently returned to a more comfortable level**



Sources: Datastream and Desjardins, Economic Studies

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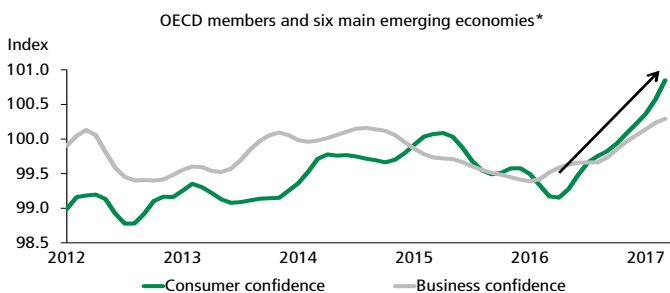
the Bank of Canada (BoC) recently adjusted its tone by closing the door to an additional easing of its monetary policy.

### Recent Drop in Yields Likely Just a Short Break in Their Upward Trend

Despite the continued tightening of U.S. monetary policy and a brighter economic outlook, the recovery of bond yields in late 2016 was followed by another drop since the start of 2017. Euphoria over Donald Trump's election has turned to disappointment as the new administration struggles to keep its promises. Growing geopolitical tensions and uncertainty over elections in Europe have also led many investors to favour safe-haven securities.

However, geopolitical concerns do not usually have long-lasting effects on the markets and the promising results of the first round of the French elections appear to have brought back a certain amount of optimism. In our opinion, the general trend for interest rates in the next few quarters will primarily reflect changes to monetary policies and the economic climate. With regard to the latter, widespread increases in consumer confidence indexes around the world (graph 3) are very encouraging. All signs point to stronger global growth in 2017 and 2018 than last year, even if the U.S. government fails to go ahead with major fiscal stimulus. In this context, the Fed should continue to gradually tighten its monetary policy and other central banks, including the BoC, will likely do the same next year. Such a scenario suggests a gradual rise in North American bond yields.

**GRAPH 3**  
A widespread, encouraging boost in consumer confidence



OECD: Organisation for Economic Co-operation and Development; \* Brazil, China, India, Indonesia, Russia and South Africa.  
Sources: OECD and Desjardins, Economic Studies

### Rates Will Rise Less Than in the Past

As the long downward trend for interest rates has contributed to the sharp rise in home prices and debt levels in Canada, the start of an upward trend can bring up some concerns. In the current climate, a rapid rise in interest rates could have serious negative consequences on Canadian economic agents.

Fortunately, there are no signs pointing to a drastic interest rate hike. First and foremost, the BoC is well aware of the debt situation in Canada and will do everything in its power to prevent

a sudden rise in rates. The other central banks are also mindful of the risk involved in interest rates increasing too quickly, and one of the main objectives of the tightening of the U.S. monetary policy is to prevent a situation in which a rapid rate hike would be necessary.

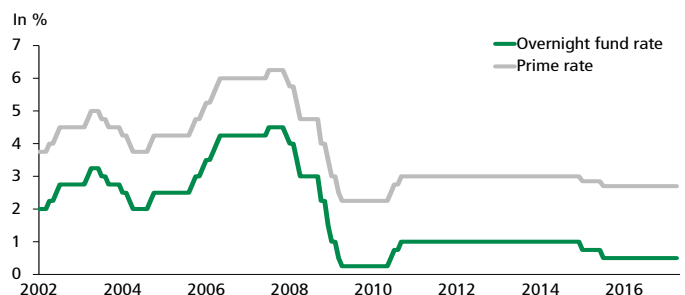
The economic environment, which is marked by an ageing population and a potential for slower economic growth, is also calling for a limited increase in interest rates. Several central banks estimate that the neutral rate, or the rate which would keep inflation at its target rate when the economy is at equilibrium, is significantly lower today than prior to the 2008 crisis. The BoC estimates that Canada's nominal neutral rate has fallen from 5.00% to approximately 3.00%.

### How Will Canadian Mortgage Rates Be Impacted?

It's reassuring to note there are no signs that Canadian interest rates will suddenly jump back up to the levels we saw in the early 2000s, or, worse, in the early 1980s. Still, economic agents need to be prepared for an increase in rates in the next few years. This is particularly important for borrowers who will have to renew their mortgages several times during the amortization period.

In Canada, variable-rate mortgages and closed 5-year mortgages are the most important. How might these two rates change in the next few years? The variable rate is directly tied to Canada's monetary policy as it is based on the prime rate offered by financial institutions. In a favourable economic climate where interest rates increase, there is no reason to think that the spreads between the prime rate and key rates would change, as was the case when rates dropped close to zero (graph 4). We can therefore expect variable rate to closely follow the Canadian overnight rate in the coming years. Meanwhile, the rate for closed 5-year mortgages reflects the financing costs of Canadian financial institutions, which closely mirrors changes in 5-year federal yields under normal circumstances.

**GRAPH 4**  
Prime rates usually follow Canada's key interest rates



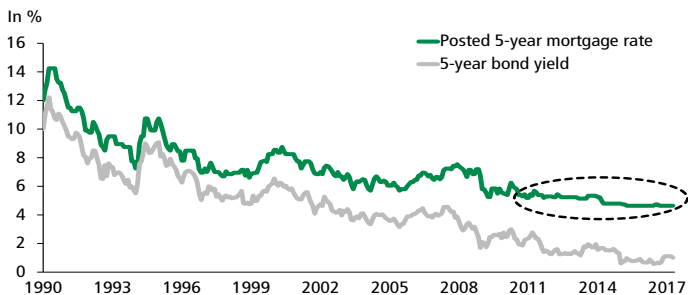
Sources: Datastream and Desjardins, Economic Studies

### Will Posted Mortgage Rates Start to Fluctuate Again?

Before going any further, it's important to differentiate between posted mortgage rates and the mortgage rates that borrowers actually obtain, which are often much lower. The tradition of offering discounts on posted rates is a long-standing one. In the past, the gap between posted rates and effective rates appeared fairly stable, at around 1%. Posted rates and effective rates followed the same trend, which was primarily dictated by bond yields.

However, things have changed in recent years, with financial institutions starting to offer ever-higher rate discounts, sometimes exceeding 2%. Mortgage rates are increasingly being adjusted based on fluctuations in the financing costs of financial institutions through changes to rate discounts, whereas posted mortgage rates have fluctuated very little, particularly in the last few years (graph 5). Since the latest macroprudential measures implemented in fall 2016 use posted rates to carry out stress tests, financial institutions may be even more reluctant to change these rates.

**GRAPH 5**  
Mortgage rates have fluctuated much less in the last few years in Canada



Sources: Datastream and Desjardins, Economic Studies

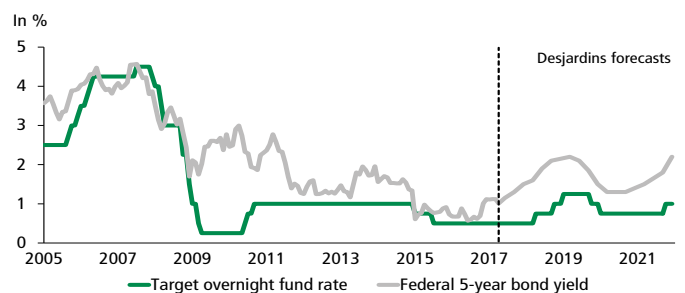
For households and financial institutions, actual borrowing rates are more important than posted rates. Unfortunately, unlike in the U.S., there are no reliable statistics on effective mortgage rates in Canada. Promotional rates, which are increasingly being publicized by financial institutions, provide a rough idea of the range of discounts that are available. We can thus confirm that it's possible to currently obtain a posted 5-year mortgage rate of less than 3.00%, even if the official posted rate is 4.64% or 4.74%, without being able to determine the average effective rate obtained by borrowers as a whole. However, while the effective rate is not directly apparent, we can assume that it will mirror fluctuations in financing costs for Canadian financial institutions in the next few years, which should follow the 5-year bond yield.

### A Relatively Harmless Baseline Scenario

What do our scenarios for Canadian interest rates in the next few years suggest? An improved outlook for the Canadian economy

and a recent change in tone by the BoC led us to slightly step up the date of the first increase in Canada's key rates. We now believe that a first increase of 0.25% could occur in April 2018 and be followed by similar increases in October 2018 and January 2019. This tightening of monetary policy, combined with higher U.S. rates, could bring Canada's 5-year yield to around 2.20% by the start of 2019 (graph 6). We could therefore see an increase of 0.75% to the variable mortgage rate and approximately 1.00% to closed 5-year mortgage rates between now and the start of 2019.

**GRAPH 6**  
The end of the boom cycle around mid-2019 would limit upward pressure on Canadian interest rates



Sources: Datastream and Desjardins, Economic Studies

In our baseline scenario, interest rate hikes would then already be over at that point as we anticipate an economic slowdown in North America towards mid-2019, putting downward pressure on rates.

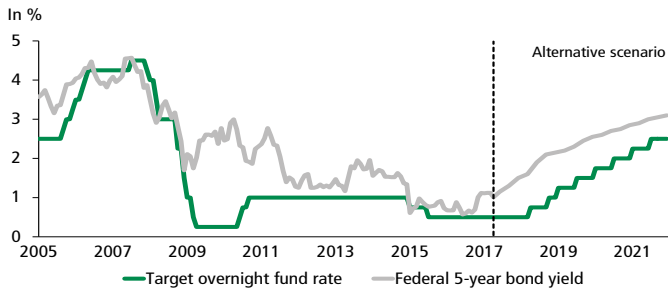
### A Longer Economic Expansion Could Lead to Higher Interest Rates

Our interest rate scenario may seem very reassuring to Canadian borrowers. However, it's important to understand that our assumption that the expansion cycle in North America will end around mid-2019 is crucial. We feel this assumption is justified by the fact that the U.S. economic expansion, which began in 2009, has already lasted a long time from a historical point of view. Rising interest rates and a protectionist push could be the catalysts for an economic slowdown. We must admit, however, that it's always difficult to forecast turnarounds in the economic cycle and it has become even harder in a context in which the 2008 crisis changed many aspects of the global economy. As signs of excess remain rare in the United States, we can easily picture an alternative scenario in which moderate economic growth continued for several more years.

In such a scenario, the monetary tightening cycle would be extended in Canada. The BoC could increase its rates by 0.50% per year from 2019 to 2021, bringing it to about 2.50%. In that climate, the Canadian 5-year rate could increase to approximately 3.10% (graph 7 on page 4). In a medium-term horizon,

variable rates and 5-year mortgage rates could thus rise by approximately 2%.

**GRAPH 7**  
**If the expansion were to continue, interest rate hikes would be more substantial in Canada**



Sources: Datastream and Desjardins, Economic Studies

Obviously, we could imagine plenty of other scenarios in which mortgage rates rise much more or much less. In the current climate, our baseline scenario, which suggests only a slight increase in mortgage rates, remains the most likely. However, to be on the safe side, mortgage borrowers should be prepared to face the alternative realistic scenario we presented. For example, they shouldn't be caught off-guard if, in five years, the mortgage rates of less than 3% currently being obtained by some borrowers have been replaced with rates closer to 5%.

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