

Rates - Where are they going?

The Bank of Canada will be meeting again in March amidst expectations of further rate drops to stimulate our recession-burdened economy. The real question on everyone's mind is - will rates drop further, if so how much and if so, for how long? - ok so that's three questions..., Here's my take:

The key to remember is that the Bank of Canada is governed by one of two things; Inflation or Stimulation. If they fear inflation, they will raise rates, but if they feel the need to stimulate the economy they will lower rates.

Clearly, we are still very much in a stimulus environment and as long as the Canadian economy continues to sputter along, we will remain in such. Translation: Expect Mark Carney and the Bank of Canada to follow suit by lowering rates again in March. The real question that remains unanswered is by how much? Personally, I am anticipating a quarter point drop, but the street is asking for another half point decrease and, in fact, the markets have already priced that in. So we could very well see another half point drop which, if the banks follow suit and lower Prime accordingly, would make the Prime rate an amazingly low 2.5%.

The other question was for how long? Coupled with this would be the need to look at the trend in bond yields and how they will impact long-term rates. You don't need to worry about becoming an economist to figure it all out, but suffice to say there is room for a further drop in the long-term rates as well. However, at one point over the next year or so, the economy will stabilize and start to swing upwards and when it does, the BOC will start to shift their focus away from stimulus and over to inflation.

This will result in a rise in interest rates both long-term and short-term. And at one point, it may very well make sense to start looking at locking in your rates.

What product should I choose for 2009?

In December's Newsletter, I spoke about the lack of liquidity in the market and how it has increased the cost for banks to offer their Variable Rate Mortgages (VRM). I suggested at the time that it would be better to take a 12-month convertible or one-year term instead of a VRM and wait for the liquidity to return to the market.

A portion of that liquidity has returned and we've seen the cost of the VRMs come down slightly to Prime + .8 or Prime + .6 in some cases. I still believe that some of the government programs announced in the most recent budget whereby the government will be purchasing some of the mortgage loans from Canadian banks will result in removing the log-jam that has increased the cost of borrowing amongst banks. The net effect for borrowers is a lower cost of getting VRMs.

It would appear that the days of Prime - .9 are gone forever, but we may very well see Prime - .25 again. In the meantime, if the BOC does decide to lower the overnight lending rate by a half point in March and the banks follow suit by lowering Prime to 2.5%, a VRM of Prime + .8 would be 3.3% and few could argue with a rate that low, given that your 1year and 3 year rates would be higher.



Furthermore, given that over the next 12-18 months, long-term rates are expected to soften, stabilize and then shift upwards, we may very well find ourselves in the near future in a rare market environment where it will make more sense to lock in your rates for the long-term instead of riding the float. 5 year mortgages are already hovering just above 4% and if they slide down below that mark, I'd be very tempted to look at locking in. The challenge will be your timing. If Prime is still 2.5%, and you lock in at 4%, you are betting that Prime will go up by at least 1% over the next 5 years if the economy recovers (depending on what you are paying for your VRM). Is a 1% increase in Prime possible? Absolutely - rates can go up just as fast as they go down, so a word of caution, if you wait for Prime to go back up to 4% before locking in - you may well be locking into a 5 year rate of over 5%.

So what should I do today?

If I were getting a mortgage in today's market, I'd definitely take a variable and take advantage of the historically low Prime while Canada works its way through this recession (which isn't going anywhere in the next few months). But I would watch it very carefully over the next 6 - 12 months for signs and signals that the economy is recovering and be prepared to lock into a long-term rate.

As for term, I would either look at a 4 year today or a 3 year a year from now so that I timed my renewal in the year of a US Presidential election - it's no guarantee that rates are lower at that time, but it puts the odds in your favour. Alternatively, if 'playing it safe' and having the security of a guaranteed payment in uncertain times is more important to you, than forget about the 3,4 or 5 year rates and take an 8 or 10 year rate - especially if they drop below 6%. There's something to be said about sleeping well at night.

I know this information is important to you, so I will endeavour to keep everyone on my Newsletter list up to date with the latest news on rates and predictions on where the market is heading. If you know of anyone who could benefit from this kind of information, please don't hesitate to pass it along to them. In the meantime, have a great month and we're happy to answer any of your questions. Simply send us an email to: clientcare@peterkinch.com

