

# WRITING IS ON THE WALL

MAY 2008

Wow, it's hard to believe we're already in the month of May. That means the 'Spring Real Estate Market' is well under way and this year the launch of the Spring Market was greatly aided by a half-point discount in the Prime lending rate. This has made all variable rate mortgages much more attractive and in turn made home purchases that much more affordable. In all, the Bank of Canada has lowered rates by a full 1.5 percentage points since December. The question now is – where do we go from here?

I found it very interesting to note that the new Bank of Canada Governor, Mark Carney, has made two public announcements since the last rate drop stating very clearly that consumers may not continue to benefit from ongoing rate reductions. This is, of course, part of the ongoing fallout from the Global Credit Crunch that just won't go away. Earlier this year I had the privilege of hearing Alan Greenspan speak when he was in Vancouver and the one point that struck a chord with me was the fact that we have yet to see the true global cost of the sub prime meltdown. I remember Mr. Greenspan noting that it is impossible to predict the full long-term impact and the possible options for recovery until we actually hit the bottom – and the problem is that no one seems to know exactly where that bottom is. Translation? We haven't seen the worst of it yet.

The true translation of this lies in the ongoing Global Credit Crunch. How it impacts you, the borrower in Canada, will be played out over the upcoming months. Things that you could take for granted a year ago won't be the case this year. I think the writing is on the wall and Mr. Carney is making it very clear to anyone who wants to listen, the Bank of Canada can only do so much and even if they do continue to lower rates in the future, that doesn't mean that the

Chartered Banks will follow suit. In fact, we've already seen evidence of this. As I've mentioned before in this Newsletter, the gap between the bond rate and the long-term fixed rate is double what it should be. The Chartered Banks have been in a position for quite some time to pass on significant savings to mortgage borrowers on the long-term fixed rates but have chosen not to because of what they call 're-pricing risk' in the wake of the collapse of the U.S. Sub-Prime mortgage market. In a nutshell, the banks need to recuperate funds somewhere to offset the massive write-downs they have incurred. In other words, they have to try to balance the books somehow.

So why choose the long-term rates instead of the Prime lending rate? Simple, it's a lot easier to hide. If a Chartered Bank chose not to lower their Prime lending rate following the Bank of Canada announcement, there would have been a massive public outcry. But, if the bond drops a bit and the 5 yr rate doesn't follow suit – it's a bit akin to a tree falling in the forest. I would think that the banks would be happy to make up for their sub-prime losses by increasing the spread they get on the bond rates (remember – bond rates dictate the long-term mortgage rates and the Bank of Canada dictates the Prime lending rate), but now they've come up with ways to cover their losses on the Variable rates as well.

Banks know that there would be public outcry if they decided not to lower Prime after the BOC lowered its overnight lending rate, so what they did instead is lessen the amount they discount off of Prime. In August, the trend in Variable Rate Mortgages (VRMs) was a higher discount such as Prime - .90, but now you're lucky to get Prime - .65 – and the trend is moving downward. True, the cost of borrowing is getting more expensive, which accounts for something, but the trend and the

language coming from the banks does not bode well for Canadian homebuyers. In fact, comments from Mr. Carney last week indicate that future rate decreases from the Central Bank may not translate into an automatic drop in the Prime lending rate offered by the Chartered Banks.

Clearly, no one is under any false illusion that the Canadian market is impervious to the perils south of the border, but it should be noted that Canada is maintaining a strong economy in relation to the pending U.S. recession. We can hope that the markets have already priced in the future losses and that we will soon find out where that bottom actually is. In the meantime, look for three definite trends over the next few months:

1. Rates (both long and short-term) will be very steady and may even dip a little lower.
2. The discount off of the bank's Prime lending rate will be less than it has been in the past.
3. Since the long-term rates are more profitable than the VRMs, look for banks to continue to offer 'Quick Close Specials' to entice you to lock in today.

For my money, even though the discount off the variable is not as much as it was in the past – it still beats going with the long-term today. But I do have one major disclaimer – a year from now it could be a completely different story – so until we actually see the bottom of the market that Mr. Greenspan was looking for, all bets are off. Go with the variable today – but be prepared to lock in on short notice.

Until next month,

Happy investing,

Peter Kinch

