



Update: Determining the Best Mortgage Strategy

May 24, 2006

*The Bank of Canada has raised its key policy rate for the seventh time in a row.
How does this impact the selection of an advantageous mortgage strategy?*

The decision on May 24, 2006 by the Bank of Canada to raise its key interest rate marks the seventh consecutive increase for variable-rate mortgages since the current Bank of Canada tightening cycle began in September 2005.¹ The current rate for a new fixed-rate mortgage has also been drifting upwards in recent months due to movements in the bond market. For both mortgage holders and new home buyers, these rate trends shape the decision of whether to hold a variable-rate mortgage or "lock in" one's payments with a fixed-rate mortgage.

Rate Scenario Revisited

On September 7, 2005, the day the Bank of Canada raised its key rate for the first time in one year, we released an Invis Mortgage Research paper outlining a potential rate hike scenario: a rapid tightening pattern of four additional rate increases (for a total increase of 1.25%, including the Sept. 7, 2005 increase). We concluded that with this particular scenario, a 5-year fixed mortgage would offer a more effective means of paying down the principal on one's mortgage.

Over the past seven months, however, the actual tightening pattern has proven to be more considerable than we had hypothesized – after the September 7, 2005 announcement, the Bank of Canada raised rates an additional six times, for a total rate increase so far of 1.75%. While a 5-year fixed mortgage would have been a somewhat more advantageous mortgage strategy in September 2005, if we have reached the end of a tightening cycle, then a variable-rate mortgage could be a more worthwhile option.

The Rate Environment

What is the likelihood of further rate hikes by the Bank of Canada? A examination of the Bank of Canada tightening cycles over the past 10 years shows there have been three other tightening cycles averaging 10½ months in length and resulting in an increase of short-term interest rates of an average of 1.65%. The current tightening cycle has lasted 8½ months so far, with the Bank hiking rates by 1.75%.

After having raised its key policy rate aggressively over the past eight months, the Bank of Canada will have to assess carefully the cumulative impact of this monetary tightening on the balance between growth and inflationary pressures in the Canadian economy.

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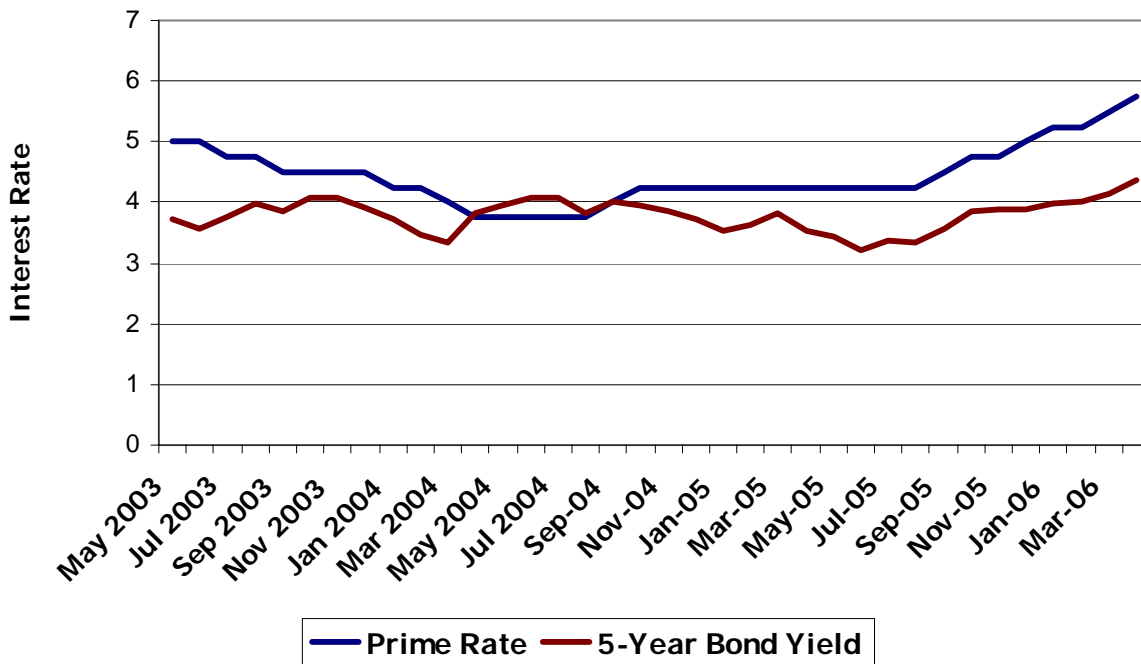
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Most economic commentators take the view that the Bank of Canada has likely finished tightening for this cycle: a view that we tend to agree with. Another way of assessing the likelihood of further increases in short-term interest rates is to look at a traded market where participants are risking their own capital to support their view on the future direction of interest rates. In Canada, the most appropriate market to examine is the Three-month Canadian Bankers' Acceptance Future, or BAX, market traded on the Montreal Exchange. Current pricing in the BAX market indicates that the market also expects that this is the end of the Bank of Canada tightening cycle, although, there is some, relatively small, probability of a further increase in Prime priced into the market through to the end of 2007.

Graph 1:
Chartered Bank Administered Interest Rates – Prime Business
&
Selected Government of Canada Benchmark Bond Yields: 5-Year
May 2003 – May 2006



Source: Bank of Canada



If there is no further monetary tightening in the coming months, this would lessen the pressure on consumers to “lock in” their borrowing costs with a fixed-rate mortgage, and make a variable-rate choice more attractive. If we are now at the end of a tightening cycle, what might come next? The three Bank of Canada tightening cycles over the past 10 years were in two cases followed by plateaus of steady interest rates lasting eight and three months (in one case, rates were lowered in the next Bank announcement). In the past 10 years, periods of interest rate easing have lasted an average of 14 months (including intervals of steady rates), and have seen the Bank lower rates by an average of 2.00%.

Pricing of Variable and Fixed Mortgages

Graph 1 shows the Prime rate for the past three years in relation to the yield on five-year government benchmark bonds. These, respectively, are the main determinants of the pricing of variable and fixed mortgages, and both have been on the rise in recent months.

Despite the recent rise in the cost to borrowers for both variable- and fixed-rate mortgages, the Canadian mortgage market has become more competitive over the past year.

Pricing of most variable-rate mortgages is the Prime minus a discount percentage. The discounts below Prime that are available today are larger than was the case six months ago. In addition, so-called “teaser rates” feature deeper discounts in the early life of the mortgage with higher rates in later years.

Fixed-rate mortgages, by contrast, are priced in relation to the government bond market, as bonds are the main competing investment to mortgages for investors. Mortgages are significantly more complex financial instruments than bonds and are priced at a higher yield to compensate investors for the additional cost of administering the mortgage (referred to as mortgage servicing), the potential for borrower to prepay the mortgage, and the risk of default amongst other factors. Heightened competition amongst lenders of fixed-rate mortgages has seen the pricing difference between the cost of a mortgage above interest rates in the bond market become extremely narrow by historical standards through much of 2006. In recent weeks, however, we have seen increases in spreads between five-year mortgages and the benchmark Government of Canada bond as mortgage lenders seem to be more focused on lending profitably than competing on price. This increase in mortgage spreads is consistent with seasonal patterns that generally, but not always, see spreads narrow in the early spring and increase in the summer months.

Mortgage Carrying Costs

With the Prime rate at 6.00%, after the 0.25% increase in rates today, a competitively priced variable-rate mortgage has a current interest rate of 5.10% to 5.15%. In comparison, the pricing on a competitive five-year fixed-rate mortgage from Invis is in the range of 5.35% to 5.40%. If the market's assessment that the Bank of Canada has finished tightening for this cycle is right, mortgage borrowers can enjoy the advantage of saving interest costs at approximately 0.25% per annum with a relatively modest risk that rates will increase in the short-term to erode this cost advantage.



Conclusions

If the Bank of Canada deems that its seven consecutive rates increases totaling 1.75% over the past 8½ months will be sufficient to tame inflationary pressures in the Canadian economy, the May 24, 2006 rate increase could mark the end of a tightening cycle. If this is indeed the case, consumers deciding on a mortgage strategy may wish to explore the benefits of a variable-rate mortgage with a mortgage consultant. Even if the Bank of Canada decides on further modest monetary tightening or there is a plateau of several months in short-term mortgage rates, a variable-rate mortgage may still be more effective in paying down the principal on one's mortgage. While the most popular type of mortgage in Canada is currently the five year fixed-rate mortgage, the carrying costs on a variable mortgage have historically been less than on a fixed mortgage.

In an ever-shifting interest rate environment, the right mortgage strategy is crucial – an Invis Mortgage Consultant can advise you on how to get the most from your mortgage financing. Invis also has a number of calculators available on www.invis.ca that allow mortgage holders and prospective home buyers to examine different financing scenarios in more detail.

¹ The Bank of Canada sets its target for the overnight rate, which directly affects the Prime rate which banks charge their customers. Most variable-rate mortgages are priced according to Prime minus a discount. A tightening cycle refers to a period in which the Bank of Canada is raising rates to restrict monetary conditions in order to reign in inflation.

Disclosure Statement

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