Intelligence MEMOS

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From: Don Drummond

To: Canadian Mortgage Watchers

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Re: **Rate Cuts Unlikely to Cut Mortgage Costs Any Time Soon**

Media reports abound with speculation Bank of Canada interest rate cuts will lift the Canadian housing market. To be sure, there are caveats that rate cuts will likely be slow. Less mentioned is the likelihood they will not reduce borrowing costs for many mortgages.

Variable-rate mortgages should see a full and immediate response, but the 2024 CMHC Mortgage Consumer Survey shows only 23 percent of mortgages are variable rate, 5 percent are a fixed/variable combination and 69 percent are fixed. Five-years is the most common fixed-rate term, although three-year terms have been gaining in popularity.

Fixed-rate mortgages are priced off the corresponding bond yield. Implicit in the anticipation of rate cuts lifting the housing market is an expectation bond yields will move down with Bank of Canada policy rate cuts. In fact, a big decline is unlikely. It would perpetuate today's inverted yield curve, which has long-term rates lower than short-term rates. That's not the norm. Because uncertainty increases with time, bond holders expect to be rewarded for the heightened risk associated with longer terms. Therefore, longer rates are usually higher than shorter ones.

To escape the impossibility of guessing the exact timing of Bank of Canada rate cuts, let us fast forward to a time, perhaps a year or two from now, when the process has been completed. If the economy is operating to the Bank's satisfaction, the policy rate should be consistent with a "neutral" rate. While the Bank's estimate of that could change, presently it is a range of 2.25 to 3.25, and here we focus on the mid-point of 2.75 percent. That means the Bank has another 200 basis points of cutting to do. What would bond yields likely be when the bank rate is 2.75 percent?

To construct a likely scenario, we need to dip back into history – 1996 to 2005 – when the bank rate averaged 3.98 percent as the Bank aimed for neutrality, wishing to neither stimulate nor restrain economic activity. This was down from the inflation fight in the previous era and before the Financial Crisis ushered in near-zero rates.

That "normal" decade's 3.98 percent is a lot higher than 2.75 percent midpoint of the Bank's estimate range. During those "normal" years, the spread between the bank rate and bond yields averaged 84 basis points for three-year bonds and 112 bps for five years. If we tack those spreads onto a 2.75-percent "neutral" bank rate, that suggests the future three- and five-year bond yields would be 3.64 and 3.87 percent, respectively.

What are they now? The three-year rate closed on Monday at 3.71 percent and the five-year rate at 3.34 percent. So three-year bonds are indeed paying a little higher than their anticipated "normal" value and do have slight room to come down. But five-year rates are almost 50 points *lower* than their expected normal rate when the bank rate is at "neutral." To get to a normal level, based on the term spread from 1996 to 2005, they would have to *rise.* If they did rise, mortgage rates likely would rise with them – which is quite different from what most pundits are predicting.

The bottom line is that a return to "normalcy" in monetary policy and conditions will bring little if any relief to the cost of most mortgages. The cost of longer -term mortgages might even go up. The corollary is that current bond yields are quite low relative to both the current bank rate and estimates of the "neutral" rate. There may still, however, be an indirect lift to the housing market from bank rate cuts as costs of other forms of borrowing decline and there is greater certainty of economic growth.

Don Drummond is the Stauffer-Dunning Fellow in Global Public Policy and Adjunct Professor at the School of Policy Studies at Queen's University and a Fellow-In-Residence at the C.D. Howe Institute.

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