The Armchair Analyst: Mortgage Interest Rates

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Housing affordability has a significant impact on housing markets. One does not need to be an economist to understand that as the carrying cost of home ownership increases, some potential homebuyers will be unable to qualify for mortgage financing. Housing affordability is often reported as the gap between the price of a home and household income. For example, "the average home price is ten times the average income". It is also commonly reported that since the current gap is head and shoulders above the long-term average, home prices *must* decline to match this so-called fundamental long-term average. This type of analysis ignores one basic fact; housing affordability is not just a function of incomes and home prices, mortgage interest rates also play a key role. Mortgage rates have been on a downward slide for more than 25 years, enabling a much larger gap between home prices and household incomes.

Interest rates are an important determinant of housing demand. Their impact on your mortgage payment or carrying cost can be dramatic. In 1982, when the 5-year fixed mortgage rate hit a high of 22.75 per cent, the housing market subsequently collapsed with home prices falling 40 to 50 per cent in many markets. The Armchair Analyst is wise to pay close attention to the direction and magnitude of interest rates. While low mortgage interest rates can be a powerful engine of demand, as recent activity demonstrates, very high interest rates can virtually pull the rug out from under any housing market.

The Bank of Canada, Canada's central bank, influences variable mortgage interest rates. Its primary focus is to keep inflation between one and three per cent with a target of two per cent. The Bank adjusts its trendsetting target overnight rate, the one day rate at which it lends to major financial institutions, in order to stimulate or slow the economy and inflation. Thus, the higher inflation typically associated with an overheated economy means that short-term interest rates will increase. The recent financial crisis created the opposite situation. Fear of a severe contraction in the economy and the potential ensuing deflation led the Bank to slash its trendsetting rate to 0.25 per cent in order to stimulate the economy.

Both short and long-term fixed mortgage rates move in tandem with deposit rates and bond yields of similar maturity. Since a mortgage embodies more risk than a bond, a premium is attached to a fixed mortgage rate. For example, 5-year fixed mortgage rates are typically around 250 basis points (+2.5 per cent) above the 5-year bond yield. However, there are exceptions. The financial crisis and sharp downturn in the stock markets had many investors fleeing to low risk options such as bonds. The resulting decline in bond yields did not create an equivalent decline in fixed mortgage rates. The fallout from the subprime mortgage debacle widened the risk premium attached to mortgages, exceeding 400 basis points (+4.0 per cent) at the time.

A key determinant of mortgage interest rates is inflation and expected inflation. High inflation means the Bank of Canada will raise its target overnight rate to put the brakes on the economy. Bond investors will also require higher yields in order not to lose ground. With interest rates at or near historic lows, there is little doubt that economic recovery will induce inflation and higher mortgage rates. How long will it take for the economy to once again fire on all cylinders and will higher interest rates mean trouble for BC's housing markets? We will explore these issues in the next installment of the Armchair Analyst.