BRITISH COLUMBIA REAL ESTATE ASSOCIATION

Mortgage Rate Forecast

LOWER, BUT FOR HOW MUCH LONGER?

HIGHLIGHTS

- Mortgage rates remain at historic lows
- Canadian economy roars back in second quarter
- Poor job growth keeps Bank of Canada in neutral

Mortgage Rate Forecast

	2014				2015			
Term	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
1-Year	3.14	3.14	3.14	3.24	3.24	3.44	3.60	3.60
5-Year	5.19	4.81	4.79	4.99	5.14	5.24	5.65	5.65

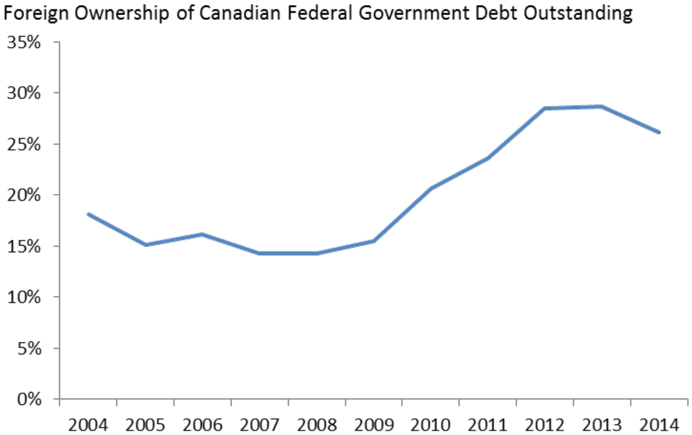
Note: Data is average of weekly rates

Source: Bank of Canada; BCREA Economics

Mortgage Rate Outlook

In stark contrast to the consensus of economists' expectations at the end of last year, bond yields have spent most of 2014 trending downward. Indeed, perhaps weary of previous false starts, bond markets have even shrugged off recent signs of a strengthening economy, an acceleration of inflation and the unwinding of stimulus from the US Federal Reserve. Lenders have responded in kind, offering homebuyers record low mortgage rates.

Foreign Investment Boosted by Canada's Financial Credibility



Source: Bank of Canada; Statistics Canada

Given well anchored inflation expectations and near consensus that short-term rates will be higher next year, the continued downtrend in bond yields this year is difficult to explain. One factor could be that investors are acclimating to the idea that the neutral rate, or the Bank of Canada's preferred destination for interest rates once it tightens, is likely much lower than in the past and that realization is being priced into expectations and therefore long-term interest rates.

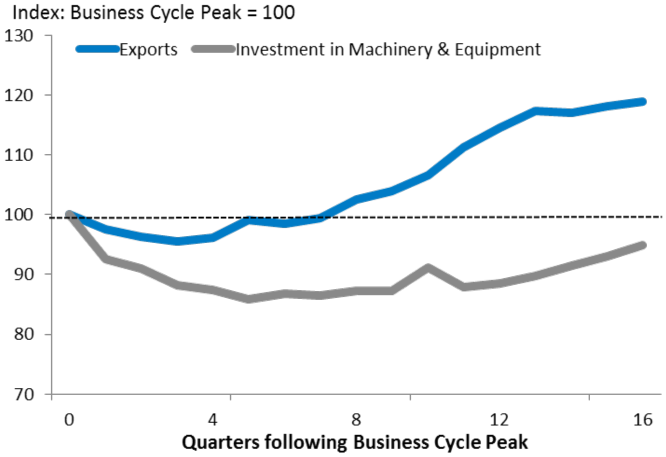
Additionally, the performance of Canada's financial and banking system post-financial crisis has won it a reputation among foreign investors as a safe harbor. Foreign holdings of Canadian government bonds and treasury bills have jumped from 15 per cent to over a quarter of outstanding debt since the global financial crisis. As uncertainty mounts in other areas of the world due to weak economic growth or unresolved conflicts, assets have crowded into both US and Canadian debt securities, forcing yields lower. Given these factors, rates could remain below historical average levels even as the Bank of Canada begins tightening.

While we do not expect the Bank to act on interest rates until late in 2015, bond yields could rise modestly before then in anticipation of higher rates, particularly if economic growth is stronger than expected. If so, we expect to see a slight increase in five-year and one-year fixed mortgage rates by the end of 2014.

Economic Outlook

As was widely expected, the Canadian economy's weak start to the year proved to be temporary as growth roared back in the second quarter. Canadian real GDP expanded 3.1 per cent at an annual rate last quarter, the highest rate of growth in close to three years. That growth was largely spurred by exports to a similarly resurgent US economy, which grew at a robust 4.2 per cent annual rate in the second quarter. If momentum in the US economy can be sustained, the long awaited rotation of Canadian economic growth towards exports and business investment could be realized. Indeed, in past business cycles, a recovery in business investment tends to lag behind a recovery in export growth.

Business Investment is Historically Slow to Recover



Source: Statistics Canada; BCREA
Note: Series are average of last three Canadian Recessions

While we expect that economic growth will slow moderately from the robust pace of the second quarter, it will remain relatively strong at 2.3 per cent for 2014 before accelerating next year to 2.7 per cent.

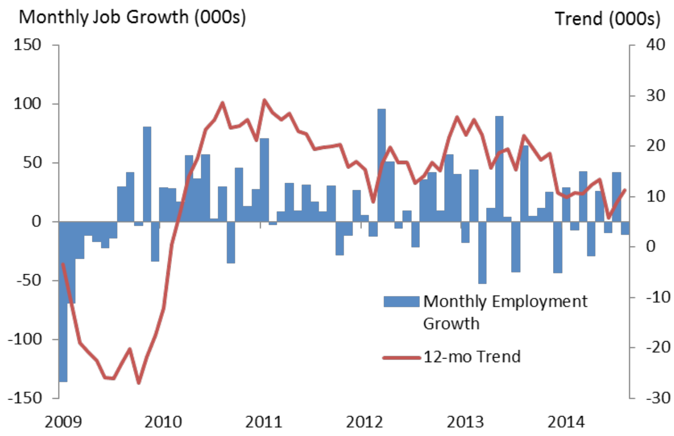
CPI inflation, which has been above the Bank's 2 per cent target for several months, is showing some signs of softening due to a sharp decline in the price of energy products and other commodities. Core inflation, which the Bank uses as its operational guide for monetary policy, has drifted higher but remains relatively muted. Though some wage inflation has occurred of late, slack in the labour market and continued competitive pressure in retail sectors will likely keep core inflation from breaching the Bank's 2 per cent target in the short-term.

Interest Rate Outlook

While economic growth exceeded expectations in the second quarter, the economy looks far more pedestrian if averaged over the entire first half of 2014. Employment growth has been uneven and the Canadian unemployment rate remains stubbornly high. Given a weak labour market, the Bank of Canada is unlikely to be moved from its current stance after just one strong quarter of economic growth. We expect that the Bank will continue to take a cautious approach to monetary policy until it sees concrete signs that the economy is growing sustainably above trend.

Our modelling exercises show the Canadian output gap closing along the same timeline as expected by the Bank of Canada, with inflation returning to target in 2016. Therefore, while the Bank left the door open to lower interest rates given its "neutral" stance, lags in monetary policy suggest a tightening of interest rates in the second half of 2015.

Canadian Labour Market Still Sluggish



Source: Statistics Canada

Send questions and comments about *Mortgage Rate Forecast* to:
Cameron Muir, Chief Economist, cmuir@bcrea.bc.ca; Brendon Ogmundson, Economist, bogmundson@bcrea.bc.ca.

Additional economics information is available on BCREA's website at: www.bcrea.bc.ca.
To sign up for BCREA news releases by email visit: www.bcrea.bc.ca/news-and-publications/publications/manage-subscriptions..

Mortgage Rate Forecast is published quarterly by the British Columbia Real Estate Association. Real estate boards, real estate associations and REALTORS® may reprint this content, provided that credit is given to BCREA by including the following statement: "Copyright British Columbia Real Estate Association. Reprinted with permission."

BCREA makes no guarantees as to the accuracy or completeness of this information.

1420 - 701 Georgia Street West, PO Box 10123, Pacific Centre, Vancouver, BC V7Y 1C6 | Phone: 604.683.7702 | Fax: 604.683.8601 | Email: bcrea@bcrea.bc.ca