

MORTGAGE UPDATE

ECONOMICS SEPTEMBER 2007

RATES TO EDGE UP, DESPITE MARKET UNCERTAINTY

After a marked increase during the second quarter of 2007, upward movement in mortgage rates has subsided. The borrowing cost on a conventional mortgage for a 5-year fixed-rate term held steady in August for the third consecutive month at 7.24 per cent, while 1 and 3-year terms were 7.05 and 7.30 per cent, respectively. Borrowing costs are now at the highest levels since 2001, but do not reflect discounts commonly offered by lenders to preferred clients.

Strength in Canada's economy suggested higher mortgage rates would be observed to year-end. However, recent financial market turmoil has since weighed on the direction and timing of future interest rate movements.

Sub-Prime and Financial Markets

Recently, concerns have grown over defaults in the US sub-prime loans market that back billions of dollars of collateral debt obligations. This has led to a repricing of risk in some markets around the world, limited willingness to lend at lower interest rates and lower demand for debt products. This market uncertainty placed upward pressure on overnight interest rates and has factored into high levels of volatility recently observed in some major stock exchanges. This liquidity crunch has been quelled, in part, by the actions of central banks, including the Bank of Canada, which injected funds to maintain financial market stability. However, markets remain relatively fragile in the current period, and prolonged stock market volatility and higher-priced credit could affect longer-term economic growth in the broader economy.

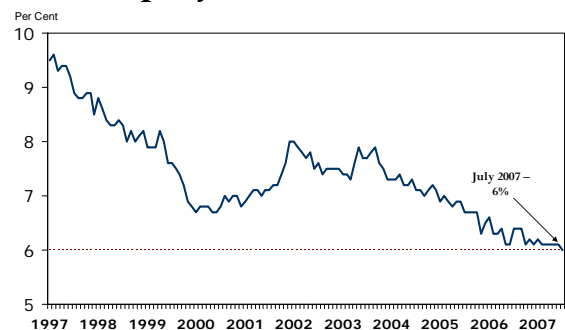
Economic Fundamentals Solid

In contrast to the recent financial market volatility, the Canadian macroeconomic environ-

ment continued to push against capacity constraints. Retail trade grew at a hefty 3 per cent during the second quarter of 2007, marking the fastest pace of growth in nearly 6 years. Strength in consumer spending contributed to second quarter annualized GDP growth of 3.4 per cent. This figure is well above the 2.8 per cent projected by the Bank of Canada in July's Monetary Policy Report Update, and the second consecutive quarter that growth exceeded expectations by a wide margin.

Labour market conditions in recent months have remained tight. Employment gains continued to outpace labour force additions, pushing the national unemploy-

Unemployment Rate - Canada



Source: Statistics Canada, Seasonally Adjusted

ment rate down to a 33-year low in July, at 6 per cent. Continued labour shortages, particularly in the western provinces, have contributed to upward pressure on wages. Average hourly wages in July grew 3.7 per cent from the same month in 2006, outpacing inflation.

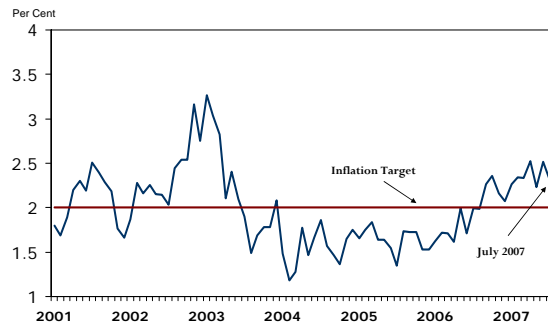
Bank of Canada Hike on Hold

Canada's healthy economy, vibrant de-



mand for housing and labour market strength have contributed to stronger inflationary pressures. Core inflation,¹ which is tracked by the Bank of Canada for monetary policy purposes, dipped from 2.5 per cent in June to 2.3 per cent in July. Despite the decline, core inflation remains above the Bank's target rate of 2 per cent, a persistent trend since late 2006.

Core Inflation



Source: Statistics Canada, Bank of Canada

In a normal scenario, the robust domestic demand picture and higher-than-target inflation would suggest the need for a future rate hike to contain inflationary pressures. However, the Bank of Canada left the overnight rate unchanged at 4.5 per cent on September 5, with little indication of the direction of future rates.

Offsetting strong domestic demand, the Bank cited weaker near-term prospects for the US economy, as the adjustment in its housing sector will be more prolonged and protracted, exacerbated by recent developments in financial markets. This implies weaker demand for Canadian exports. Further, the Bank noted that borrowers in Canada currently face tighter credit conditions due to recent financial market events, which should dampen domestic demand. The Bank's statement suggests financial market developments may work to cool the strong domestic economy.

Financial markets have currently priced in a pause in the Bank of Canada's rate hikes for the remainder of the year. In light of recent events, BCREA expects the overnight rate to remain unchanged at 4.5 per cent until the end of 2007, before increasing by 25 basis

points in early 2008 as the financial market turbulence eases.

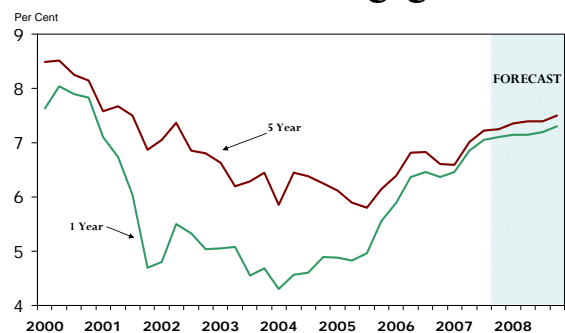
Moderate Upward Pressure on Mortgage Rates in 2008

Mortgage rates are not expected to deviate much from current levels for the rest of the year. With the overnight rate expected to be unchanged, variable mortgage rates which move with prime, should remain at current levels, notwithstanding a change in risk premiums.

In addition to short-term market conditions, longer fixed-term mortgage rates depend on expectations for future economic activity and interest rates, as well as yields on commercial bank issued instruments of similar maturities such as GICs. The economic environment in the medium term has been clouded, as the fall out from the sub-prime difficulties remains unclear.

BCREA forecasts mortgage rates to creep up slightly in 2008. One-year closed fixed-term rates are forecast to be in the 7.00-7.20 per cent range through the remainder of 2007, and rise to 7.20-7.35 per cent in 2008. Meanwhile, the 5-year closed fixed-term mortgage rate is forecast to settle in the 7.15-7.35 per cent range in 2007, and rise to 7.35-7.60 per cent in 2008.

Conventional Mortgage Rates



Source: Statistics Canada, BCREA Calculation and Forecast

¹Core inflation measure year-over-year growth in Statistics Canada's Consumer Price Index, excluding 8 of the most volatile components. The Bank of Canada uses the core index to monitor the inflation control target.

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