Higher mortgage rates are coming

Todd Mattina, PhD
Senior Vice President, Chief Economist, Portfolio Manager, Team Co-Lead
Mackenzie Multi-Asset Strategies Team

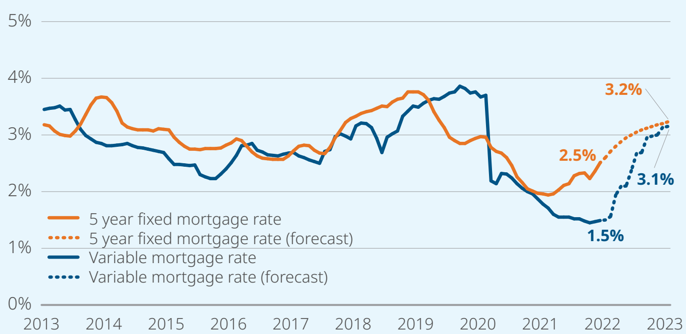
Jules Boudreau, MA
Economist
Mackenzie Multi-Asset Strategies Team

Highlights

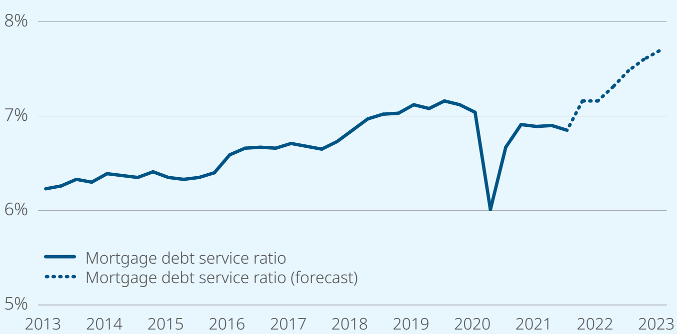
- We expect the average mortgage rate on new loans to top 3% before the end of the year, with both fixed and variable rates rising significantly throughout 2022.
- The rise in mortgage rates will increase debt servicing costs for Canadian homeowners to unprecedented levels, but we believe that risks to the financial sector are limited. Borrowers are well positioned to withstand climbing rates given solid household balance sheets, robust borrower creditworthiness and recently tightened lending standards.
- The housing market is one of the first channels through which the upcoming rate hikes will impact the real economy, by slowing mortgage credit creation and draining liquidity from borrowers.

Figure 1. Rising mortgage rates will increase the repayment burden on borrowers

Mortgage rates to exceed 3% by the end of 2022



Slowing growth in disposable income and higher rates will lead to a higher debt service ratio



Notes: Forecasts by Mackenzie's Multi-Asset Strategies Team based on market-implied pricing for interest rates via Bloomberg as of February 28. Data on mortgages from Statistics Canada.

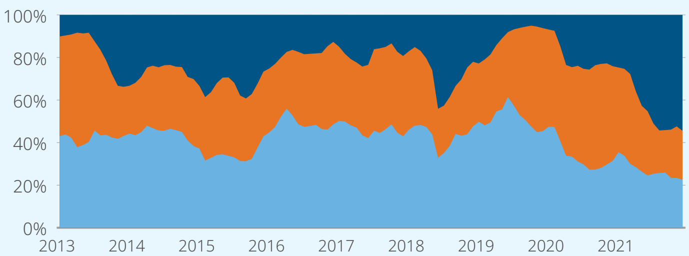
On March 2, the Bank of Canada (BoC) began its long walk towards policy normalization, raising its policy interest rate for the first time since October 2018. Markets expect the BoC to hike rates 6 additional times this year – one hike per policy meeting – as it tries to quell surging inflation. Climbing policy rates will feed into mortgage rates, leading to higher borrowing costs for Canadian homebuyers.

We forecast that both variable and fixed mortgage rates will top 3% at the end of 2022 based on future interest rates implied by market prices (Figure 1). In addition to impacting the purchasing power of prospective homebuyers, higher rates mean higher interest payments for recent homebuyers with outstanding mortgages. For Canadians with a variable rate mortgage the impact of higher rates is immediate, while those with fixed rate mortgages will feel the pinch at renewal. At the national level, the result is a higher proportion of household income going to mortgage payments. The mortgage debt service ratio – mortgage debt payments as a percentage of total disposable income – is forecast to rise above its recent 2019 peak. This increase is explained by (1) rising mortgage interest payments, (2) a higher stock of outstanding mortgage debt and (3) slower growth in disposable income than in 2020-2021, when government transfers lined consumers' pockets.

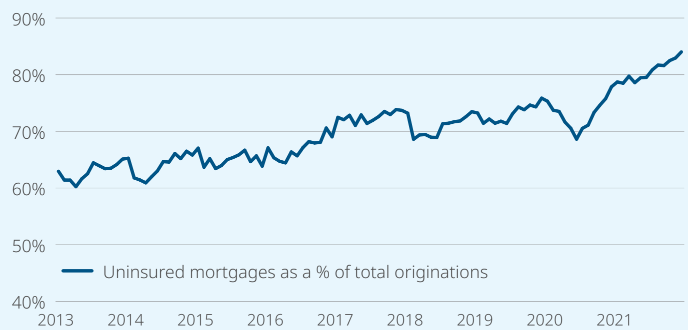
While the burden of debt payments on households will rise, the risk of a wave of mortgage defaults shaking the financial system is low. The Canadian consumer came out of the Covid crisis on a solid footing. Before the Omicron lockdowns, the Canadian economy was booming, with a strong job market and a surge in commodity prices boosting national income. We expect growth and employment data to continue bouncing back this year as Covid restrictions are phased out. As a result of the booming recovery, and large excess savings accumulated during the lockdowns, consumers have the balance sheets to withstand higher mortgage rates. The share of loans without mortgage insurance – a good proxy for the soundness of mortgages, since an uninsured borrower must post a minimum down payment of 20% – reached new highs in 2021 (Figure 2). Plus, according to the Canada Mortgage and Housing Corporation (CMHC), the credit rating of mortgage borrowers has never been better. The fact that the share of variable rate mortgages has risen is more worrying, as variable rate borrowers are impacted immediately when rates rise. But lenders have been subject to rigid "stress tests" to ensure that borrowers can fulfill their obligations in the case of rising rates. Mortgages originated between March 2020 and May 2021 had to clear a hypothetical rate of at least 4.79%. For mortgages originated after June 2021, the minimum threshold was 5.25%. Figure 1 shows that markets are pricing in average mortgage rates well below those levels in 2022. And longer-term interest rate instruments suggest that mortgage rates should not reach much above 4% over the next three years.

Figure 2. A high share of variable-rate mortgages implies a larger macro impact from rate hikes

Variable rate mortgages made up a record share of total loans in 2021



Uninsured mortgages, generally less risky, have made up a higher proportion of recent originations



Notes: Data from Statistics Canada as of February 28, 2022.

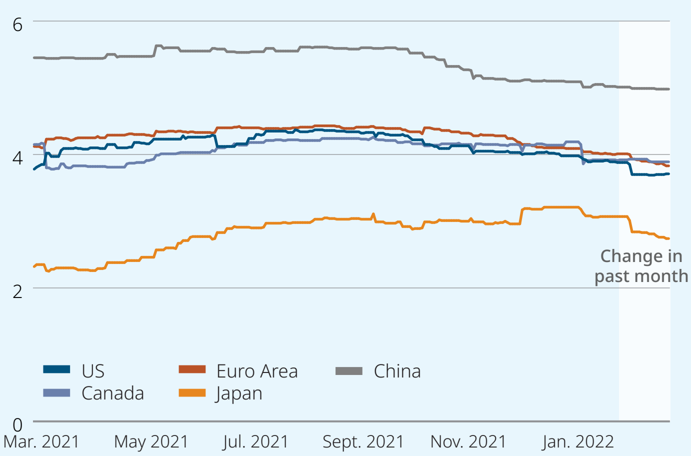
The housing market is one of the first channels through which BoC rate hikes will filter through into the real economy. Everything else equal, climbing borrowing costs for homebuyers should reduce demand for real estate. Looking back at the previous seven rate hiking cycles in Canada, six of the seven were accompanied by a drop in the share of residential investment in economic production. Only one hiking cycle – 2005-2006 – was not accompanied by a pullback in housing's contribution to GDP. Back then, the surge in construction in the Prairies driven by the 2000s oil boom continued undeterred by BoC rate hikes. Given economic fundamentals are not as strong today as they were in the mid-2000s and house prices are much higher relative to fundamentals, climbing borrowing costs should cool demand for housing. Moreover, rising interest rates could point to lower house prices, and a potential drop in house prices could trigger negative wealth effects. In this way, lower house prices would imply lower spending for those consumers accustomed to tapping into home equity like an ATM.

In addition to curbing new mortgage borrowing, higher rates will drain liquidity from homeowners with outstanding mortgages. As mortgage rates rise, borrowers will spend more on interest payments, likely leading to cuts in other expenses. Higher interest payments will flow through the economy and show up as income for someone else, such as a bank (as profit), a domestic or foreign saver (as interest income) or the government (as seigniorage). In general, those "lenders" will have a lower propensity to spend than the homeowners paying the additional interest, resulting in lower total spending and a slowdown in growth. This is what the BoC is hoping to achieve by hiking rates: progressively cooling the economy without putting financial stability at risk. As long as inflation is back in control by the time the overnight rate has climbed from 0.25% to 2.5% – the scenario currently implied by market prices – financial stress from higher debt service costs is unlikely. If it is not, the BoC will have a dilemma on its hands.

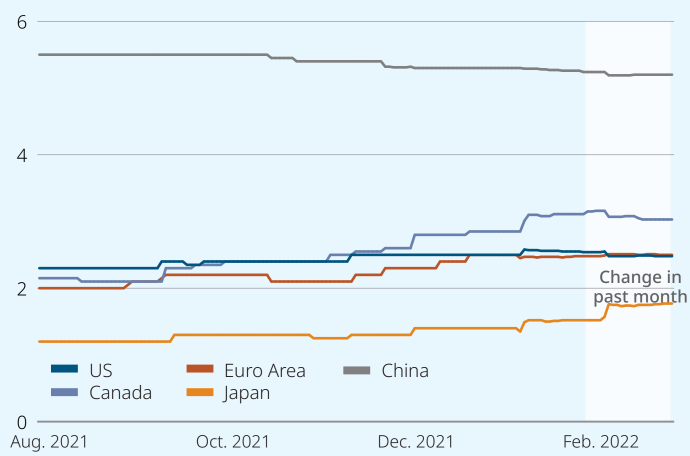
Global macro update

- **2022 consensus growth forecasts** for the US and Europe slid in February, due to a faster pace of expected rate hikes for the former and the Ukraine war for the latter. In contrast, the consensus forecast for Canada stayed solid at 3.9% annual growth in 2022. The Omicron wave subsided and provinces began reopening their economies, suggesting that employment could recover to its hot levels from 2021Q4 as soon as March. In addition, while the tragic Ukraine war could impact Canadian business and consumer confidence, higher demand for many Canadian commodities should support Canadian growth with higher world commodity prices. Canada exports similar commodities as Russia and Ukraine, including oil, wheat, potash, aluminum and nickel.
- **CPI inflation** for January clocked in at 7.5% in the US and 5.1% in Canada, year-on-year. Both readings were slightly above the average economist's forecast. We expect inflation to stay well above the Federal Reserve and Bank of Canada's 2% targets for the rest of 2022, but to begin moderating from current high levels in the second half of the year. The real surprise was in the Euro Area, where January inflation blew past expectations, with year-on-year inflation clocking in at 5.1% (vs. 4.4% expected in Bloomberg's survey). This prompted markets to start pricing in a 10bps rate hike by the European Central Bank at the end of 2022.

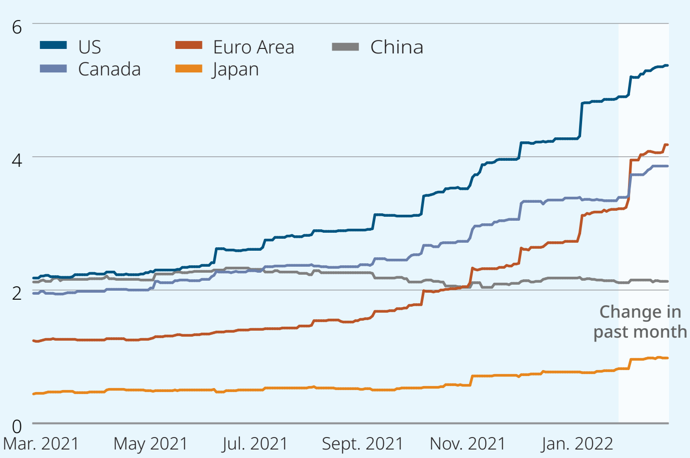
2022 real GDP growth forecast (%, consensus)



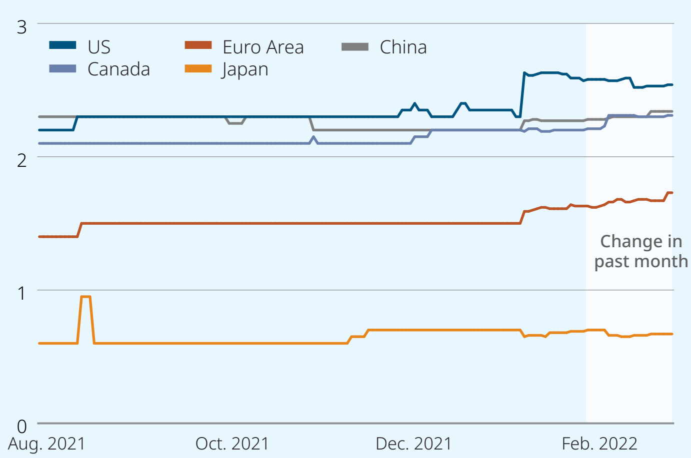
2023 real GDP growth forecast (%, consensus)



2022 inflation forecast (%, consensus)



2023 inflation forecast (%, consensus)



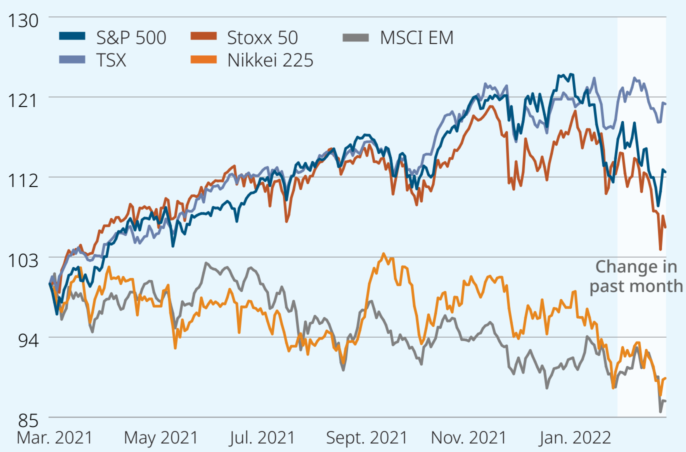
Notes: Forecasts from Consensus Economics as of February 28, 2022.

MACKENZIE
Investments

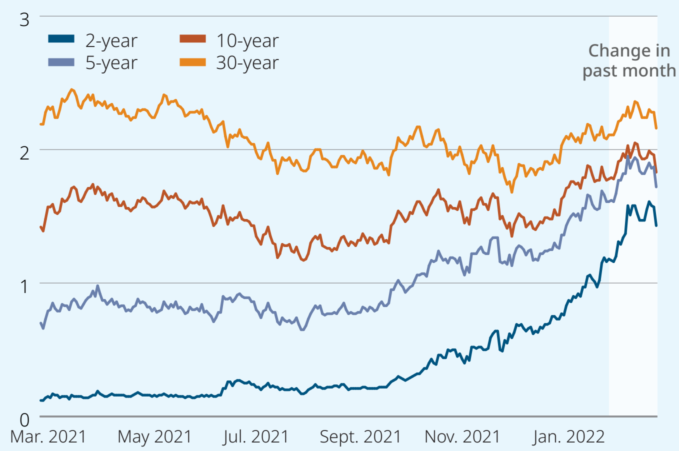
Capital markets update

- **Equity markets** sold off in the second half of February as the Ukraine invasion amplified market uncertainty, inflated commodity prices and threatened growth in the Euro Area. Canadian stocks were among the best performers globally, closing the month of February flat, while US stocks dropped 3% in the month bringing their year-to-date decline to 9%. Energy and materials stocks in the TSX drove the relative resiliency, as they benefited from a rally in commodity prices.
- **The US Treasury curve** continued on its months-long flattening trend, with yields on short-term bonds rising faster than those on long-term bonds. Shorter-term bonds were weaker, with yields on 2-year Treasuries ending the month 28bps higher than they started it (vs. 9bps for the 10-year). The difference between 10-year and 2-year yields has dropped from 1.30% a year ago to 0.40% today. A negative 10-2 spread is often interpreted as the harbinger of a recession, so keep an eye on the flattening trend.
- **Oil prices** kept climbing in February, as global energy markets remained tight. On February 24, the first day of Russia's invasion in Ukraine, WTI oil prices briefly topped US $100 before retreating and ending the month around US $96. Given low inventories, capped output from the largest producers, and the risk of additional Western sanctions on Russia, prices may have room to rise.

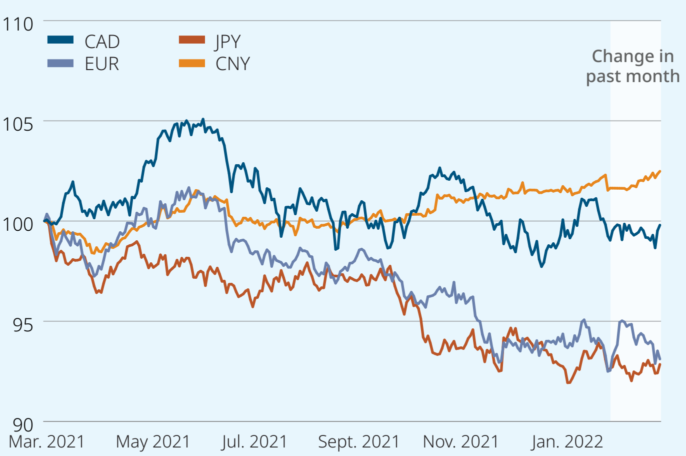
Equity indices (one year ago=100)



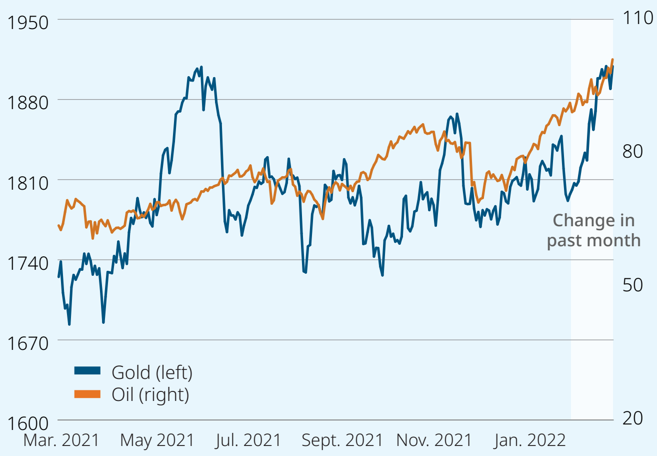
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as of February 28, 2022. Total return equity indices are in local currencies, except MSCI EM, which is denominated in USD.

MACKENZIE
Investments

What we'll be watching in March

March 10: US February Consumer Price Index (CPI) release

- The median participant in Bloomberg's survey of economists expects prices to have risen by 0.7% from January to February, resulting in a 7.8% year-over-year inflation rate. Gasoline and natural gas alone should contribute around 0.35% to month-on-month inflation, around half of the expected rise in prices.

March 16: Federal Reserve policy decision

- The February CPI release will come only six days before the Fed's policy announcement, making it a critical input to the Fed's interest rate decision. Expect greater market volatility around both the CPI release and the Fed decision.
- We expect the Fed to mirror the Bank of Canada's March 2 decision by raising its policy rate by 25 bps, although a larger rate hike is possible if February inflation comes in hot. Quantitative easing (QE) will end this month, so the Fed's balance sheet should stop expanding, but the Fed is not expected to start shrinking its balance sheet until the second half of 2022.

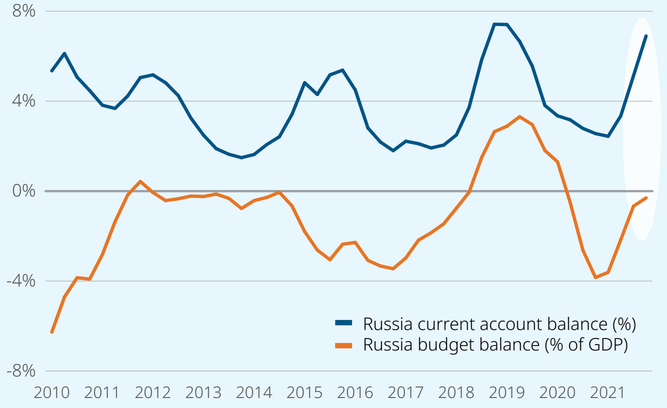
March 17: Teranet/National Bank house price index release

- After flatlining this past Fall, Canadian house prices have perked up this winter, potentially from buyers trying to front-run the upcoming rise in mortgage rates. With the Bank of Canada's rate hiking journey having now officially begun with a first 25bps hike on March 2nd, we could start seeing a pullback in demand and a return to the price trend of Fall 2021.

Emerging theme

- **One enduring economic lesson** from the Ukraine invasion is the potential punitive power of financial sanctions, even for countries trying to insulate themselves from foreign financial and economic influences. When Russia invaded Ukraine, it might have thought its balanced budget and soaring trade surplus would allow it to withstand Western sanctions. It even offloaded US government bonds from its FX reserves in the years leading up to the assault to reduce its exposure to US sanctions.
- But Russia's "financial fortress" was no match for **the speed and severity of sanctions**, which cut the legs out from under the Russian banking system and froze the majority of the central bank's liquid reserves. The collapse in the value of the ruble will likely result in surging inflation. The current account balance (grossly defined as exports minus imports) might stay positive, but only because imports will collapse as domestic Russian consumption drops.
- Russia's disciplined fiscal and external positions could **limit the contagion of the crisis to other emerging markets**. First, years of slow growth have left Russia a smaller part of the global economy: from 3% of world GDP ten years ago to below 2% today. Second, by insulating itself from global capital markets, Russia reduced its financial footprint. Third, the rise in commodity prices triggered by the invasion could favor commodity exporting EMs.

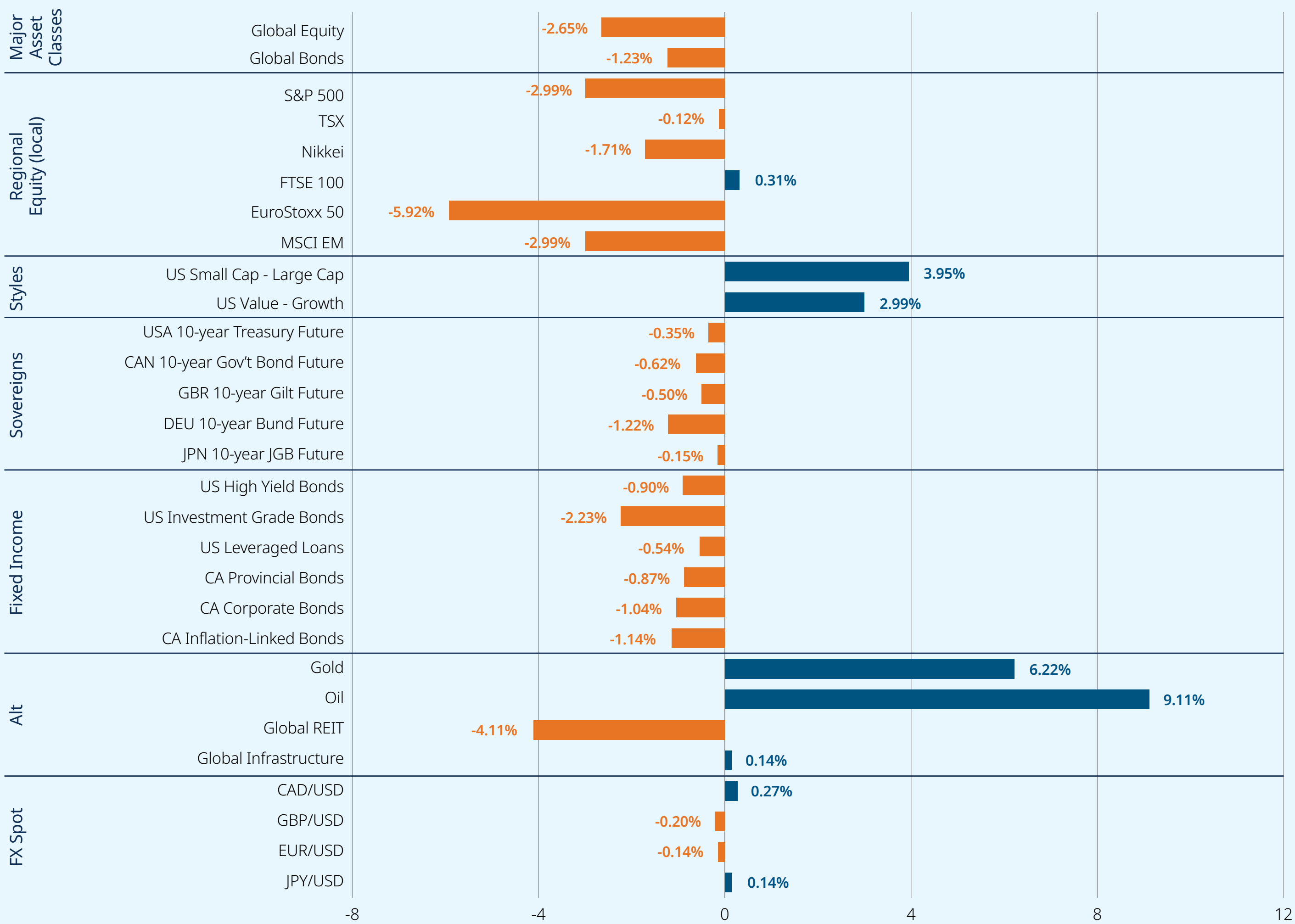
Russia's solid fiscal and external accounts won't save its economy



Notes: Data via Bloomberg. Final data point (2021Q4) is the median forecast from Bloomberg's survey of economists.

MACKENZIE
Investments

Capital market returns in February



Notes: Market data from Bloomberg as of February 28, 2022. Index returns are for the period: 2022-01-31 to 2022-02-28. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite 60 (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

2167770 03/22