IG WEALTH MANAGEMENT

Inflation is prompting the Bank of Canada to consider rate increases

Here's why this matters for Canadian mortgage renewals

Inflation has been an overriding theme in the latter half of 2021 and into 2022. In the latest Canadian CPI report, inflation gained 5.1% on a year-over-year basis through January. This was the first time inflation in Canada had crossed over the 5% level since 1991. While price increases were observed across several categories within the CPI basket, Canadians, in particular those who have a mortgage, should be prepared to see additional inflation with respect to housing costs.

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A little inflation is a good thing. Too much inflation becomes a concern for the Bank of Canada (BoC), which has an inflation target of between 1% and 3%. Bank of Canada Governor Tiff Macklem, has expressed as much. In a speech on February 9, he commented, "The economy will need higher interest rates to moderate growth in spending and bring demand in line with supply. We also agreed that we must keep inflation expectations well anchored. If inflation expectations become unmoored, the costs of getting inflation back to target will be much higher. For both of these reasons, we signalled with unusual clarity that Canadians should expect a rising path for interest rates."

The table is clearly set for a number of interest rate increases by the Bank of Canada over the course of 2022 and into 2023. According to Bloomberg data, as of February 22 market expectations are for seven rate hikes starting in March with the BoC's overnight rate increasing from its current 0.25% to 2% by the end of the year. Whether the BoC follows through with what the market expects remains to be seen. Nonetheless, we believe the overnight rate will be significantly higher from its extremely low level over the course of 2022.

This suggests that borrowers could expect to see a similar move higher in mortgage rates. According to Canada Mortgage Housing Corporation (CMHC), the average five-year conventional mortgage rate in Canada in January 2022 was 3.44%, excluding any rate discounts (source: Statistics Canada. Table 34-10-0145-01 Canada Mortgage and Housing Corporation). Since 1992 the conventional five-year mortgage rate stood on average 3.2% higher than the BoC overnight rate. Assuming the market expectations are correct for an increase of the overnight rate by 1.75%, that would imply a five-year mortgage rate of 5.2% by year end. *(See Chart 1)*

CMHC data show that 53% of Canadian homeowners have an existing mortgage and 29.6% of Canadians overall have a mortgage as of the third quarter of 2021. The average new mortgage loan value in the third quarter of 2021 was $365,000 and the overall average outstanding mortgage balance was $240,000.

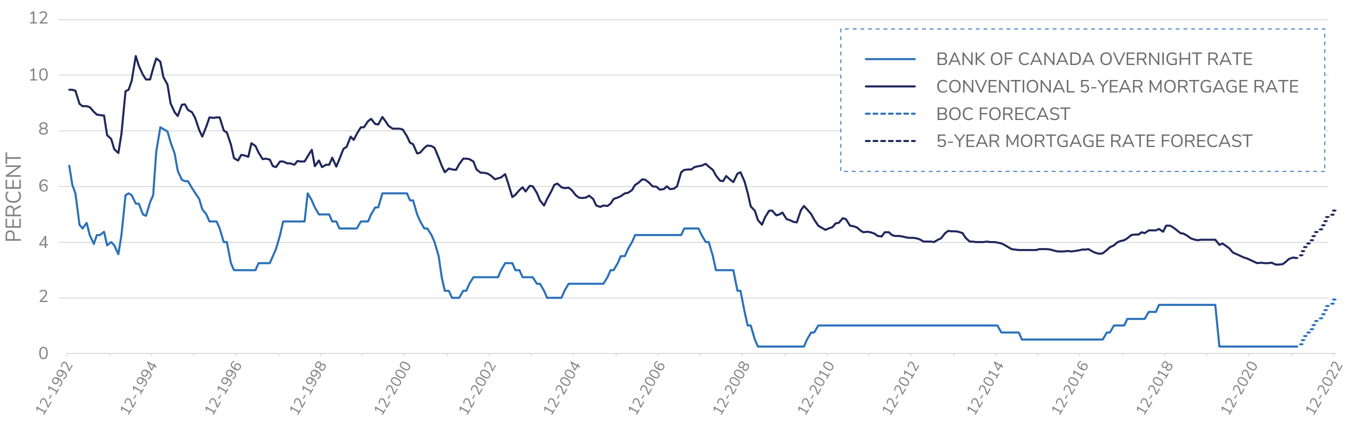
If we assume the average mortgage balance of $240,000 and calculate a 15-year amortization, the difference between 3.44% and 5.2% is an additional $38,370 in interest costs over the life of the mortgage. *(See Chart 2)* As of 2019, 74% of mortgages were fixed-rate, with the most popular term being 5-years.

In 2017 the Bank of Canada had started to raise rates following the "insurance cuts" put in place during the oil crash of 2014-16. Yet, different from today's expectations, the Bank of Canada raised rates twice in 2017 from 0.5% to 1.0%. If we see a normal distribution of mortgage renewals, that would suggest 20% of mortgages are set to renew in 2022; and if market expectations are correct, they are likely to renew at a higher rate than five years ago.

Moreover, 26% of mortgage borrowers are attached to a variable rate. These homeowners are likely to see a continued increase in their interest rate as the Bank of Canada sets along its rate-normalization/inflation fighting path.

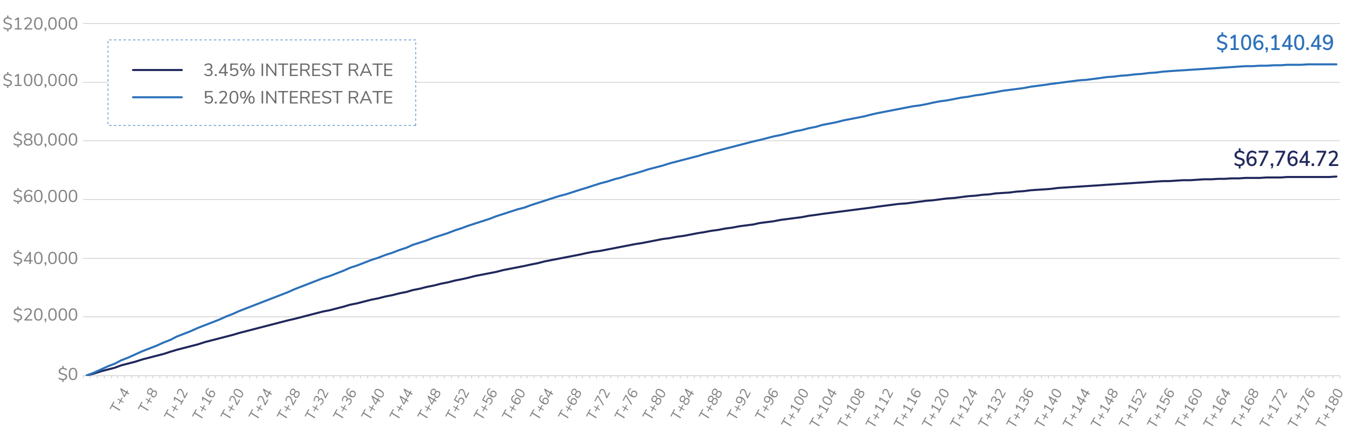
While Canadians are spending more at the gas pump and grocery store, they should be prepared for an increase in their mortgage costs too.

Chart 1: Where are mortgage rates headed?
Bank of Canada overnight rate vs. conventional mortgage rate 1992-2022 (with forecasts)



Source: IG Wealth Management, Bloomberg, Statistics Canada. Table 34-10-0145-01 Canada Mortgage and Housing Corporation

Chart 2: The difference in interest rate costs assuming $240,000 mortgage and 15-year amortization



Source: IG Wealth Management

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Philip is an established thought leader within the wealth management industry, having spent more than 25 years working for prominent financial institutions in a variety of senior leadership roles. He is recognized for his accessible approach to investment advice and regularly shares his insights in the media, through frequent press, radio and television appearances.

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