

Should I Stay (Fixed), or Should I Go (Variable)?

Douglas Porter and Benjamin Reitzes

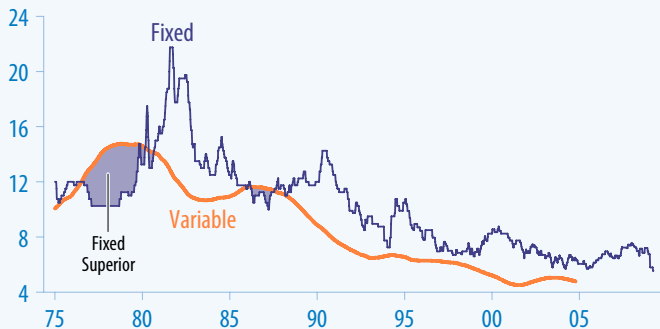
The age-old question of whether to lock into a longer-term fixed mortgage rate or stay in a variable rate has become an increasingly complex and important issue recently, with short-term rates at extreme lows and pressure likely to build for higher rates in the year ahead. Historically, there is little debate which has been the better option: typically borrowers save money by staying in variable products, and riding the rollercoaster of fluctuating rates. In fact, fully 82% of the time since 1975, the cost-effective route for borrowers was to stay variable (*Chart 1*). And, if anything, the spread between 5-year fixed mortgage rates and variable rates has been widening further in recent years, and is now close to an all-time high (*Chart 2*). However, there are a number of important caveats to point out, before rushing to assume that the variable option is again the hands-down winner.

- We have been in a long-term declining rate environment, almost without a break, since the early 1980s.
- The Bank of Canada’s overnight rate is now as low as it can go, so there is simply no further downside for variable rates. The surprises by definition can only be to the high side from here.
- Posted rates do not tell the whole story, and the actual rates that borrowers negotiate have made the call much closer between fixed and floating in recent years than the headline figures would suggest.
- Fixed rates were advantageous during only two recent periods—through the late 1970s and briefly in the late 1980s; in both cases, ahead of a period of rising interest rates, as is the case now.

CHART 1
VARIABLE INVARIABLY SUPERIOR (ALMOST)

Canada (percent)

Mortgage Rates

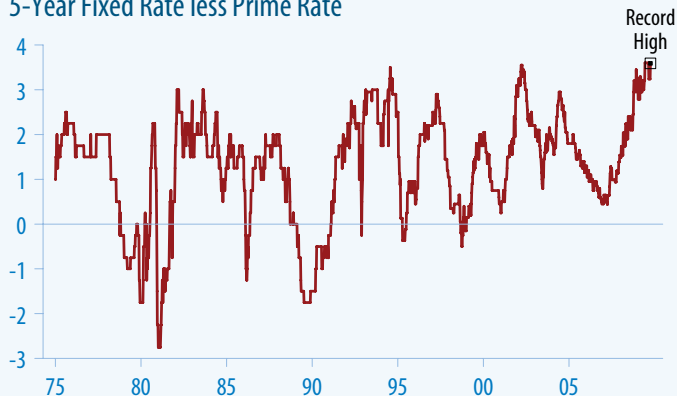


Variable = (m.a. of the next five years) Fixed = 5-year

CHART 2
PEACE OF MIND COMES WITH A PRICE

Canada (ppts)

5-Year Fixed Rate less Prime Rate



The Case for Staying Fixed

A conventional fixed rate mortgage can mitigate a number of risks. Inflation hasn’t been a problem in Canada since the Bank of Canada adopted inflation targeting, averaging precisely 2% since 1991. However, there is an outside risk of an inflation flare-up as global central banks keep the pedal to the policy metal, and amid record government deficits. These efforts risk sparking inflation, especially if the global economic recovery is stronger than expected. Either of those potential scenarios could force the Bank of Canada to raise interest rates aggressively, driving variable mortgage rates higher, but leaving fixed rate choosers

unscathed. Another reason fixed rates are attractive in the current environment is that short-term rates are already as low as they can go—rates are only going to move higher from here as the economy recovers. Considering the likely upward trend in interest rates (similar to the late 1970s and 1980s) as the economy is emerging from recession, this may be one of those rare periods when a fixed rate turns out to be the superior choice. Further illustrating the potential rationale for going fixed is the near-record low “real” 5-year rate (*Chart 3*). Finally, a fixed rate may ultimately prove more expensive, but you get certainty, and that certainty is worth something to many.

The Case for Going Variable

The clearest advantage to a variable rate mortgage is that it has been consistently less costly than its conventional counterpart over time. There have only been a small handful of occasions in modern history where a variable rate was the less favourable option. And, the current outlook for inflation remains benign, with significant excess capacity in both

Canada and the U.S., which will likely keep price pressures at bay well into 2011. The soaring Canadian dollar is putting additional downward pressure on prices, reducing the near-term need for the Bank of Canada to raise rates. There even remains some risk of deflation south of the border. Low and steady inflation, taken with a fragile global economic recovery, points to the Bank keeping its commitment to hold rates steady through June 2010 (conditional on the inflation outlook). There is also some risk to locking in as fixed rates could fall if the economy performs worse than anticipated. Even as rates start to rise, one can always lock into a fixed rate at a later date. But with BMO’s 5-year variable rate at a record low 2.25% (matching the prime rate), the extra 2.29 percentage points on the special 5-year fixed rate offer may simply be tough to swallow for many (*Table 1*).

The verdict: The decision really does depend on the individual. For those who don’t have a lot of financial flexibility, and would run into difficulty from a pronounced upswing in interest rates (typically first-time buyers), the moderate extra cost for peace of mind may be a price worth paying. And frankly there is a reasonable scenario where fixed rates may actually prove to be a cheaper alternative at this point. In fact, mortgage pricing is relatively efficient and the fixed rate is usually a good approximation of expectations of the variable rate. However, our core view is that the most likely economic and interest rate outlook will ultimately again slightly favour the variable rate option, and that’s particularly the case given BMO’s current rate of 2.25%—but it’s a much closer call than usual.

CHART 3
REALLY GOOD TIME TO BUY

Canada (percent)

5-Year Fixed Rate less Core CPI



Core CPI = (y/y % chng)

TABLE 1
BMO MORTGAGE RATES
(percent : posted as of October 21, 2009)

	Fixed	Variable
1-Year	3.70	—
2-Year	3.95	—
3-Year	4.45	3.05 *
4-Year	5.29	—
5-Year	5.84	2.25
5-Year Special	4.54	—

* open; all other rates are for closed term

The information, opinions, estimates, projections and other materials contained herein are provided as of the date hereof and are subject to change without notice. Some of the information, opinions, estimates, projections and other materials contained herein have been obtained from numerous sources and Bank of Montreal ("BMO") and its affiliates make every effort to ensure that the contents thereof have been compiled or derived from sources believed to be reliable and to contain information and opinions which are accurate and complete. However, neither BMO nor its affiliates have independently verified or make any representation or warranty, express or implied, in respect thereof, take no responsibility for any errors and omissions which may be contained herein or accept any liability whatsoever for any loss arising from any use of or reliance on the information, opinions, estimates, projections and other materials contained herein whether relied upon by the recipient or user or any other third party (including, without limitation, any customer of the recipient or user). Information may be available to BMO and/or its affiliates that is not reflected herein. The information, opinions, estimates, projections and other materials contained herein are not to be construed as an offer to sell, a solicitation for or an offer to buy, any products or services referenced herein (including, without limitation, any commodities, securities or other financial instruments), nor shall such information, opinions, estimates, projections and other materials be considered as investment advice or as a recommendation to enter into any transaction. Additional information is available by contacting BMO or its relevant affiliate directly. BMO and/or its affiliates may make a market or deal as principal in the products (including, without limitation, any commodities, securities or other financial instruments) referenced herein. BMO, its affiliates, and/or their respective shareholders, directors, officers and/or employees may from time to time have long or short positions in any such products (including, without limitation, commodities, securities or other financial instruments). BMO Nesbitt Burns Inc. and/or BMO Capital Markets Corp., subsidiaries of BMO, may act as financial advisor and/or underwriter for certain of the corporations mentioned herein and may receive remuneration for same. "BMO Capital Markets" is a trade name used by the Bank of Montreal Investment Banking Group, which includes the wholesale/institutional arms of Bank of Montreal, BMO Nesbitt Burns Inc., BMO Nesbitt Burns Ltée/Ltd., BMO Capital Markets Corp. and Harris N.A., and BMO Capital Markets Limited.

TO U.S. RESIDENTS: BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd., affiliates of BMO NB, furnish this report to U.S. residents and accept responsibility for the contents herein, except to the extent that it refers to securities of Bank of Montreal. Any U.S. person wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Corp. and/or BMO Nesbitt Burns Securities Ltd.

TO U.K. RESIDENTS: The contents hereof are not directed at investors located in the U.K., other than persons described in Part VI of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001.

™ - "BMO (M-bar roundel symbol) Capital Markets" is a trade-mark of Bank of Montreal, used under licence. © Copyright Bank of Montreal.