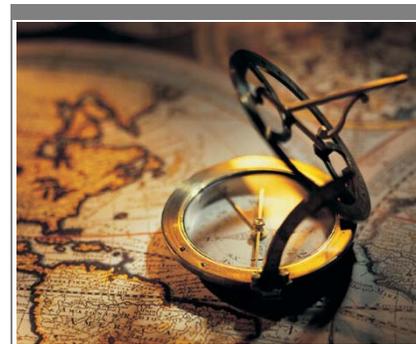


Mortgage Choices: The Fix(ed) is In

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The age-old debate of whether to lock into a longer-term fixed mortgage rate or stay in a variable rate is becoming a hot topic once again. While we have in the past supported going variable, and even though short-term rates are likely to remain low this year, current offers on long-term mortgage rates and the improving economic outlook **tilt the balance in favour of locking in at this stage**—fixed now modestly trumps variable. Not only does our interest rate outlook project an advantage to locking in at current attractive 5-year rates; but, combined with a shorter, 25-year amortization period, such a step would significantly dampen widespread concerns about the vulnerability of household finances.



Historically, there has been little contest on the better option: typically borrowers save money by staying in variable products. Fully 85% of the time since 1975, the cost-effective route for borrowers was to stay variable (*Chart 1*). But, historically low interest rates have sharply narrowed the spread between 5-year fixed mortgage rates and variable rates. And, at long last, an improving economic backdrop has markets anticipating rate hikes from both the Bank of Canada and the Federal Reserve in 2015.

True, it may have seemed that markets and economists have played the role of The Little Boy Who Cried Wolf on higher interest rates in recent years. But, there are emerging signs that the tide is finally turning for rates, especially with the U.S. economy poised to accelerate. The bond market has sent out loud warning signals over the past year that the era of low interest rates may finally be drawing to a close. For instance, 5-year Government of Canada and U.S. Treasury bond yields neared 2½-year highs early in 2014, on an improving outlook for the global economy and expectations of continued Fed tapering. As bond yields rise, the cost of funds for lenders also rises, ultimately putting upward pressure on consumer and business borrowing costs, including long-term mortgage rates. So, even if variable rates take some time to climb, we may not see such low fixed rates again any time soon.

The Case for Staying Variable

The clearest advantage to a variable rate mortgage is that it has consistently cost less than its conventional counterpart over time. There have only been a handful of occasions in modern history when a variable rate was the less favourable option. And, the inflation outlook remains relatively benign, with excess capacity in Canada and especially the U.S. likely keeping underlying price and wage pressures at bay in 2014. Tame inflation, taken with still-

Chart 1
That's History: Variable Invariably Superior

Canada (percent)

Mortgage Rates



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

Table 1
BMO Bank of Montreal Mortgage Rates

(percent : posted as of March 7, 2014)

	Fixed	Variable
1-Year	3.14	—
2-Year	3.04	—
3-Year	3.85	4.00 ¹
4-Year	4.64	—
5-Year	4.99	3.00
5-Year Low Rate	3.49	—
10-Year Low Rate	4.69	—

¹ open; all other rates are for closed term

significant excess capacity in the U.S. and the Federal Reserve's commitment to exceptionally low U.S. rates "well past the time that the unemployment rate declines below 6½ percent, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal", points to the Bank keeping rates steady well into 2015. Plus, one can always lock into a fixed rate at a later date—although there is no guarantee that future longer-term rates will be as favourable as BMO's 5-year offer of 3.49% (Table 1).

The Case for Fixing

A conventional fixed-rate mortgage can mitigate a number of risks. Inflation hasn't been a big issue in Canada since the Bank of Canada adopted inflation targeting, averaging just under 2% since 1991. While inflation remains well contained currently, the weakening Canadian dollar and upward risks to commodity prices from geopolitical uncertainty could put pressure on prices to rise. This could ultimately force the Bank of Canada to raise interest rates more 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 at extreme lows. Considering the likely upward trend in interest rates as the global recovery picks up speed in 2014, 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 2).

Moreover, the borrower gets certainty with a fixed rate, and that certainty is worth something to many. A small premium on fixed-rate mortgages and shorter amortization schedule represent inexpensive protection against a rate spike (Chart 3).

The Verdict: Our interest rate outlook now projects an advantage to choosing a fixed rate. While the decision still depends on the individual, the low rate, combined with a shorter 25-year amortization, would significantly strengthen a borrower's financial stability. For those who don't have much financial flexibility, and would run into difficulty from a pronounced upswing in interest rates (typically first-time buyers), any potential extra cost for peace of mind now appears to be a price well worth paying. Generally speaking, mortgage pricing is relatively efficient and the fixed rate is usually a good approximation of expectations of the variable rate. But, current pricing appears attractive on fixed-rate products, especially with an improving outlook for the North American economy. Given historically low long-term rates and the fact that central bankers are becoming more upbeat on the growth outlook, the fixed-rate option now looks superior.

Chart 2
Really Low

Canada (ppts)

5-Year Fixed Rate Less Core CPI

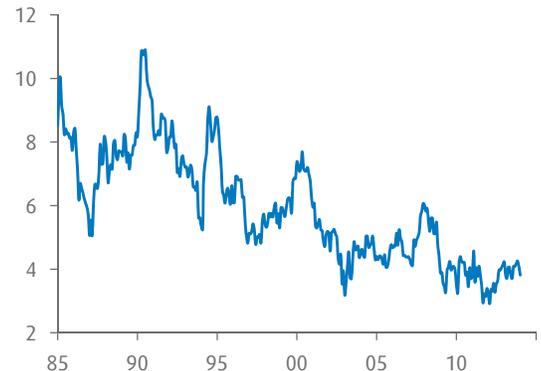
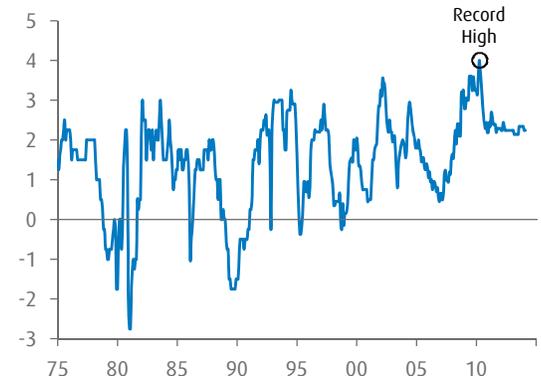


Chart 3

Peace of Mind Comes with a Price

Canada (ppts)

5-Year Fixed Rate Less Prime Rate



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