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# Market View – Mortgage hedging: What a difference a year makes

By Warren Lovely / Taylor Schleich [with an assist to IRD Trading]

If you hadn't noticed, Canada's housing market (judged by national levels of resale activity) is back. It's amazing what a difference a year (or two) can make; as at December 2019, nation-wide resales had skied 22% above year-ago levels (Chart 1). Once sufficient water ran under the macro-prudential bridge, it appears, Canada's so-called "positive fundamentals" (re)exerted themselves—particularly in markets like Toronto, Vancouver and Montréal, where jobs have been plentiful and/or household formation brisk. (Our apologies to Canada's more oil-levered jurisdictions, where activity remains muted.) If you missed it, a fresh *Special Report* from Matthieu Arseneau, entitled *"How brain gain sustains the Canadian housing market"*, offers key insights on the fundamental forces at play.

So while growth in consumer credit (including HELOCs) has downshifted sharply—another *Economics* colleague, Krishen Rangasamy, touched on this in a recent note—a reinvigorated housing market has keyed a turnaround in mortgage credit growth (Chart 2). Particularly noteworthy has been the reported pick-up at Canada's chartered banks (Chart 3), where B-20 regs had earlier produced a deeper chill.

Of course, when it comes to resuscitating housing market activity/mortgage lending, lower interest rates have also helped a lot. Here, we'd note that Canadians have increasingly opted for longer-term fixed-rate mortgages—which is understandable enough, given the historically attractive fixed rates (outright and vs variable comps) available at your friendly National Bank branch or elsewhere. Consider that over the last three months for which we have industry-wide data, variable rate mortgages accounted for an ultra-skinny 5% of total originations (well shy of the longer-term average of >20%) (Chart 4). To summarize then, Canada is seeing a meaningful increase in mortgage lending, with almost all of it fixed-rate in nature.

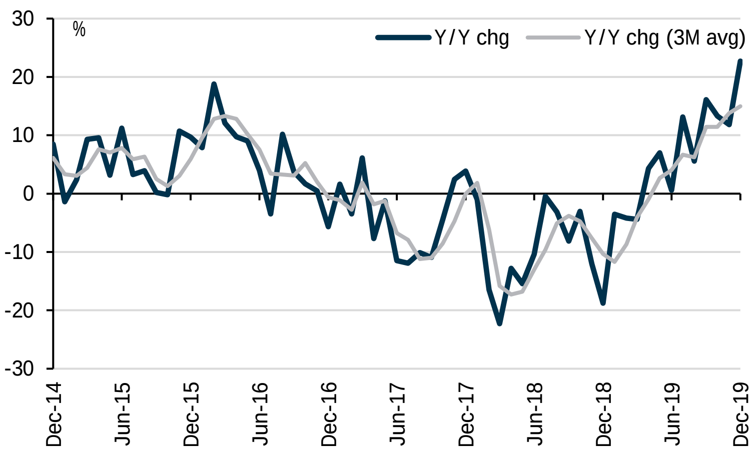
Those familiar with this subject matter understand that timing is important; few things in life are seemingly as seasonal as Canadian housing activity. If you'll forgive the stereotype, the typical Canadian homebuyer hibernates during the frigid winter months, comes to life in a big way during spring, only to shut things down again in time for summer vacation. The result is a clear seasonal tendency in mortgage originations (Chart 5) and related hedging activity (notably spring-time paying in Canada's interest rate swap market).

Now, seasonals are hardly the be-all and end-all for financial markets. Systemically test for "identifiable seasonality" (as we do every year) and you'll find it a rather illusive concept in most asset classes. Markets are efficient, with astute participants inclined to front-run/crowd-out seasonal trades. Fundamental and/or technical developments (including the odd regime shift) can likewise upset the valuation apple cart. Thinking back to a year ago, we made clear our view that spring-time mortgage paying in swaps *was not* likely to materialize in 2019, given the correction that was running through the housing market at the time. Sure enough, Canadian swap spreads failed to toe the line last year (Chart 6); rather than widening the standard 6 bps from February to June, 5-year swap spreads ground 8 bps tighter over that four-month period (Chart 7). But that was then, this is now right!?

If, as we expect, brisk fixed-rate mortgage credit growth is sustained through the spring, related hedging activity might lean towards at least a partial re-establishment of those historical swap spread seasonals that went MIA last year. Granted, as our *IRD Trading* colleagues point out, 5-year swap spreads are currently on the richer side of the ledger at OIS-6 bps (Chart 8). But we're reluctant to outright fade that notional "richness" now that the great Canadian housing boom is rolling once more. Ideally, we might look for opportunity to buy a dip in swap spreads on any prospective pick-up in bank issuance coming out of Q1 reporting. After all, as Mr. Arseneau nicely puts it: "the vigour of the Canadian housing market is soundly based and set to continue confounding the skeptics."

### Chart 1: Resale revival!

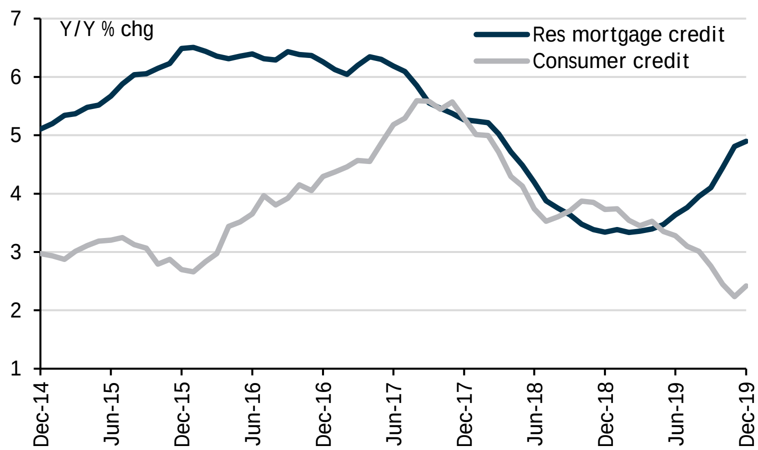
*Growth in Canadian existing home sales*




*Source: NBF, CREA*

### Chart 2: Mortgage growth up (consumer credit not so much)

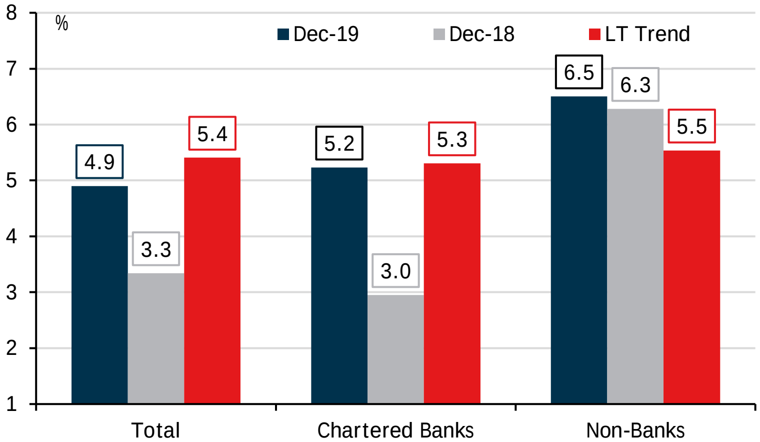
*Growth in Canadian residential mortgage credit & consumer credit*




*Source: NBF, StatCan*

## Chart 3: Banks putting B-20 behind them?

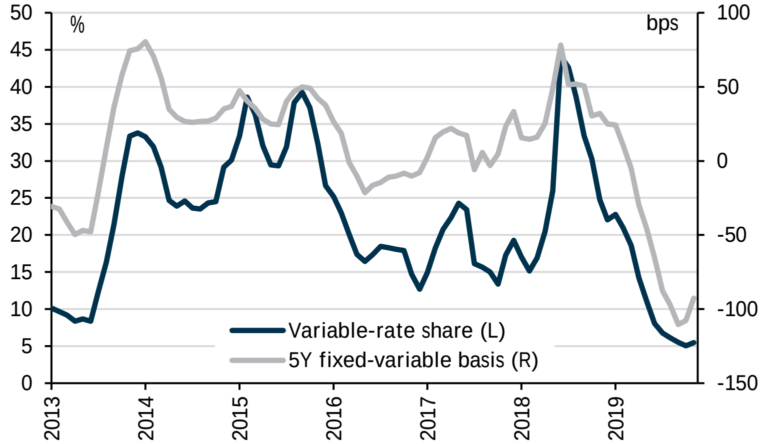
*Year-over-year growth in mortgage credit for banks & non-banks*




*Source: NBF, StatCan*

## Chart 4: Fixed-rate all the way

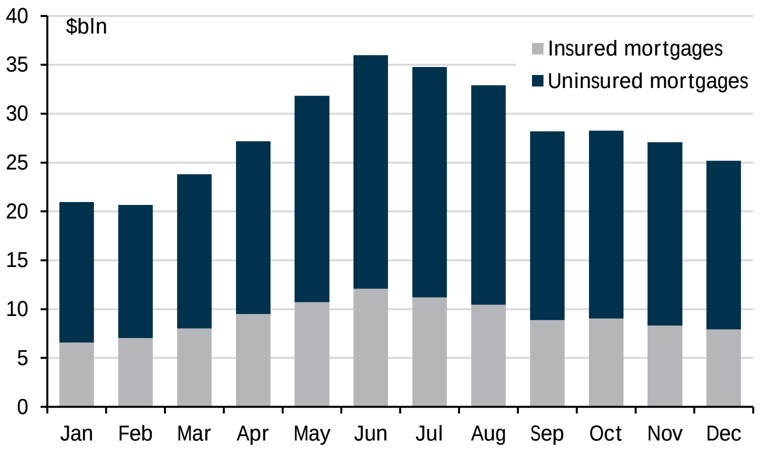
*Share of new mortgages with variable rate vs fixed-variable rate differential*




*Source: NBF, StatCan | Note: Based on insured and uninsured mortgage loans; rate differential based on weighted average of contracted rates (5-year fixed mortgages vs variable rate mortgages), not to be confused with current posted or best offer rates*

## Chart 5: Seasonals in mortgage lending? You bet

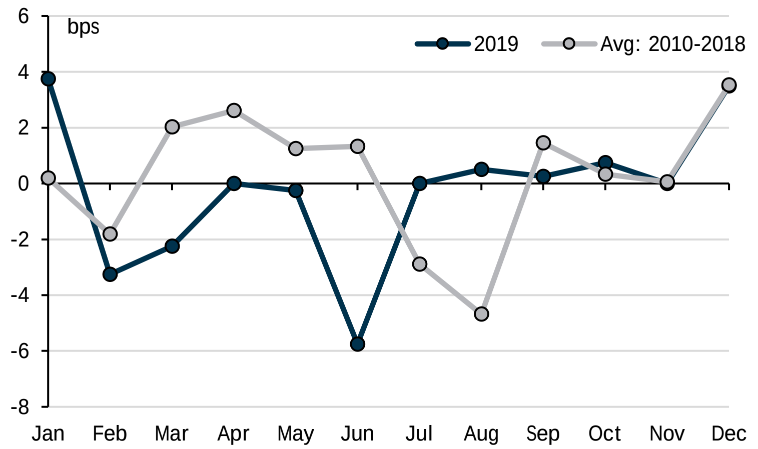
*Funds advanced for residential mortgages by month & type of mortgage*




*Source: NBF, StatCan*

## Chart 6: 2019 bucked swap spread trend bigtime

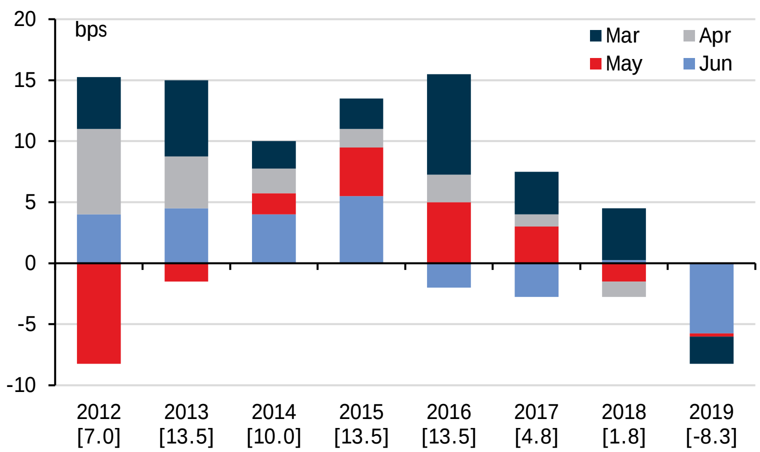
*Change in CAD 5-year swap spreads: 2019 vs prior average*




*Source: NBF, Bloomberg | Note: Based on monthly closing values*

## Chart 7: Return of the spring-time rally for swaps?

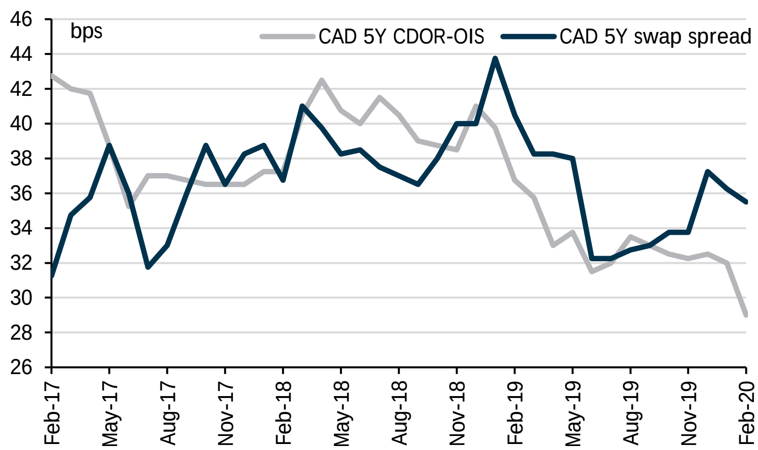
*Change in CAD 5-year swap spread by year & month*




*Source: NBF, Bloomberg | Note: Based on closing values; figures in [.] denote cumulative change over 4-month period to June*

## Chart 8: Fade "rich" swap spreads? Maybe not

*CAD term funding spreads & CAD 5-year swap spreads*




*Source: NBF, Bloomberg | Note: Based on monthly closing values; latest data point as at 13-Feb-2020*

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