NATIONAL BANK OF CANADA
FINANCIAL MARKETS

November 6, 2023 – (Vol. VII, No. 83)

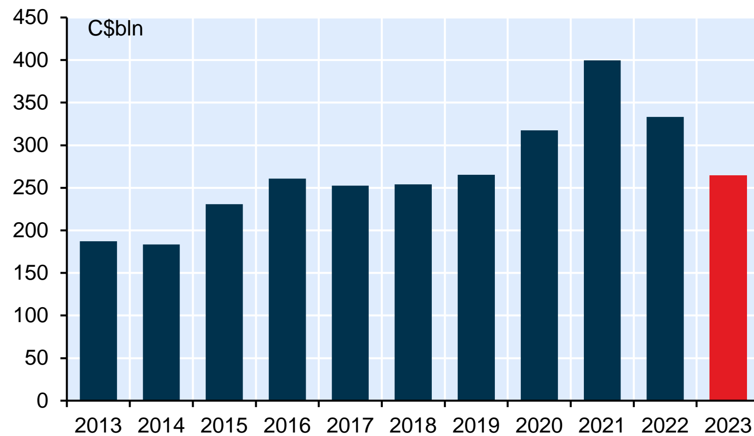
Monitoring mortgages

By Taylor Schleich (with assistance from the Interest Rate Derivatives team)

There's no shortage of interest in Canadian housing. You don't have to look too hard to find analysis/commentary on elevated prices, the squeeze on households from rising borrowing costs, the impact from immigration, negative amortizing mortgages or the long-called-for but yet-to-materialize collapse of the Canadian housing market, just to name a few. In fact, our best-in-class colleagues just in the past week have written on the precipitous drop in activity in Toronto and Calgary, and spoke to worsening affordability. Rather than focus on some of these well-covered items, here we look at trends in mortgage origination, the incentives created by rapidly changing rates and what the expected evolution of activity could mean for key financial market variables moving forward. **Specifically, our colleagues in Interest Rate Derivatives offer their thoughts on what these trends/our outlook might mean for swap spreads on Page 2**. This note is also a natural follow-on to a *Hot Chart* that our housing expert Daren King penned back in the summer, which spoke to many of the themes discussed here.

Chart 1: Mortgage origination is off to a very slow start

Year-to-date mortgage origination: Insured and uninsured, all terms

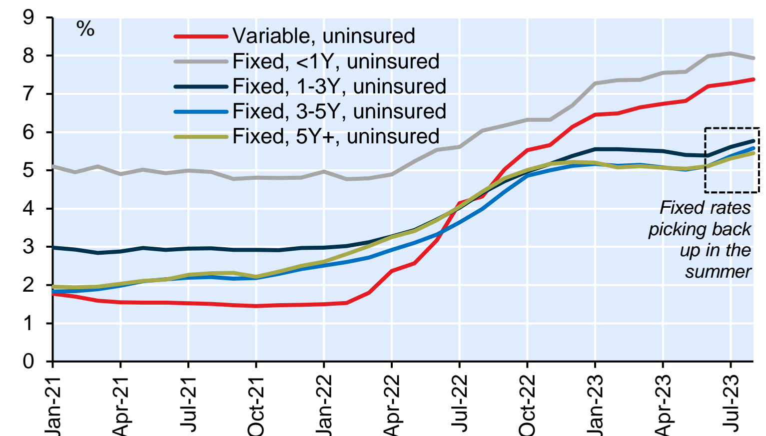


Source: NBF, BoC | Note: YTD is through August.

First, to set the tone: Mortgage origination is down big in 2023. YTD, it's off ~20% from 2022 and down over 30% vs. 2021. Volumes are comparable to pre-COVID levels only because home prices are much higher and thus, mortgage amounts are too. What's ahead? September and October home sales were seasonally slower, and a weak outlook remains through year-end. As we continue to refresh this chart, expect 2023 to look worse.

Chart 2: After first half stall, rates are moving up in H2

Uninsured mortgage rates since 2021

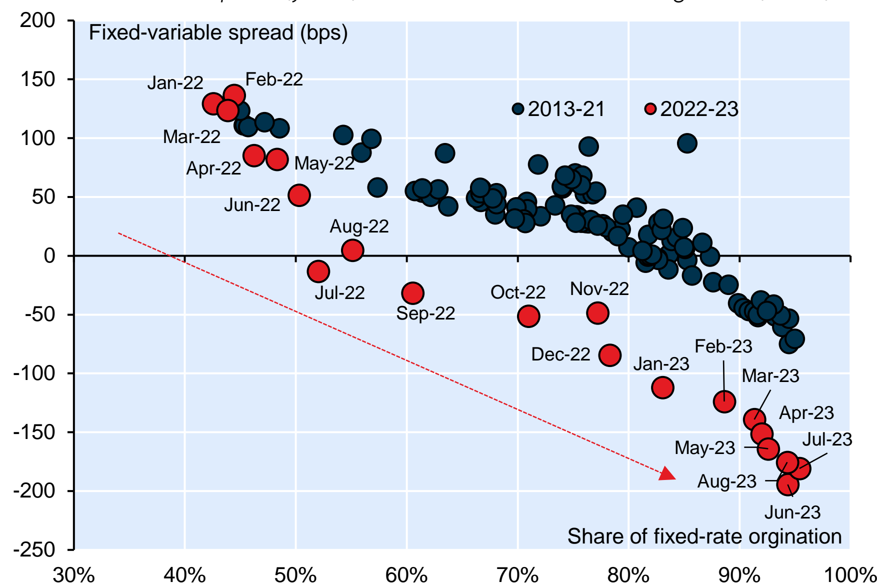


Source: NBF, BoC | Note: Latest data point is for August 2023

The latest data only extends through August, not yet reflecting the surge in borrowing costs this fall. While some of that rate sell-off had been erased last week, downward mortgage rate adjustments in coming weeks might be slow and not proportional given elevated volatility and an uncertain outlook. In any case, it was, is and will remain clear that the leveling out in fixed rates in H1:2023 is over. We're left with higher rates.

Chart 3: As variable rates soared, buyers piled into fixed

Fixed-variable rate spread (y-axis) vs. overall share of fixed rate origination (x-axis)*

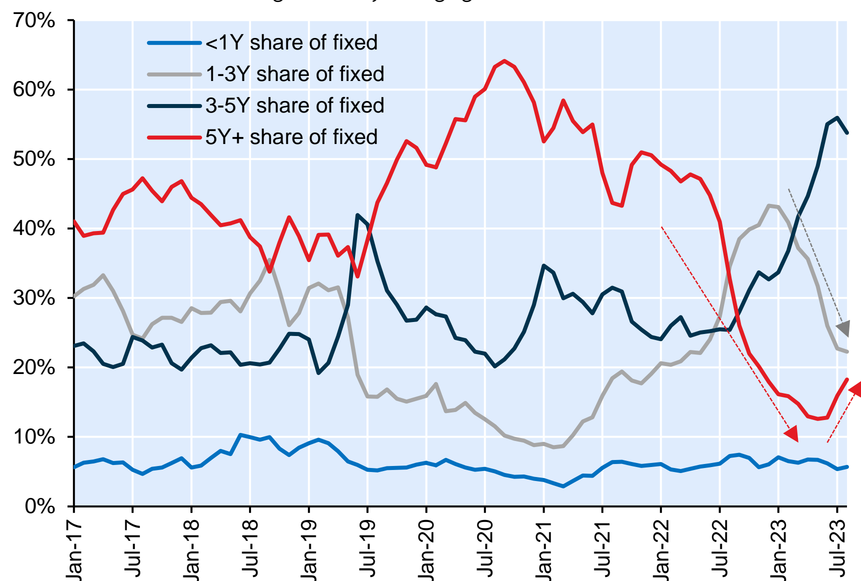


*Source: NBF, BoC | Note: *Average of rates for each fixed term bucket, weighted by origination volume*

The incentives created by *relative* mortgage rates are an important consideration. Borrowers tend to minimize their mortgage payment *today* rather than the expected payment over the course of the mortgage. In some cases, borrowers who are stretching their budget are forced into whichever rate/term offers them the smallest payment. That's clear this cycle.

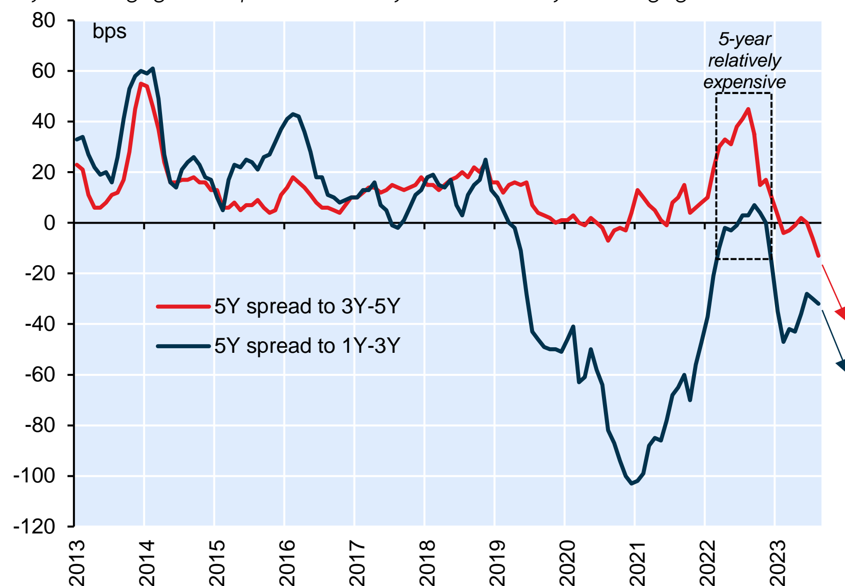
In Q1 2022, the early days of the BoC's tightening cycle, Canadians were piling into variable rate mortgages like never before. As variable rates moved up, the share of variable rate borrowers collapsed. Today, ~95% of mortgage origination is of the fixed rate variety. That's consistent with the historical record which shows any meaningfully negative fixed-variable spread (i.e., lower fixed rates) has meant single-digit shares of variable origination. This isn't likely to change anytime soon given the large gap between fixed and variable rates. At the very least it will take a clearer signal that rate cuts are imminent (or even underway) for that to swing back.

Chart 4: Borrowers weren't using 5Y fixed like they normally would…
Share of total fixed rate origination by mortgage term



Source: NBF, BoC | Note: Latest data point is for August 2023

Chart 5: …because short terms offered lower rates and more flexibility
5-year mortgage rate spread to 1 to 3-year and 3 to 5-year mortgage rates



Source: NBF, BoC | Note: Latest data point is for August 2023

It's not just relative fixed and variable rates that matter. Variations *within* the fixed rate space have become an important consideration too. As we discussed in our August Hot Chart, shunning variable rate mortgages didn't mean locking in for 5 years as is usually the case in Canada. Instead, borrowers locked in for a shorter term than normal (1 to 4 years), the share of 5-year fixed origination falling below 15% by mid-2023. That's the smallest proportion seen in at least a decade (as far back this data extends).

There are a few explanations for this. The first is the common wisdom that higher rates would exist only briefly. In the spring, the BoC stopped hiking and markets were pricing rate cuts before year-end. Locking in for five years at a high rate in a soon-to-be falling rate environment didn't look enticing. At the same time, 5-year rates were more expensive than shorter-term options, producing a higher monthly payment, all else equal. For those just trying to 'make the numbers work', a 5-year mortgage may not have been an option. Taken together, shorter fixed terms avoided the uncertainty associated with variable rates, offered a cheaper rate than a 5-year mortgage and provided flexibility to refinance earlier when rates presumably had fallen. These dynamics may be changing.

Notwithstanding last week's rate rally, "higher-for-longer" has become more pervasive/likely/accepted which may be altering consumers' rate expectations. The perceived savings from refinancing in a few years have probably lessened for many. Second, 5-year rates have become relatively cheaper than shorter-term fixed rates. Based on the "opt-for-the-lowest-payment" heuristic, it makes sense to see more 5-year borrowing.

We're starting to see signs of this shift now (i.e., in the August data) as the share of 5-year fixed origination has picked up. (Note: This dynamic already played out in the 1-3Y sector. Origination fell dramatically here since early 2023 as these rates grew relatively higher). Looking ahead, to the extent that this relative rate shift continues/persists, we should expect to see a greater share of borrowers go 5-year fixed than over the past year. Our latest read on market mortgage rates shows there's still a non-trivial discount to go 5-year.

All of these aforementioned dynamics have important implications for both the real economy and markets…

Swap market implications:

Of course, mortgage flows are an important consideration for the swap market. Depressed mortgage volumes alongside expectations for them to remain sluggish should mean less paying by mortgage-hedgers and consequently lower swap spreads (SS), all else equal. More generally, lending may also be restrained going forward which could further detract from SS paying. If mortgage rates remain inverted (or invert further), we could see a lengthening of the mortgage term putting steepening pressure on the swap curve and leave 5yr SS relatively wider than 2yr-4yr SS. For now, we maintain our bias on lower SS with a view that 5s could continue to widen vs. shorter-terms.

Economic implications:

From a real economy perspective, more Canadians locking in for 5 years at ~6% lengthens the impact of earlier tightening (assuming rates will be lower over the coming year(s)). For the Bank of Canada worried about sticky inflation and trying to encourage consumers to retrench, that might be a welcomed development. Mechanically, a slow resale market doesn't bode well for GDP either. That's particularly notable as the economy is already teetering on the edge of technical recession. Although it's somewhat circular, these higher long-term rates that we see keeping activity depressed could help keep the BoC from delivering additional rate increases… so long as pricing out of hikes doesn't cascade through the curve and unwind the financial market tightening. We don't think that's the case and a sidelined BoC remains our base case outlook. As always, we'll be closely watching these data (September's update will come later this month) and we welcome further discussion.

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