

Prof. Moshe Milevsky of York University, an expert on rates, has the simple message: "Go short and stay short — I did."

## COMMENT

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# Hang tough on mortgages

You could lose a lot  
when rates drop  
if you lock in now

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*Mortgages*

The past six months have marked an interesting time in the \$600-billion Canadian mortgage market.

With close to half of all outstanding mortgages floating against bank prime, the level of anxiety for borrowers with variable mortgages heightens with every whisper of yet higher rates.

Benjamin Tal, senior economist for CIBC World Markets, however, suggests that these brave folks should stay the course and not lock in. That may be a tough call for those who qualified for their mortgage a year or two ago at rates in the 4% range, and opted to stay floating. Many have seen their monthly payments increase by up to 25% and fear further increases.

In January, when five-year rates were still quoted at 4.85%, and a seven-year fixed term at 4.99%, I suggested it was time to seriously consider locking in, depending upon individual circumstances, due to the coming increases. Many folks did just that, and have since seen five-year rates creep upward to the recently announced level of 5.69% (TD offers 5.64%). In the interim, I have spoken to a number of folks who have actually locked in their rates due to the lurking uncertainty of a rising prime and flattening yield curves, and to a person they seem happy that they did.

Many, however, remain stead-

fast, floating with prime, which is a strategy strongly endorsed by many economists, not just Tal. York University Prof. Moshe Milevsky, author of an authoritative 2005 paper on the historical relationship between short- and long-term rates, is probably the most frequently quoted of the experts, and his simple message is, "Go short and stay short — I did."

Reinforcing Milevsky's "general theory" (my term) of personal-mortgage-rate management, Tal offers a point-in-time rationale for why, of all times, people should not panic and lock in now. Addressing a roomful of mortgage-industry professionals in Toronto recently, he argued strongly that a set of macroeconomic indicators normally resulting in higher rates is in fact pointing them in the opposite direction. He pointed out that the flat yield curve, combined with low inflation, and the disinflationary "soft landing" effect of high energy prices, are sending a strong signal to the Bank of Canada not to overshoot and raise prime, at least not by too much.

The recent strong performance of the Canadian dollar provides an even stronger rationale for cresting, and then gradually falling rates.

The "inevitable" result of this unique set of economic circumstances, according to Tal, is that short-term interest rates are poised to decline gradually over the coming year to 18 months, with the Bank of Canada prime (target overnight) rate also heading back downwards, perhaps with one or two small intervening increases.

This would have the effect of coaxing the commercial bank prime (business) rate back to current or lower rates. At the same

time, Tal feels that long-term rates will move very little, re-establishing the historical spread (upward-sloping yield curve) of one to 1.5 percentage points between short and long rates. Tal also stated that "not only could rates start heading lower again by mid-2007, but we could be looking at further rate cuts through 2008."

Were the commercial bank prime to drop back to 4.5%, as indicated by Tal's analysis, mortgages floating at prime minus 0.9% — a market-leading rate available primarily through leading mortgage brokers — could drop to as low as 3.9%.

Were the commercial bank prime to drop to 4.25%, mort-

### PEOPLE OFTEN BECOME IRRATIONAL UNDER STRESS

gages floating at prime minus 0.9% — a market leading rate available primarily through leading mortgage brokers — could drop to as low as 3.4%.

While I now agree we are approaching the top of the interest rate cycle, I would offer a word of warning. At times such as these, the human factor plays a major role in household decisions. As I write, I am sure thousands of conversations are going on between husband and wife over this very subject, and I can almost hear the words, "Honey, if prime goes up another quarter percent we're locking in, and that's all there is to it."

As irrational as such a statement is, it unfortunately reflects the way people think and act un-

der stress. And make no mistake about it, adding hundreds of dollars of interest to your mortgage payment with a half-point rate hike constitutes great stress for many young homeowners. We are seeing a quick reaction from the banks, with Scotiabank promoting their split mortgage so that both opinions can be accommodated. That's not a bad hedging strategy, as when such mortgages were first introduced in the early 1990s, led as usual by FirstLine Trust (now FirstLine Mortgages).

But my advice to you today, having missed the low long-term rates available over the past few years, is "hang tough." Unless the next 25-basis-point increase in prime rate will put you in a precarious financial position, you could now have quite a bit to lose by locking into a rate between 5% and 5.5%, and not a lot to gain, except certainty, as sub-optimal as it may be.

Remember how much is riding on lower interest rates in North America, and who is motivated to keep them down. A general increase in rates of one to two percentage points would have a dramatic impact on the markets, housing starts and borrowing in general. In the United States, to whose financial apron strings we will remain tied for the foreseeable future, and where mortgage loans routinely exceed 100% of home value, it could be cataclysmic.

If you haven't locked in yet, ride the gentle curve, or hedge your bets with a split mortgage.

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