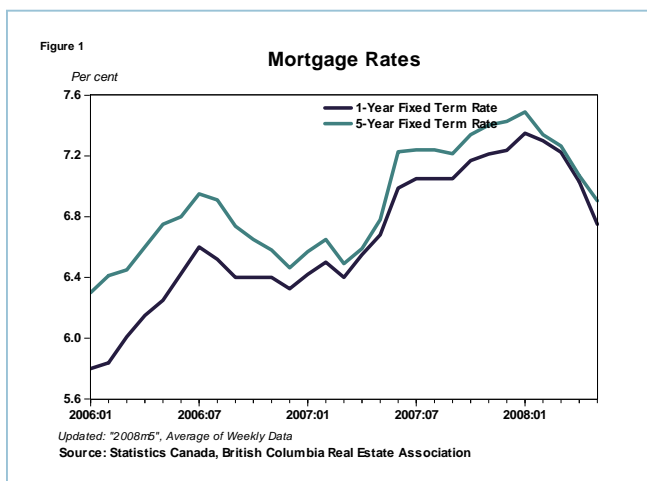


MORTGAGE UPDATE

ECONOMICS JUNE 2008

MORTGAGE RATES DROP, BUT LOOK TO RISE

Homebuyers benefited from a deep cut in posted mortgage rates during the last week of May. Borrowing costs on one- and three-year fixed-rate mortgages fell to 6.15 per cent, an 80 and 85 basis point (bps) drop from a week earlier. The five-year rate fell by a more modest 34 bps during the same period to 6.65 per cent. Posted mortgage rates fell to the lowest levels since early 2006, after climbing higher for most of 2007 (Figure 1).



The sharp decline in mortgage rates suggests that some of the additional risk associated with the credit crunch that began in August has lessened. Since that time, heightened volatility in the credit markets drove up the cost of funds for lenders, which included monies used to fund part of the mortgage loan market. This resulted in higher mortgage rates than would otherwise have been expected. Recent improvements in financial market conditions have allowed lenders to pass on more of the benefits of the Bank of Canada's interest rate cuts to consumers.

However, this recent decline likely marked a low point for rates. BCREA expects heightened concerns over future inflation risks into

2009 to result in higher interest rates in the third and fourth quarters of this year. Despite an economy that should remain weak in 2008, energy prices are expected to remain high, feeding into total inflation and higher interest rate expectations.

The Bank of Canada's overnight rate, currently at 3 per cent, is directly related to prime rates and, in turn, variable mortgage rates. With the potential for an interest rate hike in the future, some consumers may choose now as a time to lock into fixed rate mortgages.

In the fixed-rate mortgage market, rates are highly correlated to bond yields of similar maturity. While short-term rates partially filter into longer term rates, future expectations for the economy, inflation and interest rates play a larger role. The Bank's unexpected decision to hold its overnight rate steady, coupled with its message on inflation risks, led to a sharp rise in bond yields on June 10. Fixed-term mortgage rates will rise to reflect rising bond yields in the market.

Mortgage Rate Forecast ¹								
	2007			2008				2009
Term	Q2	Q3	Q4	Q1	Q2F	Q3	Q4	Avg
1-Year	6.73	7.05	7.20	7.30	6.90	7.15	7.30	7.4
5-Year	6.86	7.23	7.39	7.37	7.00	7.25	7.40	7.5

¹ Average of weekly data

Source: Bank of Canada, BCREA Forecast

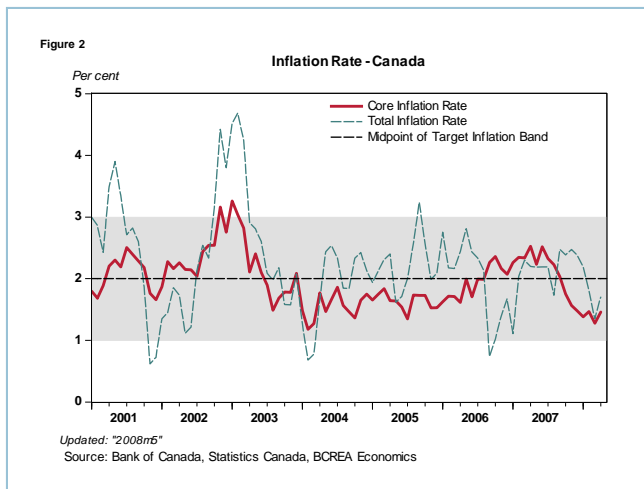
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Bank of Canada Sees Inflation Risk

In a surprising move at its June 10 meeting, the Bank of Canada kept its overnight interest rate target steady at 3 per cent, flying in the face of a widely anticipated 25 bps cut. The Bank cited upside risk to inflation for its decision, and signaled a pause in further interest rate movement to allow its previous cuts—150 basis points since December 2007—to work through the economy.



This decision came despite core inflation remaining below 1.5 per cent in April, and the first contraction of real gross domestic product (GDP) since 2003 in the first quarter of this year. The Bank pointed to high commodity prices and strong global growth as reasons for higher potential inflation moving forward, given its projection that economic growth will pick up this year and into 2009.

In particular, the Bank was more focused on headline inflation which, unlike core inflation, also tracks the price changes of the eight most volatile components of the consumer price index, including gasoline and fuel costs. The energy price aggregate grew 8 per cent in April relative to the same month in 2007, while gasoline rose 11.6 per cent.

A potential acceleration in inflation is further supported by the exchange rate factor. Last year, Canada benefited from a rise in the value of its currency vis-à-

vis the US, which led to lower-priced imports, and also contributed to lower prices on items such as automobiles. The Canadian dollar is currently near parity, and is unlikely to provide a cushion against inflation.

Economy Contracts in Q1

While higher energy prices may pass through to the final prices of other consumer goods fueling supply-side inflation, a weaker economy may prove to dampen some of the impact.

In the first quarter of 2008, Canada's real GDP declined at an annualized rate of 0.3 per cent, much lower than the 1 per cent gain projected by the Bank of Canada, and the first decrease since 2003. Despite an increase in domestic demand, widespread cutbacks in manufacturing, particularly in the motor vehicles sector, pulled down growth.

A weaker economic performance generally results in downward pressure on inflation. Lower output generally means an increase in the amount of unused capacity in the economy, which results in less upward pressure on prices. However, the Bank of Canada's June 10 communiqué noted "the risk that potential growth will be weaker than assumed." As a result, even if actual economic growth falls below projections, inflation dampening unused capacity may not increase.

Lower "potential growth," higher energy prices and a stronger global economy than projected may fuel higher inflation. The Bank of Canada uses its policy interest rate as a tool to keep inflation at the mid-point of its 1 to 3 per cent target inflation band. If the Bank views inflation as an increasing problem, it may increase interest rates.

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