All that you need to know about

Current Interest Rates and Possible Direction of Real Estate Market

by Kishore Masand

It was a beautiful Sunday morning. Clear skies, warm breeze, a perfect spring day to spend by the lake. The lakeside fortunately had a few visitors making it a perfect setting for a peaceful day.

While we were settling down, we were approached by a young couple. I immediately recognized them as Michael and Leela, my customers for whom I had arranged a mortgage in the past. They also came to the lakeside to enjoy the beautiful day. After exchanging pleasantries, they asked me the one question which I face the most these days, “What is happening with interest rates and where are they headed”? The most common topic of discussion, which matters to people from all walks of life.

So why are the interest rates rising? Interest rates and setting their potential direction is a key arsenal in the armoury of any central bank. It is an important part of a central bank’s monetary policy. If the central bank intends to promote economic growth in a country, one of the options with them is to reduce the interest rates by reducing their target overnight rate. The reduced rates would encourage people to borrow more and use that borrowed capital to spend on goods and services in the economy.

The enhanced sales would encourage businesses to produce more, for which they need more capital, raw material, and manpower.

This would further support sales for ancillary industries, raw materials, commodities and would also generate employment in the society. The newly employed workers would have more disposable income with which they will spend more, which would mean even more demand for goods and services. This cycle would lead to economic growth. In this case the monetary policy would be expansionary to promote economic growth.

On the other hand, in a scenario, wherein the demand for goods and services is very high and if the supply is not able to catch up to that demand, it would lead to higher prices (inflation) as there is a demand – supply mismatch with lots of money chasing fewer goods and services. Inflation hurts the financially vulnerable sections of the society the most as their incomes may not rise as high as the prices of goods and services, thus making them financially weaker than before. Under these circumstances, the central bank may increase interest rates to discourage people from borrowing and in turn spending. Lesser spending would reduce demand for goods and services, which would reduce the pressure on supply, eventually helping in balancing demand and supply to a point wherein the price rise can be tamed.

So, what stage of the economic cycle are we in and why are the rates rising now? To understand that, we need to go back in time to late 2019 when the world was preparing itself for the deadliest pandemic of the century, COVID 19.

To manage the pandemic, governments across the globe brought in lock downs. Factories, offices, schools, agricultural markets, trade centres, places of worship, you name the institution, and it was closed for a while. Lots of factories which produce goods that we consume were closed for a good part of 2020 and a small part of 2021.

On top of closure of factories and plants, major transportation hubs like ports, airports, railways were also shut down either partially or fully. This meant that the free flow of goods between countries was also hampered.

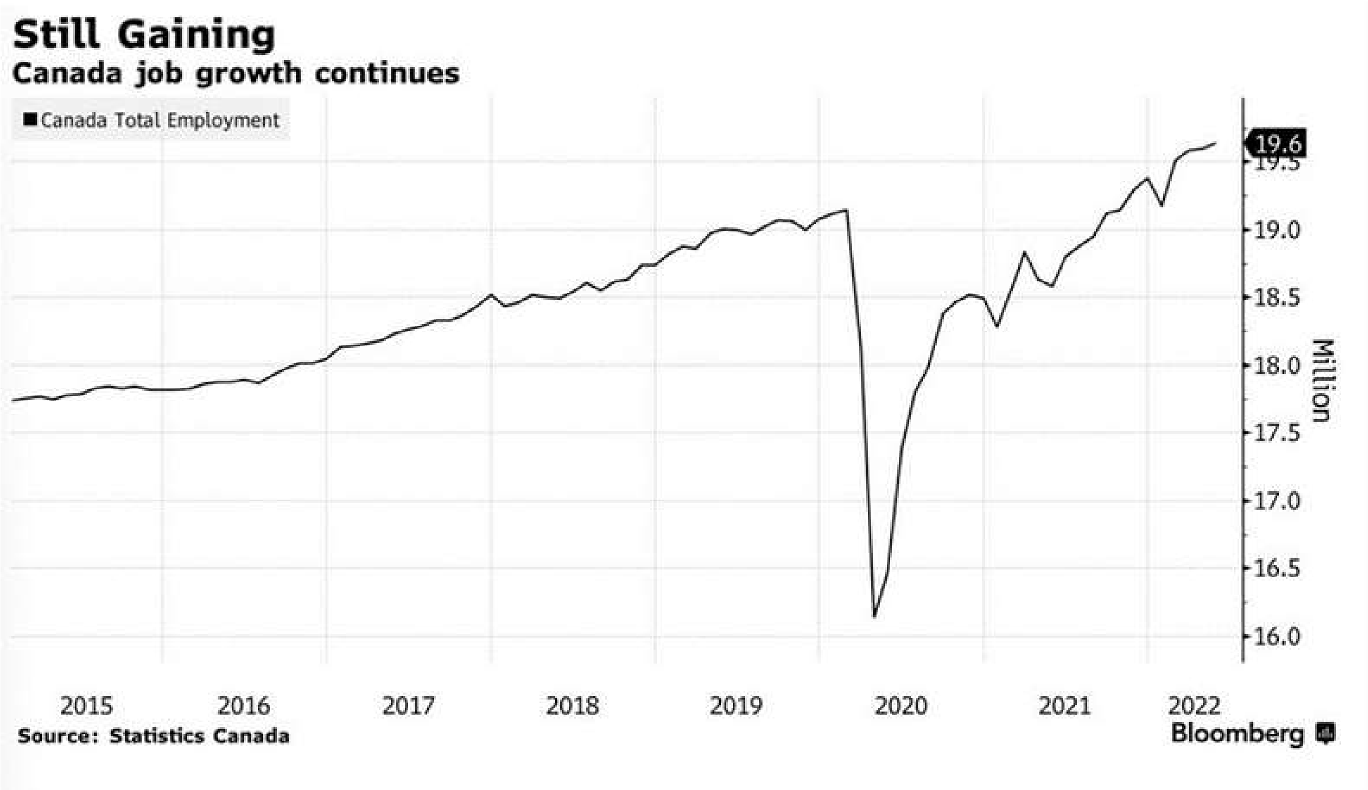
On the other hand, thanks to technology and the possibility of working from home, a lot of service industries were able to continue their businesses as usual, which saved many people from losing their jobs. People with certain skills were in high demand and their incomes accordingly went up. This created additional money in the hands of these professionals.

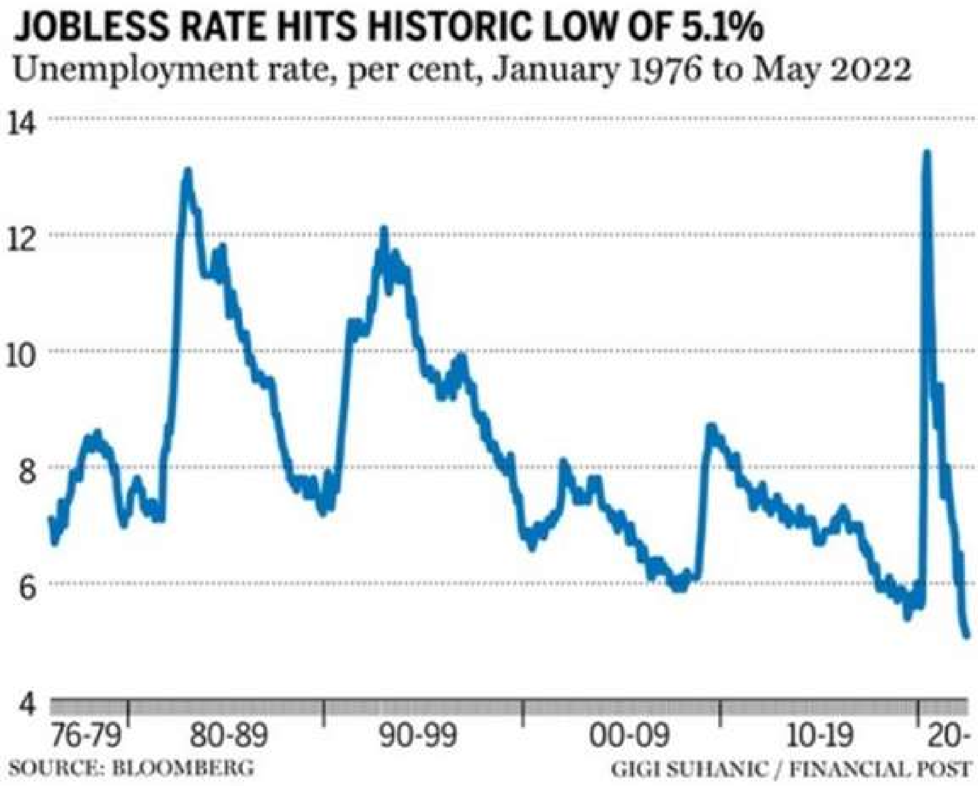
The governments also stepped in to help the people who were impacted due to job losses or reduction in income and gave them temporary financial support which also created additional cash for a large population.

So, we were in a situation wherein people had money to spend but the factories and supply chains were closed or disrupted which meant that the products cannot be delivered to the consumers in an efficient manner. This created the first demand - supply mismatch and higher prices (inflation).

The economies started opening in late 2020 / early 2021, creating a large demand for employees. Reopened economies needed manpower, this created a massive demand for labour and suddenly, the job growth picked up and jobless rate dropped to historic levels.

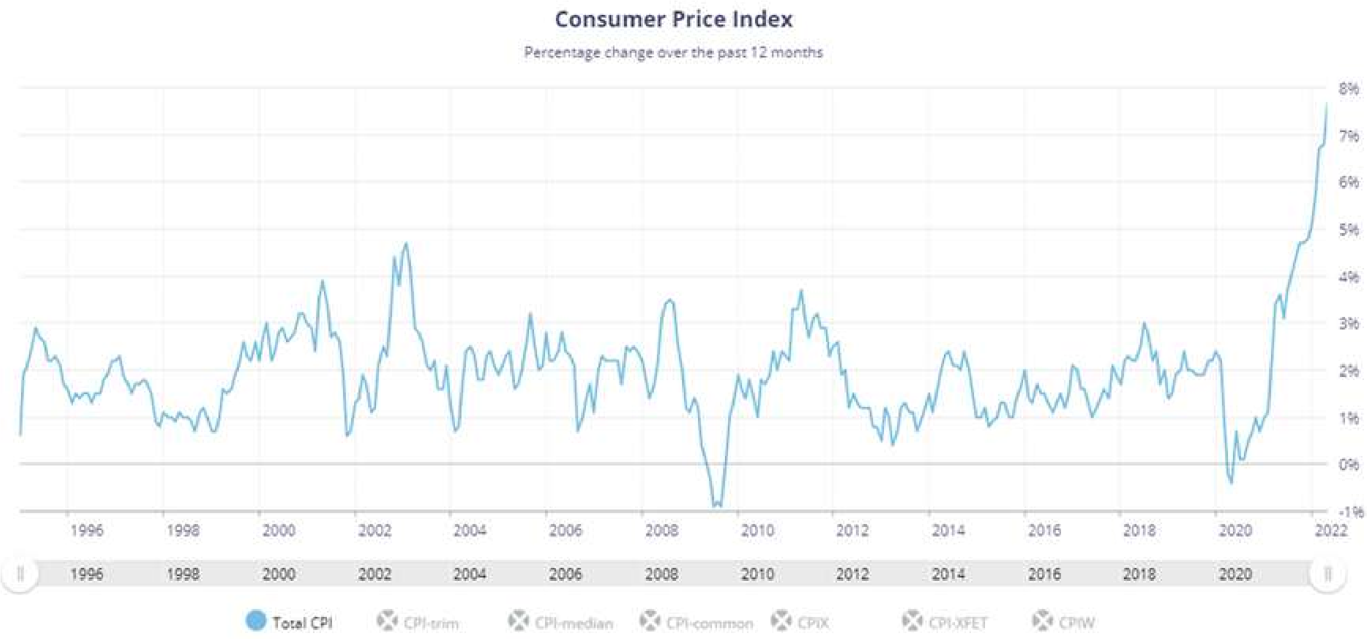
Employers suddenly found that they were not able to hire as many employees as they wanted. This created a labour shortage and employers had to increase wages to attract talent. This led to more money in the hands of people and with supply disruptions yet to be managed, the demand – supply scenario further worsened leading to further price rises.



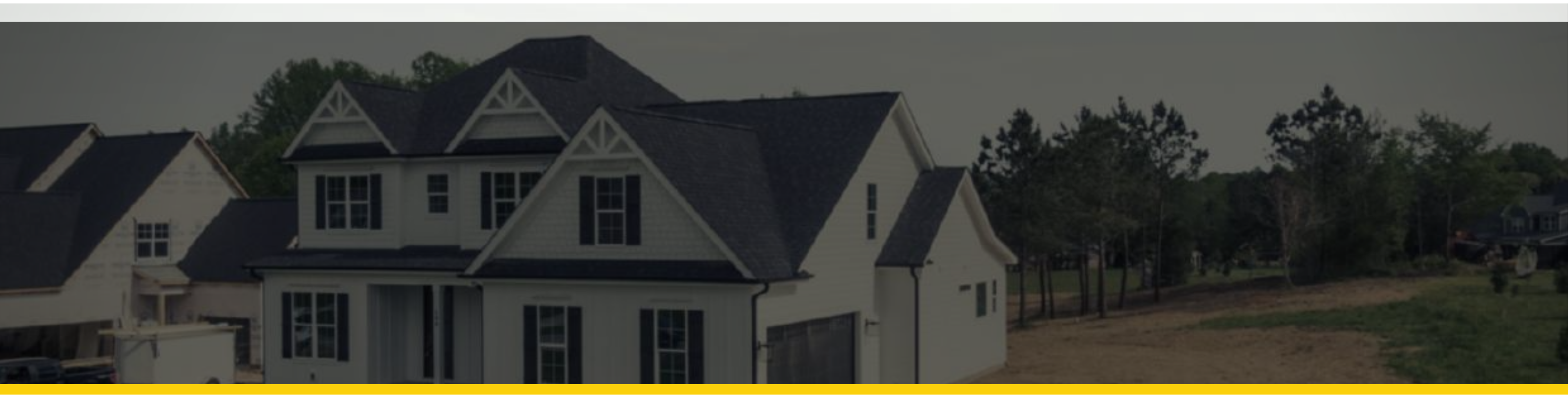


If that was not enough, war between Russian and Ukraine further complicated matters. Russia and Ukraine are large producers of wheat and a lot of other commodities. Russia is also one of the largest suppliers of oil and gas to the European continent. War between these neighbours created a spike in the price of commodities, especially oil, as disruption of supply from a major producer meant more demand and low supply. Oil is not just used as a gasoline for running passenger vehicles, but the entire global logistics business depends upon its price. Airplanes, trucks, cargo vessels, they all use crude oil in some form or the other. An increase in the price of oil means transportation becomes expensive and expensive transportation means higher prices of products on the shelves of grocery stores.

This created the third reason for run away prices for lots of products.
If you thought we were finally done, China experienced a major spike in COVID cases in early 2022 and in response to the rising cases, major trading centres and ports were shut down in China. Supply has been majorly impacted due to these lock downs as China is a major supplier of goods for the entire globe. This further aggravated the mismatch between demand, which is extremely high, and supply, which is not able to even come close to what is needed. The result, one of the highest inflations across the globe in decades.



Source: Bank of Canada



So, what can the government and its agencies do to control this substantial mismatch. They cannot control the supply lines, they cannot force the factories to increase their outputs overnight, they cannot stop the Russia – Ukraine conflict nor can they control the COVID scenario and resultant lock downs in China. So, supply side issues would take time to come back to normal. However, to control inflation and to get it back to normal levels, governments can play a role in reducing demand. A reduced demand would mean lesser pressure on supply, and an eventual equilibrium between them. This reduced demand would help in cooling down prices thus bringing inflation to manageable levels.

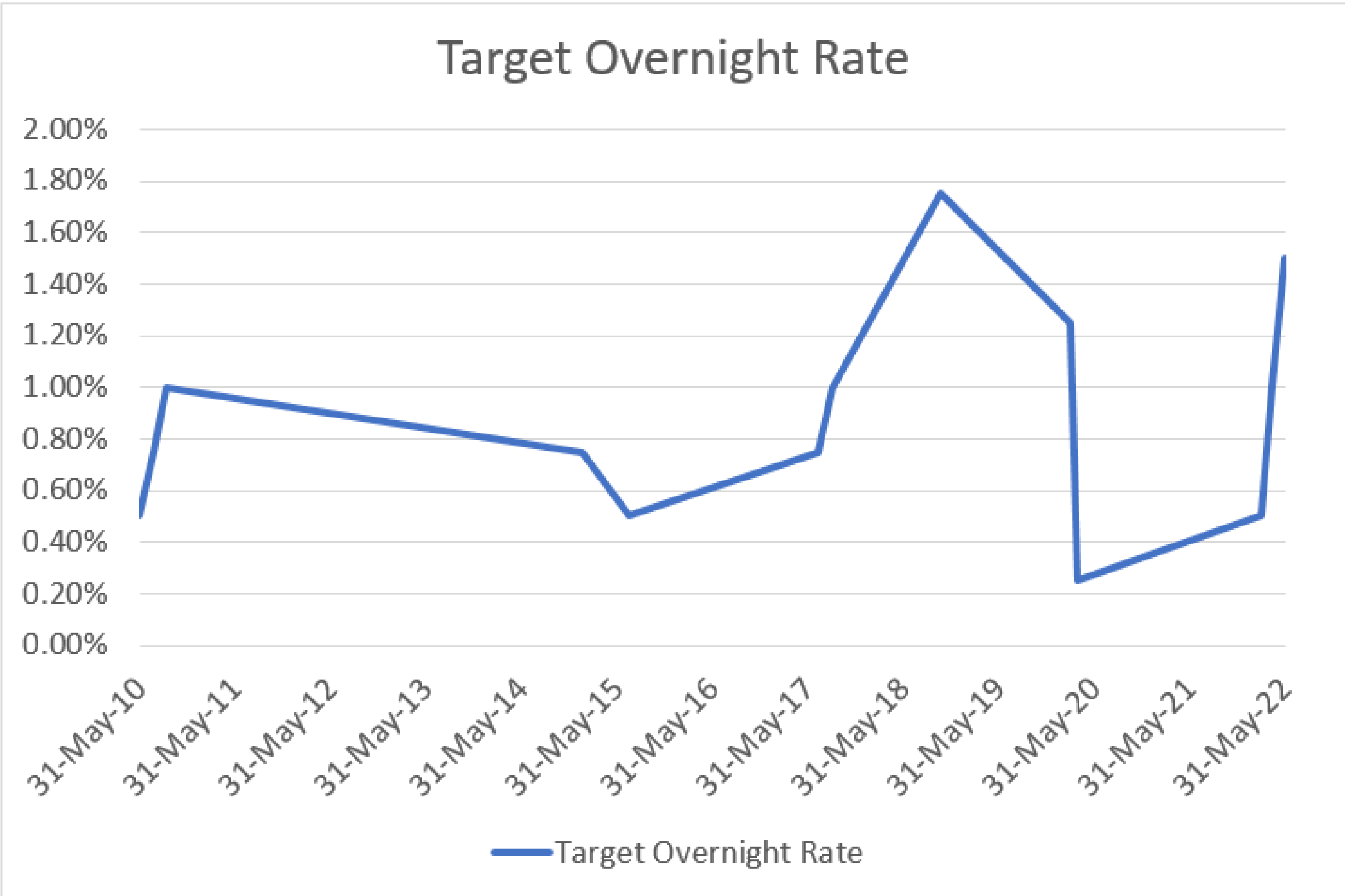
Bank of Canada has started increasing rates to make borrowing expensive. Expensive borrowing generally translates into lesser borrowing to spend on goods and services, which in turn should lead to lower prices for goods and services eventually.

ARE THE INTEREST RATES STILL EXPECTED TO GO UP?

The target overnight rate in Canada before the start of COVID 19 was 1.75%. All the banks base their prime lending rates on this target overnight rate set by Bank of Canada (BOC). Most lending done by commercial banks is directly based on their prime lending rate. Hence target overnight rate directly dictates interest rates on most variable rate lending done in Canada.

Bank of Canada reduced this rate to 0.25% from 1.75% to support the economy during the difficult COVID period. The reduced overnight rate prompted banks to reduce their prime rates, which then reduced the rates on most loans, credit lines and mortgages. Reduced rates prompted people of borrow more and spend heavily on assets (like properties and stocks) as well as on all goods and services. This high spending by people along with reduced supply of products due to supply bottlenecks led inflation to hit multi decade highs.

The central bank is now increasing overnight rates to curb the excessive demand and to make credit expensive. The bank has increased the rates thrice in the past few months and has now set the rate to 1.5%. Despite those increases, the inflation is still very strong, running at multi year highs. The central banks around the globe have made it very clear that they won't stop increasing rates unless inflation is back to manageable levels.



Source: Bank of Canada

Under the circumstances, the possibility of future rate hikes is very high. Bank of Canada believes that the neutral rate (rate where interest rate is neither expansionary nor recessionary) is between 2.5 to 3%. They have clarified their intentions of taking the overnight lending rate to this neutral level and may be higher, if needed to control inflation. This makes the possibility of future hikes extremely high.

WHAT WOULD HAPPEN TO MORTGAGES AND OTHER LOANS IN THIS SCENARIO

Commercial Banks offer loans, credit lines and mortgages on 2 interest rate types: Fixed and Variable. As the name suggests, fixed interest rate products have constant interest rates throughout the term of the loan/credit line. If the target overnight rate changes, which in turn would change the prime lending rates of the commercial banks, fixed loan products won't be impacted in terms of interest rate and the resultant monthly payments on them.

Variable loans/credit lines, on the other hand are completely linked to the prime lending rates of the banks. If prime rate goes up, the interest rate on variable loans goes up, if the prime rate reduces, interest rate on variable loans goes down.

The current increase in target overnight rate by Bank of Canada has increased the prime rate for banks. This has led to variable rate loans and mortgages go up in interest rates. Hence people holding variable rate mortgages, loans and credit lines are witnessing their interest rates go up each time Bank of Canada increases the rates.

Fixed rate mortgage holders on the other hand are at an advantage right now as their interest rate is locked in for the term of their mortgage / loan. However, whenever their mortgage would come due for a renewal, they too would feel the pinch as the renewal would be processed at the rates applicable at that time, which may be substantially higher than their current rates.

WOULD RISING INTEREST RATES REDUCE PROPERTY VALUES?

This is the most common question being asked everywhere these days.

Decision to buy and hold an asset is governed by the cost of owning and managing that asset. Real estate is no exception to that rule. The biggest cost involved in owning a real estate is the monthly mortgage cost of that property. When the interest rates are low, the mortgages payments naturally are lower as lesser amount is being paid towards the interest cost.

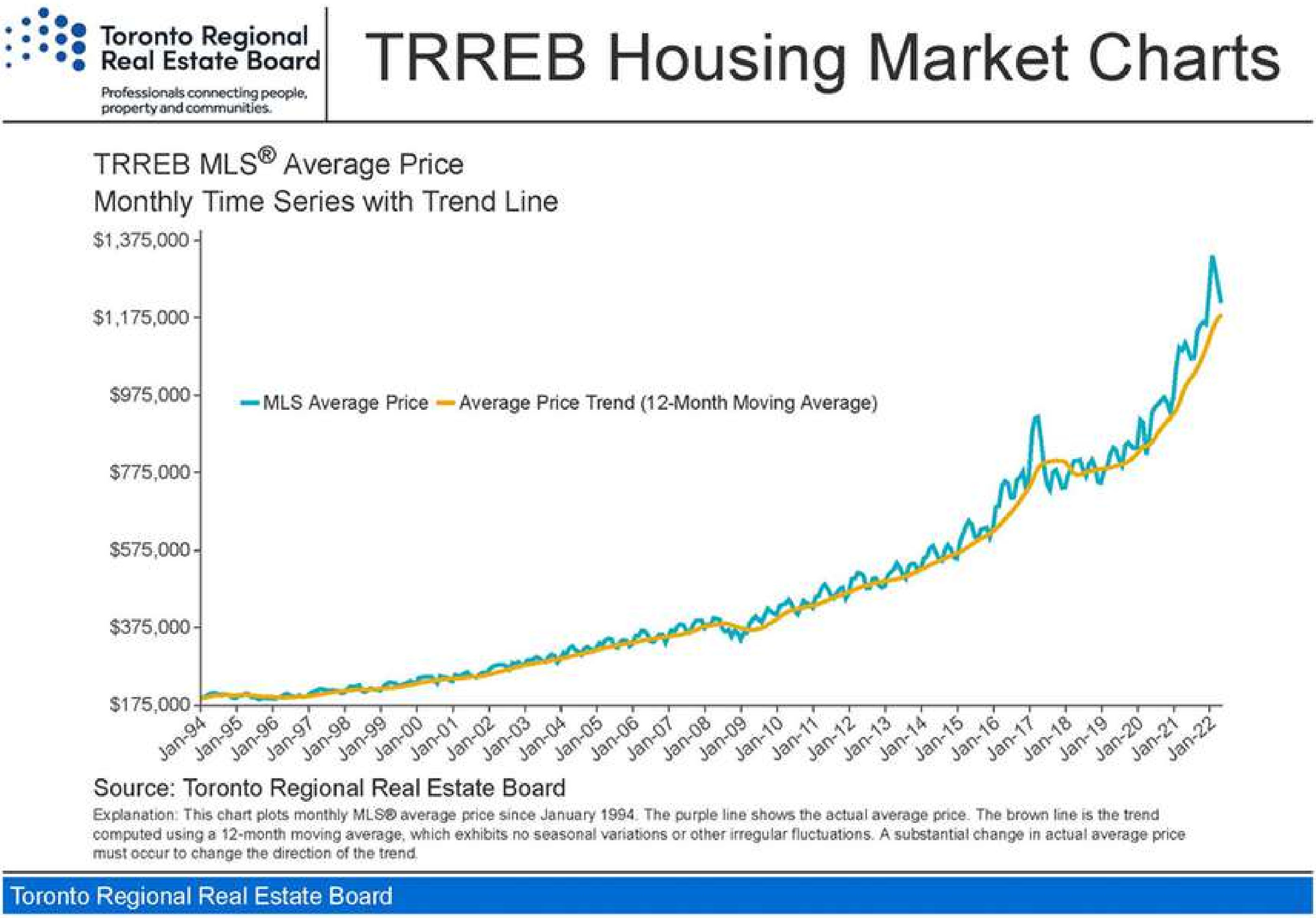
This lower monthly payment encourages people to buy and hold real estate. High demand for real estate in low interest rate environment pushes the real estate valuations higher as more and more people want to buy, and fewer people want to sell.

In low interest rate scenario, potential home buyers believe that they can easily afford the monthly mortgage payment as interest rates are low while real estate investors find buying attractive as monthly mortgage payments are low and rental income which can be generated from leasing the property, may be able to cover and exceed the mortgage payment, leaving them a positive cash flow. High demand increases property values creating wealth for real estate owners. This lures more and more people into buying, generating more demand, which leads to further increase in valuations.

However, when the interest rates go up, the cost of borrowing to buy a property goes up. Potential homeowners feel that they may not be able to afford the mortgage payments due to high interest rates while high cost of funds means that real estate investors are not able to cover their costs as rental income may not be sufficient to cover the high monthly mortgage payment. This dissuades people from buying real estate, which in turn can lead to lower valuations.

As mortgage payments go up and property values decline, some investors and homeowners either get jittery or are not able to manage their payments thus leading to panic sale scenarios which lead to further softening of valuations.

We in Canada are currently in the rising interest rate scenario. Real estate valuations have dropped since hitting the highs of February and every property type is feeling the impact of lower valuations. Is it the end of bull run in real estate or could there be a turn around with values going up again?



Only time will tell. Any financial / real estate market is governed by decisions of thousands of buyers and sellers at any given point in time. The direction of any market depends upon the mindset and expectations of these buyers and sellers. On top of that, factors like economic conditions, interest rates, demand and supply, population growth, demographics of that market, all contribute to deciding the course of that market.

We in Canada are witnessing a growth in Immigration and immigrants bring with them, experience, financial strength, and demand for housing. Canada also faces a supply side constraint on real estate, wherein the new housing stock has not been able to keep up with the rising demand. This new demand coming in from immigrants has the potential to challenge the supply of housing thus supporting the prices for real estate.

On top of that, high employment, wages, and desire to own a home, could provide support to housing values in the future. However, these are just possibilities and only time will tell where the housing prices are headed in this scenario.

Disclaimer: Customer names have been changed for privacy reasons.

ABOUT THE AUTHOR

I am a banking and financial professional with over 17 years of experience in the financial services industry.

I specialize in real estate secured lending both on the residential and commercial real estate.

Whether you are self employed, own multiple rental units, are new to Canada, are non residents of Canada or have a bruised credit, I have a mortgage solution for you. Over the course of my experience, I have dealt with possibly every type of borrowing requirement , and have perfected my craft in providing every solution possible to my valued customers, no matter how challenging their mortgage requirement may be.

I believe in treating my customers the way I would love to be treated, always striving to offer the best experience I possibly can.

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and I will be more than glad to assist.