Fix or Float?

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It's the age-old mortgage question. And, with interest rates on the rise and debt-laden households sensitive to higher borrowing costs, home owners have even more reason to ensure they make the right choice.

On October 24, the **Bank of Canada raised policy rates for the fifth time in just over a year, while signalling more moves ahead, possibly at a quicker pace**. Tighter policy and firmer inflation have recently lifted the 5-year Canada bond yield to a seven-year peak of 2.5%, two percentage points above 2016's record low (*Chart 1*). While a 5-year fixed-rate mortgage could be had for 2.75% (or less) two years ago; today, it's closer to 3.75%.[1] On a $500,000 home financed with a 5% down payment and 25-year loan, the higher 5-year rate implies an extra $250 in monthly mortgage payments or $3,000 per year.

If you opt for a variable rate loan instead of a 5-year fixed rate loan, you're wagering it will average less than the fixed rate over the next five years. Assuming it moves one-for-one with our forecast of policy rates, then **3.0% is the estimated "breakeven" variable rate that would leave you no better or worse off than if you lock in for five years at 3.75%.** At this starting level, and assuming rates rise as expected, the interest rate on a variable-rate loan would average 3.75% over five years, implying similar borrowing costs between the two choices.

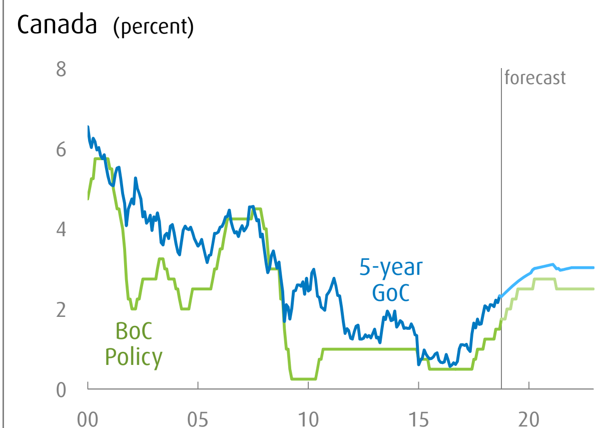
We expect the central bank to raise overnight lending rates three more times from 1.75% to 2.5% by June 2019, during which time the variable rate (assuming it's 3.0% currently) will rise to match the 3.75% fixed rate. After holding steady to April 2020, policy rates could rise a final time to 2.75%, pushing the variable rate above the (current) fixed rate by one-quarter percentage point. In March 2021, the policy rate is expected to return to the low end of a neutral range (estimated by the central bank at between 2.5% and 3.5%), at which time the variable rate will again equal the fixed rate.

Based on our forecast, choosing variable over fixed depends on **whether you can beat the 75-basis-point spread between the breakeven variable rate and the 5-year fixed rate**. If you can't "beat the spread", choosing a variable rate could end up costing more than locking in.

For most mortgage contracts, **a rising variable rate does not increase monthly payments**. However, as interest rates rise, the total interest cost over the term increases, and less of the payment goes toward reducing principal. For example, getting a variable rate that is just 25 basis points below the 5-year fixed rate (instead of 75 basis points as per the breakeven rate) would result in an extra $11,300 in total interest cost over a 5-year term, while leaving the end-of-term balance $3,600 higher.

Even if you can beat the spread, a **fixed-rate loan could be the preferred option if you see additional upside risks to interest**

Chart 1
Interest Rates: No Longer Low for Long



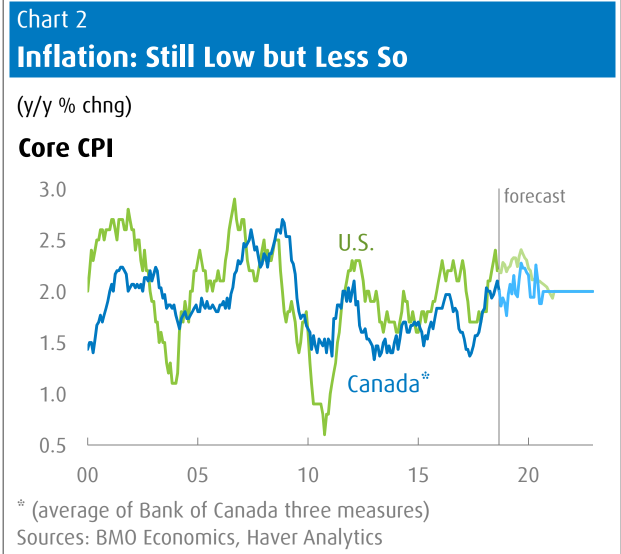
Sources: BMO Economics, Haver Analytics

[1] As of October 26, 2018, the rate on BMO's 5-year Smart Fixed Rate Closed mortgage was 3.69%.

rates. Our forecast for only gradual increases in policy rates rests on the assumption that long-term forces, such as globalization, e-commerce and automation, will largely counter pressures arising from worker shortages, import tariffs and a weak currency to restrain inflation, giving the central bank time to normalize policy before the economy overheats (*Chart 2*). **If we are wrong and inflation jumps, a variable-rate loan could end up costing much more than a fixed-rate loan**. For example, if policy rates average one percentage point above our forecast in the next five years (that is, closer to the top end of the neutral range), then the variable-rate holder would incur an additional $22,700 in interest expense over a 5-year term, while leaving the end-of-term balance $7,100 higher compared with a fixed 3.75% rate. Conversely, if you judge the risks to interest rates to be on the downside—as per most of the past decade—then going variable could be the right choice.

Of course, borrowers have **more options** than just a variable-rate loan or a five-year fixed-rate loan. Locking in for a shorter duration of two or three years instead of five could pay off if the economy hits a rough patch in 2021 in response to past rate increases. The borrower could then take advantage of subsequent lower interest rates to refinance.

Bottom Line: Assuming the Bank of Canada does what we expect it to do, 75 basis points would appear to be the magic number when deciding between a floating and fixed-rate mortgage for five years. If you can't get a variable rate that much lower than the fixed rate, it might make sense to lock in.



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