

Fixed Vs. Variable – The Debate Continues

Death and taxes – those are the only two things you can guarantee in life. Well, many believe you can add rising interest rates to that list now. We are obviously coming out of the lowest rate environment in our history. Clearly they have nowhere to go but up. Well, at least that's what the headlines keep telling us. So the natural reaction for most new homeowners is to race to their banks and lock in those rates while they're still low. But, is that necessarily the best thing to do? Whether to go fixed or variable is one of the most common questions asked of brokers and bankers across the country today. And as much as it would seem that the answer is obvious, it's not that simple.

To truly answer this question, we must first take a look at what people mean when they say 'interest rate'. I'm sure that there were more than a few individuals who were confused by the fact that the Bank of Canada (BOC) raised the Overnight Lending Rate by a quarter point in June and a variety of chartered banks announced that they were lowering their three-and five-year mortgage rates the exact same week. Sounds confusing, doesn't it? How can rates go up and down at the same time? The fact is, there are two different types of rates and they are governed by two separate factors. One is the Prime interest rate and the other is the long-term or fixed rates.

Whenever we hear about the BOC making a change to interest rates, we are referring to the Prime rate, which dictates variable-rate mortgages (VRMs). The BOC focuses on one of two things:

1. Stimulating the economy
2. Maintaining inflation at a level at or near 2%

Following the sub-prime crisis of 2007, the credit-crunch of 2008 and the global recession of 2009, the BOC's primary focus has been stimulating the economy. The best way to stimulate an economy is to get people spending money. And the best way to encourage Canadians to spend money is to make it less expensive to borrow. The result was 'emergency low' interest rates. As such, we have enjoyed almost two years of the prime rate being at a record low of 2.25% – technically as low as it can go. Obviously, by definition, this would mean that there is nowhere to go but up. And as soon as the Canadian economy begins its full recovery and we are threatened with inflation rising above 2%, the central bank will most certainly start to raise rates (as we saw by a quarter point increase on June 1st followed by a second rate increase on July 20, 2010).

The long-term or fixed rates, on the other hand, are governed by the bond markets. Fluctuations and changes in the bond yields will impact the spread or profitability of fixed-rate mortgages for the banks. The bond yields are a factor of the bond market and, like all markets, the bond market will experience daily fluctuations. The markets are definitely influenced by the BOC's decisions, so it would be inaccurate to suggest the two are unrelated – but they will most certainly act independent of each other at any given time. This is what makes the game of rate predictions so interesting.

Let's take a look at the months of April and May 2010, for example. Prior to April, BOC Governor Mark Carney stated that the Prime rate would likely remain unchanged until July of 2010. But this was a conditional promise, based on inflation remaining below 2%. The bond market does what all markets do when factoring in their pricing models – they react to the anticipation of an event more than the actual event itself. Prior to April, the markets were confident in no movement from the Bank in terms of the Prime lending rate, so there was little or no movement in the bond yields. As such, the long-term mortgage rates remained low as well. But the mood of the markets started to shift in April as talk about the Canadian recovery began gaining ground and, suddenly, there was widespread speculation that the BOC

would not wait until July to raise rates and could do so as early as May or June. The bond market reacted by 'pricing in' an anticipated increase to the Prime lending rate. Bond yields were affected and, before we knew it, there was a surge in the cost of long-term funds for Canadians. A lot of people were caught off guard by the sudden rise in rates and fears started to mount about the 'End of Cheap Money'. In the meantime, the BOC did not raise rates in April, so guess what happened to the bond market over the following weeks? It settled down and the long-term rates began to drop again.

As the June 1st BOC rate announcement began to approach, we started seeing the exact same thing happen again. Widespread speculation ('Would they increase rates by a full half point this time??') began to set in and, just as it did in April, the bond market started to price in what they thought the BOC would do. And, again, the five-year mortgage rate at your bank began to rise. Then came the long-awaited news on June 1st that, after over a year-and-a-half of no change, the BOC was going to raise the overnight lending rate (which dictates the price of the Prime rate) by a quarter point. And, as expected, the headlines across the country screamed 'Interest Rates Double', 'The End of Cheap Money'... What they didn't say was that they were referring to the overnight lending rate changing from a quarter point to a half point, which meant that the BOC Prime rate went from an historic low of 2.25% to 2.50% – hardly a shift to expensive money, but a change nonetheless. The more interesting thing to note at the time, though, was not what the headlines said, but how the bond markets reacted. The bond markets had priced in as much as a full half point increase in Prime. So, in fact, the long-term rates had already been pushed higher in the weeks leading up to the BOC decision. Once the decision turned out to be a lower increase than the markets had priced in, guess what happened? That's right – the market adjusted – the cost of borrowing dropped for long-term money and virtually every chartered bank lowered its five-year rate the day after the BOC raised Prime by a quarter point.

So now you know how rates can go up and down at the same time. But this still doesn't answer the question: 'Should I continue to float or lock in while I still can?'

The challenge that most Canadian homeowners have is that they fall into the trap of emotionally reacting to headlines. And all the headlines have been telling us that rates are going up. The obvious assumption or, rather, implied advice, is to lock in your rates while you still can. But is this the best advice? Let's look at some of the facts:

1. The BOC kept the prime rate at 2.25% as an emergency measure to stimulate the economy.
By definition it has to go up.
2. The Prime rate was 6% in January 2007.
3. The Prime rate was 7.5% in May 2000.
4. The 10-year average of the Prime rate is 4.81%.
5. Economists at the Chartered banks predict an average increase of 2.75% in Prime over the next 18 months – which would make it 5.25%.

So it's not really a question of whether the Prime rate is going up – that's a given. The real question is how high and how fast? And these answers are a little trickier to predict. In order to answer this, we have to look at another factor that influences the Prime rate. We already know that the BOC has now shifted its focus to inflation and, as such, will try to maintain inflation at or near the 2% level. Interest rates play a major role in this process. If inflation is below 2%, they will lower rates to stimulate spending. If inflation is above 2%, they will typically raise rates to slow things down. But there is one other factor that the BOC cannot ignore in the process, and that is the Canadian dollar. When the BOC raises interest rates, they inadvertently attract investment into the Canadian dollar, which causes the Loonie to rise. Now, although I personally enjoyed a dollar at par when I took my family down to Disneyland, this is not necessarily a good thing for exporting and manufacturing sectors – which are largely centred in Ontario and Quebec. As such, a dollar that

is too strong will likely slow down the economic recovery process and that will lessen the need for the BOC to focus on inflation. So as you can see, the job of predicting rates is not as straightforward as it first appears.

So let's take all this information into consideration and have another look at whether we should continue floating or lock in our interest rates. Again, let's look at the facts:

1. We know the Prime rate is going up.
2. We know that the experts are predicting an increase of 2.75% over the next year-and-a-half.
3. That means that the Prime rate could be as high as 5.25% by 2012.
4. In order for this to happen, the economy will have to gather significant steam and the Canadian dollar cannot get too strong in the process.

Now I can go on and on about my own predictions and assumptions regarding the economic recovery and impact of the ongoing debt crisis in Europe, but for the sake of argument, let's assume that the Prime rate will go as high as 6% over the next five years and that a first-time homebuyer was looking at getting a new mortgage on their first home purchase. Their choice was to take a VRM at Prime minus 0.50% or go with the prevailing five-year rate of 4.5%. Again, let's assume that this was a \$300,000 mortgage with a 35-year amortization. I worked out the following calculations prior to the June 1st rate increase and I think you would be surprised to see what I found.

We know that taking a VRM of Prime minus 0.50% prior to June 1st, 2010 would make your introductory interest rate 1.75% (2.25% - 0.50%). This is obviously much less expensive than the existing five-year rate that the client was comparing at the time (4.5%). We also know that the Prime rate is going up (assuming Prime will increase to 6% over five years) and the wonderful savings we enjoy upfront will not last. So now we are left with a very interesting question: If you take the Prime - 0.5% today, and the Prime rate rises to 6% over the next five years, would you be better off simply taking the 4.5% fixed rate today and sleeping easy?

I did some math and added a little twist and here's what I found:

First, here's the little twist. I calculated the payment on a new mortgage of \$300,000 with a 35-year amortization and the monthly payment came to \$1,412.05 on a five-year mortgage @ 4.5%. If, on the other hand, you chose to take the current VRM @ Prime - 0.5%, your payment would be \$954.78. So, in order to compare apples to apples, I decided to compare what would happen if you chose the VRM but increased your monthly payments to match that which you would have paid if you had taken the five-year fixed rate. The result was quite surprising.

Of course, to do this we had to make a few assumptions, the main one being that the Prime rate would rise by 0.75% every year over the next five years and that this would be a smooth increase in quarter point intervals. No one would be able to complain that they could not afford to increase their VRM payments, because they were already contemplating switching to the five-year rate. The difference between \$1,412.05 and \$954.78 is \$457.27 in the beginning. This difference is applied right to the principal balance and, therefore, accelerates the principal pay down. I know, theoretically, that accelerating your payments would pay off the principal faster but even I was surprised by just how much. The net result of applying this strategy over a five-year period was that the consumer who took Prime - 0.5% but made the exact same payments as the consumer who chose a fixed rate of 4.5% paid an additional \$16,608.17 off of their principle balance by the end of their five-year term even though the Prime rate was as high as 6% (which arguably is not likely).

So what is the answer to the most common question on mortgages in Canada today? Should you take the variable or

lock in your mortgage? The answer depends on what you believe. If you believe that Canada's economic recovery will be somewhat muted and the Prime rate will not go beyond 6%, then you will definitely save more money by taking the VRM today, but increasing your monthly payment to match that which you would be paying if you had chosen the five-year fixed rate. Doing so will result in two things:

1. You will adjust your family budget to the inevitable point at which rates do increase and avoid payment shock;
and
2. You will accelerate the rate at which you reduce your principal balance so that when your mortgage does come up for renewal and rates are higher, you will have paid off more of your mortgage and you will be renewing with a lower principal balance in a higher rate environment.

If, on the other hand, you believe that rates could skyrocket and that we are not impervious to double-digit interest rates (perhaps you lived through the early 1980s), then by all means locking in today is the smart choice for you. Today's long-term rates are still very much at historic lows and you can definitely not be faulted for wanting to play it safe by locking in. Like I always say, the definition of a bad investment is the one that keeps you up at night. So if I receive an email from you asking me whether you should lock in or float and the time stamp on the email is 3am, my answer will be an emphatic "Lock in right now".

At the end of the day, rates have moved upwards and they will continue to do so but, either way, they are still at historical lows. The truth is, there is no right or wrong answer. In the end, it really comes down to one last question:

What do you believe?

The interest rate analysis for this article was done using a formula that was created specifically for this purpose and the results are for illustrative purposes only. Any and all of the assumptions can be changed to match your personal situation. Feel free to send me an email (peter@peterkinch.com) and I will be able to run a personal analysis based on your assumptions.

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