December 2011

BRITISH COLUMBIA REAL ESTATE ASSOCIATION

Mortgage Rate Forecast

EURO-CRISIS LOOMS OVER OUTLOOK

HIGHLIGHTS

- Global risk-aversion is keeping Canadian bond yields near historic lows
- Euro-crisis remains the key risk to economic growth
- The Bank of Canada will be in a holding pattern for much of 2012

Mortgage Rate Forecast								
	2011				2012			
Term	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F
1-Year	3.50	3.62	3.50	3.50	3.50	3.60	3.60	3.85
5-Year	5.34	5.56	5.35	5.29	5.30	5.50	5.60	5.60

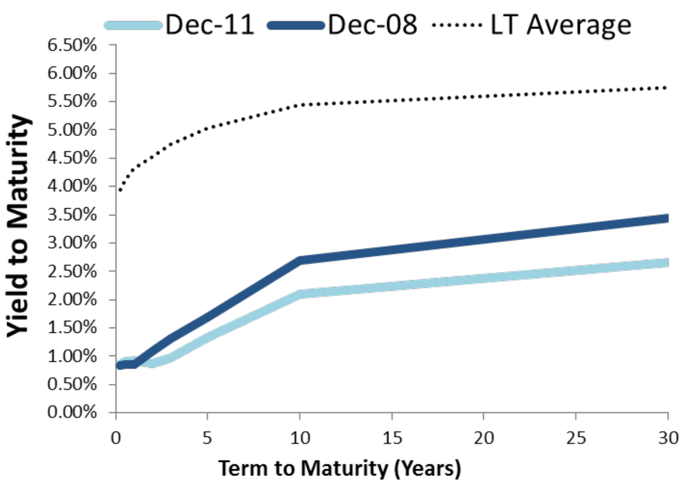
Source: BCREA, Bank of Canada

Mortgage Rate Outlook

The interminable European sovereign debt crisis is keeping bond yields near historic lows, even below yields observed at the height of the 2008 financial crisis. Low yields can primarily be explained by two factors.

First, market expectations that weak growth and muted inflation in 2012 will keep central banks sidelined for the foreseeable future are being priced into longer-dated maturities.

Bond Yields Have Fallen Below 2008 Financial Crisis Lows



Note: Bank of Canada

Second, and most important, uncertainty about the future of the Euro has pushed demand for safe assets out of European sovereign debt, even Germany is struggling to sell its bonds, creating a disproportionate amount of demand for US and Canadian debt. Therefore, until global investors feel safe buying euro-denominated sovereign debt, and until economic growth returns to a sustainable path, bond yields will stay near historically low levels.

Mortgage rates in the fourth quarter have evolved as forecast in our previous release. The five-year fixed rate briefly touched its historical low of 5.19 per cent before rising to 5.29 per cent in spite of historically low government bond rates. A shift in consumer preferences towards low variable rate mortgages is forcing lenders to slash discounts on variable rate products in order to shore up eroding profitability. As a result, most variable rate mortgages are now being offered at just 10 to 15 basis points below prime.

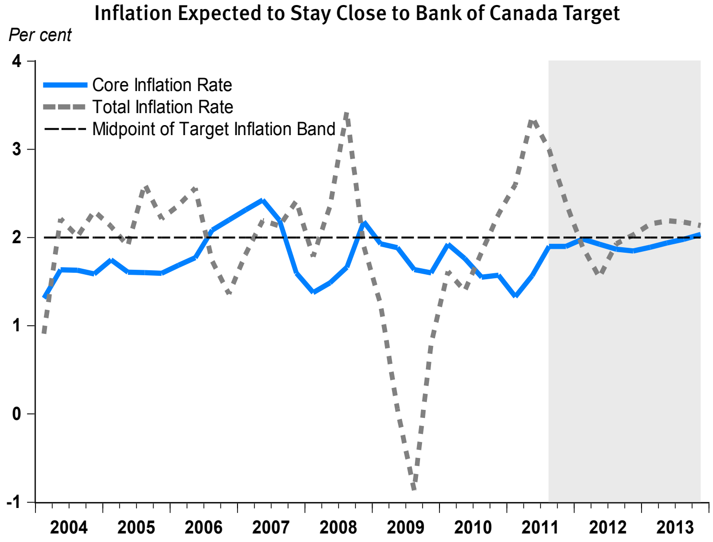
Our forecast for the remainder of 2011 assumes that the five-year fixed rate stays at its current level of 5.29 per cent while the one year remains at 3.5 per cent. We expect that the five-year rate will remain moored to 5.29 per cent for the first half of 2012 as the global economy weathers a difficult patch.

Assuming the Eurozone can inspire investor confidence with a credible, if not definitive, solution to its problems, bond yields should start moving off historically low levels in 2012. Our baseline forecast is for the five-year fixed rate to rise gradually to a still very low 5.6 per cent and the one-year to reach 3.85 per cent by the end of 2012.

Growth and Inflation Outlook

The Canadian economy rebounded strongly last quarter, surging 3.5 per cent following a 0.5 per cent contraction in the second quarter. However, economic growth was not broad-based and mainly reflected a rebound in exports following global supply-chain disruptions in the second quarter. Indeed, growth in domestic demand from consumers and businesses revealed some underlying weakness in the economy. Consumer spending in particular may only modestly contribute to growth over the next few quarters as tepid job growth and high household debt burdens dampen consumption. Moreover, the uncertain future of the Euro-zone and associated risk-aversion may constrain business investment and international trade.

Inflation Expected to Stay Close to Bank of Canada Target



Source: Bank of Canada, Statistics Canada, BCREA Economics

Given current headwinds in the economy, we are forecasting real GDP growth of just 2.4 per cent this year, falling to 2 per cent in 2012 and then rising to 3 per cent in 2013 as the global economy recovers and financial markets settle.

We anticipate that total CPI inflation will continue its glide-path towards 2 per cent from its current levels above 3 per cent as food and energy price inflation abate. Core inflation will remain well anchored to the Bank of Canada's 2 per cent target.

Interest Rate Outlook

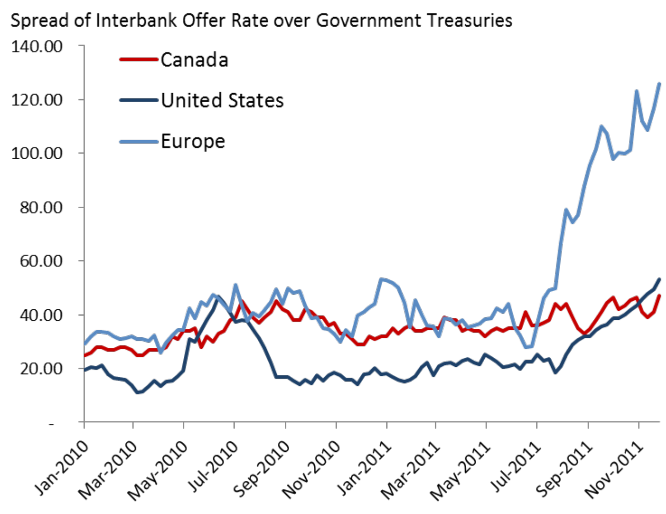
Market expectations of the Bank of Canada's overnight rate evolved dramatically in 2011 with expectations turning sharply from rate tightening to rate cutting midway through the year. Our view is that the Bank of Canada is unlikely to move on interest rates without a serious escalation of the Euro-zone crisis. That is, it will take a significant event, such as a default by a core-Euro country or the imminent break-up of the Eurozone to get the Bank of Canada to lower interest rates. While the Euro-crisis remains at an uneasy distance from a solution, these outcomes are still improbable.

If the Bank of Canada is ultimately forced to cut rates, the most likely cause will be frozen interbank lending akin to the 2008 financial crisis. As of yet, increasingly severe strains in the European banking sector have not spilled over to North American and interbank lending markets remain liquid.

Even without an escalation of the Euro-crisis, 2012 will be a challenging year in the global economy. The uncertainty as well as imposed austerity in Europe will likely cause much of the EU to dip into a recession. Moreover, the fiscal drag from fading stimulus and cuts to government spending will subtract from growth in the United States.

Given these challenges, our current forecast is for the Bank of Canada to stay on the sidelines for much of 2012 with the possibility of a rate increase coming towards the end of the year. This assumes that the economy accelerates in the second half of 2012 and that core inflation remains subdued.

Strains in Banking System Contained to Europe So Far



Source: Bloomberg, Bank of Canada

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