Why to keep an eye on the bond markets
By Greg Holohan, CFP (November 2007)

Summary: Why mortgage advisors need to keep their eye on the bond markets

There is enough to do for the average mortgage advisor in a given day without having to add the state of the Canadian bond markets to your plate. Yet the truth of the matter is that a quick refresher on how the bond markets affect mortgage rates might be very helpful in helping clients or prospects understand the common question: "should I go fixed or variable?"

How and why mortgages rates fluctuate has a lot to do with the way that mortgage lenders fund their portfolio of loans.

As you well know, variable rate loans are linked to prime rates, which are directly influenced by The Bank of Canada. Our central bank sets its target for the overnight lending rate in order to affect the various elements of the national economy relating to its monetary policy (such as inflation, the dollar, etc.).

A lender funding a portfolio of variable rate mortgages will first attempt to match these mortgage assets against a portfolio of variable rate deposits, attempting to lock in the spread over the duration of the loan. In many cases, the source of funds is either savings deposits or Banker's Acceptances, which are a type of short-term investment issued by financial institutions. To help it offset any risks associated with mismatched loan and deposit schedules, the Treasury arms of banks and other lenders will often enter into complicated swap arrangements, which seek to accomplish closer matching.

The end result is that since the lenders' source of funds will fluctuate based on the actual decisions made by the Bank of Canada, so too will variable mortgage rates.

Fixed rate mortgages are an entirely different story.

Financial institutions obviously like the idea of locking in a spread between the loans they grants and the deposits they use to fund these loans. The ideal source of funds for longer-term fixed rate loans is deposits like GICs (which also have a fixed rate over a fixed term).

However, investment deposits rates have a different competitive pressure – bond yields. An investor looking determine what yield he is willing to accept on, say, a corporate bond would start with an understanding of the lowest risk equivalent investment. So investors will first look at the Government of Canada bond yields as their benchmark.

The yield on a bond can be thought of as the 'all-in' interest rate – how much the investor would earn, expressed as an annual percentage, if the investment is purchased at current prices and held to maturity. See the "Bond Basics" section for more information.

Bond yields are volatile and fluctuate in response to political and economic events, both domestically and abroad. Just like in the stock market, where investors bid for shares of a certain company based on their expectations of future growth and profitability, bond investors also negotiate prices based on their expectations. Economic factors such as inflation, unemployment, and currency affect bond prices, as does the risk associated with default.

Therefore, when setting fixed term mortgage rates, the financial institutions need to have an eye on the bond market, since the lender will ultimately be borrowing money from investors to loan to its mortgage borrowers. When the lender sees what it views as fundamental changes in bond prices, it will act to protect its spread between loan and deposit. Practically speaking, financial institutions tend to absorb the minor fluctuations in bond yields in order to offer a more steady rate environment for mortgage advisors and their clients. (Can you imagine the chaos if fixed mortgage rates changed hourly?)

In a nutshell, what you need to know is that higher bond yields will increase the lender's cost of funds, which will lead to higher long-term fixed rates. Lower bond yields tend to lead to lower long-term mortgage rates.

Part of the confusion for mortgage advisors lies in the fact that while fixed and variable interest rates certainly can move similarly, changes in rates are motivated by different factors and therefore do not necessarily move in unison. Bond yields shift as a result of revised expectations by investors in the marketplace, generally as a result of newly released data or information. The overnight lending rate will change as a result of a decision by the Bank of Canada. While the central bank can (and does) influence longer-term bond prices, it has no direct control over them. If you want to keep an eye on where bond yields – and therefore fixed rate mortgages – may be going, watch for economic releases regarding major indicators including inflation, unemployment, and trade data, as well as general commentary from the Bank of Canada.

Currently, the expectation from Scotia Economics as of early November is for prime rates to fall to 5.75% by the second quarter of 2008 and for long-term bond yields to rise by approximately 10-30 basis points over the same period. (Please feel free to contact us for recent updates.) Whether this trend continues will, as you now know, depend on a host of factors relating to expectations of bond investors and the Bank of Canada's target for the overnight lending rates.

So to return to the original question: how should you answer your clients question about choosing a fixed or variable rate mortgage? Your more savvy borrowers may be interested in your perspective on how bond yields affect fixed term borrowing rates, but many clients will simply need to sort out their own ability and / or willingness to withstand fluctuations in their payments. So truly, only you and your clients are equipped to answer this question. However, perhaps now you would be right to answer "which ones?" when asked, "where do you think rates going?"

Greg Holohan, CFP, is an Investment Executive with ScotiaMcLeod and specializes in helping mortgage professionals maximize and protect their wealth. Greg can be reached at greg_holohan@scotiamcleod.com or 1.800.447.5854 ext. 8238.

Bond Basics

It can be challenging for some investors to understand the difference between bond yields and coupon rates. Perhaps the easiest way to address the topic is through a fictitious example.

Suppose ABC Corp. decides to borrow money from the market to finance a new factory. ABC Corp. would like to pay back the loan over five years. Based on the Government of Canada bond rates, ABC Corp. determines that it would need to offer a 7.00% coupon rate to entice investors, since investors want to be sure that the interest rate is sufficiently high to justify the higher risk of ABC Corp. defaulting on its loan, compared with a default from the Government of Canada.

Mr. Jones decides to loan $25,000 of his money to ABC Corp. (although he probably thinks of it as investing in a bond), in return for annual coupon payments of 7.00% interest. One year later, Mr. Jones decides that he wants to buy a car and therefore needs to sell his bond. However, in the meantime, interest rates have gone up. XYZ Inc., a competitor to ABC Corp, found that when it turned to the market to borrow money, it would have to pay 8.00% over four years.

At the same time, Mrs. Smith is interesting in investing in a bond. When faced with the choice between investing in a XYZ Inc. bond and receiving 8.00% over four years, or purchasing Mr. Jones' bond, which has four years remaining at 7.00% interest, the choice for Mrs. Smith is obvious!

This leaves Mr. Jones in a tough spot. If he holds his bond for four more years, he will get his money back from ABC Corp. But since he needs the money now, he has to find a way to sell the investment so that it's attractive for Mrs. Smith. As a result, Mr. Jones offers to reduce the amount of money Mrs. Smith has to pay, to the point where Mrs. Smith is indifferent between her two options.

If Mrs. Smith pays $24,137.50 (or $96.55 for every $100) for the ABC Corp. bond, she will continue to receive 7.00% interest payments; however, she will also earn the appreciation between her purchase price and the ultimate maturity value of $25,000. In this case, it is possible to calculate that her total rate of return would be exactly equal to 8.00%.

The calculation used to determine the "all-in" rate of return is known as the "yield" and is the true interest rate on a bond.