ECONOMIC VIEWPOINT

Outlook for Mortgage Rates

Despite the Economic Uncertainty, the Odds of Another Monetary Policy Rate Cut Are Low

By Hendrix Vachon, Principal Economist

The Bank of Canada (BoC) kept the policy interest rate at 2.25% last week, and it looks like we can expect it to hold steady for some time. In total, the Bank cut its rate by 100 basis points in 2025 after lowering it by 175 basis points in 2024. While there is still a great deal of economic uncertainty, it's not enough to justify further monetary easing, and the BoC still considers inflation risks to be overly high. We expect mortgage rates to remain basically stable in 2026, after two years of sizeable cuts. The recent enthusiasm for variable rate mortgages may wane in 2026, especially if borrowers start anticipating new rate increases. Borrowers may still continue to prefer fixed rate mortgages with terms of less than 5 years.

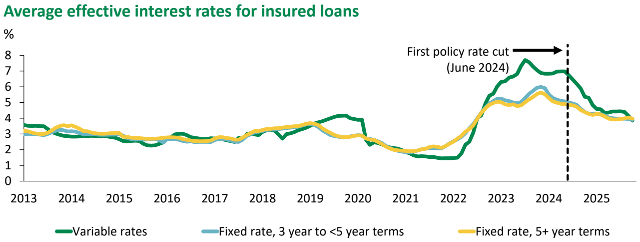
Variable Rates Have Dropped Significantly Since June 2024

Since the BoC's initial rate cut in June 2024, variable mortgage rates have fallen more than fixed mortgage rates (graph 1). Variable rates on new insured loans were around 7.00% in June 2024 and are now slightly below 4.00%. In contrast, fixed rates for loans with terms between 3 and 5 years have only fallen a bit more than 100 basis points. Fixed rates for terms over 5 years have gone down even less.

Variable rates are based on the prime rate set by financial institutions, which usually moves in step with the BoC's overnight rate (graph 2 on page 2). Most borrowers are able to negotiate a variable rate that's lower than the prime rate. For the last 10 years, the average difference was around 30 basis points. Once the borrower's rate has been agreed upon, that spread stays the same for the duration of the term. The variable rate only changes if the prime rate does. Over the past year or so, the difference between the prime rate and the average effective variable rate for new insured loans has been greater than 50 basis points, meaning that borrowers benefit from financing conditions that are slightly more favourable than usual for variable rates. This helped variable rates to fall slightly more than policy interest rates.

Graph 1
Variable Rates Have Fallen More Since June 2024

Average effective interest rates for insured loans



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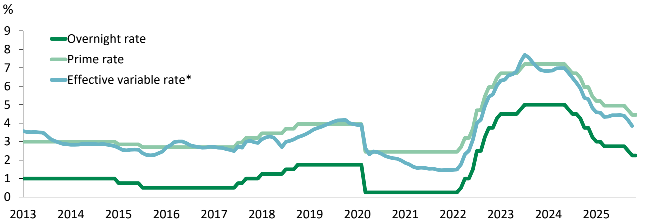
Fixed Rates Did Not Benefit from Similarly Favourable Conditions

Fixed interest rates tend to track government bond yields (graph 3 on page 2), but those yields did not move as much as key rates. For example, the 5-year Canadian government bond yield was holding near 3.7% in May 2024, then fell about 100 basis points lower in 2025, but had climbed back to around 3.00% in December.

Graph 2
The Effective Variable Rate Has Been Falling in Step with the Prime Rate and the Policy Interest Rate Since June 2024

Overnight rate and effective variable rate



* Average variable mortgage rates for new insured loans.
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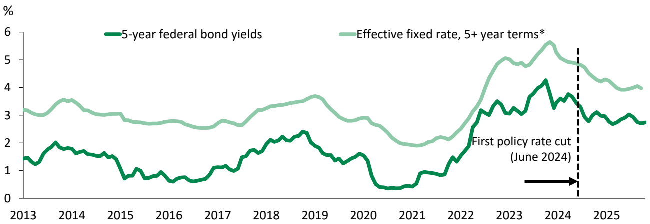
Graph 3
Fixed Mortgage Rates Tend to Track Bond Yields

Mortgage rates and bond yields



* Average fixed mortgage rates for new insured loans with terms of 5 years or more.
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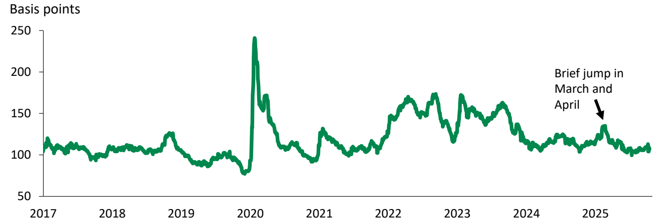
The bond market reacts to policy rate announcements, but it also tends to move in anticipation of future monetary policy decisions. Right now, bond yields are being pushed higher by a variety of factors, including the Bank's decision to hold rates steady and some recent economic data that came in better than expected. Other factors can also influence their trajectory, such as inflation, public deficits, government risk ratings and international financial conditions. Yields may also move to reflect savings and credit flows in the economy. Excess savings will tend to lower bond yields, but overly strong demand for credit will have the opposite effect.

The spread between sovereign bond yields and mortgage rates boils down to financial institutions' borrowing costs and margins. Some of the money that financial institutions use for lending comes from customer deposits, but it's not enough. Financial institutions also need to borrow money on the financial markets, and the interest they pay on these loans is higher than government bond yields. These funding costs aren't fixed over time. Instead, they generally rise and fall with risk level, as perceived by the investors who lend money to financial institutions. Funding costs spiked in March and April, when the Trump administration announced a series of tariffs. But later, as some of those tariffs were reduced and the global economy proved to be rather resilient, market risk premiums settled back down (graph 4).

Graph 4
Funding Costs for Financial Institutions Rose Temporarily Last Spring

Canada – Spread between federal and financial sector bond yields



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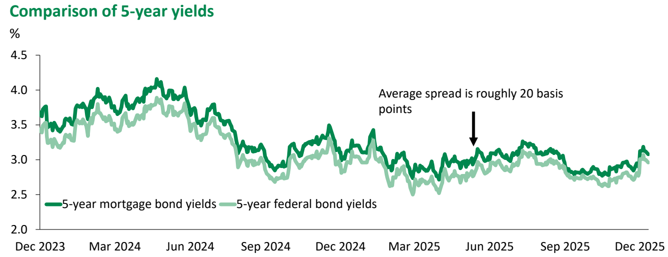
Another source of funds for financial institutions is securitization, a practice that involves pooling existing mortgages (typically insured ones) and transforming them into mortgage-backed securities. These securities can then be sold to investors or to the Canada Housing Trust, a CMHC entity that will, in exchange, issue mortgage bonds on the market. On average, 5-year mortgage yields are about 20 points higher than Canadian government bond yields, but the spread has been somewhat narrower recently (graph 5). In its November budget, the Canadian government announced that the annual issuance limit for Canada Mortgage Bonds would be rising from $60B to $80B. Through this channel, financial institutions are able to obtain funds at a lower cost than in the traditional market, even after accounting for the other costs associated with securitization. These lower financing costs mean that they're able to offer more competitive mortgage rates for insured mortgages (graph 6 on page 3).

Graph 5
Mortgage Bond Yields Are Very Close to Federal Bond Yields

Comparison of 5-year yields



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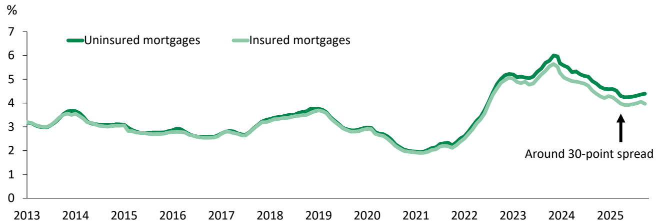
Graph 6
Financing Conditions Are More Favourable for Insured Mortgages

Average fixed rates, terms of 5+ years



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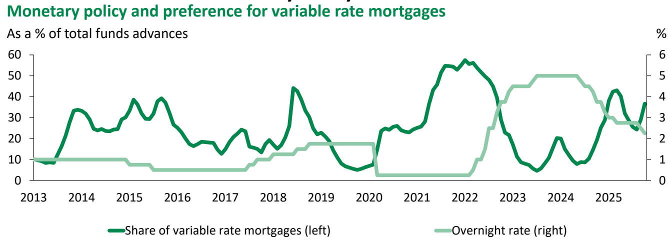
The Share of Variable Rate Mortgages Went Up

Borrower preference for variable interest rates is heavily influenced by monetary policy rate movements. When the policy rate went up in 2022 and 2023, very few borrowers opted for new variable rate mortgages. Variable rates remain riskier than fixed rates, and borrowers are naturally more cautious when interest rates go up. However, variable rates had been gaining in popularity from 2024 onward, after the BoC's initial rate cut (graph 7).

Graph 7
In Recent Years, the Popularity of Variable Rate Mortgages Has Reflected the Path of Monetary Policy
Monetary policy and preference for variable rate mortgages



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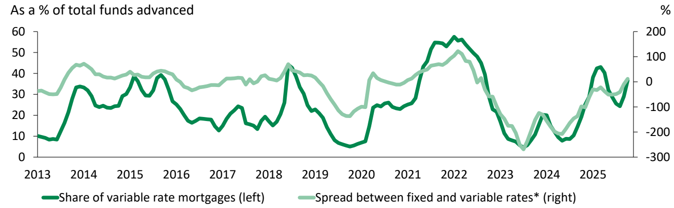
Another major factor influencing borrower preference for variable rates is their competitiveness. As mentioned earlier, variable rates have fallen significantly, and the rates negotiated for these mortgages are currently a bit more generous than the historical average. But even more importantly, borrower preference for variable rates will be influenced by their difference with fixed rates (graph 8). In 2023 and most of 2024, this spread made variable rate mortgages less attractive to borrowers, but it moved closer to its historical average in 2025.

Graph 8
Variable Rates Are Popular When They're Competitive with Fixed Rates

Preference for variable rates



* For new insured loans. Fixed rate, 5+ year terms.
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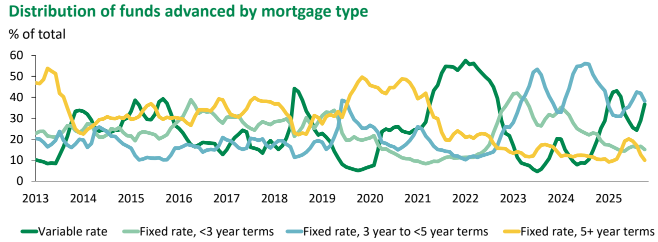
5-Year Fixed-Term Mortgages Remain Rather Unpopular

Over the last few years, it's been surprising to see how the traditional, 5-year fixed rate mortgage has dropped in popularity, even when variable rate mortgages were less attractive. According to aggregate data from the BoC, before the pandemic, about 30% of new financing was issued at a fixed rate with a term of 5 years or more. Between 2022 and 2025, that number hovered around 15%. The most popular mortgages right now are fixed rate mortgages with terms between 3 and 5 years (graph 9). Before the pandemic, mortgages with these terms typically accounted for less than 20% of all mortgages, before jumping above 50% in 2024. Right now, they're still near 40%.

Graph 9
Fixed Rates with Terms Between 3 Years and 5 Years Are the Most Popular

Distribution of funds advanced by mortgage type



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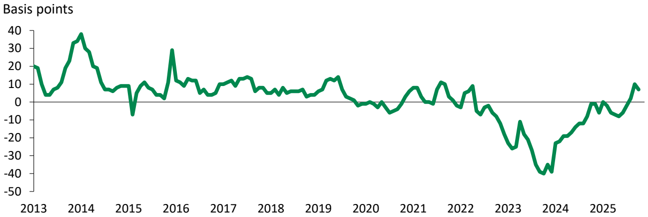
And yet, in recent years, the interest rates for shorter-term mortgages haven't been better than those for 5-year terms, though the yield curve was inverted for a long time. In 2023, rates for 5-year fixed rate mortgages were on average 40 basis points lower than rates for mortgages with shorter terms (graph 10 on page 4). Borrowers seem to be opting for shorter terms in the hope that rates will be lower the next time they renew.

Graph 10
Fixed Rate Mortgages with Terms of 5 Years or More Remained Unpopular, Even Though Rates Were Lower in 2023 and 2024
Difference between the average rate for terms of 5 years or more and the average rate for terms of 3–5 years*



* Fixed rates for new insured loans.
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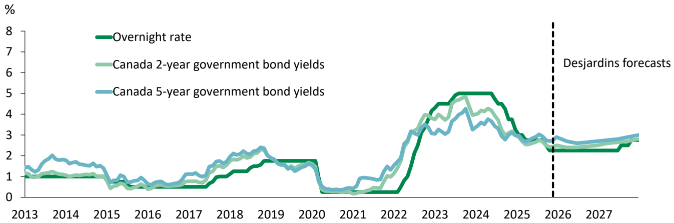
Graph 11
Few Rate Changes Are Expected in 2026, but a Slight Upward Trend Could Take Hold in 2027
Interest rates in Canada



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The Outlooks for Variable Rates Have Darkened

For 2026, the outlook is currently less favourable for variable rates. With the BoC's official pause on rate cuts, variable interest rates will remain stable in the quarters ahead. They could even rise in the coming years if the BoC announces a policy rate hike, however small it may be. The long-term neutral monetary policy rate is estimated to be around 2.75%, which suggests that variable interest rates could go up around 50 basis points from their current level. Furthermore, our forecasts call for two 25-basis-point increases to the policy interest rate in 2027. However, in an alternative scenario, the policy rate could go down again if the economy proves to be weaker than expected. There is still a great deal of uncertainty about the future path of the economy and interest rates.

There's also a chance that the discounts currently offered on variable rate mortgages will decrease, bringing them closer to the historical average. This normalization would imply an increase of about 20 basis points, but that wouldn't affect borrowers who have already taken out a variable rate mortgage with a higher discount. That discount stays the same throughout the borrower's term.

No Big Increases in Sight for Fixed Rates

Recently, the bond market has been more volatile due to the BoC's decision to pause interest rate cuts and better-than-expected economic data. We expect this rebound to be short-lived and bond yields to return to their September and October levels (graph 11). However, we could see a slight upward trend later in the year, as we near 2027 and a possible policy rate increase. Right now, the market anticipates a 25-basis-point hike by the end of 2026, which we think is too early.

Inflation data should strongly influence bond yields in the next few months. The Bank of Canada is currently worried that US tariffs could add to inflationary pressures by disrupting supply chains or raising certain input costs for Canadian businesses. However, we're not seeing much of an impact thus far, and we believe these inflation fears will ease in the first half of 2026.

The other potential sources of volatility for fixed rates will be financial market risk premiums and the rate reductions offered to borrowers, particularly for insured loans. In terms of risk premiums, our baseline scenario doesn't include any notable or lasting changes. Nevertheless, there's still a chance that risk premiums spike, as they did in March and April. The reductions on insured loans will likely remain the same. That being said, when the federal government announced the upcoming increase in the mortgage bond issuance limit, it did not announce a proportional increase to its own purchases of these bonds. In recent years, the government has purchased around half of all new mortgage bonds issued to help maintain a low interest rate spread with government bonds. What's more, the $20B increase in the issuance limit specifically targets mortgages for the multi-unit rental segment, not the entire mortgage market. This announcement could therefore have little impact on personal mortgage rates.

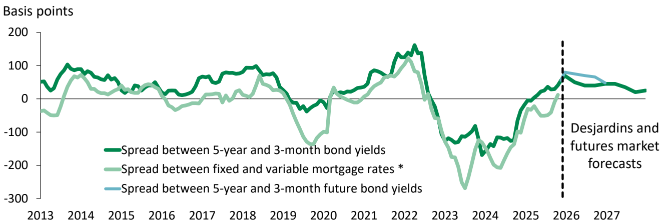
Variable Rate Mortgages May Be Less Attractive, But This Doesn't Mean Borrowers Will Flock to 5-Year Fixed Rate Mortgages

Our forecast is for mortgage rates to stabilize in 2026 after falling significantly over the last two years. There could be some movement, but odds are interest rate volatility will be much weaker than in previous years.

The recent enthusiasm for variable rate mortgages may wane in 2026, especially if borrowers anticipate monetary policy rate increases in the near future. For now, we expect two 25-basis-point hikes in 2027. The financial markets are currently positioning themselves for a rate hike by the end of 2026. However, borrower preference for fixed or variable interest rates will also be dictated by the difference between these rates.

Changes to the yield curve can give us a glimpse of how the spread may evolve between fixed and variable mortgage rates. We don't expect the bond curve to steepen significantly, which would be in line with a narrower spread between fixed rates and variable rates (graph 12). However, the futures market for Canadian bonds is instead expecting a steeper yield curve in the next few months. We're more optimistic about the future course of inflation in Canada. We believe that inflation fears will ease in the coming months, bringing market expectations closer to ours. Less rosy data on economic growth and employment in Canada should also help bring bond yields closer to their September and October levels.

Graph 12
Changes in the Bond Market Curve Effectively Mirror the Spread Between Fixed and Variable Rates
Mortgage rates and bond yields



* For new insured loans. Fixed rate mortgage with terms of 5+ years.
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If variable rate mortgages become less popular, that doesn't necessarily mean that borrowers will flock to traditional 5-year fixed rate mortgages. The preference for shorter terms has been clear in recent years, even when 5-year fixed rates were lower. Given that the spread between different fixed rates is now small—and even slightly to the advantage of rates with a shorter term—it seems likely that shorter terms will remain popular.