Mortgage De Ja Vu, All over Again.

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Here we go, again. The Canadian economy is generating more jobs, a handful of Canadian banks raise their posted mortgage rates and out march the modern-day prophets of all things financial, advising you to quickly lock-in your mortgage before the bank doors slam shut. In fact, say the Jeremiahs and Isaiahs, hurry-up and buy a house before mortgage rates escape and you are locked-out of the housing market for ever.

But, is this really a certainty?

This is not the first time that mortgage rates are on the brink of blooming, and then fade away a few months later. This has happened more than a handful of times in the last decade. The headlines are often the same. A month or two of increasing mortgage rates, the public is urged to act now, and then a few months later something unforeseen enters the horizon; not every time, but many times. The last occasion this happened was just over a year ago. The posted five-year mortgage rate in March 2010 went from 4.70% to 5.15% in April, and then to 5.30% by May. The advice was clear: lock-in. But then, by October 2010 they were back to 4.50%. The economy sputtered, Greece and Spain hit the headlines and the rest was history.

In fact, to misquote the brilliantly acerbic Economics Nobel Laureate, Professor Paul Samuelson from MIT, mortgage pundits have accurately predicted 25 of the last 10 mortgage rate increases.

Now, please don't get me wrong. Interest rates are abnormally low – especially at the short end of the yield curve – and the Bank of Canada has pledged to bring these back to normal, eventually. But, that is a far cry from advocating that you lock-in your mortgage -- which is actually driven by long-term bond market rates -- or heaven forbid using this as an excuse to buy a house before it is too late.

My unease with acting on these recommendations is not that I mistrust their crystal ball. My bigger concern is about relevance and context of this advice. I call it the fallacy of "carve-out thinking." It stems from the misguided notion that modern-day personal financial problems *can be viewed and solved in isolation.*

Remember that your mortgage payments are just one financial component on your personal balance sheet. If you are like most Canadians, you probably have RRSPs, TFSAs taxable-accounts, pensions, jobs that are sensitive, cottages and rental properties, and a very large portfolio of debts – and every single one of these holdings is sensitive to interest rates, often in different ways.

Just as one example, if long-term interest rates move up quickly and substantially then any bonds or fixed income investment you are holding will get hit and fall in value – possibly by a lot. A big and

sudden rise in interest rates won’t be kind to the real estate market either. There will be many spillover side effects.

Reacting to this “fear” by locking-in your mortgage is akin to preparing for an ice-and-snow storm by only salting your driveway, but forgetting to close your windows. Sure, that helps, but if you really believe that storm is on its way, there are many other – possibly more important -- things you should be doing to prepare.

I use the storm analogy deliberately. Too many Canadians think that TV economists – in contrast to Ivory Tower economists -- can predict the next financial storm (e.g. rising mortgage rates), just like the meteorologists predict the weather. More often than not, they end-up telling you what happened yesterday, quite accurately I might add. Hey, and if you think the Weather Chanel gets it wrong, then you certainly won’t like BNN’s track record.

Ok, you say, I get it. Predicating interest rate futures is hard and we all have complicated financial lives: but what should I do with my mortgage and housing? That’s a legitimate question, no?

Well, here is the best guidance I can offer.

First of all, please don’t rush into home ownership because you are convinced that mortgage rates are headed-up and you will never see 5% again. Hey, if you think you’re an interest rate forecasting guru then buy some exchange-traded put options on bonds, or buy an inverse bond ETF. You can benefit from rising rates, without getting into the real estate market.

If you already own a home, but your tenure as has only recently started, then you probably have a very large mortgage outstanding relative to the value of your house. So, if you have little if any financial assets other than your lovely (but likely unfurnished) house, then I urge you to lock-in your mortgage – and for as long as possible. You probably should have never “floated” to begin with and are now facing the probable risk that real estate prices decline and interest rates increase. Add to this risk caldron the possibility of job loss, disability or other macro factors, and you are the ideal candidate for a fixed rate mortgage. The last thing you want to be doing is trying to renew your mortgage in a year or two from now, if rates increase and possibly the appraised value of your house has declined by 10% or more.

Note. This has absolutely nothing to do with predicting the future and everything to do with holistic risk management. I don’t know what will happened tomorrow, but your personal balance sheet can’t handle the stress.

At the other extreme, if your mortgage payments are only a small fraction of your monthly expenses, and you have built-up substantial equity in your home, and – this is key – you have a diversified portfolio of financial assets, like stocks and bond inside your RRSP and other accounts, then my advice to you is very different.

If you are concerned that interest rates are on their way up, then perhaps you should lighten-up on the bonds in your investment portfolio. Remember, if mortgage rates increase, this is because long-term interest rates have gone-up and the longer the duration of your bonds, the greater are your losses. I say,

lighten-up on bonds. If the prognostications prove correct and rates go up, then yes you will pay more on the mortgage but you were spared the pain in your RRSP. On the other hand, if rates stay around their current levels, then you win. Remember, locking-in will likely involve paying more than what you are paying right now, often by 1% to 2% more. That is insurance.

The point in all of this, of course, is to think more holistically about all the financial assets – and risk exposures -- on your personal balance sheet. At the very least, please resist the urge to outguess your local bond trader. They are two steps ahead of you and the Canadian public, and would have bid-up interest rates if they were absolutely convinced they belong there today.

Ah yes, for those of you who are curious about my own mortgage – I'm still floating. No, I'm not a prophet. I am just very risk tolerant and strive to minimize paying for unnecessary insurance.

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