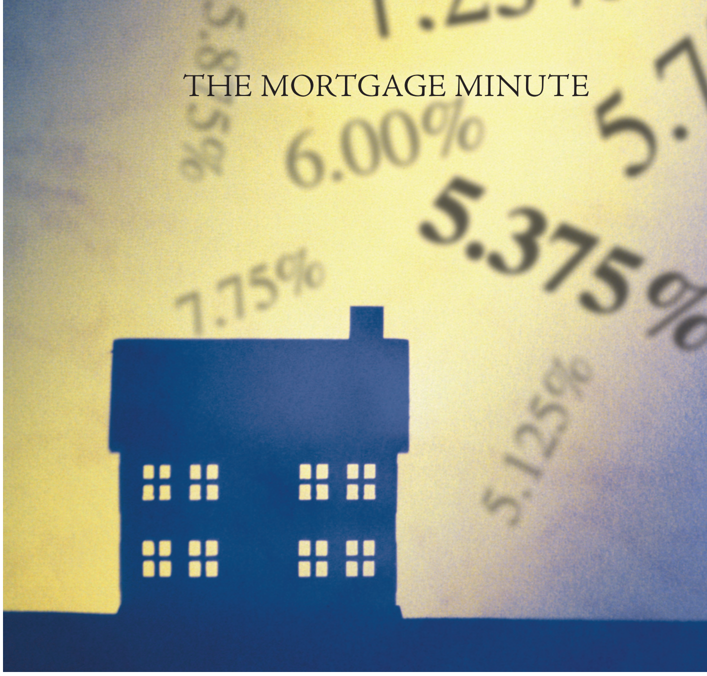

RISING INTEREST RATES
SHOULD YOU LOCK IN?

By Peter Kinch

With the recent upswing in interest rates, those who are currently in a variable rate mortgage may consider locking in at the best five-year rate available. And if you are a new homebuyer (especially first-timers), the prevailing logic is to choose a long-term fixed-rate mortgage for the comfort and security that it provides.

The argument from those who prefer floating with the prime rate is that anyone who has taken the variable-rate mortgage over the fixed-rate mortgage has been further ahead 88 per cent of the time over the last 20 to 30 years. This begs the question: now that we are coming out of historically low rates as a result of the global recession, are we now in that "12-per-cent" period of time where it makes sense to choose a fixed rate?

I decided to do some math of my own to try and separate truth from hype, and the results were interesting. At the time of writing, the prime rate was three per cent and the best five-year rate mortgage was 4.05 per cent. A recent report by RBC Economics suggested that prime would go up by one per cent by the end of 2011, with a further 1.5 per cent increase by the end of 2012. This is in line with what many analysts and economists are predicting. I could go on about why I believe that any increase in the prime rate will slow our economic recovery, and that until the US and global economies start to show signs of sustained growth the Bank of Canada will be limited in terms of how much it can raise rates. But alas, that is fodder for a separate debate.

Instead of arguing about whether rates will go up, I'm going to assume that the prime rate in Canada will double to six per cent over the next five years. I then compared a client with a $300,000 mortgage and 25-year amortization who locked in today for a five-year mortgage at 4.05 per cent, to a client who chose to float in a variable rate at prime minus 0.60 per cent. I kept the monthly payments the same for both clients, and compared where they were at the end of the five years. The results were surprising.

The client who chose to stay floating at prime minus 0.60 per cent over the five-year period ended up saving slightly less than $5,000, even though their interest rate at the end of the five-year term was 5.4 per cent.

What does this tell us? The average interest rate for the variable ended up being around 3.7 per cent over the five-year period. The reason is a fundamental key to all mortgages. You pay the bulk of the interest up front. This shows us that having a lower interest rate in the first few years but choosing to make a higher payment has the effect of accelerating your debt reduction to the point that it is still more economical to remain floating – even if the prime rate was to double.

Here are two key points:

1 | Every time you choose to lock into a long-term interest rate; you are choosing to pay a higher rate as an insurance premium against future rate hikes. This gives you peace and comfort knowing you never have to worry about where rates are going.

2 | Some may suggest that there is no guarantee that rates won't go up even higher than a prime at six per cent. This is true, nothing is guaranteed. Therefore, it is extremely important to maintain perspective over the following months when there's talk of rising rates and potential housing bubbles. Today's rates are still at historical lows. If you have any concerns about where rates are going, or you simply don't want to take a chance, lock your mortgage into a five, six or even a 10-year rate and sleep well. Even if rates took off and the housing market dips, if you are locked in and can afford your mortgage payment, simply ride out the market and wait for prices to rebound and rates to fall in time for your mortgage to come up for renewal.

There is no right or wrong answer when it comes to whether you should float or lock in. For my money, I'll continue to float and focus on reducing as much debt as I can over the next five years.

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