Variable mortgages (almost) always win

Whether They're Taking On New Mortgages Or Renewing Ones They've Held For Years, Homeowners End Up Asking Themselves The Same Question: Should They Lock In Their Mortgage Or Should They Let It Float With A Variable Rate. Here, Toronto-Based Wealth Manager Scott Tomenson Makes The Case For Variable.

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ARE VARIABLE MORTGAGES AS GOOD AS THEY LOOK?

Q: My fiancé and I have just bought our first home and we are going in circles about what is the best mortgage for us before we close. We currently have a locked-in fixed rate with a bank of 3.98%, which we prefer to the uncertainty of taking a variable mortgage. But would we be better off with a variable-rate mortgage, especially if we saved money during periods when rate are low and use that to make payments on principal? Will that offset costs when our payments are higher than our current fixed rate? Getting Dizzy, Ontario

A: Historically, as far as interest rates are concerned, it is better to float your mortgage interest rate (i. e., choose a variable rate mortgage). This is a result of the "yield curve." The "normal" yield curve is positively sloped, with interest rates lower for short-term maturities (one to two years) and higher for longer-term maturities (five to 30 years). When the economy strengthens, the Bank of Canada will raise short-term interest rates (they only have control over short-term rates) and the base for variable-rate mortgages (usually the prime rate) is moved higher. This action signals a period of "tightening" of monetary policy to cool the economy and reduces inflationary pressures.

The vehicles that determine longer-term interest rates -- bonds -- tend to move according to inflationary expectations: If bond investors anticipate inflation (because of economic growth), they demand higher returns (interest rates) as protection from inflation. When the Bank of Canada is perceived as "fighting" inflation by raising short term interest rates, long-term rates have a tendency, in most cases, to remain stable or improve, because long-term bond investors are content that inflation will not grow.

In essence, while short-term interest rates may go up, they do so only until the Bank of Canada has slowed the economy enough to curb anticipated inflation. Then, as economic growth slows, the bank starts to lower them. The yield curve will flatten (with higher short-term interest rates) for a time, but when the economy slows, short-term rates will go back down and the yield curve returns to its "normal" positive slope.

Over this time, variable-rate mortgages will move up to being approximately equal to locked-in five-or 10-year rates, but that's followed by a period when they return to lower levels. More often than not, over this time, it is less costly to have held the variable rate debt. Exceptions to this situation would be times of hyper-inflation (like in the 1980s) when short-term interest rates went to extreme levels.

If you had a variable mortgage at prime minus over the past few years, as I did, it's been a great ride. I kept my payments level and the low interest rates allowed to me to pay off massive amounts of principal. True, the economy is strengthening and short term rates will go up a bit over the next couple of years, but I don't think it will be dramatic. The case for variable-rate mortgages remains strong.