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Bank of Canada on hold for now, but don't break out the champagne just yet

The Bank of Canada "(BoC" or "the Bank") left its benchmark overnight rate unchanged at 1.75% on January 9, providing temporary relief to Canadians who have been grappling with rising interest costs for the past 18 months (Figure 1) on near-record levels of debt.

But the Bank hitting the pause button on its rate-hike campaign should be little reason to celebrate, based on its assertion that the benchmark rate will need to rise over time to the "neutral range." Bank officials including BoC Governor Stephen Poloz estimate that range to be somewhere between 2.5% and 3.5%.

Canadians will have to contend with significantly higher interest expenses if the benchmark interest rate does get to the neutral range, and mortgage and other loan rates trend higher with it. As an example, a one-percentage point increase in the five-year mortgage rate – from 3.3% to 4.3% – would result in an increase of approximately 11% in monthly payments for a mortgage amortized over 25 years.

Note that we said "if" (the benchmark rate gets to neutral), not "when." That's because financial markets are pricing in little possibility of multiple rate hikes in the next couple of years[1], while some economists are questioning whether the BoC may have already made an error by tightening monetary policy too much.

There's little doubt that five 25 basis-point increases in the benchmark rate since mid-2017 have had an impact on the Canadian economy. Higher rates and more stringent mortgage rules have led to steep declines in home sales across Canada, especially in the overheated Vancouver and Toronto markets. In addition, sales of automobiles in Canada fell in 2018 for the first time in almost a decade[2].

Not surprisingly, the Bank of Canada last week slashed its 2019 forecast for Canadian economic growth to 1.7%, compared with its October estimate of 2.1%. However, the BoC said its revised forecast reflects a temporary slowing in the last quarter and current one, and expects growth to get back to 2.1% in 2020.

As for the future trajectory of interest rates, the BoC noted that this would depend on how the outlook evolves, specifically for oil markets, Canadian housing and global trade policy. While global oil prices have tumbled 25% since October, the Bank estimates that their effect on the Canadian economy is only about one-fourth the impact from the 2014-16 oil plunge[3], partly because the Canadian dollar has declined with oil prices (Figure 2). The Bank also noted that while the US-China trade conflict is already having negative economic consequences, this is a two-sided risk, meaning that while this dispute could escalate, it could also be resolved.

Two plausible scenarios for 2019 are therefore as follows:

Scenario 1 – the US-China trade spat gets resolved, the global economy and oil prices recover, and Canadian housing stabilizes; this positive scenario for the Canadian economy could result in the BoC hiking rates once or possibly even twice in 2019.

Scenario 2 – the US-China trade dispute gets messier, the global economy and oil prices go into a tailspin, and Canadian housing deteriorates; this gloomy scenario could continue to force the BoC to the sidelines with regard to interest rate hikes this year.

Regardless of how events develop in the months ahead, most economists concur that rate hikes – if any – by the Bank of Canada over the next year or two are unlikely to be anywhere near the pace at which it raised rates between July 2017 and October 2018.

While a pause in interest rate hikes may provide some relief to overleveraged Canadian homeowners and consumers, keep in mind that this has been triggered by growing challenges to the Canadian and global economies, which manifested themselves in dramatic fashion in the fourth quarter of 2018. Indicators of financial stress such as loan delinquencies and insolvencies[4] are already on a rising trend across Canada. While one hopes that the Canadian economy returns to 2%+ growth next year as forecast by the Bank of Canada, until such time as the economic signs and signals turn more encouraging, it might be best to put the champagne on hold.

Figure 1: Bank of Canada benchmark overnight rate – Jan.2013 to Jan.2019 (Source: Bloomberg)

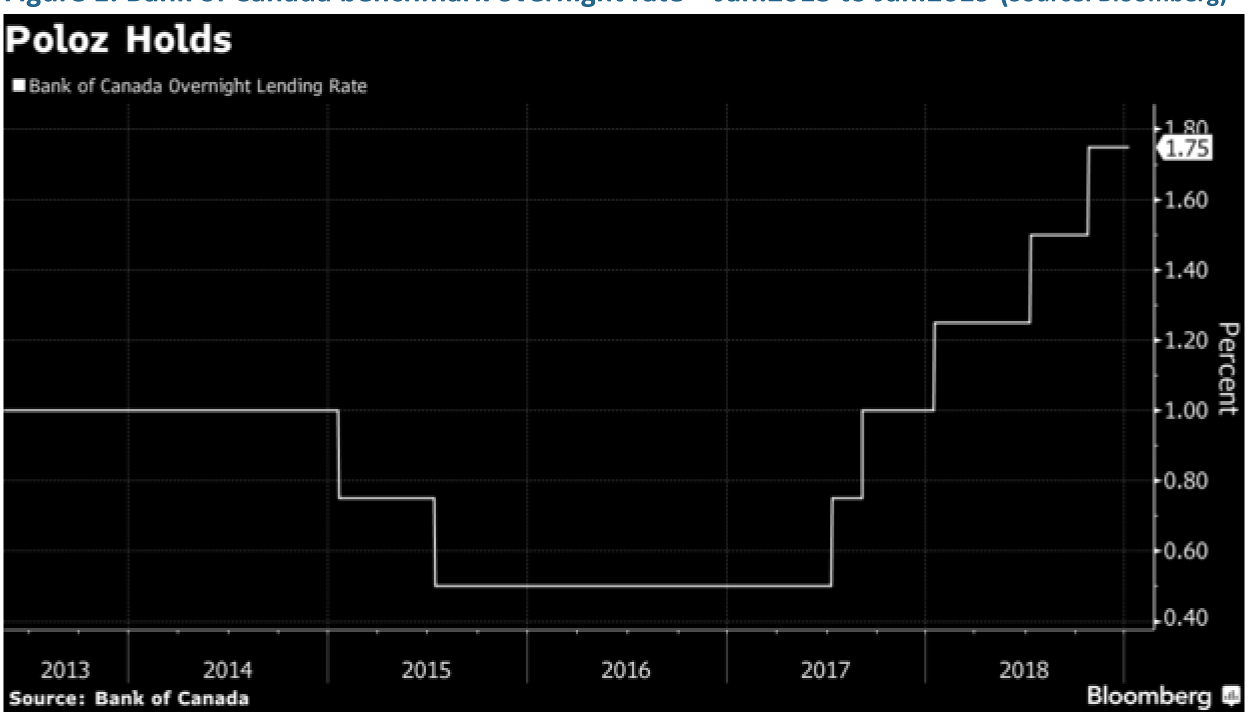

Figure 2: C$ again moving in sync with crude oil (Source: FactSet)

References

[1] https://www.bnnbloomberg.ca/why-it-wouldn-t-take-much-to-end-the-bank-of-canada-s-rate-hikes-1.1179388

[2] https://canada.autonews.com/retail/2-million-new-vehicles-sold-2018-even-sales-fell-65-december

[3] https://www.bankofcanada.ca/2019/01/opening-statement-090119/

[4] https://www.thestar.com/business/2018/12/20/business-booms-for-insolvency-trustees-amid-higher-canada-rates.html

[4] https://www.lowestrates.ca/news/canadian-debt-levels-spiral-out-control-transunion-25409

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