Integra Market Insights

Equity Associates Inc.

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December 1st, 2013

Issue #23 - "The Future of…Interest rates"

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"Compound interest is the eighth wonder of the world. He who understands it, earns it … he who doesn't … pays it."
— Albert Einstein

As financial advisors, we are frequently asked for our thoughts on what we expect interest rates to do in the future. In an attempt to bring some clarity to our current position, we have dedicated this month's issue of Integra Market Insights to interest rates.

The short answer
The Bank of Canada will not raise interest rates in any meaningful way until after the United States Fed does so. Before raising rates, the Fed must first unwind its quantitative easing programs known as 'tapering'. For that reason, we don't foresee substantial rate hikes until the end of 2015, and into 2016 for Canada, unless the real estate market bubble refuses to 'pop'.

The long answer
To help you better understand our forecast, let's discuss interest rates in general and clearly define the target rate set by the Bank of Canada and how it relates to you as an individual.

The backstory – the target rate
Interest is the compensation a lender earns for lending to a borrower over a given period of time. The higher the risk to retrieving your borrowed capital, the higher you expect to be compensated, by means of a higher level of interest. This explains why a mortgage secured by a property levies a lower rate of interest than a credit card used to buy furniture.

Consumer interest rates are largely based upon the target overnight rate set by a country's central bank. This number is the lowest common denominator for lending as it is the annualized rate that a central bank charges the big banks for borrowing money overnight, the shortest possible duration for borrowing. As you can imagine, the longer you lend someone money, the higher the risk of default and thus the more you would expect to be compensated for your risk.

As such, lending to a very credible borrower (Treasury) for a very short amount of time, is considered to be the benchmark for interest rates (Target rate in Canada, Fed rate in the US) and can be referred to as 'risk-free'. All other interest rates are influenced by this rate as it is assumed that a logical investor will always choose the highest return, with the smallest amount of risk. Should this rate skyrocket suddenly to 10%, you would expect that all other interest rates would jump up as well to reflect the 'risk-free' return that individuals can earn by lending overnight, and thus investors would expect to be compensated by more than that if they lend to a less credible borrower.

For that reason, the overnight target rate as set by a country's central bank is the foundation to consumer interest rates, and so when the Bank of Canada raises rates, it affects everyone. Most commercial banks (TD, RBC, etc.) use a 'Prime-Rate' as their base rate that is typically 2% above the Bank of Canada's target rate.

Why do central banks raise/lower the overnight rate?
The manipulation of interest rates is a controversial policy proposed by economist John Maynard Keynes following the Great Depression. He argued that it was the government's role to intervene in market behaviour by supporting the economy when it was in poor condition and to slow it down when it was over-heating. Known as Keynesian economics, this school of thought led the Federal Reserve to its current agenda of 'printing money' to support economic growth at all costs.

By lowering interest rates, it is argued that consumers and businesses will have more money to spend on goods, which will spur the economy.

Conversely, when the economy overheats, prices get pushed up rapidly and inflation runs rampant. In an effort to counteract this excessive growth, rates are increased to constrict the monetary supply, reducing the number of booms and busts.

Proponents believe that this softens the economic cycle, reducing the number of booms and busts. Opponents of this school of thought believe that this only hides the problems and never resolves the true causes of economic upheavals by shifting the focus elsewhere.

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Will the bank of Canada raise rates?

Absolutely, the question is when. Over the last few years, central banks have begun a new policy of foreshadowing their future increases by tying them to specific economic goals, like employment levels. This is known as 'forward guidance' and brings important clarity to rate expectations.

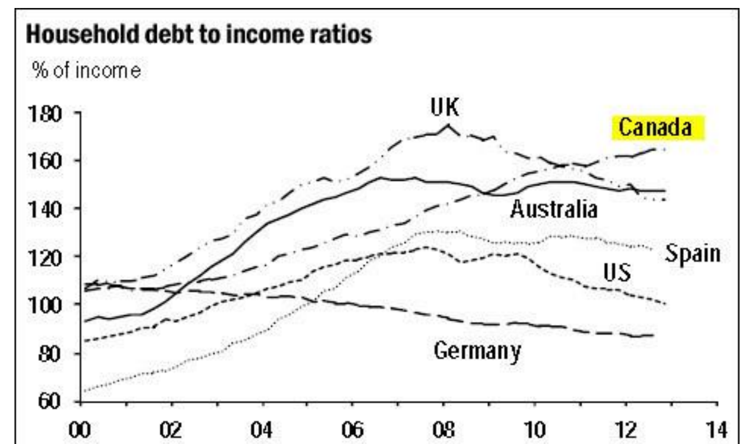
It is our belief that we will not see the Bank of Canada raise rates until the US raises theirs. Simply put, they will likely want to raise rates before we do as their economy is recovering faster and their rates are considerably lower than ours at the moment. Further, their housing market and consumer debt levels are in much better positions to absorb the effects of a rate increase then we are.

As such, we turn our focus to the US Fed rate to determine when we can expect rates to rise. Since the 2008 financial collapse, the Federal Reserve has aggressively pursued Keynesian economic policies to support the economy. During that time, borrowings have quadrupled in an effort to keep the US economy afloat. To this day, it continues to buoy the markets with cheap capital.

Long before it is able to raise rates, it will need to wean the economy off this steroid and have it return to normal economic growth before it turns its focus to cooling down the economy with interest rate increases. We do not see this happening until late 2015, early 2016, which pushes our estimates for rising rates in Canada back to 2016.

How will this affect you?

As Canadian's, most of us are exposed to interest rates by means of our investments in bonds and our mortgages, lines of credits and other borrowings. Over the last decade, Canadian's have seen their levels of household debt to income rise dramatically.



This makes us very vulnerable to increases in interest rates, as the more debt you carry, the larger the impact of rising rates, particularly if you hold variable rate debts, over fixed-rate mortgages.

More importantly, the real estate market has been historically shown to be particularly sensitive to economies harbouring high levels of personal debt during a rising rate environment. A rapid rise in rates could quickly affect real estate prices, sending them tumbling down.

From an investment standpoint, rising rates will hurt the low-risk investor as bond prices are negatively correlated to interest rates. For this reason, we have been making changes to your portfolio throughout the last year to shorten the duration of bonds and reduce our exposure to potential rate increases.

Related: Why Canadian homes are more unaffordable than ever

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