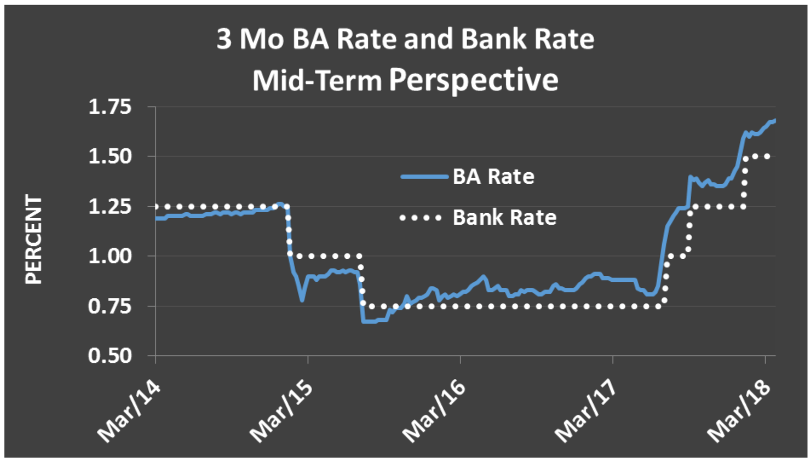
Are Interest Rates in Canada Moving Higher?

When the Bank of Canada changes the Bank rate, the rate at which the Bank of Canada lends funds to financial institutions, the impact on Canada's short-term interest rates is both direct and immediate.

The adjacent chart highlights the almost perfect correlation (99.2%) between the Bank rate and 3-month BA rates. BA rates, also known as Banker's Acceptance rates which are the yields Canada's largest banks offer investors when they need to borrow 90-day money in the Canadian money market.

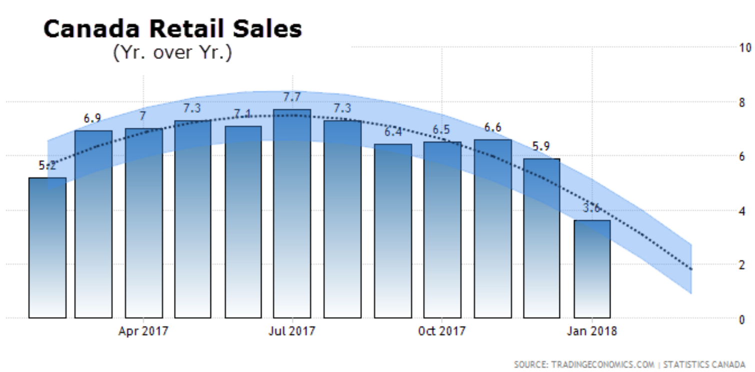


The point is, when the Bank of Canada raises the Bank rate, BA rates immediately move upward, as do 30-day, 90-day and 1-Year T-Bill rates.

Central Banks generally raise interest rates to slow down an over-heated economy, which is usually defined as an economy with rapidly increasing demand for:

a) goods and services, as measured by rising GDP
b) labour, as measured by increasing wages, and
c) prices of goods and services, as measured by inflation

Canada has none of the above. Canada's GDP is expected to fall from 3.0% to 1.8% in 2018. Wages have been forced upward through legislation rather than by wage pressures generally associated with low unemployment.

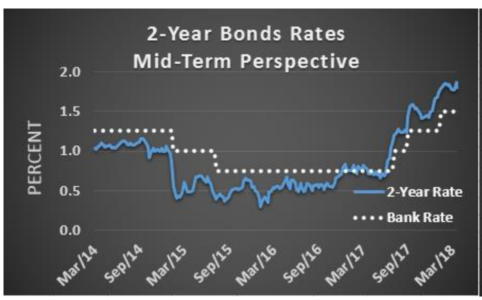


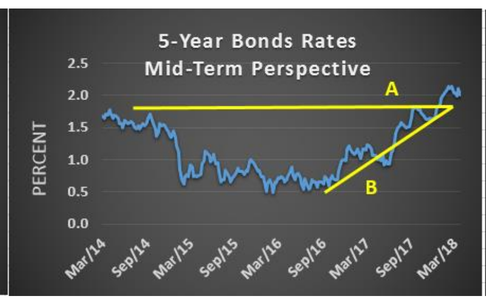
Inflation at 2.2%, although above the 2.0% target set by the Bank of Canada, is more a result of an extremely weak Canadian dollar (worth only 77¢ US), where every imported consumer and commercial product costs Canada more and more ($1.30 CAD). Prices for food, travel, internet, mortgage interest, machinery & equipment, autos, gasoline, software are all up. Thus, as seen in the adjacent chart, traditional retail sales are down.

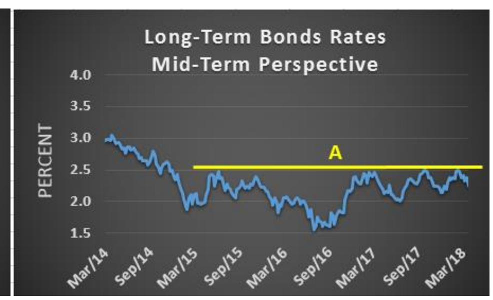
Central Banks throughout the world, not just in Canada, are eager to raise interest rates as rates have been too low for far too long. Central Banks seem to be searching every economic release for signs of a recovery from the “new normal” economic lows arising from the financial crisis of 2008.

The question that must be asked is, “Are Central Banks too eager to raise interest rates?” Are interest rates being raised to slow down overly strong, high output, high growth economies or are interest rates being raised “just because”? Tuff Risk hopes it is the former.

The Bank of Canada has raised the Bank rate three times in 2017. From a low of 0.75%, the Bank rate is now 1.50%. Below, the chart on the left highlights the impact of changes in the Bank rate on 2-year bonds between March 2014 and March 2018. Note how 2-year bond rates move almost in-step with the Bank rate. Even 5-year rates, as shown in the middle, appear to be directly impacted by the Bank rate.

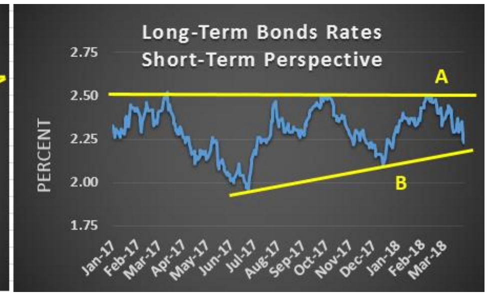






The Bank of Canada’s influence however diminishes beyond the 5-year term. The chart on the right shows long-bonds pretty much ignore the Bank rate and instead chart their own path based on the marketplace expectation of economic growth and inflation.

When one looks over the last year (as shown in the charts below), it appears that since the beginning of 2018, both the 2-year and 5-year bonds have signaled no further increases in the Bank rate for the foreseeable future, as both these rates seemingly refuse to move any higher. Long-bonds, as usual, continue to ignore the possibility of rising rates in Canada.



Previous Tuff Market Insight newsletters have pointed out the strong correlation between USA/CAD interest rates (80% to 90%+). This high correlation means, whether or not economic conditions within Canada warrant an increase in interest rates, if interest rates move up in the USA interest rates will also move up in Canada.

The question then becomes, “What are interest rates doing in the USA?” All economic data points to the US economy getting stronger over the next year.

Looking at the US 10-year Treasury bond rate in the adjacent chart, one sees that longer interest rates in the USA are also having difficulty rising further.

The pause in rising rates may be temporary or it may be the result of overall economic uncertainty. Potential trade disputes add to that uncertainty.

With an inflation rate of 2.2%, the Bank of Canada has a clear mandate to raise the Bank rate at its next meeting, even with yields rising no further. Unless things change dramatically between now and the next Bank of Canada meeting, Tuff Risk & Investment Management does not believe the Bank of Canada will raise the Bank rate.

Given the experience charting interest rates in Canada and the USA, Tuff Risk & Investment Management knows the market can change in an instant. Should you want to be kept up-to-date on the changes in interest rates, sign up to receive the *Tuff Market Insight* weekly email.