



What's happening with Rates?

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There's been a lot of talk and speculation over the past month about what's happening with interest rates. As in most cases, speculation is fueled by media hype and misinformation. So let's take a look beyond the hype and analyze some of the facts.

We know that the Bank Of Canada chose not to raise rates at the end of May, but we also know that based on the language they used it is a virtual certainty that they will be raising rates when they meet again on July 10th. The question is not if, but by how much? Although predicting rates is far from an exact science, there are certain factors that can take the guesswork out of it.

First off, we need to understand that there are really two different types of rates that we are talking about. When we say that the Bank of Canada did not raise rates last month, we are referring to the BOC's overnight lending rate. This is the rate that determines the Prime lending rate, which in turn dictates the cost of Variable Rate Mortgages. The long term fixed rates (such as your 3, 5, or 10 year rates) are determined by the bond market, and although there are definitely some parallels between the two, there is not a direct correlation with every rate move. We saw a perfect example of this at the end of May. The BOC decided to stand pat and make no rate adjustment and then the very next day the bond market starts to take off in reaction to fears of future rate hikes. Since the long term rates are governed by the bond market, we saw the chartered banks react by raising their fixed rates accordingly.

Can get confusing can't it? On the one hand the media is reporting that rates have remained unchanged then the next day you read that rates are going up! You can even read two opposing articles in the same paper on the same day. What they're not saying (or rather clarifying) is that they are talking about two different rates – and each of those rates is governed by two different factors.

For our purposes, let's focus on the Prime lending rate and what governs those decisions. Again, the Prime lending rate is determined by the overnight lending rate, which is established by the Bank Of Canada every time they meet (which is about 5 or 6 times a year). We are just coming out of a prolonged period whereby the BOC has left the Prime rate unchanged for the past year but it is widely anticipated that this period of stability will end in July.

To do a proper analysis, we have to first understand what factors determine their decision-making process. The Bank of Canada, amongst other things, keeps a keen eye on inflation. The general rule of thumb for the bank is to try and keep inflation below 2%. If inflation rises above 2%, they will raise the interest rate to control it. Canada's economy is performing at a very high level right now (especially in the West) and inflation has crept up to 2.5%. So an oversimplification of this analysis would be to predict a rate hike to offset inflationary pressures. If this is what you predicted, then you'd be right – in fact, that is exactly what the markets have predicted and therefore we saw the bonds go up and with it, the long-term fixed rates.

Well that was easy, wasn't it! If inflation goes up over 2%, rates will go up as well – hey being an economist isn't that difficult after all - right? Well there is one little thing that throws a monkey wrench into mix (I know, you knew there had to be a catch...) and that's the Canadian Dollar.

The other area that the BOC keeps an eye on is the price of the Canadian dollar and its effect on the economy in general. An interesting question is whether a high Canadian dollar is a good thing or a bad thing. Well that would depend on who you asked. Talk to an importer out West who has to pay US\$ and he loves the high Loonie, talk to a manufacturer in Ontario or Quebec and they'll be quick to tell you that a high dollar will throw us into a recession.

So what does the interest rate have to do with a price of the dollar? Again, at the risk of oversimplifying the process, higher interest rates inadvertently attract more investment to the dollar thus increasing its price. Simply put; if David Dodge and company want a lower Canadian dollar, they will lower rates. Oh, and don't forget that minor issue of a U.S. housing slump that doesn't seem to want to go away. If it continues for much longer, then the FED south of the

border will be forced to lower their rates in an effort to stimulate economic growth. This will make it very difficult for Canada's Central Bank to move in an opposite direction without creating even more upward momentum for the Canadian dollar. So clearly this means that the bank will have to lower rates – right? But then there's still that inflation issue, hmm....

Gee, this predicting thing is getting hard; maybe I don't want to be an Economist after all. If inflation goes over 2% rates should go up, but if rates go up, the dollar will start to rise, if the dollar starts to rise then the Bank risks driving Ontario into a recession (and there's a lot of votes there). So clearly the Bank Of Canada finds itself between a rock and a hard place. So what are they going to do?

Well, we can't say for sure, but it is almost certain that the Prime rate will go up by at least 25 points on July 10th. Where it goes from there will be a matter of whether Canada's Central Bank fears inflation more than it fears the potential for a recession. As for me, I'm not pushing the panic button yet and will continue to float with my mortgages, but please remember this! If anything you read here confuses you and causes you to lose sleep at night – LOCK-IN today! Regardless of where rates may or may not go, they are still within the historically low spectrum and if you are investing in real estate there is nothing wrong with having a fixed cost as your revenues rise.

Until next time happy Investing,

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