PERSPECTIVE

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THE WOLF IS GETTING CLOSER

Over the past couple of years I have felt like the little boy who cried wolf. I have repeatedly warned Canadians to be careful with their finances because interest rates are bound to rise eventually. I said that at the start of last year, and interest rates ended the year lower. Regardless, I keep stressing that you have to read the book – the wolf does show up at the end. Well, the Bank of Canada's messaging this week suggests that the wolf is getting closer and there aren't too many pages left.

The Bank clearly laid out the case for raising rates before long. It raised the economic growth outlook for 2012 to 2.4%, implying that the slack in the economy would be eliminated sooner than previously expected. The output gap is projected to be closed in the first half of 2013, rather than the previously predicted end of 2013. That means that inflation risks are higher, despite the central bank's comment that it views the inflation risks as balanced, and the Bank remains squarely focused on its mandate of keeping inflation at 2% over the medium term.

Moreover, while risks remain, there was a strong sense that the central bank is more comfortable with them. The economic environment is characterized as one in which emerging market economies achieve a soft landing, the U.S. economy grows at a steady pace and Europe emerges from its recession before long. In this benign scenario, the Bank is signaling that higher rates will soon be appropriate in Canada. And while not spelled out explicitly, higher interest rates would have the happy coincidence of tempering household debt growth, which is identified as "the biggest domestic risk".

The hawkish perspective outlined above raises two core questions: First, when will interest rates rise? Second, how much will they increase?

The Bank of Canada is keenly aware of how financial markets interpret changes in central bank language. It had to assume that money managers would respond by pricing in rate hikes before the end of the year – which they did. Now it is possible that the stronger language was intended to raise interest rate expectations, thereby raising bond yields and ultimately lift borrowing costs, including fixed mortgage rates. However, the impact of talking up bond yields only lasts so long. Eventually the central bank has to put its money where its mouth is. So, unless it changes its tone in the coming months, the assumption has to be that a tightening is coming in 2012.

It is hard, however, to envision a significant and extended tightening cycle. So, perhaps this wolf could prove to be cub with sharp teeth rather than a beast with fangs. The Bank will be sensitive to the moderate pace of economic growth, the low risks of a dramatic acceleration of inflation, the continued risk-filled global environment, and uncertainty as to how the domestic economy will respond to higher rates at a time when real estate is overvalued and household finances are exceedingly stretched. This argues for a step-wise tightening of monetary policy, with periodic pauses to assess how the risks and economic environment are unfolding. TD Economics has also long held the view that the Bank of Canada cannot raise interest rates by more than one percentage point while the Federal Reserve is on hold.

To do significantly more would cause the Canadian dollar to rise dramatically, and create monetary conditions that would gravely weaken the economic outlook.

So here is our best guess as to how monetary policy could play out. Looking at a calendar of fixed rate announcement dates, the July MPR would be an ideal time to update the Bank's economic forecast and outline the rationale for a quarter-point hike at the next meeting on September 5th. A second quarter-point hike on October 23rd would then allow the subsequent MPR to provide the case for a pause. The Bank could then wait for a period to assess the impact of the tightening and the evolution of risks. In the spring of 2013, a further half-point tightening could occur, followed again by a pause. It should be noted that this is not a dramatic change from our prior forecast for a 1 percentage point hike in the second half of 2013. We are just pulling forward and extending out the same degree of tightening.

One can quibble with exact timing. It could easily be argued that the Bank will act sooner and use the July MPR for justification. Equally, if the global economic risks intensify (with Europe being the leading candidate) it could once again change its messaging and stay on the sidelines longer. So, like any good forecast, the risks to the new base case scenario outlined above are balanced.

There are many implications of the earlier-than-expected rate hikes. First, the Canadian dollar will be modestly stronger in 2012, but we still see the currency in a trading range of 95 to 105 U.S. cents, averaging close to par. Second, bond yields will also be somewhat higher this year; but, one needs to keep perspective – a half-point rise in the overnight rate will raise 10-year bond yields by about a quarter of a percentage point. This would translate into about a 30-35 basis point rise in 5-year bond yields, which would lift 5-year mortgage rates by a similar amount if sustained. A similar half point of rate hikes in the first half of 2013 would have roughly matching effects on bond yields, still leaving interest rates relatively low. Revised interest rate and foreign exchange rate forecast tables will be included in the upcoming publication of *Dollars & Sense*. Higher interest rates and a stronger Canadian dollar will act to temper economic growth, but not in a dramatic fashion.

The greatest impact is likely to be on consumer spending and real estate. Higher interest rates are poised to arrive at the same time that chartered banks are pursing tighter lending policies consistent with new regulatory guidelines, both of which will act to lower personal debt growth and dampen real estate activity. Of course, there could be a rush to buy, but this will pass. Ultimately, moving the timetable for higher interest rates forward adds to our conviction that home sales and home prices are headed for a correction in 2013. The main point is that while the Bank of Canada is aiming to maintain price stability, the outcome will be a gradual leaning against personal debt growth, and this will have economic consequences.

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