OBSERVATION

TD Economics

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ARE CANADIANS PREPARED FOR HIGHER INTEREST RATES?

Highlights

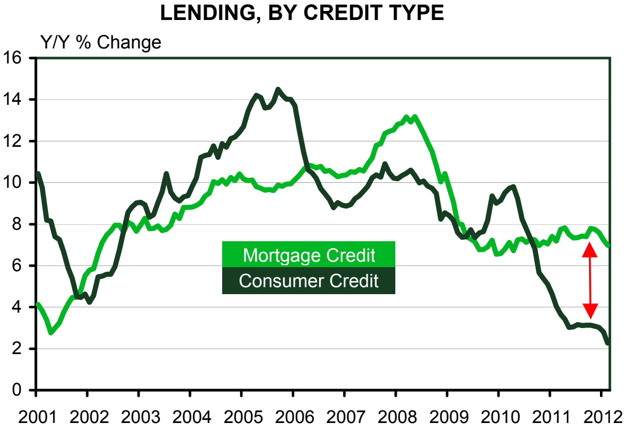
- With the Bank of Canada recently signalling that interest rates may rise sooner than many were anticipating, the question becomes how well-prepared Canadians are for higher rates?
- Over the medium-term, interest rates will likely rise at least 2 percentage points and there is no doubt that a significant minority of Canadian households will be at-risk when this occurs.
- There have been some preliminary signs that Canadians have begun to hunker down and/or protect themselves from interest rate increases. Household consumer credit growth has slowed to a substantial degree.
- Interest rates are set to rise at a gradual pace and the ability of consumers to fix into low interest rates now imply that the impact of higher rates may be felt over a number of years.
- These developments give credence to our expectation that the imbalances in the housing market and in the household debt-to-income ratio will unwind over time rather than in a precipitous fashion. At the same time, however, medium-term prospects for consumer spending remain limited.

The Bank of Canada caught many Canadians off guard at its April fixed announcement date by signalling that rate hikes could be coming sooner than many were anticipating. In response, forecasters brought forward their expectations of when interest rates will rise to as early as this coming fall. This naturally raises the question of how well-prepared Canadians are for higher rates. It is safe to say that with household debt levels at record highs, a sizeable number of Canadian households are ill-prepared and could lead to difficulty keeping up with higher interest payments when rates eventually increase. At the same time, however, recent trends suggest that a growing number of households are starting to hunker down and protect themselves from this eventuality.

Recent trends in debt growth

The first sign that Canadians have been heeding the warnings is that debt is being accumulated at a slower rate. Notably, consumer credit, which includes unsecured lines of credit, personal loans, credit cards, and home-equity lines of credit, grew at just 2.3% on a year-over-year basis in February (chart 1) with all types having either decelerated or outright declined. This is the slowest pace in almost two decades and is underperformed only by the pace of growth seen during the worst years of the 1990s recession. The most dramatic moderation has been in lines of credit where

CHART 1: ECONOMY-WIDE HOUSEHOLD LENDING, BY CREDIT TYPE



Source: Bank of Canada, OSFI

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growth has ratcheted down consistently for almost 3 years, from more 21% year-over-year to less than 5.0%. This is the slowest pace on record which goes back to 1986.

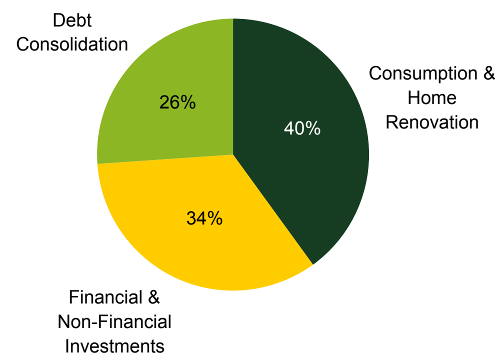
Since the majority of consumer credit is used to finance consumption (chart 2), the moderation in debt accumulation speaks to a more cautious approach to consumer spending. Indeed, retail sales growth has decelerated in lockstep with the slowdown being felt mostly in non-discretionary areas such as furniture, home furnishings, electronics, appliances, and home renovation spending. Interestingly, despite the considerable pullback in the outstanding balances of credit cards (chart 3), the data show that card usage continues to grow. This is truly reflective of the more conservative stance Canadian households are taking: they continue to spend, but an increasing number simply do not hold a balance on their cards.

Based on these facts alone, it may appear that Canadians are taking a more prudent approach to debt accumulation. However, the federal government has also changed mortgage lending rules on three separate occasions since 2008. For example, by reducing the maximum amortization period or maximum amount of financing, the ability of many borrowers to obtain large amounts of credit has been reduced. Interestingly, while the majority of the rules have been applied to mortgages, the slackening in debt accumulation in the wake of these changes has been more pronounced in consumer credit. This development was likely motivated by borrowers wishing to take advantage of extremely attractive special offers from some banks to enter the housing market or consolidate higher cost debt, thus substituting away from other forms of debt towards mortgages.

As chart 1 reveals, there appears to be no stopping mortgage credit growth. Though down from its pre-recession pace, residential mortgage credit has grown at an almost constant 7-8% year-over-year pace for the last three years. In addition to substitution, this strength is clearly connected with the robust pace of housing sales and home price growth in recent years (chart 4). The average price of an existing home has grown roughly 30% over the last 3 ½ years and is almost 15% higher than even the pre-recession peak. And although sales activity has been very volatile in recent years, the trend pace remains extremely robust at around 38,000 sales per month, far above what was seen in decades prior (chart 5).

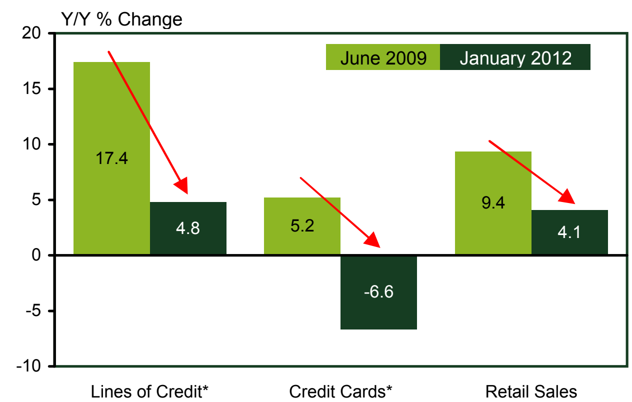
Overall, the slowdown in consumer credit has led to a reduction in the growth of total debt. However, the challenge

CHART 2: USES OF HOME EQUITY EXTRACTION, 1999-2010



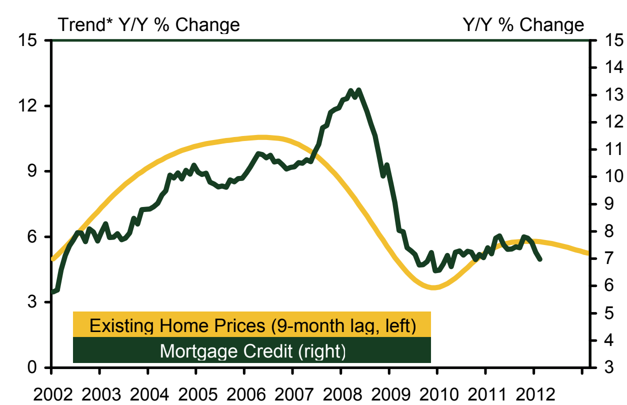
Source: Bank of Canada, Ipsos Reid Canadian Financial Monitor

CHART 3: CHARTERED BANK LENDING, BY CREDIT TYPE



*In outstanding balance; Source: Bank of Canada

CHART 4: EXISTING HOME PRICES & MORTGAGE CREDIT



*Hodrick-Prescott filter; Source: CREA, Bank of Canada lies in that mortgage credit seems unyielding and income growth is simply not sufficient to bring down the debt-to-income ratio, leading to an increasing level of vulnerability among households.

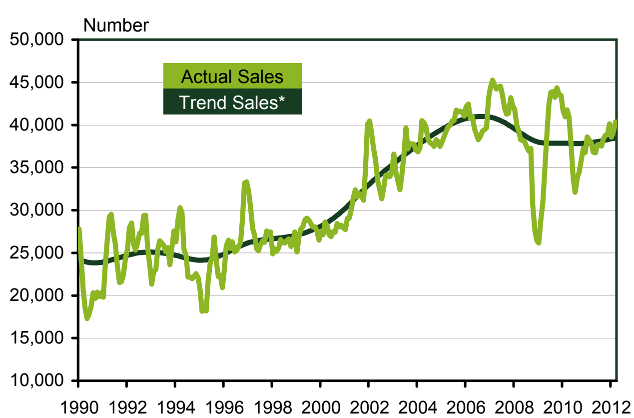
How high will interest rates go?

In light of the still-lofty debtloads, the signal emerging from the central bank in April that interest rates are likely to rise sooner than later will present a challenge to many households. In response, we, along with many other forecasters, have tinkered with our interest rate forecast.

We now believe that the Bank of Canada will likely resume hiking interest rates this coming fall rather than in the winter. However, those increases are still likely to be very gradual. We feel that they will be limited to just 1 percentage point in increases over the next two years. With the U.S. Federal Reserve on hold likely until 2014, any hikes in excess of that by the Bank of Canada would put upward pressure on the Canadian dollar, dampen export growth, and weaken the economic recovery. However, once the U.S. economy gains more traction and interest rates head higher, the Bank of Canada will have more scope to raise the overnight rate further. This is necessary as even 2.00% – which is where we expect the overnight rate to reach by the end of 2013 – is still well below its equilibrium value, which is in the range of 3.00-4.00%. Unless another major shock hits the global economy, the overnight rate is likely to rise by at least 2 percentage points by 2015 (chart 6).

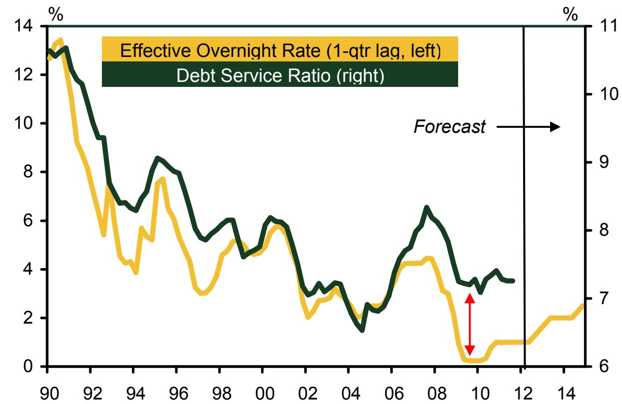
From the perspective of the actual rates paid on consumer debt, the overnight rate acts as a benchmark for all other

CHART 5: CANADIAN EXISTING HOME SALES



*Hodrick-Prescott filter; Source: Canadian Real Estate Association

CHART 6: DEBT CARRYING COSTS & INTEREST RATES



Source: Bank of Canada, Statistics Canada

interest rates. Canadians may be more familiar with the prime rate, which is used to price almost all variable-rate debt. However, many may not be aware that the prime rate is typically a fixed spread on top of the overnight rate. In other words, the prime rate will also rise by at least 2 percentage points by 2015. For borrowers who are on fixed-rate products, the standard 5-year fixed mortgage rate tends to move in lockstep with the yield on the 5-year Government of Canada bond (chart 7). In contrast to the prime rate, the relationship is not fixed, but predictions of 5-year yields provide a good guide post for mortgage rates. As with the overnight rate, the 5-year yield is expected to grind higher by 2 to 3 percentage points over the next few years.

So how vulnerable are we?

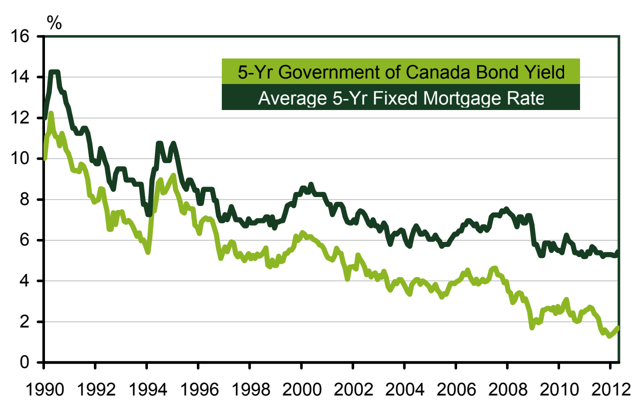
The question then turns to what extent Canadians will be affected if recent expectations of earlier rate hikes materialize. Given the current interest rate environment, debt service costs are already at an elevated level due to the sheer amount of outstanding debt. Chart 6 shows a clear break in the relationship between the overnight rate and the debt service ratio in which the latter is more consistent with an overnight rate at 4% rather than the current 1%.

While the majority of Canadians appear to be well-positioned to absorb a rate increase of around 2 percentage points, there is a substantial minority that cannot. According to the Canadian Association of Accredited Mortgage Professionals, roughly 21% of current mortgage holders, equating to roughly 1.2 million mortgages in Canada, may face financial difficulties with such an increase. Bank of Canada research also provides a similar figure. Their analysis suggests that as many as 7.5% of households could be put into a financially difficult position if interest rates normalize.

There are two factors limiting the pool of at-risk households. First, as mentioned above, interest rates will rise at a very gradual pace in view of prospects for still-tame inflation and modest economic growth. The Bank of Canada is also cognizant that raising rates too far, too fast would potentially spark a substantial amount of household deleveraging. But with only one percentage point of hikes expected over the next two years, this will likely be enough lead time for households to adjust their spending habits to account for the higher monthly payments. Second, not all mortgages and consumer credit are structured in the same way. The fact that 65% of mortgages are locked into fixed terms implies that the majority of households will not suffer immediate impacts by rising rates. And even among those with variable-rate products, one could protect themselves by locking into a fixed rate. In fact, the share of home equity lines of credit that are locked in has nearly doubled over the last year, from 16% to 29% (chart 8). In part, this is likely being driven by competitive pressures pushing fixed rates down, while variable rates have stayed relatively steady. However, as borrowers look to delay facing higher borrowing costs, the share of fixed debt is likely to rise further in the coming months as the first Bank of Canada rate hike approaches.

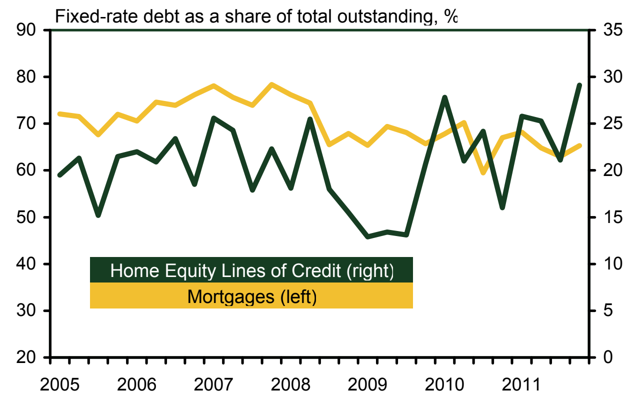
The fact that a growing number of households are likely to lock-in low rates in the run-up to the first rate hike is not to say that there will not be a negative income adjustment. First, there will be a short-term impact since, notwithstanding the recent narrowing, fixed-rate debt tends to still have a higher interest rate than variable-rate debt. Second, the impact simply becomes spread out over a longer period of time. Ultimately, borrowers will need to renew the terms of their obligations and will, at that point, be subject to higher rates. Hopefully, with a few years of building equity and paying down principal, they will be in a better position to absorb the higher debt carrying costs.

CHART 7: GOVERNMENT OF CANADA BONDS & FIXED MORTGAGE RATES



Source: Bank of Canada

CHART 8: FIXED-RATE AND VARIABLE-RATE HOUSEHOLD DEBT



Source: Ipsos Reid Canadian Financial Monitor

A slow unwinding of household debt

The key implication is that while excessive debt levels remain the economy's largest domestic medium-term threat, a combination of slowing credit accumulation, gradual increase in interest rates and efforts to lock-in at still-low fixed rates will help to ease the adjustment on households. These developments give credence to our expectation that the imbalances in the housing market and in the household debt-to-income ratio will unwind over time rather than in a precipitous fashion. At the same time, however, medium-term prospects for consumer spending remain limited. Looking ahead, TD Economics expects the level of debt to grow more in line with income at around 4% in the coming years.

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