# CIBC CAPITAL MARKETS



# **Economics** IN FOCUS

November 4, 2021

# Are Canadian households ready for higher rates?

by Benjamin Tal benjamin.tal@cibc.com

The market is turning hawkish, pricing in no less than 6 hikes by the Bank of Canada in 2022, starting as early as March, and an additional hike in 2023. The bond market is smelling blood, as 10 and 5-year rates have risen by 52bps and 68bps, respectively, over the past few weeks (Chart 1).

Market expectations and actual rate changes are of course two different things. Our own call is for a more gradual hiking trajectory, spread out over 2022 and 2023. But clearly, we have reached a point in which we have to assess the impact of any potential Bank tightening.

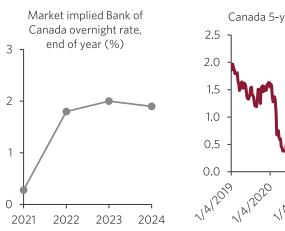
And here, of course, the focus is on heavily indebted Canadian households that saw their overall debt levels rise by close to 10% during the pandemic, to reach more than \$2.53 trillion or 173% of disposable income. Seventy percent of that debt is mortgage debt, of which one quarter is variable rate mortgages (Chart 2).

# The mortgage portfolio

So how sensitive is that huge pile of debt to higher interest rates? Let's start with the mortgage portfolio.

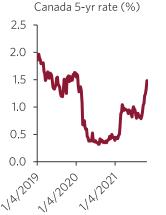
Clearly, the rising size of new mortgages means increased sensitivity to higher rates. With the average size of a new mortgage having reached \$450,000 (up by 20% during the pandemic), a one percent increase in mortgage rates from today's levels will cost an average new buyer \$230 or 12% more in additional monthly interest payments. Assuming mortgage originations return to pre-pandemic levels, that translates into an additional \$1.6 billion in annual interest payments relative to 2021 borrowers.

So higher rates can clearly slow down demand, but what about existing mortgage holders? How sensitive are they to higher rates?

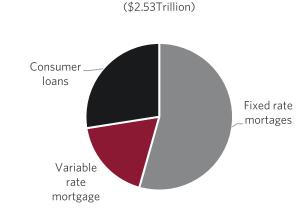


#### Chart 1: Markets are pricing in an aggressive Bank of Canada

Source: Bank of Canada, Bloomberg, CIBC



#### Chart 2: The market



Source: Statistics Canada, CIBC

#### Chart 3: The 2017-18 hiking cycle

Mortgage interest payments

rose but not by much

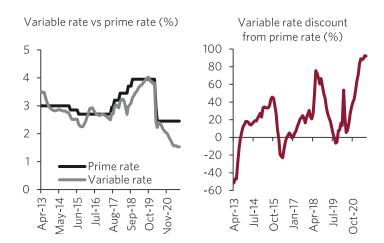
(%)

15 16 17 18 19 20 21

Bank rate (R)

share of disp. income \_ 2.0

#### Chart 5: Rising discount from prime rate



Source: Bank of Canada, Statistics Canada, CIBC

of Canada's 2017/18 hiking cycle, which saw the overnight rate rise by a cumulative 125 basis points.

Chart 3 tells the tale. Yes, overall mortgage interest payments in 2017 and 2018 rose in response to the Bank's hiking, but a closer look reveals that the increase amounted to only 0.5% of disposable income — hardly a macro story. Reflecting that, the effective interest rate on mortgages (the ratio of actual interest payments to mortgages outstanding) rose by only 30 basis points during that hiking cycle.

What was behind that muted response was not only limited exposure, but also the fact that those who had to reprice in 2017 and 2018 did it at a rate more or less similar to what prevailed five years earlier — so the interest rate change they faced was minimal.

Fast-forward to today's situation. As illustrated in Chart 4, both fixed and variable rates fell notably during the pandemic, with the gap between fixed and variable rates reaching record territory due to the recent increase in the five-year rate. Note the quick response by borrowers to that shift, with the share of variable rate mortgages in origination rising notably.

Importantly, the variable rate trajectory is impacted not only by the prime rate (which dances to the tune of the overnight rate), but also by the discount from prime offered by lenders. And as illustrated in Chart 5, that discount has widened notably recently.

Given the above, we can now compare the current rate environment to the one that prevailed when mortgages that face resetting in the coming two years were originated. So, the only thing we need to do is look at the rate environment in 2017 and 2018 which happened to be, as discussed earlier, the last hiking cycle. That clearly makes the comparison more favourable. Charts 6 illustrates exactly how favourable. In 2017,

Source: Bank of Canada, Statistics Canada, CIBC

Interest payment (L)

#### **Exposure**

5

4

3

2

First, we assess the share of mortgage holders that will be exposed to higher rates. The vast majority of non-fixed rate mortgage debt is variable, meaning that during the term (usually 5 years), payments don't change due to higher rates, but amortization does. For fixed-rate mortgages, only about one-fifth reset in any given year. We estimate that roughly \$350 billion of mortgages will be repriced in the coming year. So, not a trivial segment of the mortgage market will be repriced when the Bank makes its move. But repriced to what?

Effective mortgage rate hardly

moved

**1** in rates 2017-18 (bps)

Bank rate

100

90

80

70

60

50

40

30

20

10

1.5

1.0

0.5

0.0

Cumulative average increase

Effective

mortgage

rate

60%

50%

40%

30%

20%

10%

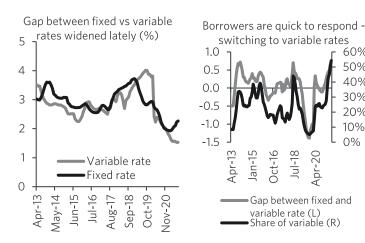
0%

Apr-20

#### Repricing

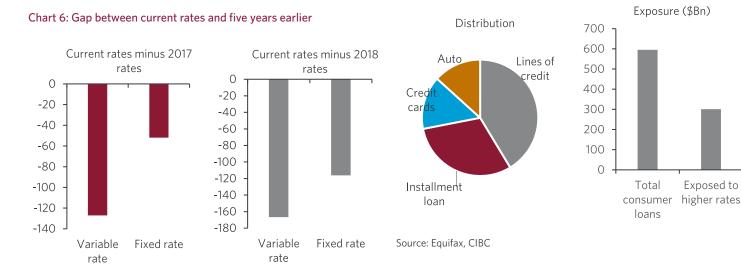
To get a sense of the potential impact of rate hikes, we can start by examining the impact on the mortgage market of the Bank

#### Chart 4: Variable vs fixed rate



Source: Statistics Canada, Bank of Canada, CIBC

#### Chart 7: Consumer loans



Source: Bank of Canada, Statistics Canada, CIBC

the five-year fixed rate stood at 2.84% while the variable rate was at 2.74%. Compare those rates to today's rate (Chart 6, left), and you see that today's variable and fixed rates are 127 bps and 52 bps lower, respectively. In other words, the five-year rate will have to rise by an additional 50 bps to start costing more, while the overnight rate will have to rise by close to 130 bps before starting to cause any damage. And with interest rates having risen in 2018, the comparison to 2023 is even more favourable (Chart 6, right). In fact, with rates remaining elevated in 2019, the borrowing cohort of 2024 is also relatively protected.

So the structure of the mortgage market and the rate hikes in 2017 and 2018, along with elevated rates in 2019, provide current mortgage holders with some immunity against rising rates. That immunity will cover borrowers that reprice in 2022 through 2024. But without a booster (lower rates in 2025/2026), that immunity will fade for borrowers that entered into mortgages during the pandemic. And given that in the past two years mortgage originations rose by more than 60% relative to their pre-crisis level, that might be a significant shock.

#### **Consumer** loans

As for the \$660 billion consumer loan portfolio, the sensitivity to Bank of Canada rate hikes varies widely across credit products. For direct loans, roughly half of those outstanding are variable and are adjusted once a year. Lines of credit, of course, fully adjust to changes in prime. However, while in theory interest rates on credit cards are adjustable, rates would have to rise significantly more than we expect during this cycle before actual borrowing costs would even budge. Accordingly, we expect roughly half of the current outstanding consumer debt to be repriced due to increases in the overnight rate (Chart 7). We estimate that a 100bps hike would lead to an increase of half a percent in interest payments as a share of disposable income.

### **Bottom line**

Elevated and rapidly rising household debt levels mean increased sensitivity to higher interest rates. The good news is that existing borrowers whose mortgages originated in 2017 through 2019 will not be exposed to the full impact of potential rate hikes in the coming years.

That, however, is not to say that higher rates will not bite. Potential buyers will face a higher interest payment trajectory, leading to reduced demand for new and existing units, potentially resulting in some slowing in the important construction industry. Current variable rate holders might choose to keep their principal payments untouched and thus will absorb the full impact of higher rates — potentially at the expense of other spending. And the sizable lines of credit in the loan portfolio are fully exposed to any rate hikes, resulting in a direct impact on consumption. Furthermore, if rates stay elevated into 2025, the massive borrowing undertaken during the pandemic will feel the full bite of higher rates.

Accordingly, despite the protection enjoyed by existing mortgage holders, higher rates will still be effective in slowing economic activity. Moving too fast (as the market suggests now) is therefore inadvisable.

## **Contacts:**

Avery Shenfeld 416 594-7356 avery.shenfeld@cibc.com

Royce Mendes 416 594-7354 royce.mendes@cibc.com

CIBC Capital Markets PO Box 500 161 Bay Street, Brookfield Place Toronto, Canada, M5J 2S8 <u>Bloomberg @ CIBC</u>

economics.cibccm.com

Benjamin Tal 416 956-3698 benjamin.tal@cibc.com

Katherine Judge <u>416 956-6527</u> katherine.judge@cibc.com Andrew Grantham 416 956-3219 andrew.grantham@cibc.com

CIBC World Markets Inc., CIBC World Markets Corp., CIBC World Markets Plc., CIBC Australia Limited and certain other corporate banking and capital markets activities of Canadian Imperial Bank of Commerce operate under the brand name CIBC Capital Markets.

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice. This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2021 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.

The CIBC logo and "CIBC Capital Markets" are trademarks of CIBC, used under license..