CIBC PRIVATE WEALTH

“MISUNDERSTANDING”

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When a central bank raises interest rates, it slows the economy. That is the point: higher rates make borrowing more expensive, so people and businesses spend less, which takes pressure off prices. The trouble is that the Canadian economy is already struggling. And yet the Bank of Canada (BoC) raised rates anyway. There must be some misunderstanding. "Misunderstanding" is a song by the English rock band Genesis, released on their 1980 album Duke. If memory serves me, I was introduced to Genesis in the early 1980s by a friend of mine at the time, Stephen Friedman, who now teaches at the Schulich School of Business at York University. I have to admit that I am now a fan of Genesis, Phil Collins and Peter Gabriel.

When the BoC raises its rate, the banks raise their own "prime" rate, which is what variable-rate mortgages and lines of credit are based on. This time, the banks moved prime from 4.45% to 4.70% the day after the announcement. If you have a $500,000 variable-rate mortgage, that increase adds roughly $1,250 a year in interest, a little over $100 a month. Businesses and governments with variable-rate debt see their borrowing costs rise in exactly the same way. Why would the BoC do this when the economy is weak? The US Federal Reserve has a dual mandate, or two goals, keeping as many people employed as possible, and keeping prices stable. The BoC's main goal is keeping inflation close to 2% a year. Jobs matter to it, but they come second. That is how the BoC could raise rates on October 28, 2026, even with the economy struggling. It lifted its key rate by 25 basis points, from 2.25% to 2.50%, its first increase since July 2023.

Canada lost 68,000 jobs in September, and that was not a one-off, as the country lost 42,000 jobs in August. The unemployment rate has risen to 6.5%, and Canada has now lost more jobs this year than it has gained. And yet the BoC raised interest rates. Some could argue the BoC wants to support the Canadian dollar, since higher rates tend to make a currency more attractive to investors. But even that I would question. A cheaper dollar makes Canadian goods less expensive for foreign buyers, which helps our

exporters in the middle of a trade war. We get it that if the CAD was seriously eroded that would add to inflation, but the CAD is relatively flat to the USD over the past year. Many of you have asked whether you should lock in your mortgage at a fixed rate. Historically, this has not paid off. The best-known Canadian research on this question comes from Professor Moshe Milevsky of York University's Schulich School of Business, who was one of my son's professors. Professor Milevsky concluded that the floating borrower came out ahead 88.6% of the time. When he updated the study in 2008 to cover 1950 to 2007, the floating borrower came out ahead 90.1% of the time. Fixed rates mainly won in the late 1970s, the early 1980s and the late 1980s, when variable rates climbed above fixed rates and stayed there. What matters most when you choose is the gap between the two rates today. As of November 2, the best 5-year variable rate in Canada is approximately 3.69%, versus 4.44% for a comparable 5-year fixed. On a $500,000 mortgage, that 0.75-point gap means roughly $3,750 less interest in the first year with a variable rate, about $300 a month. Put simply, today's variable rate is 0.75 percentage points (75 basis points) below the fixed rate. If the BoC raises rates 3 more times (by 0.25% each) or more , and keeps them there for most of the five years, locking in at today's fixed rate would come out ahead. If it doesn't, variable wins. We don't expect rates to rise that much as think they already went too far.

When rates are high and stock markets expensive, like now, no matter whether you choose variable or fixed, paying down your mortgage is often preferable than putting extra money into a non-registered investment account. Every dollar you pay down saves you interest at your mortgage rate, so it earns you a guaranteed return of, say, 4.44% after tax since mortgage interest on your home isn't tax-deductible. In a non-registered account, the interest you earn is taxed. For someone in a 43% tax bracket, a safe investment would need to pay about 7.8% before tax just to match paying down a 4.44% mortgage. Safe Government of Canada bonds pay well under that today, closer to 3.5%.

The BoC may raise rates one more time, maybe, but in my opinion that would be adding to its existing mistake. As I have stated before, a central bank cannot fix inflation caused by a supply shock, meaning prices rising because something is scarce rather than because people are spending too much. Raising interest rates does not produce more oil. If demand holds up while oil supply is disrupted, oil prices will rise. The BoC has said that it is worried about the knock-on effects. Think of a trucking company, when its fuel bill goes up, it either accepts lower profits or raises its delivery charges, and those higher charges eventually show up in the price of groceries and everything else on store shelves.

I think the BoC is making a policy mistake, like they did in 2007, when they raised rates just ahead of the financial crisis. However, it is Canadians who will be paying for this mistake. As if the housing market in Canada wasn't bad enough, higher rates are certainly not going to help. There must be some misunderstanding. There must be some kind of mistake.

One more thing, which matters if you own stocks. When analysts value a company, they estimate the cash it will earn in the future and then work out what that future cash is worth today, using what is called a hurdle rate. The hurdle rate starts with the "risk-free" rate (roughly what you could earn on safe Government of Canada bonds) and adds extra return for the risk of owning the business. When rates go up, money promised in the future is worth less today. For example, $1,000 a company will earn five years from now is worth about $784 today at a 5% hurdle rate, but only about $747 at 6%. Even if nothing about the business changes, higher interest rates discount its future cash flows.

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