Commentary

BoC hikes rates: More to come.

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- **The BoC delivered a 100 basis point (1%) interest rate hike during the week ending July 15.**
- **The sizable rate hike demonstrates the central bank's willingness to combat inflation at all costs.**
- **In the short-term, we expect to see additional hikes and do not see much to celebrate either as consumers or investors. During times like these, it is important to remember that investing is a long-term endeavour.**

Canada faces a serious inflation problem, and the Bank of Canada (BoC) knows it. Inflation has soared across the board—impacting consumer prices, real estate values, and labour costs—and now stands four times higher than the BoC's 2.0% target. To combat rising costs, the BoC delivered a 100 basis point interest rate hike during the week ending July 15. The sizable rate hike demonstrates the central bank's willingness to combat inflation at all costs. The July hike follows three previous hikes since the start of the year (25 basis points (0.25%) in March, 50 (0.50%) in April, 50 (0.50%) in June). BoC Governor Tiff Macklem stated "By front-loading interest rate increases now, we are trying to avoid the need for even higher interest rates down the road."

Our view: A long way to go

The 100 basis point (1%) hike was designed to shock markets and get consumers to realize that the BoC is serious about taming inflation. From an academic perspective, this makes sense. Interest rate increases raise the prices for goods and services bought on credit, consequently slowing demand. Reduced demand will eventually bring down inflation. That's the good news.

Recently bond investors have had little to celebrate as rate hikes have temporarily reduced the value of existing bonds (bond prices and yields move in opposite directions). This is not good news for bondholders. But remember that in most cases bonds eventually mature at par (assuming they do not default). Bond investors know that they are owed their money back at maturity. They are also aware that the temporary impairment of the value of their bond portfolio represents an opportunity cost as they wait for their bonds to mature. Selling your bonds now would of course lock in that loss, and free up cash to reinvest at higher current rates. But just how much higher rates will go, nobody knows. This is why most long-term investors remain patient and allow their bonds to mature before reinvesting at prevailing market rates.

Opportunity costs and re-investment risks are important considerations in the current environment. The BoC is expected to raise interest rates even further in coming months and there is no guarantee rates hikes will have their desired effect. Based on the Boc's recent move, it has become clear they seem willing to combat inflation at all costs.

In the meantime, short-term rates have started to move higher than longer-term rates. This is typically a harbinger of bad news for the economy and generally associated with much slower economic growth. It can also be a warning sign of an oncoming recession. Yet, a slower economy is part of the BoC's plan to help lower inflation and pull it back to its lower longer-term average. Higher interest rates also create an opportunity to reinvest cash flows from bonds at higher average yield levels generating more income over time.

Consumers and businesses are seeing costs rise at the fastest pace in a generation. While the BoC's efforts may tame inflation, they come at the cost of higher interest rates on loans, credit lines, and mortgages. With a significant portion of borrowers taking out variable rate mortgages (37% of new insured mortgages were variable rate, according to the latest data from Statistics Canada and the Bank of Canada), rising rates are not good news. Most other homeowners have fixed-rate mortgages that typically mature within 5 years. These homeowners could face increasingly tough times ahead as they are forced to refinance at much higher rates than the previous 5 years. On top of the already high cost of housing and the notable recent decline in home sales (down approximately 40% in the Toronto area as of April, according to the Toronto Regional Real Estate

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Board), highly levered landlords could get squeezed out of the market placing downward pressure on home prices.

In the short-term, there seems little to celebrate either as consumers or investors. During times like these, it is important to remember that investing is a long-term endeavour. Getting caught up in the day-to-day headlines can be exhausting. It could also be justification to enjoy the summer, although with the cost of fuel, goods, and airport delays maybe a 'staycation' might be the better option. Rest assured higher interest rates will lead to higher rates of income being paid on your bonds going forward. Bonds are one of few asset classes that generate income that accrues in your favour every day, even when you are on staycation.

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