Why Canada Needs to Raise Interest Rates

Description

Consumer debt in Canada reached another high recently; the average Canadian owes $1.65 per dollar of disposable income–a statistic that has changed the lending landscape in the country. Canada's biggest banks are experiencing a slew of delinquencies, which Fitch Ratings Agency predicts will lead to a continued lessening of lending quality, leading to higher lending rates from Canadian banks eager to maintain profits. In a recent report, Fitch Ratings Agency outlined a number of key factors which may lead to interest rate increases in Canada.

I will dive into a few key considerations for what the average investor should expect in the coming quarters.

Current economic environment not as stable as before

Two key factors negatively affecting the Canadian economy which were highlighted in the report by Fitch Ratings Agency are delinquencies in auto lending and credit cards led by record household debt levels, and depressed earnings among key economic industries in the Canadian economy, such as oil and gas.

The Fitch report notes that positive forces within the Canadian economy in sectors such as housing, driven by strong asset quality, are being supported by low interest rates, justifying the current low interest rate environment. However, should "sustained energy price declines dampen economic activity, Fitch expects to see broader consumer lending asset quality deterioration…"

This may force the banks to raise rates internally, with or without the Bank of Canada leading the way.

Canada's banks no longer "safest in the world"

For the first time in a long time, Canadian banks have been relegated from "safest banks in the world" status, falling behind banks in the U.S. and Europe in key metrics measuring the health of the banking sector.

Canada's largest banks, which include **Royal Bank of Canada** (TSX:RY)(NYSE:RY), **Bank of Nova Scotia**

(TSX:BNS)(NYSE:BNS), **Bank of Montreal** (TSX:BMO)(NYSE:BMO)**, Canadian Imperial Bank of Commerce** (TSX:CM)(NYSE:CM), **National Bank of Canada** (TSX:NA), and **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) have an average leverage ratio of 3.9%–the most commonly used measure of the health of a nation's banking system.

The U.S., by comparison, currently sits at 6.6%, with European banks sitting at 4.6%.

Another key metric used to gauge the health of a nation's banking system is the Basel Ratio. Canada ranks near the bottom compared with most other industrialized nations.

U.S. likely to raise rates in December

Many analyst reports covering the recent rise in U.S. treasuries point to the assertion that the U.S. will likely be raising rates in December. This reinforces the probability that global lending rates will increase, offering a window of opportunity for the Bank of Canada to follow suit.

While the Bank of Canada has not moved in lockstep with the U.S. in terms of monetary policy in recent years, this can be considered another potential reason to be ready for a "surprise" interest rate hike in the near future.

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2. NYSE:BNS (The Bank of Nova Scotia)
3. NYSE:CM (Canadian Imperial Bank of Commerce)
4. NYSE:RY (Royal Bank of Canada)
5. NYSE:TD (The Toronto-Dominion Bank)
6. TSX:BMO (Bank Of Montreal)
7. TSX:BNS (Bank Of Nova Scotia)
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