Why Canada Shouldn't (But Probably Will) Raise Rates Today

Description

The results of a recent survey conducted by Ipsos for MNP on the health of the Canadian consumer found some very disheartening results, posing an interesting scenario for Canada's central bank, which is widely expected to raise interest rates today. The decision, one which has seemingly been pre-determined given the fact that all of Canada's six largest banks have raised interest rates recently, poses this question: Is an interest rate increase the right thing to do for Canada's economy, given its fragile state currently?

I have contended in a previous piece that Canada's banks are currently suffering from a flattening yield curve, a phenomenon which understandably has led the country's banks to raise mortgage rates. In order to maintain previous levels of profitability, raising five-year mortgage rates is perhaps the only tool banks have to combat increasing costs of shorter-term debt typically used by banks to finance said mortgages.

That said, the actions of Canada's largest banks, such as **Royal Bank of Canada** (TSX:RY)(NYSE:RY), are not necessarily 100% predictive of what Bank of Canada governor Stephen Poloz will decide to do; rather, it certainly pushes the conversation in one direction, making it much harder for an interest rate increase to be taken off the table, given the relatively strong economic data posted by Canada in other areas, such as employment and rising commodity prices.

Implied odds have fluctuated in recent days; however, an approximate three-in-four chance that the Bank of Canada will raise rates yet again during the first meeting of 2018 has started the discussion, once again, on what the potential medium-term impacts of such a move will be.

In the aforementioned consumer health survey, approximately one-third of respondents noted that bankruptcy could be a real possibility if interest rates climb higher; this is due to an increasing reliance on variable-rate debt instruments such as mortgages, home equity lines of credit, car loans, student debt, and other interest rate-sensitive debts held by everyday, working-class Canadians.

The argument that Canada's debt-driven economy is likely to continue to speed up in 2018 in the face of rising interest rates is one which I would challenge is an unlikely one to prevail over the overly bearish sentiment felt by consumers heading into another year in which stock markets around the world approach all-time highs in terms of valuation.

Bottom line

This interest rate increase which is set to come into effect today is unlikely to create havoc in the very near term. That said, if expectations of three interest rate hikes in 2018 do indeed play out as intended, I foresee pain in the medium term unlike anything investors have experienced in a decade or more.

Brace yourselves; the ride has only just begun.

Stay Foolish, my friends.

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