The Bank of Canada Is Set to Be More Active Going Forward: How Will This Impact Stocks?

Description

In a quarterly review released in December 2017, the Swiss-based Bank for International Settlements (BIS) compared the situation in the waning weeks of 2017 to the 2008 financial crisis. The BIS warned in its statement that interest rate hikes from central banks had failed to curb risky investments and that financial bubbles were growing.

Claudio Borio, the head of the BIS monetary and economic department, said, “The vulnerabilities that have built around the world during the long period of unusually low interest rates have not gone away. High debt levels, in both domestic and foreign currency, are still there. And so are frothy valuations.” Another reason for high valuations, Borio pointed out, is the tendency of central bankers to ostensibly guarantee intervention in the event of turbulence to prop up financial markets.

“If gradualism comforts market participants that tighter policy will not derail the economy or upset asset markets, predictability compresses risk premia,” Borio continued. “This can foster higher leverage and risk-taking. By the same token, any sense that central banks will not remain on the sidelines should market tensions arise simply reinforces those incentives.”

In mid-February new reports suggested that the Bank of Canada would explore closer ties with the federal government to provide interest rate relief and boost stimulus during economic turbulence. Deputy Governor Lawrence Schembri recently warned that monetary policy could be less effective when it comes to future economic downturns.

The warnings come after new reports have shown Canadian household and consumer debt continue to hit all-time highs. Schembri warned that low interest rates have encouraged households and consumers to accrue more debt and resulted in less space for central banks for stimulate growth. The benchmark interest rate currently sits at 1.25%, and the Bank of Canada has raised its “neutral rate of interest” down to the range between 2.5% and 3.5% compared to 3% and 4% three years ago.

In addition to this, economists also expect that this period of global growth will subside in the coming years. Canadian GDP growth is expected to slip below 2% by 2021.

The S&P/TSX Index climbed 2.7% week over week as of close on February 16. However, the index is still down 4.6% in 2018, as investors now look ahead to the first quarter of bank earnings. The success of the largest Canadian financial institutions is sometimes used as a benchmark by market watchers for the broader economy.

Shares of **Royal Bank of Canada** (TSX:RY)(NYSE:RY) have dropped 2.1% in 2018 thus far. The bank is set to release its first-quarter results on February 23. **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), which has seen its stock fall 1.5% so far in 2018, is set to release its first-quarter earnings on March 1.

Analysts are expecting positive earnings as Canadian and global growth has remained strong, but there continues to be anxiety surrounding some of the above concerns. Some analysts are calling for a pullback in mortgage portfolios due to the new rules introduced by the OSFI. However, U.S. tax reform is expected to be a big boost for banks with a sizable footprint south of the border.

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