Tiff Macklem Demands 2% Inflation – Will Bank Stocks Benefit?

Description

Recently, Bank of Canada governor Tiff Macklem said that he was intent on reducing Canada's inflation rate to 2%. Re-affirming the bank's long-term target, he said he wouldn't settle for anything less (or rather, anything more). In a *Financial Post* article titled, *"Tiff Macklem Says He Won't Settle for Anything Less Than a 2% Inflation Rate,"* Kevin Carmichael interviewed the bank chief, who re-affirmed his commitment to lower inflation – even if it takes more interest rate hikes. All year long, the bank has been raising interest rates, leading to hefty mortgage payments and a sagging stock market. The policy has been controversial but, for Macklem, it's worth it if it gets inflation back to the target range.

This naturally leads to the question: Are bank stocks like **Royal Bank of Canada** (TSX:RY) buys here? In theory, banking is one of the few sectors that can benefit from rising interest rates. When central bank interest rates go up, commercial banks like RY raise their interest rates, too. As a result, such banks can capture higher interest revenue in periods of rising interest rates. However, high interest rates can cause recessions, which reduce lending and long-term bank earnings. It's a mixed picture overall. In this context, I will explore whether bank stocks are buys after considering Tiff Macklem's policy goals, zeroing in on the Royal Bank of Canada.

What it would take to hit 2% inflation

Reducing inflation to 2% will likely require more interest rate hikes. The current Bank of Canada policy rate is 4.25%, which is lower than the current inflation rate. One theory on interest rates is that they have to be higher than the inflation rate to bring inflation down. If the Bank of Canada is following this theory, then it'll have to raise rates more.

However, the rate hiking could be over sooner than most people think. There's a concept in economics known as base effects, which says that an increase in inflation is likely to be lower if the previous year's inflation was very high. It takes more *numerical* growth to achieve high *percentage* growth, after some growth occurred in the past. This means that inflation is likely to be low following high inflation, unless some truly extraordinary monetary factors or supply shocks are at play. In February, Russia's invasion of Ukraine will be a full year into the past. The invasion increased global oil prices; a year on, gasoline prices might show low or negative growth.

How banks could benefit

If the Bank of Canada keeps raising interest rates, then banks could benefit from it.

Let's look at Royal Bank of Canada to see how that would work.

Royal Bank of Canada makes its money by issuing loans. The higher the interest rate, the more loan interest is collected. Provided the interest rate doesn't deter people from borrowing, then the Royal Bank collects more revenue. Now, if the higher interest rate does deter people from borrowing, the effect is more complicated. In that scenario, Royal Bank may collect more, less, or an unchanged amount of revenue, depending on which factor is stronger. If yields rise more than borrowing falls, then RY should collect higher revenue despite the slow borrowing.

There's also the matter of the yield curve. The yield curve is a chart with bond yields on the Y axis and terms to maturity on the X axis. Royal Bank borrows on the short end of this curve and lends on the long end. When the curve has a negative slope, RY's interest income may shrink, even while total revenue rises, because it starts paying more interest on deposits. So far, RY's net interest income has only grown this year, but if the yield curve inverts (i.e., turns negative) even more than it already has, then that may change.

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Date
2025/09/02
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