Part 1: What Lower Rates for Longer and the Risk of Recession Mean for Canada's Banking Sector

Description

It feels like we've been hashing through this narrative for quite some time now, but particularly as of late, markets have been confronted with a confluence of interrelated and fairly serious threats to the current bull cycle.

Trade talks between the world's two largest economic superpowers, China and the United States, continue, leaving loads of uncertainty among investors and businesses leaders alike in terms of what the future could eventually hold.

And while earlier this year, we appeared set for a period of gradually rising interest rates intended to moderately cool off a strong economy, those plans have not only since been put on hold but actually reversed course with 87% of analysts now expecting the U.S. Fed to cut its policy interest rate by another 25 basis points at its next upcoming meeting.

Falling interest rates — although it may seem counter intuitive — are usually not the best sign for an economy, as it tends to suggest the need for external stimulus or support.

Meanwhile, in Canada, we have seen rates fall nearly in lock-step, mimicking those of our southern neighbour, which is almost a necessary evil to support our very important trade economy; however, sharply lower rates have had the (possibly unintended) consequence of sending home prices skyrocketing once again, including one of the strongest months on record in September.

So, what does this all mean for Canada's ever-important banking sector?

In this two-part series, we'll take a closer look at some of the more likely scenarios that could play out as well as what it could pose for Canada's banking sector over the short, medium, and long term.

All else equal, banks prefer interest rates to be higher and not lower…

There are few different factors at play that, taken together, suggest that all else equal, commercial banks like Canada's "Big Five" tend to favour environments featuring higher rather than lower borrowing costs.

- Higher rates generate higher interest income in nominal (reported terms)
- Higher rates tend to facilitate wider spreads between borrowing and lending costs
- Higher rates tend to be most commonly found in healthy, growing economies

In times when rates are depressed, like they are presently, banks essentially need to give out larger loans to earn the same nominal returns on their investments (investments including quarterly earnings per share are virtually always quoted in nominal terms).

In order for banks like **Royal Bank of Canada**, **Toronto-Dominion Bank**, and others to appease the market's demand for consistent year-over-year earnings growth and dividend increases, they are essentially forced to decide between lending out more money at lower rates (not desirable) or not lending out money at all (almost unthinkable).

So, with Canada's largest financial institutions essentially finding themselves squeezed between a rock and a very hard place, in part two of this series, we'll take a look at what the current environment may or may not be implying for the rest of the Canadian economy at large and how Canada's banks continue to play a critical role in that development.

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