WHAT RISING RATES AND INFLATION MEAN FOR CANADA'S ECONOMY

It seems like as soon as central banks start raising interest rates and we're seeing that in both the U.S. and Canada, you get those stories about the R word that is recession.

[The exteriors of the Federal Reserve and the Bank of Canada.]

People start to worry that a rate hike cycle inevitably has its conclusion, not just in easing inflation, but sending the economy spinning downward.

[The Federal Reserve in Washington. The European Central Bank in Frankfurt.]

And while that has sometimes been true in past tightening cycles, there have been a number of cycles where the central banks hiked rates for a while, then paused or even eased rates a bit, and the cycle continued. And I would argue that if you look back to where we were in 2019, we were exactly at that point.

[The exteriors of the Federal Reserve and the Bank of Canada.]

The Bank of Canada had stopped raising rates at relatively low rates of interest and the economy was still moving forward. And the U.S. had actually started to ease off a little bit on interest rates in 2019 and might have averted a recession if not for the emergence of COVID-19.

[A man wears a mask and looks out the window. Busy hospital hallways.]

So not all rate hike cycles certainly end in recession, and there are some reasons to expect that Canada and many Canadian-listed companies should be able to tolerate higher rates of interest than we've now seen in the past.

[Can Canadians tolerate higher rates?]

Even if you look at Canada's household sector, albeit a very indebted household sector, it's not like the first couple of years of rate hikes are going to be all that much of a squeeze on that sector of the Canadian economy.

[Aerial views of suburban neighbourhoods in Canada.]

Remember that the mortgages, for example, that will come due in 2022 and 2023. These were mortgages that typically, if they were four- or five-year mortgages, were taken out before the pandemic at interest rates that are probably quite close to where mortgage rates will be over 2022 and 2023.

[Images of people signing mortgage documents. A man is handed a folder and a set of keys.]
So, they'll be higher than they were at the height of the pandemic. But those mortgages won't come due until 2024 or 2025. The Bank of Canada also understands the debt level of Canadians and should be careful to perhaps pause on the way towards higher interest rates to make sure that the economy is living with that. Ultimately, we do see short-term interest rates getting into the sort of mid 2% range in both the U.S. and Canada.

[Images of people wearing masks in a city. Vials of COVID-19 vaccines.]

That should be something the economy can live with over the medium term if COVID manages to behave itself and not return to a full force anytime soon.

[Outlook for investors]

The question is for investors, how much of a dent does this do? It certainly has raised concerns about companies that have all their earnings way off in the future because you're now discounting that flow of earnings at a higher interest rate. So the growth companies that don't have a lot of current profitability certainly have been marked down by the equity market. It does pose a bit of a challenge for companies whose only value is as a substitute for bonds.

But then there's a whole group of companies that will benefit from the ongoing growth in the Canadian economy. It is, after all, that growth that is compelling central banks to start raising interest rates. And therefore, there certainly should be elements of the equity market that benefit more from the further improvement in economic activity than they're hurt by the rise in interest rates.

[Inflation]

We are, of course, monitoring the spike in inflation. The longer it persists, the more there will be a concern that central banks really have to dole out severe punishment to the economy to get that back down.

[A shipping barge docked in ice. An empty warehouse. An empty supermarket. The Ukrainian flag.]

But we do believe that some of the inflation we're seeing today is still the remnants of supply chain difficulties caused by COVID, as well as, more recently, the war in Ukraine. And as we look ahead to 2023, at least those elements of inflation should give way to much lower rates of inflation on things like energy prices and other things impacted by the war. And we're hoping that therefore it only takes a modest cooling in economic growth in Canada, in the U.S., and therefore a relatively moderately paced dose of rate hikes to get overall inflation back under control. We'll be keeping an eye on that forecast, of course. But as I said at the outset, no hard and fast rule that central banks have to err on the side of causing a recession. And certainly, a number of cases in the past where they've successfully managed to pool growth without taking the whole economy down with it.