THE GLOBE AND MAIL

July 11, 2018

Why Canadian bank investors should shudder with each rate increase

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The Bank of Canada's interest-rate decisions, often a rather humdrum affair, are becoming downright fascinating. The announcement on Wednesday of a hike, and the growing probability of more before year-end, suggest that the future will be very different than the past for Canadian banking stocks.

While the latest increase was widely expected, the tone of the announcement "was more hawkish than markets expected," according to Derek Holt of Bank of Nova Scotia. He is counting on at least one more rate hike this year and would not be shocked to see two.

If this occurs, it would mark a significant turning point, both for the BoC and for the Canadian economy. Over the past quarter-century, and even more so over the past decade, Canadian households have borrowed with abandon as rates have generally headed lower.

Now that the economy appears to be running close to capacity, the central bank is faced with the difficult task of raising rates at a time when household debt burdens are massive by historical standards. Every upward tick in interest rates magnifies the burden of carrying all that borrowing. But the BoC appears increasingly confident that consumers can bear it.

Others have their doubts. The Parliamentary Budget Officer (PBO) warned in a report last year that "the financial vulnerability of the average Canadian household would rise to levels beyond historical experience" if rates climb as it expects over the next few years.

Some investors have their issues as well. In a report last month, ***Veritas Investment Research*** in Toronto said the pass-through of higher interest rates to highly indebted households will "drive higher delinquency rates and credit losses among Canada's Big Six banks."

The math behind these predictions is straightforward. It rests on the debt-service ratio (DSR), a measure of how much of a household's disposable income goes to paying off loans, both in terms of principal and interest. The DSR was typically around 12 per cent in the 1990s and early 2000s. After the financial crisis, however, as rates tumbled and borrowing became more attractive, it jumped up to about 14 per cent.

What will happen if borrowing rates tick up by a percentage point over the next couple of years? Canadians owe an average of 168 per cent of their disposable incomes, so, all things being equal, a one-percentage-point bump in interest rates would result in a nearly 1.7-percentage-point increase in the DSR. This would leave the DSR close to 16 per cent, a level not seen in Canada before.

For its part, the PBO report predicts the DSR will hit 16.3 per cent by the end of 2021. To be sure, this ominous forecast could be disrupted if Canadians suddenly start vigorously paying off their debts or incomes jump upward. But whichever number you choose, the logic is clear: As more and more money goes to servicing existing debt at higher rates, less will be left for spending on everything else – or for servicing new debt.

For investors, this suggests Canadian bank stocks should be approached with caution. The Big Six and other lenders have thrived over the past quarter-century as households have more or less doubled their debt levels in relation to their disposable incomes. But if we're entering a period in which loan growth will be slower, and default rates will rise, bank stocks look distinctly less shiny.

The housing market, too, is likely to feel headwinds. And there's also the effect on the broad economy as the DSR grows. *Veritas* calculates that consumers are likely to see a significant slide in their spendable incomes as a result of higher borrowing costs. "We would expect these income effects to have materially negative implications for Canadian household discretionary spending and Canada's overall economy," it says.

To be sure, the BoC is aware of all these issues. Governor Stephen Poloz gave a speech in May in which he examined the issue and expressed confidence the central bank can manage the risks. Other countries, such as Norway and Australia, have even higher levels of debt in relation to incomes, he pointed out.

The central bank continued its confident tone on Wednesday, arguing that higher oil prices offset increased trade tensions and that the housing market is stabilizing nicely. So everything is good? Perhaps. But investors counting on a continuation of bank stocks' endless good fortune may want to temper their expectations.

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Tickers mentioned in this story

Symbol	Name	Last	Change	% Change
BNS-T	Bank of Nova Scotia	75.65	+0.18increase	+0.24%increase
BNS	Bank of Nova Scotia	57.56	+0.21increase	+0.37%increase
CM-T	Canadian Imperial Bank of Commerce	116.06	-0.01decrease	-0.01%decrease
RY-T	Royal Bank of Canada	101.53	+0.07increase	+0.07%increase
TD-T	Toronto-Dominion Bank	75.97	+0.02increase	+0.03%increase
BMO-T	Bank of Montreal	103.27	+0.14increase	+0.14%increase
NA-T	National Bank of Canada	63.31	+0.06increase	+0.09%increase