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Brief Comments Regarding Short- and Long-Term Interest Rates

1. The Bank of Canada made it very clear that it is going to raise rates come July 10. The bond market is already anticipating it. In fact, the bond market is already discounting roughly 50 basis points rate hike by September 2007.
2. Note that we had false alarms in the past where the bond market discounted rate hikes only to be proven wrong, with the 5 and 10 year bond rates rising and falling accordingly.
3. But this time it seems that the bond market has a very good reason to predict a rate hike. The Bank of Canada is concerned about inflation (which at 2.5% is about 0.5% above the Bank's comfort level) and the fact that the labour market is still very strong.
4. It is very possible that raising rates now will end up to be a monetary policy error (as we have seen in the past) with the Bank of Canada probably overshooting. But at this point, this kind of argument is academic. The Bank of Canada appears to be determined to raise rates, and that's what counts. The question is: by how much?
5. Here, we have to realize that there are two important factors that should limit the magnitude of any rate hike.
 - It is far from clear that the slump in the US housing market is over. If indeed the housing market continues to slide and the US economy surprises on the downside, then the Canadian economy will feel some of the pain.
 - This also means that the Fed might cut rates by the end of the year — which will make it very difficult for the Bank of Canada to raise rates in an environment of falling US rates. Such a situation will boost the Canadian dollar significantly (to well over 95 cents) — with all the negative implications.
6. Here, it is very important to understand the impact of a stronger dollar on monetary policy. We distinguish between two types of dollar appreciation: Type A is the good type, in which the dollar rises due to higher commodity prices. The Bank of Canada is not concerned about such appreciation since any damage to the manufacturing sector is being offset by a gain in the commodity sector. Type B appreciation (the bad type) is the one that reflects mainly expectations that Canadian interest rates will rise by more than US rates. In this situation, there is only damage with no positive offset. Clearly, the recent (and probably the upcoming) appreciation in the dollar was Type B — something that the Bank of Canada will have to take into account.
7. Another factor to consider is that most of the inflation in Canada is coming from the west. By raising rates too much, the Bank is risking taking Ontario into a recession.

8. So, the bottom line is that the Bank will raise rates — but probably not too much. Fifty basis points rate hikes by September is a reasonable guess. This means that the main damage from this point will be in the prime rate, and less in the five year rate.
9. From a practical perspective. As we have mentioned many times before, the mortgage interest rate curve is relatively flat and will remain flat for a while. This means that taking a variable rate mortgage vs. fixed term mortgage will not result in any material savings. And given that there is the risk that the US economy will surprise on the upside, then a risk averse borrower will be probably better off locking now in the current (still attractive) rates.

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