



April 21, 2006

A Brief Assessment Of The Economy And Implications For Interest Rates And The Mortgage Market

- In May 2000, during the FOMC meeting of the US Federal Reserves, the Fed's Chairman Mr. Greenspan said: "*The risk of moving 50 basis points today are not very large because I think the underlying momentum in the economy remains very strong*". And indeed, the Fed went ahead and raised rates by 50 basis points. Eight months later, the US economy was in a recession. Clearly, the Fed made a policy monetary error by overshooting and raising rates much too aggressively — in a way that triggered an economic recession.
- In fact, recent economic research show that all economic recessions over the past 40 years were helped by monetary policy errors or overshooting.
- Are the Bank of Canada and the Fed in a process of overshooting now? From reading newspaper headlines about recent economic numbers, one might get very confused about the right course of action for both Central Banks. For example, over the past two weeks, we got an array of good news such as strong employment numbers and housing activity. But we also got many bad news such as slowing exports, further decline in manufacturing activity, and disappointing retail sales. Which numbers should we believe?
- My experience is that reacting to media reports is a sure recipe for over reacting and potentiality making the wrong move.
- It is very clear that the economy is strong — with the labour market even stronger. The Bank of Canada has been raising rates and indicated that more "may" be needed. From the language of the Bank we learn that the Bank, at this point, does not see a need to "aggressively" raise rates, but will do it on a very gradual basis.
- Also, note that the Bank knows that the impact of today's rate hikes will be felt only 8-10 months from now. The lag effect is something that is missed by the popular media.
- A reasonable guess is that the Bank will move by another 50 basis points and that the 5-year rate will further rise by 20-25 basis points — all within the coming 3-4 months or so. (There is a risk of about 25% probability that the Bank will move by 75 basis points. This risk reflects the potential inflationary impact of rising wages in Western Canada and their impact on wage pressures in the rest of the country. The likelihood is that productivity growth will rise fast enough to offset any wage-related inflationary pressures. Nevertheless, this is probably the most significant risk to the forecast.)
- The Bank will also take a close look at the Fed. And it is widely expected that the Fed will not go beyond an additional 25 basis points from now. The story here is the fact that the US economy is

widely expected to soften in late-2006 and into 2007, reflecting the lag impact of higher interest rates, a leveling off in the housing market, and the impact of higher energy prices.

- We then might enter a period of not much movement in both short and long-term rates as the Bank assesses the situation and examines to what extent previous rate hikes are starting to impact the economy.
- Beyond that, it is very possible that by mid-late 2007 the market will start factoring in a possible rate cut by the Bank. (This might be more so if the Bank ends up raising rates by 75 basis points.) We do not view it as a major downward trend in rates, but probably some fine-tuning of rates — of say, 25-50 basis points (not unlike what the Bank did in the past).
- This means that in 18 months from now, both short and long-terms rates might not be very different than their current levels. (After rising and falling roughly by the same magnitude.)
- Implications: Shifting now from Variable to Fixed mortgage rates will probably be proven a mistake 5 years from now, albeit not a big one. While variable rate mortgages will not be as attractive as it used to be in the past five years and the savings will not be as significant (at least in the next 2-3 years), they will continue to outperform. The likelihood is that we are getting closer and closer to the end of the tightening cycle.

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