INSIGHTS & STRATEGIES

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April 2024 Insights & Strategies: Housing, Inflation, and Interest Rates

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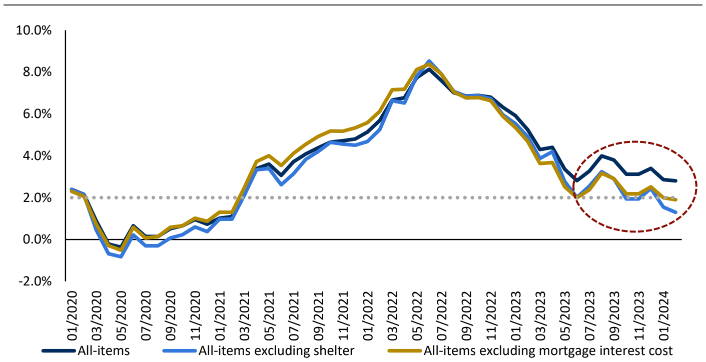
While fixed-rate mortgage holders have been relatively unaffected by all the rate increases over the past two years, variable-rate mortgage holders have been grappling with the burden of elevated monthly payments or negative amortization. In its latest meeting in March, the Bank of Canada (BoC) decided to keep its target rate steady at 5 per cent, citing underlying inflation as a reason to hold off on rate cuts. Currently, Canadian financial markets have priced in a 17 per cent chance of a rate cut in April and a 67 per cent chance in June, versus 37 per cent and 82 per cent, respectively, on March 4, just before the latest policy update. The economy has also proven to be more resilient than expected and the unemployment rate remains below its historical average, giving the BoC greater leeway to further delay the start of rate cuts. However, is prolonging the current interest rate level the answer to continued inflation improvement, or is inflation already sufficiently contained, or on the right trajectory, and could further delays possibly trigger a (more severe) recession in the Canadian economy? We believe that the BoC should cut sooner rather than later and exclude shelter inflation from its considerations, for the benefit of the overall economy. To delve deeper into this, we will examine three key aspects: shelter inflation, household financial health, and long-term housing supply.

Shelter Inflation

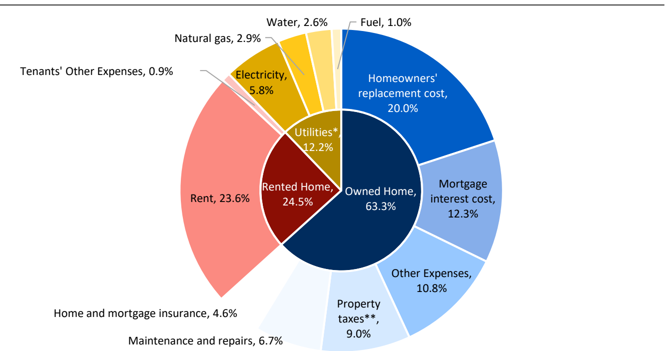
Shelter inflation, driven by mortgage interest increases, has become a driving force behind elevated Consumer Price Index (CPI) growth. Headline CPI remained above target, at 2.8 per cent, in February, although by excluding shelter and mortgage interest costs that metric would be at or below the 2 per cent target (Chart 1). So, is it fair to exclude shelter costs to get a more representative measure of inflation, considering that the elevated interest rates being used to combat inflation might in this case be adding to the problem? Shelter CPI is lagging in nature. If the BoC were to lower its policy rate today, fixed-rate mortgage holders would likely still face higher monthly costs on renewal this year, as rates would likely be higher than those of their last renewal. It also takes time for landlords to adjust costs to renters. Consequently, regardless of whether the BoC decides to hold rates for longer or not, shelter CPI would likely remain elevated for the rest of 2024. Considering that shelter holds a weight of 28 per cent in the headline CPI, to bring headline CPI back to its 2 per cent target, the rest of the CPI components would need to remain much lower, implying more stress on various parts of the economy. Even the BoC's preferred core measure, CPI trim, which helps filter out extreme price movements, still includes a significant portion of shelter CPI components, skewing the measure higher. That said, if the BoC continues to hold rates until observing further progress towards the 2 per cent inflation target, it could potentially push the economy into a (more severe) recession, especially given that rate hikes affect almost all other sectors, and GDP growth has remained stagnant since the second quarter of 2023.

Chart 1 - CPI ex Shelter Has Achieved The 2% Target



Source: Statistics Canada; Data as of February 29, 2024.

Chart 2 - Shelter CPI Basket Weight Breakdown



Source: Statistics Canada; Data as of December 31, 2022. *Water, fuel and electricity; **Property taxes and other special charges.

Furthermore, it might seem reasonable to assume that a rate cut would trigger a resurgence in housing prices and therefore of the shelter component of CPI and consequently overall inflation. However, upon closer examination of the breakdown of shelter CPI components and their interrelationships, the outcome becomes less obvious. At a high level, shelter CPI comprises three main components represented in the inner circle of the pie chart (Chart 2): owned accommodation, rented accommodation, and utilities, with the breakdown for each of these components shown in the outer ring. The components driving the rise in shelter CPI—namely owned accommodation and rented accommodation—have seen average year-over-year growth of 6 to 7 per cent over the past 12 months, while spending on utilities has remained relatively stable. Now, what's particularly intriguing is that the impact of rate decisions on certain heavy components varies significantly.

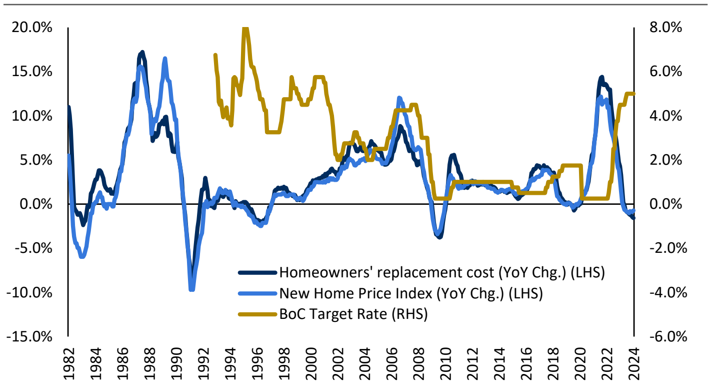
Homeowners' Replacement Cost

Unlike other components of owned accommodation, homeowners' replacement cost is not an immediate or direct out-of-pocket expense for most people, as it is considered a depreciation component. This cost is derived from various sources, including data from the Survey of Household Spending, where respondents are asked about their expected selling price for their house, as well as external sources such as the Canadian Real Estate Association (CREA) and the Canada Mortgage and Housing Corporation (CMHC).

The methodology used to determine homeowners' replacement cost is a key factor behind the notion that a rate cut can lead to higher shelter CPI. Not surprisingly, it closely correlates with the new home price index, as the latter serves as an easily accessible benchmark for homeowners (Chart 3). Furthermore, since homeowners' replacement cost is not incurred out-of-pocket, there is minimal lag between real-time data and homeowners' expectations.

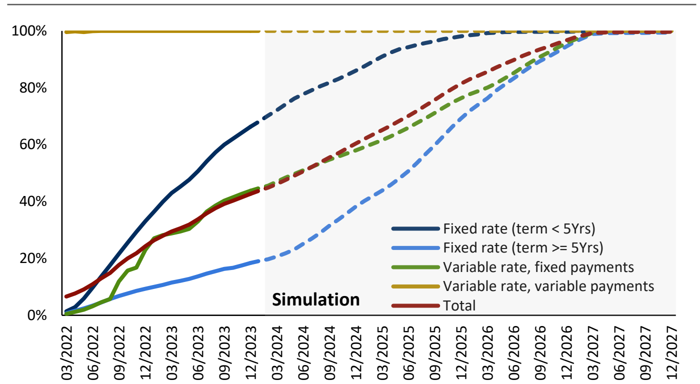
Historically, the BoC target rate and new home prices have tended to move in opposite directions, as a lower target rate typically translates to lower mortgage interest rates, making it more favourable for home buyers (Chart 3). With some modest signs of increased activity over the last three months compared to a subdued fall market in 2023, the BoC remains concerned that a rate cut could further fuel home price surges. However, according to CREA senior economist Shaun Cathcart, the focus may shift away from the exact timing of interest rate cuts, with the emphasis placed more on the number of homes available for sale this year, given that significant demand has piled up on the sidelines[1]. This observation underscores the structural supply issue. Therefore, while holding the rate unchanged may have a lesser impact compared to a rate cut on the potential rebound in home prices, it is unlikely to significantly alter the trend. On a positive note, from an inflation perspective, the sales-to-new listing ratio decreased in February, indicating that sales were down and new listings were up. This suggests that there hasn't been a rapid rebound in home prices yet.

Chart 3 - Rate And New Home Prices Move in Opposite Directions



Source: Statistics Canada, Raymond James Ltd.; Data as of January 31, 2024.

Chart 4 - Most Mortgages Have Not Yet Seen Increased Payments



Source: Regulatory filings of Canadian banks and Bank of Canada calculations; Scenario: Rates evolve according to financial market expectation as of December 1, 2023.

Mortgage Interest Cost

Mortgage interest costs stand out as the primary force driving inflation upwards, with average year-over-year growth of monthly payments of around 28 per cent. This metric measures the impact of price changes on the amount of mortgage interest owed by the target population on their mortgage balance. Notably, changes in mortgage rates tend to have a larger impact than recent changes in house prices, as the total value of houses purchased during a given period is always a small proportion of the total stock of dwellings with mortgages.

[1]CREA (2024), Canadian Home Prices See Sudden End to Declines in Advance of Spring Market, CREA, https://www.crea.ca/media-hub/news/canadian-home-prices-see-sudden-end-to-declines-in-advance-of-spring-market/

It's important to highlight that increases in mortgage interest costs can have long-lasting effects and a broader impact compared to the rise in new home prices. To begin with, roughly 36 per cent of Canadians own homes with mortgages, while 23 per cent own homes outright, and the remaining 41 per cent rent. Following a significant rate hike of 475 basis points since March 2022, approximately 43 per cent of mortgage holders in Canada have personally felt the financial strain as they renewed their terms through December 2023, and it's anticipated that number will increase to 80 per cent of mortgage holders by the end of 2025 (Chart 4). This also affects renters, as landlords with mortgages pass on the costs. This process unfolds gradually and affects a majority of Canadian households, whereas new homebuyers make up only a fraction.

Furthermore, the magnitude of the increased mortgage interest payment is expected to be significant, particularly considering that just three to five years ago, we were still in an era of exceptionally low interest rates. According to BoC staff analytical notes[2], assuming rates evolve according to financial market expectations as of December 2023, the median monthly mortgage payment for all outstanding mortgages is projected to rise from $1,200 in February 2022 to $1,600 by the end of 2027—an increase of 34 per cent (Chart 5). Variable-rate mortgage holders with variable payments may be relatively less affected from this point onward. Conversely, those with variable-rate mortgages and fixed payments, who have yet to see their mortgages adjust, will experience the most significant shock, with median payments increasing from $1,418 in February 2022 to $2,190 by December 2027, representing a 54 per cent increase. While fixed-rate mortgage holders are in a relatively better position, they are still expected to experience further increases in the next two years. Additionally, the year-to-date development in the target rate is more hawkish than the financial market expectations at the time when this simulation was conducted, suggesting that these amounts are likely to be understated.

That being said, mortgage holders are finding themselves needing to make significant cuts to their spending, particularly after renewing their mortgage terms. However, as mentioned earlier, only about half of mortgage holders have completed their renewals. The lingering effect of rising mortgage interest costs will continue to put financial pressure on households. Therefore, the sooner the rate is cut, the quicker households can find relief in the future. It's important to recognize that, just as it takes time for households to feel the impact of higher mortgage rates, it also takes time for the benefits of lower mortgage rates to be felt across the board.

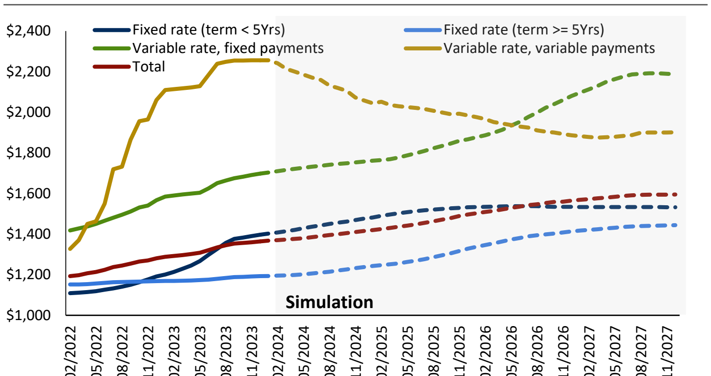
Rent

Rent stands out as the largest component within the shelter CPI. Data on rent are collected through a supplementary questionnaire included in the Labour Force Survey, where respondents are asked about their total monthly rent. Despite the straightforward methodology used to derive the rent CPI, it is actually intertwined with the homeowners' replacement cost and mortgage interest cost we discussed earlier, to different extents.

Analysis of monthly CPI data from 1981 to the present shows a notable difference in correlations. Rent has a much stronger relationship with mortgage interest cost (70.6 per cent) compared to its correlation with homeowners' replacement cost (12.6 per cent). This indicates a stronger relationship between rent and mortgage interest cost. In practical terms, if there is a rate cut leading to a decrease in mortgage interest cost, it is likely to offset any increase in homeowners' replacement cost, resulting in a decrease in rent. This decrease in rent is beneficial for overall inflation and for renter households. On the flip side, keeping the rate unchanged would have the opposite effect.

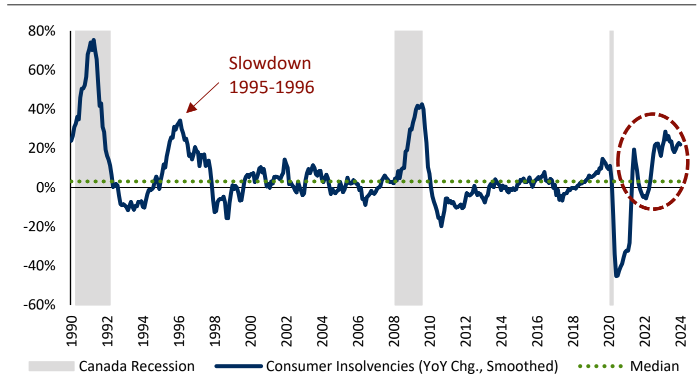
In summary, while the impact of the two different rate decisions on shelter inflation remains uncertain due to the divergent movements of the three key components, it appears that a rate cut may not lead to as significant a resurgence in shelter inflation as one might first think.

Chart 5 - Median Payments Will Continue To Increase



Source: Regulatory filings of Canadian banks and Bank of Canada calculations; Scenario: Rates evolve according to financial market expectation as of December 1, 2023.

Chart 6 - Consumer Insolvencies On the Rise



Source: Statistics Canada, Raymond James Ltd.; Data as of January 31, 2024.

Household Financial Health

Since the Global Financial Crisis, Canada's household debt to disposable income ratio has steadily increased, hovering around 180 per cent since the second quarter of 2021. This heightened level of debt renders Canadian households more vulnerable to interest rate hikes. As previously mentioned, the impact of sudden increases in mortgage and rent payments upon renewal is significant. With households allocating a larger portion of their income to debt payments, they may need to reduce consumption spending by a greater extent, because mortgage and rent payments are typically prioritized. According to Equifax Canada[3], there has been a notable increase in the number of consumers with a mortgage missing payments on some type of credit product in the fourth quarter of 2023, up 11.6 per cent compared to the previous year, while those without a mortgage saw a 9.5 per cent increase. The rise in revolving debt on credit cards also suggests that individuals are not paying their balances in full.

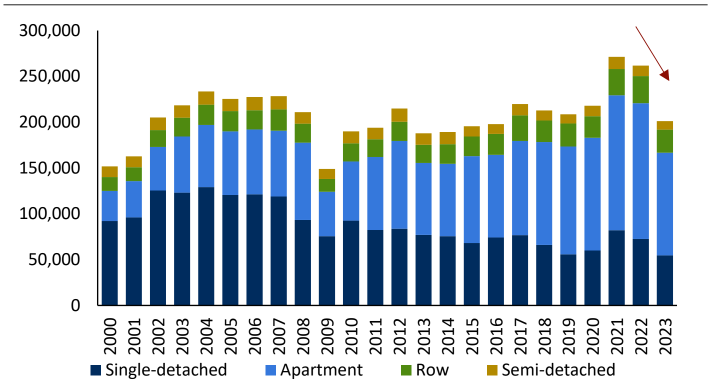
Moreover, it's important to note the significant increase in consumer insolvencies, primarily due to the rise in consumer proposals (Chart 6). While the total number of consumer insolvencies remains close to pre-pandemic levels, the spike in the year-over-year growth rate is typically only observed during recessions or periods of pronounced economic slowdown (such as 1995-1996). This indicator suggests that the Canadian economy may be weakening and may not be as resilient as it appears on the surface. Having rates unchanged for an extended period could prolong the recovery process, whereas an earlier rate cut could allow for more flexibility in establishing cushioning.

Long-term Housing Supply

Perhaps it's time to step back from the current business cycle and adopt a broader perspective on the housing problem. In our "Housing Crisis or Opportunity?" report from last October, we delved into several underlying structural issues. The upward pressure on housing prices predominantly stems from a shortage of supply and the rapid population growth driven by immigration. While the Canadian government is taking steps to stabilize the intake of international students by setting a cap and potentially aims to attract more skilled labour, however, on the other hand, there has not been much progress in addressing the supply shortage. In 2023, housing starts sharply declined, dropping back to 2016 levels (Chart 7). Developers are struggling with high borrowing costs and increasing construction expenses. Consequently, an increasing number of residential construction projects have faced receivership over the past 12 months, which has further deterred developers from initiating new projects. Investment in residential building construction has also remained subdued since mid-2022. Underinvestment today will likely lead to undersupply tomorrow. Therefore, keeping the rate at an elevated level will probably intensify pressure on future housing supply and contribute to higher housing prices.

In summary, the BoC's rate hiking cycle has generally been effective, except in the shelter sector, where components within the shelter CPI react differently to rate decisions and structural issues resurface. While the impact of holding or cutting rates on shelter CPI remains uncertain, it appears that a rate cut may not result in as significant a resurgence in shelter inflation as might be anticipated. Moreover, given the observed increase in financial stress among Canadian households and the potential worsening of structural issues in Canadian housing due to a prolonged period of elevated rates, we believe that a rate cut may be more beneficial for the overall economy in the current environment (Table 1).

Chart 7 - Housing Starts Declined Due to Elevated Borrowing Costs



Source: Statistics Canada; CMHC; Raymond James Ltd.; Data as of December 31, 2023.

Table 1 - Rate Decision Impact - Summary Table

	Holds Rate	Cuts Rate
Shelter CPI	uncertain	uncertain
Homeowners' replacement cost (wgt. 20%)	favourable	unfavourable
Mortgage interest cost (wgt. 12.3%)	unfavourable	favourable
Rent (wgt. 23.6%)	unfavourable	favourable
Household Financial Health	unfavourable	favourable
Long-term Housing Supply	unfavourable	favourable

Source: Raymond James Ltd.

[2]Maria teNyenhuis and Adam Su (2023), The impact of higher interest rates on mortgage payments, Bank of Canada, https://www.bankofcanada.ca/2023/12/staff-analytical-note-2023-19/

[3]Equifax Canada (2024), Q4 2023 Consumer Credit Trends Webinar, Equifax Canada, https://www.consumer.equifax.ca/business/market-pulse

Canadian Leaders & Laggards

Peter Tewolde - Senior Equity Specialist

In 2024, Canadian markets have continued the trend higher since the Q4 2023 rally from late October, increasing another 4.3 percent in the first quarter this year, as of March 19, 2024. Markets continue to be dominated by AI themes and macroeconomic uncertainties related to interest rates, inflation, and geopolitical tensions. In the article below, we review the leaders and laggards of Q1 2024, highlighting the drivers behind their recent performance.

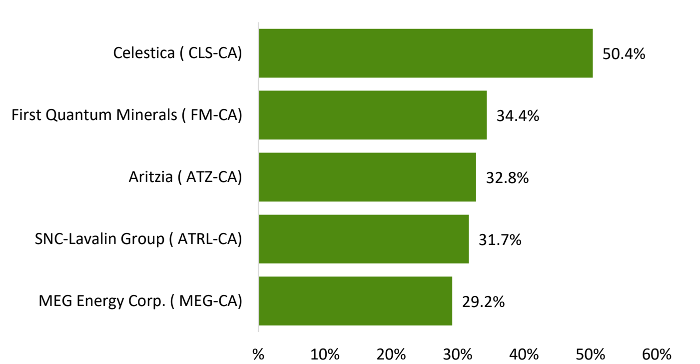
Leaders

Leading the TSX during the quarter was **Celestica (CLS-CA)**, which continued to benefit from AI trends in early January, while also reporting earnings that beat sales and EPS estimates, helping it fuel momentum as it rallied 50.4 per cent in the quarter. **First Quantum Minerals (FM-CA)** rallied off its 2023 lows following news of its Cobre Mine closing last year, which negatively impacted its stock price and growth forecasts. In late February, management reported earnings results that missed street estimates, but the stock continued higher after management indicated its balance sheet initiatives, including negotiation efforts with lenders and asset sales that helped to improve investor sentiment during the quarter. **Aritzia (ATZ-CA)** reported strong earnings results during the quarter that also included a raise in its forward guidance, with management indicating that it was pleased with its inventory levels normalizing and expects further optimizations in 2024. **SNC-Lavalin Group (ATRL-CA)** also reported positive earnings results that beat sales and EPS estimates by 9.4 per cent and 29.9 per cent, respectively, lifting the stock 11.5 per cent after the announcement. The strong results highlighted better than expected revenue growth from its Engineering Services Regions segment, and a 2024 outlook for an additional 8-10 per cent organic revenue growth from 2023 levels. **MEG Energy (MEG-CA**) was up on no particular news and moved with oil prices higher during the quarter (Chart 8).

Laggards

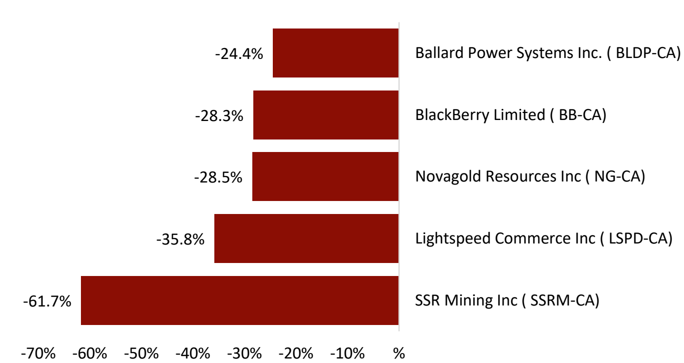
Looking at the bottom performers of the TSX, **SSR Mining Inc (SSRM-CA)** faced an unexpected accident at its Çöpler mine when it had a large slip on the heap leach pad that required suspension of its operations and 9 unaccounted for employees, which required an emergency response. Following the slip, it also had its environmental permit for the mine revoked, the rescue efforts stopped as they focused on stability of the heap, and analysts downgrading the stock, which further hindered investor sentiment. **Lightspeed Commerce (LSPD-CA)** reported earnings in February with management negatively surprising the street after having achieved positive adjusted EBITDA, with a new focus on reinvesting in sales and marketing (S&M) to drive software/new logo growth. The change in management's strategic focus weighed on the stock for the remainder of the quarter, despite results that beat on sales and EPS street estimates. **Novagold Resources Inc (NG-CA)** reported earnings results that showed a larger loss than street estimates for EPS in Q4 2023, that weakened investor sentiment on the name throughout the quarter. **BlackBerry Limited (BB-CA)** was down during the quarter on no news as it continued its separation plans to break off into two standalone business, Internet-Of-Things (IoT) and Cybersecurity. **Ballard Power Systems (BLDP-CA)** was lower during the quarter after reporting earnings in March that had a larger than expected EPS loss, that missed street estimates by ~32 per cent, leading to a 10.2 per cent negative price impact following the announcement (Chart 9).

Chart 8 - Top 5 S&P/TSX Performers in Q1 2024



Source: FactSet; Performance data as of March 19, 2024.

Chart 9 - Bottom 5 S&P/TSX Performers in Q1 2024



Source: FactSet; Performance data as of March 19, 2024.

Money Market Fund Slowdown

Luke Kahnert, MBA, CIM - Mutual Fund & ETF Specialist

The Canadian Money Market Fund category includes a list of low-risk strategies such as money market funds/ETFs, T-Bill strategies, and High Interest Savings Account (HISA) ETFs. Over the last two years, since the Bank of Canada (BoC) initiated a series of rapid policy rate hikes to control inflation, flows into the category surged as higher interest rates made it more attractive to hold money market funds. However, while the money market category has consistently appeared at the top of fund flow charts throughout 2022 and 2023, demand has decelerated in recent months. Chart 10 highlights mutual fund and ETF flows across various time ranges in the Canadian Money Market category compared to other popular fund categories. Using fund flow data, one can presume that future market rate expectations is slowing down investor demand into money market strategies.

Chart 10 - Category Fund Flows

CIFSC Fund Category	1 Month Net Flows	YTD Net Flows	3 Month Net Flows	6 Month Net Flows	1 Year Net Flows
Canadian Money Market	($291,618,145)	$800,006,902	$740,434,506	$6,304,057,127	$18,342,411,663
Canadian Fixed Income	$1,492,856,794	$2,070,344,102	$1,180,172,366	$1,969,161,527	$6,732,229,106
Global Fixed Income	$219,976,607	$1,097,392,904	$1,273,856,979	$2,379,401,329	$6,578,049,799
Multi-Sector Fixed Income	$989,715,720	$1,851,554,355	$2,510,502,623	$2,219,196,515	$5,671,877,850
Emerging Markets Equity	$65,312,992	$216,232,052	$434,068,178	($162,599,709)	$2,143,749,837
International Equity	$543,676,310	$1,075,140,094	$878,707,963	$698,668,720	($228,122,840)
Global Small/Mid Cap Equity	($74,498,437)	($98,323,217)	($325,527,753)	$271,065,887	($370,265,424)
Canadian Equity	$484,335,040	($203,390,411)	$314,834,507	($733,733,473)	($477,100,620)
US Equity	$3,002,567,768	$4,372,988,716	$6,034,794,149	$5,668,803,728	($1,231,823,961)
Global Neutral Balanced	$1,111,489,103	$530,727,200	($1,850,641,965)	($6,380,801,469)	($12,626,098,144)

Source: Morningstar; Data as of Feb 29, 2024.

Changes within HISA ETFs

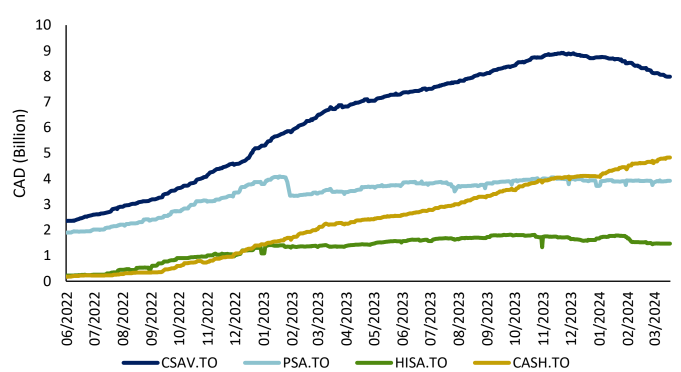
Many of the attractive qualities that appealed to investors during the BoC's series of rate hikes were highlighted in our October 2022 report, High Interest Savings ETFs are in the Spotlight. Since then, we have seen changes within the HISA ETF subcategory due to OSFI's review and subsequent January 31st requirement for banks to hold more capital against HISA fund deposits. This change has impacted the attractive net yields offered by these products and in response, some HISA ETF providers have tilted their investment objectives to include other money market securities outside of savings account deposits to maintain their yield attractiveness. It appears that, in addition to the expectation of future interest rate cuts, changes in the underlying money markets exposures found in some HISA ETFs have further contributed to the recent HISA ETF outflow. Data highlighted in the charts below suggests that investor appetite for HISA funds may be slowing.

Chart 11 - Top Canadian ETF Outflows in February 2024

Ticker	Name	Net Flows ($M)
HBB	Horizonsd Cdn Select Universe Bond ETF	(614)
CSAV	CI High Interest Savings ETF	(376)
HISA	Evolve High Interest Savings Account Fund	(248)
HTB	Horizons US 7-10 Year Treasury Bond ETF	(244)
ZCN	BMO S&P/TSX Capped Composite Index ETF	(209)
ZEB	BMO Equal Weight Banks Index ETF	(107)
BTCC.U	Purpose Bitcoin ETF	(101)
XIC	iShares Core S&P/TSX Capped Composite Index ETF	(88)
HHL	Harvest Healthcare Leaders Income ETF	(88)
NXF	CI Energy Giants Covered Call ETF	(83)
XEG	iShares S&P/TSX Capped Energ Index ETF	(82)
PSA	Purpose High Interest Savings Fund	(80)

Source: National Bank ETF Research; Data as of March 2024.

Chart 12 - HISA ETF AUM



Source: FactSet; Raymond James Ltd.; Data as of March 19, 2024.

Final Thoughts

HISA funds made quite a splash in last year's overall money market activity. To put it into perspective, 2023 net sales into HISA funds amounted to $7.5 billion (representing 51 per cent of all money market mutual fund sales) and net sales into HISA ETFs amounted to $7.1 billion (representing 78 per cent of all money market ETF sales). While HISA funds aren't expected to go anywhere and can still serve as a valuable money market vehicle, future interest rate expectations along with the recent OSFI liquidity requirement ruling appear to be slowing down investor demand in HISA funds and subsequently the broader money market fund category.

The 'Dollar Smile'

Ajay Virk, CFA, CMT - Head Trader, Currencies

The original "dollar smile framework," first theorized over two decades ago, attempts to explain how the U.S. dollar behaves in different scenarios (Chart 13). The beauty of the framework lies in both its simplicity and track record of success. In essence, there are two scenarios which typically coincide with U.S. dollar strength (i.e., the left- and right-side of the smile):

1. Bad times: A risk-off environment when global economic growth is weak and capital moves into seemingly safe-haven assets; or
2. Good times: A risk-on environment with improved optimism in markets and where the U.S. economy is outperforming its peers.

The theory behind this framework makes intuitive sense; when the U.S. economy is relatively strong, capital will flow into U.S. assets, which will drive up the value of the U.S. dollar. On the other hand, risk-off shocks tend to redirect capital towards safe-haven assets like the U.S. dollar.

The "middle" of the smile is typically characterized by low or falling interest rates, a sluggish U.S. economy, or situations where the U.S. economy is under-performing its global peers. In these environments, capital tends to flow into riskier and/or relatively better performing assets.

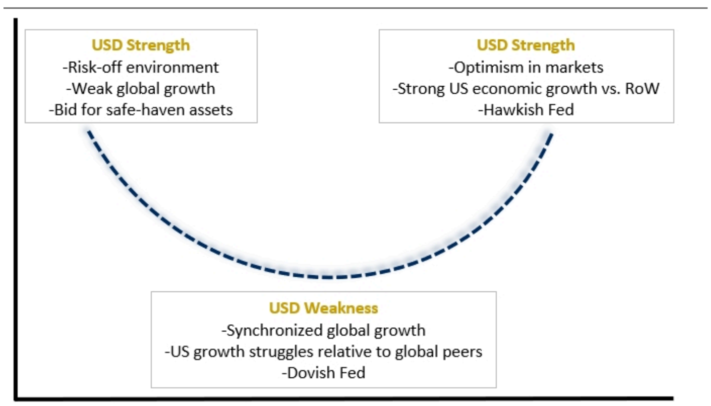
Where Are We on the 'Smile'?

It is not a straightforward exercise to pin-point where exactly the dollar is on this simplified framework. In practice, there is typically a tug-and-pull effect between the left- and right-hand sides of the smile, which may cause the dollar to fluctuate between the two.

The resilience of the U.S. economy cannot be understated, which has underpinned recent U.S. dollar strength as of late. However, we believe the dollar will likely weaken to some degree as the Fed kicks off their easing cycle amid falling inflationary pressures. As for the global economy, the picture seems to have improved lately given the consecutively stronger global composite PMI prints.

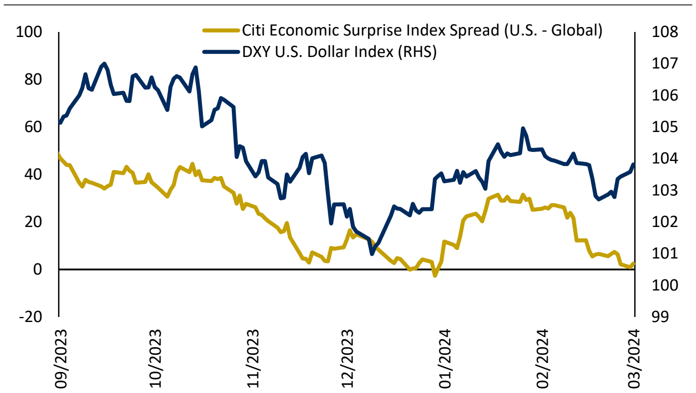
With the global economy expanding at a modestly faster pace than the U.S., it appears we may be heading towards the middle of the 'dollar smile' framework. In times of such coordinated global economic growth, where a sizeable share of global composite PMIs are now in expansionary territory, this would imply a possible period of dollar weakness ahead (Chart 14).

Chart 13 - The 'Dollar Smile' Framework



Source: FactSet; Raymond James, Ltd.

Chart 14 - Global Sentiment Appears to be Improving as US/ Global Economic Surprise Index Spread Moves Lower



Source: FactSet; Raymond James, Ltd.; Data as of March 19, 2024.

A Crack in the 'Smile'?

Taking a look at both U.S. and global economic surprise indexes, we can see that the spread between the two has been trending lower, implying that global economic data and sentiment has been improving relative to the U.S.

By leveraging this framework, one can see a period of modest dollar weakness upon us this year; however, we have not ruled out a last stretch of dollar strength in the immediate short term.

A caveat to this dollar-weakness outlook is the likelihood that many of the major central banks (the Fed included) are all expected to embark upon a seemingly synchronized rate cutting cycle this year. At the time of writing, the market still expects the Fed to close out the year with the second-highest policy rate among its G10 peers, coming in a fraction behind that of New Zealand.

A New Season

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It's the first full month of spring in Canada, which is often associated with renewal, or fresh start. However, investors have not received a new beginning, as inflation concerns, which have plagued the Canadian economy for approximately three years, still persist. Headline inflation has remained elevated but has trended largely downward since the peak in mid-2022. Interestingly, the last two headline prints have come in below consensus estimates, suggesting that broader audiences have anticipated inflationary pressures to be more burdensome than what they actually were, at least as calculated by CPI. Here, we update our expectations for rate cuts in 2024 and how future changes in the overnight rate may affect bond yields.

Rate expectations

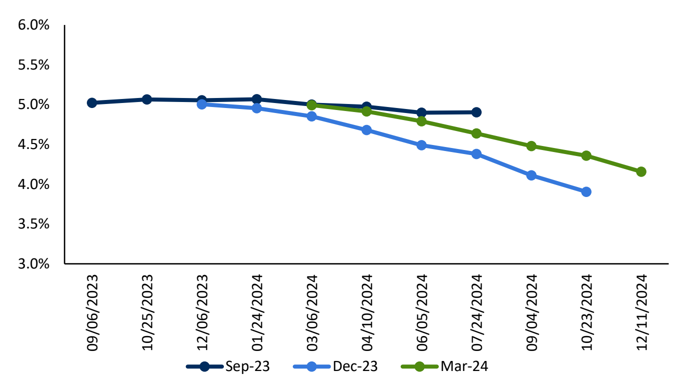
The Bank of Canada (BoC) has maintained that their rate decisions are largely data dependent. However, even if you had all relevant data available to you, the exact factors and the level of importance given to each component is not public knowledge. Ultimately, investors can only theorize about future outcomes. The BoC has remained on the sidelines for a number of seasons, building anticipation for that first rate cut of the cycle. The last change was a rate hike on July 12, 2023, where the central bank increased the overnight rate by a quarter point. Today, economists are predicting a total of three rate cuts in 2024, with the first slated for the summer (June or July, depending on who you ask). We feel that three rate cuts could happen, but with as we move further into the year without clarity on when this next phase may begin, we could see one of those moves occurring in early 2025 instead.

The Impact of Rate Decisions on Fixed Income

Short-term rates tend to align quite closely with the overnight rate set by the BoC. However, longer-dated yields take into account additional factors like the risk of the security, investor preferences, future yield expectations, and market sentiment. In normal market conditions, longer-dated securities demand a yield premium given a higher level of risk, generating an upward sloping curve. Since July 2022 the Government of Canada yield curve has been inverted, meaning investments with fewer days/years to maturity carry a higher yield than bonds with maturities further into the future. When the BoC begins to lower the overnight rate, we can anticipate short-term yields will follow.

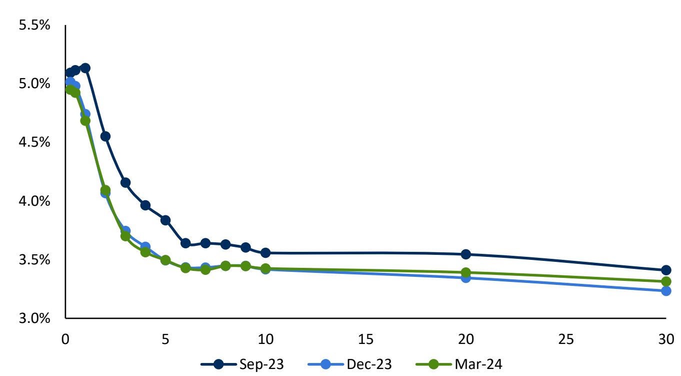
To reduce the risk of reinvesting those funds for a future term at a lower rate, investors could consider investing capital in maturities further out on the curve. Although the preferred time to maturity is driven by a number of factors unique to each client, looking out five to seven years could be beneficial. Alternatively, a laddered approach, where the purchaser invests in bonds with maturities in different years, can help to reduce risk by adding an additional factor of diversification.

Chart 15 - Implied Yields Have Moderated



Source: FactSet; Raymond James Ltd.

Chart 16 - Yield Curve Shows Little Change Since Dec 23



Source: FactSet; Raymond James Ltd.

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