

How high can they go?

The messaging coming out of the Bank of Canada and other central banks is clear: rising inflation is a problem, and higher interest rates are needed to bring prices down. Recently the Bank shared the view that “some Canadians who took out mortgages in 2020-21 could see their monthly payments jump by as much as 45% in 2025-26.” Scary stuff!

However, what does history suggest will happen once central banks start to raise rates towards historic norms of one to two percentage points above the rate of inflation? Will they be able to raise interest rates enough to actually arrest inflation? Having created a dangerously indebted economy through decades of interest rate suppression and quantitative easing, the Bank of Canada (and other central banks around the world) will likely prove unable to raise rates much beyond 3% before they are forced to jam them back down towards zero.

Interest rates ought to have been raised in a consistent manner 12 or 13 years ago, once the acute problems caused by popping of the 2008 subprime housing bubble (itself caused by the near-zero interest rates instituted in 2001 in the wake of the popping of the ‘dot-com’ stock bubble of the late 1990s) had passed.

However, persistent central bank intervention at the first signs of trouble in the financial markets has meant that we have trained almost two generations of investors to borrow and speculate without the caution and prudence that periodic financial crises teach and reward.

Looking at the investor psychology cycle below:



Source: RealInvestmentAdvice.com

We can see that we have, since the late 1990s, experienced a truncated cycle that includes only enthusiasm, exuberance, euphoria, anxiety and denial. As soon as genuine fear has entered the picture, central banks have intervened to save the day.

This incomplete investor psychology cycle has boxed central banks into a trap of their own making. If they are serious about raising interest rates sufficiently high to extinguish the speculative excess that is partially to blame for rising housing and commodity prices, interest rates will need to be set above the inflation rate. Inflation just came in at 7.7%, which suggests a Bank of Canada reference rate of 10% and mortgage and corporate interest rates of 12% or higher.

However, long before rates reach such elevated levels, rising home foreclosures, corporate and small business bankruptcies, and unemployment would force rates lower. No central bank governor wants to continue raising interest rates while people are losing their homes and their jobs.

So, the consensus among professional investors and fund managers is that while interest rates may continue to rise for the remainder of this year, 2023's much-anticipated recession will see rates collapsing back towards zero percent, and the return of quantitative easing (a.k.a. money printing) to both bail out the financial sector and fund burgeoning government spending.

Which will, of course, only reinforce the conviction among investors that rates can never rise in a meaningful way, and that as soon as fear makes an appearance, the smart thing to do is to 'buy the dip' in order to front-run central bank intervention. So long as such easy profits are available for those with access to credit, assessing risks realistically and behaving in a prudent manner will remain a game for losers. Winners focused on increasing their wealth will, on the other hand, borrow in order to buy real estate, stocks and other assets that appreciate in value when interest rates fall and torrents of newly-printed cash are released into the banking system.

So, unable to actually raise interest rates enough to change the speculative mindset of borrowers, homebuyers and investors, all that central banks can do is hope to scare us into behaving more prudently with apocalyptic predictions of 45% increases in monthly mortgage payments. However, if rates actually did rise to such a degree, they couldn't remain there for long as our entire economy is simply too burdened with debt to bear positive real interest rates. Thus, if you currently have a variable rate mortgage, don't worry - near-zero percent interest rates will be back before you know it.