Economics

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Will higher rates break the consumer's back?

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Milton Friedman famously stated that monetary policy works with a long and variable lag. What determines the length and variability of that lag is of course the speed and magnitude of the change in monetary policy as well as the level of economic readiness to absorb that change. Not surprisingly, the ultra-rate sensitive housing market has been the most visible victim of the meteoric ascent in the cost of borrowing. But so far, the consumer has been surprising on the upside. While a slowing in spending is unavoidable, we suggest that the consumer has enough juice left to complicate the downward trajectory in inflation, and therefore prevent a rate cut in the second half of 2023.

Buying time

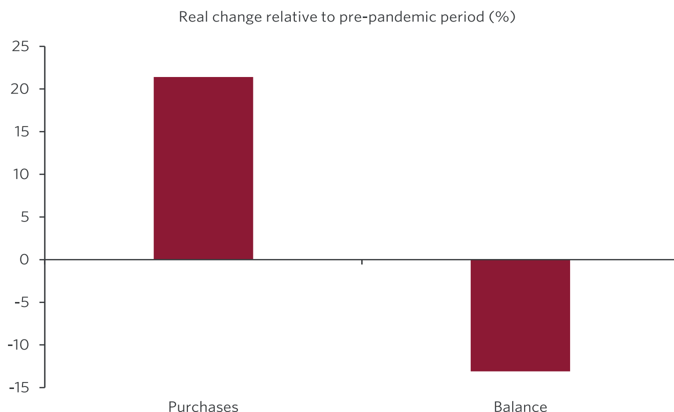
Four hundred and twenty-five basis points rate hikes in a short 12-month period, and the consumer is acting like nothing happened. Amazingly, the Conference Board index of consumer confidence is at its highest level since June of last year while any planning to reduce spending is minor at best. Now, we do not follow consumer sentiment surveys very closely since we prefer to judge consumers by their actions and not by their words. And by their actions consumers send a clear message of assurance. In fact, since the summer, the level of purchases made on credit cards are more than 20% higher than pre-pandemic, even after accounting for the increase in prices (Chart 1). Meanwhile, balances are lower, implying that Canadians have not only the desire, but also the means to keep spending.

Though consumers are entitled to a well-deserved rest, once again households are being asked to do most of the heavy lifting and to buy not only goods and services but also time. Time that corporate capex needs in order to find its footing.

Excess deposits more liquid than perceived

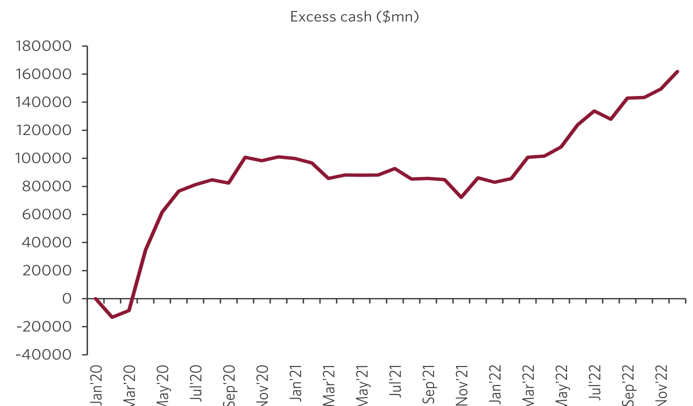
That consumer resiliency should not be surprising given the 350K new jobs created in Canada since the summer. And that labour market strength allowed Canadians to keep a large portion of government transfer payments as excess deposits and, in fact, to continue to grow that amount (chart 2). While

Chart 1: Credit cards spending up..balances down



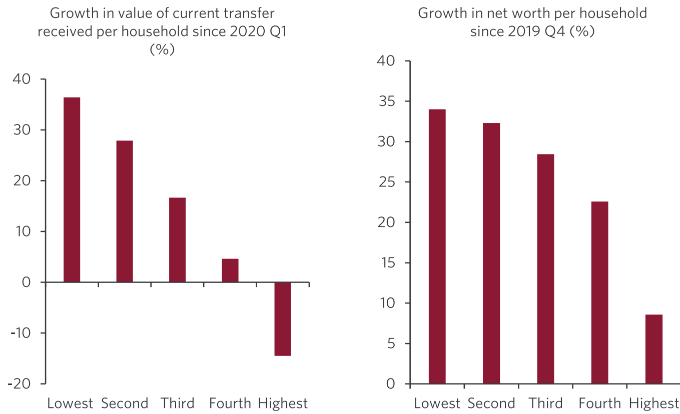
Source: Statistics Canada, CIBC

Chart 2: Excess cash is still rising



Source: Statistics Canada, CIBC

Chart 3: Net worth improved across the distribution, supported by transfers



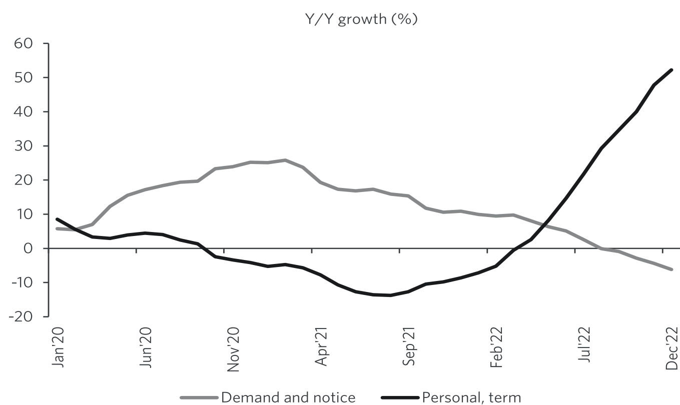
Source: Statistics Canada, CIBC

most of that excess savings is held by high income Canadians, data as of December 2022 suggests that net financial position among low-income Canadians is better than it was pre-covid (chart 3).

Now, how much of that cash is readily available for spending and to compensate for the current inflationary bite and the expected slowing in the labour market? A quick glance at chart 4 might suggests that less and less of that cash is liquid as many Canadians, blinded by the attractive 4-5% yield on GICs, have been aggressively transferring funds from their checking accounts to their GIC accounts.

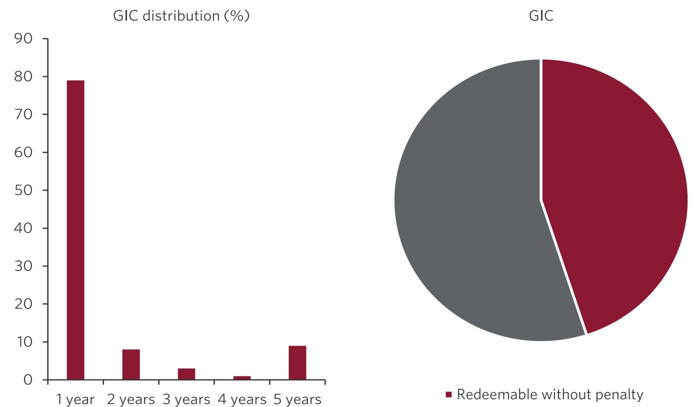
But here we must dig deeper. From chart 5 we learn that households are not so quick to give up liquidity. An estimated 85% of those GICs are for only one-year term (not a surprise given the inverted yield curve) while almost half of GIC balance is with redeemable option suggesting that households are willing to sacrifice return for liquidity. So while not all of the $160 billion of excess deposits are available for spending, that amount is more liquid than perceived.

Chart 4: Canadians are switching to GICs



Source: Statistics Canada, CIBC

Chart 5: Liquidity is higher than perceived



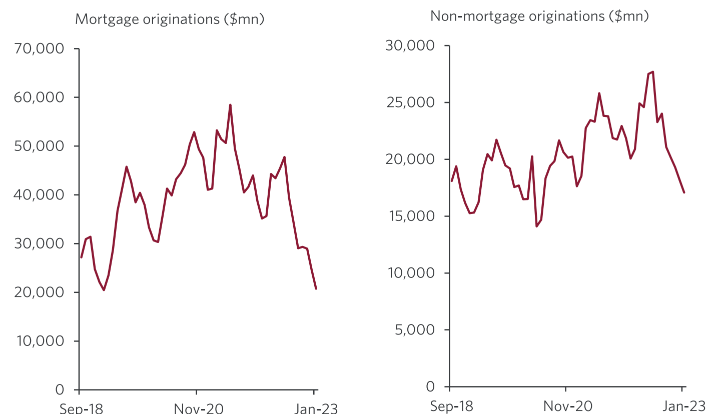
Source: Statistics Canada, CIBC

Credit conditions still ok

That is not to say that consumers are immune to higher interest rates. Consumers have moderated the overall demand for credit, with both mortgage and non-mortgage originations slowing markedly since rates started to rise (Chart 6). This is a healthy response to higher rates.

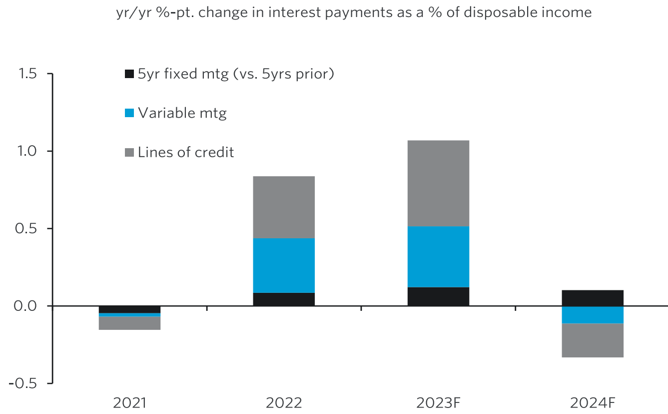
Naturally, households are also devoting more of their income to servicing the debt they already have. In 2022, Canadians spent almost $230bn, or about 15% of their disposable income, on servicing debt. Interest payments accounted for about half of debt-service costs. With higher rates on average in 2023, Canadians are set to devote an additional 1% of their disposable income to interest payments on mortgages and lines of credit (Chart 7).

Chart 6: Originations are slowing



Source: Statistics Canada, CIBC

Chart 7: Interest payments are set to rise further in 2023

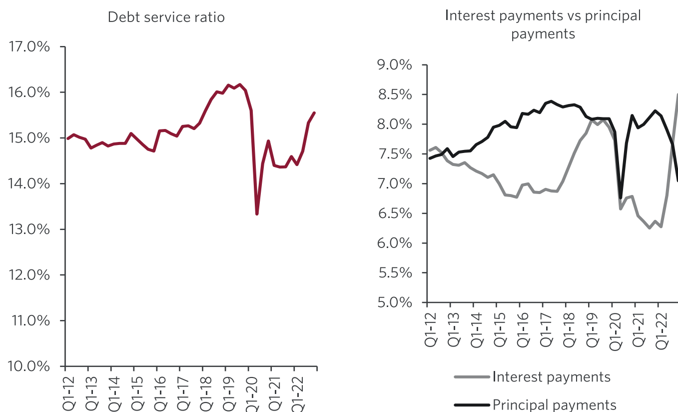


Source: Statistics Canada, CIBC

This will clearly work to slow spending growth, but the benign starting point for the debt-service ratio will help to temper the impact. Despite the most aggressive rate increase since the early-1980s, the debt-service ratio is only back to where it was in 2018, and still below its 2019 level (Chart 8, left). This is masking two opposing forces: an increase in interest payments and a fall in principal payments, as the fixed payments on many variable mortgages are now mostly devoted to covering interest only (Chart 8, right). So, consumers still have room to absorb the increase in the debt-service ratio that we will see in 2023.

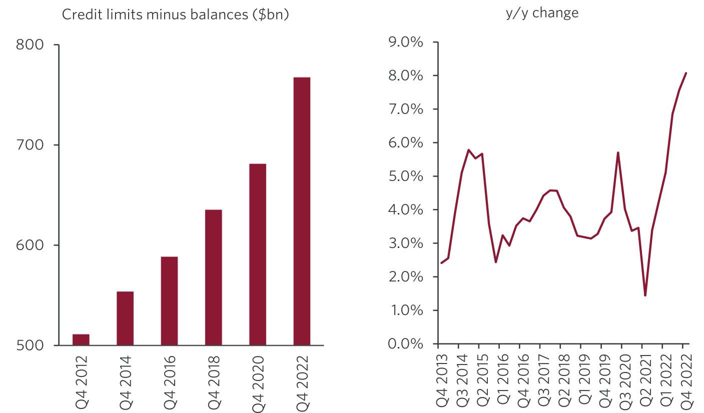
Of course, some households are more exposed than others. And those who purchased a home in 2020 or 2021, when rates were exceptionally low, are set to see a large increase upon renewal. But rates in 2025 and 2026 should be lower than they are now, softening the blow.

Chart 8: DSR similar to pre-pandemic, but interest payments higher



Source: Statistics Canada, CIBC

Chart 9: Consumers have lots of room to borrow



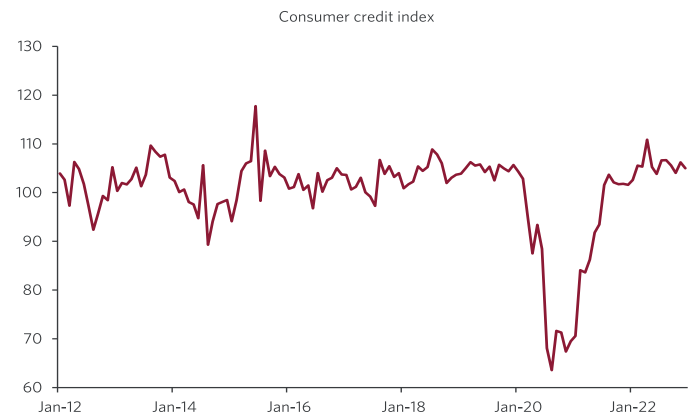
Source: TransUnion, CIBC

Credit quality: solid at the center, fraying at the margins

The amount of room consumers have available to borrow provides an indication of credit conditions, and, at least for now, Canadian consumers have some headroom. The difference between consumer credit limits and balances (on credit cards and lines of credit) is large and still growing (Chart 9) This means that, on average, people are still spending without fully drawing on their available credit. So, the observed slowing in credit origination is a healthy response by consumers to higher rates, rather than a constraint imposed by lenders.

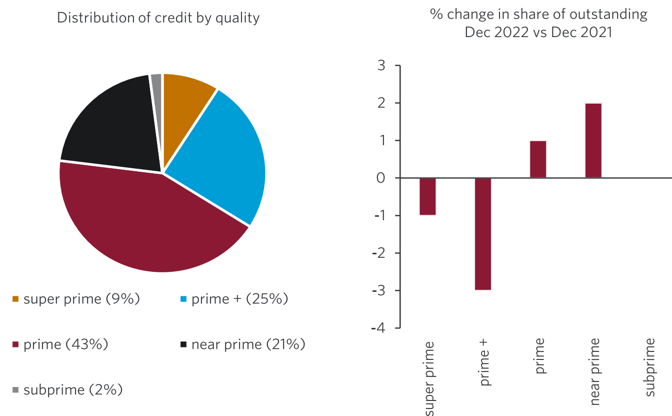
In fact, this cautious behavior on the part of consumers helps explain why overall credit quality indicators are not worse than normal despite higher rates. For example, the TransUnion Credit Industry Indicator, which is a comprehensive measure of overall consumer credit health trends, is still in line with its pre-pandemic level (Chart 10).

Chart 10: Overall credit health is still good



Source: TransUnion, CIBC

Chart 11: Delinquencies will rise as the portfolio quality deteriorates



Source: TransUnion, CIBC

What's happening at the margins?

Clearly the headline numbers give us an overall assessment, but they do not tell the whole story. To get a full understanding of the impact of higher rates, we also have to look at the margins of the debt market spectrum. Even if households across the distribution have been able to weather the storm better than expected due to savings, the quality of credit is deteriorating: the share of riskier borrowers is increasing (Chart 11). This should lead to some increase in delinquencies ahead, but the riskier margins are not wide enough to generate a wave of defaults.

Overall, consumers entered this tightening cycle in excellent financial shape, and are still in a strong position due to large amounts of excess cash and a strong labour market. Despite much higher interest rates, credit conditions are similar to pre-pandemic levels. Going forward however, we expect consumers to increasingly feel the pinch from past interest rate hikes. Consumption is therefore set to slow meaningfully in the months ahead and delinquency rates will rise (Table 1). However, we should avoid a free fall that would require the Bank of Canada to ease policy in the second half of the year (Table 3).

Table 1: Canada forecast detail (real % change, SAAR, unless otherwise noted)

Variable	22Q3A	22Q4A	23Q1F	23Q2F	23Q3F	23Q4F	2022A	2023F	2024F
Real GDP Growth (AR)	2.3	0.0	2.5	0.3	-0.6	0.8	3.4	1.2	1.2
Real Final Domestic Demand (AR)	-0.8	1.0	1.2	0.1	-0.5	1.0	2.7	0.5	1.4
Household Consumption (AR)	-0.4	2.0	1.3	-0.3	-1.0	0.3	4.8	1.0	0.8
All Items CPI Inflation (Y/Y)	7.2	6.7	5.1	3.2	3.0	2.7	6.8	3.5	2.0
Unemployment Rate (%)	5.1	5.1	5.0	5.2	5.5	5.7	5.3	5.4	5.5

Table 2: US forecast detail (real % change, SAAR, unless otherwise noted)

Variable	22Q3A	22Q4A	23Q1F	23Q2F	23Q3F	23Q4F	2022A	2023F	2024F
Real GDP Growth (AR)	3.2	2.6	1.8	-0.4	0.3	-0.2	2.1	1.3	1.0
Real Final Sales (AR)	4.5	1.1	2.4	-0.2	1.0	-0.4	1.3	1.5	1.0
All Items CPI Inflation (Y/Y)	8.3	7.1	5.8	4.0	3.2	2.8	8.0	4.0	2.5
Core CPI Inflation (Y/Y)	6.3	6.0	5.6	5.0	3.8	2.8	6.2	4.3	2.2
Unemployment Rate (%)	3.6	3.6	3.5	3.8	4.2	4.3	3.6	3.9	4.1

Table 3: Canadian interest rates (end of period)

Variable	2023 18-Apr	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
Overnight target rate	4.50	4.50	4.50	4.50	4.00	3.50	3.25	3.00
98-Day Treasury Bills	4.42	4.35	4.25	4.00	3.50	3.25	2.90	2.60
2-Year Government Bond	3.88	4.15	3.90	3.50	3.10	2.75	2.40	2.30
10-Year Government Bond	3.09	3.30	3.25	3.10	2.90	2.80	2.65	2.50
30-Year Government Bond	3.17	3.25	3.15	3.15	3.00	2.90	2.85	2.75
Canada - US T-Bill Spread	-0.68	-0.75	-0.85	-0.95	-1.00	-0.65	-0.70	-0.70
Canada - US 10-Year Bond Spread	-0.51	-0.45	-0.40	-0.40	-0.60	-0.60	-0.70	-0.50
Canada Yield Curve (10-year — 2-year)	-0.79	-0.85	-0.65	-0.40	-0.20	0.05	0.25	0.20

Table 4: US Interest rates (end of period)

Variable	2023 18-Apr	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
Federal funds rate (midpoint of range)	4.875	5.125	5.125	5.125	4.625	4.125	3.875	3.625
91-Day Treasury Bills	5.10	5.10	5.10	4.95	4.50	3.90	3.60	3.30
2-Year Government Note	4.19	4.40	4.20	4.00	3.90	3.40	3.20	2.80
10-Year Government Note	3.60	3.75	3.65	3.50	3.50	3.40	3.35	3.00
30-Year Government Bond	3.81	3.90	3.85	3.75	3.70	3.70	3.70	3.60
US Yield curve (10-year — 2-year)	-0.60	-0.65	-0.55	-0.50	-0.40	0.00	0.15	0.20

Table 5: Foreign exchange rates

Exchange rate	2023 18-Apr	2023 Jun	2023 Sep	2023 Dec	2024 Mar	2024 Jun	2024 Sep	2024 Dec
CAD-USD	0.75	0.75	0.76	0.76	0.77	0.77	0.78	0.78
USD-CAD	1.34	1.34	1.32	1.31	1.30	1.30	1.29	1.28
USD-JPY	134	125	123	121	120	118	116	115
EUR-USD	1.10	1.10	1.11	1.13	1.14	1.15	1.15	1.16
GBP-USD	1.24	1.24	1.24	1.26	1.27	1.28	1.28	1.30
AUD-USD	0.67	0.69	0.70	0.71	0.72	0.74	0.75	0.76
USD-CNY	6.88	6.85	6.80	6.78	6.75	6.73	6.71	6.69
USD-BRL	4.95	5.05	5.20	5.40	5.20	5.20	5.40	5.00
USD-MXN	18.0	19.5	20.0	19.8	20.0	20.5	21.0	20.0

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