MONTHLY COMMENTARY

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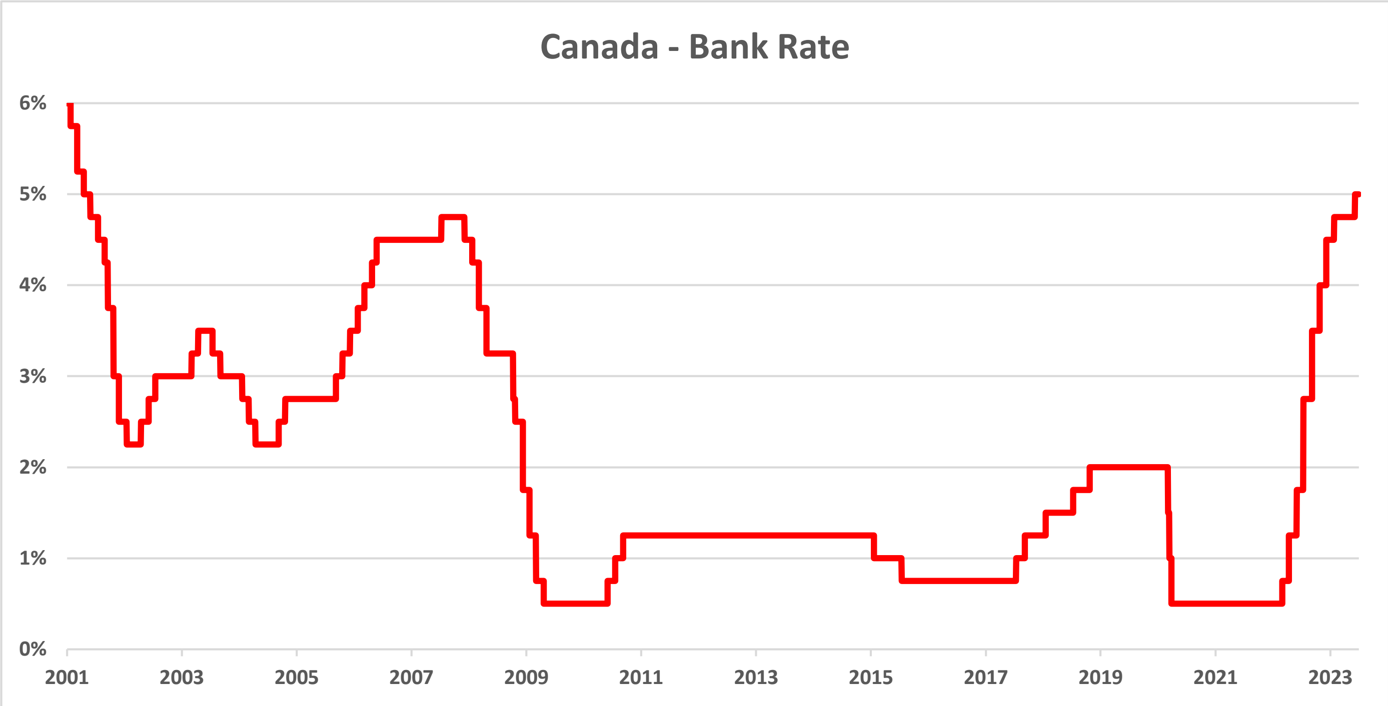
What's next for interest rates?



Source: Bank of Canada

MARKET FOCUS

Bank of Canada's "pause" ends

The Bank of Canada announced that it was raising administered interest rates by 25 basis points (a basis point is 1/100th of one per cent), at the conclusion of its June monetary policy meeting. The range for overnight borrowing was set at 4.75% to 5.00% with the official Bank Rate at 5.00%. This move came following two "on hold" policy announcements where the Bank paused in order to "assess whether monetary policy is sufficiently restrictive." Canada's gross domestic product (GDP) grew by 3.1% (on an annualized basis) in the first quarter of 2023, after contracting a revised 0.1% (on the same basis) in the final quarter of 2022. This first-quarter result is well above the 2.3% forecast that was provided by the Bank of Canada in its April Monetary Policy Report.

Further, annual growth in the Consumer Price Index (CPI) rose to 4.4% in April after declining steadily from the 40-year peak of 8.2% in January 1983. The Bank's primary core inflation measure (CPI Common) came in at 5.7% in April. As can be seen in the accompanying graph, the Bank Rate is now at its highest level since May 28, 2001. The cumulative 450 basis points of tightening that began on March 2, 2022 is the largest set of interest rate increases since November 1987 to May 1990, when the Bank Rate moved from 8.09% to 14.05% (596 basis points). Importantly, the policy announcement was accompanied by the following statement, "Overall, excess demand in the economy looks to be more persistent than anticipated…and concerns have increased that CPI inflation could get stuck materially above the 2% target." The market will continue to debate the probability of another 0.25% rate hike ahead of the next policy meeting scheduled for July 12.

U.S. Industrial output falters

The U.S. Federal Reserve announced that industrial production fell 0.2% in May, the fifth decline in eight months. The move down left annual production growth at 0.2%, the slowest pace since February 2021, when the economy was beginning to come out of the lock downs associated with the pandemic. Capacity utilization was also reported to have slipped lower to 79.6% in May, further below the 14+-year high of 80.8% (81.1% in January 2008) seen as recently as September 2022. In addition, the Institute for Supply Management reported that its Purchasing Managers Index (PMI) edged lower to a 46.9 reading in May. This was a 0.2-point decline from April's 47.1 figure, and it remained below the key 50.0 (generally expanding) level for a seventh consecutive month – its longest such stretch since the financial crisis. It appears that higher interest rates are dampening industrial activity in the United States.

LONGER VIEW

Following a series of rate hikes by central banks, the days of a significant portion of global bonds paying negative yield are over. Investors should expect long-term returns of over 3% from owning a government bond that matures in 10 years. It is good enough if your objective is capital preservation and collecting income; it is not ideal if you need to grow your assets. In the equity land, U.S. markets are trading at premium valuation over Canada, Europe, Asia and a basket of emerging countries. How long this will continue is dependent on the performance of the U.S. technology sector. The United States dominates in the space of cloud storage, software, internet, online shopping, electric vehicles and artificial intelligence development, which all play a big part in our everyday lives. From time to time, there will be bad investment due to extreme valuations but never a bad business, at least in the near future.

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