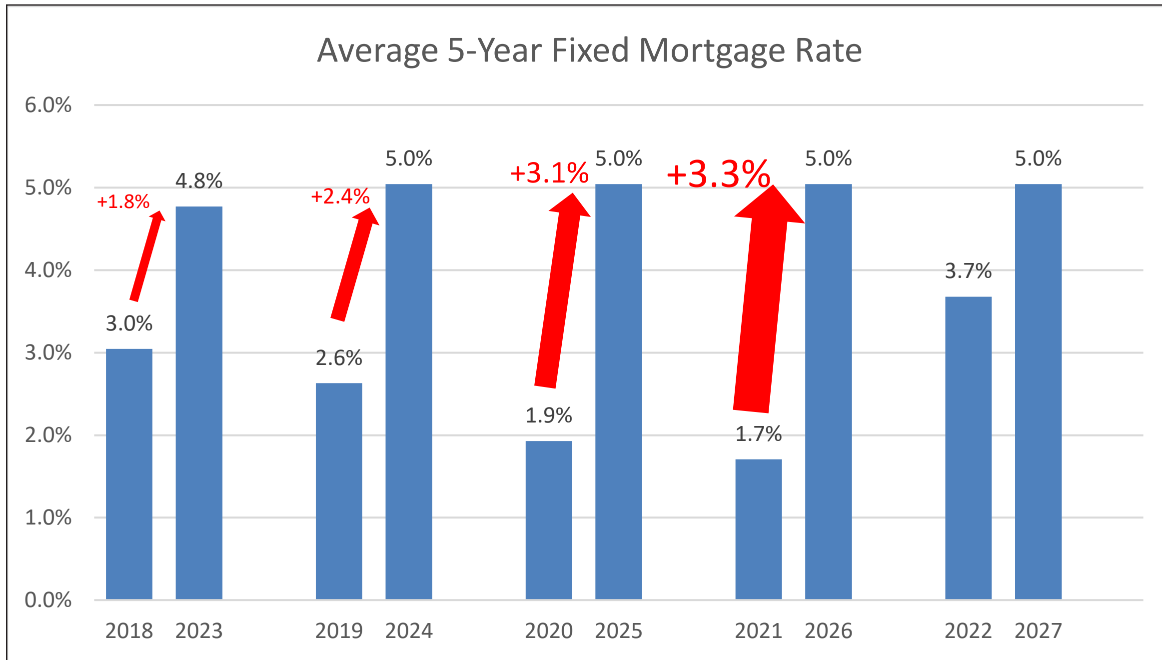
Interest Rates Headwind for 2-3 more Years in Canada

Canada's economic situation has been challenging, with immigration offsetting clear signs of consumer and economic weakness (per capita GDP down almost 4% annualized in Q3[1]). However, we know that sitting here today, Canada will probably see continued economic headwinds for the next 2-3 years due to **higher 5 year mortgage rate renewals**. This is due to the fact that interest rates have risen. The rate shock will continue to increase in magnitude through 2026. We believe that the worst of the rate shock won't start until 2025 (rates were at record lows in 2020) assuming current rates remain. In the chart below, we show what the original 5-year fixed mortgage rates were and what the new rate will be when those mortgages renew.



Source: https://www.ratehub.ca/, CREB, Timelo estimates. Dated December 14th, 2023.

For instance, in 2020, rates were 1.9%, as shown above – 5 years later (year 2025), rates would jump to 5% if current rates hold which is almost a triple. Even if rates were going to go down by 200 bps to 3%, the mortgage rates would still be up 50%.

You can see that the gap between current rates and existing mortgage rates grows in size for the 2019-2021 cohorts, this means that 2025 and 2026 will see increased pain to the consumer. In fact, for a 2020 home purchase at the average Canadian home price of the time and a 20% down payment, monthly payments will jump almost $600 in 2025, and for 2021 purchases, monthly payments will jump nearly $800 in 2026. Consider the median after-tax Canadian household income is $68,400[2] and you can see why a $7,200 to $9,600 annual mortgage payment jump is going to be felt.

Portfolio Positioning

After the recent strong rally, we expect a pull back early in the new year as many investors avoid realizing gains to lower their tax bill and postpone these profitable trades to early January. On the other side of the ledger, investors realize losses which puts temporary pressure on certain stocks. Like almost every year, we are trying to take advantage of tax loss selling again this year.

Furthermore, we believe the economy will slow as the extreme government interventions of the pandemic go away (deficit spending is too high). Keep in mind that the FED is still doing QT (Quantitative Tightening). This means in 2024, we will see the double effect of reduced liquidity from the FED and reduced economic activity from goverments spending (to reduce deficits). That's why we believe investors expectation of sales and earnings growth are too high. The fact that most large cap stocks are way overbought suggest to us that the risk reward profile is unattractive at this time.

That's why our portfolio has a low net exposure and we are spending more time looking for further short ideas.

Jean-Francois Tardif
President & Portfolio Manager
Timelo Investment Management Inc.

1 https://thoughtleadership.rbc.com/wp-content/uploads/2023_Q3CanGDP2.pdf
2 https://www150.statcan.gc.ca/n1/daily-quotidien/230502/dq230502a-eng.htm

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