The Tip of the Spear

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Economic resilience was the key macro theme of the first half of 2023. Last year's frenzied tightening by the Fed and the Bank of Canada was supposed to have caused a recession by now; it didn't. Equity markets have cheered the extent to which growth has defied expectations of slowdown by posting double-digit gains. The persistence of those gains will depend on the persistence of that economic resilience ahead.

A wide range of factors has accounted for the resilience of the US economy, making it difficult to judge its persistence. As a result, we would consider the macro pillar of our active asset allocation process to be roughly neutral at present which, in combination with mixed indications from the other pillars of our process (bottom up, valuation and sentiment), have led us to adopt a more neutral weighting in equities across our funds.

Where we have greater conviction, however, is that the resilience of the Canadian economy will be more challenged ahead than in the US. Canada's economic resilience has, in our view, been more narrowly supported by two clearly unsustainable factors – excess household savings and effective lender forbearance. Their end may not be nigh, but it is visible on the horizon.

The prospective exchange rate implications here are clear – the Canadian dollar is likely to weaken against the US dollar, in order to cushion the Canadian economy from the sooner and sharper impact of the interest rate shock already in the pipeline. As a result, after covering some of our short in May in anticipation of the resumption of the Bank of Canada's interest rate tightening cycle, we have restored a larger underweight to the Canadian dollar as part of our active asset allocation strategy.

Below we delve deeper into those two factors that we believe have lent powerful but clearly transitory support to the Canadian economy over the past year.

Excess household savings

Canadian households accumulated a considerable cushion of excess savings during the pandemic, as the combination of government stimulus and forgone consumption caused the savings rate to spike to nearly 27%. Spending has since rebounded as the world has reopened, but between robust wage growth and an inherently gradual release of pent-up demand (if you didn't get your hair cut during the pandemic, you're unlikely to book ten consecutive appointments to make up for lost time), Canadian households have not had to dip too far into their excess savings.

Beyond supporting an elevated rate of current spending, excess savings is also available to households to meet higher debt service costs as interest rates have spiked. Even for borrowers with fixed term mortgages who have yet to see the direct impact of higher interest rates, the presence of excess savings provides less incentive to pull back on spending today as those funds can be used to offset the eventual increase in their borrowing costs. The upshot for the Bank of Canada is that the presence of excess savings has reduced the interest rate sensitivity of the economy. In other words, and all things equal, interest rates need to be higher today, and likely for longer, to have the same impact on slowing economic growth and bringing inflation sustainably back to target.

The party provided by excess savings can rage for a while still, but by definition cannot continue forever. Exhibit 1 below shows four different scenarios for when excess savings may be exhausted based on assumptions regarding a return to trend for either the savings rate or real money balances.

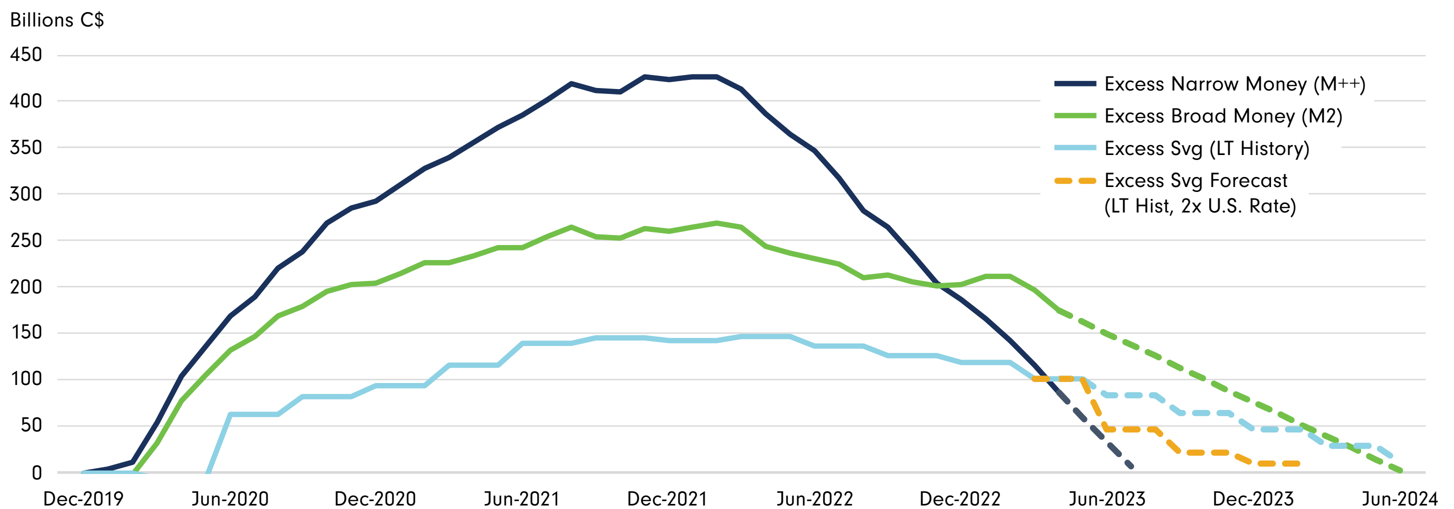
There is a range of outcomes, reflecting the uncertainty surrounding just how much excess is out there, but in all cases the cushion is gone in a year. And these scenarios may be overly optimistic, as none of them consider the potential for a labour market shock, which would dissipate excess savings even sooner.

Ultimately as savings are depleted and the labour market cools, the pillars supporting household spending will be significantly eroded by the rising tide of interest rates. For an economy that has long relied on its household sector to drive the wider economy, a period of retrenchment will have an outsized impact on slowing Canadian growth.

Effective Lender Forbearance

When interest rates soar, mortgagees have to pay a lot more. This is a truism. Those on a fixed rate mortgage have the reckoning delayed, though given the common 5-year term, that day will come inexorably in the months and years ahead. For those with a variable rate mortgage, the rate

EXHIBIT 1: Excess savings estimates



Forecasts assume last 3-month run rate continues. Source: Statistics Canada, Fidelity Investments Asset Allocation Research Team (AART)

shock comes right away. But because of the common fixed-payment structure of variable rate mortgage borrowers in Canada, the cash flow effects are deferred, just with more of the fixed payment going to interest rather than principal repayment (which has the effect of lengthening amortization periods, a practice that has been sanctioned by the government which also has an interest in deferring the shock).

There are two ways to estimate the scale of the interest rate shock and the extent to which its impact has been deferred.

First, the Bank of Canada estimates that only one-third of Canadian mortgagees have had to pay more so far, and of those, many have not had to pay nearly as much more as they ultimately will. Yet even still, the amount of mortgage interest paid by Canadians has risen more in the past year than in the prior 32 years combined. The ultimate shock will be several times larger yet.

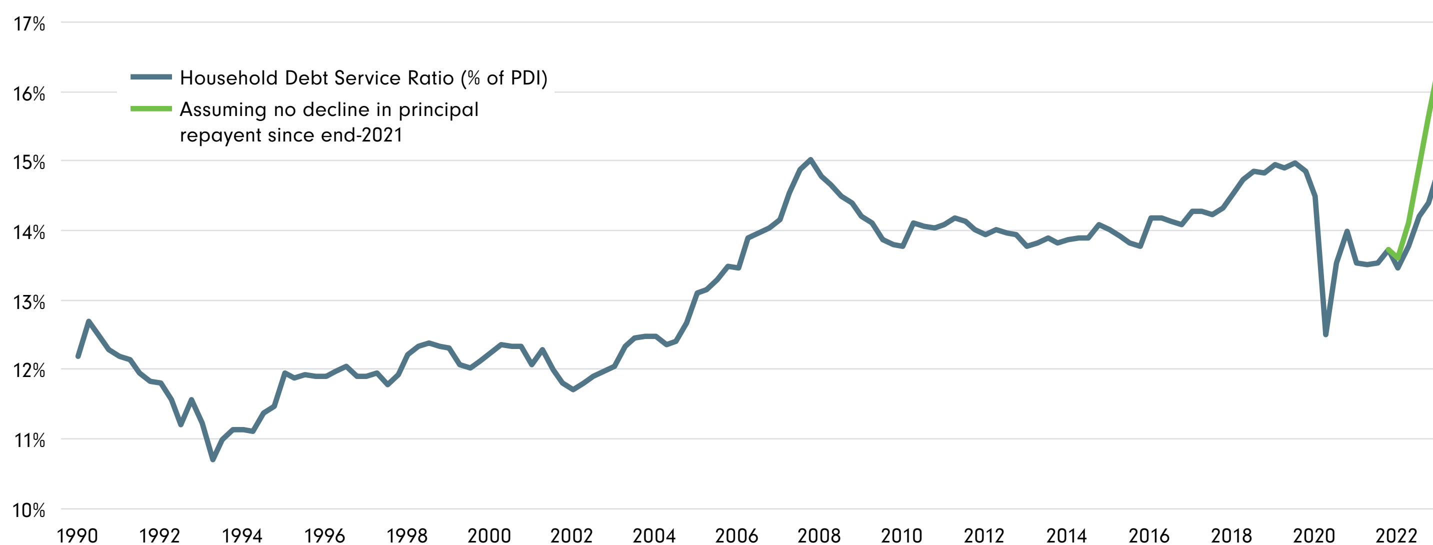
Second, we can estimate the extent to which this deferment has postponed the cash flow impact on those already on the hook for more. Canada's household debt service ratio has risen only moderately over the past year, roughly back to where it was pre-pandemic (see Exhibit 2). But had principal payments been forced to keep up, the increase in debt service would have been the sharpest in history to by far its highest level ever. That will eventually happen.

The consequences

Putting these together, effective lender forbearance has deferred the cash flow impact of higher interest rates on Canadian households, and what impact we have seen has been cushioned by excess savings left over from the pandemic. Both will inevitably run out. We've only seen the tip of the spear, one which will ultimately strike hard at an economy that has long been overly reliant on debt-fueled growth in household spending on consumption and housing.

EXHIBIT 2: Deferment has cushioned the blow from rising rates

Canada Debt Service Ratio with and without Deferred Principal Repayments



Source: Statistics Canada, FMR calculations

Now, the Bank of Canada knows all of this. They know there's a huge rate shock waiting out there, even if they (and we) don't know precisely when and how hard it's going to hit. That was true even before the latest round of rate hikes. So why not hold off and wait for it to happen? Why did they resume raising rates in June and July? It's because they can't afford to wait, can't allow the current resiliency and its effects on an already-tight economy to persist – with inflation well above target, wages swelling and price expectations at risk of becoming de-anchored. They know they risk making the ultimate shock that much worse. But given their mandate and the horizon over which monetary policy impacts the economy, they have little choice. They can always reverse and cut when things get bad.

That's what we think will eventually need to happen, but that will probably take quite some time – the rate shock is still only beginning to be felt, and the Bank will need to be comfortable that inflation has finally been quelled before easing. Rate cuts are not on the visible horizon; rate hikes may not even be done. But as the wave ultimately crashes over, easing will be required, in our view. And that easing will come as US economic resiliency and elevated US interest rates likely remain in place, as lower household debt and longer mortgage terms means the rate shock will likely be smaller and more drawn out over time.

The consequences for financial markets are myriad, but as we discussed earlier, one implication is fairly clear – the Canadian dollar will need to weaken against its US counterpart to cushion Canada's much heavier blow from the generational normalization in interest rates we've just seen. This has been a (very) long time coming as Canada's household imbalances have ballooned unchecked for many years, but the catalyst for adjustment is finally in place. And while we were able to adjust our active allocation to capture a brief period of Canadian dollar outperformance, we believe reestablishing a larger underweight will leave the funds we manage for Canadian investors well positioned for the longer-term economic fallout.

David Wolf, David Tulk and Ilan Kolet, July 19, 2023

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Ilan Kolet is an Institutional Portfolio Manager for Fidelity Investments. In this role, Mr. Kolet serves as a member of the investment management team, maintaining a deep knowledge of portfolio philosophy, process and construction. He assists portfolio managers and their CIOs in ensuring portfolios are managed in accordance with client expectations.

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