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Household debt

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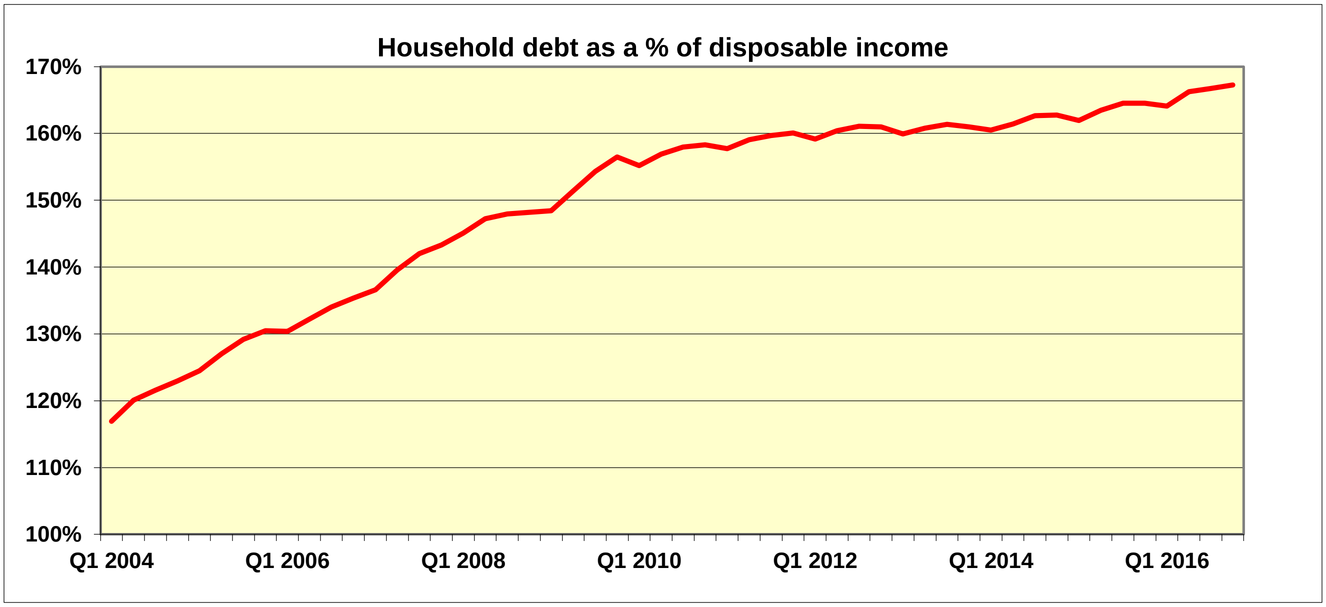
The Bank of Canada's website prominently displays its mandate: "We are Canada's central bank. We work to preserve the value of money by keeping inflation low and stable." Despite what may, at first glance, appear to be a fairly narrow mandate, the bank occasionally comments on issues or developments that fall outside the tight bands of monetary policy. For most, Statistics Canada's release of the national balance sheet and financial flow accounts would illicit mostly yawns outside the ranks of economists and statisticians. However, for the last few years, the Bank of Canada has been vocal following the release of this data. The level of Canadians' overall household debt, particularly when compared to their disposable incomes, has prompted cautionary commentary from a number of officials. Debt, relative to income, has been rising steadily since the data were first collected in 1990. For investors, understanding the risks that high debt levels pose to both the housing market and the broader economy can help when sorting out the responses of various financial market participants.

Figure 1

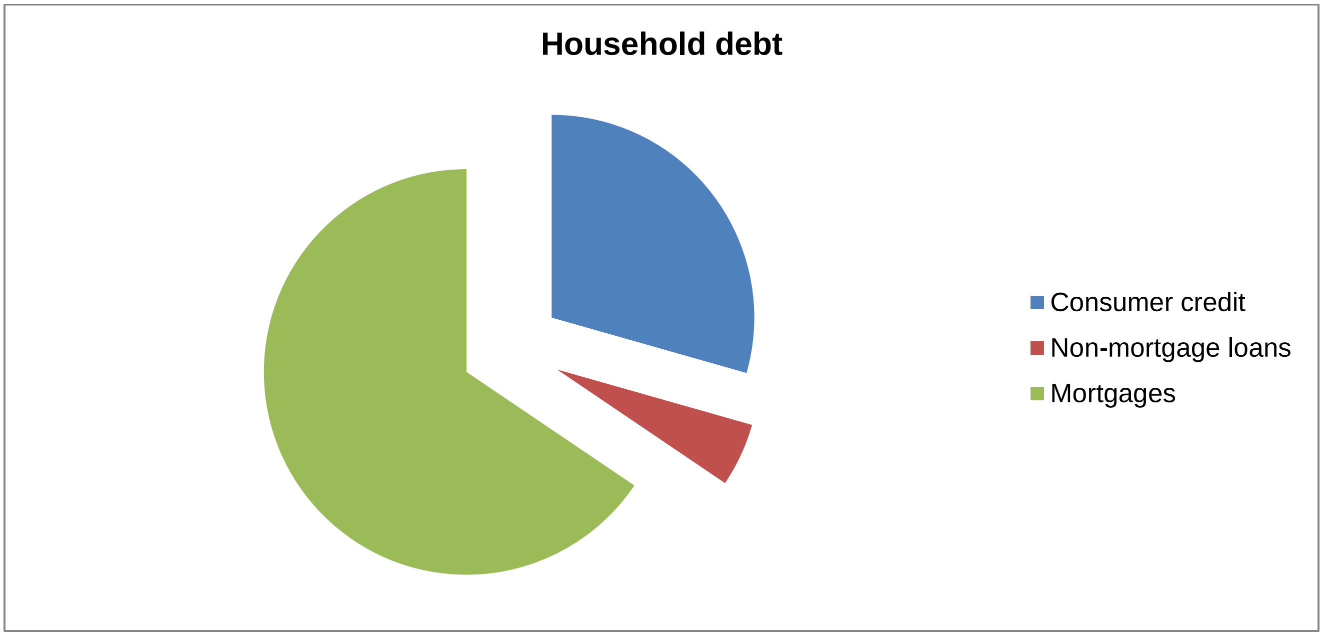


Source: Statistics Canada

Figures from Statistics Canada revealed that Canadians owed over $2 trillion at the end of 2016, a record high. Perhaps more importantly, as can be seen in Figure 1, the ratio of debt to disposable income rose to

167.3%, also a record level. Not surprisingly, the bulk of this debt (65.5%) is mortgages. The balance was made up of consumer credit (29.4%) and non-mortgage loans (5.1%), as can be seen in Figure 2. Since 1990, the ratio of the three debt components has been relatively stable. Mortgage debt has ranged between 60.5% and 68.5% of total debt and consumer credit has ranged between 24.2% and 34.0%. Meanwhile, the portion of debt associated with non-mortgage loans was the smallest component over the same period, ranging from 4.7% to 8.7% of total debt.

Figure 2

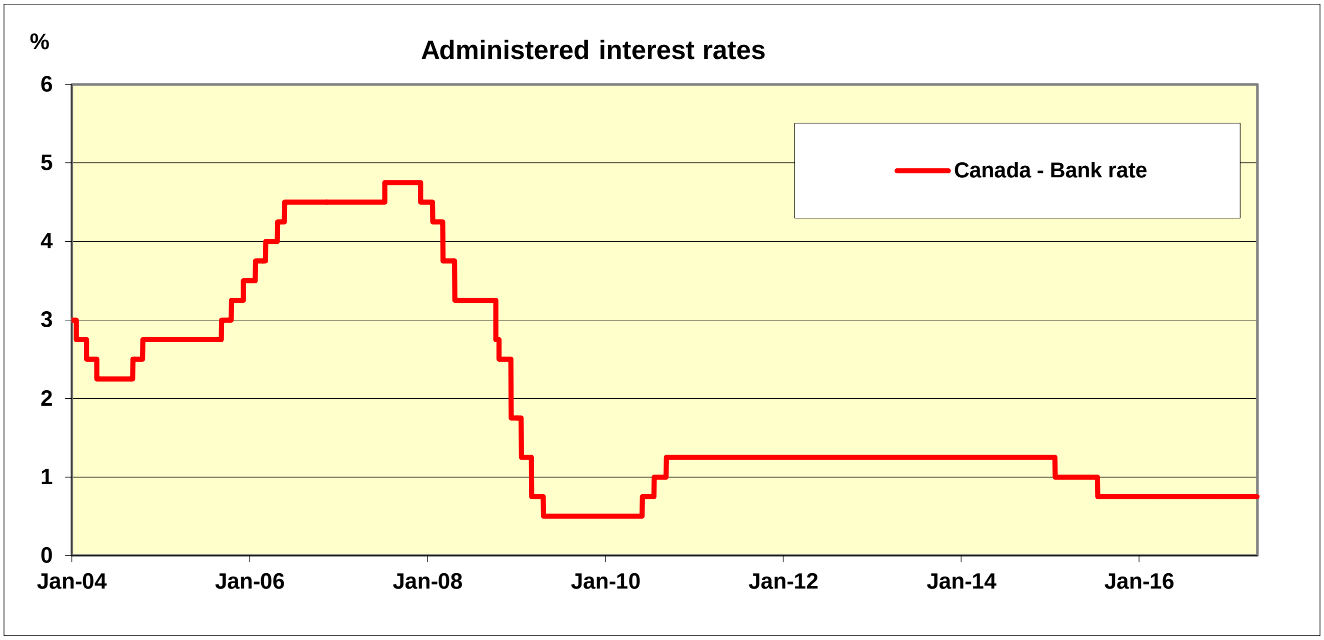


Source: Statistics Canada

Interest rates

As one might expect, the secular trend of falling interest rates since the early 1980s is at least partially responsible for rising debt levels in a general sense. As interest rates steadily declined, borrowing continued to become more and more "affordable." So, although the Bank of Canada has commented on the risks, its own policy of extremely low interest rates has helped fuel the most recent increase in the debt-to-disposable income ratio. Of late, the bank has focused its public statements on its concerns over "high-ratio" mortgages. High-ratio mortgages are those where the loan is worth more than 80% of the value of the property. However, recent changes to taxation on home sales in some jurisdictions, coupled with more stringent lending practices, are expected to dampen the growth of high-ratio mortgages. The U.S. Federal Reserve increased interest rates by 25 basis points (a basis point is 1/100th of one percent) in March and it is widely expected that further rate hikes are in store over the balance of 2017. The Bank of Canada has not signalled any intent to follow suit, particularly given the greater slack in the domestic economy. However, changing economic circumstances may eventually result in similar action on administered interest rates here in Canada.

Figure 3



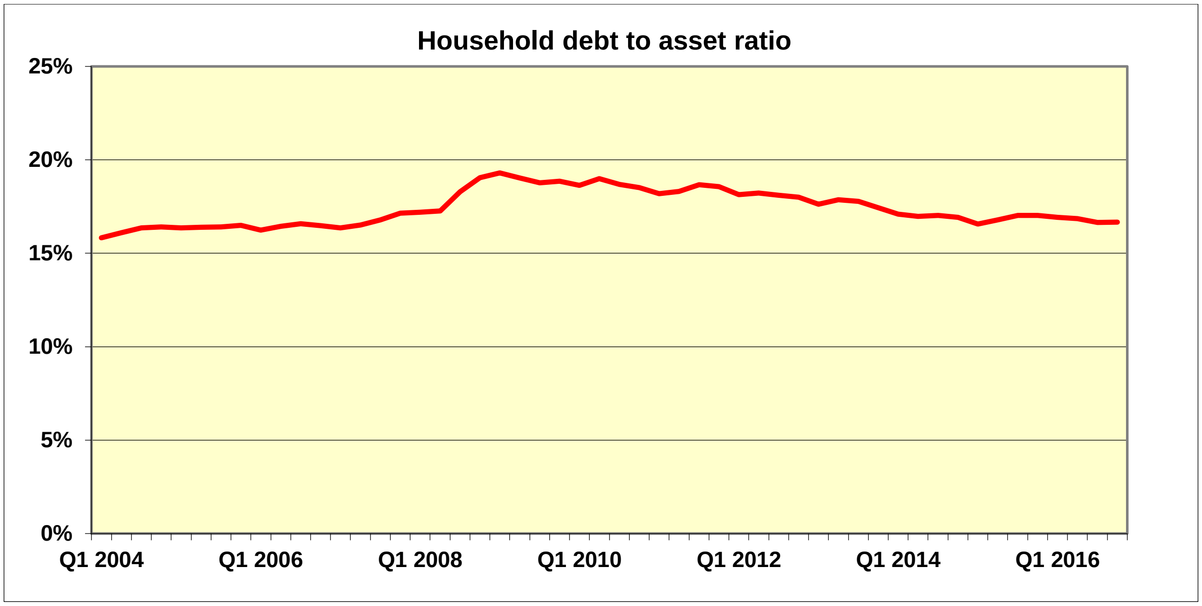
Source: Statistics Canada

The concern here is self-evident, as the borrowers in this category may find themselves in a bind even with a modest increase in mortgage rates, such as 0.25%. The strength of the housing market and rapid price increases in some regions has exacerbated the situation. It raises the risk of a bursting housing "bubble," where a sharp decline in house values can dramatically erode what little equity value these homeowners may currently have. While mortgage debt is the greatest share of Canadians' total debt, consumer credit debt can also represent a risk. As well, any hike in administered rates would translate into higher interest rates, not just for mortgages, but for all borrowing. While it comprises a much smaller portion of overall debt, the interest burden is typically a multiple of a traditional mortgage. Consumer credit debt stood at just under $600 million at the end of 2016, another record level. Naturally, already stretched individual home finances can be significantly impacted by a change in circumstances such as job loss or illness. This level of credit debt also poses a potentially broader risk with respect to consumer spending. Going forward, without considerably more robust growth in employment and incomes, consumers can be expected to limit spending in order to avoid adding to the burden of their existing debt load.

Irresponsible borrowing?

Even though the above risks suggest that the Bank of Canada's cautionary commentary is well placed, the truth is never one sided and the data show that Canadians, typically, are responsible borrowers. Commensurate growth in household assets has left Canadians' household debt-to-asset ratio stable over the past 25 years. As can be seen in Figure 4, even the mild spike higher to 19.3% in the first quarter of 2009 during the height of the financial crisis has been followed by a general decline. The ratio fell to 16.7% at the end of 2016.

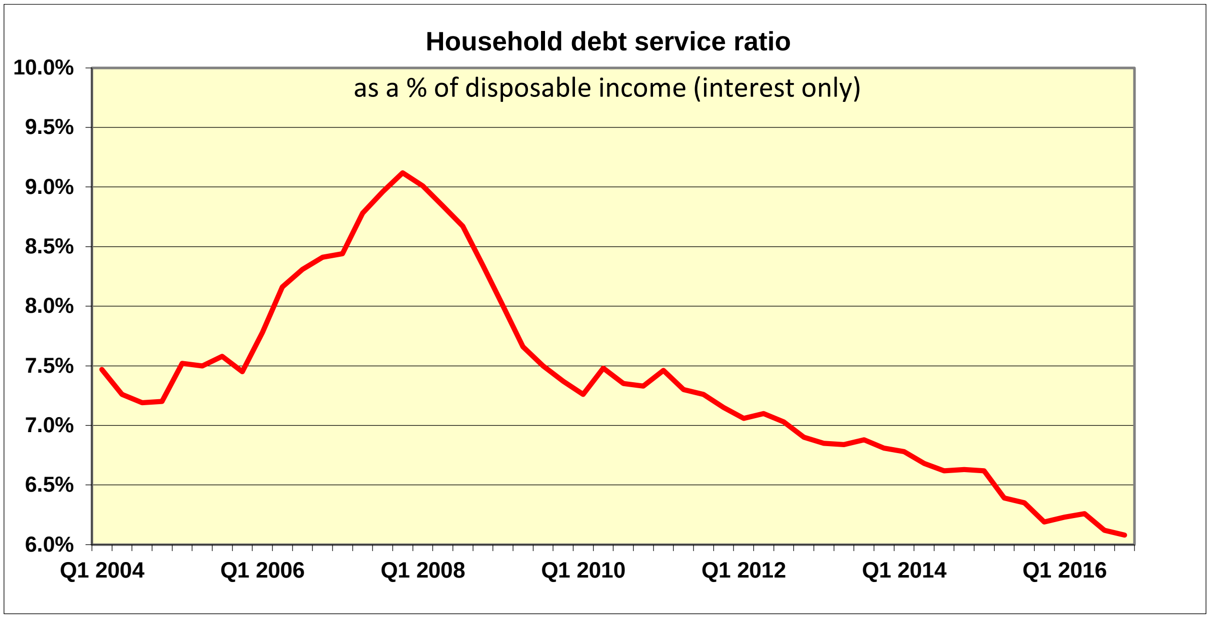
Figure 4



Source: Statistics Canada

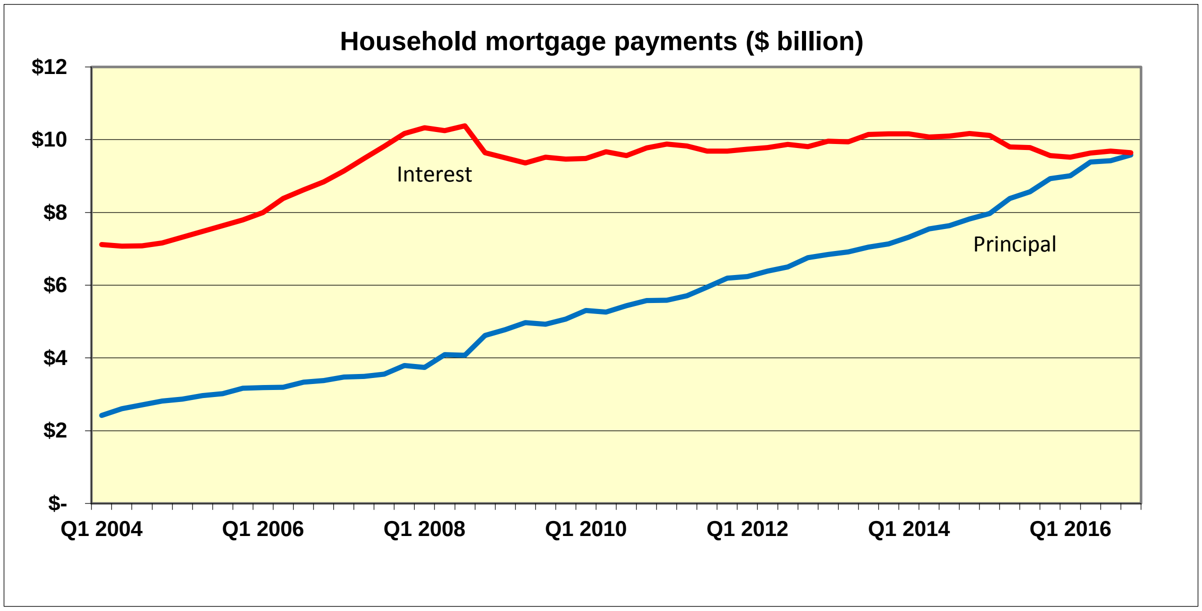
Additionally, with extremely low interest rates, debt servicing has become less burdensome. As shown in Figure 5, at the end of 2016 the ratio of interest paid to disposable income was 6.1%, the lowest since the current data were first collected in 1990. At the same time, as seen in Figure 6, households have increased their mortgage principal payments to the point that they largely match the interest being paid. Taken together, the low debt servicing burden and the near balance in interest and principal payments suggests that, for most, an interest rate bump would not be a critical issue. A widespread unwinding is unlikely as many would be able to withstand a higher debt servicing burden and would alter the proportion of debt repayment (lower) compared to the proportion of interest payment (higher).

Figure 5



Source: Statistics Canada

Figure 6



Source: Statistics Canada

Conclusions

- Interest rates have begun to rise in the U.S. While economic fundamentals suggest that the Bank of Canada's interest rate hikes remain on the horizon, it is likely that they will eventually raise rates here as well.
- Being aware of the risks posed by household debt to Canada's notoriously "regionally focused" housing market and to the broader economy can help individuals avoid emotional responses if and when any changes do occur.
- Professional financial advice can help investors gain a more secure view of the markets and a better understanding of the direction in which they are heading. By having an advisor and a financial plan, investors are better positioned for changing market environments.