Era of Rising Interest Rates

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The recent increases in the Bank of Canada and Federal Reserve prime rate in the past few months signal the end of historically low interest rates. According to a Bank of England study released in early 2016, current low interest rates are the lowest in 5000 years of recorded history[*]!

Media reports in July pointed to a Parliamentary Budget Office (PBO) report that warns the debt service ratio (the percentage of gross income needed to cover debt repayment costs) will move up by 3.5% by 2021 to 16.3% from the average of 12.9% seen between 1990 and 2017.

The increase is expected to leave heavily indebted Canadian households stretched in their ability to manage and repay debt, especially in the event of any kind of shock to the economic system such as a recession or the risk of job losses.

The change to an expected rising interest rate environment in the coming years, from a falling interest rate environment, is something that most Canadians have not experienced for over 30 years. This trend change will likely affect household **cash flow management**, debt repayments **[1]** and **savings rates** amongst other impacts for many years to come.

The good news is that while media reports generally focus on the total household debt being at historic highs of $1.67 of debt for every $1 of disposable income, much of that debt is mortgage debt rather than credit card or other short term loans. Large debt loads by a select group of Canadians who have purchased homes in the hot real estate markets of Toronto, Vancouver etc., have likely distorted the overall debt picture for average Canadians. Homeowners do not need to repay those loans in the short term, which makes the comparison of gross total consumer debt to current disposable income less important than managing the risk of rising rates and increasing monthly payments over time as mortgage terms come up for renewal.

The key is to make sure that you are **building equity in your home** by paying a little more each month than just the minimum required to service a 25-year amortization schedule. Even paying bi-weekly (26 payments) versus monthly can reduce the amortization by several years, which will give you the flexibility to perhaps extend your amortization in the future if interest rates rise faster than your capacity to service the loan. The key will be to find a monthly payment that you can manage while continuing to service your mortgage payment and maintain ownership of your residence.

A good rule of thumb when looking at your mortgage servicing costs is to compare it to the cost of renting an equivalent house, since after all, you still need to put a roof over your head whether it is a rental or owned. If the cost of carrying your mortgage is the same or up somewhat higher than the cost of renting, then keeping your home in the face of rising interest rates continues to make sense, even if you have to minimize the mortgage principal repayment for a few years.

A new approach may also be needed to manage mortgage term renewals in future. A common strategy in the past was to renew your mortgage using short term variable rate fixed-terms to get a better interest rate with a fixed payment while directing more principal towards the capital repayment. A better strategy, in a generally and possibly gently rising interest rate environment in the coming years, may be to go to a fixed rate term to protect you against rising rates during the course of the term.

Finally, make it a priority to pay off high interest credit card debt and to pay more than the minimum monthly payment on any personal lines of credit to avoid the risk of more of your monthly payments in future going to interest rather than principal repayments.

Call us today if you have any questions about your personal situation [2] and the impact of a rising interest rate world on your family’s finances.

*__Business Insider,__ *The 5,000-year history of interest rates shows just how historically low US rates are right now* **[3]. Retrieved on August 21, 2017.**

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