Canada's Interest Rate Problem

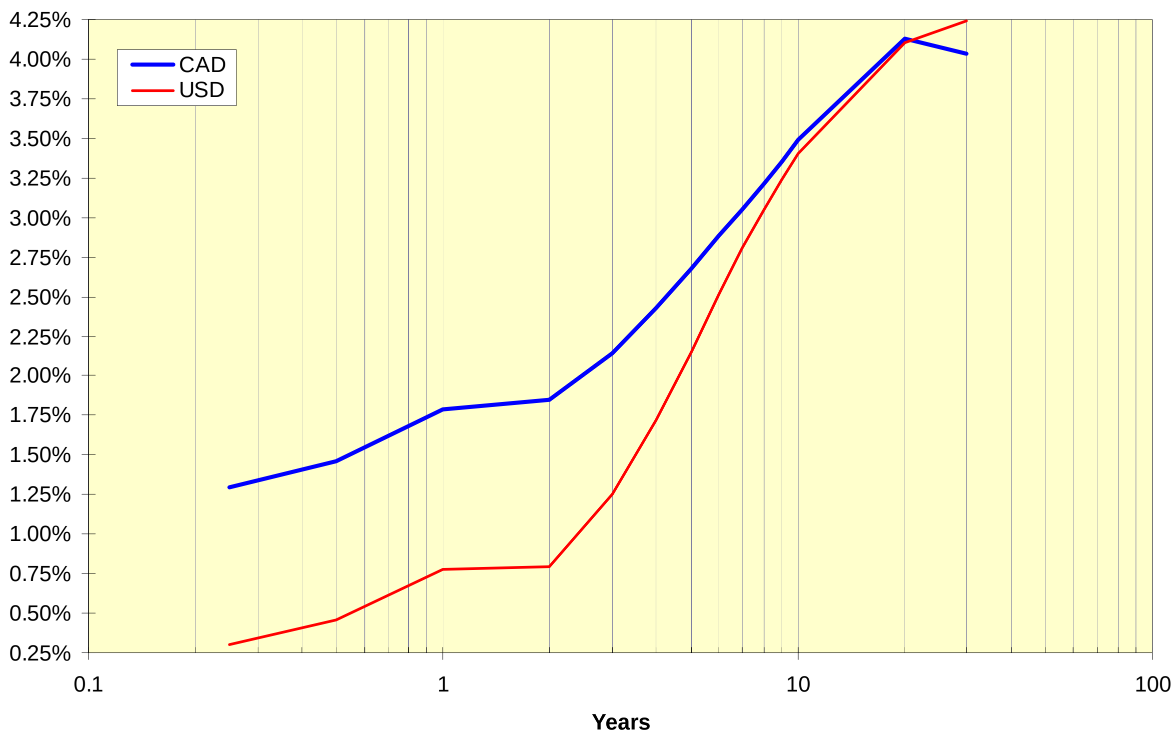
One of the downsides of living in multi-family housing, if that is how the apartments I lived in during my long-ago student days can be described, is you have neighbors. Like the kind whose eight-track tape player got stuck whilst they were in some manner of altered state and played Superfly and Papa Was A Rolling Stone in an endless loop.

The only upside is I can understand how Canada must feel having the U.S. for a neighbor; they must pray for the printing press to run out of ink with the same religious fervor I exhibited that evening. The Canadian dollar has been threatening to take out its 2007 all-time highs, and while the Canadian economy has been doing quite well by virtue of its strong resource sectors, there comes a time when, to paraphrase Mae West, too much of a good thing no longer is wonderful.

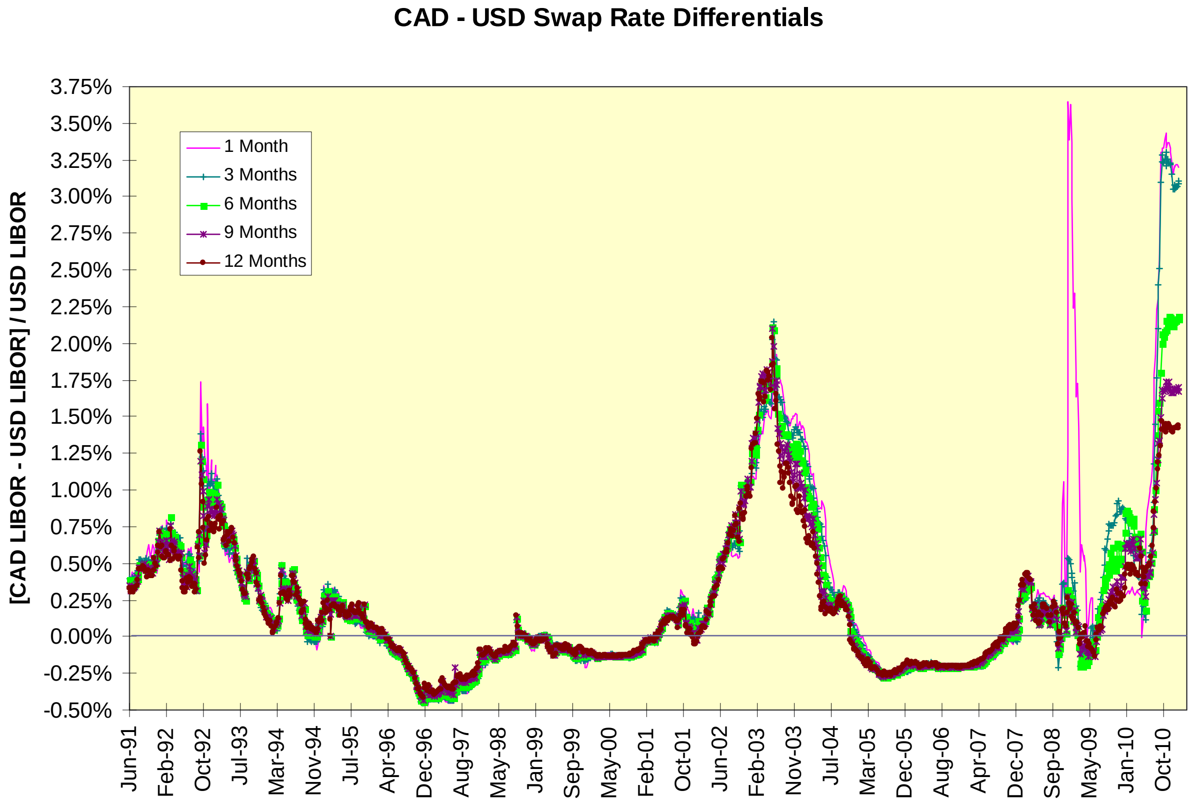
The Bank of Canada (rated "eh-plus," I am sure) noted the country's growing current account deficit in its decision last week not to adopt a more hawkish stance; they felt an upward move in the CAD only would compound the problem. However, if Canada is importing inflation from you-know-where, keeping rates too low would create other problems.

The interest rate gap can be illustrated in several ways. First, let's take a snapshot of comparative swap yields from last week. Please note how the Canadian curve is well above its U.S. counterpart out to two years, at which point the gap starts to narrow. As currency rates are established in money-market arbitrages between forward rates, Canada would have to be willing to align its yield curve to the American one as the FOMC is just as unlikely to meet them halfway as the Superfly crowd was to meet me.

Comparative U.S. And Canada Swap Yield Curves



Now let's step back and take a look at the swap rate differentials expressed as the difference between Canadian and American LIBOR divided by USD LIBOR over the past two decades. That huge spike in the one-month differential during the 2008-2009 financial crisis was not bad data; it was a bad time in the markets.



Where have we been recently, though? The gap at one and three months is at crisis levels, but where is the crisis? I thought all of the stimulus and money-printing had ended the crisis. If we are in a crisis, then why have we been out of a recession since June 2009, global bourses are on their horses and credit spreads are moving back down to 2007 levels.

Something is wrong with this picture, and it is U.S. interest rates are too low and are affecting our neighbor's disposition for the worse. Canada cannot ignore the U.S. any more than Poland can ignore Russia or New York can pretend New Jersey is someone else's sister state. You have to play the cards you are dealt. It would be nice if we fixed the broken printing press and stopped exporting both inflation and an overvalued CAD to Canada. Today would be a good time to start.