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THE WEEK AHEAD

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What Can a Rate Cut Do?

by Avery Shenfeld

The Fed came, it saw, and it tried to conquer any downside threats to growth by taking a small step towards lower interest rates. While that cut, and a likely follow-up move, might be seen as a counter to a confidence denting trade war, just what will a half point easing in rates this year do for the economy in 2020? Where should we be looking for the assumed lift to growth?

Traditionally, the two big beneficiaries of lower rates are interest-sensitive big ticket purchases: houses and autos. Both have in fact been trending lower of late.

But autos and housing are unlikely to return to their former vigor, even if lower rates provide a cushion for buyers. Autos are not only durable goods, they're more durable than they used to be, making it hard to sustain year after year growth in a long cycle. This deep into an expansion, there are too many well-functioning vehicles on American driveways to set new peaks in unit sales, and the next major innovation, a truly self-driving car, still seems well off on the horizon.

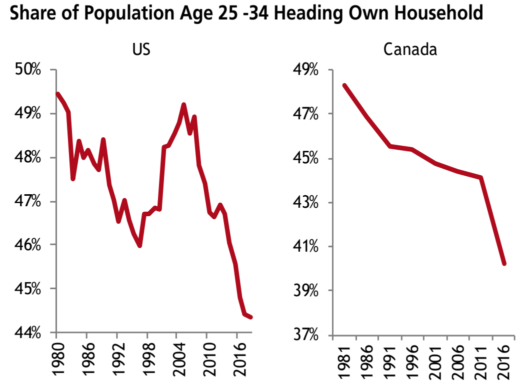
Homebuilding has frankly been a disappointment in this cycle. We were counting on an end to the steady climb in Americans aged 25-34 still living with their parents or roommates, expecting at least some recovery in the share of this group forming new households as their job prospects improved. That's not happening, and there may be a sociological trend, rather than just economics behind it. While the data in Canada are biased downward in level terms (see our In Focus May 14, 2019), we've seen the same downturn in that group's household headship rates in Canada (Chart).

Still, lower rates can still be of assistance in two key areas. They are creating a window in which Americans can refinance mortgages at lower rates, freeing up income for consumption. Indeed, this cycle has benefited from multi-decade lows in the share of income diverted to debt service.

Second, as central banks in Europe, Japan and China turn dovish, Fed cuts will be key to avoiding a further US$ appreciation, thereby supporting net exports. After all, most of what the ECB could accomplish through a monetary ease would come through its impact on the euro, since yields are already so low.

That's how the story might also play out for the Bank of Canada. It has no reason to cut rates now, with growth holding up and inflation running on target. But a stand pat policy could threaten headwinds for exporters as other central banks take rates lower, if as we expect, the loonie gets nudged stronger in the process. A token quarter point cut next year won't set off a housing or auto sales boom, but it might be key to keeping the Canadian dollar at levels at which exporters can compete.

Share of Population Age 25 -34 Heading Own Household



Source: US Census Bureau, StatCan, CMHC, CIBC