Inflation Planning:
What's the risk and what can you do about it?

With inflation at a 30-year high of 4.8% as of December 2021*, it is likely that the Bank of Canada will raise interest rates sometime this year to help curb inflationary pressures. If borrowing costs increase, there is typically a reduction in consumer and business spending as disposable income declines, resulting in a decrease of inflationary pressures on the economy. The Bank of Canada's target inflation is about 2%, so it stands to reason that interest rate hikes may be coming soon.

What does this mean to you?

If interest rates rise, the potential impacts at a personal level could include:

- Increased monthly interest payments on any variable rate debt you have, such as lines of credit or variable rate loans.
- Additional risk to your monthly debt servicing costs if you have more debt now than you did a few years ago. Like many Canadians, you may have tapped into the equity of your home to fund "pandemic renovations" or other purchases.
- Potential increased interest costs when your mortgage, or other fixed rate loans, renew.
- A reduction in the value of your home – if the cost to buy homes increases due to rising interest rates, the real estate market may cool and house prices could drop.
- Rising debt servicing costs could push highly leveraged homeowners into a situation where they may no longer be able to afford their home – and more people selling homes would put further downward pressure on property values.
- A negative change in the loan-to-value ratio for any loans you have that are secured with your home, where your bank may require you to pay down principal to get back to the target ratio.
- Actual inflation for most of us may be much higher than the reported figure (food, fuel, etc.). This creates a widening gap between what we make after-tax and what our expenses are.
- The "value" of your savings decreases, as it will take more dollars to buy the necessities of life. Additionally, rising interest rates can have a negative impact on the value of your current equity and bond investments.

* Source: **Statistics Canada** / www.statcan.gc.ca/en/subjects-start/prices_and_price_indexes/consumer_price_indexes

The chart below illustrates impact of higher interest rates on payments and interest costs on the Canadian average new home loan of $355,000:

	Current	Alternative 1	Alternative 2
Payment Frequency:	Monthly	Monthly	Monthly
Mortgage Type:	Variable Rate	Variable Rate	Variable Rate
Interest Rate:	1.5%	2.5%	3.5%
Term (years):	5.00	5.00	5.00
Amortization (years):	25	25	25
Payment Amount:	$1,420	$1,593	$1,777
Total Payments in First Year:	$17,037	$19,111	$21,327
Total Interest Cost For Term:	$24,412	$41,099	$58,070
Total Interest Cost For Amortization Period:	$70,932	$122,777	$178,164
Mortgage Balance at End of Term:	$294,226	$300,544	$306,437

Source: Average new home loan of $355,000 based on Equifax data as of June 30, 2021.

What can you do?

Some potential actions could include:

- With mortgage rates at, or near, historic lows, consider locking in for a set term, or even renewing early if the penalties aren't an issue. This ensures your cash flow is more secure, as your mortgage costs will be known for a set number of years.
- Consolidate debt. Again, knowing your monthly debt costs are fixed can give you peace of mind and allow you to plan for other costs and/or savings for your future.
- If you are in the market to buy a house, or trading up to a larger home, ensure you could still carry any corresponding mortgage at a higher interest rate. This ensures you have a "built-in" buffer in your capacity to make your mortgage payments if interest rates increase.
- Take some of the profits of your non-registered investments, or TFSA investments, and establish a cash reserve that you can use to pay down debt if interest rates rise.
- Meet with your financial advisor and your portfolio manager to determine if any action is required to ensure inflation risk doesn't derail your financial planning goals. Also, review your investment portfolio while you're at it – proper asset diversification is a prudent defense against inflation and essential to ensure that your long-term returns outpace the rising cost of living.

Have Questions? Contact Lucja (Lucy) Davson at 780-463-8101 or email wealth@kbh.ca.

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