

April 1, 2022

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Central banks playing catch-up

All of the central banks we monitor are plotting an exit from the highly accommodative policies put in place two years ago. But divergence is re-emerging, with the Fed and BoC now set to lead the charge toward a more neutral stance. Having committed to keep rates low until their economies fully recovered, both are increasingly worried they've fallen behind the curve on inflation. Rapidly-declining jobless rates, broadening inflation and ongoing commodity and supply chain pressures have added to the urgency to scale back stimulus. Last cycle's playbook for gradual tightening is being thrown out the window with both central banks hinting at larger and faster rate increases to come. Rates markets were already priced for a more aggressive approach to fighting inflation, and have only been encouraged by the recent shift in rhetoric. Meanwhile, those (including ourselves) that put more weight on previous central bank guidance are marking their policy rate forecasts higher. We now see both the Fed and BoC hiking by 50 bps at their next meetings, getting a head start on the move toward neutral (2% or higher) by year end. In essence, the tightening we expected over the next two years is now likely to come by the end of 2022.

Bond markets were already under pressure from rising breakeven inflation rates in the wake of Russia's invasion of Ukraine and associated commodity price increases. Central bank hawkishness in the second half of March only added to the pain, with US Treasuries recording their steepest monthly losses in decades. Higher yields spilled over into other jurisdictions where central banks aren't expected to move as quickly as the Fed and BoC—German 2-year yields, for instance, rose into positive territory for the first time since 2014. Equity markets

Central bank near-term bias



While the BoC hasn't been as overtly hawkish as the Fed, we think it's also keen to get monetary policy into a less stimulative position. We look for a 50 bp hike and QT announcement in April.



The Fed's March dot plot suggests it wants to get the fed funds rate close to neutral by year end. As such, we look for back-to-back 50 bp rate hikes at each of its next two meetings.



After three consecutive hikes and the start of QT, we think the BoE will slow the pace of tightening going forward with its next rate hike not coming until August.



The ECB sounded relatively hawkish at its first meeting following Russia's invasion of Ukraine, emphasizing inflation over growth risks. It left the door open to a hike later this year, slightly earlier than we expect.



A solid labour market and hawkish central banks should see the RBA raise rates slightly earlier than we previously thought (June rather than August). But we continue to look for a gradual tightening path.



Highlights

▲ The Fed's March 'dot plot' showed a much steeper rate path than in December.

▲ With headline US CPI inflation running at a 40-year high, the Fed expressed concern about broadening price pressures.

▲ The Fed tightening we expected by the end of next year is now likely to come in 2022.

▲ Headline CPI is expected to slow toward 2% in 2023, but core inflation is likely to remain elevated.

have taken the prospect of higher interest rates in stride—the week of the Fed's hawkish March meeting was the S&P 500's best in more than a year—even as flattening yield curves flag growing recession risk. Investors are hoping central banks can deliver a soft landing, reining in inflation without reversing recent labour market gains. Balancing those objectives will be much more challenging as rates approach neutral heading into 2023, and we expect the Fed and BoC will be much less active next year as they seek to prolong the current cycle.

Bringing forward hikes following the Fed's hawkish surprise

The Fed kicked off its tightening cycle in March with a widely expected 25 bp hike. A relatively brief policy statement let the committee's economic projections do the talking, and the message was hawkish. While the 'dot plot' showed a wide range of views among FOMC members, most expect fed funds to rise by a further 150 bps by the end of this year—100 bps more than they projected back in December. Additional rate increases in 2023 are seen pushing fed funds above its longer run level (~2.5%), which would make monetary policy restrictive for the first time since prior to the financial crisis. While a number of FOMC speakers foreshadowed a hawkish shift in March, the dot plot pointed to a more accelerated tightening cycle than anticipated, pushing shorter-term yields sharply higher.

The Fed's more aggressive approach to raising rates reflects growing concern about inflation. The policy statement warned of "broader price pressures" and the committee marked its inflation forecasts substantially higher. Headline and core PCE are both expected to end the year north of 4% and remain well above target by the end of 2023. The central bank thinks it can engineer a soft landing, bringing inflation closer to target by 2024 while keeping the unemployment rate below its longer-run level.

The economic backdrop clearly calls for less stimulative monetary policy, and with the Fed having validated that market view (and then some) in March, a much more accelerated tightening cycle looks increasingly likely. We're now penciling in 50 bp hikes in both May and June, followed by 25 bp hikes at each meeting in the second half of the year. That would bring fed funds up to 2.38% by the end of 2022—roughly in line with current market pricing. But we think any further tightening in 2023 will be limited. While we agree with the FOMC's near-term inflation outlook—our forecast assumes headline and core CPI will only slow to 4.5% by the 2022—we think headline inflation will slow toward 2% next year as supply chain bottlenecks improve and past increases in commodity prices fall out of year-over-year CPI calculations. That should give the Fed cover to take a more balanced approach in the complex trade-off between still-firm core inflation and a sub-trend growth outlook. In seeking to prolong the economic cycle, we think the Fed will ultimately avoid making monetary policy restrictive (in a meaningful way) even if that means slower progress toward 2% core inflation. So while we expect some further selloff in Treasuries over the course of 2022, we look for a modest rally (led by the front end) as markets price out additional tightening. If we're wrong and an aggressive inflation-fighting approach is needed in 2023, we're likely to see deeper yield curve inversion as the risk of a short economic cycle intensifies.

BoC seen following the Fed's lead

Markets expect the BoC to mirror the Fed's steeper rate path with Canadian short-term yields rising in lock step with the Treasury market. The BoC seemed to validate that



move in a late-March speech that came across as more hawkish than Governor Macklem's remarks earlier in the month. Deputy Governor Kozicki said "the pace and magnitude" of rate hikes will be discussed at the BoC's April meeting, further opening the door to a 50 bp move that Macklem refused to rule out. Kozicki also suggested the start of QT—shrinking the BoC's balance sheet—would be deliberated at the bank's upcoming meeting. As in the Fed's policy statement, she expressed concern about broadening price pressure and said the BoC is "prepared to act forcefully" to return inflation to target. The Deputy Governor also downplayed risks to the household sector from rising interest rates.

Last month we noted the risk of a more accelerated start to the BoC's tightening cycle than the once-a-quarter hikes we were assuming. With the Fed now expected to normalize monetary policy much faster, and the BoC not pushing back against market pricing for a more aggressive rate path, we've brought forward the tightening that was previously expected in 2023. We look for a 50 bp increase in April (alongside a QT announcement) to be followed by a series of 25 bp hikes, bringing the overnight rate to 2% by year end. That's slightly above last cycle's 1.75% peak, but we don't see the BoC going further from there. The effect of front-loaded rate increases is likely to build in 2023, slowing consumer spending and weighing on housing activity which has accounted for a disproportionate share of GDP during the pandemic recovery. Looking ahead to sub-trend growth in 2023, we think the BoC will move to the sidelines rather than lifting the overnight rate to a restrictive level (market pricing suggests the latter). As with the Fed, we think the BoC will prioritize prolonging the economic cycle rather than trying to engineer a faster return to 2% core inflation which would increase recession risks. As such, we look for GoC yields to come down modestly over the medium term following the recent, sharp selloff.

Inflation isn't the only data arguing for higher rates

While the Fed and BoC are laser-focused on inflation—and seem keen to get monetary policy back toward neutral in short order—near-term economic data could still influence the pace of rate hikes. With Canada's economy having held up well through winter's Omicron wave we think Q1 saw a healthy 3.5% annualized increase in GDP. We look for even stronger growth in the coming quarters—annualized gains average 5% in Q2 and Q3—as services spending continues to recover amid limited health restrictions. Higher prices will restrain spending by lower income households, and consumer confidence is close to one-year lows. But Canadians (in aggregate) continue to sit on significant excess savings, in addition to sizeable wealth gains built up amid rising home and equity valuations. A number of provinces have provided temporary transfers or energy price relief to help households manage the rising cost of living. Meanwhile, federal government spending is set to remain elevated in the upcoming fiscal year—even with Canada's economy running close to full capacity—and we're likely to see even more structural spending announced in the April 7 budget. All told, it's hard to see a catalyst for the BoC pausing its tightening cycle in the next few quarters.

With the US economy having reopened earlier, we don't expect near-term GDP growth will be quite as robust as in Canada. Nonetheless, domestic demand growth appears to have picked up in the early stages of 2022 with a healthy increase in consumer spending in January, further increases in business capex and solid homebuilding activity. Net trade and inventories are likely to dampen headline growth in Q1 (+1.5%) but strong job gains throughout the quarter suggest growth momentum was sustained. Eye-

Highlights

▲ The BoC said it will discuss the "pace and magnitude" of rate hikes in April, suggesting a 50 bp move is on the table.

▲ We now see the BoC lifting the overnight rate to 2% by year end.

▲ Canada's economy continued to grow through the Omicron wave, and saw a solid increase in activity in February as restrictions eased.

▲ The US job market maintained momentum in Q1 with the unemployment rate falling to 3.6% in March.



Highlights

▲ The BoE emphasized the economic hit from rising inflation and expressed less conviction regarding further rate hikes.

▲ The ECB's March meeting didn't dial back the hawkishness as much as we expected.

▲ We think the ECB is underestimating the economic impact of Russia's invasion of Ukraine.

▲ Australia's jobless rate is now the lowest since 2008, and higher wages are likely in the pipeline.

watering inflation and faltering confidence flag some downside risk to the consumer outlook, but with a number of other supportive factors still in place (including wage growth and excess savings) we think above-trend GDP growth will continue for much of 2022, keeping the Fed in tightening mode.

Other CBs won't keep up with the Fed and BoC

The BoE is a bit further along in its tightening cycle, having raised rates at each of its past three meetings and started the process of shrinking its balance sheet. But while the Fed and BoC have sounded more hawkish of late, the UK's central bank is signaling a slowdown in the pace of rate hikes going forward. In March the BoE emphasized the economic impact of sharply rising inflation, noting a "weaker outlook for growth and employment." With the Bank Rate now back to its pre-pandemic level (0.75%), policymakers sounded less convinced of future rate hikes, saying further modest tightening "may be" appropriate in the coming months. The bank's updated projections are likely to include downward revisions to growth forecasts and potentially a lower medium-term inflation profile, so we think the BoE will take a pass on raising rates in May. We look for one further rate hike this year (August) leaving Bank Rate at 1% by year-end—well below current market pricing which the BoE has pushed back against.

The ECB's first meeting in the wake of Russia's invasion of Ukraine didn't dial back the central bank's earlier, hawkish shift as much as we thought. It suggested its asset purchase program was likely to end in Q3—a bit sooner than we thought. While its guidance weakened the link between ending QE and raising rates, that timeframe still opens the door to interest rate liftoff by year-end—also somewhat sooner than the January 2023 hike in our forecast. The ECB's emphasis on the inflationary impact of recent geopolitical developments, rather than the expected hit to growth, also suggests risks of slightly faster pace of rate hikes than we are assuming next year. That said, we think the ECB is underestimating the economic impact of Russia-Ukraine related trade disruptions and price increases—while we look for a hit of close to 1 ppt of GDP in 2022 while the ECB has penciled in a 0.5 ppt impact. A greater near-term slowdown could force the ECB to take a more balanced approach to inflation and growth risks.

Australian labour market data suggest the economy is rapidly closing in on full employment with both the headline jobless rate and the broader underutilization rate hitting their lowest levels since 2008. While core inflation is likely to rise above the RBA's 2-3% target range in the near-term, the central bank has emphasized stronger wage growth will be needed to keep inflation on target in the medium term. With the labour market tightening faster than expected, the RBA should have more conviction that rising labour costs are in the pipeline. Combined with a hawkish shift from other central banks, we now see the RBA raising rates somewhat sooner than we previously thought—our forecast now assumes June liftoff rather than in August. We continue to look for the cash rate to rise to 0.75% by year-end and 1.25% by the end of 2023.



Interest rate outlook

%, end of period

	Actual					Forecast						
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
Canada												
Overnight	0.25	0.25	0.25	0.25	0.50	1.25	1.75	2.00	2.00	2.00	2.00	2.00
Three-month	0.09	0.15	0.12	0.16	0.60	1.40	1.85	2.05	1.95	1.95	1.95	1.90
Two-year	0.23	0.45	0.53	0.95	2.29	2.30	2.20	2.10	2.00	2.00	1.90	1.80
Five-year	0.99	0.98	1.11	1.26	2.41	2.45	2.30	2.20	2.15	2.10	2.00	1.95
10-year	1.56	1.39	1.51	1.43	2.40	2.40	2.35	2.25	2.20	2.15	2.10	2.10
30-year	1.99	1.84	1.99	1.68	2.38	2.35	2.35	2.30	2.30	2.25	2.20	2.20
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.38	1.38	1.88	2.38	2.63	2.63	2.63	2.63
Three-month	0.03	0.05	0.04	0.06	0.52	1.45	1.93	2.43	2.60	2.55	2.55	2.55
Two-year	0.16	0.25	0.28	0.73	2.28	2.65	2.80	2.85	2.80	2.70	2.60	2.50
Five-year	0.92	0.87	0.98	1.26	2.42	2.65	2.75	2.80	2.70	2.55	2.40	2.30
10-year	1.74	1.45	1.52	1.52	2.32	2.55	2.60	2.55	2.55	2.55	2.50	2.45
30-year	2.41	2.06	2.08	1.90	2.44	2.50	2.55	2.55	2.60	2.60	2.60	2.60
United Kingdom												
Bank rate	0.10	0.10	0.10	0.25	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25
Two-year	0.11	0.07	0.40	0.68	1.36	1.50	1.55	1.75	1.75	1.85	1.75	1.65
Five-year	0.40	0.33	0.62	0.82	1.40	1.50	1.55	1.75	1.75	1.80	1.75	1.70
10-year	0.85	0.72	1.02	0.97	1.60	1.70	1.75	1.75	1.75	1.75	1.75	1.75
30-year	1.40	1.24	1.37	1.12	1.77	1.80	1.80	1.75	1.75	1.70	1.70	1.75
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.25	0.00	0.25	0.25
Two-year	-0.69	-0.67	-0.69	-0.64	-0.08	0.15	0.25	0.40	0.55	0.60	0.50	0.40
Five-year	-0.62	-0.59	-0.56	-0.45	0.37	0.50	0.60	0.75	0.80	0.95	0.90	0.80
10-year	-0.29	-0.20	-0.21	-0.18	0.55	0.60	0.75	0.90	1.00	1.10	0.90	0.75
30-year	0.26	0.30	0.29	0.20	0.67	0.70	0.80	0.90	0.90	1.00	1.00	0.90
Australia												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.25	0.50	0.75	1.25	1.25	1.25	1.25
Two-year	0.08	0.06	0.04	0.54	1.78	1.60	1.70	1.80	1.75	1.70	1.70	1.60
10-year	1.74	1.49	1.49	1.67	2.84	2.95	2.95	2.80	2.75	2.75	2.65	2.60
New Zealand												
Cash target rate	0.25	0.25	0.25	0.75	1.00	1.50	2.00	2.25	2.50	2.75	2.75	2.75
Two-year swap	0.46	0.78	1.39	2.16	3.27							
10-year swap	1.95	1.87	2.21	2.62	3.38							
									UNDER REVIEW			
Yield curve***												
Canada	133	94	98	48	11	10	15	15	20	15	20	30
United States	158	120	124	79	4	-10	-20	-30	-25	-15	-10	-5
United Kingdom	74	65	62	29	24	20	20	0	0	-10	0	10
Eurozone	40	47	48	46	63	45	50	50	45	50	40	35
Australia	166	143	145	113	106	135	125	100	100	105	95	100
New Zealand	149	109	82	46	11							

*Midpoint of 25 basis point range, **Yields refer to German government bonds, *** Two-year /10-year spread in basis points,

Source: Reuters, RBC Economics



Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>	2021	2022F	2023F
Canada*	4.8	-3.6	5.5	6.7	3.5	5.5	4.5	1.7	1.5	1.3	1.2	1.0	4.6	4.3	2.0
United States*	6.3	6.7	2.3	7.0	1.5	3.0	2.5	2.2	1.8	1.3	0.9	0.8	5.7	3.4	1.8
United Kingdom	-1.2	5.6	1.0	1.0	0.7	0.5	0.4	0.3	0.5	0.4	0.4	0.4	7.5	3.9	1.7
Euro Area	-0.2	2.2	2.3	0.3	0.4	0.2	0.3	0.6	0.4	0.4	0.4	0.4	5.3	2.8	1.7
Australia	1.9	0.8	-1.9	3.4	0.8	1.9	0.9	0.7	0.7	0.4	0.5	0.4	4.7	4.0	2.8

*annualized

Inflation outlook

% change, year-over-year

	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>	2021	2022F	2023F
Canada	1.4	3.3	4.1	4.7	5.6	5.7	4.6	3.5	2.4	2.0	2.0	2.1	3.4	4.8	2.1
United States	1.9	4.8	5.3	6.7	8.0	7.4	6.1	4.5	2.7	1.9	2.0	2.2	4.7	6.5	2.2
United Kingdom	0.6	2.0	2.8	4.9	5.8	8.1	7.4	6.3	4.6	2.5	2.2	2.2	2.6	6.9	2.9
Euro Area	1.1	1.8	2.8	4.6	5.5	5.9	5.9	5.8	4.6	4.3	3.8	3.3	2.6	5.8	4.0
Australia	1.1	3.8	3.0	3.5	4.2	4.4	4.4	3.8	3.1	2.9	2.7	2.6	2.9	4.2	2.9

Source: Statistics Canada, Bureau of Economic Analysis, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics

Currency outlook

Level, end of period

	<u>Actuals</u>					<u>Forecast</u>						
	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>
Canadian dollar	1.26	1.24	1.27	1.26	1.25	1.27	1.27	1.27	1.28	1.30	1.32	1.34
Euro	1.17	1.19	1.16	1.14	1.11	1.10	1.09	1.08	1.07	1.08	1.08	1.09
U.K. pound sterling	1.38	1.38	1.35	1.35	1.31	1.28	1.21	1.19	1.18	1.19	1.20	1.21
Japanese yen	111	111	111	115	122	113	115	117	118	119	120	120
Australian dollar	0.76	0.75	0.72	0.73	0.75	0.70	0.68	0.67	0.67	0.67	0.67	0.67

Canadian dollar cross-rates

	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>
EUR/CAD	1.47	1.47	1.47	1.44	1.38	1.40	1.38	1.37	1.37	1.40	1.43	1.46
GBP/CAD	1.73	1.71	1.71	1.71	1.64	1.62	1.54	1.51	1.51	1.54	1.58	1.62
CAD/JPY	88	90	88	91	97	89	91	92	92	92	91	90
AUD/CAD	0.95	0.93	0.92	0.92	0.94	0.89	0.86	0.85	0.86	0.87	0.88	0.90

Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

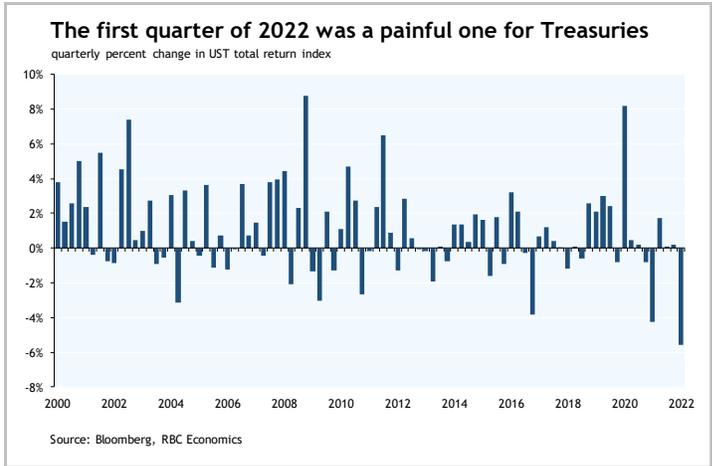
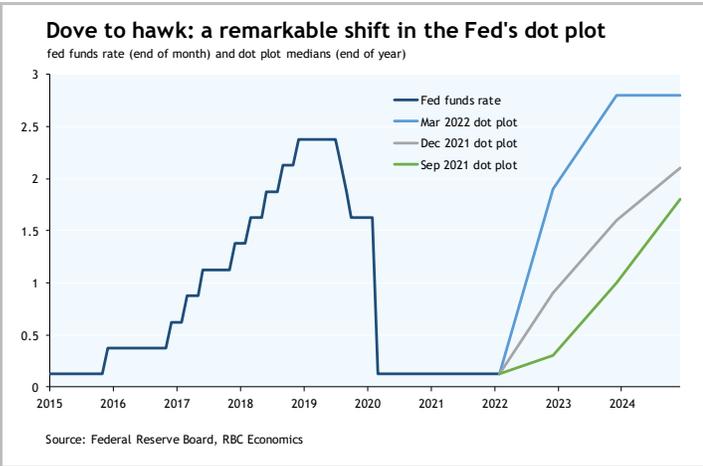
Source: Bloomberg, RBC Economics



Digesting the Fed's hawkish shift

We anticipated a shift higher in the Fed's policy rate path, but March's 'dot plot' went well beyond expectations. The end of 2022 median showing an additional 100 bps of hikes relative to December. The committee sees fed funds rising above its longer run level in 2023 and 2024, and several members are looking for even more restrictive policy.

An increase in breakeven inflation rates (10-year +30 bps YTD) combined with expectations for rapid rate hikes has made for a painful start to the year for the bond market. One index of Treasury returns showed the worst performance in decades as yields (which move inversely with bond prices) rose sharply.



Equity markets handled the Fed's hawkish shift well, with the S&P 500 recording its strongest weekly gain since November 2020. But even with a solid rally in March, the index fell by nearly 5% in the first quarter of 2022.

Yields have increased across the curve but most significantly at the front end given rising policy rate expectations. A flattening yield curve—a common recession predictor—points to slower medium-term growth and central banks eventually having to reverse some of their near-term tightening.

