

February 9, 2022  
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## Moving on from pandemic stimulus

The hawkish turn from major central banks that began late last year only accelerated in the early stages of 2022. Both the BoC and Fed used their January meetings to flag imminent rate increases and we look for hikes from both in March, slightly earlier than we previously assumed. The Fed sounded particularly hawkish, with Chair Powell not ruling out an accelerated pace of tightening relative to last cycle. Not to be outdone, the BoE and ECB surprised markets in early-February. The former raised rates as expected, but with several MPC members voting for a larger hike it looks like further tightening is on the way in March. The ECB sounded increasingly worried about inflation and looks set to announce an accelerated QE wind-down in March. We now see the central bank beginning to gradually raise rates later this year—quite a bit sooner than previously thought—and finally ending its negative interest rate policy by March 2023. We’ve also moved forward our forecast for the RBA to begin raising rates this year after it ended QE as expected in February.

It’s not surprising that rapidly shifting central bank rhetoric has led to some market volatility. The S&P 500’s 5.3% decline in January was the worst since March 2020 and the VIX volatility index hit a one-year high late in the month. Previously high-flying tech stocks have been hurt by rising rate expectations (putting a steeper discount on future earnings) with the NASDAQ falling 9% in January. Geopolitical tensions haven’t helped risk appetite, and concerns about potential supply disruptions (combined with OPEC+’s gradual approach to adding barrels) pushed WTI oil prices above US\$90/bbl for the first time since 2014. Higher energy prices have been a key contributor to rising inflation—a dynamic central banks would normally look through but one that is difficult to ignore amid decades-high inflation rates and a number of other sources of price pressure.

### Central bank near-term bias



The BoC opted not to hike in January in one of the closest calls in recent memory. But it cleared the decks for a rate increase in March, which we’ve incorporated into our forecast. We could see a follow-up hike in April before getting on a once-a-quarter schedule for rate increases.



Chair Powell heavily hinted at a March rate hike and we’ve updated our forecast to reflect that. We now expect four rate increases in 2022 with a QT announcement likely in the first half of the year.



The BoE raised rates at a second consecutive meeting and looks set to make it three in a row in March. We expect the pace of hikes will slow thereafter as QT also acts to tighten financial conditions.



Following a surprisingly hawkish shift from the ECB in February, we now see the central bank winding down its QE program by mid-year. That will tee up a series of gradual rate increases—starting this year—as the ECB seeks to exit its negative interest rate policy.



The RBA ended its QE program in February but didn’t sound nearly as hawkish as its global counterparts. We expect low unemployment and firming inflation will ultimately see the RBA raise rates in August.

#### Overview

..... page 1

#### United States

..... page 2

#### Canada

..... page 3

#### UK, Europe & Australia

..... page 4

#### Interest rate outlook

..... page 5

#### Economic & FX outlook

..... page 6

#### Charts we’re watching

..... page 7



## Highlights

▲ Inventory investment made an outsized contribution to US GDP growth in Q4/21.

▲ We expect a hospitality-driven slowdown in services spending will be short-lived.

▲ Aside from a dip in hours worked, the US labour market didn't appear to be significantly impacted by Omicron in January.

▲ Chair Powell sounded hawkish in January, refusing to rule out a 50 bp hike or raising rates at consecutive meetings.

## Omicron slows US spending...

US GDP was firmer than expected in the final quarter of 2021 with a 6.9% annualized gain marking the strongest increase in more than a year. Inventory investment made an outsized contribution to growth—normally a red flag though in this case it looks like businesses were simply restocking following drawdowns in the first half of last year. Consumer spending posted a healthy increase but lost momentum late in the quarter. Spending fell 1% in December as goods purchases continued to normalize while hospitality and other services spending softened as the threat of Omicron emerged.

Even in the absence of government-imposed restrictions, a pullback in close-contact services appears to have continued in January—restaurant bookings, for instance, were down 10% month-over-month. We think this dip in spending will be short-lived (indeed, card spending data suggest non-hospitality spending picked up as January progressed) and we've marked down our Q1 GDP growth forecast only slightly to a still-healthy 2.5%. We see a similar, above-trend pace of growth being sustained over the course of 2022 despite the economy now operating close to its long-run capacity.

## ...but not job growth

An Omicron-related pullback in spending didn't do much to slow the US labour market with more than 400,000 jobs added in January for a ninth consecutive month. Hours worked, though, were down slightly for the first time in nearly a year likely reflecting COVID-related absences. The unemployment rate ticked higher to 4% though that was arguably a positive development driven by a jump in labour force participation as more Americans looked for work. Even with labour supply expanding, tight conditions were clearly evident with wages rising strongly in the month. Year-over-year wage growth is now approaching 6%, about twice the pre-pandemic pace. We expect wage growth will remain robust over the course of 2022, acting as a more persistent source of upward price pressure as others (supply chain disruptions, rising energy prices, re-opening effects) begin to fade. Our forecast assumes headline inflation will slow to slightly less than 3% by the end of this year, though core inflation will be closer to 4%.

## Hawkish Powell tees up March hike

The Fed's January meeting was notable despite no policy changes being made—the fed funds rate was held steady and QE is still on track to end by early March. The statement said it will “soon be appropriate” to begin raising rates, and if that wasn't clear enough Chair Powell added that “the Committee is of a mind to raise the federal funds rate at the March meeting.” The hawkishness didn't end there, with Powell refusing to rule out a faster pace of tightening than the once-a-quarter hikes that were the norm last cycle, or even increasing fed funds by 50 bps at a single meeting. Indeed, he noted key differences between now and the start of the last tightening cycle—a stronger economy and labour market, and higher inflation—and said “those differences are likely to be reflected in the policy that we implement.”

What should we make of those comments? It was fairly clear that the Fed plans to shrink its balance sheet sooner and faster than it did last cycle. We expect a QT announcement by mid-year with a significantly higher cap on the amount of maturing assets that won't be reinvested. As for the pace of rate hikes, there is some risk that the Fed moves faster than once per quarter early in its tightening cycle. But it's hard to imagine a committee that just six weeks ago thought two or three rate increases might be appropriate in 2022, suddenly thinks it needs to raise rates in 50 bp increments or at every meeting this year. With a March liftoff looking close to a sure thing, we now expect four rate hikes this year and another four in 2023. We wouldn't rule out back-to-back hikes early in the cycle but don't see an accelerated pace of rate increases being sustained.



## Canada's economy feeling the (temporary) effects of Omicron

November GDP came in stronger than previously estimated with flooding in BC constraining some industries but not having a significant impact on overall growth. StatCan's flash estimate pointed to flat activity in December with declines in hospitality and retail likely reflecting Omicron's early impact. On balance, that left StatCan's flash estimate for Q4 GDP (~6.5% annualized) close to our 6% call.

Omicron's effect will be most significant in January. Our consumer spending tracker already showed some signs of softening in December and that continued last month as restrictions ramped up. Canada shed 200,000 jobs in January—about in line with declines seen during lockdowns last winter and spring—and hours worked fell by more than 2% with one in ten employees missing time due to illness or disability in the survey week. With containment measures beginning to ease in February, we think January's decline will start to be reversed as soon as this month. It took one or two months for the economy to retrace job losses recorded during 2021's lockdowns and we expect it will be no different this time around. We see a slow start to the year (Q1 GDP +1.5%) being made up for in subsequent quarters with growth averaging 6% in Q2 and Q3.

## Capacity and price pressures prominent in latest BoC survey

In December, the BoC noted significant uncertainty about the current degree of economic slack and said it would be evaluating a broader range of indicators—beyond the standard output gap—to judge capacity pressures. That put an even greater spotlight on the bank's Q4 Business Outlook Survey which showed a record share of respondents would have difficulty meeting an unexpected increase in demand. Labour shortages (the most intense in the survey's two decade history), supply chain disruptions and strong demand all contributed to capacity pressures. Many businesses expected to raise wages to attract and retain workers, and near-term inflation expectations continued to rise with many firms thinking it could take more than a year for supply chains to return to normal. In more positive news, indicators of future sales remained strong and hiring and investment intentions were robust. While the survey was conducted pre-Omicron, we think it provided strong evidence that the economy has little spare capacity in aggregate, notwithstanding ongoing shortfalls in a few hard-hit sectors.

## Bank of Canada tees up near-term liftoff

Abstracting from temporary Omicron impacts, recent data make a strong case that Canada's economy no longer needs near-zero interest rates. That made a hike at January's meeting a close call—the market and several analysts were looking for a move—but in the end the BoC opted to hold rates steady and drop its forward guidance, thus opening the door to rate increases at coming meetings. Indeed, Governor Macklem made it clear that Canadians should expect borrowing costs to rise soon.

The decision not to hike came down to two factors: communications and Omicron. On the latter, the BoC said the economic impact of the current wave is likely to be less severe than past waves of COVID-19. However, holding off on raising rates in January gives it time to evaluate whether the current wave is in fact peaking and the extent to which containment measures are easing. On the communications side, raising rates one month after reiterating its “middle quarters of 2022” timeframe for liftoff would have made for a messy exit from the BoC's forward guidance—not ideal for the credibility of a policy tool the bank might have to use again in the future. Governor Macklem said the bank wanted to move forward “in a deliberate series of steps” which meant dropping its forward guidance before beginning to raise rates.

With forward guidance out of the way and Omicron starting to recede, we think there's a strong case for March liftoff and have incorporated that into our forecast. A slightly earlier start suggests we're more likely to see four hikes than three this year (our previ-

## Highlights

▲ Canada's Omicron-driven job losses were similar to those seen during 2021's lockdowns...

▲ ...and history suggests those declines will be reversed quickly.

▲ The BoC's latest business survey suggests the economy was operating close to full capacity in Q4/21.

▲ After dropping its forward guidance in January we now see the BoC raising its policy rate in March.



## Highlights

▲ Four of nine MPC members surprisingly voted for a 50 bp rate increase in February...

▲ ...suggesting a low bar for the BoE to hike again in March.

▲ Growing concern about inflation—which has consistently surprised to the upside—had the ECB sounding much more hawkish.

▲ The RBA revised its inflation forecasts higher and unemployment lower, but still sees wage growth picking up only gradually.

ous call) though we still see market pricing for five to six rate increases as aggressive, particularly in light of the BoC's patience in January. While we might see back-to-back hikes to start the tightening process—as was the case in 2017—we doubt such a pace will be sustained. The BoC also indicated that, once it begins to raise rates, it will consider exiting the reinvestment phase of QE and begin shrinking its balance sheet. We think such a move could come in the first half of this year, though we'd emphasize that most tightening in financial conditions will come from the bank raising its policy rate, not shrinking its balance sheet.

### BoE hikes again, with more to come

As expected, the BoE followed up December's hike by raising Bank Rate by 25 bps to 0.50% in February. That's the level at which the central bank said it would start passively shrinking its balance sheet, and it confirmed it won't be reinvesting its holdings that mature in March. We thought the BoE would pause its tightening cycle for a few meetings while QT got underway but that looks less likely following February's meeting. Four of nine MPC members voted for a 50 bp rate hike, and with a smaller move having won the day, we think they'll back a further 25 bp increase next month. It's not hard to see at least one more joining that group, so we've added a March hike to our forecast. With another rate increase expected in August, we see the Bank Rate ending the year at 1% rather than 0.75% previously. That remains well below market pricing for four or five additional hikes this year. For all its hawkishness in February, the BoE softly pushed back against that pricing with projections suggesting the market path for Bank Rate would eventually push inflation below target. So after a more accelerated start to tightening than we thought, we continue to see a more gradual pace of hikes as the BoE shrinks its balance sheet.

### ECB to accelerate stimulus withdrawal

The ECB also struck an unexpectedly hawkish tone at its early-February meeting. Lagarde noted "unanimous concern" about stronger-than-expected inflation—January's flash HICP reading came in well above market expectations at 5.1% year-over-year—and hinted at upward revisions to the central bank's forecast with medium-term inflation now seen getting "much closer to target." That suggests the ECB sees progress toward its key forward guidance condition—it wants to see inflation returning to 2% on a sustained basis "well ahead of the end of its projection horizon" before raising rates. As of December those forecasts showed inflation at 1.8% in 2023 and 2024. Adding to the sense that the ECB might be contemplating raising rates, Lagarde didn't rule out a hike this year as she had previously, saying "the situation has indeed changed." On top of that, reports suggest some on Governing Council that wanted to accelerate tapering in February, which would clear the deck for rate increases (recall, the ECB said it will end net QE purchases shortly before raising rates). That discussion will likely intensify in March and we expect a decision to wind down QE by the middle of this year. We now look for the ECB to begin gradually reversing its negative interest rate policy that has been in place since 2014, starting with a 10 bp hike in September and getting the deposit rate back to zero by March 2023.

### RBA to join global tightening cycle in 2022

Australia saw its own upside surprise on inflation with both headline and core CPI coming in well ahead of expectations in Q4. The latter is now running at its fastest pace since 2014, and our diffusion measure shows a breadth of price pressure not seen in two decades. That data came on the heels of an unexpectedly large decline in the jobless rate in December (now the lowest since 2008) and in our view sealed the deal for the RBA to end QE in February. We also see these developments—a faster return to full employment and within-target inflation—as arguing for an earlier start to tightening and have brought forward our forecast for the first rate hike to August 2022 from February 2023 previously. The RBA didn't rule out raising rates this year but continues to eye 2023 liftoff, leaving our forecast between an aggressively-priced market and central bank that seems reluctant to join the global tightening cycle.





## Interest rate outlook

%, end of period

	Actual				Forecast							
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
<b>Canada</b>												
Overnight	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.50	1.75	1.75	1.75
Three-month	0.09	0.15	0.12	0.16	0.60	0.85	1.10	1.30	1.50	1.65	1.70	1.70
Two-year	0.23	0.45	0.53	0.95	1.25	1.40	1.50	1.65	1.80	1.90	1.95	2.00
Five-year	0.99	0.98	1.11	1.26	1.60	1.70	1.75	1.85	1.95	2.00	2.05	2.10
10-year	1.56	1.39	1.51	1.43	1.80	1.90	1.95	2.00	2.05	2.10	2.15	2.20
30-year	1.99	1.84	1.99	1.68	2.05	2.10	2.15	2.20	2.25	2.30	2.30	2.30
<b>United States</b>												
Fed funds*	0.13	0.13	0.13	0.13	0.38	0.63	0.88	1.13	1.38	1.63	1.88	2.13
Three-month	0.03	0.05	0.04	0.06	0.35	0.63	0.88	1.15	1.41	1.66	1.92	2.18
Two-year	0.16	0.25	0.28	0.73	1.40	1.50	1.65	1.80	1.95	2.05	2.20	2.30
Five-year	0.92	0.87	0.98	1.26	1.85	1.95	2.10	2.20	2.25	2.30	2.35	2.40
10-year	1.74	1.45	1.52	1.52	2.00	2.05	2.15	2.25	2.35	2.40	2.45	2.45
30-year	2.41	2.06	2.08	1.90	2.25	2.30	2.35	2.40	2.45	2.45	2.50	2.50
<b>United Kingdom</b>												
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	1.25	1.20	1.30	1.30	1.40	1.40	1.40	1.40
Five-year	0.40	0.33	0.62	0.82	1.30	1.30	1.35	1.40	1.45	1.55	1.55	1.55
10-year	0.85	0.72	1.02	0.97	1.40	1.45	1.50	1.55	1.65	1.75	1.75	1.75
30-year	1.40	1.24	1.37	1.12	1.50	1.55	1.55	1.60	1.70	1.75	1.75	1.75
<b>Euro area**</b>												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.40	-0.25	0.00	0.00	0.25	0.25
Two-year	-0.69	-0.67	-0.69	-0.64	-0.30	-0.20	-0.10	0.00	0.15	0.20	0.30	0.30
Five-year	-0.62	-0.59	-0.56	-0.45	0.10	0.10	0.15	0.20	0.40	0.45	0.50	0.50
10-year	-0.29	-0.20	-0.21	-0.18	0.25	0.25	0.30	0.40	0.55	0.60	0.65	0.65
30-year	0.26	0.30	0.29	0.20	0.40	0.40	0.45	0.50	0.60	0.65	0.70	0.70
<b>Australia</b>												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.10	0.50	0.75	1.00	1.25	1.25	1.25
Two-year	0.08	0.06	0.04	0.54	0.90	1.10	1.30	1.50	1.60	1.70	1.75	1.80
10-year	1.74	1.49	1.49	1.67	1.95	2.05	2.20	2.30	2.40	2.55	2.60	2.70
<b>New Zealand</b>												
Cash target rate	0.25	0.25	0.25	0.75	1.25	1.50	1.50	1.50	1.75	2.00	2.25	2.25
Two-year swap	0.46	0.78	1.39	2.16	2.35	2.40	2.35	2.40	2.55	2.65	2.70	2.80
10-year swap	1.95	1.87	2.21	2.62	2.55	2.60	2.60	2.65	2.80	2.85	2.95	3.05
<b>Yield curve***</b>												
Canada	133	94	98	48	55	50	45	35	25	20	20	20
United States	158	120	124	79	60	55	50	45	40	35	25	15
United Kingdom	74	65	62	29	15	25	20	25	25	35	35	35
Eurozone	40	47	48	46	55	45	40	40	40	40	35	35
Australia	166	143	145	113	105	95	90	80	80	85	85	90
New Zealand	149	109	82	46	20	20	25	25	25	20	25	25

\*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>	<u>2021</u>	<u>2022F</u>	<u>2023F</u>
Canada*	4.9	-3.2	5.4	6.0	1.5	6.5	5.5	2.5	2.2	2.0	1.8	1.8	4.6	4.0	2.8
United States*	6.3	6.7	2.3	6.9	2.5	3.0	2.5	2.5	2.0	1.8	1.7	1.5	5.7	3.6	2.1
United Kingdom	-1.3	5.4	1.1	1.1	0.7	0.9	0.7	0.5	0.5	0.4	0.4	0.4	7.3	4.5	2.1
Euro Area	-0.2	2.2	2.3	0.3	0.4	1.0	0.8	0.6	0.4	0.4	0.4	0.4	5.2	3.6	2.1
Australia	1.8	0.7	-1.9	2.5	0.8	1.9	0.9	0.7	0.7	0.4	0.5	0.4	4.0	2.8	2.6

\*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>	<u>2021</u>	<u>2022F</u>	<u>2023F</u>
Canada	1.4	3.3	4.1	4.7	4.8	4.4	3.4	2.6	2.3	2.3	2.3	2.3	3.4	3.8	2.3
United States	1.9	4.8	5.3	6.7	7.0	5.3	4.2	2.8	2.2	2.3	2.2	2.1	4.7	4.8	2.2
United Kingdom	0.6	2.0	2.8	4.9	5.8	7.1	6.7	5.7	4.2	2.2	2.0	2.0	2.6	6.3	3.2
Euro Area	1.1	1.8	2.8	4.6	3.2	2.8	2.1	1.5	0.9	1.1	1.6	1.8	2.6	2.4	1.4
Australia	1.1	3.8	3.0	3.5	3.9	4.1	4.1	3.4	3.1	2.9	2.7	2.6	2.9	3.9	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	1.26	1.27	1.27	1.27	1.28	1.30	1.32	1.34
Euro	1.17	1.19	1.16	1.14	1.13	1.11	1.09	1.08	1.07	1.08	1.08	1.09
U.K. pound sterling	1.38	1.38	1.35	1.35	1.33	1.26	1.21	1.19	1.18	1.19	1.20	1.21
Japanese yen	111	111	111	115	112	113	115	117	118	119	120	120
Australian dollar	0.76	0.75	0.72	0.73	0.71	0.69	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	1.42	1.41	1.38	1.37	1.37	1.40	1.43	1.46
GBP/CAD	1.73	1.71	1.71	1.71	1.68	1.60	1.54	1.51	1.51	1.54	1.58	1.62
CAD/JPY	88	90	88	91	89	89	91	92	92	92	91	90
AUD/CAD	0.95	0.93	0.92	0.92	0.89	0.88	0.86	0.85	0.86	0.87	0.88	0.90

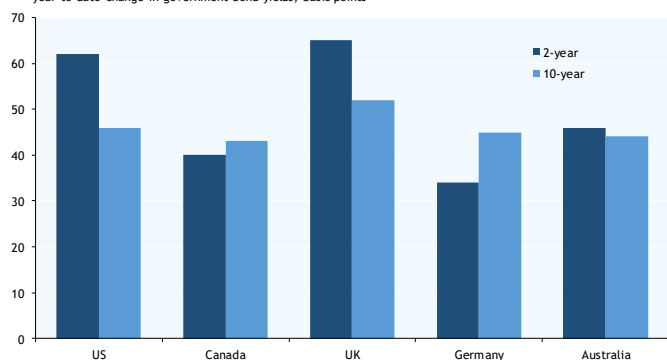
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics

## High inflation + strong labour markets = hawkish central banks

Government bonds have sold off sharply in the early stages of 2022 amid a hawkish pivot from central banks. We now expect more policy tightening this year (and generally earlier liftoff) from all of the central banks we track. Further increases in bond yields should be moderate, though, with markets already pricing in significant tightening in 2022.

**Hawkish central banks pushing bond yields higher in early '22**  
year-to-date change in government bond yields, basis points

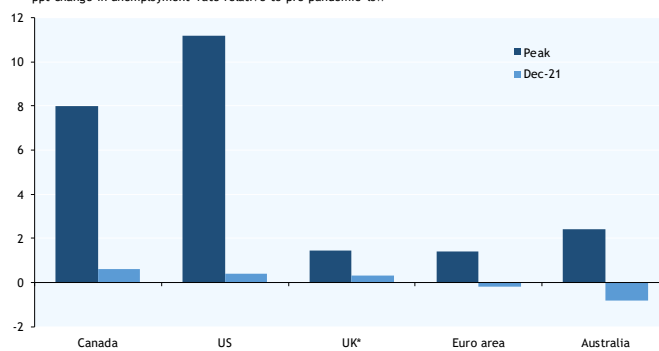


Source: Refinitiv, RBA, RBC Economics

Rapidly improving labour markets have contributed to central bank hawkishness. Jobless rates fell close to or below pre-pandemic levels at the end of last year—which in many cases were the lowest in decades—even as government supports were pared back. Central banks will be keeping an eye on wages as a potential driver of inflation going forward.

**Labour markets have largely recovered**

ppt change in unemployment rate relative to pre-pandemic low



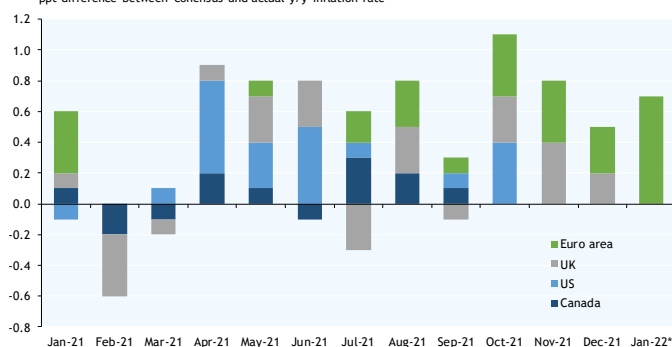
\*UK as of Nov-21

Source: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics

A substantial upside surprise in euro area inflation—just ahead of the ECB's February meeting—continues a trend we've seen over the past year with price growth consistently overshooting market expectations. Central banks have been surprised, too, adding to their uneasiness about inflation.

**Inflation has consistently surprised to the upside**

ppt difference between consensus and actual y/y inflation rate



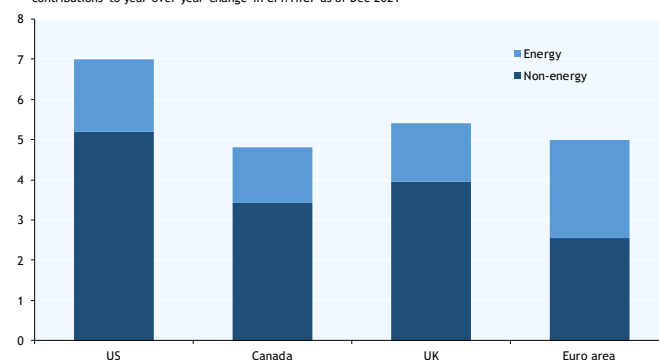
\*only Euro area reporting for Jan-22

Source: Refinitiv, RBC Economics

Energy prices haven't been the only driver of inflation—price pressure is generally broadening—but they've been a key factor. Geopolitical concerns have added to upward pressure on oil and natural gas prices, making energy inflation more persistent than previously thought.

**Energy prices are one of several inflation drivers**

contributions to year-over-year change in CPI/HICP as of Dec 2021



Source: StatCan, BLS, ONS, EuroStat, RBC Economics