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Front-loading can't guarantee a soft landing

Front-loading has become the motto of central banks looking to quickly remove policy support amid intense inflationary pressure. The BoC continued with its steepest tightening cycle in decades, lifting its overnight rate by a further 75 bps in early September. The ECB matched that increase the following day and we expect the Fed will do the same later this month. It's telling that the 50 bp increase we expect from the BoE this week now looks modest. There's more to come from each of these central banks as they blow past "neutral" into "restrictive" territory, tapping the brakes on demand in an effort to keep an inflationary spiral from developing.

[BIS research](#) suggests front-loaded rate hikes "can help prevent a hard landing." But with policymakers pledging to do what it takes to rein in inflation, we think a soft landing is becoming a distant prospect. Central banks are aware of the challenge but only the BoE has been bold enough to forecast a recession. For our part, we think a European downturn is already underway as a continental energy crisis deepens. Canada, the US and UK are likely to see their own economic contractions beginning later this year or in 2023. These declines, while unpleasant, are arguably needed to return supply and demand to better balance and ease inflationary pressure. While some of the global drivers of inflation—oil and non-energy commodity prices, supply chain pressures and shipping costs—are easing, domestic price pressures and elevated inflation expectations continue to make "restrictive" monetary policy the preferred path for central banks.

Hawkish BoC points to even more rate hikes...

The BoC followed up July's surprisingly large 100 bp hike with another oversized 75 bp increase in September (this time in line with expectations). At 3.25% the overnight rate is now slightly above the 2-3% range the BoC considers neutral. Debate was previously heating up over whether September's hike would be followed by a pause—in July the BoC itself said it was

Central bank near-term bias



A hawkish BoC made clear it isn't ready to pause tightening just yet, though it did hint at a slower pace of hikes going forward. We expect a 50 bp increase in October and final 25 bp hike in December to reach a terminal overnight rate of 4%—firmly above the 2-3% neutral range.



The Fed pushed back against markets in August and now has to follow up its hawkish language with action. We look for a 75 bp hike in September and a stepped-down pace of tightening in Q4 leaving fed funds in a 3.75-4% range by year end.



Some energy price relief from the new government should soften the peak in UK inflation and in our view will see the BoE stick to a 50 bp hike in September. Further tightening in Q4 should leave Bank Rate at 3% by year end.



We see September's stronger-than-expected 75 bp hike being repeated in October as a front-loading ECB aims to remove accommodation quickly. We now think the deposit rate will peak at 2.5%, up from 1.5% previously and well above most neutral estimates.



The RBA has hiked by 50 bps at each of its past four meetings but hinted that the pace of tightening will slow going forward with the cash rate now firmly in neutral territory. We expect 25 bp hikes at each of its next three meetings.



Highlights

▲ The BoC opted for another oversized hike in September, bringing monetary policy into “restrictive” territory.

▲ We now see the BoC lifting its overnight rate to 4% by year end.

▲ Canada’s economy recorded solid GDP growth in Q2 but most of the increase came early in the quarter.

▲ Canada has lost jobs over the past three months and unemployment is drifting higher.

front-loading hikes to get the policy rate “quickly to the top end or slightly above the neutral range.” But September’s policy statement made clear the BoC isn’t done raising rates yet, saying “Governing Council still judges that the policy interest rate will need to rise further.” It did, however, hint that the pace of increases is likely to slow going forward.

That guidance wasn’t the only hawkish element of the BoC’s policy statement. It emphasized that July’s decline in headline inflation (the first in more than a year) was driven by lower gasoline prices, while core measures accelerated and price pressure broadened. We expect that combination—lower headline readings but firm core inflation—will continue in the near term. While Q2 GDP was softer than projected, the BoC emphasized strength in domestic demand. It said growth is expected to slow in the second half of the year but we didn’t detect much discomfort with forecasts presented in July’s MPR—including a 1.8% GDP gain projected in 2023 that looks increasingly optimistic relative to consensus and particularly our own call for a 0.6% increase.

We were previously expecting a final 25 bp rate hike at the BoC’s next meeting in October. But given the central bank’s hawkish language as well as ongoing acceleration in core inflation and wage growth we now see a 50 bp increase next month and a further 25 bp hike in December for a terminal overnight rate of 4% (up from 3.5% previously). That’s slightly ahead of market expectations, but we think upcoming inflation reports and inflation expectations (particularly the BoC’s BOS and CSCE surveys in October) will be key to whether consensus lands on a 25 or 50 bp hike at the next meeting.

...even as the economy’s momentum begins to fade

Canadian GDP rose an annualized 3.3% in Q2, roughly matching the previous quarter’s 3.1% pace and marking a fourth straight quarter of above-trend growth. But much of the increase in activity came early in Q2, and with StatCan’s flash estimate showing a 0.1% decline in July GDP the economy has essentially failed to expand over the past three months. Housing acted as a sizeable drag on second-quarter growth and an ongoing pullback in resale activity over the summer suggests a repeat performance in Q3. Household spending accelerated in Q2, led by services as Canadians faced the fewest pandemic restrictions since early-2020. But RBC’s consumer tracker shows spending volumes leveling off in August, including in high-touch services like restaurants and travel, as higher inflation sapped confidence and ate into households’ purchasing power.

Labour market data also suggest the economy has lost a step in recent months. Employment declined in each of the past three months and the jobless rate has drifted higher, albeit to a still-healthy 5.4% as of August. Job postings have moderated though employers continue to report widespread labour shortages and wages accelerated over the summer. These wage gains, though, are failing to stay ahead of consumer prices and real average hourly earnings have failed to increase relative to pre-pandemic. While headline inflation has likely peaked we think a sharp increase in the cost of living combined with reversing wealth effects will make for a challenging consumer spending backdrop going forward. A steady increase in economy-wide debt servicing costs as the impact of rate hikes filters through the economy will also slow spending. We look for GDP growth to slow to a sub-trend pace in the second half of the year and think it will be difficult to avoid an outright recession in 2023. Despite its rosy GDP forecast, the BoC has acknowledged a soft landing will be difficult to achieve. With the BoC now expected to take monetary policy even further into restrictive territory, we’re even more convinced of that.

Canadian dollar struggling to keep up with high-flying USD

The Canadian dollar fell to 76 cents at the beginning of September, its lowest level relative to the US dollar since late-2020. An ongoing pullback in oil prices—WTI fell below US\$90 per barrel for the first time since Russia’s invasion of Ukraine—has weighed on the loonie. But the bigger headwind has been broad US dollar strength, with the trade-weighted USD continuing to climb to fresh two-decade highs. Aggressive Fed tighten-



ing, global growth concerns and risk aversion have all contributed to the greenback's double-digit year-to-date increase. The Canadian dollar has actually held its own, outperforming all other G10 currencies through the first eight months of the year with the ex-USD trade-weighted index up more than 5% year-to-date. We think the US dollar will lose some of its shine next year, though a challenging global growth backdrop will continue to weigh on commodity currencies like the Canadian dollar which we see gravitating toward 75 cents in 2023.

Fed pushes back against rate cut bets...

August saw a course correction from the Fed after the market interpreted its July policy meeting as dovish. Recall, Powell's comments suggesting it will soon be appropriate to slow the pace of rate hikes, and that the Fed is "getting closer to where we need to be," were seen as signaling the tightening cycle is nearing an end. Investors went a step further, pricing in several rate cuts next year. Falling Treasury yields (exacerbated by growth concerns and signs of slowing inflation) and an equity market rally made for easing financial conditions that the Fed likely saw as premature.

Cue push-back from the central bank, with a raft of speakers in August talking up more rate hikes to come and emphasizing that the Fed won't begin reversing course in 2023. Chair Powell continued with that messaging in his brief Jackson Hole address in late August. He said getting inflation back to target "will likely require maintaining a restrictive policy stance for some time"—clearly an effort to deter market pricing for rate cuts next year. And Powell acknowledged higher interest rates will "bring some pain to households and businesses"—in our view meant to suggest the Fed won't 'blink' and cut rates in the face of a slowing economy. Markets got the message, with equities selling off sharply following Powell's address and yields climbing in early-September.

We think the Fed needs to follow up these words with action, and we now look for another 75 bp hike later this month, up from the 50 bp increase previously expected. We still think the pace of tightening is likely to slow later this year and see 50 and 25 bp hikes in November and December, respectively, lifting fed funds to a 3.75-4% range. That's at the upper end of expectations in the Fed's September 'dot plot', though the committee median did see rates rising to that level next year and we think a desire to front load hikes is consistent with our call. We've lifted our Treasury yield forecasts but still think 10s will come down toward the 3% mark—reasserting the deeper yield curve inversion seen in August—as inflation slows and growth concerns intensify.

...amid mixed US data

While GDP data point to a 'technical' recession in the first half of the year, a broader set of indicators continue to paint a more mixed picture of the US economy. We've emphasized that a declining unemployment rate in H1/22 is inconsistent with the economy actually being in recession. While the jobless rate ticked higher in August, payrolls increased by a healthy 315,000—enough to finally lift the employment count above its pre-pandemic level. Job openings rose in July, and the recent upward drift in initial claims appears to have run its course for now, suggesting the labour market remains healthy. Wage growth has consistently exceeded 5% this year, though that has done little to boost real disposable income amid surging inflation. The rising cost of living has weighed on consumer confidence, though sentiment improved in August as pump prices tumbled lower.

We look for US GDP to return to the growth column in the second half of the year, albeit to a below-trend pace. As the Fed moves its policy rate into restrictive territory and high inflation continues to bite we see that slowdown intensifying in the first half of next year—that's when the "recession" label will finally be appropriate. The downturn we expect in 2023 is on the mild end of past recessions, with the jobless rate seen rising toward 5% by the end of next year from as low as 3.5% this summer.

Highlights

▲ Hawkish language from a number of Fed speakers drove a renewed selloff in Treasuries.

▲ We now see fed funds rising to 3.75-4% by year end—at the upper end of September's dot plot.

▲ The modest upward trend in US jobless claims appears to have stalled and the labour market remains healthy...

▲ ...though we expect an increase in the US unemployment rate in 2023 as a mild recession takes hold.



Highlights

▲ The ECB has rapidly moved away from a negative policy rate...

▲ ...and we see key rates rising into “restrictive” territory in the coming months.

▲ The UK government’s energy relief plan will soften the peak in headline inflation.

▲ RBA Governor Lowe hinted rate increases will slow after 200 bps of hikes at the past four meetings.

ECB to hike aggressively even as recession likely underway

The ECB accelerated its nascent tightening cycle in September, raising its key policy rates by 75 bps to build on an initial 50 bp hike in July. In a hawkish press conference, President Lagarde said rates are still far away from levels needed to rein in inflation, implying they’ll need to rise another 150 to 200 basis points over the next several meetings. As such, we’ve revised our terminal deposit rate forecast significantly higher to 2.5% from 1.5% previously. We think another 75 bp hike is in store for October before the pace of tightening is geared down with a final 25 bp hike seen next March. That would move monetary policy clearly into restrictive territory—neutral in the euro area is likely around 1.5%—with the ECB keen to tamp down inflation and inflation expectations even as higher energy prices are likely to cause a recession in their own right.

Indeed, we’ve marked down our euro area GDP growth forecast and now see a contraction beginning in the current quarter and continuing through Q1/23. The economy is expected to see little growth in 2023 as a whole with our 0.1% forecast coming in well below the ECB’s assumed 0.9% increase. The latter, though, was conditioned on Russian gas flows remaining near mid-August levels—an assumption that now looks optimistic given the indefinite suspension of imports via a key pipeline. With sharply higher natural gas prices putting a squeeze on consumers and the industrial sector—notwithstanding government support—we think a recession is now unavoidable. GDP declines could be even deeper if shortages are more severe than expected and government rationing and forced business closures are required.

Some inflation relief coming, but BoE set to continue hiking

We expect another 50 bp increase in Bank Rate at the BoE’s meeting this week, matching the August increase. While a larger 75 bp hike is likely to be considered (market pricing is between 50 and 75 bps) we think recent inflation developments will keep the BoE from accelerating its tightening cycle. New PM Truss’s £150 billion energy relief plan will cap household energy bills, preventing sizeable increases that were due to kick in this fall and early next year. That should keep CPI inflation from rising as high as the 13% projected by the BoE later this year. This massive fiscal support will offset some of what would have been a significant drag on consumer spending, and could actually add to domestic inflationary pressure outside of energy prices, though the BoE’s chief economist said the net effect should be lower inflation.

Even with some energy price relief, UK inflation looks set to remain well above the BoE’s target through 2023. That should keep the BoE in tightening mode with a further 75 bps of hikes in the fourth quarter expected to lift Bank Rate to 3% by year end. Rising interest rates add to a list of growth headwinds including a cost of living squeeze, higher energy costs for businesses (where relief is less generous) and recession in Europe. We’ve revised our GDP growth forecasts lower... and agree with the BoE that the UK economy will enter a recession toward the end of the year.

RBA set to slow its tightening cycle after rapid-fire hikes

Having already front-loaded its tightening cycle with 50 bp hikes at each of its past four meetings since June, we think the RBA will opt for smaller increases at upcoming meetings. We look for 25 bp hikes in October, November and December leaving cash rate at 3.1% by end of year—slightly higher than the 2.85% terminal rate previously assumed and just above the 2-3% range considered neutral, but not quite as restrictive (relatively speaking) as our expectations for other central banks. Indeed, the RBA sounded dovish compared with its global counterparts in September. Governor Lowe noted Australian wage dynamics—key to inflation expectations—are not as strong as in other developed economies and thus rate dynamics should differ as well. He also emphasized lags in the effect of monetary policy on the economy and said the case for slower rate hikes becomes stronger as the cash rate rises. Lowe’s speech followed a firm set of national accounts data for Q2, albeit with early signs of moderation in rate-sensitive housing. We look for GDP gains to slow in the coming quarters as tightening financial conditions and global growth headwinds increase.



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	1.50	3.25	4.00	4.00	4.00	4.00	3.75
Three-month	0.09	0.15	0.12	0.16	0.60	2.08	3.30	3.90	3.90	3.90	3.90	3.45
Two-year	0.23	0.45	0.53	0.95	2.29	3.09	3.55	3.55	3.40	3.30	3.20	3.00
Five-year	0.99	0.98	1.11	1.26	2.41	3.11	3.15	3.00	2.90	2.80	2.70	2.50
10-year	1.56	1.39	1.51	1.43	2.40	3.23	3.00	2.85	2.80	2.70	2.65	2.55
30-year	1.99	1.84	1.99	1.68	2.38	3.14	3.00	2.85	2.85	2.80	2.75	2.70
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.38	1.63	3.13	3.88	3.88	3.88	3.63	3.38
Three-month	0.03	0.05	0.04	0.06	0.52	1.72	3.20	3.85	3.80	3.70	3.50	3.25
Two-year	0.16	0.25	0.28	0.73	2.28	2.92	3.60	3.55	3.40	3.25	3.15	3.00
Five-year	0.92	0.87	0.98	1.26	2.42	3.01	3.45	3.40	3.20	3.00	2.90	2.80
10-year	1.74	1.45	1.52	1.52	2.32	2.98	3.15	3.00	2.85	2.75	2.65	2.55
30-year	2.41	2.06	2.08	1.90	2.44	3.14	3.30	3.15	2.95	2.80	2.75	2.70
United Kingdom												
Bank rate	0.10	0.10	0.10	0.25	0.75	1.25	2.25	3.00	3.00	3.00	3.00	3.00
Two-year	0.11	0.07	0.40	0.68	1.36	1.85	3.00	3.00	3.00	2.85	2.65	2.60
Five-year	0.40	0.33	0.62	0.82	1.40	1.88	3.00	3.00	2.80	2.60	2.50	2.40
10-year	0.85	0.72	1.02	0.97	1.60	2.22	3.00	3.25	3.00	2.75	2.60	2.50
30-year	1.40	1.24	1.37	1.12	1.77	2.59	3.40	3.50	3.25	3.00	2.90	2.85
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	0.75	2.00	2.50	2.50	2.50	2.50
Two-year	-0.69	-0.67	-0.69	-0.64	-0.08	0.64	1.25	1.40	1.60	1.50	1.50	1.50
Five-year	-0.62	-0.59	-0.56	-0.45	0.37	1.09	1.50	1.70	1.60	1.60	1.55	1.50
10-year	-0.29	-0.20	-0.21	-0.18	0.55	1.36	1.75	2.00	1.75	1.70	1.65	1.55
30-year	0.26	0.30	0.29	0.20	0.67	1.63	1.90	2.10	1.90	1.85	1.80	1.75
Australia												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.85	2.35	3.10	3.10	3.10	3.10	2.85
Two-year	0.08	0.06	0.04	0.54	1.78	2.73	2.95	2.75	2.60	2.50	2.25	2.00
10-year	1.74	1.49	1.49	1.67	2.84	3.66	3.50	3.20	3.15	3.15	3.05	2.80
New Zealand												
Cash target rate	0.25	0.25	0.25	0.75	1.00	2.00	3.00	3.75	3.75	3.75	3.50	3.25
Two-year swap	0.46	0.78	1.39	2.16	3.27	4.06	4.10	4.00	3.75	3.50	3.25	3.00
10-year swap	1.95	1.87	2.21	2.62	3.38	4.10	3.90	3.70	3.55	3.40	3.20	3.10
Yield curve***												
Canada	133	94	98	48	11	14	-55	-70	-60	-60	-55	-45
United States	158	120	124	79	4	6	-45	-55	-55	-50	-50	-45
United Kingdom	74	65	62	29	24	37	0	25	0	-10	-5	-10
Eurozone	40	47	48	46	63	72	50	60	15	20	15	5
Australia	166	143	145	113	106	93	55	45	55	65	80	80
New Zealand	149	109	82	46	11	4	-20	-30	-20	-10	-5	10

*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*	4.4	-3.1	5.3	6.6	3.1	3.3	1.5	0.8	0.4	-0.5	-0.5	0.2	4.5	3.3	0.5
United States*	6.3	6.7	2.3	6.9	-1.6	-0.6	1.8	0.6	-0.4	-0.5	0.0	0.5	5.7	1.7	0.1
United Kingdom	-1.2	5.6	0.9	1.3	0.8	-0.1	-0.1	-0.3	-0.2	0.1	0.2	0.2	7.4	3.4	-0.3
Euro Area	-0.1	2.0	2.2	0.5	0.7	0.8	-0.2	-0.5	-0.3	0.1	0.2	0.2	5.2	3.0	-0.4
Australia	1.9	0.6	-1.8	3.9	0.7	0.9	0.5	0.6	0.3	0.3	0.2	0.2	4.9	3.9	1.6

*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>	2021	2022F	2023F
Canada	1.4	3.3	4.1	4.7	5.8	7.5	7.2	6.3	4.9	2.9	2.4	2.5	3.4	6.7	3.2
United States	1.9	4.8	5.3	6.7	8.0	8.6	8.0	6.3	4.5	2.4	1.8	2.1	4.7	7.7	2.7
United Kingdom	0.6	2.0	2.8	4.9	6.2	9.2	10.0	9.5	8.0	4.3	2.9	1.7	2.6	8.7	4.2
Euro Area	1.1	1.8	2.8	4.6	6.1	8.0	8.5	8.6	7.1	4.3	3.8	3.3	2.6	8.0	4.6
Australia	1.1	3.8	3.0	3.5	5.1	6.1	7.0	7.7	6.7	5.9	5.3	4.3	2.9	6.5	5.6

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	1.29	1.32	1.31	1.32	1.33	1.34	1.34
Euro	1.17	1.19	1.16	1.14	1.11	1.05	0.99	0.97	0.95	0.98	1.02	1.05
U.K. pound sterling	1.38	1.38	1.35	1.35	1.31	1.22	1.13	1.08	1.04	1.08	1.13	1.17
Japanese yen	111	111	111	115	122	136	145	147	150	145	142	139
Australian dollar	0.76	0.75	0.72	0.73	0.75	0.69	0.67	0.66	0.66	0.67	0.67	0.68

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	1.35	1.31	1.27	1.25	1.30	1.37	1.41
GBP/CAD	1.73	1.71	1.71	1.71	1.64	1.57	1.49	1.41	1.38	1.43	1.52	1.56
CAD/JPY	88	90	88	91	97	105	110	112	114	109	106	104
AUD/CAD	0.95	0.93	0.92	0.92	0.94	0.89	0.88	0.86	0.87	0.89	0.90	0.91

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.

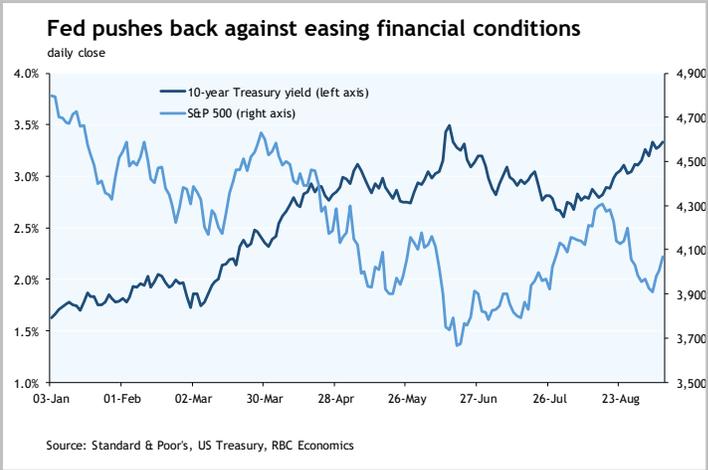
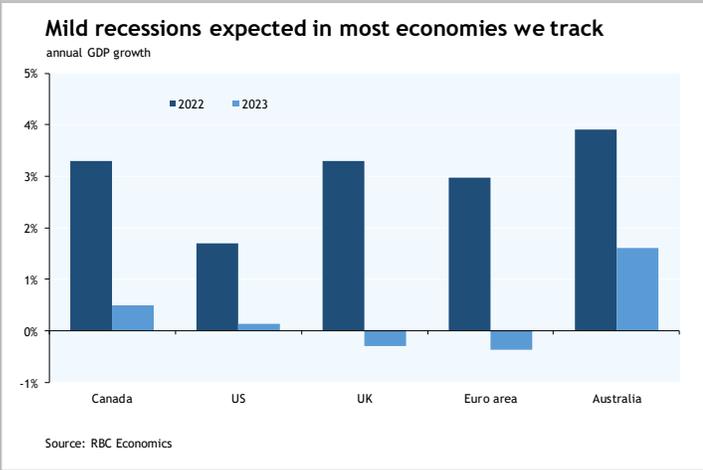
Source: Bloomberg, RBC Economics



Charts we're watching

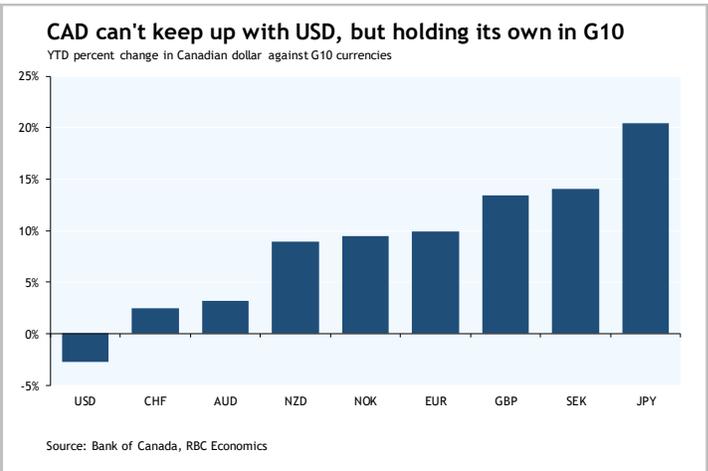
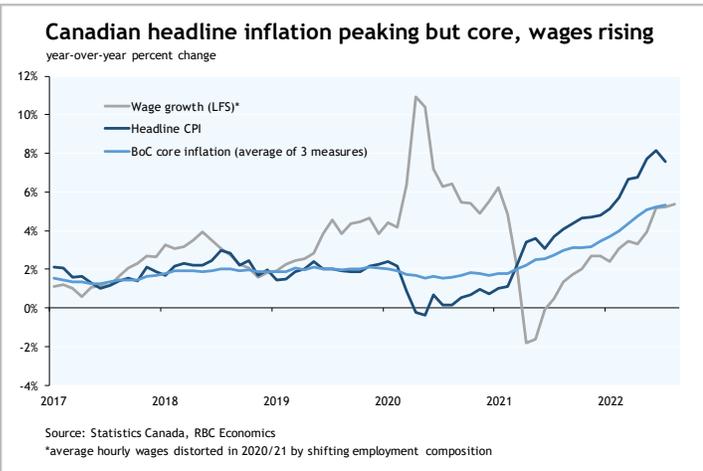
Central banks are quickly moving monetary policy into “restrictive” territory to address multi-decade-high inflation. Tighter financial conditions combined with a cost-of-living squeeze (particularly in Europe with rising energy prices) is expected to result in mild recessions over the second half of this year or in 2023 in Canada, the US, UK and euro area.

An early-summer rally in Treasuries and rising equity markets brought about a premature easing in financial conditions. The Fed pushed back in August—including at Jackson Hole—by emphasizing rates are still moving higher, and will have to remain elevated for an extended period. Treasury yields have retraced higher and equities have suffered.



Canadian headline inflation appears to have peaked with consumers seeing some relief at the pumps. But core inflation continued to accelerate in July and wage growth is picking up—signs that underlying price pressure remains firm. That’s expected to keep the BoC in hiking mode in Q4.

The Canadian dollar has struggled to keep up with the US dollar—which is at a multi-decade high—but has made gains against other G10 currencies so far this year. A relatively hawkish BoC and stronger commodity prices (until recently) have supported the loonie.



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