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Omicron won't deter hawkish central banks

December's central bank meetings were generally more hawkish than expected as policymakers placed more weight on rising inflation and shrinking economic slack than emerging risks from Omicron. The BoE became the first G7 central bank to raise interest rates from pandemic lows and the Fed accelerated its QE tapering, opening the door to rate hikes in the first half of this year (we now expect three rate increases in 2022). The ECB also laid out a plan to slow bond buying by more than expected—we think rate hikes remain a distant prospect though some hawkish ECB officials are starting to talk up an eventual move.

But with the fast-spreading variant now driving record case growth, the question is whether central banks will continue to look through Omicron risks in early-2022. Despite generally causing less severe illness, the sheer number of cases still threatens to overwhelm health care systems. Some jurisdictions have started to re-impose containment measures (but not lockdowns) and a large number of infected individuals staying home and isolating could exacerbate near-term supply challenges. We should get more information on the severity of this wave in the coming weeks but at this stage we are treating it as a speed bump in an economic recovery that will otherwise continue to progress in 2022.

The BoC will provide an early litmus test on how central banks are managing evolving Omicron risks. Even with containment measures set to slow Canada's recovery early this year, we think the BoC will lean hawkish in January and lay the groundwork for near-term rate increases. Markets likewise don't see Omicron derailing central banks' tightening plans with three or more hikes still priced in for the BoC, Fed, BoE and RBA this year.

Central bank near-term bias

Limited labour market slack and high inflation could prompt a more hawkish tone from the BoC in January even in the face of near-term growth risks. We continue to expect April liftoff.

A hawkish Fed accelerated tapering in December, opening the door to rate hikes in H1/22. We now expect three rate hikes this year beginning in Q2, though even March's meeting looks "live" at this point.

Omicron risks didn't deter the BoE from a 15 bp rate hike in December. We expect a follow up move in February that will lift Bank Rate to 0.50%, the point at which the BoE will start shrinking its balance sheet.

The ECB announced it will taper its QE program by more than expected this year (purchases will still continue throughout 2022) but the central bank remains a long way from meeting the criteria it has set out to start raising interest rates.

We now expect the RBA will end net QE purchases in February rather than tapering over three months. We still don't see rate increases until early-2023 though the market is pricing in three hikes this year.

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Highlights

▲ We think the US closed out 2021 with another 6% annualized GDP gain—the third such increase in four quarters.

▲ The US has responded to COVID waves with less severe restrictions than other countries—that looks to be the case again with Omicron.

▲ The Fed's December 'dot plot' unexpectedly showed a median of three rate hikes this year.

▲ The Fed's accelerated taper makes March's meeting "live" for rate hikes though we've penciled in a Q2 liftoff.

US economy headed into 2022 with solid momentum

Recent data suggest the US economy had even more momentum heading into 2022 than previously thought and we've lifted our Q4/21 GDP growth forecast to 6% annualized from 4.5%. Consumer spending in particular remains robust while indicators of business investment continue to improve as well. Even home sales and housing starts were showing more signs of life in late-2021 though we don't see housing as a sustained source of growth in 2022. With the economy beginning to bump up against longer-run capacity limits, we doubt the past quarter's pace of growth can be maintained this year. However, we still see scope for above-trend gains of around 2.5-3% annualized per quarter in 2022.

Omicron represents some near-term downside risk—in early-January the US became the first country globally to record more than one million daily cases—though state and local governments have generally refrained from tightening restrictions in recent waves and that appears to be the case again with Omicron. But the economy will still be impacted by people staying home due to illness (or fear of contracting COVID) and global supply chain disruptions that could be exacerbated by the variant. On the latter, December's ISM manufacturing survey pointed to some *easing* in supply chain bottlenecks though that was likely too early to capture Omicron impacts.

December Fed even more hawkish than expected

Rapidly rising inflation and a sizeable drop in the unemployment rate in recent months prompted the Fed to accelerate its tapering process in December, just one month after its initial tapering announcement. The new pace will wind down QE by mid-March rather than mid-2022, opening the door to earlier rate hikes (recall the committee said it will end QE before raising rates). The Fed sees the inflation half of its mandate as having been met and the timing of interest rate liftoff is now contingent on the economy reaching maximum employment. Chair Powell said all committee members expect that test will be met this year, with the median unemployment rate forecast falling to 3.5% (the past cycle low) in late-2022. In an unexpectedly hawkish development, most of the committee now expects three rate hikes will be appropriate in 2022 (in September the committee was evenly split on raising rates just once this year) and the median points to another three rate increases in 2023.

The dot plot and accelerated taper timeline represent a remarkable shift for a Fed that was very careful laying the groundwork for its initial tapering decision—it only began "talking about talking about" tapering back in June. The central bank is clearly worried about falling behind the curve on inflation with CPI closing in on 7%. A sharp fall in the unemployment rate also gives the Fed coverage for a hawkish shift. Notwithstanding pockets of labour market slack, the combination of rising wages, high vacancies and stubbornly low labour force participation have the Fed in no mood to keep rates near zero and "probe" for maximum (and inclusive) employment. We've shifted our forecast to three rate hikes in 2022 from two previously, looking for the first move to come in Q2 though even March's meeting appears to be "live" with markets pricing in roughly two-thirds odds of a move. The Fed has indicated it could start shrinking its balance sheet soon after interest rate liftoff and we think that process could begin as early as mid-year.

A hawkish Fed pushed shorter-term Treasury yields to fresh pandemic highs and 10-year yields are flirting with last year's high of 1.75%. We expect 10-year yields will continue to drift upward by a moderate 50 bps over the course of 2022.

Canada ended 2021 with another quarter of robust growth

Canada's economic recovery continued to gain momentum in Q4 with GDP rising 0.8% in October and a 'flash' estimate pointing to a further 0.3% gain in November. The latter is despite devastating floods in BC that reduced economic activity in the province in the second half of the month—a drag that should be reversed as rebuilding begins. Those gains left industry GDP right around its pre-pandemic level in November, with hours worked having also recovered in the month. Employment numbers have been even more impressive with 154,000 jobs added in November and the unemployment rate falling to 6%, just 1/2 percent above its pre-pandemic low. Wage growth has accelerated in recent months as the labour market has tightened, though average hourly earnings grew at a moderate 2.6% annualized pace over the past two years when controlling for changes in employment composition.

While Canada's economy carried a head of steam into 2022, we've revised our near-term growth forecasts lower (Q1 +1.5% annualized vs. +4% previously) as an Omicron-driven surge in cases has prompted the re-imposition of some containment measures, mostly affecting high-contact services industries. Given the economy's growing resilience to repeated waves of the pandemic, and a demonstrated ability to bounce back as restrictions ease, we think slower growth in Q1 will be made up for in the subsequent quarters. We still expect 4-handle GDP growth (4.0%, down from 4.3% previously) for 2022 as a whole.

BoC's hawkish pivot coming in January?

It was a busy year-end for the Bank of Canada with a rate decision, economic progress report, mandate renewal, and speech by Governor Macklem packed into the first half of December. The inflation-target renewal saw Finance and the BoC extend the bank's flexible inflation targeting framework and added what we would call a secondary objective to pursue maximum sustainable employment (MSE) but only when the inflation backdrop allows (so not at this stage, according to Governor Macklem). This stops short of an explicit dual mandate and was in line with our expectations heading into the renewal. We see the refreshed mandate as an endorsement of the BoC's policy approach during the pandemic—greater focus on labour market outcomes, and extended forward guidance that allows for an overshoot of 2% inflation. We don't see any immediate implications for our policy rate forecast in 2022 and 2023 though on balance the new mandate leans slightly dovish given its support for extended forward guidance and MSE as a secondary policy objective.

We saw the BoC's other communications in December as hinting that it could adopt a more hawkish tone in January. The bank expressed uncertainty about traditional measures of economic slack (i.e. the output gap) and said labour market data indicate the economy is nearing full employment. We agree, and even with Omicron likely to dent near-term growth, we think there's scope for the BoC to bring forward its forward guidance in January (i.e. slack absorbed in H1/22 rather than the middle quarters of 2022). Alternatively, the central bank could drop its forward guidance altogether (as it did before raising rates in 2010) citing substantial progress made in the recovery and less need to provide extraordinary stimulus through forward guidance. Either outcome would make subsequent meetings "live" for rate hikes. We continue to look for once-a-quarter rate hikes beginning in April (until the overnight rate reaches last cycle's high of 1.75%) but wouldn't rule out back-to-back rate increases early on as was the case in 2017.

Highlights

▲ Canadian GDP and hours worked returned to pre-pandemic levels in November.

▲ Omicron's spread has triggered renewed restrictions in some provinces and we've marked down our Q1/22 growth forecast.

▲ The BoC has expressed uncertainty about economic slack but it sees the labour market nearing full employment.

▲ We're watching to see if the BoC brings forward or drops its forward guidance in January—either would be seen as hawkish.

Highlights

▲ Unexpectedly strong inflation and a resilient labour market prompted the BoE to raise rates in December…

▲ …making it the first G7 central bank to lift its policy rate from pandemic lows.

▲ The ECB's tapering plan will leave 2022 bond purchases short of our earlier expectations.

▲ A hawkish shift from global central banks should contribute to the RBA ending QE next month.

BoE follows through on rate hike despite Omicron spread

Omicron's rapid spread through the UK didn't deter the BoE from raising Bank Rate by 15 bps in mid-December, in line with our forecast. The central bank revised its near-term growth forecasts lower amid "tentative signs that economic activity had started to be affected by the emergence and spread of Omicron." (We've also trimmed our growth forecasts for Q4/21 and Q1/22 but see some of the shortfall being made up in subsequent quarters.) However, the MPC thought the value in waiting for further information on Omicron and its impact was outweighed by growing concern about inflation. CPI surprised to the upside in November with a 5.1% year-over-year increase matching the fastest pace in 30 years. The BoE now sees inflation hitting 6% in the spring when regulated energy price increases kick in. The bank was concerned that holding rates low amid such high inflation, and with limited slack in the economy, might contribute to a rise in inflation expectations.

Since the BoE's December meeting, Omicron has continued to spread rapidly throughout the UK though PM Johnson has said he wants to avoid re-imposing restrictions. We continue to look for a follow-up 25 bp hike in February, bringing Bank Rate to 0.50%—the level at which the BoE said it might began reducing reinvestment of its QE holdings. We think this 'quantitative tightening' option will see the central bank raise rates more gradually after February, disappointing market expectations for nearly 100 bps of hikes this year.

ECB also tapering but no rate hikes in sight

The ECB's December meeting came in on the hawkish side of expectations, though relatively speaking it's still among the most dovish central banks globally. The ECB confirmed its pandemic-era QE program will end in March, with a slightly slower pace of asset purchases in the first quarter of 2022 leaving a small margin of the PEPP's €1.85T purchase envelope unused. As that program expires, the central bank will double the pace of bond buying under its APP (to €40B) but taper that pace over the course of 2022, leaving purchases for the year below our expectations heading in. That said, the ECB expects to continue with net asset purchases until "shortly before" it starts raising interest rates. The ECB revised up its 2023 inflation forecast from to 1.8% from 1.5% and expects a similar reading in 2024. But recall the central bank wants to see inflation reaching 2% "well ahead of the end of its projection horizon" before raising rates—a condition that we don't see being met in the foreseeable future. Omicron's rapid spread in Europe has some countries tightening restrictions but not resorting to lockdowns. We expect the currency bloc's recovery will slow in Q1/22 but with activity rebounding in subsequent quarters and we look for healthy GDP gain of nearly 4% in 2022.

RBA now expected to end QE in February

Australia saw a sharp rebound in employment in November, more than retracing lockdown-related declines in the prior three months. A sizeable increase in hours worked supports our forecast for Q4 GDP to fully reverse Q3's 1.9% non-annualized drop. High vacancies and shrinking labour market slack point to improving wage growth this year and we see some upside risk to the RBA's forecast for 2.5% wage growth by the end of 2022. We think a strong jobs rebound combined with a hawkish shift from global central banks will prompt the RBA to end its QE program entirely in February rather than extending and tapering purchases as we previously thought. Such a move would do little to discourage market pricing for multiple hikes this year though we continue to see the RBA holding off on increasing rates until the first quarter of 2023. There is certainly risk of an earlier move if wage growth accelerates even more than expected, putting a higher floor under inflation.

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	0.25	0.50	0.75	1.00	1.25	1.50	1.75	1.75
Three-month	0.09	0.15	0.12	0.16	0.25	0.55	0.80	1.05	1.30	1.55	1.75	1.75
Two-year	0.23	0.45	0.53	0.95	1.05	1.20	1.35	1.50	1.60	1.70	1.75	1.75
Five-year	0.99	0.98	1.11	1.26	1.35	1.45	1.55	1.65	1.75	1.85	1.90	1.95
10-year	1.56	1.39	1.51	1.43	1.70	1.80	1.85	1.90	2.00	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
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.13	0.38	0.63	0.88	1.13	1.38	1.63	1.88
Three-month	0.03	0.05	0.04	0.06	0.10	0.40	0.70	0.95	1.20	1.45	1.70	1.95
Two-year	0.16	0.25	0.28	0.73	0.75	1.00	1.20	1.35	1.55	1.75	1.90	2.00
Five-year	0.92	0.87	0.98	1.26	1.50	1.80	2.05	2.10	2.20	2.30	2.35	2.40
10-year	1.74	1.45	1.52	1.52	1.85	2.00	2.15	2.20	2.30	2.40	2.45	2.50
30-year	2.41	2.06	2.08	1.90	2.15	2.25	2.30	2.35	2.40	2.50	2.55	2.60
United Kingdom												
Bank rate	0.10	0.10	0.10	0.25	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.00
Two-year	0.11	0.07	0.40	0.68	0.70	0.75	0.80	0.85	0.95	1.10	1.10	1.15
Five-year	0.40	0.33	0.62	0.82	0.95	1.10	1.15	1.30	1.40	1.50	1.60	1.70
10-year	0.85	0.72	1.02	0.97	1.25	1.45	1.55	1.70	1.85	2.00	2.10	2.25
30-year	1.40	1.24	1.37	1.12	1.40	1.60	1.70	1.85	1.95	2.00	2.10	2.20
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Two-year	-0.69	-0.67	-0.69	-0.64	-0.60	-0.60	-0.55	-0.50	-0.50	-0.45	-0.40	-0.35
Five-year	-0.62	-0.59	-0.56	-0.45	-0.50	-0.45	-0.40	-0.30	-0.20	-0.10	0.00	0.10
10-year	-0.29	-0.20	-0.21	-0.18	-0.05	0.05	0.15	0.20	0.30	0.40	0.50	0.60
30-year	0.26	0.30	0.29	0.20	0.50	0.65	0.80	0.85	0.95	1.00	1.05	1.10
Australia												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.50	0.75	0.75	0.75
Two-year	0.08	0.06	0.04	0.54	0.60	0.70	0.85	1.10	1.35	1.55	1.65	1.75
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
New Zealand												
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	2.20	2.30	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
Yield curve***												
Canada	133	94	98	48	65	60	50	40	40	40	40	45
United States	158	120	124	79	110	100	95	85	75	65	55	50
United Kingdom	74	65	62	29	55	70	75	85	90	90	100	110
Eurozone	40	47	48	46	55	65	70	70	80	85	90	95
Australia	166	143	145	113	135	135	135	120	105	100	95	95
New Zealand	149	109	82	46	35	30	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

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021F	2022F	2023F
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	6.0	3.0	3.0	2.5	2.5	2.0	1.8	1.7	1.5	5.6	3.6	2.1
United Kingdom	-1.3	5.4	1.1	0.6	1.0	0.8	0.6	0.4	0.6	0.4	0.4	0.4	7.1	4.3	2.0
Euro Area	-0.2	2.2	2.2	0.7	0.4	1.0	0.8	0.6	0.4	0.4	0.4	0.4	5.2	3.9	2.1
Australia	1.8	0.7	-1.9	2.8	1.4	1.1	0.9	0.7	0.7	0.4	0.5	0.4	4.5	4.2	2.6

*annualized

Inflation outlook

% change, year-over-year

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021F	2022F	2023F
Canada	1.4	3.3	4.1	4.8	4.3	3.7	2.9	2.4	2.3	2.1	1.9	1.9	3.4	3.3	2.0
United States	1.9	4.8	5.3	6.6	6.2	4.6	3.6	2.3	2.2	2.1	1.9	1.8	4.7	4.1	2.0
United Kingdom	0.6	2.0	2.8	4.4	4.7	5.1	4.7	3.5	3.2	2.2	2.0	2.0	2.5	4.5	2.3
Euro Area	1.1	1.8	2.8	4.1	3.2	2.8	2.1	1.5	0.9	1.1	1.6	1.8	2.5	2.4	1.4
Australia	1.1	3.8	3.0	3.1	3.2	3.0	2.8	2.6	2.6	2.7	2.7	2.6	2.8	2.9	2.7

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

	Actuals				Forecast							
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
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	1.11	1.10	1.08	1.08	1.07	1.08	1.08	1.09
U.K. pound sterling	1.38	1.38	1.35	1.35	1.26	1.22	1.20	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

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
EUR/CAD	1.47	1.47	1.47	1.44	1.40	1.40	1.37	1.37	1.37	1.40	1.43	1.46
GBP/CAD	1.73	1.71	1.71	1.71	1.59	1.55	1.52	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

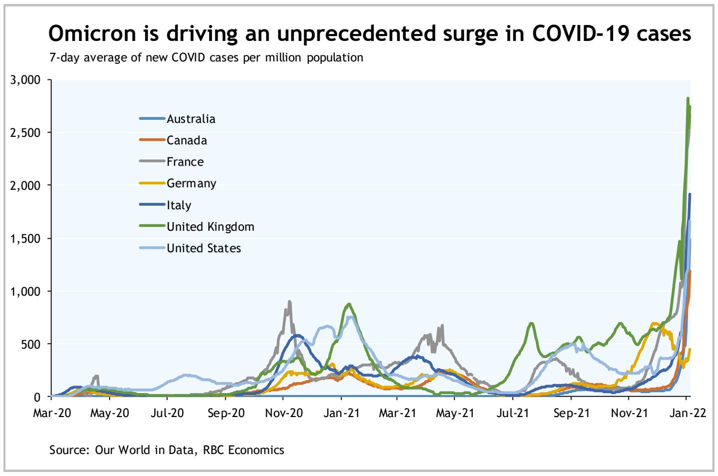
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics

Hawkish central banks looked through Omicron risks in December

The fast-spreading Omicron variant has pushed case counts to record highs in many countries—including those with high vaccination rates and booster campaigns. Even if governments don't re-impose lockdowns, infected individuals having to isolate could exacerbate near-term labour shortages in some sectors.

While Omicron causes less severe illness and leads to fewer ICU visits per infection, the sheer volume of cases still threatens to overwhelm health care systems. Some jurisdictions have re-imposed targeted restrictions but haven't resorted to lockdowns at this stage.

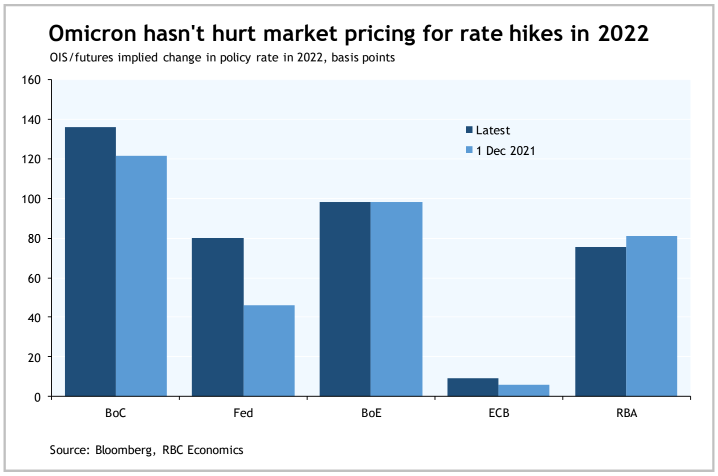


Omicron is driving an unprecedented surge in COVID-19 cases
7-day average of new COVID cases per million population
Source: Our World in Data, RBC Economics

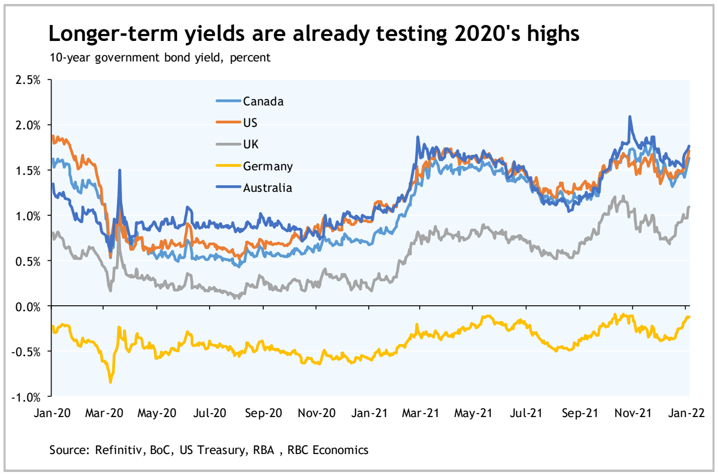
ICU hospitalizations are rising due to sheer case volumes
COVID-related ICU hospital patients per million population
Source: Our World in Data, RBC Economics

While Omicron should be a near-term negative for economic activity, its impact on inflation is less clear with further supply chain disruptions potentially exacerbating goods inflation. With central banks focusing more on inflation than Omicron in December, market pricing for rate hikes in 2022 is little changed.

Persistent inflation and growing expectations that central banks will respond have pushed government bond yields higher over the past month, with 10-year yields testing last year's highs in early-January. We expect further, moderate (30-60 bps) increases in longer-term yields over the course of 2022.



Omicron hasn't hurt market pricing for rate hikes in 2022
OIS/futures implied change in policy rate in 2022, basis points
Source: Bloomberg, RBC Economics



Longer-term yields are already testing 2020's highs
10-year government bond yield, percent
Source: Refinitiv, BoC, US Treasury, RBA , RBC Economics