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End of an era

Both equity and bond markets continued to sell off in April and early May amid heightened volatility as investors grapple with a new central bank regime ushered in by the highest rates of inflation in the inflation targeting era. Gone is the cautious approach to monetary policy seen over the past decade—central banks are raising rates to their highest levels post-financial crisis (BoE), for the first time in a decade (RBA and soon the ECB), or opting for the largest single-meeting hikes in more than twenty years (Fed and BoC). Markets look for those moves to continue with central banks seen lifting rates toward a more neutral stance or even beyond—something we didn't see last cycle—as the urgency to tackle inflation grows. The latest round of consumer price data provided more upside surprises (the biggest yet in some of the countries we track) while falling jobless rates and rising wages suggest domestic price pressure will provide a floor for inflation even if global factors start to ease.

We find ourselves once again revising our central bank forecasts higher, both accelerating the pace of tightening previously expected and lifting terminal rates for this cycle. That said, we maintain the view that in most jurisdictions market pricing is too aggressive—particularly in 2023—as late-cycle growth concerns and inflation that is starting to slow will eventually see policymakers tone down their hawkishness. For now, though, it's full steam ahead as central banks look to remove stimulus and get monetary policy to a more appropriate setting for current economic conditions. We expect more 50 bp hikes from the Fed and BoC, consistent increases from the RBA, a few more BoE hikes, and the start of the ECB's tightening cycle after eight years of negative interest rate policy. If we're correct in our view that market pricing

Central bank near-term bias

The BoC hiked by 50 bps and began QT in April. We expect follow-up 50 bp hikes in June and July as the bank aims to get monetary policy to a neutral level (now 2-3%) in short order.

The Fed also hiked by 50 bps in May and will begin QT in June. Powell said additional 50 bp hikes will be on the table at upcoming meetings (we expect such moves in June and July) with consensus on the Fed that monetary policy needs to get to a more neutral level.

The BoE hiked at a fourth consecutive meeting despite flagging a coming, inflation-driven slowdown in economic activity. We expect two more hikes this year in June and August.

Broadening consensus among ECB officials that rate hikes will soon be appropriate has prompted us to shift our forecast forward. We now expect 25 bp hikes in July, September and December will finally see the deposit rate return to positive territory by year-end.

The RBA hike in May for the first time since 2010 and we expect a series of 25 bp hikes at upcoming meetings will lift the cash rate to 1.85% by year-end.

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Highlights

▲ Chair Powell said hikes of 75 bps or more are not being actively considered.

▲ 10-year Treasury yields rose above 3% in April, having started the year around 1.5%.

▲ With the overnight rate at a still-accommodative 1%, the BoC wants to get to neutral (2-3%) in the coming months.

▲ Canada's inflation rate surprised to the upside by the largest margin since at least 2007 in March.

for rate hikes is stretched, we should see yields stabilize around current levels with some retracement likely heading into 2023. But if recent trends are any indication, the road there could be bumpy.

Fed signals more half-point hikes to come

After kicking off its tightening cycle with a 25 bp hike in March, the Fed accelerated its withdrawal of stimulus with a 50 bp increase in May, the largest hike since 2000. That move was widely expected, as was the Fed's announcement that it would begin shrinking its US$9 trillion balance sheet in June. Fed-watchers were looking out for any hint that the central bank is contemplating even larger rate hikes going forward. Chair Powell threw cold water on that idea, saying a 75 bp increase "is not something the committee is actively considering." However, he noted consensus on the committee that 50 bp increases should be on the table "for the next couple of meetings" as the Fed looks to move "expeditiously" to a more neutral stance (a fed funds rate of 2-3% according to most FOMC participants' estimates). Investors initially saw that messaging as dovish, with yields falling during Powell's press conference, but Treasuries sold off sharply the following day.

Given Powell's comments—and firm economic data that suggest the central bank has little time to lose in removing accommodation—we expect 50 bp rate hikes at each of the next two meetings (June and July) with 25 bp hikes thereafter taking fed funds up to 2.75-3.00% early next year. That's at the upper end of most estimates of neutral but well within the range of policy paths shown in March's dot plot. Our forecast is now fairly close to market pricing, which suggests that after a sharp selloff through the first four months of 2022—10-year Treasury yields have doubled to slightly more than 3%—yields should peak around current levels.

More 50 bp hikes also in the BoC's future

The BoC met expectations in April announcing a 50 bp hike—also its largest move since 2000—and the start of QT that will see about 40% of government bond holdings roll off the bank's balance sheet over the next two years. Governor Macklem said Canadians should expect the overnight rate to rise toward the BoC's 2-3% neutral estimate (that range was lifted by 25 bps in April's MPR). But he maintained a good deal of flexibility in that guidance, saying the BoC could pause its tightening cycle earlier if demand responds quickly to rising rates, or the bank might have to make monetary policy restrictive (i.e. modestly above neutral) to get inflation back to target.

Given data flow since April's meeting, including a significant upside surprise on March inflation (headline +6.7% vs. expectations for 6.1%) and a further decline in the unemployment rate, we now think the BoC will want to get the overnight rate into the middle of that neutral range before pausing to assess the impact of its moves. We look for additional 50 bp hikes in June and July followed by 25 bp increases at the following two meetings to get the policy rate to 2.50%. At that stage, we think slowing growth and inflation will keep the BoC on the sidelines, holding its policy rate steady through 2023.

Divisions emerging among BoE policymakers

The BoE raised its policy rate at a fourth consecutive meeting in May but had a hard time presenting a united front on the path forward. While three MPC members voted for a larger, 50 bp increase, some on the committee thought the guidance that "some degree of further tightening in monetary policy might still be appropriate in the coming months" was a bit strong given more evenly balanced risk around growth and inflation. Indeed, the BoE faces a tough task as it now expects inflation to peak above 10% later this year (regulated increases in gas prices spread out the inflationary impact of higher commodity prices relative to other jurisdictions) with rising prices seen contributing to a sharp slowdown in growth later this year. While we've added further rate hikes to our forecast in June and August we continue to think the market is over-priced for tightening. Indeed, the BoE's projections showing excess supply and below-2% inflation toward the end of its forecast horizon suggest a 2.5% Bank Rate (which those forecasts were conditioned on) is more tightening than the economic outlook warrants.

ECB and RBA hiking rates for the first time in a decade

A number of ECB officials—including those not traditionally in the hawkish camp—have continued to discuss the need to begin normalizing monetary policy this year even as rising inflation is set to take a toll on the euro area economy. Given a strong starting point for the labour market—March's jobless rate was 1/2 ppt below pre-pandemic and pre-financial crisis lows—and rising inflation and inflation expectations we think the ECB will seize on this window to move away from negative rates after eight years. We now see the central bank ending its asset purchase program around mid-year, opening the door to 25 bp hikes in July, September and December that would lift the deposit rate to +0.25% by year-end from -0.50% currently. We see the ECB becoming more data dependent in 2023 and look for two additional hikes to bring the deposit rate to 0.75% by mid-2023, below market pricing.

Like the ECB, the RBA's policy rate has only moved lower over the past decade but that changed in May with the first of what we expect will be a series of 25 bp interest rate hikes. Lower unemployment rate forecasts and upwardly-revised inflation projections—core inflation is only seen slowing to the top of the central bank's 2-3% target range by mid-2024—reinforced the tightening bias at the end of the RBA's policy statement. We've consistently noted the wage backdrop is key to the monetary policy outlook so an admission that "the direction of change is now clear" added to the hawkish tone. We now look for 25 bp hikes at every policy meeting until November, lifting the cash rate to 1.85% by year-end. While Governor Lowe said a 2.5% neutral cash rate is likely we don't see the RBA getting there in our forecast horizon with rate sensitive sectors likely to be feeling the effects of policy tightening and the global push toward higher rates likely to slow in 2023.

Soft or strong, GDP data supports Fed and BoC moves

US GDP came in softer than expected in Q1 with a 1.4% annualized decline marking the first pullback in activity since Q2/20. Domestic demand wasn't an issue with final sales posting its best gain (+2.6% annualized) in three quarters driven by a solid increase in consumer spending and resurgent business investment. Rather it was a combined 4 ppt drag from net trade and inventories that caused GDP to decline. We think that is another sign that the US economy is running out of room to grow with spending having to be met by imports rather than domestic production while companies are having difficulty restocking inventories. We look for growth to rebound somewhat in Q2 (+3% annualized) but it's increasingly clear that the days of 6% growth—seen in three of four quarters last year—are in the rear view mirror.

Highlights

▲ Some BoE officials voted for a larger hike in May, but others were cautious on the need for further moves.

▲ The ECB's focus on inflation, even with the economy set to slow, should see it begin to normalize monetary policy in H2/22.

▲ The RBA sees core inflation overshooting its 2-3% target range over the next two years.

▲ US GDP data wasn't as soft as headline figures suggest—domestic demand posted its best gain in three quarters.

Highlights

▲ Canada's economy posted a tenth consecutive month of growth in March.

▲ Longer-term interest rates have risen sharply in anticipation of a rapid tightening cycle...

▲ ...and Canadian and US housing markets already appear to be feeling the effects.

▲ The US dollar is up by more than 7% year-to-date and 13% higher over the past year.

Canada's economy had a stronger start to the year than previously expected and we now look for a 4.5% annualized increase in Q1 GDP led by services spending as the economy began moving on from Omicron. Business investment likely also saw a healthy gain as strong demand, capacity pressures and rising commodity prices trumped emerging geopolitical uncertainty. The economy had decent momentum heading into Q2—StatCan's flash estimate suggests 0.5% growth in March, marking a tenth consecutive monthly gain. We look for above trend growth over the middle quarters of 2022 as activity in the services sector continues to return to normal and the mining, oil and gas sector gets a boost from higher global prices. But as rate hikes start to bite and the economy runs out of room to grow—demand already exceeds long-run supply—we think gains of 2% or more will be harder to come by in 2023.

Impact of rate hikes already showing up

It can take up to six to eight quarters for the economy to feel the full effects of changes in monetary policy. But the impact can still be front-loaded, and there is reason to expect that will be particularly true in the current cycle. Rates are rising significantly faster than last cycle with both the Fed and BoC hiking by 50 bps for the first time in more than two decades and likely to do so again at upcoming meetings. Markets have also been pricing in a relatively aggressive tightening cycle, which pushed term yields sharply higher even before the first rate hike was delivered. 10-year government bond yields in both Canada and the US are now above 3%. US Treasuries only reached that point well into the Fed's last tightening cycle, and GoCs peaked around 2.5% at the top of the BoC's tightening cycle.

In short, recent and even *expected* rate hikes have already pushed longer-term borrowing costs higher—US 30-year mortgage rates are now well above last cycle's 5% peak and Canadian 5-year fixed rates are climbing quickly. The impact is already apparent in resale markets with the US seeing the slowest existing home sales since mid-2020 in March (albeit still above pre-pandemic levels) and some local markets in Canada showing signs of turning over in April. Residential investment has accounted for an outsized share of economic activity in both countries during the pandemic but will be the leading edge of the impact of rising rates. That impact will only grow as policy rates continue to move higher over the course of 2022.

Canadian dollar sideswiped by risk aversion

The Canadian dollar traded in a fairly narrow 77 to 80 US cent range over the past six months but fell from the upper end to the lower end of that band in late-April and early-May. That was despite key factors that have supported the Canadian dollar—including rising commodity prices and market expectations that the BoC will keep up with the Fed—remaining in place. Rather, it was rising risk aversion that drove the US dollar higher and hurt riskier currencies like the loonie. The S&P 500 recorded a nearly 9% decline in April, its worst month since March 2020, and is now down 16% year-to-date. The US dollar, meanwhile, rose by nearly 5% on trade weighted basis in April, its strongest monthly gain in more than a decade. Aside from the early stages of the pandemic, the dollar hasn't been this strong since 2002, so despite the Canadian dollar's decent performance against other currencies this year it has had trouble keeping up with the greenback. April's move was in the direction of our longer-term forecast (weaker Canadian dollar) but happened sooner than we anticipated. We continue to expect the currency will struggle to hold its value against the US dollar in the coming quarters, particularly with the Fed likely to take its tightening cycle further than the BoC—something we've seen in each of the past three major tightening cycles but that isn't reflected in current market pricing.

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	2.25	2.50	2.50	2.50	2.50	2.50
Three-month	0.09	0.15	0.12	0.16	0.60	1.85	2.35	2.45	2.45	2.45	2.45	2.45
Two-year	0.23	0.45	0.53	0.95	2.29	2.60	2.60	2.60	2.50	2.50	2.40	2.30
Five-year	0.99	0.98	1.11	1.26	2.41	2.75	2.65	2.60	2.50	2.45	2.30	2.20
10-year	1.56	1.39	1.51	1.43	2.40	2.85	2.75	2.60	2.60	2.60	2.50	2.45
30-year	1.99	1.84	1.99	1.68	2.38	2.80	2.70	2.60	2.65	2.65	2.60	2.55
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.38	1.38	2.13	2.63	2.88	2.88	2.88	2.88
Three-month	0.03	0.05	0.04	0.06	0.52	1.65	2.30	2.75	2.80	2.80	2.80	2.80
Two-year	0.16	0.25	0.28	0.73	2.28	2.66	2.80	2.90	2.95	2.90	2.80	2.60
Five-year	0.92	0.87	0.98	1.26	2.42	2.75	2.85	2.90	2.95	2.85	2.75	2.50
10-year	1.74	1.45	1.52	1.52	2.32	2.80	2.85	2.90	2.90	2.85	2.70	2.50
30-year	2.41	2.06	2.08	1.90	2.44	2.90	2.95	3.00	3.00	2.90	2.70	2.55
United Kingdom												
Bank rate	0.10	0.10	0.10	0.25	0.75	1.25	1.50	1.50	1.50	1.75	1.75	1.75
Two-year	0.11	0.07	0.40	0.68	1.36	1.50	1.45	1.45	1.45	1.60	1.60	1.60
Five-year	0.40	0.33	0.62	0.82	1.40	1.70	1.75	1.65	1.60	1.70	1.70	1.70
10-year	0.85	0.72	1.02	0.97	1.60	2.15	2.25	2.20	2.15	2.10	2.10	2.10
30-year	1.40	1.24	1.37	1.12	1.77	2.25	2.30	2.20	2.15	2.10	2.10	2.10
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	0.00	0.25	0.50	0.75	0.75	0.75
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	0.90	1.00	0.90	0.80	0.75	0.75	0.70
10-year	-0.29	-0.20	-0.21	-0.18	0.55	1.25	1.35	1.25	1.10	1.10	1.00	1.00
30-year	0.26	0.30	0.29	0.20	0.67	1.30	1.40	1.30	1.20	1.20	1.10	1.10
Australia												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.60	1.35	1.85	1.85	1.85	1.85	1.85
Two-year	0.08	0.06	0.04	0.54	1.78	2.55	2.65	2.55	2.40	2.35	2.30	2.30
10-year	1.74	1.49	1.49	1.67	2.84	3.20	3.20	3.15	3.10	3.05	2.85	2.65
New Zealand												
Cash target rate	0.25	0.25	0.25	0.75	1.00	2.00	2.50	2.75	2.75	2.75	2.75	2.75
Two-year swap	0.46	0.78	1.39	2.16	3.27	3.70	3.60	3.50	3.40	3.30	3.20	3.10
10-year swap	1.95	1.87	2.21	2.62	3.38	3.90	3.80	3.70	3.60	3.55	3.40	3.20
Yield curve***												
Canada	133	94	98	48	11	25	15	0	10	10	10	15
United States	158	120	124	79	4	14	5	0	-5	-5	-10	-10
United Kingdom	74	65	62	29	24	65	80	75	70	50	50	50
Eurozone	40	47	48	46	63	110	110	85	55	50	50	60
Australia	166	143	145	113	106	65	55	60	70	70	55	35
New Zealand	149	109	82	46	11	20	20	20	20	25	20	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

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021	2022F	2023F
Canada*	4.8	-3.6	5.5	6.7	4.5	5.0	4.0	1.7	1.5	1.3	1.2	1.0	4.6	4.3	2.0
United States*	6.3	6.7	2.3	6.9	-1.4	3.0	2.5	2.2	1.8	1.3	0.9	0.8	5.7	2.6	1.8
United Kingdom	-1.2	5.6	0.9	1.3	1.0	0.0	0.2	0.2	0.5	0.4	0.4	0.4	7.4	3.9	1.4
Euro Area	-0.1	2.2	2.2	0.3	0.2	0.2	0.3	0.6	0.4	0.4	0.4	0.4	5.4	2.5	1.7
Australia	1.9	0.8	-1.9	3.4	1.4	0.7	0.6	0.8	0.8	0.4	0.5	0.4	4.7	4.3	2.6

*annualized

Inflation outlook

% change, year-over-year

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021	2022F	2023F
Canada	1.4	3.3	4.1	4.7	5.8	6.7	5.8	4.8	3.4	2.3	2.1	2.2	3.4	5.8	2.5
United States	1.9	4.8	5.3	6.7	8.0	7.6	6.6	5.1	3.3	2.1	1.9	2.1	4.7	6.8	2.3
United Kingdom	0.6	2.0	2.8	4.9	6.2	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	6.1	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	5.1	5.6	5.9	5.8	4.6	4.1	3.9	3.4	2.9	5.6	4.0

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	1.25	1.28	1.29	1.31	1.32	1.33	1.34	1.34
Euro	1.17	1.19	1.16	1.14	1.11	1.06	1.03	1.00	1.02	1.04	1.07	1.09
U.K. pound sterling	1.38	1.38	1.35	1.35	1.31	1.23	1.14	1.10	1.12	1.14	1.19	1.21
Japanese yen	111	111	111	115	122	130	133	135	135	135	135	135
Australian dollar	0.76	0.75	0.72	0.73	0.75	0.71	0.70	0.69	0.69	0.70	0.70	0.71

Canadian dollar cross-rates

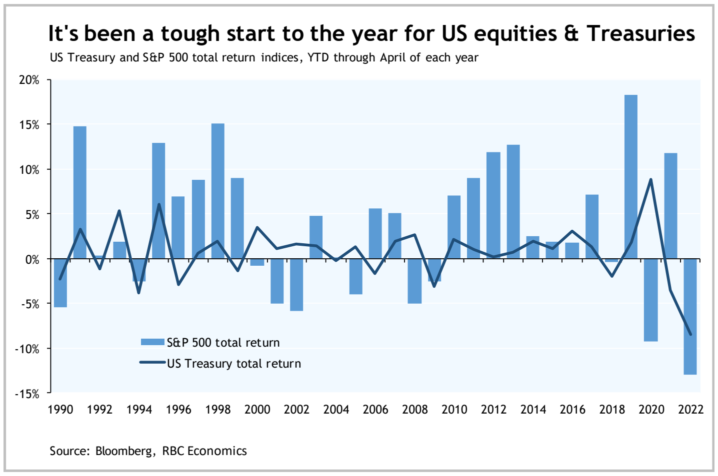
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
EUR/CAD	1.47	1.47	1.47	1.44	1.38	1.36	1.33	1.31	1.35	1.38	1.43	1.46
GBP/CAD	1.73	1.71	1.71	1.71	1.64	1.58	1.48	1.44	1.48	1.52	1.59	1.62
CAD/JPY	88	90	88	91	97	102	103	103	102	102	101	101
AUD/CAD	0.95	0.93	0.92	0.92	0.94	0.91	0.90	0.90	0.91	0.93	0.94	0.95

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.

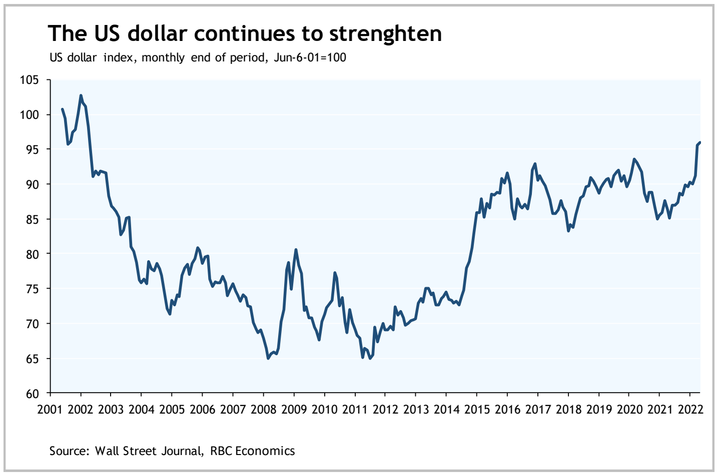
Source: Bloomberg, RBC Economics

Rising inflation, hawkish CBs impacting equity and FX markets

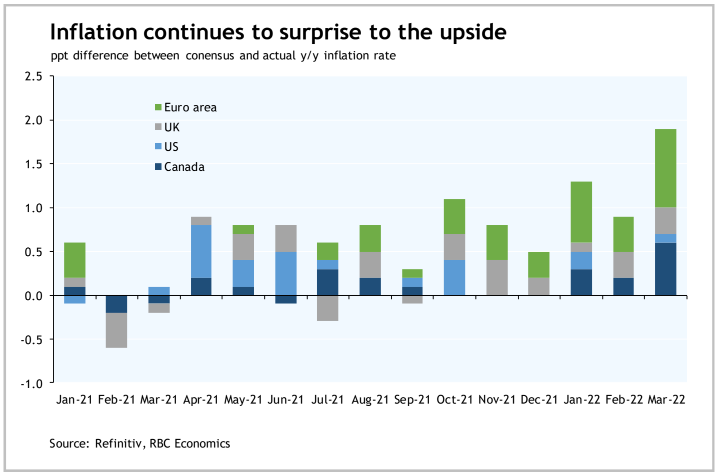
US equity and Treasury markets are both off to their worst start to the year in decades. The "Fed put"—the idea that the central bank will turn dovish if equity markets are falling sharply—appears to be dead with the Fed determined to rein in inflation that is now the highest since the early-1980s. Growth stocks are being hit particularly hard after outperforming in 2020 and 2021.



A hawkish Fed and deteriorating risk sentiment have pushed the US dollar to a two-decade high (aside from a brief spike higher early in the pandemic). Its biggest gains this year have come against advanced economy currencies like the yen and euro. We look for the US dollar to continue to strengthen into year-end.



With inflation continuing to surprise to the upside we're updating a chart from three months ago. Canada, the UK and euro area all saw inflation come in well ahead of expectations in March, adding to policymakers' urgency to remove accommodation and keep inflation expectations well anchored.



After a long battle against disinflation following the financial crisis and euro crisis, inflation expectations have surged past the ECB's 2% target. While higher prices and the region's exposure to Russia-Ukraine will slow growth, the ECB thinks it's time to finally begin normalizing monetary policy.