Dollars and Sense:
Central Banks: Learning to Skip

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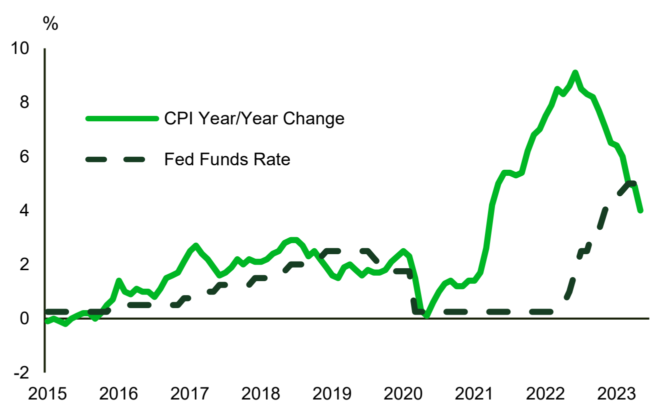
Highlights

- The Federal Reserve has moved to a meeting-by-meeting approach as it explores the stopping point on interest rates.
- We think that occurs at 5.50%, but even in that case, the Fed will need to ensure communication jawbones the market to prevent a drop in yields.
- The Bank of Canada has already jumped back in with another hike after pausing in January. The population surge poses a challenge for a central bank that would prefer to remain on the sidelines but cannot ignore the demand shock.

Was it truly an innocent slip when Federal Reserve Chair Powell referred to the decision to not hike rates in June as a "skip" in the meeting cadence? Probably not. The Fed is treating every meeting as a live decision of "go" or "no go". This is a shift from the previously telegraphed path of continuous rate hikes, where only the magnitude was the point of discussion. And this is a good thing.

With 500 basis points in rate hikes in the rear-view mirror and inflation decelerating, there is no longer a need for speed. The real policy rate is officially in restrictive territory and presses deeper with every month that inflation decelerates (Chart 1). This is the stage where a central bank's true skills on inflation management are tested. By creating longer gaps between rate decisions to observe a larger subset of data, it should limit the risk of a policy overshoot, or at least the magnitude of any overshoot. At the same time, there is strategic design behind the central bank's intent to keep markets guessing. If the Fed had stated an outright pause, yields would likely have fallen. The market's mindset would have shifted to the belief that the next most probable move is a rate cut. This is precisely what occurred north of the border when the Bank of Canada explicitly noted a pause in January. Central banks are now at the stage of fine-tuning policy, and this includes the art of jawboning markets to prevent a counterproductive easing in monetary policy expectations when the inflation fight has not yet been won. And jawboning required credibility with action when core inflation metrics prove stubbornly slow to decelerate. With this framework in mind, we view one more rate hike as a high probability over the summer months.

Chart 1: Fed Funds is Getting Real

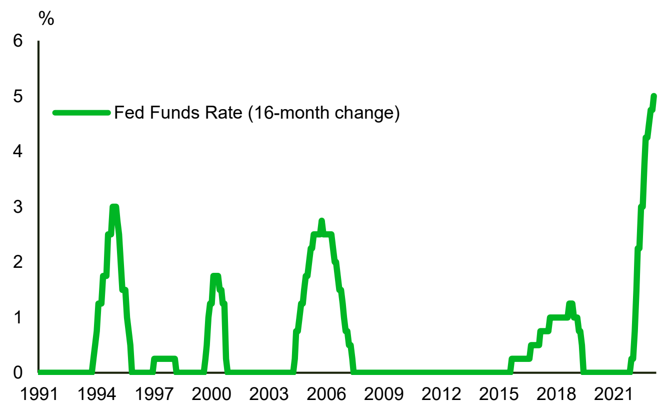


Source: BLS, FRB, TD Economics.

The Art of Inflation War

The current rate hike cycle has been the most aggressive since the Fed began targeting inflation in the 1990s (Chart 2) but doesn't deviate from how the path on policy adjustments typically occur. Chair Powell highlighted the three stages of the Fed's hiking strategy as: "The speed of tightening, the level to

Chart 2: The Fed's Rapid Rate Hikes



Source: FRB, TD Economics.

which rates need to go, and then a period of time over which we'd need to keep policy restrictive." The matter of speed is done. After 15 months of rate hikes, including four meetings of 75 basis point adjustments, the Fed slowed to smaller increments before skipping the decision to hike in June. With the policy rate now at 5.25% and inflation having fallen to 4%, the real rate is already at a level that is historically consistent with a slow economic growth trajectory. This takes pressure off the Fed to remain aggressive.

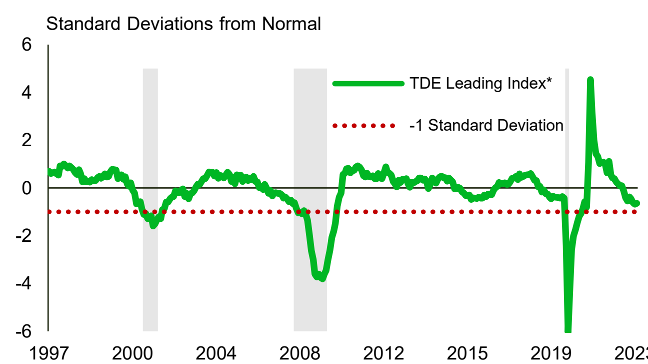
However, history is only a guide. This business cycle has not followed the typical rules of thumb, making many economists question whether economic relationships have become permanently muted or just require more patience due to longer lags. Consumer sensitivity to interest rates is being tested by excess household savings, past generous government transfers, and abnormally strong and persistent labor demand. The Fed's decision to skip a meeting to observe the evolution of the data doesn't necessarily mean an end to the rate hike cycle. It just means that they're in the pocket of being close to peak levels and moving at a more cautious pace helps avoid overshooting that mark.

The best way to describe the Fed's next meeting is 'live'. The Fed could easily justify another skip to buy more time to observe inflation, given that it has started to ease in a convincing manner. Or, it could hike again, given inflation is still far off the 2%-mark and economic data confirm strength and resilience. We are in the camp that another hike in July still makes sense in striking the right balance. Although consumer spending has recently wobbled, more convincing is needed that this is not a head-fake with consumers oscillating between blow-out months followed by temporary breathers. Consumer confidence improved in June, financial market sentiment has pushed stocks higher and the job market is still producing jobs above a long-term sustainable pace. There's reason to believe another quarter-point hike won't upset the apple cart, but at the same time, the Fed must remain attuned to the potential for a re-emergence of financial risks — a harsh reality that already played out within the regional banking sector in March. There's a fine balance in trying to tap down the credit and consumer cycle versus triggering unintended financial turmoil. High interest rates have already exposed the banking system to a strong impulse on deposit outflows, with the financial environment made more difficult by a sustained inverted yield curve.

As a result of these cross currents, we have pencilled in July's rate hike as the final tweak, but this requires a broader set of consumer and inflation metrics to manifest the signals already coming from other indicators. July would mark 18 months since the Fed started raising rates – right around the maximum lag for when interest rates start to hit the labor market. After this point, we would have to assess whether this business cycle is truly a reflection of longer lags or testing economic relationships all together. At present, our economic leading indicator has been flashing yellow for some time, moving sideways over 2023 on the threshold that predicts a significant slowdown in economic momentum, and in some cases, a recession within the next three-to-six months. Basically, it's right on the bubble (Chart 3).

However, as previously noted, every meeting is live. If the economy and core inflation metrics continue to show tenacity, we can't rule out further moves. In that instance, the central bank may also stretch out the time period between those decisions in order to better evaluate the totality of the data.

Chart 3: Leading Index on the Bubble



* Index is comprised of eight leading economic indicators. Readings of 0 are consistent with historical average (1995-present) points in the business cycle, while readings of -0.4 or +0.4 should be interpreted as one standard deviation below/above average, respectively.
Source: TD Economics.

Finding the right level of interest rates is only the first order of tasks. The next becomes how long to hold at that level. Over the last three cycles, the Fed held the policy rate at the peak for an average of 9 months before starting to cut rates, but the range is wide at 7 to 14 months. The longest period occurred in 2006 and 2007. Then too, consumer spending was surprising resilient in the face of falling house prices, before a wave of poorly underwritten mortgages tipped the scales.

If July is indeed going to mark the final hike, than history's guide would imply the Fed would see sufficient data to prompt a rate cut as early as January 2024. We deem that outcome to be a long shot and have instead penciled the first rate cut in the second quarter as the earliest timing. This is when our core inflation metric finally cracks below 3% alongside sputtering job demand, hopefully offering sufficient comfort to the Fed that inflation is on a sustained trajectory towards its 2% target. In that environment, if the Fed does not cut interest rates, a real (inflation-adusted) interest rate north of 3% would materialize. This would be a significant development. In all historical instances of recessions, monetary policy settings were left at this level or higher, indicating that the cost of capital became too crippling for too long.

Bank of Canada Dives Back In

The Bank of Canada (BoC) has already deployed a stop-and-go strategy, following up on a pause in January with a quarter-point rate hike in June. This was likely not its initial intention. At the time, the BoC's conditional pause made sense. The economy had absorbed 400 basis points in rapid-fire succession, making many economists squeamish given the disproportionate risks related to household leverage. Canadian households spend roughly 6 percentage points more of their after-tax income on servicing debt relative to their American counterparts. This should have translated into increased interest rate sensitivity, but the exact opposite played out.

Consumer spending clocked in at nearly 6% (annualized) in the first quarter, the fastest pace among peer countries. Housing demand also came roaring back. Sales jumped 20% in just two short months despite a modest 15 bps drop in 5-year posted mortgage rates. The U.S. saw less of a reaction in housing demand with more than four times the drop in their preferred mortgage rate term.

The wrinkle in the BoC's plan and overall analysis came via population statistics. At the time of the announced pause, it was not readily observable that Canada was experiencing a massive demand shock. It turns out that the population expanded by 1.2 million persons over the last year, creating a demand force not seen since the 1950s. Despite a permanent immigration target of 431k in 2022, the total population swelled due to a less transparent surge in non-permanent residents. This puts the central bank into a bind. Even though spending per capita has softened, the whole matters more than the parts and the BoC must set policy for economy-wide inflationary forces that are pressing on capacity. At the same time, employer demand for workers is consistent with historical periods of ongoing economic expansions, averaging 28k jobs over the past three months. Momentum is even stronger within full time positions and among the core working age group (25-54 year olds).

The BoC highlighted this consumer/labour market/housing trio as sufficient reason to raise interest rates again. This was made more compelling by a bad-news inflation report in April, revealing stickier price pressures than expected. At least on this front, daylight has re-emerged. Inflation in May was surprisingly cooperative, easing to 3.4% year-on-year (from 4.4% in April), the lowest level since June 2021. Much of this was thanks to lower energy prices compared to last year. By comparison, the deceleration in the BoC's core inflation metrics are occurring at a slower pace, averaging 3.9%. Likewise, on a three-month annualized basis, core inflation has been stuck at around 3.5% for almost a year. For a central bank trying to anchor inflation back at 2%, there is plenty of reason to consider another interest rate adjustment.

This is why we view another rate hike by the BoC as a likely outcome. The population surge and strong labour markets point to more spending. In turn, this would limit the degree to which inflation can cool, ultimately posing a risk of entrenching higher inflation expectations. Something has to break in this chain to build confidence that inflation will not just move back to target, but be sustained there. That moment has not yet come. Like the Fed, the BoC will have to probe and find its cruising speed on the right level of interest rates.

Interest Rate Outlook

Interest Rates	Spot Rate Jul-06	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3F	2023 Q4F	2024 Q1F	2024 Q2F	2024 Q3F	2024 Q4F
CANADA													
Overnight Target Rate	4.75	0.50	1.50	3.25	4.25	4.50	4.75	5.00	5.00	5.00	4.50	4.00	3.50
3-mth T-Bill Rate	4.94	0.60	2.08	3.58	4.23	4.34	4.90	5.00	5.00	4.75	4.25	3.75	3.25
2-yr Govt. Bond Yield	4.76	2.27	3.10	3.79	4.06	3.74	4.66	4.70	4.40	4.00	3.70	3.40	3.10
5-yr Govt. Bond Yield	3.92	2.39	3.10	3.32	3.41	3.02	3.78	3.80	3.55	3.25	3.00	2.80	2.70
10-yr Govt. Bond Yield	3.50	2.40	3.23	3.16	3.30	2.90	3.36	3.45	3.30	3.10	3.00	2.95	2.90
30-yr Govt. Bond Yield	3.26	2.38	3.13	3.09	3.27	3.00	3.08	3.30	3.25	3.20	3.15	3.15	3.15
10-yr-2-yr Govt Spread	-1.26	0.13	0.13	-0.63	-0.76	-0.84	-1.30	-1.25	-1.10	-0.90	-0.70	-0.45	-0.20
U.S.													
Fed Funds Target Rate	5.25	0.50	1.75	3.25	4.50	5.00	5.25	5.50	5.50	5.50	5.00	4.50	4.00
3-mth T-Bill Rate	5.22	0.51	1.66	3.22	4.30	4.68	5.17	5.40	5.40	5.15	4.65	4.15	3.65
2-yr Govt. Bond Yield	5.00	2.28	2.92	4.22	4.41	4.06	4.87	4.90	4.50	4.10	3.70	3.30	3.00
5-yr Govt. Bond Yield	4.37	2.42	3.01	4.06	3.99	3.60	4.13	4.20	3.90	3.60	3.30	3.05	2.85
10-yr Govt. Bond Yield	4.04	2.32	2.98	3.83	3.88	3.48	3.81	4.00	3.80	3.55	3.35	3.20	3.05
30-yr Govt. Bond Yield	4.00	2.44	3.14	3.79	3.97	3.67	3.85	4.00	3.95	3.85	3.65	3.50	3.35
10-yr-2-yr Govt Spread	-0.96	0.04	0.06	-0.39	-0.53	-0.58	-1.06	-0.90	-0.70	-0.55	-0.35	-0.10	0.05
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	-0.28	0.09	0.42	0.36	-0.07	-0.34	-0.27	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
Can - U.S. 10-Year Bond Spread	-0.54	0.08	0.25	-0.67	-0.58	-0.58	-0.45	-0.55	-0.50	-0.45	-0.35	-0.25	-0.15

F: Forecast by TD Economics, July 2023; Forecasts are end-of-period.
Source: Bloomberg, Bank of Canada, Federal Reserve.

Foreign Exchange Outlook

Currency	Exchange rate	Spot Price Jul-06	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q3F	2023 Q4F	2024 Q1F	2024 Q2F	2024 Q3F	2024 Q4F
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	7.25	6.34	6.70	7.11	6.90	6.87	7.25	7.20	7.15	7.20	7.20	7.15	7.10
Japanese yen	JPY per USD	144	121	136	145	132	133	144	142	141	142	143	142	141
Euro	USD per EUR	1.09	1.11	1.05	0.98	1.07	1.09	1.09	1.09	1.08	1.07	1.06	1.08	1.10
U.K. pound	USD per GBP	1.27	1.32	1.22	1.11	1.21	1.24	1.27	1.27	1.26	1.25	1.23	1.26	1.28
Canadian dollar	CAD per USD	1.34	1.25	1.29	1.38	1.35	1.35	1.32	1.33	1.35	1.36	1.37	1.36	1.33
Australian dollar	USD per AUD	0.66	0.75	0.69	0.64	0.68	0.67	0.67	0.66	0.65	0.65	0.64	0.65	0.66
NZ dollar	USD per NZD	0.62	0.70	0.63	0.56	0.63	0.63	0.61	0.61	0.60	0.60	0.59	0.60	0.61
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.09	1.11	1.05	0.98	1.07	1.09	1.09	1.09	1.08	1.07	1.06	1.08	1.10
Japanese yen	JPY per EUR	157	135	142	142	141	144	158	155	152	152	152	154	155
U.K. pound	GBP per EUR	0.85	0.84	0.86	0.88	0.89	0.88	0.86	0.86	0.86	0.86	0.86	0.86	0.86
Canadian dollar	CAD per EUR	1.45	1.39	1.35	1.35	1.45	1.47	1.45	1.45	1.46	1.46	1.45	1.47	1.47
Australian dollar	AUD per EUR	1.64	1.48	1.52	1.52	1.57	1.62	1.64	1.64	1.65	1.65	1.65	1.67	1.67
NZ dollar	NZD per EUR	1.77	1.60	1.68	1.73	1.69	1.73	1.78	1.79	1.80	1.79	1.79	1.81	1.81
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	144	121	136	145	132	133	144	142	141	142	143	142	141
Euro	JPY per EUR	157	135	142	142	141	144	158	155	152	152	152	154	155
U.K. pound	JPY per GBP	184	160	165	161	159	164	184	180	177	177	176	179	181
Canadian dollar	JPY per CAD	107.9	97.3	105.4	105.2	97.4	98.2	109.2	106.8	104.4	104.4	104.4	104.4	105.8
Australian dollar	JPY per AUD	95.5	91.1	93.7	93.2	89.7	89.0	96.3	94.1	92.1	92.1	92.0	92.1	93.3
NZ dollar	JPY per NZD	88.8	84.4	84.7	81.6	83.6	83.2	88.6	86.6	84.8	84.7	84.7	84.7	85.9
Exchange rate to Canadian dollar														
U.S. dollar	USD per CAD	0.75	0.80	0.78	0.73	0.74	0.74	0.76	0.75	0.74	0.74	0.73	0.74	0.75
Japanese yen	JPY per CAD	107.9	97.3	105.4	105.2	97.4	98.2	109.2	106.8	104.4	104.4	104.4	104.4	105.8
Euro	CAD per EUR	1.45	1.39	1.35	1.35	1.45	1.47	1.45	1.45	1.46	1.46	1.45	1.47	1.47
U.K. pound	CAD per GBP	1.70	1.64	1.57	1.53	1.63	1.67	1.68	1.69	1.70	1.69	1.69	1.71	1.71
Australian dollar	AUD per CAD	1.13	1.07	1.12	1.13	1.09	1.10	1.13	1.13	1.13	1.13	1.13	1.13	1.13
NZ dollar	NZD per CAD	1.22	1.15	1.24	1.29	1.17	1.18	1.23	1.23	1.23	1.23	1.23	1.23	1.23

F: Forecast by TD Economics, July 2023; Forecasts are end-of-period.
Source: Federal Reserve, Bloomberg.

Global Stock Markets					
Major Market Indexes	Price Jul-06	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	4,408	3.1	14.8	4,456	3,577
S&P/TSX Composite	19,811	-0.6	2.2	20,767	18,206
DAX	15,529	-2.7	11.5	16,358	11,976
FTSE 100	7,281	-4.2	-2.3	8,014	6,826
Nikkei	32,773	1.7	25.6	33,753	25,717
MSCI AC World Index*	682	3.0	12.7	685	550

*Weighted equity index including both developed and emerging markets.
Source: Bloomberg, TD Economics.