Dollars and Sense:
To Infinity and Beyond

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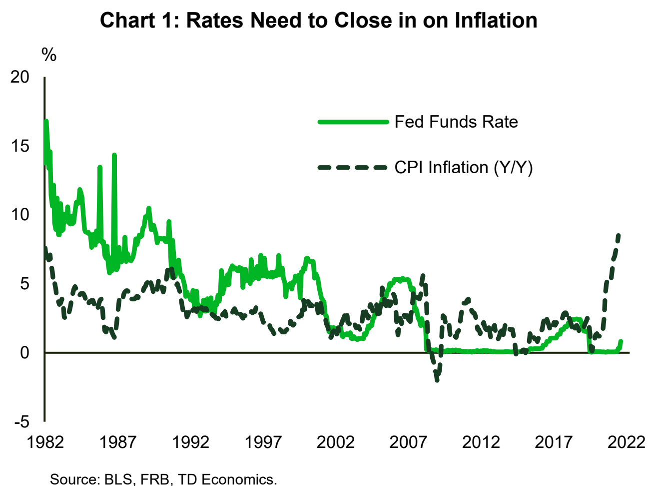
Highlights

- The Federal Reserve followed the Bank of Canada's lead yesterday by delivering a supersized 50 basis point hike. This was likely the first of two more to come, with policy rates still less than half-way to the finish line.
- We expect a swift adjustment to 2% by July. Once inside the neutral range, more cautious 25 basis points increments then become warranted. The urgency of coming from behind on inflation must be balanced against the risk of what the economy can bear under one of the most rapid policy adjustments in history.
- In a twist, although inflationary pressures are significantly higher south of the border, the Bank of Canada may end up with the harder task on normalization due to a greater growth impulse from ongoing government expenditures within an economy already stretched to the limits.

The Federal Reserve mirrored the Bank of Canada by accelerating its normalization cycle with a 50-basis point rate hike. Both central banks have a policy rate that's still less than half-way to the finish line. We anticipate each will move in 50 basis point increments at the next two meetings, before returning to quarter-point adjustments. The former allows for a swift recalibration to the lower end of their estimated neutral range, while the latter allows the central bank to monitor the lagged impact of rapid interest rate hikes and quantitative tightening on the economy. Still, with inflation stubbornly high, there is tremendous uncertainty on the final resting place for the policy rate (Chart 1).

While the Bank of Canada does not provide forward guidance, the Federal Reserve does. In their Summary of Economic Projections, members expected the policy rate to sit between 1.6% and 2.4% (central tendency) by the end of this year and reach towards 3% by the end of 2023. However, past cycles have shown that the Fed tends to fall short of its end point expectation before cracks appear in economic momentum. Already, U.S. existing home sales have dropped 11% in two months, and this retreat is likely to extend for several more months. A key forward indicator - pending sales - has also declined over the same time period. This is not a bad thing. In fact, it's needed.



Canada's economy is showing more stubbornness - or perhaps it's more aptly described as resilience – than its neighbour. In an

odd twist, although inflationary pressures are significantly higher south of the border, the Bank of Canada may have its hand forced to a greater degree due to strong population growth and ongoing government expenditures.

Nonetheless, the urgency of coming from behind on inflation must be balanced against what the economy can bear under one of the most rapid adjustments in history. An error on the front end of this cycle of having waited too long, can quickly swing into a second error that undermines confidence by overcorrecting. When an economy has already pushed into excess demand territory, the forces needed to quell inflationary pressures require a sustained period of sub-potential (sub-2%) growth. That thin growth-buffer leaves little margin of error for an overshoot on the downside.

Please Wait: Map is Rerouting

In our recent report (0 to 100 Real Quick), we explained how the Fed's new operational framework put it behind the eight-ball. It did this by focusing on real-time data and overweighting the downside risks. As the evidence piled up reaffirming the resilience of the labor market and the economy despite each virus-related disruption, other evidence of inflation's staying power was downplayed. This 'patience' framework pushed aside the standard operating procedure, where policy decisions were based on the economy's most likely trajectory and the related inflationary risks this would present. Now that the central bank is forced to play catch-up, it is also forced to revert to making decisions based on where the economy is going. It needs to make assumptions on how its recent and upcoming interest rate hikes will feed through to the economy and ultimately anchor inflation expectations.

The Fed's new strategy to tackle inflation was mapped out by Chair Powell in late April when he stated that the Fed was "going to be raising rates and getting expeditiously to levels that are more neutral." After that, the fine tuning comes into play, as the central bank must decide on how much more is needed to orchestrate the elusive soft landing.

Driving with the rearview mirror

It sounds simple…get rates to neutral. However, this is a complicated task. The range of estimates for neutral by Fed members is between 2% and 3%, which is wide and still subject to further revisions. One reason for this is that the neutral rate is estimated and unobserved. Nobody can definitively say where the neutral rate lies. It's a theoretical concept that pinpoints a rate of interest that keeps the unemployment rate and inflation stable. Operationally, we only really know what neutral is once it has been passed. It's akin to driving a car while looking through your rear-view mirror – you only know you have missed the highway exit once it's been passed.

In the last business cycle, the Fed's policy rate peaked at 2.5%, even though Fed members thought it was headed above 3%. The interest rate-sensitive sectors of the economy had already begun to stall. This led to a quick U-turn to cut the policy rate back to 1.75%. For this reason, we expect the Fed to quickly hike its policy rate to the lower end of the neutral range of 2% by July, before continuing more cautiously as it tests the economy's threshold.

When I say jump, you say how high

This second stage of the hiking cycle will be trickier than the first. Over the last year, the Fed's hawkishness has pushed up long-term Treasury yields by about 2%. But at the same time, inflation has risen by more than 4%. The Fed's shift has not been enough to temper inflation. However, the latter is a lagging indicator, raising the risk that with too rapid of an adjustment, rates could overshoot the ideal threshold that would keep the economy in balance. As former Fed Chair and current Treasury Secretary Janet Yellen recently said, "it will require skill and also good luck." First off, it's never comforting that the central bank needs to rely on luck to achieve its goals. Secondly, it implies that bringing down inflation will require more than just the Fed. Think of it this way, if inflation were to stay at 8.5%, the Fed would need to raise rates by over 8% to get the real policy rate into positive territory to sufficiently restrict economic activity. This is where the luck comes in. The Fed needs some of the inflationary pressures related to supply disruptions to come off without having to raise rates to such great heights.

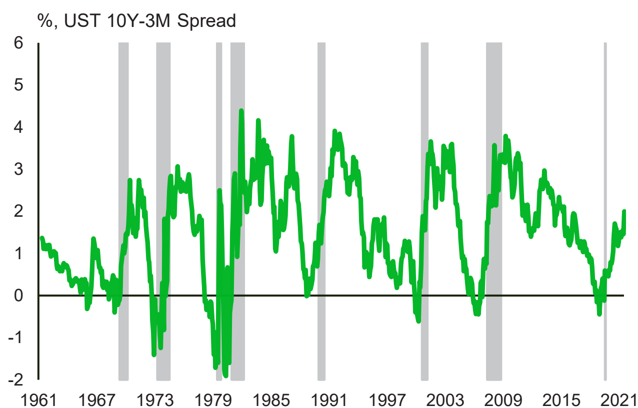
Supporting the notion that price gains are not solely a function of strong domestic demand forces, China's zero-covid policy has maintained tension on supply chains for more than two years since the start of the pandemic. Then along came an unanticipated war in Europe. This is forcing a sudden recalibration of food and energy supply, along

with a host of raw materials that were already facing challenges from pandemic disruptions, including shortages of inputs needed to make semiconductors.

Another price shock could appear at any moment, but the intensity is likely to be smaller going forward. For instance, used vehicle prices increased by 37% in 2021, contributing an outsized 1.3 percentage points to the U.S. CPI measure. While supply is slow to adjust due to ongoing disruptions, companies are increasing investment and production. Consumers have likewise shown their intolerance for an ongoing ascent in prices and, in the past two months, vehicle prices have leveled off. This will impose a downward pressure on overall inflation by year end.

It's often said that the cure for high prices, is high prices. Elevated inflation and rising interest rates will tighten consumer wallets, even in a persistently solid job backdrop. This should slow demand and ease some of the supply troubles. This combination would open the window for the Fed to slow the pace of rate hikes, which is why we have the hiking pattern shifting to 25 basis point increments in September, moving the policy rate to 2.5% by the end of this year.

In turn, the risk of yield curve inversion would be mitigated – a telltale sign that financial markets are upping the recession probability from 'maybe' to 'most likely'. If, instead, the Fed stays in the fast lane, we would expect to see yield inversion due to investor concern of an overshoot. Although the Fed will certainly need some luck as it tackles inflation, applying a careful approach once it moves past the neutral estimate will be imperative.



Let's talk recession

There is a lot of client discussion occurring about the risk of recession. History is littered with episodes where bouts of inflation and Fed rate hiking cycles push the economic drivers too far into contraction. Just recently, the spread on the 10-year Treasury yield was briefly eclipsed by the 2-year yield. This implies that markets (for that brief moment in time) thought the Fed was going to take rates too far within the next two years. As the Fed continues to raise rates in the coming months, there's a good chance the 10-year/2-year spread will flirt with inversion again, and potentially even the more closely analyzed 10-year/3-month spread (Chart 2). The Fed will be closely watching this and may have to slow or end its rate hiking cycle in order to avoid the negative sentiment from creating the outcome they are trying to avoid.

However, let's entertain the notion that this plane won't hit a soft landing. The word 'recession' is loosely thrown around, but rarely appropriately defined by the analysts using it. There is a big difference between a 2008 experience, and a 2001 cycle. Given that the U.S. economic cycle lacks the leverage excesses and the risky financial assets of 2008, a policy miss would more likely land us into shallow recession territory. In fact, American households in this cycle are far better positioned to withstand pressure, given that they have benefited from a 30% surge in net worth over the past two years, and continue to sit on excess savings, while facing a job market where there are more available jobs than available workers. These metrics leave plenty of buffer to withstand some erosion, without completely upending the cycle into a deep recession. In fact, since economic growth needs to recalibrate below potential to ease pressure on inflation, if it were to marginally overshoot and tread water in shallow negative territory for a short period, this should not be cause for panic. It could accelerate the recalibration. So, don't fear the recession, only fear the depth and duration.

Bank of Canada in a tight spot

The Bank of Canada (BoC) is facing similar issues as the Fed. In Canada, economic growth has rebounded in impressive fashion, with GDP tracking a robust 5.6% pace in the first quarter of this year. At the same time, the unemployment rate is beyond full employment at 5.5%, and inflation is running at 6.7% year-on-year. Although there

are differences in the timing of the economic reopening in Canada, and even in the composition of strength compared to the U.S., the song remains the same. The economy is hot and needs attention.

As a consequence, the BoC moved ahead of the Fed with a 50-basis point hike in April. We look for it to follow the same stages as the Fed, and continue with 50-point hikes until July, which will send the policy rate to 2%. At that point, it too will be surveying the inflation trends against the turning points of the economy. We currently have the BoC rate reaching a high of 2.5% in December, but admit there's upside risk to this forecast, discussed next.

Governments need to row in the same direction

When the pandemic struck, the central bank and governments were on the same page in both rhetoric and action. It was important to row in the same direction with policy. Central banks moved swiftly to cut interest rates and ensure stable lending facilities, while governments offered enhanced income supports to households and businesses. Now that we are on the other side of the cycle, the same should be occurring, but it's not. In Canada, government initiatives continue to add economic stimulus. In contrast, the U.S. has moved in the other direction. This means that the Bank of Canada may face a larger challenge than the Federal Reserve in snuffing out the inflation impulse. In addition, Canada has two times the population growth of the U.S., which means that when supply is already on the backfoot, it has a higher hurdle to jump to meet the demand needs for housing and other services.

We assess that the combination of net-new federal and provincial budget spending will add 0.5 percentage points to economic growth this year, at a time when activity is already pressing deep into excess demand territory, amidst labour shortages and households with excess savings.

From a household perspective, one of the biggest income transfer initiatives is related to last year's commitment of $10/day childcare, that will start flowing through to households. We are fully in agreement with this policy, but the timing happens to hit at an awkward moment in the cycle. Over time, lower daycare costs should alleviate pressures in the labour market by incenting higher female participation, but this will occur with a lag relative to the immediate distribution of funds. In addition, this year's provincial budget season revealed many other initiatives that were under the guise of providing support to households due to inflation, but ultimately were not restrained to low-income individuals who bear the brunt of the higher costs for necessities. To address high inflation, there needs to be some degree of demand destruction among those that can sustain the costs, mainly middle- and higher-income groups. If too many additional income supports occur, it can place more pressure on the Bank of Canada to act as 'the hammer' with its single, blunt policy tool: interest rates.

Even well needed and intentioned spending can do this by increasing the competition for the same resources when the economy is already stretched to its capacity limit. For instance, infrastructure spending was a key underpinning of every budget this season. The pandemic laid bare to significant deficiencies in healthcare and education facilities, while pressing on affordable housing options. Meanwhile, Russia's invasion of Ukraine brought clarity to the need for greater domestic defense spending. Not to mention the impact of various infrastructure spending plans across the country by all levels of government. However, this means that the government sector will be competing with the private sector for workers that are already in short supply. The Bank of Canada's Business Outlook Survey in April showed most businesses reporting that labour-related constraints and supply chain disruptions are affecting their ability to meet demand. The natural extension is greater wage-push inflation that can be compounded if the government sector is competing for the same labour and equipment, particularly anything that's in construction and trade. This labour competition is already underway in other areas. Relative to the pre-pandemic period, Canada has added 400,000 service sector jobs, of which public administration reflects 100,000 of those new workers.

If policy makers do not row in the same direction, the central bank may have to row even harder against the tide. Despite Canadian households having higher debt levels than their American counterpart and the associated risks to interest rate sensitivity, the Bank of Canada may have to act more aggressively than the Federal Reserve amidst stronger domestic demand fundamentals.

Interest Rate Outlook

Interest Rates	Spot Rate May-04	2021				2022				2023			
		Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CANADA													
Overnight Target Rate	1.00	0.25	0.25	0.25	0.25	0.50	1.50	2.25	2.50	2.50	2.50	2.50	2.50
3-mth T-Bill Rate	1.45	0.09	0.15	0.12	0.16	0.60	1.88	2.38	2.50	2.50	2.50	2.50	2.38
2-yr Govt. Bond Yield	2.62	0.22	0.45	0.53	0.95	2.27	2.80	2.85	2.80	2.60	2.50	2.35	2.20
5-yr Govt. Bond Yield	2.77	0.99	0.97	1.11	1.25	2.39	2.90	2.95	2.90	2.70	2.60	2.45	2.30
10-yr Govt. Bond Yield	2.92	1.55	1.39	1.51	1.42	2.40	3.00	3.05	2.95	2.80	2.65	2.55	2.45
30-yr Govt. Bond Yield	2.87	1.98	1.84	1.99	1.68	2.38	3.00	3.10	3.05	3.00	2.95	2.85	2.75
10-yr-2-yr Govt Spread	0.31	1.33	0.94	0.98	0.47	0.13	0.20	0.20	0.15	0.20	0.15	0.20	0.25
U.S.													
Fed Funds Target Rate	1.00	0.25	0.25	0.25	0.25	0.50	1.50	2.25	2.50	2.50	2.50	2.50	2.50
3-mth T-Bill Rate	0.86	0.03	0.05	0.04	0.06	0.51	1.75	2.25	2.40	2.40	2.40	2.40	2.40
2-yr Govt. Bond Yield	2.64	0.16	0.25	0.28	0.73	2.28	2.85	2.90	2.85	2.65	2.55	2.40	2.30
5-yr Govt. Bond Yield	2.91	0.92	0.87	0.98	1.26	2.42	2.95	3.00	2.95	2.75	2.65	2.50	2.40
10-yr Govt. Bond Yield	2.93	1.74	1.45	1.52	1.52	2.32	3.00	3.10	3.05	2.85	2.75	2.65	2.55
30-yr Govt. Bond Yield	3.03	2.41	2.06	2.08	1.90	2.44	3.05	3.15	3.10	3.05	3.00	2.95	2.85
10-yr-2-yr Govt Spread	0.29	1.58	1.20	1.24	0.79	0.04	0.15	0.20	0.20	0.20	0.20	0.25	0.25
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	0.59	0.06	0.10	0.08	0.10	0.09	0.13	0.13	0.10	0.10	0.10	0.10	-0.02
Can - U.S. 10-Year Bond Spread	-0.01	-0.19	-0.06	-0.01	-0.10	0.08	0.00	-0.05	-0.10	-0.05	-0.10	-0.10	-0.10

F: Forecast by TD Economics, May 2022; Forecasts are end-of-period.
Source: Bloomberg, Bank of Canada, Federal Reserve.

Foreign Exchange Outlook

Currency	Exchange rate	Spot Price May-04	2021				2022				2023			
			Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.61	6.55	6.46	6.44	6.36	6.34	6.39	6.44	6.49	6.54	6.59	6.64	6.69
Japanese yen	JPY per USD	129	111	111	112	115	121	130	125	120	115	110	105	103
Euro	USD per EUR	1.06	1.17	1.19	1.16	1.13	1.11	1.06	1.05	1.06	1.09	1.12	1.15	1.18
U.K. pound	USD per GBP	1.26	1.38	1.38	1.35	1.35	1.32	1.25	1.27	1.30	1.33	1.35	1.38	1.39
Swiss franc	CHF per USD	0.97	0.94	0.93	0.93	0.92	0.92	0.93	0.94	0.95	0.96	0.97	0.98	0.99
Canadian dollar	CAD per USD	1.27	1.26	1.24	1.27	1.28	1.25	1.26	1.25	1.24	1.25	1.25	1.25	1.25
Australian dollar	USD per AUD	0.73	0.76	0.75	0.72	0.72	0.75	0.72	0.72	0.72	0.73	0.73	0.74	0.74
NZ dollar	USD per NZD	0.65	0.70	0.70	0.69	0.68	0.70	0.67	0.67	0.67	0.67	0.68	0.68	0.69
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.06	1.17	1.19	1.16	1.13	1.11	1.06	1.05	1.06	1.09	1.12	1.15	1.18
Japanese yen	JPY per EUR	137	130	132	129	130	135	138	131	127	125	123	121	121
U.K. pound	GBP per EUR	0.84	0.85	0.86	0.86	0.84	0.84	0.85	0.83	0.82	0.82	0.83	0.83	0.85
Swiss franc	CHF per EUR	1.03	1.11	1.10	1.08	1.04	1.02	0.99	0.99	1.01	1.05	1.08	1.12	1.17
Canadian dollar	CAD per EUR	1.35	1.48	1.47	1.47	1.44	1.39	1.34	1.31	1.31	1.36	1.40	1.44	1.48
Australian dollar	AUD per EUR	1.46	1.54	1.58	1.60	1.56	1.48	1.47	1.46	1.47	1.50	1.53	1.56	1.60
NZ dollar	NZD per EUR	1.62	1.68	1.70	1.68	1.66	1.60	1.59	1.58	1.58	1.62	1.65	1.69	1.73
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	129	111	111	112	115	121	130	125	120	115	110	105	103
Euro	JPY per EUR	137	130	132	129	130	135	138	131	127	125	123	121	121
U.K. pound	JPY per GBP	163	153	153	150	155	160	163	159	156	153	149	145	143
Swiss franc	JPY per CHF	132.8	117.4	120.0	119.4	125.7	131.8	139.7	133.0	126.4	120.0	113.6	107.4	104.0
Canadian dollar	JPY per CAD	101.3	88.0	89.5	88.0	90.2	97.3	103.2	100.0	96.8	92.0	88.0	84.0	82.1
Australian dollar	JPY per AUD	93.7	84.2	83.2	80.6	83.3	91.1	93.6	89.9	86.8	83.6	80.4	77.2	75.9
NZ dollar	JPY per NZD	84.5	77.3	77.5	76.9	78.5	84.4	86.7	83.3	80.4	77.4	74.5	71.5	70.3
Exchange rate to Canadian dollar														
U.S. dollar	USD per CAD	0.79	0.80	0.81	0.79	0.78	0.80	0.79	0.80	0.81	0.80	0.80	0.80	0.80
Japanese yen	JPY per CAD	101.3	88.0	89.5	88.0	90.2	97.3	103.2	100.0	96.8	92.0	88.0	84.0	82.1
Euro	CAD per EUR	1.35	1.48	1.47	1.47	1.44	1.39	1.34	1.31	1.31	1.36	1.40	1.44	1.48
U.K. pound	CAD per GBP	1.61	1.73	1.71	1.71	1.72	1.64	1.58	1.59	1.61	1.66	1.69	1.73	1.74
Swiss franc	CHF per CAD	0.76	0.75	0.75	0.74	0.72	0.74	0.74	0.75	0.77	0.77	0.77	0.78	0.79
Australian dollar	AUD per CAD	1.08	1.04	1.08	1.09	1.08	1.07	1.10	1.11	1.11	1.10	1.09	1.09	1.08
NZ dollar	NZD per CAD	1.20	1.14	1.15	1.14	1.15	1.15	1.19	1.20	1.20	1.19	1.18	1.18	1.17

F: Forecast by TD Economics, May 2022; Forecasts are end-of-period.
Source: Federal Reserve, Bloomberg.

Commodity Price Outlook															
Commodity	Price	52-Week	52-Week	2021				2022				2023			
	May-04	High	Low	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	108	124	62	58	66	71	77	94	110	100	90	85	80	76	73
Natural Gas ($US/MMBtu)	8.29	8.29	2.78	3.56	2.94	4.36	4.77	4.66	4.60	4.40	4.20	4.00	3.80	3.60	3.50
Gold ($US/troy oz.)	1881	2051	1726	1796	1815	1790	1796	1876	1950	1850	1800	1809	1818	1827	1836
Silver (US$/troy oz.)	22.98	28.19	21.54	26.25	26.71	24.30	23.35	24.05	25.00	24.00	23.00	23.12	23.23	23.35	23.46
Copper (cents/lb)	427	513	403	385	439	425	440	453	460	440	425	427	429	431	434
Nickel (US$/lb)	14.05	21.81	7.62	7.97	7.86	8.67	8.99	12.73	15.00	14.00	13.00	13.07	13.13	13.20	13.26
Aluminum (Cents/lb)	132	175	108	95	109	120	125	148	150	135	120	121	121	122	122
Wheat ($US/bu)	13.38	13.88	8.11	7.41	8.53	10.27	11.44	11.55	13.00	12.00	11.00	11.06	11.11	11.17	11.22

F: Forecast by TD Economics, May 2022; Forecast are period averages; E: Estimate.
Source: Bloomberg, USDA (Haver).

Global Stock Markets					
Major Market Indexes	Price May-04	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	4,300	-5.4	-9.8	4,797	4,063
S&P/TSX Composite	21,185	-3.5	-0.2	22,087	19,108
DAX	13,971	-3.3	-12.0	16,272	12,832
FTSE 100	7,493	-0.6	1.5	7,672	6,844
Nikkei	26,819	-3.1	-6.9	30,670	24,718
MSCI AC World Index*	656	-7.9	-13.1	759	654

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

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