Market Insight:
Central Banks Getting Hawkish

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Highlights

- Bond yields are rising on the expectation that central banks will speed up the start of their interest rate hiking cycles.
- The Federal Reserve poised to take a first step in reducing its support by tapering its Quantitative Easing (QE) program as early as this week and is likely to execute its first interest rate hike in the coming months.
- As the hiking cycle gets further cemented in market pricing, this will provide even greater upside for government yields.

The time has finally arrived. Central bankers have pivoted to a more hawkish tone, preparing markets for the inevitable – higher policy rates. Vaccines have supported domestic economic resilience in the face of COVID variants. Meanwhile, determination and stubbornness are highly regarded characteristics when it comes to economic progress. The same cannot be said when it comes to high inflation. This economic backdrop no longer warrants emergency-level monetary settings, pivoting central banks to speed up the timing of policy normalization.

The Great Pivot

Several central banks have already taken their first steps down this path. Some have lifted the policy rate, while others have ceased Quantitative Easing (QE, Table 1). The Bank of Canada (BoC) was the latest to join the ranks of those ending QE, providing it the flexibility to pursue rate hikes at any point in 2022. In contrast, the Federal Reserve's more cautious approach will leave it lagging many of its peers, risking a greater overheating of inflation, should supply-side dislocations persist for longer than expected.

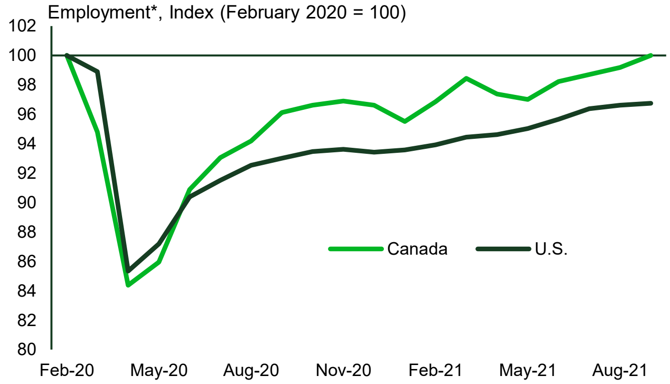
Why the difference in approach? Much comes down to labor market conditions. Countries like Canada have enjoyed a rapid return to pre-crisis job levels, while the U.S. continues to dig out (Chart 1). This better positions the recovery to be supported by wage and salary growth. When coupled with already-high levels of savings and wealth, Canada has a trifecta of strong domestic demand forces. Federal Reserve action has also been stymied by a slow recovery in labor force participation, whereas

Table 1: Central Banks Turning Hawkish

Already hiking	Getting ready to hike	Getting ready to cut QE
RBNZ	BoC	Fed
BoK	BoE	ECB
Norges		BoE
Banxico		RBA

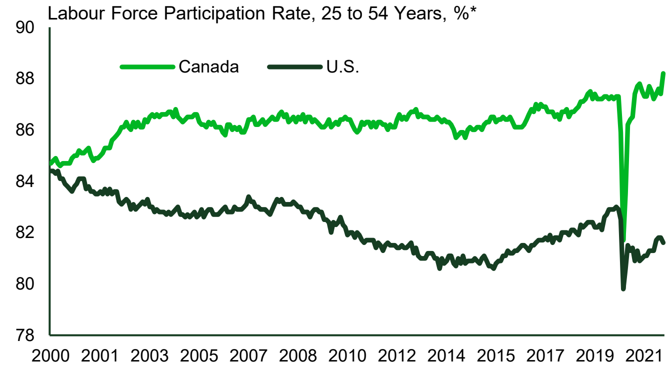
Source: TD Economics.

Chart 1: U.S. Still Lagging Canada on Employment Gains



*Seasonally adjusted.
Source: Statistics Canada, Bureau of Labor Statistics, TD Economics. Last observation: September 2021.

Chart 2: Labour Force Participation a Headwind in the U.S., A Tailwind in Canada



*Seasonally adjusted.
Source: Statistics Canada, Bureau of Labor Statistics, TD Economics. Last observation: September 2021.

its northern neighbor does not face the same constraint (Chart 2). The Fed has a mandate to consider not just inflation outcomes, but also the broader progress of the labor market. The latter remains a diminished representation of its former self, which the Fed has interpreted as requiring more patience relative to other central banks.

However, since the Fed acts as the central banker to the world, erring on the side of too much patience could eventually lead to a faster rate-hike path. This would impart tremendous influence over global yields that may disrupt both the domestic and the broader global economy. Waiting to strike a perfect balance between inflation and labor market health is a risky proposition, and the Fed will have to settle for 'good enough'.

The tapering of its balance sheet will commence in the coming weeks, allowing for an end to all net-new purchases in the first half of 2022. This will open the door for rate hikes in the months that follow. By the time the Fed ends QE, the economy will likely be in excess demand. In other words, transitory inflationary forces due to pandemic-related supply disruptions will be amplified by strong demand-side forces related to domestic fundamentals. A highly stimulative zero-policy environment, implemented in response to a crisis, will not be sufficient to counter these kind of demand-push dynamics. We anticipate that the Fed will be compelled to start its rate-hiking cycle in the first half of 2022, followed by one hike every three months until the policy rate reaches 2%. This course is not set in stone. If inflation proves sturdier and market expectations begin to reflect this paradigm, the timing and speed may be pulled forward.

Yields have been on an upward trajectory from exceptionally low levels since the end of September. We expect the U.S. 10-year yield to rise another 50 basis points to 2.0% over the next six months. This would return longer term yields to levels seen in the 2014-2017 period.

The notion of yields this high has caused some nail-biting among analysts who fret about weaker longer-term growth prospects. Some point to the compression in the UST 10-2 year spread as a cautionary signal. This angst is typical when markets must adjust to a new direction in central bank communication, but a flatter yield curve is a natural by-product of higher policy rate expectations. The current spread of 100 basis points is nowhere near levels that signal caution. In fact, this spread should continue to narrow to about 0.25% over the next two years. It's important to bear in mind that having monetary policy set for 3-4% economic growth, when capacity can only accommodate 2% on a sustainable basis, can quickly create asymmetrical risks to inflation and asset prices. Those on the other side of the debate argue that the U.S. and other nations may already be staring down this barrel.

Bottom Line

With the durability of the economic recovery and the persistence of high inflation, central bankers around the world are moving to reduce pandemic-driven monetary policy supports. The Fed will be among the laggards, but it will begin to taper its emergency QE program soon and create the opportunity to raise interest rates from emergency levels in the first half of 2022.

The Fed is focused on employment gains, with the goal of closing in on maximum employment. But, threading the needle in an already elevated inflation environment could lead to a policy error. Central bankers are mindful that risks are two-sided. Hiking a little earlier and leaving sufficient time between policy decisions to monitor outcomes helps to mitigate the adverse impact of leaving policy rates too low for too long.

The yield curve will continue to respond as the months roll forward, putting upward pressure on a wide array of lending rates from corporate bond yields to individual mortgage rates. The time for patience on monetary policy is ending.