Who's Afraid of the Big, Bad Fed?

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The drumbeat on coming Fed rate hikes grew louder this week. At nomination hearings before Congress, both Chair Powell and Governor Brainard made a strong case for removing ultra-accommodative policies, and with some haste. And a string of Fed officials chimed in with open remarks that a rate move was possible as soon as the March FOMC meeting—our trusty Fedspeak decoder indicates that "*it's possible*" translates to "*it's probable*". Many members appear to view three hikes as the "baseline" for 2022; but, again, many are also openly discussing the *possibility* of more hikes—i.e., it's probable. The as-expected hot December inflation reading simply added to the mix, solidifying rate hike expectations. So, **which markets showed fear in the face of a tougher Fed?**

Not bonds: After a big back-up in yields early in the year on the hawkish Fed Minutes, they were mixed this week, with a moderate flattening trend. Ten-year Treasuries stepped back a notch after flirting with two-year highs of 1.8% on Monday. In fact, these yields are currently a touch below their Canadian counterparts, even with much hotter inflation stateside. U.S. yields were partly kept in check by a surprisingly sluggish December retail sales result (down 1.9% m/m), as well as a mostly mixed bag of other major indicators this week. We look for long-term yields to push higher this year, but this week's consolidation suggests it's not going to be a straight trip north.

Not oil: Crude oil prices built on last week's rally and are again close to seven-year highs at almost $84/bbl. Energy prices are on the march generally, brushing aside Omicron-related concerns on the travel outlook. Suffice it to say that the fast rebound in oil prices complicates an already-fraught inflation backdrop. We have nudged up our assumption on WTI for this year to $75; if current price levels hold (or even rise), that would add further to our above-consensus inflation projections for 2022.

Not metals: Largely ignoring any growth dampening hit from interest rate hikes, many base metals are seeing a rollicking recovery to start the year. Even with a setback on Friday, copper is spying all-time highs again, while nickel is at decade-highs. These metals are particularly benefitting from the decarbonization drive, but aluminum and zinc are also strong amid still-solid global recovery prospects.

Not currencies: The broad U.S. dollar index has been softening in the past month, even with the aggressive hawkish Fed pivot over that period. It's not a huge move—the euro is up less than 2% in the past month—but notable, nonetheless. The **Canadian dollar** has managed to climb back up to around the 80-cent level ($1.25/US$) after dipping as low as 77 cents a month ago. In that case, the roaring rebound in oil has likely overwhelmed a further tightening in Canada/US spreads. The gap on two-year yields has tightened to below 20 bps after peaking at about 60 bps at the start of November, as markets have reconsidered the likelihood of the BoC far outpacing Fed tightening. A purer example of the big dollar's step-back is against the Aussie dollar—

the latter has managed to climb almost 3% in less than two months, even with the Fed pivot. (Perhaps Novak Djokovic & entourage were big buyers of the currency?)

Not value stocks: While some of the broadest equity averages took another modest step back this week, there are certainly many sectors holding up well in the face of a more hawkish Fed. To wit, the TSX edged higher for the week, and is actually at a small gain for the year. (Okay, yes, the year is less than 4% old.) Cyclically sensitive stocks, energy, and financials are all managing just fine, with the latter even poised to partially benefit from a rising rate environment.

Long-duration equities? Yep. The one big corner of the market that has clearly been exposed by the tide rushing out has been high-multiple, or growth, stocks. The Nasdaq has stumbled out of the gate in 2022 with a 6% setback. No doubt, many of these high-flying companies have tremendous long-term potential. But those distant earnings prospects face the cold calculation of being discounted by current yields, so the Fed's sudden turn is a clear-cut headwind for lofty valuations.

The bravery in other corners of financial markets to coming Fed rate hikes may well get tested in the months ahead. **We brought forward our view on the Fed this week, and are now looking at a March rate hike, and then a steady series of 25 bp moves every quarter until we are roughly back to neutral at just above 2%.** However, there is the very real possibility that the Fed will move faster and perhaps ultimately do more than what markets are pricing. After all, just one short month ago, the prevailing view was that the Fed wouldn't end QE until the middle of 2022, and then begin a leisurely pace of rate hikes in H2. Fast forward to today and now they're going in March and looking at QT before year-end.

Who is to say that the Fed won't again accelerate the pace of proceedings at some point this year? It was not so long ago—2006 to be precise—that the Fed was hiking every meeting (for 17 meetings!). There is also the outlier possibility that the Fed truly senses danger on the inflation front and that they move by more than 25-bp clips. There actually was one 50 bp hike in this century (May 2000), and—way back in the mists of time—the cycle before that saw the Fed going at 50 bp clips on a regular basis (and included a 75 bp volley in November 1994).

We are not yet forecasting anything so aggressive, but simply noting that Fed officials have rapidly adjusted their view on the inflation landscape in recent weeks and may be forced to do so again. To gauge the risks of that, we must ask: **What flipped the Fed's switch?** It was likely a number of factors, including clear evidence that supply bottlenecks weren't fading. But, most important, were likely two factors hiding in plain sight—both sides of their policy mandate roared to life.

- On the **employment** side, we haven't seen anything like the plunge in the jobless rate in the second half of last year in 70 years (aside from the wildness in 2020). With December's drop, the unemployment rate fell 2 full percentage points in six months. For reference, at the June 2021 FOMC meeting members did not see the jobless rate falling below 4% until the end of 2022, whereas it reached that milestone last month.
- On the **inflation** side of the mandate, core prices roared back after a seeming lull in the summer. Recall that core PCE rose at an average monthly pace of 0.6% in

Q2, but that was largely put down to soaring used car prices and airfares. And, sure enough, core calmed to a more tolerable 0.3% monthly pace in Q3. But, prices then suddenly regained momentum in Q4, and perked back up to a too-hot-for-comfort 0.5% pace (with the December 0.6% rise in core CPI suggesting more of the same), burying the transitory rhetoric. A meaty rise in December would lift the annual rate on the Fed's key inflation measure close to 5% y/y, boosting the two-year gain to above 3% (annualized).

So, to answer the question to this piece, it may not be long before many more show some fear of the Fed, even with the generally brave face so far. The difference with tightening cycles of the recent past is that the Fed doesn't have the low-inflation luxury of being able to back off if the waters get choppy, not with core inflation around 5% and the headline at 7%.

This week's U.S. CPI reading gave a whole new meaning to the 7% solution, famously clocking in at the fastest pace since the summer of 1982. Canada's December CPI reading is up next week, and it is expected to remain at a less heated pace. We look for prices to be little-changed in the month, holding the annual inflation rate a bit below 5% (4.8% to be precise). **How much of that hefty U.S./Canada inflation gap of more than 2 percentage points is real, and how much is statistical illusion?** For example, some have decried the absence of used car prices from Canada's CPI—that factor alone accounts for almost half the inflation spread between the two countries.

Still, on the other side, airfares in Canada have reportedly been much firmer than their U.S. counterparts in the past year, while U.S. shelter costs are really only starting to stir. And, at least so far, Canadian wage trends have been much milder than the U.S. pace of nearly 5%. On balance, the groaning inflation gap may be a bit of an overstatement, but we suspect there truly is more of an inflation issue facing the U.S. at present. And, accordingly, we also believe that it is the Fed that must now act with some urgency, and less so the Bank of Canada.

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