New Year, New Policies

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Starting off the first week of 2022, it is safe to say that only a rarified few had circled the FOMC Minutes as the main event. But the scribblings from three weeks earlier landed with a great thud on financial markets, sending a clarion call that **the game had truly changed**. Yes, we have had plenty of warnings in the past month, from Chair Powell's assertion that Omicron heightened, not lowered, inflation risk, to Governor Waller's warning that the March meeting was "live" (which St. Louis President Bullard was only too happy to agree with this week). And, of course, there was the Fed's own projections from the—now infamous—December FOMC meeting, which looked for three rate hikes this year. But the new news in the Minutes was that many members are already openly discussing running down the balance sheet (i.e., quantitative tightening), and with some haste. This clearly signals that **the Fed is now deeply concerned about the inflation backdrop**, shifting from "*transitory*" to trepidation in a matter of weeks.

Doing nothing to soothe those mounting concerns, **oil prices have staged a spectacular recovery** after a brief swoon when the news on Omicron first emerged six weeks ago. After quietly powering higher in the holiday week, WTI rose another 5% this week to around $80, or essentially back to mid-November levels. That's up from as low as $65 a month ago, a fast rebound which will soon reverse any temporary relief in some headline price metrics. (For example, U.S. gasoline prices dipped roughly 3% last month, which will help contain CPI…somewhat. We still expect next week's key CPI to print 7% on the headline rate and a hot 5.3% on core.)

Then there is the **December jobs report**, which felt uncannily similar to the prior month's release. Again, the headline print fell well shy of expectations at 199,000. But, again, that's where the bad news ended, as the report was replete with big upward revisions to earlier months and contained a big gain in the companion household survey (jobs up 651,000). The latter helped chop the unemployment rate yet again to just 3.9%. While the big gap in payroll and household job tallies may raise some eyebrows, note that the latter may just be playing catch-up—for all of 2021, both saw monthly average gains of more than 500,000.

The theme of a tightening job market was reinforced by the **record level of quits** reported earlier in the week (a staggering 4.5 million, or a 3% rate), as well as 10.6 million open jobs (versus now just 6.3 million officially unemployed). As a result, wages continue to simmer. Perhaps the most notable surprise in the jobs data was the piping hot 0.6% rise in **average hourly earnings** last month. While this actually trimmed the yearly pace to 4.7% (from 5.1%), it will provide the Fed with precisely zero comfort. Recent trends in wages are heading due north, with earnings rising at above a 6% clip since the summer.

The double punch of robust wages and a plunging jobless rate kept the flame flickering on bond yields, even with the dud headline payroll rise. As of mid-morning Friday, it was the middle part of the curve that took the heaviest hit this week, with 5-year yields sprinting 24 bps to around 1.5%, while 10s jumped 25 bps to just above 1.75%—rivalling the highs hit last March. The move in yields has mostly been in real rates, not inflation expectations, with the Fed's hawkish vibe leading the charge. **Markets are now pricing in a reasonable chance of a March rate hike, and—while we expect them to start a bit later—nothing can be ruled out, given the abrupt pivot by the Fed in recent weeks.** We remain comfortable calling for three rate hikes, but readily recognize the risks of more and earlier.

Where does this leave the Bank of Canada? Well, it's **complicated**. On one side, the Bank has been signaling greater concern on the inflation front for longer and was well ahead of all others on winding down QE. But, on the other side, the restrictions on the Canadian economy are much more intense, with both Ontario and Quebec stepping in with aggressive new measures this week to stem the wave of new Omicron infections. While it was partly predictable that Canada would see deeper restrictions, the degree is surprising, prompted by a sudden rise in hospitalization rates in the past week. By some measures, Canada is now facing some of the most intensive restrictions in the world, aside from some locked down cities in China. At the very least, this will skewer activity in January, and could lead to a repeat of last spring when the economy stepped back for a full quarter (GDP fell at a 3.2% a.r. in Q2 following restrictions in Ontario and elsewhere). It's possible this wave of closures is briefer, albeit more widespread.

But complicating matters for the BoC is that it is clear that **the economy had powerful momentum heading into year-end**—and, by extension, could rebound quickly again when this wave of restraints passes. To wit, **employment** easily cruised above modest expectations last month, rising by a sturdy 54,700, powered by a hefty 122,500 jump in full-time positions. Combined with a strong **trade** report for November (overcoming the B.C. floods), it now looks like GDP will easily surpass our prior call of 4.5% in Q4. Sectors less affected by restrictions (e.g., construction and manufacturing) led the way, and even the hospitality sector saw only a small dip in jobs last month. The market tightened further, with the jobless rate dipping a tick to 5.9%, although a back-up in January is expected. As well, in contrast to the U.S., **wages remain mild**, as average hourly pay was up a calm 2.7% y/y. Canada's **participation rate** is back to normal, with the core age group at a record high, helping contain wage pressures.

And then there is housing—and, for Canada, it always seems to come back to housing. Sales remained firm in December in most major cities, and prices continued to rip, in an extremely tight market. For example, the HPI benchmark index soared 31% y/y in the Toronto region, matching the height of the 2016/17 froth, when policymakers stepped in with a suite of measures to cool the market. While many assert that BoC policy should not be aimed at a specific sector like housing, the reality is that soaring home prices will both seep into the official inflation stats as well as keep a blazing fire under inflation expectations. Moreover, the persistent strength in housing is a clear symptom of a bigger theme—**ultra-loose policy has caused widespread asset price inflation**, which has become too much of a good thing. No doubt, the Fed has arrived at the same conclusion (finally) in recent weeks.

On balance, even with the expected short-term plunge in activity around the turn of the year, we suspect that this will not meaningfully affect the timing on potential BoC rate hikes. True, a January hike looks like an extreme long shot (even as the market continues to price in reasonable odds of such), but policymakers could be opening the door for rate rises as soon as that meeting—with the timing ultimately dependent on how soon the current COVID wave crests. **We continue to circle the April meeting for the first rate increase;** then, expect them to move with some haste, especially if it is apparent that activity is rapidly recovering from the current restrictions.

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