Focus

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Who's Afraid of the Big, Bad Fed?

Douglas Porter, CFA,
Chief Economist
douglas.porter@bmo.com

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 $83/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 5% 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.

U.S. Inflation: Unlucky 7

Michael Gregory, CFA,
Deputy Chief Economist
michael.gregory@bmo.com

The annual change in the **U.S. CPI** hit 7% in December, the highest headline inflation rate in 40 years. Excluding food and energy, the CPI increased 5.5%, the loftiest core inflation rate in 30 years and just a tenth away from also being the highest since 1982. Even if these rates are primed to move lower past the winter months, as last spring's price surges owing to reopening exit the annual comparisons, the fact is that **extremes matter**.

If you're under 40, and 51% of Americans are, then these are the fastest inflation rates you've seen in your lifetime. For this majority, along with retirees on fixed incomes and those who can well remember when inflation ran at double-digit rates, how can these extremes not influence expectations about what inflation will be in a year or three—even by just a bit? With the economy plagued by labour shortages and supply bottlenecks and having a massive amount of liquidity sloshing around within it, **even tiny tweaks to expectations have a greater chance of becoming self-fulfilling prophecies**.

In response to rising inflation expectations, more workers could ask for higher wages or quit to go where they are higher. In today's tight labour market, with wage gains topping 4½% amid record high quits rates, many employers will have no choice but to pay up and hope they can cover at least some of the cost increases by lifting selling prices. To avoid future price hikes, more consumers could spend sooner rather than later which will exacerbate current supply bottlenecks. And, to counter the expected erosion in their purchasing power, more households could draw from their 'excess' savings, which, in the inflation process, is akin to receiving compensating wage gains.

Amid these expectations-stoking extremes, **core inflation likely hasn't even peaked yet** and this could be the case for headline inflation as well. For the total CPI, the first two monthly changes of this year will be compared to last year's 0.3% and 0.4%. However, for the core CPI, the first three moves will be compared to 2021's 0.0%, 0.1% and 0.3%. Inflation peaks will likely occur in Q1 (if not already in December for the headline), given that last year's monthly changes for the remaining period until June surged to the 0.6%-to-0.9% range as the economy reopened.

Importantly, **2021 concluded with strong inflation momentum**. In the three months ending December (which is far removed from last spring's surges), the total CPI increased 9.1% annualized with the core CPI increasing 6.9%. These translate to average monthly moves of 0.7% and 0.6%, respectively. December's advances alone were 0.5% and 0.6%, with the headline helped by lower energy prices. But both crude oil and natural gas prices have since rebounded.

During the first half of this year, the trend in monthly moves will not only determine when, and at what level, inflation rates peak, but also how much of the impact of last spring's surges dropping out of the annual comparison will be muted. For example, if Q4's trends persist through H1 (not impossible), then headline inflation would first peak at 8.1% in March with core inflation peaking at 6.7%. Then, as last spring's surges exit the annual comparisons, headline inflation would be 7.9% by June, with core inflation at 5.8%. Admittedly, 9%- and 6%-range annualized trends seem excessive. If we assume a more reasonable 4½% annualized path across the board (which translates to monthly moves averaging 0.37%), then headline inflation would peak at 7.2% in February with core inflation peaking at 6.1% in March. The mid-year readings would be 5.6% and 4.6%, respectively. The key is that with historically high starting points and strong momentum to start the year, we could still be left with relatively high inflation readings after the reopening surges wash out.

The coming trend could be slower still. However, with items such as rents and owners' equivalent rent (with their combined 31% weight in the total index and 40% weight in the core) on track for 0.4%-plus monthly gains, supply bottlenecks only slowly being remedied, and at least mildly extrapolative expectations (and consequent behavioural changes) prodding the inflation process, **the days of modest monthly moves in the CPI seem behind us for the time being**.

This week we **raised our inflation forecast**. By year-end, we now see total and core CPI inflation around 3¾% and 3½%, respectively, with the annual change in the total and core PCE price indices around 3½% and 3¼%, respectively. These were all under 3% before, and for the PCE indices, they are now well above the FOMC's 2.6%-to-2.7% median forecast from last month's Summary of Economic Projections. These latter facts emphasize the net upside risk to our Fed call.

We also pulled forward our call for Fed liftoff to March from June, and the kickoff of a quarterly rate hike campaign. We suspect the FOMC is concluding that tightening sooner is a means to minimize the influence of high (and potentially higher) inflation readings on already stirring expectations. And, given stubborn bottlenecks, it's becoming increasingly clear that the inflation process is not going to be adequately checked unless the demand side is also curbed.

The week's Fed speakers have all either emphasized the chance of a March rate hike or at least not talked down the odds of one. However, we were struck by a couple comments about what happens if inflation still surprises on the upside (which we think it will from the Fed's perspective). In the nomination hearing, **Chair Powell** said: *"If we see inflation persisting at high levels longer than expected [and]... we have to raise interest rates more over time we will."* Later, **Governor Waller** (self-acknowledged in the three-hike camp) said the rate path depends on *"what inflation looks like in the second half of the year. If it continues to be high, the case will be made for four, maybe five hikes."* It appears that the acid test for the Fed will be how inflation unfolds in the second half of this year, during which time the FOMC could either start speeding up tightening or slowing it down, amid a likely Q4 commencement of balance sheet runoff. We reckon the net risk lies on the side of a quicker track to a neutral rate setting.

Priscilla Thiagamoorthy,
Economist
priscilla.thiagamoorthy@
bmo.com

Indications of stronger growth and a move toward price stability are **good news** *for the economy.*

United States

- Fed Chair Powell pledges to tame inflation
- Some Fed officials support a March rate hike
- Fed's Beige Book: economic activity grew at a "*modest pace*"
- Greenback weakens against the majors

Good News

NFIB Small Business Optimism +0.5 pts to 98.9 (Dec.)

Budget Deficit narrowed to $21.3 bln (Dec.)

Business Inventories +1.3% (Nov.)

Bad News

Retail Sales -1.9% (Dec.)

Industrial Production -0.1% (Dec.)—and **Capacity Utilization Rate** -0.1 ppts to 76.5%

Consumer Prices +7.0% y/y (Dec.)—fastest in almost 40 years

Producer Prices +9.7% y/y (Dec.)

Import Prices +10.4% y/y (Dec.)

Initial Claims climbed 23k to 230k (Jan. 8 week)—but continuing claims plunged further

U of M Consumer Sentiment -1.8 pts to 68.8 (Jan. P)

China

- More cities facing lockdown measures

Good News

China—Exports +20.9% y/y (Dec.)

Consumer Prices +1.5% y/y (Dec.)

Aggregate Financing 2.4 trln (Dec.)—**and New Yuan Loans** 1.1 trln

M2 Money Supply +9.0% y/y (Dec.)

Bad News

Imports sharply slowed to +19.5% y/y (Dec.)

Producer Prices +10.3% y/y (Dec.)—but easing

Japan

- Yen stabilizes from weakest levels in 5 years

Good News

Machine Tool Orders +40.5% y/y (Dec. P)

Bank Lending ex-Trusts +0.5% y/y (Dec.)

Bad News

Current Account Surplus narrowed to ¥897.3 bln (Nov.)

Europe

- PM Johnson under fire after public learns of COVID violations at start of pandemic

Good News

Euro Area—Jobless Rate -0.1 ppts to 7.2% (Nov.)

Euro Area—Industrial Production +2.3% (Nov.)

Italy—Jobless Rate -0.2 ppts to 9.2% (Nov.)

Italy—Industrial Production +1.9% (Nov.)

U.K.—Monthly GDP +0.9% (Nov.)—and **Services Index** +0.7%

U.K.—Industrial Production +1.0% (Nov.)

U.K.—Trade Deficit narrowed to £11.3 bln (Nov.)

Bad News

Euro Area—Trade Deficit €1.3 bln (Nov.)

Italy—Retail Sales -0.4% (Nov.)

Other

- Bank of Korea hikes rates 25 bps to 1.25%

Good News

Australia—Retail Sales +7.3% (Nov.)

Australia—Building Approvals +3.6% (Nov.)

Bad News

Australia—Trade Surplus narrowed to $9.4 bln (Nov.)

Taylor Says: The Fed Is Far Too Lax

Sal Guatieri,
Senior Economist
sal.guatieri@bmo.com

"*The economy no longer needs or wants the very accommodative policies we have had in place.*"—Fed Chair Powell, January 11, 2022

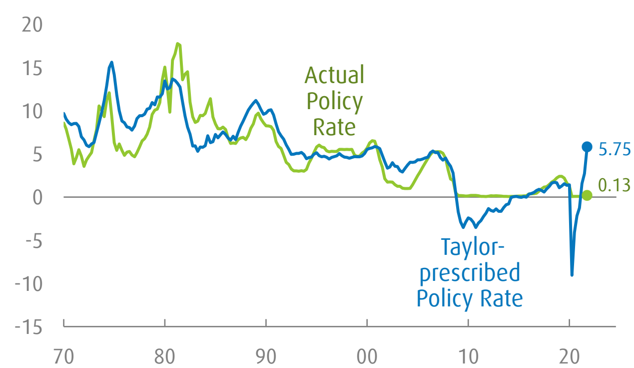
How loose is U.S. monetary policy? Are the levers calibrated just right to sustain maximum employment and price stability; or, are they set too loose, risking the need for corrective action that could send the economy into a tailspin? One simple way to help answer this question is with the **Taylor rule**, named after the Stanford University economist who created it in 1993 [1]. In its simplest form, the rule prescribes an optimal policy rate to achieve full employment and price stability. If inflation is above target or the jobless rate too low, the rule recommends raising the policy rate, and vice versa. When full employment and price stability are reached, the rule suggests keeping the policy rate at a neutral level consistent with both goals.

The Taylor rule has gone through many iterations since inception. **We use a standard version adopted by the Atlanta Fed** [2]. It recommends a policy rate based on: the deviation of the current policy rate from neutral; the gap between current inflation (the year-over-year change in the core PCE measure) and target inflation; and the difference between the actual unemployment rate and its sustainable rate (we use the median FOMC member's estimate of 4.0% for the current period and an estimate by the Congressional Budget Office for the historical period). For the neutral policy rate, i.e., the rate consistent with full employment and price stability, we use the median FOMC member's estimate of 2.5% (as of December 2021) for the current period. Subtracting the inflation target implies a neutral *real* policy rate of 0.5% today. The neutral real policy rate has likely fallen in recent decades due to lower potential growth, excess global savings, and higher debt levels, and the downward trend is confirmed by a decline in the ten-year rolling average real policy rate since the 1990s. This is the series used for the neutral real policy rate in our Taylor rule calculation over history.

Chart 1 plots the actual fed funds rate against the recommended rate back to 1970. Note three things: First, the Taylor rule broadly tracks actual policy, albeit with periodic wide gaps. Second, the prescribed rate was negative after the 2008 financial crisis and the 2020 pandemic shutdown, warranting quantitative easing in lieu of negative policy rates to address high unemployment and low inflation. Third, and most relevant to our discussion, **the rule suggests the Fed's policy rate should be almost 6% today**. (By comparison, the rule suggests the Bank of Canada's policy rate should be around 2½%, a far smaller deviation from actual policy.) One caveat is that current U.S. core inflation of 4.7% partly reflects low prices a year ago. But even using the two-year annualized rate of 3.0% to filter out so-called base effects suggests the policy

Chart 1
Tracking the Fed

United States (percent)



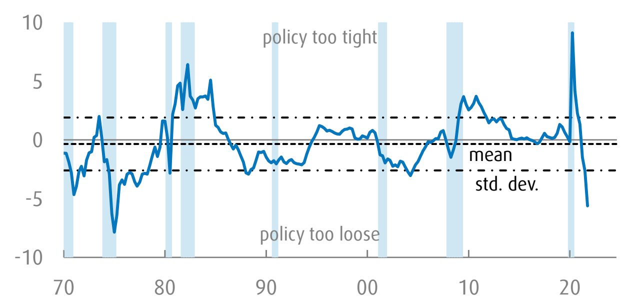
Sources: BMO Economics, Federal Reserve rate should be close to 4%. Moreover, given expected increases in wages and rents, the yearly rate could be the better proxy of trend inflation, as suggested by shorter-term price movements.

In either case, with the actual funds rate close to zero, **the current policy stance is the laxest since the mid-1970s**. This was the last time the recommended policy rate deviated from the actual rate by more than two standard deviations on the high side. In fact, policy is likely even looser today since a doubling of the Fed's balance sheet over two years has applied further downward pressure on longer-term borrowing costs.

Chart 2 hints at the **possible cost of running a too-loose policy**. Five of the last seven U.S. economic downturns (in 1974, 1980, 1981, 1990, and 2008) were preceded by an actual policy rate that was well below the recommended rate, albeit with a lengthy lag. Prior to the downturn, inflation pressures and financial imbalances emerged to eventually derail the expansion. In most cases, the Fed needed to over-tighten policy to remedy the situation, resulting in a downturn. Ominously, the mid-1970s was also plagued by both double-digit inflation and a recession.

Chart 2
That '70s Show

United States (ppts)
Actual Policy Rate less Taylor-prescribed Rate



Shading marks periods of U.S. recession
Sources: BMO Economics, Federal Reserve

Of course, as its name implies, the **Taylor rule isn't a hard-and-fast law**. It leaves no room for the many nuances that decision makers need to consider when setting policy, such as a pandemic. Despite the adverse effect on supply and inflation, COVID-19's severe impact on some sectors and uncertain path likely warrant an easier policy stance than a simple rule suggests. For this reason, the Taylor rule is often only one of many inputs used to inform central bank judgement.

Still, at the very least, the Taylor rule shouts that the **Fed has put too much rum in the punchbowl**. Ultra-loose policy has fed excess demand, thereby contributing to supply shortages and inflation pressures. *(For more on this topic, see Robert Kavcic's article, "Extraordinary Popular Delusions and the Madness of Policymakers" on page 10.)* It may also have fuelled excess risk taking and asset price imbalances that threaten to come to the fore. Most disturbing, by trying to juggle several goals—price stability, maximum jobs, inclusive recovery—the Fed now risks fumbling all three.

Endnotes:

[1] http://web.stanford.edu/~johntayl/Papers/Discretion.PDF [^]

[2] https://www.atlantafed.org/cqer/research/taylor-rule.aspx [^]

Extraordinary Popular Delusions and the Madness of Policy

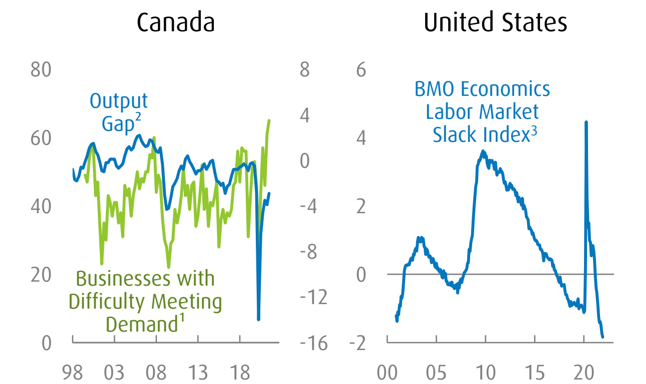
Robert Kavcic,
Senior Economist
robert.kavcic@bmo.com

Policymakers reacted to the pandemic with a swift and aggressive response, which was appropriate early on given the unknowns facing the economy. But, as the pandemic progressed it became clear that **policy was left far too stimulative, for far too long**, resulting in inflation pressure and some excesses in asset prices. That has been partly the result of some key misinterpretations, which we highlight below.

Belief: *There is considerable excess capacity in the economy.* ***Reality:*** *There's next to none.*

The Bank of Canada's latest policy statement argued that, *"in view of ongoing excess capacity, the economy continues to require considerable monetary policy support"*. Meantime, the Federal Reserve has maintained interest rates at the lower bound *"until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment"*. In both cases, official data and feedback from the business community have been suggesting full capacity for some time. In Canada, the share of firms with difficulty meeting demand has never been higher (*Chart 1*). In the U.S., record job vacancies highlight a labour market that is much tighter than policymakers have given it credit for. Part of the misinterpretation likely comes from the fact a sliver of the economy has experienced an extreme hit, somewhat masking broad strength almost everywhere else. At the same time, the pandemic-induced negative supply shock has likely held back potential output, thereby closing output gaps faster than believed.

Chart 1
No Capacity



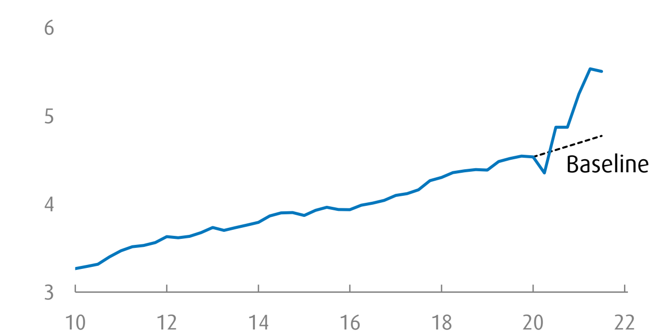
[1] some + significant (lhs : % of firms); [2] (rhs : %); [3] (dev. from July '90 –Dec. '07 median)
Sources: BMO Economics, Haver Analytics

Belief: *Supply constraints are driving inflation.* ***Reality:*** *Spending (demand) has surged.*

The economy has faced a negative supply shock, especially as labour and production are held back by the pandemic. But, a historic surge in household spending on goods would clog supply chains in even the best of times. In the U.S., nominal spending on goods has surged more than 20% above pre-COVID levels (*Chart 2*), or a mind-boggling $800 bln in excess above the baseline (that's not *spending*, that's *extra* spending). The supply chain never stood a chance to respond to this surge. A rapid job recovery in most sectors, cheap credit and fiscal transfers have all aided the surge. And, it hasn't simply come as a substitute for services spending, as the latter is now back to pre-COVID levels.

Chart 2
Demand Boom

United States ($ trlns : s.a.a.r.)
Personal Consumption Expenditures — Goods



Sources: BMO Economics, Haver Analytics

***Belief:** We need more houses. **Reality:** It's demand.*

While there is truth to longer-term supply issues in Canada, development hurdles and intensification crowding out single-family homes, the acute issue today is heated demand. Home sales in Canada surged more than 50% above pre-COVID norms at one point in 2021 (*Chart 3*), vapourizing what has been a normal run-rate of new listings. At the margin, multiple-property owners (e.g., investors) have led the increase, accounting for the largest share of transaction volume in 2021, according to Teranet registry data. Survey data suggest expectations of home price growth are getting engrained. Now, raise your hand if you saw any houses in your area change hands three times in 2021—hand goes up.

***Belief:** We need ongoing fiscal support. **Reality:** There's been more than enough.*

Highly-targeted measures aimed at sectors forced to curb operations still make sense. But, on a large scale, federal government support has gone beyond replacing lost income due to the pandemic. In Canada, household disposable income has surged well above the pre-COVID baseline, as enormous government transfers have more than offset the decline in employment income. The latter is back to baseline, but fiscal support continues to flow. There has been roughly $85 billion in excess government-to-household transfers through 2021Q3 (*Chart 4*). That's almost 4% of GDP beyond replacing lost incomes, which has fuelled housing, spending and inflation.

***Belief:** There's no risk in risk assets. **Reality:** They're about to get tested.*

Asset prices of all types have feasted on excessively stimulative monetary policy. This week, the Federal Reserve made it clear that it would draw down its balance sheet earlier and faster than in past cycles which, along with potentially abrupt interest rate hikes, could pose a headwind. Stocks have historically struggled during periods of change in the Fed's balance sheet trajectory (*Chart 5*), and valuations in some higher-flying sectors could be stressed by higher interest rates. The investor component of the housing market could also be tested if already cash-flow-negative properties (assuming the standard 20% down) soon face higher mortgage payments. In Canada, the shift into variable-rate mortgages that has fuelled the latest bout of strength will be tapped out soon.

Chart 3
Housing Imbalance

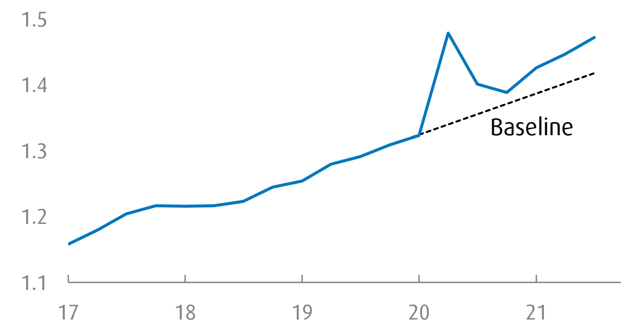
Canada (2019=100)

Sources: BMO Economics, Haver Analytics

Chart 4
Government Gone Wild

Canada ($ trlns : s.a.a.r.)

Household Disposable Income



Source: BMO Economics

Chart 5
Fueled by the Fed

United States

[1] (lhs : $ trlns); [2] (rhs : 1941-43 = 100)
Sources: BMO Economics, Haver Analytics

Economic Forecast Summary for January 14, 2022

		2021				2022				Annual		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2020	2021	2022
CANADA												
Real GDP	(q/q % chng : a.r.)	4.9	-3.2	5.4	4.5	0.0	8.0	7.0	4.5	-5.2	4.5	4.0
Consumer Price Index	(y/y % chng)	1.4	3.3	4.1	4.6	4.5	3.9	3.1	2.6	0.7	3.3	3.5
Unemployment Rate	(percent)	8.4	8.0	7.1	6.2	6.4	5.6	5.5	5.5	9.6	7.4	5.7
Housing Starts	(000s : a.r.)	306	280	262	272	258	257	247	240	219	280	250
Current Account Balance	($blns : a.r.)	6.6	5.5	5.5	4.4	4.1	3.0	-1.7	-5.4	-39.4	5.5	0.0
Interest Rates	(average for the quarter : %)											
Overnight Rate		0.25	0.25	0.25	0.25	0.25	0.58	1.00	1.25	0.50	0.25	0.77
3-month Treasury Bill		0.08	0.11	0.16	0.10	0.20	0.50 ↑	0.90	1.15	0.44	0.11	0.70 ↑
10-year Bond		1.13	1.49	1.24	1.58	1.70 ↑	1.75 ↑	1.85 ↑	1.90	0.75	1.36	1.80 ↑
Canada-U.S. Interest Rate Spreads	(average for the quarter : bps)											
90-day		3	8	11	5	6 ↓	10 ↓	27 ↓	27 ↓	7	7	18 ↓
10-year		-19	-10	-9	4	-7 ↑	-8 ↑	-9 ↑	-10	-14	-8	-8 ↑
UNITED STATES												
Real GDP	(q/q % chng : a.r.)	6.3	6.7	2.3	5.5	1.5	4.5	3.5	2.5	-3.4	5.6	3.5
Consumer Price Index	(y/y % chng)	1.9	4.8	5.3	6.7	7.5 ↑	6.5 ↑	5.6 ↑	4.2 ↑	1.2	4.7	5.9 ↑
Unemployment Rate	(percent)	6.2	5.9	5.1	4.2	3.8	3.6	3.5	3.4	8.1	5.4	3.6
Housing Starts	(mlns : a.r.)	1.60	1.59	1.56	1.60	1.61	1.63	1.64	1.65	1.40	1.59	1.63
Current Account Balance	($blns : a.r.)	-758	-793	-859	-889	-905	-940	-960	-973	-616	-825	-945
Interest Rates	(average for the quarter : %)											
Fed Funds Target Rate		0.13	0.13	0.13	0.13	0.21 ↑	0.46 ↑	0.71 ↑	0.96 ↑	0.38	0.13	0.58 ↑
3-month Treasury Bill		0.05	0.03	0.05	0.05	0.15 ↑	0.40 ↑	0.65 ↑	0.85 ↑	0.37	0.04	0.50 ↑
10-year Note		1.32	1.59	1.33	1.54	1.75 ↑	1.85 ↑	1.90	2.00	0.89	1.44	1.85
EXCHANGE RATES	(average for the quarter)											
US¢/C$		79.0	81.4	79.4	79.4	78.9	79.5	80.1	80.8	74.6	79.8	79.8
C$/US$		1.27	1.23	1.26	1.26	1.27	1.26	1.25	1.24	1.34	1.25	1.25
¥/US$		106	109	110	114	115 ↑	115 ↑	115 ↑	115 ↑	107	110	115 ↑
US$/Euro		1.21	1.21	1.18	1.14	1.13	1.12	1.11	1.10	1.14	1.18	1.12 ↑
US$/£		1.38	1.40	1.38	1.35	1.35 ↑	1.33 ↑	1.32 ↑	1.30	1.28	1.38	1.33 ↑

Blocked areas mark BMO Capital Markets forecasts; up and down arrows (↑↓) indicate forecast changes; spreads may differ due to rounding

Canada


Benjamin Reitzes,
Canadian Rates & Macro Strategist
benjamin.reitzes@bmo.com


Shelly Kaushik,
Economist
shelly.kaushik@bmo.com

Existing Home Prices

Monday, 9:00 am (expected)

	Existing Home Sales	Average Prices
Dec. (e)	**unch**	**+21.5% y/y**
Nov.	-0.7% y/y	+19.6% y/y

MLS Home Price Index	
Dec. (e)	**+25.5% y/y**
Nov.	+25.3% y/y

The **housing market** remained strong in December, as seasonal weakness suggests activity accelerated on an adjusted monthly basis. On an annual basis, we expect sales to have steadied in December as year-ago comparables have become more reasonable. The regional picture is mixed, with most western cities posting double-digit yearly gains while Toronto, Montreal, and Ottawa were down. Meantime, we're expecting average prices to have accelerated to 21.5% y/y and growth in the quality-adjusted MLS HPI to edge up to 25.5% y/y.

BoC Business Outlook Survey and Survey of Consumer Expectations (Q4)

Monday, 10:30 am

The Bank of Canada's Business Outlook Survey (BOS) for Q4, likely compiled from around mid/late-November to mid-December, is expected to capture the ongoing strength in the economic recovery. Omicron worries and restrictions didn't really ramp up until later in December, though it's possible the BoC may have followed up with some additional questions after the survey period ended. Accordingly, the survey results won't capture any dampening from the current wave. Look for the **BOS Indicator** to remain at a historically high level, but dip modestly from the extreme strength seen in Q3.

A continued return to somewhat more normal conditions in the quarter will dampen the **sales growth** outlook somewhat, as the base will no longer be as depressed for most sectors as it was over the prior year. Nonetheless, sales expectations are expected to remain positive. There's nothing to suggest investment and hiring intentions weakened at all from the record levels hit in Q3. Job vacancies were close to one million in the quarter, pointing to strong demand for labour, and an appetite to invest in productivity enhancing machinery & equipment. And, credit conditions likely stayed easy, though rising interest rates could be a bit of a dampener.

BOS **capacity pressure** metrics hit a record high in Q3, and likely didn't retreat in Q4. The economy picked up steam, reinforcing many of the factors putting upward pressure on prices. Ongoing strength in goods demand will likely show up in pressure on goods producers, while more service-driven sectors could see less pressure as demand has yet to fully rebound for some industries. Meantime, as noted above, a jump in vacancies points to ongoing heightened labour shortages.

On the **inflation** front, look for expectations to remain elevated, with a likely fresh record high number of respondents looking for inflation above 3%. Input and output inflation both slowed in Q3, but given ongoing price pressures, that will be a tough act to repeat.

Overall, the tone of the survey is expected to remain very strong as it came pre-Omicron. Despite the likely speedbump the economy is currently experiencing, the BOS will provide a glimpse of where things will probably rebound toward once this wave passes. Don't expect anything here to suggest the BoC should still have rates at emergency low levels.

The Bank's **Consumer Expectations Survey** will be out at the same time, and is expected to stay solid as well. Watch inflation expectations, as an acceleration would put even more pressure on the BoC to start hiking as soon as possible.

Consumer Price Index

Wednesday, 8:30 am

Dec. (e)	**-0.1% (+0.2% sa)**	**+4.8% y/y**
Nov.	+0.2%	+4.7% y/y

Core CPI Measures (Nov.)

CPI Core - Trim	+3.4% y/y
CPI Core - Median	+2.8% y/y
CPI Core - Common	+2.0% y/y

Consumer prices likely dipped a touch (-0.1%) in December for the first time in 2021. Note that December is historically the weakest month of the year for CPI, so after seasonal adjustment, prices will likely be modestly higher (+0.2%) from the prior month. Gasoline prices were down sharply, as oil swooned in the month. However, energy rebounded to start 2022, so expect that to be a source of upward pressure in the new year. Housing continues to be a strong spot, with new home prices reaccelerating in the prior month, pushing replacement cost higher. Strength in apparel in the U.S. CPI suggests we'll get less seasonal weakness than usual. Air fares are seasonally strong, and with new restrictions only ramping up later in the month, prices likely rose on limited capacity and pent-up demand. There's also upside risk from autos, with prices up about 6.5% y/y versus more than 10% in the U.S. The risks remain skewed to the upside in the near term. While January 2021 CPI was relatively strong, the following two months were weak, so there's a good chance we may not have seen peak inflation just yet.

The Bank of Canada's **core CPI** measures look to accelerate in December. Two of three metrics slowed a year ago, and core prices are projected to be generally firmer than a year ago. That would push the average of the three metrics to the highest since 1991 when the BoC first adopted inflation targeting.

Retail Sales

Friday, 8:30 am

		Ex. Autos
Nov. (e)	**+1.2%**	**+2.0%**
Oct.	+1.6%	+1.3%

Canadian **retail sales** likely posted their second straight increase in November despite the severe B.C. floods. StatCan pegged the preliminary increase at 1.2%. We are sticking with that estimate as prices remained supportive and demand is healthy given robust consumer balance sheets. Auto sales slumped in the month as supply-chain issues continued to weigh on production. Given another month of elevated inflation, we expect that volumes will increase less than the headline. Keep an eye on the flash reading for December to see how retail activity fared as restrictions tightened to end the year.

United States

Priscilla Thiagamoorthy,
Economist
priscilla.thiagamoorthy@bmo.com

Housing Starts

Wednesday, 8:30 am

Dec. (e)	**1.66 mln a.r. (-1.2%)**
Consensus	*1.65 mln a.r. (-1.7%)*
Nov.	1.68 mln a.r. (+11.8%)

Building Permits

Dec. (e)	**1.70 mln a.r. (-1.0%)**
Consensus	*1.71 mln a.r. (-0.4%)*
Nov.	1.72 mln a.r. (+3.9%)

Housing starts look to take a breather in December, edging down 1.2% to 1.66 mln a.r. after catapulting 11.8% in the prior month. Despite persistent supply issues and elevated material costs that capped overall activity through much of last year, starts for all of 2021 will likely hit the best level since 2006. Although momentum could cool this year as interest rates rise, we still expect homebuilding to stay at healthy levels as builders make progress on backlogs. Homebuilders' confidence hit a 10-month high in December, while **building permits**, a good proxy for future home construction, remain elevated. December permits are expected to pull back only modestly after two big monthly gains.

Existing Home Sales
Thursday, 10:00 am

Dec. (e)	**6.45 mln a.r. (-0.2%)**
Consensus	*6.41 mln a.r. (-0.8%)*
Nov.	6.46 mln a.r. (+1.9%)

Existing home sales caught a second wind in the back half of last year after slowing sharply earlier on. Low mortgage rates and a pandemic-related desire for 'more house' continued to fuel demand, despite surging prices. For the first time since 2006, sales likely surpassed the 6-million mark last year, as the tight labour market continued to lift overall sentiment. Still, there are signs that momentum may have eased at the end of the year. Pending homes sales unexpectedly declined in November amid lean inventories. As such, existing home sales in December look to end a three-month winning streak, likely falling 0.2% to 6.45 mln annualized.

China

Art Woo,
Senior Economist
art.woo@bmo.com

Real GDP
Monday

Q4 (e)	**+1.4%**	**+3.5% y/y**
Consensus	*+1.2%*	*+3.3% y/y*
Q3	+0.2%	+4.9% y/y

Reflective of the economy's recent struggles, we expect Q4 **real GDP** in **China** to have posted a sluggish 3.5% y/y increase, down from a 4.9% rise in Q3. This is also broadly in-line with the Bloomberg poll of 3.3% y/y. The slowdown is being driven by a confluence of factors but mainly the regulatory crackdown (on education and online gaming), the power crisis, the Evergrande-driven housing downturn, and sporadic COVID outbreaks and accompanying lockdowns. These factors likely dragged down retail sales (+3.9% y/y in November) and fixed asset investment (+5.2% y/y in the year-to-date to November) further for December. On the flip side, the government reported that merchandise trade remained quite strong given the boom in global goods demand. Exports grew 20.9% y/y in December (vs. +22% y/y in November); however, imports slipped to 19.5% y/y (vs. 31.7% in November).

Taking a step back to survey the longer-term picture, real GDP likely grew around 8.0% for the full year (assuming our Q4 call proves to be accurate), following a 2.3% rise in 2020. Thus, China's economy has expanded roughly 5% annually since the pandemic, which is broadly at or just slightly below the medium-term potential growth rate. That is a pretty impressive feat given challenging circumstances.

Financial Markets Update for January 14, 2022

		Jan 14 [1]	Jan 7	Week Ago	4 Weeks Ago (basis point change)	Dec 31, 2021
Canadian	Call Money	0.25	0.25	0	0	0
Money Market	Prime Rate	2.45	2.45	0	0	0
U.S. Money	Fed Funds (effective)	0.25	0.25	0	0	0
Market	Prime Rate	3.25	3.25	0	0	0
3-Month Rates	Canada	0.26	0.20	6	21	10
	United States	0.12	0.09	3	9	9
	Japan	-0.09	-0.10	1	2	3
	United Kingdom	0.40	0.49	-9	18	14
	Australia	0.07	0.07	1	0	1
2-Year Bonds	Canada	1.14	1.07	7	23	19
	United States	0.94	0.86	8	30	21
10-Year Bonds	Canada	1.75	1.72	3	43	33
	United States	1.75	1.76	-1	35	24
	Japan	0.14	0.14	0	10	7
	Germany	-0.05	-0.05	-1	33	13
	United Kingdom	1.14	1.18	-3	39	18
	Australia	1.85	1.86	0	27	18
Risk Indicators	VIX	21.3	18.8	2.5 pts	-0.3 pts	4.1 pts
	Inv. Grade CDS Spread [2]	52	52	0	0	3
	High Yield CDS Spread [2]	305	307	-2	-5	12
					(percent change)	
Currencies	US¢/C$	79.73	79.10	0.8	2.8	0.8
	C$/US$	1.254	1.264	—	—	—
	¥/US$	113.83	115.56	-1.5	0.2	-1.1
	US$/€	1.1422	1.1360	0.5	1.6	0.5
	US$/£	1.368	1.359	0.6	3.2	1.1
	US¢/A$	72.28	71.81	0.7	1.4	-0.5
Commodities	CRB Futures Index	242.90	237.90	2.1	7.9	4.5
	Oil (generic contract)	83.02	78.90	5.2	17.2	10.4
	Natural Gas (generic contract)	4.21	3.92	7.4	14.0	12.7
	Gold (spot price)	1,818.07	1,796.55	1.2	1.1	-0.6
Equities	S&P/TSX Composite	21,224	21,084	0.7	2.3	0.0
	S&P 500	4,630	4,677	-1.0	0.2	-2.9
	Nasdaq	14,772	14,936	-1.1	-2.6	-5.6
	Dow Jones Industrial	35,803	36,232	-1.2	1.2	-1.5
	Nikkei	28,124	28,479	-1.2	-1.5	-2.3
	Frankfurt DAX	15,878	15,948	-0.4	2.2	0.0
	London FT100	7,544	7,485	0.8	3.8	2.2
	France CAC40	7,146	7,219	-1.0	3.2	-0.1
	S&P ASX 200	7,394	7,453	-0.8	1.2	-0.7

[1] = as of 11:30 am *[2] = One day delay*

	Monday January 17	Tuesday January 18	Wednesday January 19	Thursday January 20	Friday January 21
China	**Real GDP** **Q4 (e) +1.4% +3.5% y/y** *Consensus +1.2% +3.3% y/y* Q3 +0.2% +4.9% y/y **Industrial Production** **Dec. (e) +3.7% y/y** Nov. +3.8% y/y **Retail Sales** **Dec. (e) +3.8% y/y** Nov. +3.9% y/y **Fixed Asset Investment** **Dec. (e) +4.8% y/y** Nov. +5.2% y/y				
Japan	**Core Machine Orders** **Nov. (e) +1.2% +6.6% y/y** Oct. +3.8% +2.9% y/y **Tertiary Industry Index** **Nov. (e) +1.0%** Oct. +1.5% BoJ Monetary Policy Meeting and Outlook Report (Jan. 17-18)	**Industrial Production** **Nov. F (e) +7.2% +5.4% y/y** Oct. +1.8% -4.1% y/y		**Trade Balance** **Dec. '21 (e) -¥789.2 bln** Dec. 20 +¥708.3 bln	**CPI / Core CPI** **Dec. (e) +0.9% y/y +0.6% y/y** Nov. +0.6% y/y +0.5% y/y **CPI ex. Food & Energy** **Dec. (e) -0.6% y/y** Nov. -0.6% y/y
Euro Area	**ITALY** **Consumer Price Index** **Dec. F (e) +0.5% +4.2% y/y** Nov. +0.7% +3.9% y/y	**GERMANY** **ZEW Survey—Expectations** **Jan. (e) 32.0** Dec. 29.9	**GERMANY** **Consumer Price Index** **Dec. F (e) +0.3% +5.7% y/y** Nov. +0.3% +6.0% y/y	**EURO AREA** **Consumer Price Index** **Dec. F (e) +0.4% +5.0% y/y** Nov. +0.4%` +4.9% y/y **Core CPI** **Dec. F (e) +2.6% y/y** Nov. +2.6% y/y ECB Minutes from Dec. 16 meeting **FRANCE** **Business Confidence** **Jan. (e) 109** Dec. 110	**EURO AREA** **Consumer Confidence** **Jan. A (e) -9.0** Dec. -8.3
U.K.		**Jobless Claims** **Dec.** Nov. -49,800 **Employment (3m/3m)** **Nov. (e) +127,000** Oct. +149,000 **Avg. Wkly Earnings Ex. Bonus (3 mma)** **Nov. (e) +3.8% y/y** Oct. +4.3% y/y **Jobless Rate (3 mma)** **Nov. (e) 4.2%** Oct. 4.2%	**Consumer Price Index** **Dec. (e) +0.3% +5.2% y/y** Nov. +0.7% +5.1% y/y **Core CPI** **Dec. (e) +3.9% y/y** Nov. +4.0% y/y **Producer Price Index (Output)** **Dec. (e) +0.6% +9.4% y/y** Nov. +0.9% +9.1% y/y		**GfK Consumer Confidence** **Jan. (e) -15** Dec. -15 **Retail Sales (incl. Fuel)** **Dec. (e) -0.6% +3.4% y/y** Nov. +1.4% +4.7% y/y
Other			**AUSTRALIA** **Westpac Consumer Confidence** **Jan.** Dec. -1.0%	**AUSTRALIA** **Employment** **Dec. (e) +60,000** Nov. +366,100 **Jobless Rate** **Dec. (e) 4.5%** Nov. 4.6%	

D = date approximate

Upcoming Policy Meetings | Bank of England: Feb. 3, Mar. 17, May 5 | European Central Bank: Feb. 3, Mar. 10, Apr. 14

	Monday January 17	Tuesday January 18	Wednesday January 19	Thursday January 20	Friday January 21
Canada	**8:30 am** **Mfg. Sales** / **Mfg. New Orders** **Nov. (e)** **+2.5%** **+3.0%** Oct. +4.3% +1.9% **8:30 am** **Int'l Securities Transactions** **Inflows** / **Outflows** **Nov.** Oct. $23.9 bln $5.4 bln **8:30 am** **New Motor Vehicle Sales[D]** **Nov. (e)** **-14.0% y/y** Oct. -17.1% y/y **9:00 am** **Existing Home Sales[D]** / **Average Prices** **Dec. (e)** **unch** **+21.5% y/y** Nov. -0.7% y/y +19.6% y/y **9:00 am** **MLS Home Price Index[D]** **Dec. (e)** **+25.5% y/y** Nov. +25.3% y/y **10:30 am** **BoC Business Outlook Survey and Survey of Consumer Expectations (Q4)**	**8:15 am** **Housing Starts** **Dec. (e)** **290,000 a.r. (-3.7%)** Nov. 301,279 a.r. (+26.4%) 10:30 am 3-, 6- & 12-month bill auction $14.0 bln (new cash -$3.0 bln)	**8:30 am** **Consumer Price Index** **Dec. (e)** **-0.1% (+0.2% sa)** **+4.8% y/y** Nov. +0.2% +4.7% y/y **8:30 am** **CPI Core (% y/y)** **Trim** / **Median** / **Common** **Dec.** Nov. +3.4 +2.8 +2.0 **8:30 am** **Wholesale Trade** **Nov. (e)** **+2.5%** Oct. +1.4% **8:30 am** **Household Credit** / **Mortgage Credit** **Nov.** Oct. +7.2% y/y +10.2% y/y BoC Buyback: 10-year sector	Noon 3-year bond auction $3.0 bln 30-year bond auction announcement BoC Buyback: 2-year sector	**8:30 am** **Retail Sales** / **Ex. Autos** **Nov. (e)** **+1.2%** **+2.0%** Oct. +1.6% +1.3% **8:30 am** **New Housing Price Index[D]** **Dec. (e)** **+0.6%** **+12.0% y/y** Nov. +0.8% +11.7% y/y
United States	**Martin Luther King, Jr. Day (markets closed)**	**8:30 am** **Empire State Manufacturing Survey** **Jan. (e)** **25.0[C]** Dec. 31.9 **10:00 am** **NAHB Housing Market Index** **Jan. (e)** **84[C]** Dec. 84 **4:00 pm** **Net TIC Flows** **Total** / **Long Term** **Nov.** Oct. $143.0 bln $7.1 bln 11:30 am 13- & 26-week bill auctions $111 bln	**7:00 am** **MBA Mortgage Apps** **Jan. 14** Jan. 7 +1.4% **8:30 am** **Housing Starts** **Dec. (e)** **1.66 mln a.r. (-1.2%)** *Consensus* *1.65 mln a.r. (-1.7%)* Nov. 1.68 mln a.r. (+11.8%) **8:30 am** **Building Permits** **Dec. (e)** **1.70 mln a.r. (-1.0%)** *Consensus* *1.71 mln a.r. (-0.4%)* Nov. 1.72 mln a.r. (+3.9%) 1:00 pm 20[R]-year bond auction $20 bln	**8:30 am** **Initial Claims** **Jan. 15 (e)** **220k (-10k)[C]** Jan. 8 230k (+23k) **8:30 am** **Continuing Claims** **Jan. 8 (e)** **1,514k (-45k)[C]** Jan. 1 1,559k (-194k) **8:30 am** **Philadelphia Fed Index** **Jan. (e)** **20.0[C]** Dec. 15.4 **10:00 am** **Existing Home Sales** **Dec. (e)** **6.45 mln a.r. (-0.2%)** *Consensus* *6.41 mln a.r. (-0.8%)* Nov. 6.46 mln a.r. (+1.9%) 11:30 am 4- & 8-week bill auctions 1:00 pm 10-year TIPS auction $16 bln	**10:00 am** **Leading Indicator** **Dec. (e)** **+0.8%[C]** Nov. +1.1%

[C] = consensus [D] = date approximate [R] = reopening

Upcoming Policy Meetings | Bank of Canada: Jan. 26, Mar. 2, Apr. 13 | FOMC: Jan. 25-26, Mar. 15-16, May 3-4

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