May 11, 2022- (Vol. VI, No. 41)

The abnormal anatomy of this hiking cycle

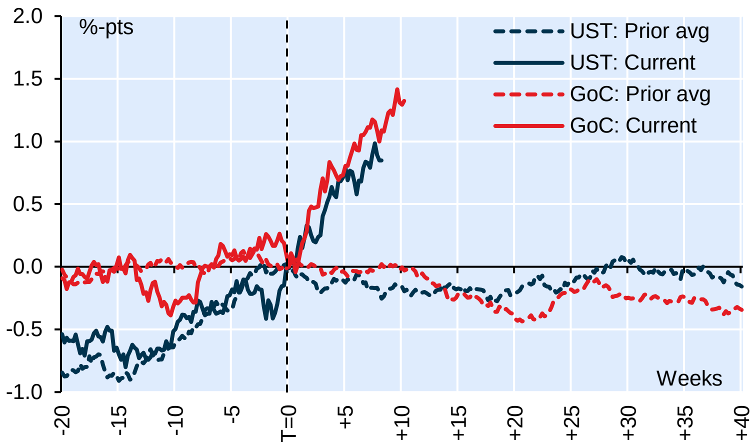
By Taylor Schleich & Warren Lovely

There's been no reprieve from rate volatility in recent sessions, with today's yo-yoing coming in the wake of another red-hot CPI print. To be sure, markets are still trying to grapple with how sticky inflation will prove to be, how the Fed will ultimately respond and as a result, what that means for bond yields. For now, this abnormal economic environment has led to a significant deviation from the traditional response to central bank tightening cycles. As we discussed in our recently-released Fixed Income Monitor, the *average* tendency has been for long-term rates to trade sideways/down as hikes are implemented (Chart 1). No, this isn't a perfect relationship and there have been instances where rates still climbed. However, in the past 25 years' worth of hiking cycles, this recent sell-off is the largest we've seen at this point after the first hike.

The culprit for this deviation is easy enough to identify: inflation. Unlike those prior cycles, price pressures were already surging well past 2% targets when tightening began this go round (Chart 2). Indeed, back when central banking was *pro*active rather than *re*active, hiking tended to get underway when inflation was *below* 2%. But past inflation is water under the bridge. Now, the Fed and BoC are in catch-up mode and poised to continue rapidly withdrawing monetary policy stimulus. Appropriately, the pace and magnitude of this round of rate hikes is far more aggressive than we saw in the late-2010s (Chart 3). Moreover, the pacing of rate hikes we're expecting this cycle would dwarf *any* cycle in the past quarter century (and we concede that risks to our policy rate forecast are probably skewed higher). Not to mention we'll be contending with an accelerated QT exercise from the Fed and, for the first time, the BoC. All that to say, the accumulation of this tightening will cool demand (we're already seeing tighter financial conditions). Yes, inflation has proven stickier and broader which means a return to 2% is going to be slower than previously thought. But as long as an expected moderation does come, central banks are likely to shift the focus to preserving some semblance of an economic heartbeat (i.e., not hiking into oblivion). Given the choice between (a) a recession with flat prices and (b) modest growth/healthy-ish labour markets with, say, 4% inflation, we expect central banks to choose the latter (particularly the Fed given its dual mandate). Bringing it back to rates, there may be scope for sell-off to briefly resume near-term as markets grapple with supersized hikes. But we feel *most* of the juice has been squeezed from the short duration trade. That needn't mean a return to sub-2% 10-year yields anytime soon (QT, elevated inflation should prevent that). But long-term yields trading in the high 2%'s a year from now? That's what we're betting on.

Chart 1: Rate moves this cycle have been abnormal…

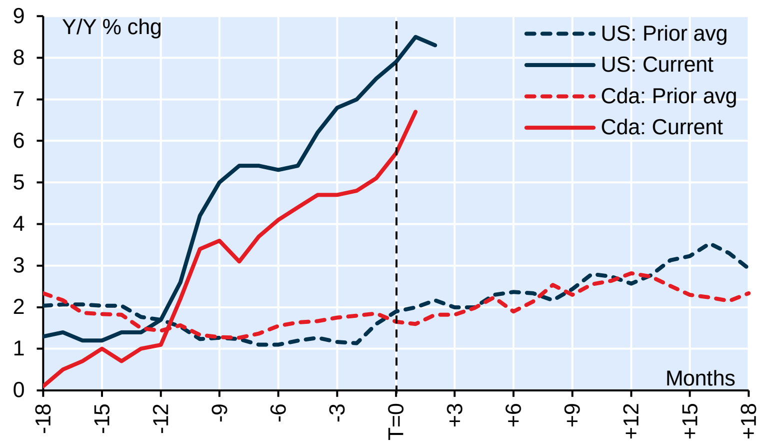
10Y yield trajectory before/after first rate hike: 2022 vs. past-cycle avg.



Source: NBF, Bloomberg | Note: Sample includes all cycles since BoC O/N target adopted

Chart 2: … but so has inflation

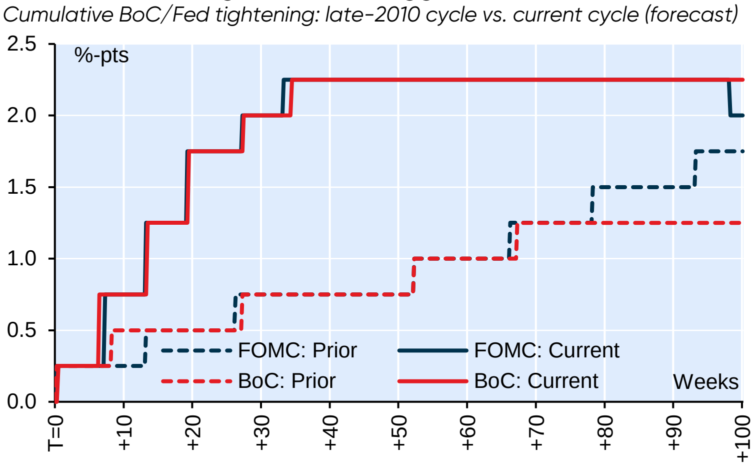
All-items CPI trajectory before/after first rate hike: 2022 vs. past-cycle avg.



Source: NBF, Bloomberg | Note: Sample includes all cycles since BoC O/N target adopted

Chart 3: This hiking to be more aggressive than the last…

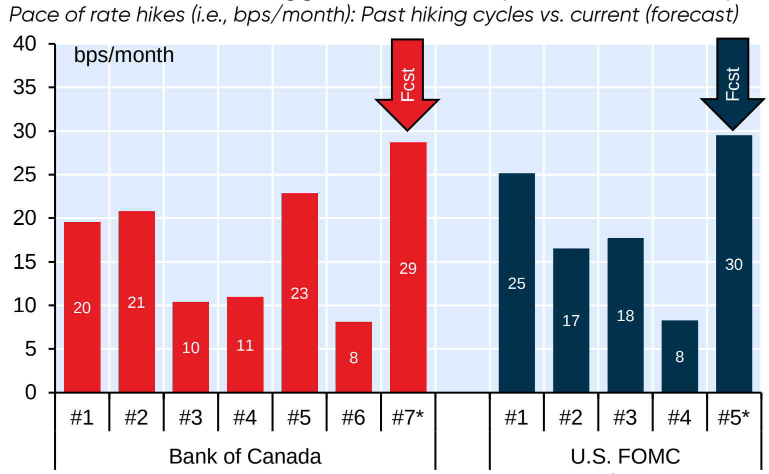
Cumulative BoC/Fed tightening: late-2010 cycle vs. current cycle (forecast)



Source: NBF, Bloomberg

Chart 4: … and more aggressive than *any* in recent memory

Pace of rate hikes (i.e., bps/month): Past hiking cycles vs. current (forecast)



Source: NBF, Bloomberg | Note: Sample includes all cycles since BoC O/N target adopted

Economics and Strategy

Montreal Office
514-879-2529

Stéfane Marion
Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau
Deputy Chief Economist
matthieu.arseneau@nbc.ca

Kyle Dahms
Economist
kyle.dahms@nbc.ca

Daren King
Economist
daren.king@nbc.ca

Jocelyn Paquet
Economist
jocelyn.paquet@nbc.ca

Alexandra Ducharme
Economist
alexandra.ducharme@nbc.ca

Angelo Katsoras
Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office
416-869-8598

Warren Lovely
Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich
Rates Strategist
taylor.Schleich@nbc.ca

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