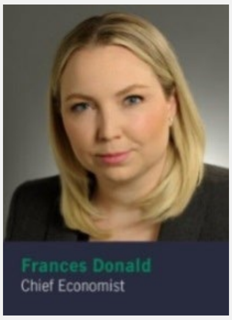
Manulife Investment Management

Market Note

18 Feb 2022



Major central banks worldwide are becoming increasingly hawkish in response to rising inflation, and markets are interpreting that as a sign that interest rates could get much higher sooner. Will they follow through? In this market note, Frances Donald, Global Chief Economist and Global Head of Macroeconomic Strategy, shares her global interest rate outlook.

Global interest-rate outlook—central banks turn hawkish

A not entirely unexpected hawkish pivot

Central bank hawks swooped across the globe in recent weeks. The Bank of England (BoE) hiked interest rates for the second time in three months on February 3 amid inflationary concerns. Notably, four out of the nine members of the bank's Monetary Policy Committee voted for a 50 basis points (bps) hike. This after the Bank of Canada (BoC) signaled on January 19 that a rate hike in March was effectively a done deal.

Incidentally, the European Central Bank (ECB), which is widely seen as the last remaining dove among global central banks, also struck a significantly hawkish tone at its rate-setting meeting (also on February 3) on the back of unexpectedly high European inflationary data released the day before. The ECB's Governing Council said it has "unanimous concerns" about inflation, and ECB President Christine Lagarde declined to confirm—as she had done in previous press conferences—that "interest- rate hikes are very unlikely" this year. The market reacted accordingly: European yields jumped, the yield curve flattened, and the spread between German and Italian yields widened aggressively.[1]

Meanwhile, on the other side of the Atlantic, several U.S. Federal Reserve (Fed) members emphasized that a March rate hike was certainly in play, although many pushed back against a 50bps move, and a few—including Philadelphia Fed President Patrick Harker—noted that four rate hikes this year could make sense, validating what markets have priced in so far. Indeed, Fed officials seemed undeterred by market volatility.

Yet, these central banks' rosy outlooks and seeming urgency to lift rates are out of sync with how we expect the global economy to develop in the coming months. As we highlighted in our 2022 outlook, we expect to see a material growth slowdown in the first half of 2022. The key ingredients for slowing growth are all there: significant fiscal tightening, declining liquidity, tighter monetary policy in emerging markets, the lagged impact of a slowing China (in 2021), lower Purchasing Managers' Indexes, and a weakening U.S. consumer. These factors are likely to produce uncomfortably low growth just as central banks communicate their policy normalization plans. Problematically, while we expect inflation to fall back precipitously in the second half of the year, it likely won't fall far enough to enable these global central banks to change their messaging until well into the second quarter.

Five key themes

Synthesizing what we've heard from central banks with our own high-conviction views, we end up with five key central bank themes for the next six months.

1) We expect many major central banks to raise interest rates in March—including the Fed and the BoC. In our view, even doves such as the ECB will seem incrementally hawkish over the

[1]Bloomberg, as of February 8, 2022.

next month and a half; it's also conceivable that the BoE could hike rates once a quarter this year. While we don't have a rosy view of the global economy at this point, global central banks have made themselves clear: The rate lift-off is happening.

2) Although four out of nine members of the BoE's rate-setting committee thought that a 50bps rate hike was appropriate, we aren't expecting any global central bank to introduce hikes of such a magnitude this year. There are some, however, who have priced in a 50pbs Fed interest-rate hike in March,[1] suggesting that—if our read of the situation turns out to be correct—some of that expectation will need to be unwound.

3) Despite being surrounded by central bank hawkishness at this juncture, we continue to expect them to make an important dovish pivot in Q2 as inflation and growth data slows in the coming months (bear in mind that many key economic data is lagging in nature). As a result, we believe the Fed and the BoC will only be able to follow up their March hikes with another one or two hikes before switching to a more gradual, multi-year rate normalization path.

4) Until the global central banks make the expected dovish pivot, we should expect U.S. yield curves to continue to flatten, signaling a policy mistake and heightened risks of a more material slowdown in the coming few years.

5) We expect real interest rates to rise this year. This is a logical perspective since nominal rates will move higher. In addition, inflation expectations should unwind, particularly after global centrals make a dovish pivot as per our expectation.

There are many good reasons why central banks are keen to normalize monetary policy; however, whether they can implement their plans at the pace they intend to will ultimately depend on how rapidly macroeconomic conditions change.

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