RBC Economics

Daily Economic Update

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Fed signals rate hikes are imminent

- No changes to policy rate or pace of QE tapering
- All eyes on March meeting as statement notes "it will soon be appropriate" to raise rates
- Fed to start shrinking its balance sheet after rate hikes begin

The Fed continued to set the stage for interest rate liftoff by clearly signaling rate hikes will "soon be appropriate" in light of high inflation and a strong labour market. Recall that at its December meeting, the Fed accelerated its QE tapering timeline to wind down net purchases by early March, opening the door to a mid-March rate hike. Subsequent comments from a number of FOMC members increased the odds of such a move, and today's statement adds to the risk of an earlier rate hike than our Q2 call. A below-4% unemployment rate, a sluggish rebound in labour supply, accelerating wage growth and persistently high inflation all argue for the Fed to begin removing accommodation sooner rather than later.

An earlier start would also mean upside risk to our forecast (and the Fed's dot plot median) for three rate increases in 2022, with markets now pricing in four hikes. Whether tightening begins in March or Q2, we expect a measured pace of rate increases with quantitative tightening (QT) also set to begin in the coming months. The Fed indicated today that it expects to begin shrinking its balance sheet after the process of raising rates has begun. We expect that process will be accelerated relative to 2017-19 (starting sooner and with a higher cap on maturities not reinvested) given a stronger starting point for the economy and a larger Fed balance sheet. Indeed, Chair Powell indicated in his press conference that the Fed is "willing to move sooner than we did the last time and also perhaps faster" when it comes to shrinking the balance sheet.

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