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New rules

Easing inflation concerns globally have allowed central banks to hold key interest rates steady at what are likely to be the highest levels for this cycle. The duration that we expect them to keep interest rates at peak levels is not outside of the historical norms. But the factors underpinning the length of the pause, and the potential end of the coming easing cycle could all be different this time around.

Overview

Highlights:

- In the last round of meetings, most central banks hinted at rate cuts this year but all continued to push back discussions for an imminent move, stressing the need for patience before inflation sustainably returns to target rates.
- We maintain our view that the Bank of Canada and Federal Reserve will start easing in June, and now also expect the European Central Bank to cut rates in June, followed by the Bank of England in August Q3 and the Reserve Bank of Australia in Q4 this year.
- Topic in focus: How will the rest of this current rate cycle from the BoC compare with previous ones? In short, we expect more things to differ than to stay the same.

Expectations for first cuts gather around mid-year

Central banks kicked off the first round of policy meetings in 2024 by reinforcing that additional interest rate hikes won't (likely) be necessary, while at the same time stressing that it's too early to pivot to outright rate cuts. All opted to hold rates steady and, for the first time since 2022, did so without an explicit hiking bias. While inflation readings have broadly been moving lower, we continue to expect patience from the central banks, and anticipate the ECB, BoC, and Fed to all make that first cut in Q2 (June) with the BOE to follow in Q3 (August).

To borrow Chair Powell's words, global central banks are currently in a "risk management mode," balancing between inflation and downside economic risks. Those downside risks have also been receding, leaving more room for central banks to stay idle at peak policy rates for longer. The U.S. economy continues to surprise significantly on the upside without a reacceleration in inflation to-date. And purchasing managers' indices suggest demand in the Euro Area and the UK may already have bottomed. Equity markets have climbed to new highs on persistent resilience in the US economy, and the U.S. dollar has remained strong.

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Central bank bias

<table>
<tr><th>Central bank</th><th>Current policy rate (latest move)</th><th>Next move</th></tr>
<tr><td>BoC</td><td>5.00%
+0 bps in Jan/24</td><td>0 bps
Mar/24</td></tr>
<tr><td colspan="3">The BoC maintained its rates pause for a fourth policy decision in January while dropping language around its readiness to move rates higher if needed. Lack of “sustained declines” in core inflation measures was mentioned but the bank’s estimate of a negative output gap by the end of 2023 suggests inflation should ease further. We look for the BoC to stay on the sidelines before making a first cut in the overnight rate in June.</td></tr>
<tr><td>Fed</td><td>5.25-5.50%
+0 bps in Jan/24</td><td>0 bps
Mar/24</td></tr>
<tr><td colspan="3">The Fed held the fed funds range unchanged at its January meeting while noting risks to its inflation and employment goals "are moving into better balance." Chair Powell confirmed members’ desire to move rates lower this year but pushed back firmly against a move in March, calling it unlikely. We continue to expect a first cut in June.</td></tr>
<tr><td>BoE</td><td>5.25%
+0 bps in Feb/24</td><td>0 bps
Mar/24</td></tr>
<tr><td colspan="3">The BoE held the bank rate unchanged in January, dropped a hiking bias along with its messaging of “high for long.” Still, the tone was more cautious than that of the Fed or ECB with Governor Andrew Bailey noting upside risks to their forecast. We expect the BoE to start cutting rates in August.</td></tr>
<tr><td>ECB</td><td>4.00%
+0 bps in Jan/24</td><td>0 bps
Mar/24</td></tr>
<tr><td colspan="3">The ECB left the deposit rate unchanged in its January meeting alongside a significant dovish tilt. President Christine Lagarde highlighted slowing in wage growth and stood firmly by her earlier comments on a first rate cut likely happening before the summer. We now expect a first cut from the ECB to happen in June.</td></tr>
<tr><td>RBA</td><td>4.35%
+0 bps in Feb/24</td><td>0 bps
Mar/24</td></tr>
<tr><td colspan="3">The RBA held rates steady in its February meeting. It was in line with expectations, especially after a downside inflation surprise in Q4. The inflation readings were still above target but also showed more improvements in pressures that are tied to domestic demand. We now expect the RBA to start cutting rates in Q4.</td></tr>
</table>

How will this rate cycle compare to prior ones?

Let's start with similarities

1. Duration of peak interest rate

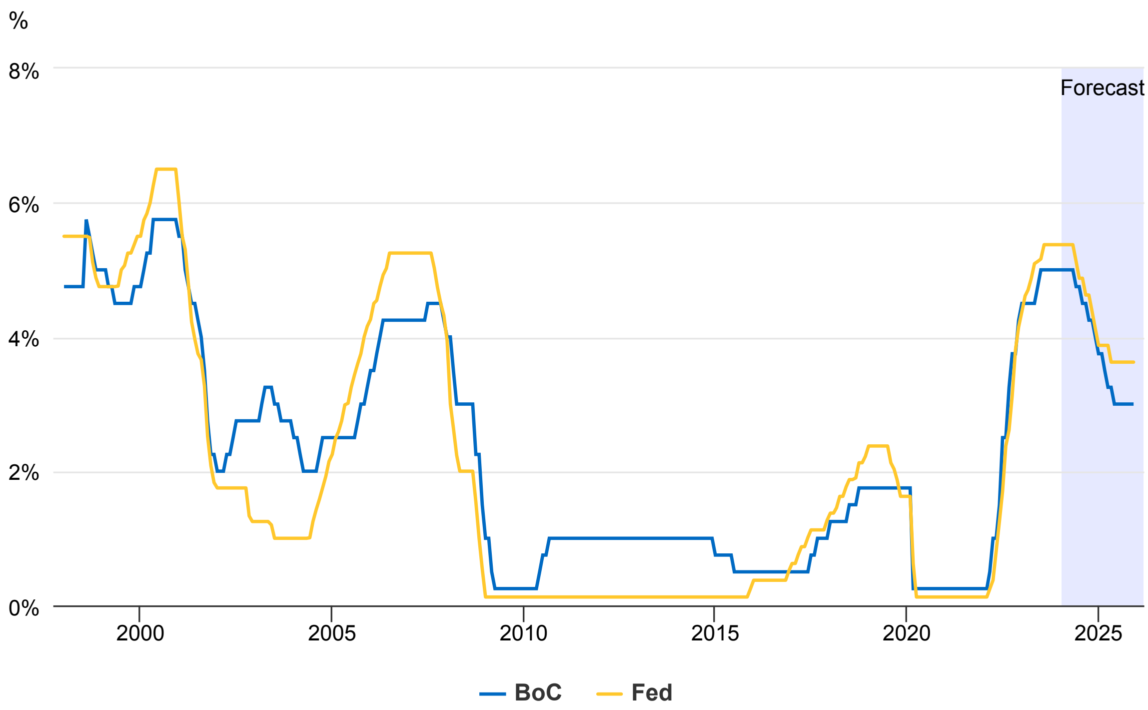
The last rate hikes from the BoC and Fed were in July 2023. The expectation for the first cut to come around summer this year means both central banks will have been maintaining peak levels of key rates for just under a year. That's within the range of historical precedents.

Over the course of the start of inflation targeting in Canada in 1991 to the onset of the pandemic in 2020, the overnight rate has, generally, been shifting lower from cycle to cycle. It's seen less movement overall and was held at peak levels for longer periods. More recently, the overnight rate was held at 1.75% for 17 months before the pandemic led to cuts in March 2020. Historical trends look very similar for the Fed, which held the peak level of Fed funds range for periods ranging from six to 18 months in cycles since the 1990s.

2. BoC and Fed's independent monetary policy turning into similar paths

The BoC is an independent central bank and bases decisions on domestic economic conditions instead of mirroring the Fed's actions. For example, the central bank hiked rates in 2010 upon a faster rebound in the Canadian economy from the global financial crisis, when the Fed chose to remain on hold. The gap between the Fed funds target rate and the BoC's overnight rate has been as wide as 250 basis points over the last three decades.

BoC and the Fed to turn into similar paths



Source: Statistics Canada, RBC Economics projections

Still, with the Canadian economy inextricably linked to the U.S., and the potential for changes in the currency to impact inflation trends, monetary policy can only diverge so much. Historically, broader divergence in interest rate policy has mostly resulted from timing with the BoC lagging the Fed's actions often by a few months.

Our expectation that the BoC and Fed will start cutting rates around the same time this year stems from two factors. First, the two countries have seen very similar progress with inflation over the past year. And secondly, the Fed has historically been more reactive at the turns of rate cycles, and would likely have already acted if the U.S. economic backdrop looked like Canada's soft conditions.

That similar path for interest rate policy - despite a very different macroeconomic growth backdrop – also suggests limited impact on the Canadian dollar, which we expect to remain broadly rangebound versus the U.S. dollar this year.

What's different?

1. BoC has been slower to react to weaker economy in this cycle

The current expectation for the overnight rate to start edging lower this year before returning to a "neutral" level in 2025 will mark the first time since the 1990s that the key rate has been held in a restrictive territory for nearly two years since it started rising in March 2022. Central banks typically respond quickly with lower interest rates once labour markets start to soften. But the start of rate cuts in Canada that we expect in June would mark more than a yearsince the unemployment rate started to rise in the spring of 2023.

BoC slower to react to rising unemployment

12-month percentage point change, Shaded areas indicate start of BoC easing cycles

Source: Bureau of Labor Statistics, RBC Economics

The longer reaction time (relative to that softening economic backdrop) has been due to a couple of factors. The BoC hasn't needed to be this worried about inflation for decades, and part of the plan to bring inflation lower included cooling off overheated labour markets. Also, the increase in the unemployment rate is more due to longer job search times as labour supply growth outpaces hiring demand instead of outright layoffs.

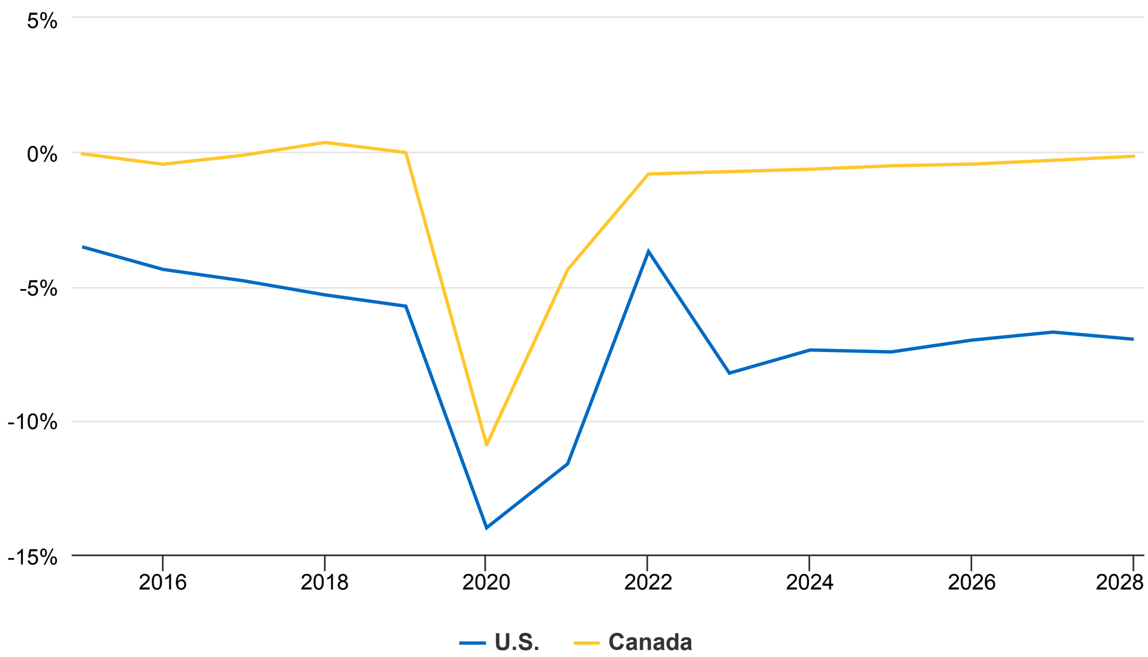
Still, the Canadian economy looks soft enough to warrant interest rate reductions. The question is how long it will take policymakers to be reassured that inflation pressures are back under control.

2. The landing point

Unlike prior cycles, central banks are not expected to cut interest rates back to the ultra-low levels they started hiking from. The global economy looks better able to handle higher interest rates than previously feared, even with more pronounced softening in regions like Canada that are more sensitive to interest rates. In a previous FMM update, we outlined how interest rates will likely be settling at a permanently higher level by the end of the upcoming easing cycle to keep price pressures contained. That's given the upward pressure on the medium-term inflation outlook brought on by deglobalization, decarbonization, and an aging demographic.

Higher rates needed to offset large U.S. fiscal tailwinds

%, General government net lending/borrowing to GDP



Source: International Monetary Fund, RBC Economics

Another element that differentiates this cycle is the political backdrop. 2024 marks a crucial election year where half of the global population is expected to head to the polls. The Fed is unlikely to react to pressure from candidates in the U.S. and neither is the central bank expected to respond in any way to prove its independence. What matters more is the medium-term fiscal outlook, especially in the U.S. where large deficits will remain a tailwind for the economy, regardless of the election result. CBO's latest projections were for U.S. government budget deficit to widen to 6% of GDP by 2025. With the economy already running hot, higher interest rates (than otherwise would be the case) are needed to offset the inflationary impact of fiscal tailwinds.

Overall, we expect the neutral policy rates - the level of interest rates needed to maintain inflation at 2% to have increased in Canada and the U.S., and anticipate the overnight rate to be lowered to 3%, and the Fed funds range at 3.25%-3.5% sometime in 2025.

Interest rate outlook

Policy rates and government bond yields, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
Canada												
Overnight rate	4.50	4.75	5.00	5.00	5.00	4.75	4.50	4.00	3.50	3.00	3.00	3.00
Three-month	4.34	4.90	5.07	5.04	4.95	4.65	4.35	3.85	3.35	2.90	2.95	3.00
Two-year	3.74	4.58	4.87	3.88	4.20	3.80	3.50	3.25	2.90	2.75	2.90	3.00
Five-year	3.02	3.68	4.25	3.17	3.45	3.30	3.10	2.90	2.70	2.80	2.90	3.00
10-year	2.90	3.26	4.03	3.10	3.40	3.25	3.10	2.95	2.75	2.85	2.95	3.00
30-year	3.02	3.09	3.81	3.02	3.35	3.25	3.15	3.05	2.90	2.95	3.05	3.10
United States												
Fed funds midpoint	4.8750	5.1250	5.3750	5.3750	5.38	5.13	4.63	4.13	3.88	3.63	3.38	3.38
Three-month	4.85	5.43	5.55	5.40	5.28	4.98	4.48	3.98	3.75	3.55	3.30	3.30
Two-year	4.06	4.87	5.03	4.23	4.50	4.30	4.10	3.95	3.80	3.70	3.65	3.65
Five-year	3.60	4.13	4.60	3.84	4.15	4.00	3.85	3.75	3.70	3.65	3.65	3.65
10-year	3.48	3.81	4.59	3.88	4.15	4.00	3.85	3.80	3.75	3.70	3.65	3.75
30-year	3.67	3.85	4.73	4.03	4.30	4.20	4.15	4.10	4.05	4.00	3.95	4.05
United Kingdom												
Bank rate	4.2500	5.0000	5.2500	5.2500	5.25	5.25	4.75	4.25	4.00	3.75	3.75	3.75
Two-year	3.42	5.27	4.91	3.98	4.50	4.40	4.30	4.15	4.00	3.75	3.50	3.50
Five-year	3.33	4.66	4.53	3.46	4.00	3.90	3.80	3.60	3.45	3.40	3.40	3.50
10-year	3.47	4.39	4.46	3.54	4.10	4.00	3.90	3.75	3.60	3.50	3.45	3.50
30-year	3.82	4.42	4.92	4.14	4.75	4.70	4.60	4.50	4.40	4.30	4.30	4.40
Euro area*												
Deposit Rate	3.00	3.50	4.00	4.00	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
Two-year	2.66	3.27	3.20	2.40	2.75	2.70	2.70	2.60	2.25	2.00	1.75	1.80
Five-year	2.30	2.58	2.79	1.94	2.50	2.40	2.30	2.20	2.00	1.90	1.80	1.85
10-year	2.28	2.39	2.85	2.03	2.55	2.40	2.35	2.20	2.00	1.95	1.90	2.00
30-year	2.35	2.38	3.05	2.27	2.70	2.60	2.50	2.50	2.35	2.25	2.25	2.30
Australia												
Cash target rate	3.60	4.10	4.10	4.35	4.35	4.35	4.35	3.85	3.35	3.35	3.35	3.35
Two-year	2.96	4.21	4.09	3.71	3.70	3.65	3.50	3.40	3.40	3.40	3.60	3.75
10-year	3.30	4.02	4.49	3.95	4.30	4.25	4.10	4.00	3.95	3.95	4.00	4.25
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.00	4.50	4.00	4.00	4.00	4.00
Two-year swap	5.01	5.46	5.69	4.63	5.00	4.75	4.40	4.25	4.25	4.25	4.30	4.35
10-year swap	4.27	4.46	5.13	4.12	4.50	4.40	4.30	4.25	4.30	4.45	4.50	4.60

Sources: Refinitiv, BoC, Fed, BoE, ECB, RBA, RBNZ, RBC Economics, RBC Capital Markets | *German government bond yields

Economic outlook

Real GDP, quarter-over-quarter percent change

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2022	2023	2024	2025
Canada*	2.5	1.4	-1.1	0.5	0.3	1.4	1.8	2.2	2.0	2.1	2.6	2.9	3.8	1.1	0.7	2.1
United States*	2.2	2.1	4.9	3.3	1.0	0.0	1.0	1.2	1.8	1.8	1.8	1.8	1.9	2.5	1.8	1.5
United Kingdom	0.3	0.0	-0.1	-0.1	0.0	0.1	0.2	0.2	0.3	0.3	0.3	0.3	4.3	0.3	0.2	1.1
Euro area	0.1	0.1	-0.1	0.0	0.0	0.1	0.2	0.3	0.3	0.4	0.4	0.4	3.4	0.5	0.2	1.2
Australia	0.5	0.4	0.2	0.4	0.3	0.6	0.9	0.7	0.8	0.8	0.8	0.7	3.8	2.1	1.6	3.1

*annualized

Inflation, year-over-year percent change

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2022	2023	2024	2025
Canada	5.1	3.5	3.7	3.2	3.1	2.7	2.0	1.9	2.0	2.0	1.9	1.8	6.8	3.9	2.4	1.9
United States	5.8	4.0	3.5	3.2	2.8	2.7	2.4	2.3	2.2	2.2	2.1	2.0	8.0	4.1	2.6	2.1
United Kingdom	10.2	8.4	6.7	4.2	4.3	2.8	2.9	2.7	2.2	1.7	1.9	1.8	9.1	7.3	3.2	1.9
Euro area	8.0	6.2	5.0	2.7	2.6	2.5	2.1	2.3	2.2	2.1	2.1	2.1	8.4	5.4	2.4	2.1
Australia	7.0	6.0	5.4	4.1	3.5	3.4	2.9	3.1	3.0	2.9	2.9	2.8	6.6	5.6	3.2	2.9

Sources: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics, RBC Capital Markets

Currency outlook

US dollar cross rates, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
USD/CAD	1.35	1.32	1.35	1.32	1.34	1.36	1.33	1.31	1.31	1.30	1.30	1.29
EUR/USD	1.09	1.09	1.06	1.11	1.08	1.06	1.06	1.08	1.10	1.12	1.15	1.18
GBP/USD	1.24	1.27	1.22	1.27	1.27	1.25	1.23	1.24	1.24	1.23	1.24	1.26
USD/JPY	133	144	149	141	140	145	150	145	143	141	138	135
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.64	0.66	0.68	0.70	0.71	0.72	0.74

Canadian dollar cross rates

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
EUR/CAD	1.47	1.44	1.43	1.46	1.45	1.44	1.41	1.41	1.44	1.46	1.49	1.52
GBP/CAD	1.67	1.68	1.65	1.68	1.70	1.70	1.64	1.63	1.61	1.60	1.60	1.62
CAD/JPY	98	109	110	107	104	107	113	111	110	108	107	105
AUD/CAD	0.91	0.88	0.87	0.90	0.87	0.87	0.88	0.89	0.91	0.92	0.93	0.95

Sources: Federal Reserve Board, Bank of Canada, RBC Economics, RBC Capital Markets