

Financial Markets Monthly



February 2023

Know when to hold 'em

Pinning down terminal policy rates remains a challenge as central banks weigh slowing inflation and lagged effects of past tightening against mixed activity indicators and strong labour markets. The BoC became the first major central bank to hit pause on its tightening cycle after delivering a 25 bp hike in January, but others aren't ready to move to the sidelines just yet. Equity and bond markets rallied last month as investors grew more confident that the Fed is nearing the end of its tightening cycle, but a surprisingly strong jobs report cast doubt on that view. Following a round of central bank meetings in early-February we've raised our terminal policy rate forecasts for the BoE (+50 bps), ECB (+25 bps) and RBA (+25 bps). We continue to assume the Fed's next hike will be its last though payroll strength and Fed guidance leave risks skewed to the upside.






With inflation slowing but labour markets proving resilient, hopes for a soft landing are growing. After consistently trimming its global growth projections last year, the IMF revised its GDP forecasts higher in January, expecting a 2.9% gain this year that would be close to the global economy's trend growth rate. Stronger-than-expected economic data and lower energy prices have us expecting a shallower recession in the UK, and a slowdown rather than outright contraction in the euro area. But we still anticipate mild recessions in Canada and the US in 2023 as recent indicators (outside jobs data) show both economies losing momentum late last year.

While labour markets remain too hot for central banks' comfort, we think they'll eventually follow the BoC's lead and move to the sidelines after a year of aggressive tightening, waiting for an "accumulation of evidence" to support or oppose further hikes. Markets are generally priced for cuts later this year and in 2024, so if central banks are ultimately forced to resume tightening due to persistent inflation and excess demand (not our base case) the bond market would be in for a potentially painful adjustment.

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Central bank bias

Central bank	Current policy rate (latest move)	Next move
 BoC	4.50% +25 bps in Jan-23	On hold until Q1-24
<p>The BoC announced a conditional pause in January, saying it would take an “accumulation of evidence” to support further hikes. With the economy slowing, we don’t see the BoC resuming its tightening cycle.</p>		
 Fed	4.50-4.75% +25 bps in Feb-23	+25 bps in Mar-23
<p>The Fed dialed back to a 25 bp increase in February but continued to suggest ongoing rate hikes are needed. As evidence of an economic slowdown continues to emerge we don’t see the Fed hiking past March.</p>		
 BoE	4.00% +50 bps in Feb-23	+25 bps in Mar-23
<p>The BoE delivered a larger rate increase than we expected in February but its next decision should be between a hike and hold. We now see one more 25 bp move before the BoE steps to the sidelines.</p>		
 ECB	2.50% +50 bps in Feb-23	+50 bps in Mar-23
<p>The ECB made it clear that another 50 bp hike is coming in March, but it offered limited guidance beyond that. We’ve revised our terminal deposit rate forecast higher to 3.25% which we see being reached in May.</p>		
 RBA	3.35% +25 bps in Feb-23	+25 bps in Mar-23
<p>The RBA sounded more concerned about high inflation in February and said further rate hikes will be needed in the months ahead. We’ve revised our terminal cash rate forecast higher to 3.85%.</p>		

BoC moves to the sidelines

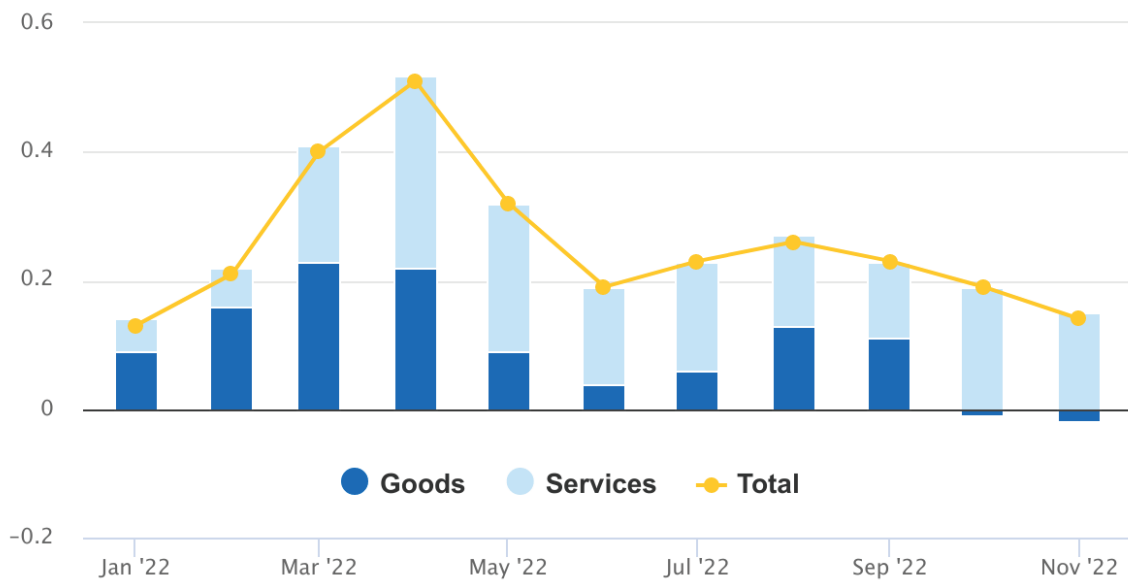
The BoC delivered a widely-expected 25 bp hike in January, and while we assumed it would be the last of the cycle, the bank's move to the sidelines was more explicit than we anticipated. Governing Council said that if the economic outlook evolves as expected—the BoC continues to see Canada's economy stalling in the coming quarters—it will hold the overnight rate at its current level. Governor Macklem elaborated that it would take an “accumulation of evidence” in support of further hikes for the BoC to resume tightening.

We think that's a wise approach given the lags with which monetary policy impacts the economy. The 425 bps of hikes delivered over the past year will be felt more acutely by households in 2023, in our view pushing average debt servicing costs to a record high and taking a bite out of consumer spending. Stepping back from the increased data dependence espoused in December reduces the risk that the BoC will over-tighten monetary policy by following lagging (and volatile) indicators like jobs numbers.

The BoC's guidance should make March's meeting a non-event by recent standards. April's meeting and MPR is likely the earliest point at which the BoC would have enough evidence to resuming tightening, but we don't see the data moving in that direction. Canada's economy carried little momentum into 2023. StatCan's preliminary estimate of Q4/22 GDP (+1.6% annualized) was below our assessment of the economy's potential growth rate (slightly above 2%) for the first time in six quarters. StatCan suggested activity was “essentially unchanged” in December after increasing by just 0.1% in November, and our tracking of cardholder spending held steady in the early stages of 2023. While the labour market remained firm in late-2022, the BoC's latest Business Outlook Survey pointed to slower future sales growth with firms paring back hiring and investment plans.

Canada's economy is losing momentum

ppt contributions to GDP growth, 3-month average



Source: StatCan, RBC Economics

While there's no clear evidence that a recession is currently underway, Canada's economy appears to be running close to stall speed and we continue to think modest GDP declines are likely over the first half of 2023. That should keep the BoC on the sidelines, and is likely to increase the focus on potential rate cuts later this year. Macklem said it's far too early for that discussion, and our forecast continues to assume the BoC will be on hold until early 2024.

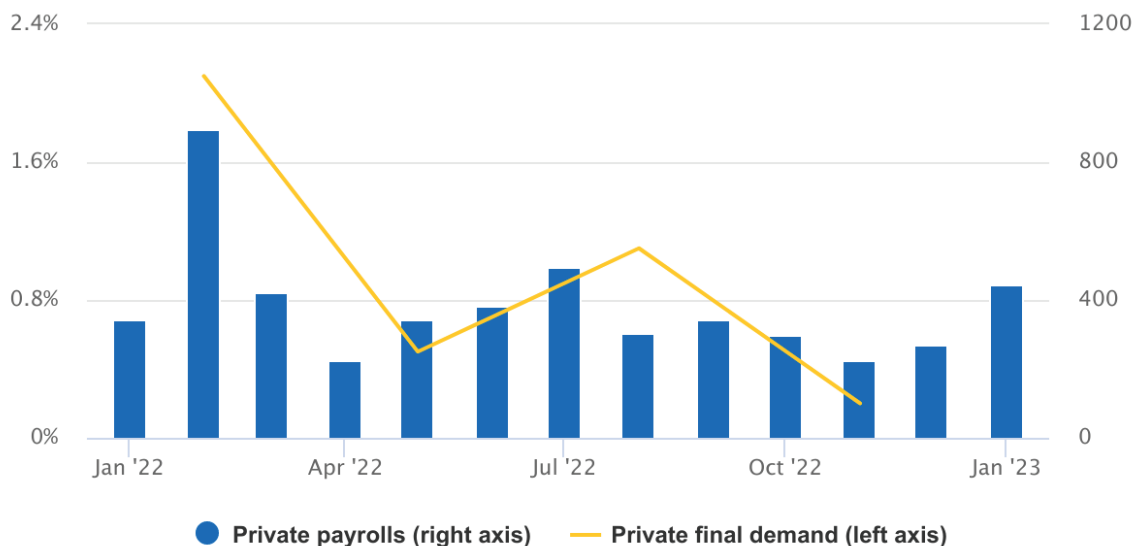
Fed dials back but isn't done yet

The Fed dialed back its tightening cycle with a 25 bp hike at the beginning of February. The policy statement called for ongoing rate increases, in line with December's dot plot that pointed to an above-5% terminal rate. But Chair Powell offered less push-back than usual against market pricing for a lower peak rate and cuts later this year, attributing that to investors anticipating a faster improvement in inflation than the Fed projected in December. We continue to think the Fed's end-of-2023 inflation forecasts (3.1% year-over-year for headline PCE and 3.5% for core) look too strong, particularly given recent trends (three-month annualized rates at 2.1% and 2.9%, respectively, in December).

While Powell didn't guide policy rate expectations higher, a strong jobs report two days later did just that. The US economy reportedly added 517,000 jobs in January—a pace that stands head and shoulders above gains seen during the post-GFC recovery—and the unemployment rate ticked down to a fresh cycle (and half-century) low of 3.4%. Markets are now pricing in more than 50 bps of further rate hikes by mid-year and fewer rate cuts by the end of 2023.

US private payrolls accelerated despite slowing demand

Real final sales to private domestic purchasers (q/q annualized) and private non-farm payroll growth (thousands)



Source: BEA, BLS, RBC Economics

We're inclined to take the jobs report with a grain of salt, particularly as other non-labour market indicators paint a more mixed picture. The US economy expanded at a healthy 2.9% annualized rate in Q4/22 but private final domestic demand (i.e. consumer spending and private investment) increased at the slowest pace since the pandemic recovery began. Consumer spending declined in the final two months of 2022, led by a pullback in goods purchases, and industrial production also slowed. We continue to expect GDP will be flat in the first quarter of 2023. Clear signs that the economy is losing momentum and inflation is slowing should make the Fed's March hike its last. That said, there is a risk that persistent labour market strength (even if not as robust as January's payrolls) keeps the Fed hiking in May, in line with its December dot plot and current market pricing.

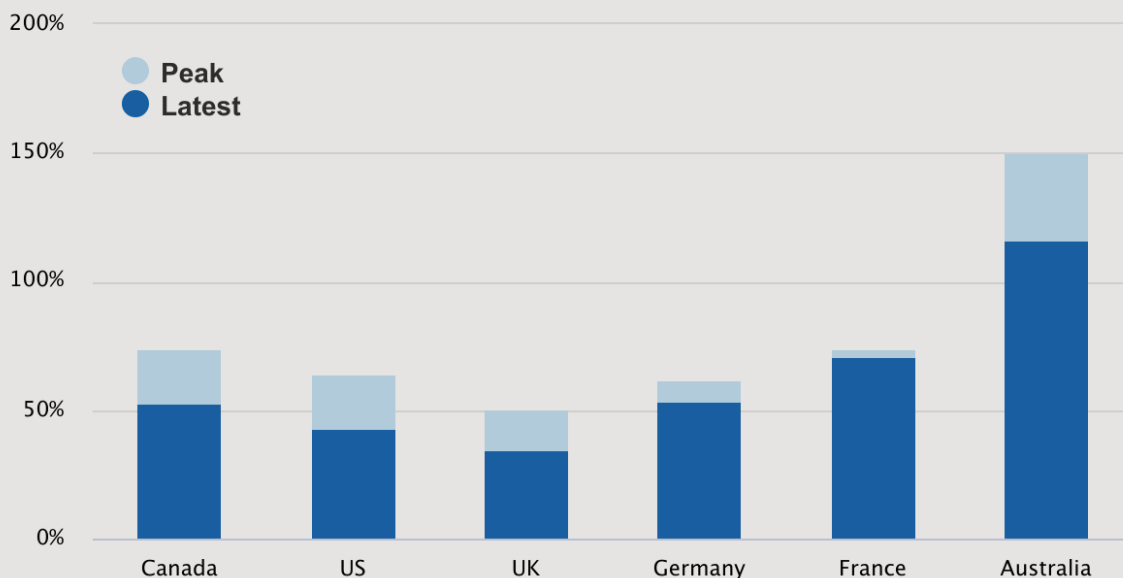
Will resilient labour markets keep central banks on the offensive?

While we've been emphasizing that the labour market is a lagging indicator—it's not likely to point to a slowdown until we're in one—the degree of resilience seen across many advanced economies is still surprising. As noted above, the US saw an unexpected (and somewhat puzzling) acceleration on job growth in January despite signs domestic demand is softening. Canada recorded average monthly job gains of 55,000 in Q4/22 (more than twice the pre-pandemic run rate) in the face of sub-trend GDP growth, and the jobless rate ticked down for second straight month in December. UK payroll employment growth remained robust late last year and the unemployment rate held near cycle lows even as the economy stalled. Both euro area and Australian jobless rates are now well below pre-pandemic levels.

And forward-looking labour market indicators aren't particularly discouraging. Across most geographies, employment indices are the bright spot in otherwise lackluster PMI surveys, suggesting hiring demand remains solid. Job openings have come down from cycle highs but remain historically elevated. Fears that vacancies couldn't decline without a significant increase in unemployment have thus far been unfounded.

Job openings have come down from cycle highs

Percent change in job openings vs. Feb 2020



Source: Indeed Hiring Lab, RBC Economics

Despite tight labour market conditions, wage growth appears to have peaked in some economies. Average hourly earnings in the US were up 4.4% year-over-year in January, down from a nearly 6% pace in early-2022. Two of Canada's key wage measures are off their cycle highs but still running at 4-5% year-over-year. The key question for central banks is whether pay growth can continue to cool without a meaningful increase in unemployment that rebalances the job market. If current wage and productivity trends hold, it's hard to see inflation returning sustainably to target.

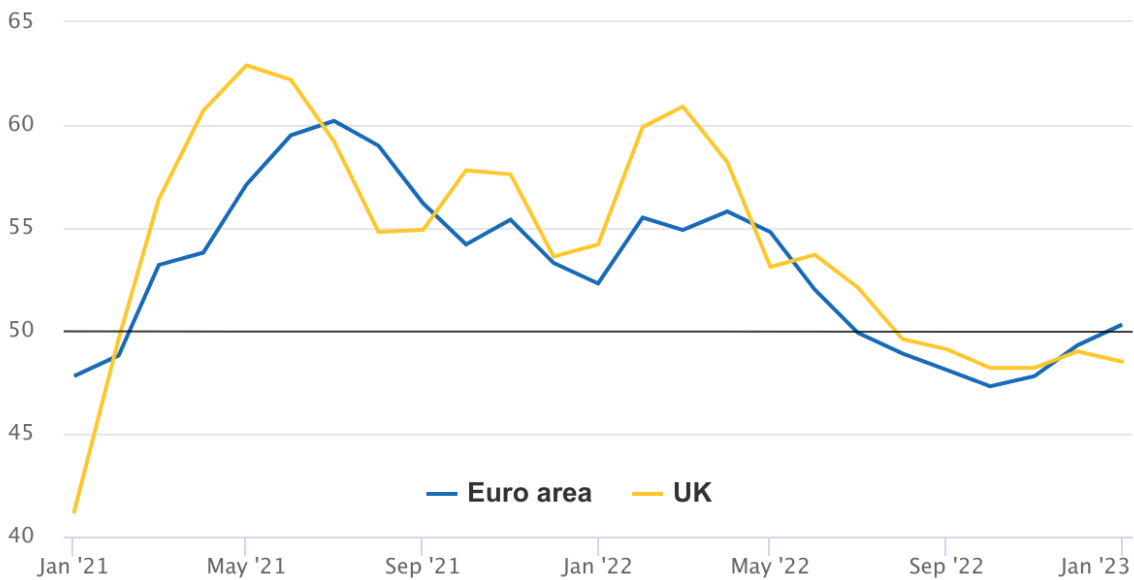
Again, the labour market is a lagging indicator so we think central banks need to practice some patience in evaluating the pass through of monetary policy into economic activity, the labour market, wages and underlying inflation. We expect other central banks will soon follow the BoC's lead and step to the sidelines to see how that process plays out. If, as we expect, economic activity and (eventually) job markets begin to soften, policy rates are likely to peak in the first half of this year and discussion will turn to when rate cuts might begin. But if labour market resilience persists well into 2023, central banks will be looking at restarting their tightening cycles rather than easing. We see that as an upside tail risk to the interest rate forecasts presented here.

Europe may dodge recession, UK to see shallower declines

The euro area defied expectations for a Q4/22 pullback, eking out a 0.1% non-annualized GDP gain to close out the year. A sizeable increase in often-volatile Irish GDP flattered the headline reading—growth would otherwise have been flat—and we think domestic demand was soft with country-level releases flagging a decline in consumer spending across the currency bloc’s largest economies. But survey data suggest growth prospects are improving, with the euro area composite PMI returning to expansionary territory in January for the first time in seven months. Our forecast now assumes the currency bloc will avoid an outright recession, though growth over the first half of 2023 is expected to be sluggish. While natural gas prices are at their lowest level since September 2021, they’re still two to three times pre-pandemic levels. Higher energy costs will continue to squeeze consumers and the industrial sector, leaving growth at a sub-trend pace in the near term.

Latest surveys point to euro area expansion, UK contraction

composite purchasing managers' index (50+=expansion)



Source: S&P Global, RBC Economics

It looks like the UK managed to avoid a second straight quarter of contraction with the economy expected to post a modest 0.1% GDP gain in Q4/22. Unlike the euro area, we don't think the UK will be able to dodge a recession in 2023—the latest PMI data continue to point to modest declines in activity early this year. But we don't think the slowdown will be as deep as previously feared, with the economy now expected to contract by 0.4% for the year as a whole rather than our previous -1.0% projection.

Looking for more hikes from the ECB, BoE and RBA

Following the latest round of central bank meetings, we've revised our terminal rate forecasts higher for the ECB, BoE and RBA. Hiking by an as-expected 50 bps in February, the ECB made clear that a similar increase should be expected in March (our previous forecast assumed 25 bps). It offered little explicit guidance beyond that, although President Lagarde said March's hike was unlikely to be the last. We continue to expect a 25bp increase in May, with a larger move in March leaving the terminal deposit rate at 3.25% rather than our previously assumed 3%.

The BoE delivered a larger-than-expected 50 bp hike in February but hinted that it's nearing the end of its tightening cycle. Governor Bailey's comments and the MPC's updated guidance effectively raised the bar for further rate hikes. We think the BoE's next decision in March will be between a hold and a 25 bp hike, with our forecast now assuming the latter which would leave terminal Bank Rate at 4.25% (rather than the 3.75% previously assumed). But we think the BoE will move to the sidelines thereafter, like the BoC waiting for evidence to accumulate whether monetary policy needs to tighten further.

The RBA delivered another 25 bp hike, as expected, at its first policy meeting of 2023. But following a worrying set of inflation data—core inflation in particular was stronger than expected and well above the central bank's forecast—the RBA's messaging was more hawkish than late last year. Policymakers sounded particularly concerned about the potential consequences of persistently high inflation. With the statement pointing to further rate hikes “over the months ahead” we've added another 25 bp move to our forecast, with a terminal cash rate of 3.85% being reached in April.

Interest rate outlook

Policy rates and government bond yields, end of period

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
Canada												
Overnight rate	0.50	1.50	3.25	4.25	4.50	4.50	4.50	4.50	4.00	3.50	3.25	3.00
Three-month	0.60	2.08	3.58	4.23	4.40	4.40	4.40	4.30	3.70	3.25	3.00	2.85
Two-year	2.27	3.10	3.79	4.06	3.90	3.75	3.60	3.40	3.00	2.90	2.80	2.70
Five-year	2.39	3.10	3.32	3.41	3.15	2.95	2.85	2.75	2.70	2.65	2.60	2.55
10-year	2.40	3.23	3.16	3.30	2.95	2.80	2.75	2.70	2.65	2.60	2.60	2.60
30-year	2.37	3.14	3.09	3.28	3.00	2.90	2.85	2.85	2.85	2.85	2.85	2.85
United States												
Fed funds midpoint	0.38	1.63	3.13	4.38	4.88	4.88	4.88	4.38	4.13	3.88	3.63	3.38
Three-month	0.52	1.72	3.33	4.42	5.05	4.75	4.60	4.10	3.90	3.65	3.45	3.25
Two-year	2.28	2.92	4.22	4.41	4.35	4.20	3.90	3.60	3.30	3.00	2.75	2.50
Five-year	2.42	3.01	4.06	3.99	3.70	3.55	3.40	3.30	3.20	3.10	3.05	3.00
10-year	2.32	2.98	3.83	3.88	3.65	3.55	3.45	3.35	3.25	3.20	3.15	3.15
30-year	2.44	3.14	3.79	3.97	3.70	3.65	3.65	3.65	3.65	3.65	3.65	3.65
United Kingdom												
Bank rate	0.75	1.25	2.25	3.50	4.25	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Two-year	1.36	1.85	4.29	3.71	3.40	3.30	3.25	3.15	3.10	3.00	2.90	2.90
Five-year	1.40	1.88	4.40	3.62	3.10	3.00	3.00	2.90	2.80	2.75	2.70	2.70
10-year	1.60	2.22	4.08	3.67	3.15	3.00	2.90	2.80	2.70	2.65	2.60	2.60
30-year	1.77	2.59	3.82	3.95	3.60	3.45	3.25	3.10	3.05	3.00	3.00	3.00
Euro area*												
Deposit Rate	-0.50	-0.50	0.75	2.00	3.00	3.25	3.25	3.25	3.25	3.25	3.25	3.25
Two-year	-0.08	0.64	1.78	2.76	2.60	2.60	2.50	2.40	2.40	2.35	2.30	2.25
Five-year	0.37	1.09	1.98	2.58	2.25	2.20	2.10	2.00	1.90	1.85	1.80	1.80
10-year	0.55	1.36	2.12	2.57	2.15	2.05	2.00	1.95	1.90	1.85	1.80	1.80
30-year	0.67	1.63	2.10	2.46	2.15	2.05	2.00	1.95	1.90	1.85	1.80	1.80
Australia												
Cash target rate	0.10	0.85	2.35	3.10	3.60	3.85	3.85	3.85	3.85	3.60	3.35	3.35
Two-year	1.78	2.73	3.43	3.41	3.35	3.20	2.95	2.75	2.65	2.50	2.50	2.50
10-year	2.84	3.66	3.90	4.05	3.75	3.65	3.60	3.55	3.50	3.40	3.30	3.25
New Zealand												
Cash target rate	1.00	2.00	3.00	4.25	5.00	5.25	5.00	4.50	4.25	4.00	3.75	3.50
Two-year swap	3.27	4.06	4.76	5.36	5.00	4.50	4.10	3.70	3.60	3.50	3.40	3.30
10-year swap	3.38	4.10	4.50	4.78	4.20	4.15	4.00	3.80	3.75	3.70	3.65	3.60

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

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	2021	2022	2023	2024
Canada*	2.8	3.2	2.9	1.5	-0.5	-1.0	0.2	0.5	1.5	2.0	2.6	2.8	5.0	3.6	0.6	1.3
United States*	-1.6	-0.6	3.2	2.9	0.0	-1.2	-1.5	0.5	1.0	1.5	2.0	2.0	5.9	2.1	0.5	0.7
United Kingdom	0.6	0.1	-0.3	0.1	-0.3	-0.2	0.1	0.2	0.2	0.2	0.3	0.3	7.6	4.1	-0.4	0.7
Euro area	0.6	0.9	0.3	0.1	0.1	0.2	0.4	0.4	0.4	0.5	0.5	0.5	5.3	3.5	1.0	1.7
Australia	0.4	0.9	0.6	0.6	0.2	0.2	0.2	0.3	0.6	0.9	0.9	1.0	5.2	3.6	1.5	1.8

*annualized

Inflation, year-over-year percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	2021	2022	2023	2024
Canada	5.8	7.5	7.2	6.7	5.3	3.3	2.5	2.0	2.2	2.3	2.2	2.0	3.4	6.8	3.3	2.2
United States	8.0	8.6	8.3	7.1	5.2	3.1	2.3	2.2	2.4	2.4	2.4	2.2	4.7	8.0	3.2	2.3
United Kingdom	6.2	9.2	10.0	10.8	9.8	8.0	6.7	4.6	4.2	1.6	1.4	1.3	2.6	9.1	7.3	2.1
Eurozone	6.1	8.0	9.3	10.0	8.6	7.0	5.7	3.5	2.8	2.6	2.3	2.2	2.6	8.4	6.2	2.5
Australia	5.1	6.1	7.3	7.8	6.6	6.0	5.7	5.4	5.2	5.0	4.7	4.4	2.9	6.6	5.9	4.8

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

Currency outlook

US dollar cross rates, end of period

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
USD/CAD	1.25	1.29	1.38	1.35	1.33	1.34	1.35	1.36	1.34	1.32	1.30	1.28
EUR/USD	1.11	1.05	0.98	1.07	1.10	1.07	1.05	1.03	1.03	1.07	1.11	1.15
GBP/USD	1.32	1.22	1.11	1.21	1.22	1.18	1.14	1.13	1.14	1.19	1.23	1.28
USD/JPY	121	136	145	132	125	130	135	140	140	139	137	135
AUD/USD	0.75	0.69	0.64	0.68	0.72	0.71	0.70	0.68	0.66	0.64	0.63	0.62

Canadian dollar cross rates

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24
EUR/CAD	1.39	1.35	1.34	1.45	1.46	1.43	1.42	1.40	1.38	1.41	1.44	1.47
GBP/CAD	1.64	1.57	1.51	1.63	1.63	1.58	1.54	1.54	1.53	1.57	1.60	1.64
CAD/JPY	97	105	105	97	94	97	100	103	104	105	105	105
AUD/CAD	0.94	0.89	0.89	0.92	0.96	0.95	0.95	0.92	0.88	0.84	0.82	0.79

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