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New legs, or familiar lags?

After a year of aggressive interest rate hikes, major economies continue to show signs of resilience and in some cases acceleration in early-2023. And core inflation isn't slowing as quickly as central bankers would like. That raises the question of whether the current economic cycle has new legs—necessitating even higher interest rates to rein in growth and inflation—or if patience is needed as monetary policy acts with well-known lags. Some policymakers are leaning toward the latter. The BoC moved to the sidelines in March and both the BoE and RBA are approaching a pause. But the Fed and ECB think there's more work to be done. We've added 50 bps to terminal rate forecasts for both.

With more tightening in the pipeline, government bonds were on the back foot in February. Treasuries suffered their worst monthly decline since September and Bund yields rose to new cycle highs. US equities fell modestly but stayed well above levels seen four month ago, the last time 10-year yields were at 4%. Yield curve inversion deepened as investors continue to see restrictive monetary policy slowing growth and inflation over time. Despite some upside surprises in recent data, we continue to think the tightening delivered thus far will result in modest GDP declines in the US, Canada and UK, and sluggish growth in the euro area and Australia in the coming quarters. That should create a more constructive environment for fixed income as the year progresses.

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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>4.50%
No change in Mar-23</td><td>On hold
until Q1-24</td></tr>
<tr><td colspan="3">The BoC held its overnight rate steady in March and reiterated a conditional pause in its tightening cycle. The policy statement was slightly dovish, giving no indication the bank plans to act on its tightening bias.</td></tr>
<tr><td>Fed</td><td>4.50-4.75%
+25 bps in Feb-23</td><td>+25 bps
in Mar-23</td></tr>
<tr><td colspan="3">Strong data has the Fed sounding more hawkish and we've revised our terminal fed funds forecast higher to 5.25-5.50%. We think they'll stick with 25 bp increments though Chair Powell opened the door to a larger move.</td></tr>
<tr><td>BoE</td><td>4.00%
+50 bps in Feb-23</td><td>+25 bps
in Mar-23</td></tr>
<tr><td colspan="3">The BoE hasn't sounded nearly as hawkish as the Fed and ECB, and we continue to expect it will downshift to a 25 bp hike in March. We think the market is overestimating tightening beyond the next meeting.</td></tr>
<tr><td>ECB</td><td>2.50%
+50 bps in Feb-23</td><td>+50 bps
in Mar-23</td></tr>
<tr><td colspan="3">With core inflation continuing to accelerate, the ECB looks set to raise rates even further and we've revised our terminal deposit rate forecast up to 3.75%. We expect 25 bp moves after one more 50 bp hike in March.</td></tr>
<tr><td>RBA</td><td>3.60%
+25 bps in Feb-23</td><td>+25 bps
in Mar-23</td></tr>
<tr><td colspan="3">Dovish language in March suggested the RBA is nearing the end of its tightening cycle. We expect another hike in April will be followed by a pause, though the RBA won't be as firmly on the sidelines as the BoC.</td></tr>
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Strong January data has the Fed sounding more hawkish

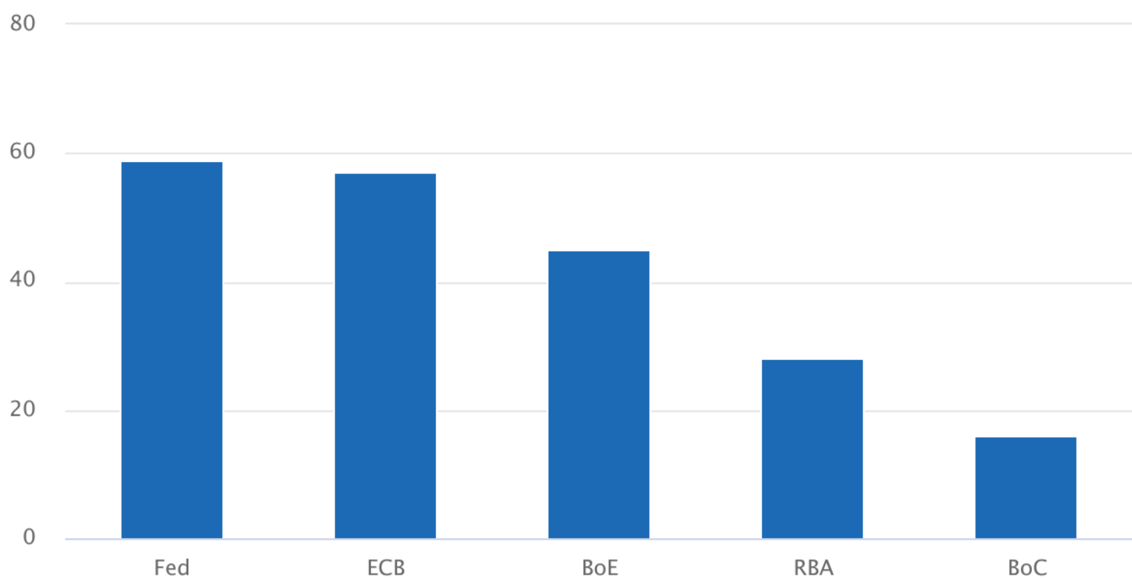
After signs that the US economy was losing momentum late last year—private domestic demand was essentially flat in Q4—recent data suggest a surprising resurgence in early-2023. Payroll employment rose by more than 500,000 in January and surpassed market expectations again in February. Inflation-adjusted consumer spending recorded its strongest monthly increase in nearly two years in January, more than retracing declines in the prior two months. And manufacturing output posted its strongest gain in almost a year. Perhaps most worrying for the Fed, headline PCE inflation ticked higher year-over-year for the first time in seven months, and core inflation (and core services ex housing) accelerated on a monthly basis. All told we've revised our Q1 GDP forecast higher to 1.0% annualized from flat previously, and our 2023 projections for headline and core CPI inflation have been revised about ½ ppt higher.

Warm weather and post-pandemic seasonal adjustment issues might explain some of the strength in January data. And it's not as if rate increases aren't having an impact. The US's housing downturn deepened in January with existing home sales falling to a 12-year low and starts down 20% from a year earlier. Business investment is also softening with capital goods orders little changed in recent months. But the Fed isn't willing to risk pausing its tightening cycle prematurely, and a number of FOMC speakers have suggested interest rates will have to rise further than December's dot plot indicated. Chair Powell reiterated that message in March and even re-opened the door to larger rate increases after the Fed downshifted to a 25 bp hike in February. But with February's jobs data looking soft beyond the headline gain (unemployment rate up, wage growth slowing and hours worked down) we think the Fed will opt for another 25 bp hike in March.

We continue to think monetary policy has become restrictive enough to slow the economy, and the Fed should be mindful of the lagged impact of 450 bps of hikes delivered over the past year—the steepest increase since the early-1980s. The real fed funds rate will also become more restrictive as inflation continues to slow, passively tightening monetary policy even if nominal fed funds is on hold. But with the Fed clearly preferring to err on the side of more aggressive action, we've revised our terminal rate forecast 50 bps higher to 5.25-5.50%. We continue to think the Fed will begin to gradually reverse course around the turn of the year.

Markets reassessing terminal policy rates

basis point change in market-implied terminal rate since end of January (as of March 9)



Source: Bloomberg, RBC Economics

BoC moves to the sidelines, and sounds comfortable there

The BoC held the overnight rate steady in March after hiking at each of its past eight meetings (+425 bps cumulatively). Its move to the sidelines was widely expected with January's statement having clearly signaled a pause and mixed data since then falling well short of the "accumulation of evidence" needed for the BoC to restart tightening. Q4 GDP was disappointing (flat vs. an expected 1.3% annualized increase) though the miss was largely due to slower inventory investment—final domestic demand rose 1%. The BoC made no mention of a rebound in January's flash GDP estimate, which led us to revise our Q1 growth forecast from a modest decline to a 1% annualized gain (the BoC was already forecasting a 0.5% increase).

We continue to expect Canada's economy will see some modest quarterly declines in 2023, but now in the middle quarters rather than first half of the year. For its part, the BoC expects "weak economic growth for the next couple of quarters." Unlike January's statement, there was no mention of "excess demand" in the economy, though other comments suggested an ongoing supply-demand imbalance. With headline CPI easing and 3-month annualized core inflation running at 3.5%, the BoC maintained its view that inflation will slow to 3% (the upper end of its inflation-control target range) by the middle of the year, in line with our own forecast. But a "very tight" labour market continues to cause discomfort. The bank pointed to wage growth of 4-5% which, given weak productivity, is well above levels consistent with 2% inflation. With the economy now growing at a sub-trend pace—implying excess demand is easing—it's hard to see the unemployment rate holding at a near-record low of 5%. Sluggish growth gives the BoC cause for patience but it will eventually want to see the labour market returning to better balance if it is going to remain on the sidelines and not raise rates any further.

Hard landing, soft landing... no landing?

Amid ongoing debate over whether central banks will be able to deliver a soft landing—restoring price stability without causing an economic downturn—or if efforts to rein in inflation will cause a hard landing, a new term has emerged recently. Stronger-than-expected data have raised the prospect of a "no landing" scenario in which the economy and labour market fail to slow despite the increase in interest rates over the past year. But would that be acceptable to central banks? Unless their assessments of sustainable levels of economic activity and unemployment are way off the mark, it's hard to see inflation returning to target in such a scenario. That's particularly true in Canada and the US where we think overheating is greatest. So "no landing" should be a no-go for the BoC and Fed—it would simply necessitate even tighter monetary policy to slow the economy, increasing the odds of a hard landing in 2024. That remains one of the key downside risks to our outlook. But our base case continues to be that the tightening delivered thus far (425 bps by the BoC and 450 bps by the Fed) will be enough to push the Canadian and US economies into a mild recession this year, restoring better balance between supply and demand and helping inflation return to target.

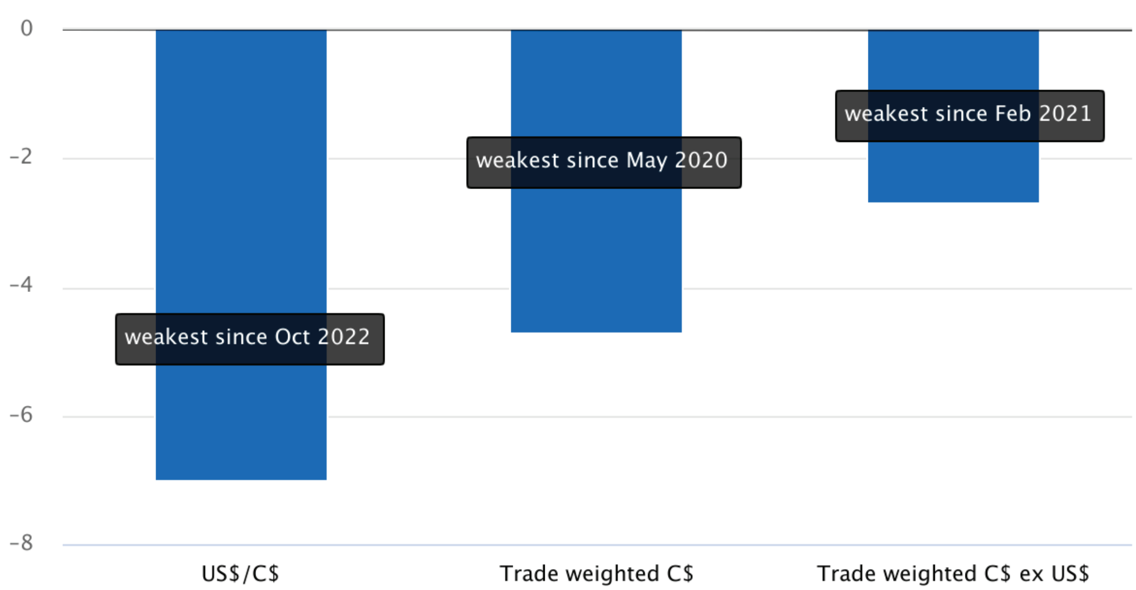
Canadian dollar under pressure amid policy divergence

A hawkish Fed and on-hold BoC has pushed 2-year Canada-US spreads to their tightest levels since 2019. That has put downward pressure on the Canadian dollar which is closing in on October's lows relative to the US dollar (around 72 cents). Back then, there was speculation—fueled in part by comments from Governing Council—that the BoC might have to continue with aggressive rate hikes to keep up with the Fed and support the currency. But the market was ultimately disappointed when the BoC downshifted to a 50 bp hike in October.

As was the case last year, we don't think the currency's recent weakness will have a significant impact on monetary policy. Policy divergence between the Fed and BoC is not unusual—terminal fed funds was 63-100 bps higher than the BoC's overnight rate in each of the past three major tightening cycles—and not unjustified given faster interest rate pass-through and higher levels of household debt in Canada. And it remains the case that some of the recent depreciation reflects US dollar strength. The Canadian dollar is down by 7% year-over-year against the greenback but only 3% lower against the currencies of Canada's other key trading partners. In the BoC's March policy statement, it put the focus on a strong US dollar rather than a weak Canadian dollar. It also pointed to tightening financial conditions, and in our view the recent increase in Canadian bond yields offsets any stimulative impact from a weaker currency. From an inflation perspective, a 5% year-over-year decline in the trade-weighted Canadian dollar will add to import costs but puts only modest upward pressure on broader consumer prices.

Canadian dollar depreciating, particularly vs. strong US$

year-over-year percent change in C$ as of March 8, "weakest since" refers to level



Source: Bank of Canada, RBC Economics

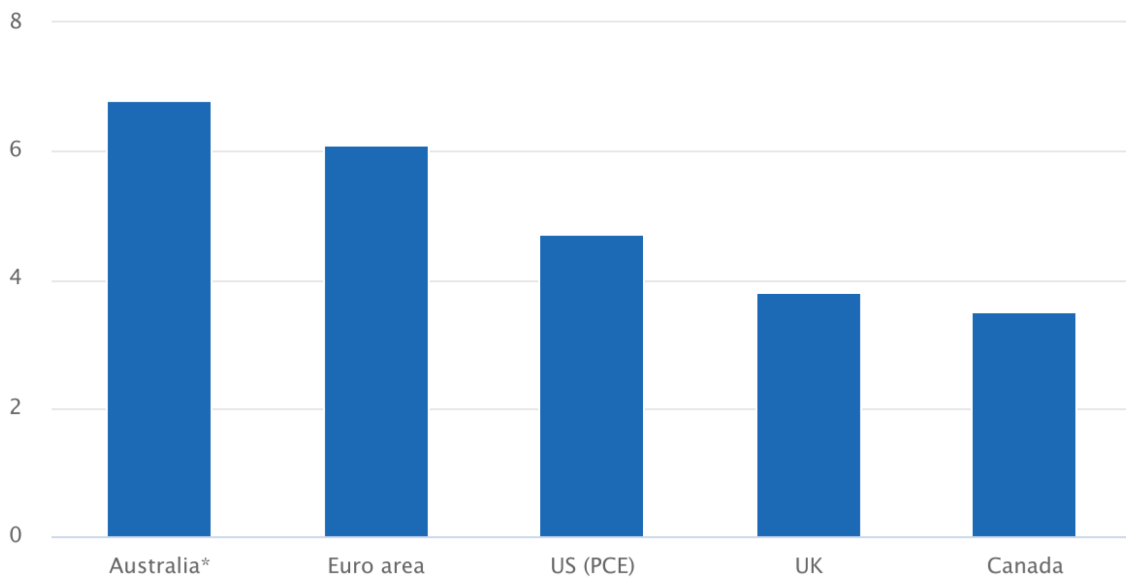
Accelerating core inflation forces the ECB to do more

Recent activity indicators for the euro area have been more mixed than in the US. Q4 GDP growth was revised down to flat and domestic demand posted its largest decline (-1%) since the initial pandemic lockdowns. PMI data point to a return to growth in early-2023—the composite reading rose to an eight-month high in February—and consumer sentiment has improved, though soft retail sales suggest actual spending remains lackluster. But it's the latest inflation data that will have more sway over monetary policy. Headline inflation was stronger than expected in February and core inflation rose to a fresh high of 5.6% year-over-year. While most other advanced economies have seen some flattening or moderation in core readings, the euro area is seeing acceleration. Some of that reflects ongoing pass-through of higher energy prices into broader goods inflation, and we continue to think core inflation will peak on a year-over-year basis in the coming months.

But it looks like lack of progress in taming core inflation will force the ECB to do more. We've added another 50 bps to our terminal deposit rate forecast (now 3.75%), expecting a 50 bp increase later this month will be followed by 25 bp hikes through July. The market is pricing in an even higher 4% terminal rate and we think the risk is skewed in that direction. Perhaps more importantly, we don't see the ECB following the Fed and BoC in cutting interest rates around the turn of the year. Even with inflation slowing, its real policy rate will be only modestly above zero and below past cyclical peaks. With the ECB likely to hold rates at terminal for longer, we don't see Bunds rallying as much as Treasuries over the next year.

Core inflation remains uncomfortably high

latest 3-month annualized percent change in seasonally adjusted core inflation



Source: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics | *Q4 annualized

BoE and RBA getting closer to a pause

Other central banks haven't sounded nearly as hawkish as the Fed and ECB. The BoE's chief economist suggested continuing with 50 bp increases would cause the central bank to over-tighten, and we look for a smaller 25 bp hike later this month. Market-implied terminal Bank Rate has been dragged higher alongside the Fed and ECB but we think the BoE will be cautious beyond its next meeting. Headline inflation has peaked and is set to slow further as last spring's sharp increases in energy prices fall out of calculation. Core inflation is also beginning to moderate, and while wage growth remains too firm, declining job vacancies suggest labour market pressure is beginning to ease. Our forecasts assumes the BoE will be on hold after March with a terminal Bank Rate of 4.25%.

The RBA hike by 25 bps at its March meeting but softened its language on further rate increases and hinted that it might soon be ready to pause its tightening cycle. Weaker-than-expected Q4 GDP growth (including a slowdown in household spending amid tightening financial conditions), early evidence that inflation has peaked, and less concern about a wage-price spiral all contributed to the more dovish tone. We continue to look for one more 25 bp hike in April before the central bank moves to the sidelines. But with monetary policy only modestly restrictive, we think the RBA's pause will be less firm than the BoC's and risks around our terminal cash rate forecast are still skewed to the upside.

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	4.10	3.85	3.60	3.40	3.00	2.90	2.80	2.70
Five-year	2.39	3.10	3.32	3.41	3.30	3.05	2.85	2.75	2.70	2.65	2.60	2.55
10-year	2.40	3.23	3.16	3.30	3.05	2.90	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	5.38	5.38	5.13	4.63	4.38	4.13	3.88
Three-month	0.52	1.72	3.33	4.42	5.00	5.50	5.25	4.75	4.40	4.15	3.90	3.65
Two-year	2.28	2.92	4.22	4.41	4.70	4.50	4.30	3.95	3.60	3.30	3.05	2.80
Five-year	2.42	3.01	4.06	3.99	4.00	3.70	3.55	3.40	3.30	3.20	3.15	3.10
10-year	2.32	2.98	3.83	3.88	3.90	3.75	3.60	3.45	3.35	3.30	3.25	3.25
30-year	2.44	3.14	3.79	3.97	3.80	3.70	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	3.55	3.75	3.55	3.50	3.35	3.25	3.15	3.00
Five-year	1.40	1.88	4.40	3.62	3.55	3.75	3.60	3.55	3.45	3.35	3.25	3.15
10-year	1.60	2.22	4.08	3.67	3.55	3.75	3.65	3.65	3.40	3.40	3.35	3.35
30-year	1.77	2.59	3.82	3.95	3.85	4.00	3.95	3.95	3.90	3.90	3.85	3.85
Euro area*												
Deposit Rate	-0.50	-0.50	0.75	2.00	3.00	3.50	3.75	3.75	3.75	3.75	3.75	3.75
Two-year	-0.08	0.64	1.78	2.76	3.00	3.15	3.10	3.05	3.00	2.95	2.85	2.70
Five-year	0.37	1.09	1.98	2.58	2.55	2.75	2.70	2.65	2.60	2.60	2.50	2.40
10-year	0.55	1.36	2.12	2.57	2.50	2.65	2.65	2.55	2.50	2.50	2.45	2.35
30-year	0.67	1.63	2.10	2.46	2.25	2.35	2.35	2.30	2.25	2.25	2.25	2.20
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	3.45	3.40	3.20	3.00	2.90	2.80	2.75	2.75
10-year	2.84	3.66	3.90	4.05	3.70	3.65	3.60	3.55	3.45	3.35	3.25	3.25
New Zealand												
Cash target rate	1.00	2.00	3.00	4.25	5.00	5.25	5.25	4.75	4.25	4.00	3.75	3.50
Two-year swap	3.27	4.06	4.76	5.36	5.30	5.20	5.00	4.50	4.10	3.80	3.50	3.30
10-year swap	3.38	4.10	4.50	4.78	4.50	4.45	4.25	4.00	3.90	3.80	3.70	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*	2.4	3.6	2.3	0.0	1.0	-0.5	-1.0	0.5	1.5	2.0	2.6	2.8	5.0	3.4	0.6	1.2
United States*	-1.6	-0.6	3.2	2.7	1.0	-1.2	-1.5	0.5	1.0	1.5	2.0	2.0	5.9	2.1	0.7	0.7
United Kingdom	0.5	0.1	-0.2	0.0	-0.2	0.0	0.1	0.2	0.2	0.2	0.3	0.3	7.6	4.0	-0.1	0.8
Euro area	0.6	0.9	0.4	0.0	0.1	0.2	0.4	0.4	0.4	0.5	0.5	0.5	5.3	3.5	0.9	1.7
Australia	0.6	0.9	0.7	0.5	0.2	0.2	0.1	0.2	0.5	0.8	0.8	0.9	5.2	3.7	1.3	1.5

*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	5.1	3.2	2.6	1.9	2.0	2.3	2.3	2.1	3.4	6.8	3.2	2.2
United States	8.0	8.6	8.3	7.1	5.7	3.7	2.9	2.6	2.3	2.4	2.3	2.2	4.7	8.0	3.7	2.3
United Kingdom	6.2	9.2	10.0	10.8	9.6	6.4	4.1	2.1	2.0	0.6	1.4	1.3	2.6	9.1	5.6	1.3
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	7.2	6.7	6.4	5.7	5.3	5.0	4.7	4.4	2.9	6.6	6.5	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	1.36	1.37	1.38	1.39	1.37	1.35	1.33	1.31
EUR/USD	1.11	1.05	0.98	1.07	1.07	1.07	1.05	1.03	1.03	1.07	1.11	1.15
GBP/USD	1.32	1.22	1.11	1.21	1.19	1.18	1.14	1.13	1.14	1.19	1.23	1.28
USD/JPY	121	136	145	132	135	130	135	140	140	139	137	135
AUD/USD	0.75	0.69	0.64	0.68	0.67	0.68	0.67	0.66	0.65	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	1.47	1.45	1.43	1.41	1.44	1.48	1.51
GBP/CAD	1.64	1.57	1.51	1.63	1.62	1.61	1.58	1.57	1.57	1.61	1.64	1.67
CAD/JPY	97	105	105	97	99	95	98	101	102	103	103	103
AUD/CAD	0.94	0.89	0.89	0.92	0.91	0.93	0.92	0.92	0.89	0.86	0.84	0.81

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