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Financial Markets Monthly

March 2024

U.S. outperformance continues but no sunshine yet for the Canadian economy

Resilience in the U.S. economy continued to buoy investors' confidence, driving equities higher and narrowing credit spreads in February. Conditions also looked to have bottomed in the euro area and U.K. as purchasing manager indices pointed to a sustained rebound in services demand. In Canada, things are much less upbeat—output growth in Q4 2023 inched along but per-capita output continues to decline. Insolvencies among businesses and consumers are continuing to rise, sounding the alarm for downside economic risks ahead.

Highlights:

- Global central banks are reiterating that more progress is still needed on inflation before they can commit to cutting interest rates.
- We continue to expect the U.S. Federal Reserve to make its first cut to rates in its June meeting, and the Bank of Canada and European Central Bank in the week prior to the Fed (also in June), and a much more hawkish sounding Bank of England to follow suit later in August.
- Resurfacing inflation pressures in the U.S. over early 2024 means a more cautious Fed after the start of rate cuts. We expect them to go by a slower pace (once every other meeting) for the rest of 2024.
- <u>Topic in focus:</u> Business insolvencies have surged in Canada in early 2024. Granted, the increase is from exceptionally low levels during the pandemic, and the January deadline for federal CEBA pandemic support loans is likely playing a role. But the trend looks concerning nonetheless and serves as a reminder that downside economic growth risks remain, and further deterioration in labour market conditions and household incomes are not entirely off the radar.

Overview

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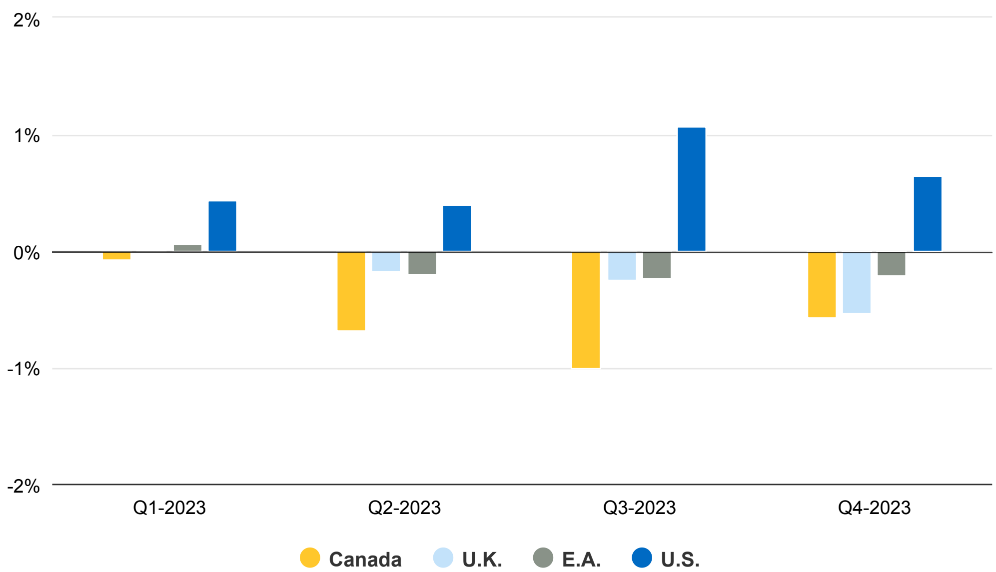
U.S. resilience stretching on but inflation risks also resurfacing

The outperformance of the U.S. economy persisted for another month. Personal spending on services was still running hot in January, and February's payroll report extended the streak of solid employment gains. A strong macro backdrop won't be problematic as long as inflation stays low. However, CPI data over early 2024 also showed price pressures reaccelerating. That's likely to set the Federal Reserve back a step in its assessment of the sustainability of low inflation over the second half of last year. Markets have pared back pricing for rate cuts this year, moving towards a June starting point that is consistent with our forecast. Beyond then however, we expect fewer cuts this year at a pace of every other meeting for the rest of 2024 (we had expected the Fed to cut in every meeting previously), leaving the Fed Funds range 50 bps higher than we previously expected, at 4.5% - 4.75% by the end of this year.

Economic growth disparity persisting among economies

Quarterly growth in per-capita GDP



Source: Haver, RBC Economics calculations | *Estimates for UK and the EA are based on working age population

Economic conditions in Canada, euro area and the U.K. remain much softer. Gross domestic product growth in Canada trudged along in Q4 2023 with a surge in exports masking a large contraction in business investment. GDP growth in Q4 also came in weak in the euro area (barely changed from Q3) and the U.K. (a larger than expected -0.3% non-annualized decline.) Monthly PMI surveys did show a rebound in activities in both regions over the early months of 2024, primarily driven by stronger demand for services as the sub-indices are now within the expansion zone for both. The same cannot be said about Canada, where insolvencies are still rising and labour market conditions continue to soften.

Despite the divergence in economic growth backdrops, the messaging from global central banks has remained largely uniform—more progress is needed on inflation before they can commit to cutting interest rates. The BoC and ECB both reiterated that message last month while delivering widely expected holds on interest rates. U.S. economic outperformance has raised concerns that the Fed will need to be more cautious about easing than previously expected. But comments from policymakers, including chair Jerome Powell, have largely reinforced the central bank's preference, which is to begin cutting interest rates this year. We continue to look for the BoC, Fed and the ECB to start to move rates lower in June, followed by BoE in August and the Reserve Bank of Australia later in December.

Central bank bias

Central bank	Current policy rate (latest move)	Next decision
BoC	**5.00%** +0 bps in Mar/24	**0 bps** Apr/24
The BoC left rates unchanged for a fifth meeting in March, highlighting softening in the economy as evidence that monetary policy is working to restrict activity. The catch is still elevated core inflation readings, which the BoC expects to gradually fall in the second half. We continue to expect price pressures to keep easing, driving a first rate cut around mid-year.		
Fed	**5.25-5.50%** +0 bps in Jan/24	**0 bps** Mar/24
Recent CPI data showed a rebound in underlying price pressures in the U.S. in early 2024. That coupled with the backdrop of a booming economy means the Fed will likely be extra cautious around their assessment of where inflation is heading (our expectation is still down), and when rates should be moving lower. We continue to expect a first cut in June after inflation follows rent growth lower.		
BoE	**5.25%** +0 bps in Feb/24	**0 bps** Mar/24
Impact on monetary policy in the U.K. from the recently announced budget is expected to be minimal. The boost to aggregated demand from measures announced is expected to be offset by added labour supply and is not expected to add to inflation. The BoE expressed the need to see persistent signs of CPI returning to target before cutting rates. We expect the first move to come in August.		
ECB	**4.00%** +0 bps in Mar/24	**0 bps** Apr/24
The ECB left the deposit rate unchanged in its March meeting with the updated staff forecast showing downgrades to the near and medium-term inflation forecast. February's early euro area inflation data showed a lack of progress especially in the services components, but still tracks closely to ECB's forecast on a quarter basis. President Christine Lagarde endorsed a first rate cut in June in line with our view.		
RBA	**4.35%** +0 bps in Feb/24	**0 bps** Mar/24
Q4 GDP data was on consensus to confirm softening in the Australian economy, especially in interest rate sensitive sectors. Labour market conditions have weakened, although not to a degree that would warrant immediate easing from the RBA. Our base case remains for rate cuts to begin in Q4 (50bps total in the quarter), followed by two more cuts in the first half of 2025 taking the cash rate to 3.35%.		

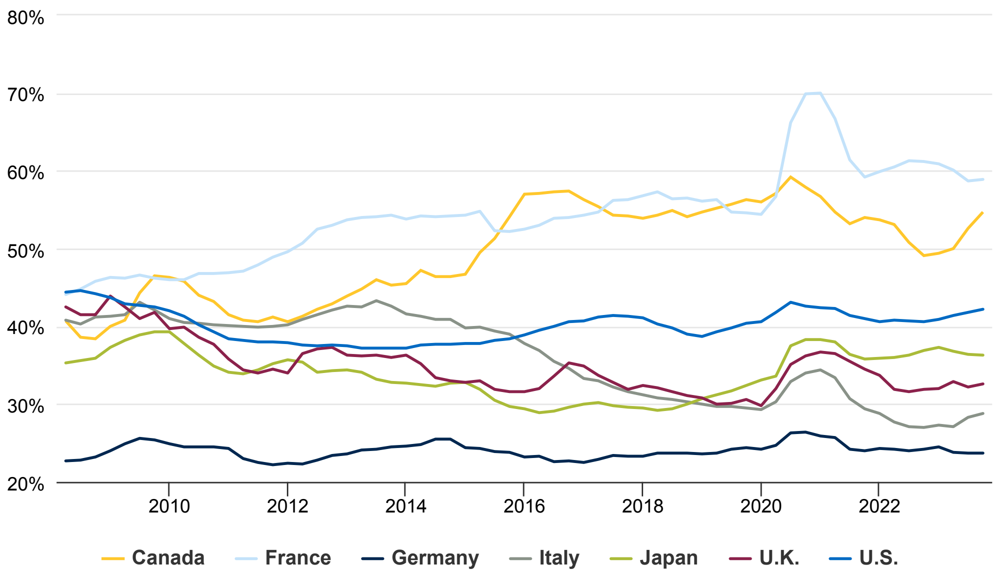
Corporate bankruptcies are rising in Canada

Business insolvencies surged in Canada in early 2024 to levels not seen since the great financial crisis. What's concerning is that most of the insolvencies were driven by actual bankruptcies that have more than doubled since last fall, instead of proposals for businesses to settle debt with creditors under conditions outside of the existing terms. Part of the increase may have been tied to the end of some government pandemic support programs. The repayment deadline for federal CEBA loans was in January. The rise also follows a period of exceptionally low business insolvencies during the pandemic.

Data from the Business Investment Survey also showed a large pickup in the Canadian non-financial corporate sector's debt servicing ratio. Several factors likely contributed, including a more indebted non-financial corporate sector as a whole (debt-to-GDP ratio was the second highest among G7 just after France), and differences in term structures for business non-mortgage borrowing.

Debt servicing for Canadian businesses jumps as rates rise

Debt service ratio for private non-financial businesses



Source: Bank of International Settlement, RBC Economics

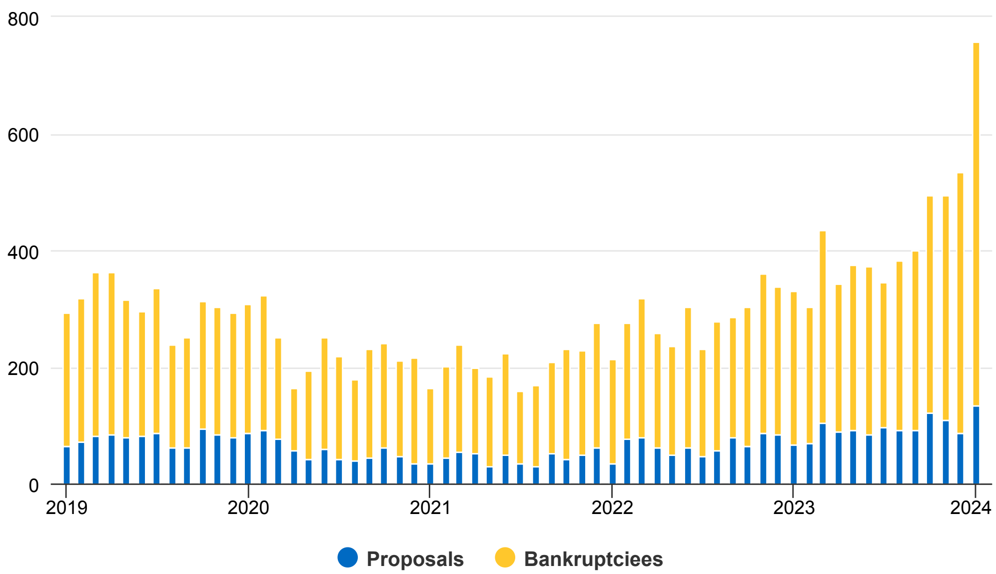
Consumer facing sectors harder hit

Many Canadian companies that survived the pandemic with the help of government support are now facing a triple whammy of slowing consumer demand, rising borrowing costs and deteriorating productivity. The conditions look worse for businesses in consumer-facing sectors such as retail, housing and accommodation, food, and recreation, which have seen the largest increase in insolvencies and the worst deterioration in credit access. Lenders have tightened standards in part due to anticipating softer demand in these areas, according to the Q4 2023 Bank of Canada Business Outlook Survey.

A high concentration of small businesses in these sectors also likely explains part of the underperformance, as small businesses tend to have less diverse financing sources. The deadline for small businesses to pay back CEBA loans without forgoing the forgivable portion likely further exacerbated the situation. We already saw an unusual increase in chartered banks' business loans advanced towards the end of last year, likely driven by higher demand among small businesses to refinance debt to meet the CEBA January deadline.

Canadian business insolvencies surged over early 2024

Number of business insolvencies



Source: Innovation, Science and Economic Development Canada, RBC Economics

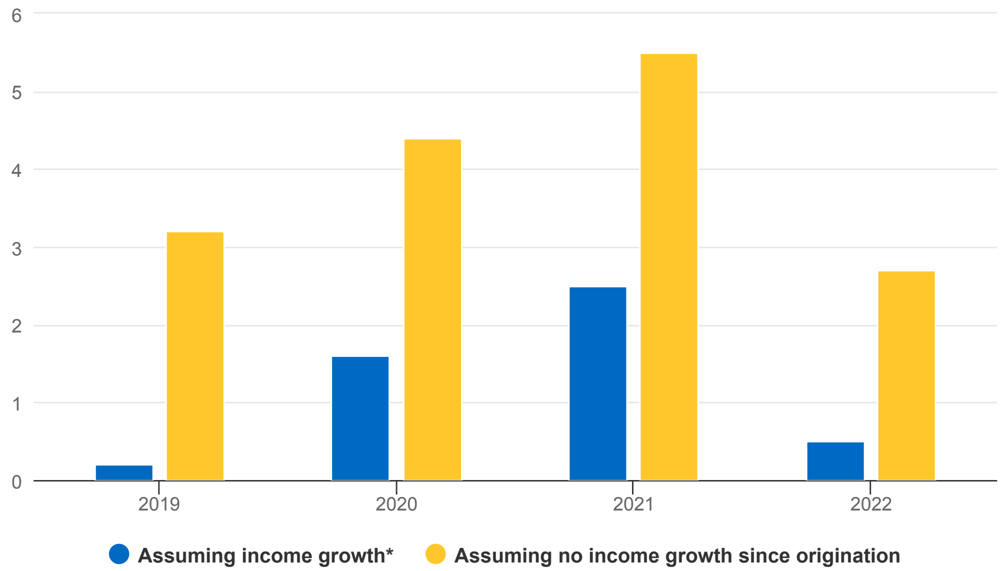
Surging insolvencies pose risks to household income

It remains to be seen whether this recent rise in business insolvencies will be "transitory" (remember the last time that word was used to describe inflation?), or if it's reflective of persistent underlying weakness in businesses operating conditions. Regardless, it will have a negative impact on the labour market.

As highlighted in the last Financial Market Monthly, the current cycle already counts as the longest where the unemployment rate has risen without the Bank of Canada cutting interest rates. The biggest reason behind that is rising inflation risks that have yet to fully subside. It also has to do with the fact that most of the deterioration in labour market conditions to date has not been coming from outright layoffs, implying less spillover to household income and credit conditions. That outlook will be put to the test in the coming quarters if the acceleration in business closures is followed by an acceleration in layoffs.

Rise in mortgage payments managable, if income continues to grow

Median increase in mortgage debt service ratio at renewal



Source: Bank of Canada, RBC Economics*Assumes income grows by 2.4% per year - the average growth rate over last 10 years

Loss of employment and income could be especially dangerous in an environment where households are highly indebted and expected to keep facing payment increases as fixed-rate mortgages get renewed at higher interest rates. Earlier analysis from the BoC highlighted continued income growth as key for households to be able to handle increasing mortgage payments. The expected increase in the mortgage debt servicing ratio could more than double or in some cases quintuple if households lose their income from layoffs.

We continue to expect a mild slowing in the Canadian economy (on a per capita basis) with some improvement over the second half thanks to strong population growth and expected easing from the BoC. But the rise in business bankruptcies is a reminder that downside risks remain.

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	4.25	4.00	3.75	3.25	3.00	3.00
Three-month	4.34	4.90	5.07	5.04	4.95	4.65	4.10	3.95	3.60	3.20	3.00	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	3.00	2.85	2.90	2.90	3.00
10-year	2.90	3.26	4.03	3.10	3.40	3.25	3.10	3.00	2.90	2.95	3.00	3.10
30-year	3.02	3.09	3.81	3.02	3.35	3.25	3.15	3.05	3.00	3.05	3.10	3.15
United States												
Fed funds midpoint	4.88	5.13	5.38	5.38	5.38	5.13	4.88	4.63	4.63	4.38	4.38	4.13
Three-month	4.85	5.43	5.55	5.40	5.33	5.01	4.78	4.53	4.58	4.33	4.33	4.08
Two-year	4.06	4.87	5.03	4.23	4.60	4.50	4.35	4.30	4.25	4.20	4.20	4.25
Five-year	3.60	4.13	4.60	3.84	4.15	4.05	3.95	3.95	3.95	4.00	4.10	4.20
10-year	3.48	3.81	4.59	3.88	4.15	4.05	3.95	4.00	4.05	4.10	4.20	4.30
30-year	3.67	3.85	4.73	4.03	4.30	4.20	4.15	4.20	4.25	4.30	4.35	4.40
United Kingdom												
Bank rate	4.25	5.00	5.25	5.25	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	3.90	4.00	4.00
Five-year	3.33	4.66	4.53	3.46	4.00	3.90	3.80	3.60	3.50	3.55	3.60	3.65
10-year	3.47	4.39	4.46	3.54	4.10	4.00	3.90	3.75	3.70	3.75	3.85	3.95
30-year	3.82	4.42	4.92	4.14	4.75	4.70	4.60	4.50	4.50	4.60	4.70	4.85
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	2.50	2.40	2.30	2.30
Five-year	2.30	2.58	2.79	1.94	2.50	2.40	2.30	2.20	2.15	2.20	2.20	2.25
10-year	2.28	2.39	2.85	2.03	2.55	2.40	2.35	2.20	2.20	2.20	2.25	2.30
30-year	2.35	2.38	3.05	2.27	2.70	2.60	2.50	2.50	2.50	2.50	2.60	2.70
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

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada*	3.9	3.8	1.8	-0.9	2.6	0.6	-0.5	1.0	0.3	1.4	1.8	2.2	2.0	2.1	2.6	2.9	5.3	3.8	1.1	0.8	2.1
United States*	-2.0	-0.6	2.7	2.6	2.2	2.1	4.9	3.2	2.0	0.5	1.0	1.2	1.8	1.8	1.8	1.8	5.8	1.9	2.5	2.1	1.5
United Kingdom	0.5	0.1	-0.1	0.1	0.2	0.0	-0.1	-0.3	0.0	0.1	0.2	0.2	0.3	0.3	0.3	0.3	8.7	4.3	0.1	0.0	1.1
Euro area	0.6	0.8	0.5	0.0	0.0	0.1	-0.1	0.0	0.0	0.1	0.2	0.3	0.3	0.4	0.4	0.4	5.9	3.5	0.5	0.2	1.2
Australia	0.5	0.8	0.2	0.8	0.6	0.5	0.3	0.2	0.3	0.6	0.9	0.7	0.8	0.8	0.8	0.7	5.6	3.8	2.1	1.6	3.1

*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	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada	5.8	7.5	7.2	6.7	5.1	3.5	3.7	3.2	3.0	2.8	2.2	2.0	2.0	1.9	1.9	1.8	3.4	6.8	3.9	2.5	1.9
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.2	3.1	3.0	2.8	2.7	2.3	2.2	2.1	2.1	4.7	8.0	4.1	2.9	2.2
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.2	4.3	2.8	2.9	2.7	2.2	1.7	1.9	1.8	2.6	9.1	7.3	3.2	1.9
Euro area	6.1	8.0	9.3	10.0	8.0	6.2	5.0	2.7	2.6	2.5	2.1	2.3	2.2	2.1	2.1	2.1	2.6	8.4	5.4	2.4	2.1
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.4	4.1	3.5	3.4	2.9	3.1	3.0	2.9	2.9	2.8	2.9	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

	Q1-22	Q2-22	Q3-22	Q4-22	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	1.25	1.29	1.38	1.35	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	1.11	1.05	0.98	1.07	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	1.32	1.22	1.11	1.21	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	121	136	145	132	133	144	149	141	145	145	150	150	146	141	138	135
AUD/USD	0.75	0.69	0.64	0.68	0.67	0.67	0.65	0.68	0.65	0.64	0.65	0.66	0.68	0.70	0.71	0.73

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	Q1-25	Q2-25	Q3-25	Q4-25
EUR/CAD	1.39	1.35	N/A	1.45	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	1.64	1.57	N/A	1.63	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	97	105	N/A	97	98	109	110	107	108	107	113	115	112	108	107	105
AUD/CAD	0.94	0.89	N/A	0.92	0.91	0.88	0.87	0.90	0.87	0.87	0.86	0.86	0.89	0.91	0.92	0.94

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