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Crunch time

Banking sector turmoil returned to the fore in late April with the collapse of another mid-sized US lender. A debt ceiling stalemate is also adding to concerns with Treasury Secretary Yellen warning the government could run out of money as early as the beginning of June. Markets have generally taken these risks in stride—the S&P 500 is little changed since the end of March despite the regional banking sub-index declining by a further 14% (it's nearly 50% lower year-over-year). Investors are taking some comfort from expectations that the Fed's latest rate hike will be its last. Aside from near-term bills impacted by debt ceiling drama, Treasury yields remain range-bound after falling sharply in the first half of March when banking worries first surfaced.

While slowing inflation is allowing central banks to move to the sidelines, that doesn't mean the impact of policy tightening is at an end. We've emphasized ongoing pass-through of higher interest rates to households in the coming quarters. Businesses, too, will increasingly feel the effects of tightening credit conditions as lenders become more restrictive, particularly in the US and euro area where banking concerns are most prevalent. We've downgraded our growth forecasts in those geographies and continue to expect modest GDP declines in Canada and the US in the coming quarters, and sluggish growth elsewhere. Labour markets have remained resilient but we're starting to see cracks that will spread as economic activity gears down. For the central banks that are now hitting pause, that should keep them from acting on their tightening biases.

Overview

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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 Apr-23</td><td>On hold
until Q1-24</td></tr>
<tr><td colspan="3">Recent BoC communications have maintained a hawkish tilt with Governing Council playing up its tightening bias. But with the economy losing momentum, we don't see the BoC coming off the sidelines.</td></tr>
<tr><td>Fed</td><td>5.00-5.25%
+25 bps in May-23</td><td>On hold
until Q4-23</td></tr>
<tr><td colspan="3">The Fed met expectations with another 25 bp hike in May but signaled it may pause tightening as soon as June. We see non-trivial odds of another hike but our base case is that the Fed is done raising rates.</td></tr>
<tr><td>BoE</td><td>4.25%
+25 bps in Mar-23</td><td>+25 bps
in May-23</td></tr>
<tr><td colspan="3">Strong inflation and employment data caused us to add a final 25 bp hike to our Bank Rate forecast. We think the BoE will leave its options open after its May meeting but we see it moving to the sidelines thereafter.</td></tr>
<tr><td>ECB</td><td>3.25%
+25 bps in May-23</td><td>+25 bps
in Jun-23</td></tr>
<tr><td colspan="3">The ECB dialed back to a 25 bp hike in May but suggested further rate increases should be expected. We continue to look for two more 25 bp hikes with a terminal deposit rate of 3.75%.</td></tr>
<tr><td>RBA</td><td>3.85%
+25 bps in May-23</td><td>On hold
until Q2-24</td></tr>
<tr><td colspan="3">The RBA quickly reversed its April pause, hiking by 25 bps in May and leaving the door open to further increases. The flip-flop adds uncertainty to our forecast but we assume the RBA will be on hold from here.</td></tr>
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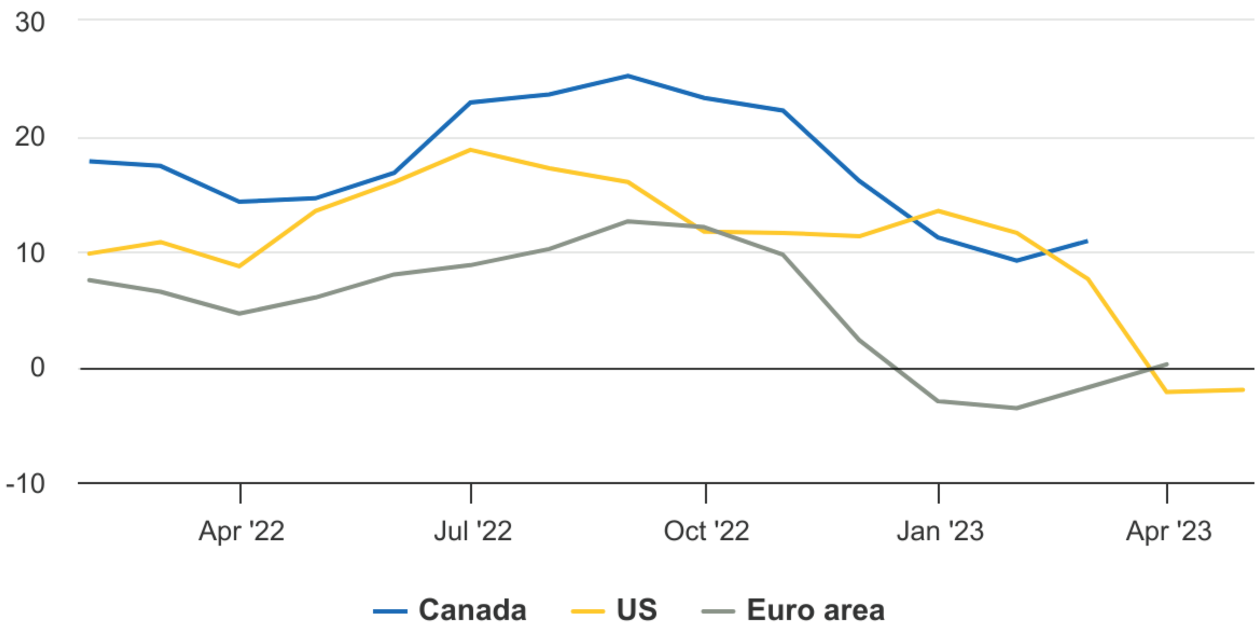
Trimming growth forecasts as credit conditions tighten

US banks have cut back on business loans in the wake of financial sector turmoil, and the Fed's latest Senior Loan Officer Opinion Survey suggests credit conditions will continue to tighten for the rest of 2023. Mid-sized banks in particular—a group that has seen several high profile failures since March—are tightening standards due to concerns about liquidity, deposit outflows and funding costs. Lending standards for commercial real estate (CRE) tightened more significantly than commercial and industrial loans, with deteriorating credit quality and collateral values contributing to the former. A pull-back in CRE lending—where smaller banks are particularly active—alongside deteriorating asset values remains a financial stability concern.

Relative to other advanced economies, the US is less reliant on bank lending to fund business investment. But higher interest rates and volatile or declining stock markets have also made market-based financing less attractive, and bond and equity issuance has slowed to multi-year lows. US business investment in structures and machinery has been flat over the past year and with further tightening in the pipeline we've reduced our capex forecast in the quarters ahead. Our GDP growth forecast has been lowered by a cumulative half percent in 2023 and 2024 though we still expect an impending US recession will be on the mild side.

US and euro area business lending already rolling over

seasonally adjusted 3-month annualized percent change in bank loans to businesses



Source: Statistics Canada, Federal Reserve Board, European Central Bank, RBC Economics

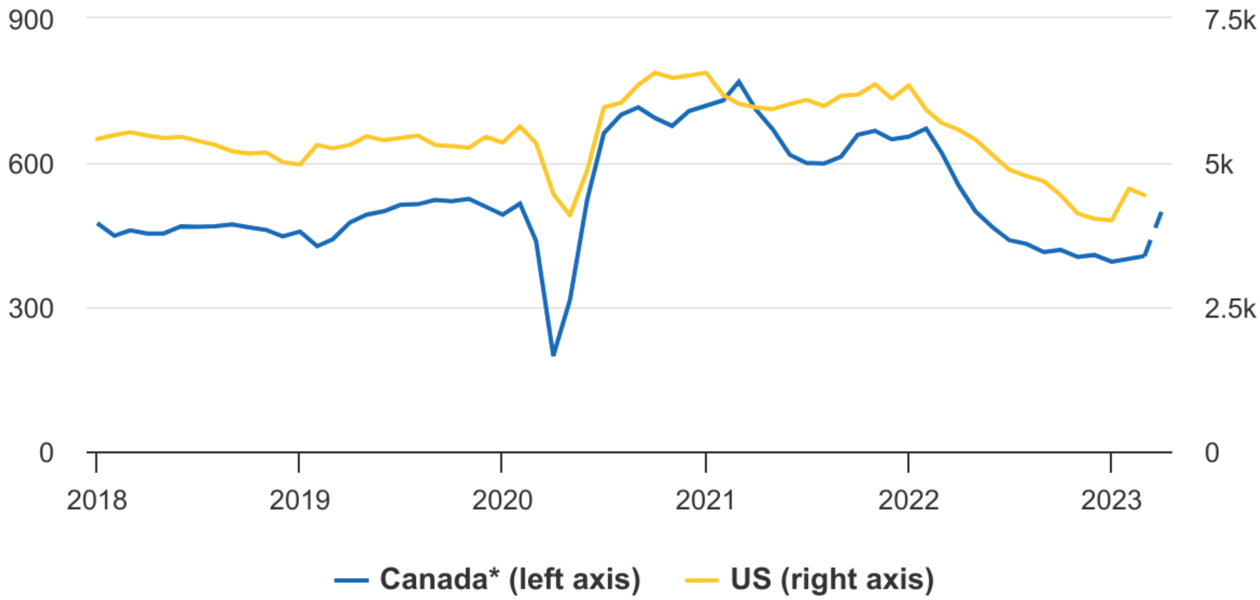
Euro area businesses are relatively more reliant on bank funding, which has already retrenched in recent months. For a second consecutive quarter, the ECB's Bank Lending Survey showed the highest net share of banks tightening lending standards since the euro crisis. Lenders also expect to continue tightening in the near-term. A further slowdown in bank lending is expected to weigh on business investment in particular and we've lowered our euro area growth forecasts for the second half of this year and 2024. But that isn't expected to keep the ECB from delivering further rate increases in the near term. The central bank's May policy statement implied multiple further rate hikes are needed to ensure monetary policy is sufficiently restrictive, consistent with our call for another 50 bps of tightening.

Central banks to keep an eye on nascent housing rebound

Canadian home sales rose in February and March, the first back-to-back gains in more than a year, and regional reports suggest a further increase in April. New listings have been slower to pick up and there are few signs of distressed home sales despite a sharp increase in mortgage rates, although non-mortgage delinquencies have started to rise. With supply-demand conditions tightening, pricing has stabilized after a year of declines, and is beginning to heat up again in some markets. The US housing market is also showing signs of life, with resales up 3% in Q1 and one measure of home prices rising in February after seven straight monthly declines. But mortgage applications remain subdued, and on both sides of the border, homebuilding activity has yet to show a definitive turnaround—although that would be consistent with its usual lagging relationship with the resale market.

Canadian and US housing markets starting to rebound

Home resales, thousands of annualized units

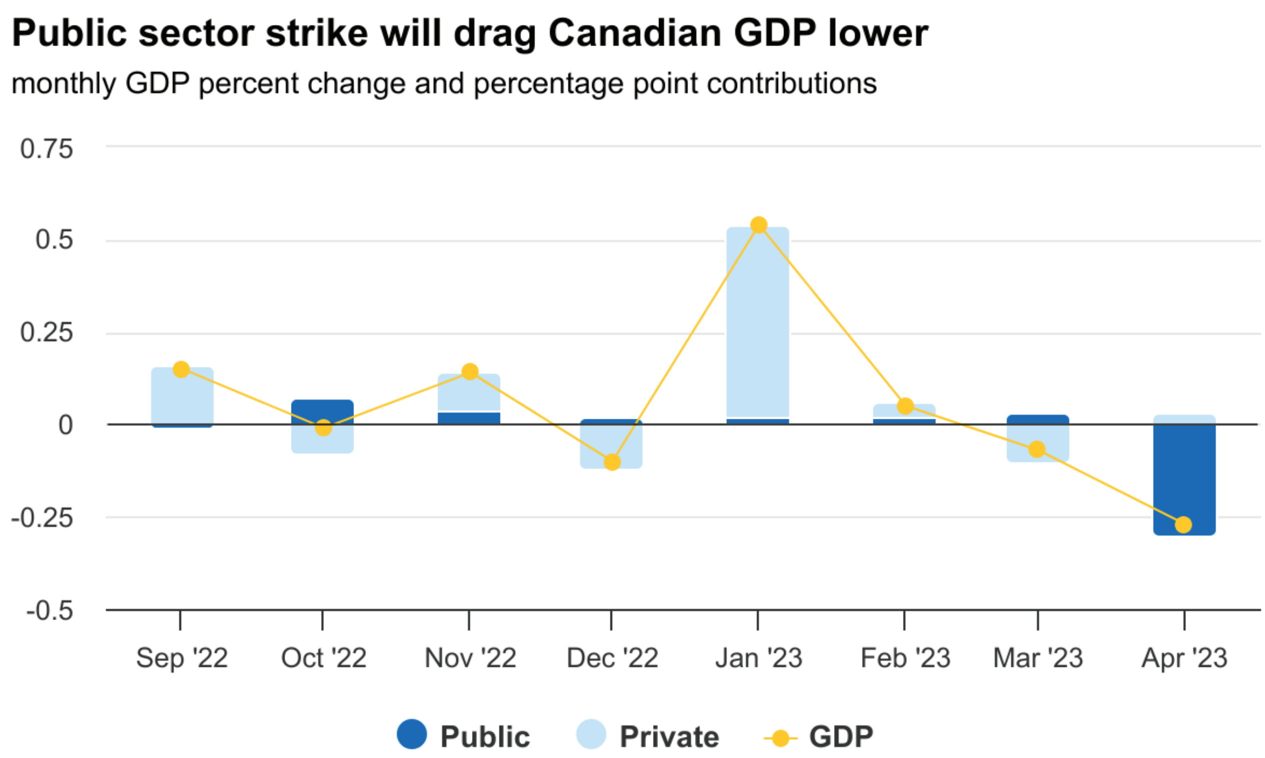


Source: National Association of Realtors, Canadian Real Estate Association, RBC Economics | *Canadian resales for April based on reported percent change in largest markets

With the Fed and BoC trying to slow overheating economies, we think any rebound in housing activity will be cause for concern. Residential investment, the most rate sensitive sector of the economy, acted as a significant drag on growth last year, subtracting half a percentage point from US GDP growth and record percentage point in Canada. A pickup in home sales and prices would see that headwind ease and could also support consumption through wealth effects and housing-related spending. But at this stage, with mortgage rates remaining elevated, we think any near-term rebound will be fairly limited. And the broader effects of past interest rate hikes—driving debt servicing costs higher as more households renew mortgages—is still flowing through into less rate-sensitive sectors.

Canada's economy losing momentum; strike to hit Q2 growth

Canadian GDP was close to expectations with a 2.5% annualized increase in Q1, according to preliminary estimates. That's slightly ahead of the economy's potential growth, implying no further progress in reducing excess demand in the quarter. However, much of the Q1 increase came in January—GDP was flat on average in February and March. That already suggests a loss of momentum heading into Q2 when economic activity will be dragged down by labour disruptions. By our math, a major strike by federal public employees in the second half of April will reduce that month's GDP by 0.3%. Notwithstanding a rebound in May as striking workers return, we've trimmed our Q2 GDP forecast from -0.5% to -1.0% annualized.



Source: Statistics Canada, RBC Economics | *April GDP includes estimated impact of PSAC strike

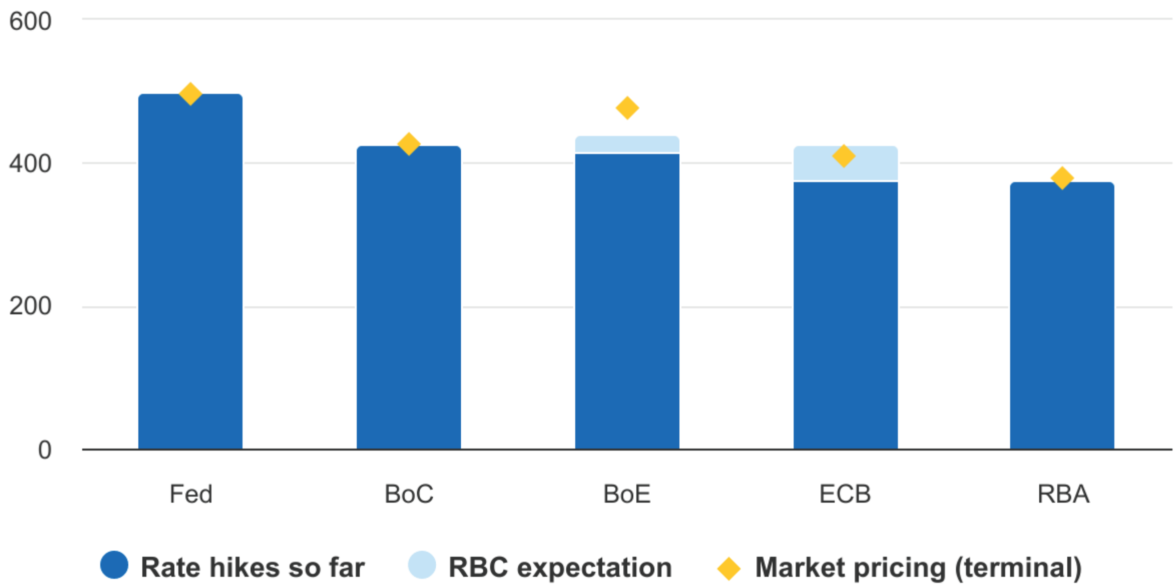
Our updated Q2 forecast is well below the BoC's (pre-strike) call for a 1% annualized gain. Even looking through the impact of labour disruptions, we think Canada's economy has a bit less momentum than the central bank assumed in its April forecast. However, ongoing labour market strength will continue to cause the BoC some discomfort. Job growth remained robust in April (+41,000) with the labour market readily absorbing strong immigration-driven population growth. Canada's unemployment rate has been steady at a near record low of 5.0% for the past five months and wage growth is showing few signs of slowing. Job openings and forward-looking survey indicators of hiring and wage growth are easing, giving the BoC some cause for patience alongside other signs that the economy is softening. We think Governing Council will continue emphasizing its tightening bias near-term, but don't see it being acted upon. Our forecast doesn't envision rate cuts beginning until early 2024.

Other central banks to join the BoC on the sidelines

The Fed hiked its policy rate by another 25 bps in May but opened the door to a pause in June. The current fed funds target range of 5.00-5.25% is now consistent with March's dot plot median, and updated language in the policy statement is reminiscent of when the Fed ended its tightening cycle in 2006. Chair Powell emphasized that a decision to pause in June wasn't made at May's meeting, and we're mindful that, as of March, 7 of 18 FOMC participants thought rates would need to move higher still. But with, in Powell's words, "some signs that supply and demand in the labor market are coming back into better balance" as well as growing evidence of policy traction and uncertainty about the impact of banking turmoil, we think the Fed's base case is to move to the sidelines in June. Market pricing is in line with that view, though policymakers continue to push back against the 2-3 rate cuts priced in by year end.

More central banks appear to be done raising rates

change in policy rate, basis points



Source: Refinitiv, RBC Economics

With UK inflation surprising to the upside, the labour market remaining strong, and GDP growth coming in firmer than the BoE expected, we now look for another 25 bp Bank Rate hike in May. The BoE is likely to keep its options open, maintaining a data dependent approach going forward. We've revised our UK growth forecasts slightly higher given the economy's stronger momentum early this year—PMI readings have swung from contractionary levels firmly into expansionary territory. But given growing global headwinds and with inflation still expected to slow significantly over the next year (albeit from a higher starting point) we continue to think the BoE is nearing the end of its tightening cycle. The market is pricing in 1-2 further hikes after an anticipated May increase but we think 4.50% will be the terminal Bank Rate this cycle.

The RBA surprised the market with a 25 bp hike in May, quickly putting an end to its April pause. That was despite downward revisions to its GDP, inflation, and wage growth forecasts for 2023. While the central bank previously seemed willing to accept a gradual return of inflation to target, May's statement said policymakers want to see that happen within "a reasonable timeframe." With updated forecasts still only showing inflation slowing to 3% by mid-2025, it maintained a tightening bias. We think a more restrictive stance may very well be needed to rein in inflation faster—having lifted its cash rate by 375 bps thus far, the RBA's tightening cycle still lags a number of other advanced economy central banks. Its inconsistent communications add uncertainty to our forecast for the RBA to revert to a pause in June.

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	4.34	4.40	4.40	4.30	3.70	3.25	3.00	2.85
Two-year	2.27	3.10	3.79	4.06	3.74	3.85	3.60	3.40	3.00	2.90	2.80	2.70
Five-year	2.39	3.10	3.32	3.41	3.02	3.05	2.85	2.75	2.70	2.65	2.60	2.55
10-year	2.40	3.23	3.16	3.30	2.90	2.90	2.75	2.70	2.65	2.60	2.60	2.60
30-year	2.37	3.14	3.09	3.28	3.02	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	5.13	5.13	4.63	4.38	4.13	3.88	3.63
Three-month	0.52	1.72	3.33	4.42	4.85	5.05	4.80	4.40	4.20	3.95	3.70	3.50
Two-year	2.28	2.92	4.22	4.41	4.06	4.10	3.60	3.25	2.95	2.70	2.50	2.40
Five-year	2.42	3.01	4.06	3.99	3.60	3.50	3.25	3.05	2.90	2.80	2.75	2.70
10-year	2.32	2.98	3.83	3.88	3.48	3.55	3.35	3.20	3.10	3.05	3.00	3.00
30-year	2.44	3.14	3.79	3.97	3.67	3.70	3.65	3.65	3.60	3.60	3.60	3.60
United Kingdom												
Bank rate	0.75	1.25	2.25	3.50	4.25	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Two-year	1.36	1.85	4.29	3.71	3.42	3.75	3.55	3.50	3.35	3.25	3.15	3.00
Five-year	1.40	1.88	4.40	3.62	3.33	3.75	3.60	3.55	3.45	3.35	3.25	3.15
10-year	1.60	2.22	4.08	3.67	3.47	3.75	3.65	3.65	3.40	3.40	3.35	3.35
30-year	1.77	2.59	3.82	3.95	3.82	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	2.66	3.15	3.10	3.05	3.00	2.95	2.85	2.70
Five-year	0.37	1.09	1.98	2.58	2.30	2.75	2.70	2.65	2.60	2.60	2.50	2.40
10-year	0.55	1.36	2.12	2.57	2.28	2.65	2.65	2.55	2.50	2.50	2.45	2.35
30-year	0.67	1.63	2.10	2.46	2.35	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	2.97	3.00	2.90	2.85	2.85	2.80	2.75	2.70
10-year	2.84	3.67	3.89	4.05	3.30	3.45	3.45	3.35	3.20	3.10	3.00	3.00
New Zealand												
Cash target rate	1.00	2.00	3.00	4.25	4.75	5.50	5.50	5.00	4.50	4.00	3.75	3.50
Two-year swap	3.27	4.06	4.76	5.36	5.01	4.90	4.50	4.30	4.00	3.80	3.50	3.30
10-year swap	3.38	4.10	4.50	4.78	4.27	4.20	4.05	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	2.5	-1.0	-0.5	0.3	1.4	2.0	2.6	2.8	5.0	3.4	0.9	1.1
United States*	-1.6	-0.6	3.2	2.6	1.1	-0.8	-2.5	-0.5	0.8	1.5	2.0	2.0	5.9	2.1	0.6	0.4
United Kingdom	0.5	0.1	-0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3	0.3	7.6	4.1	0.5	1.0
Euro area	0.6	0.9	0.4	0.0	0.1	0.3	0.2	0.1	0.0	-0.1	0.1	0.2	5.3	3.5	0.8	0.3
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	3.4	2.9	2.3	2.1	1.7	1.8	1.8	3.4	6.8	3.4	1.8
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.1	2.7	2.3	2.1	2.2	2.2	4.7	8.0	3.9	2.2
United Kingdom	6.2	9.2	10.0	10.8	10.2	7.5	5.2	3.2	2.4	0.7	1.4	1.2	2.6	9.1	6.5	1.4
Eurozone	6.1	8.0	9.3	10.0	8.0	6.8	5.4	3.7	3.3	2.5	2.4	2.4	2.6	8.4	6.0	2.7
Australia	5.1	6.1	7.3	7.8	7.0	6.5	5.9	5.1	4.6	4.2	4.0	3.6	2.9	6.6	6.1	4.1

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	1.35	1.36	1.38	1.39	1.37	1.35	1.33	1.31
EUR/USD	1.11	1.05	0.98	1.07	1.09	1.08	1.05	1.04	1.04	1.07	1.11	1.15
GBP/USD	1.32	1.22	1.11	1.21	1.24	1.20	1.15	1.13	1.16	1.19	1.23	1.28
USD/JPY	121	136	145	132	133	134	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	1.47	1.47	1.45	1.45	1.42	1.44	1.48	1.51
GBP/CAD	1.64	1.57	1.51	1.63	1.67	1.63	1.59	1.57	1.58	1.61	1.64	1.67
CAD/JPY	97	105	105	97	98	99	98	101	102	103	103	103
AUD/CAD	0.94	0.89	0.89	0.92	0.91	0.92	0.92	0.92	0.89	0.86	0.84	0.81

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