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Letting it be - central banks hold the line as more clouds roll in

U.S. bond yields briefly hit decade highs in August on expectations that central banks will need to leave interest rates higher for longer. Still, the yield curve remains sharply inverted with markets expecting a softer economic growth backdrop to eventually soften inflation pressures. That will allow central banks to shift from hikes to cuts, but not until 2024. Equity markets remain firm, though the S&P 500 registered its first monthly decline since the spring.

The U.S. economy continues to surge with households showing remarkable resilience despite very restrictive monetary policy. But elsewhere, the outlook is dimming. GDP has started to decline in Canada as higher interest rates dig in. Output growth has also slowed in the Euro area and the UK with closely watched PMI surveys suggesting more weaknesses heading into Q3. And the Chinese economy is wobbling on softer consumer spending and a sluggish property sector. The long-anticipated softening is expected to carry on through the remainder of 2023, with central banks expected to continue tapping the economy's brakes into early next year in the U.S. and Canada, and even longer in Europe and the UK.

This sentiment also led to a strengthening in the U.S. dollar in August. Energy prices are moving higher after key oil exporters announced an extension to production cuts. But non-energy commodity prices have continued to edge lower. The recent surge in oil prices will likely boost global headline inflation in the coming months. But central banks will pay more attention to broad underlying price pressures related to domestic demand and supply conditions. The BoC last week opted to forego another hike in the overnight rate, and we look for the ECB and the U.S. Fed to do the same at their meetings tomorrow, and next week, respectively. By contrast, we expect the BOE will be forced to hike its Bank rate by another 25 basis points next week as inflation pressures remain stickier in the UK than elsewhere.

Overview

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Central bank bias

Central bank	Current policy rate (latest move)	Next move
BoC	**5.00%** +0 bps in Sep-23	**+0 bps** in Oct-23

The BoC left the overnight rate steady at 5% in October, amid weakening data including a contraction in Q2 GDP, and higher unemployment rates. We continue to expect the economy will soften more to slow inflation further, and that the BoC will stay on pause for the rest of 2023.

Fed	**5.25-5.50%** +25 bps in Jul-23	**+0 bps** in Sep-23

Improvements in inflation data in the U.S. over the summer had taken pressures off the Fed to keep moving rates higher. Absent a sharp rebound in price pressures, we see the Fed pausing rates at currently elevated levels until 2024.

BoE	**5.25%** +25 bps in Aug-23	**+25 bps** in Sep-23

Growth and labour market conditions both look to be deteriorating in the U.K., but services inflation and wage growth each reaccelerated in their latest prints. That means the BoE will have little option but to take the bank rate higher by 25 bp in September, before pausing for reassessment.

ECB	**3.75%** +25 bps in Jul-23	**+0 bps** in Sep-23

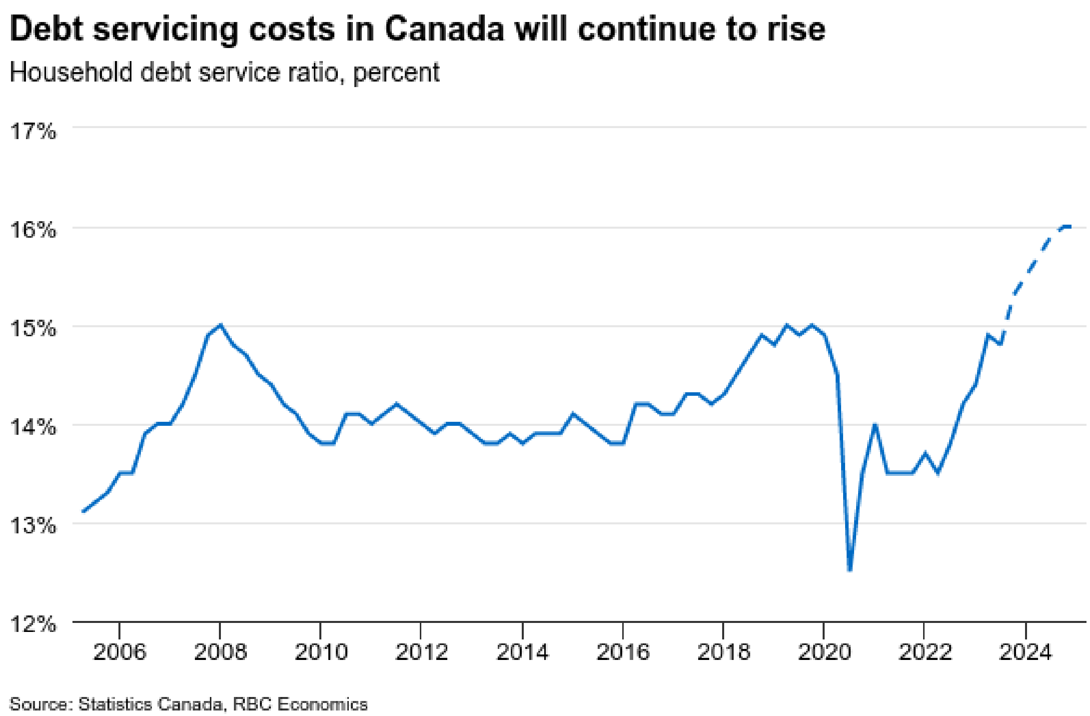
Survey data out of the euro area suggest weakening activities, for both manufacturing and service sectors early in Q3. Upon a dovish pivot from ECB President Lagarde in the July meeting, we expect the ECB to be moving to the sidelines, and keep rates steady at its meeting in September.

RBA	**4.1%** +0 bps in Sep-23	**+0 bps** in Oct-23

Q2 GDP growth came largely in line with earlier forecast from the RBA. Household spending on discretionary items continue to soften, suggesting impacts from higher interest rates are finally being felt. We expect the RBA to stay on the sideline in October, but expect one more hike later in Q4.

The Bank of Canada has done enough to slow inflation

Core inflation measures in Canada have been stuck well above the Bank of Canada's 2% target rate, running in the 3.5% to 4% range since late last year. But inflation lags the economy—and GDP growth and labour markets are both slowing. The BoC has just one mandate: to keep inflation low, steady, and predictable at its target 2%. So further upside inflation surprises could well push it to hike again. But evidence is building that interest rates are already high enough to cool price growth. The BoC opted to pause its rate-hiking cycle in September, holding the overnight rate steady at 5%. That followed a surprise contraction in Q2 GDP and a 0.5% rise in the unemployment rate from April to August — the largest outside of the pandemic since the 2008/09 recession.



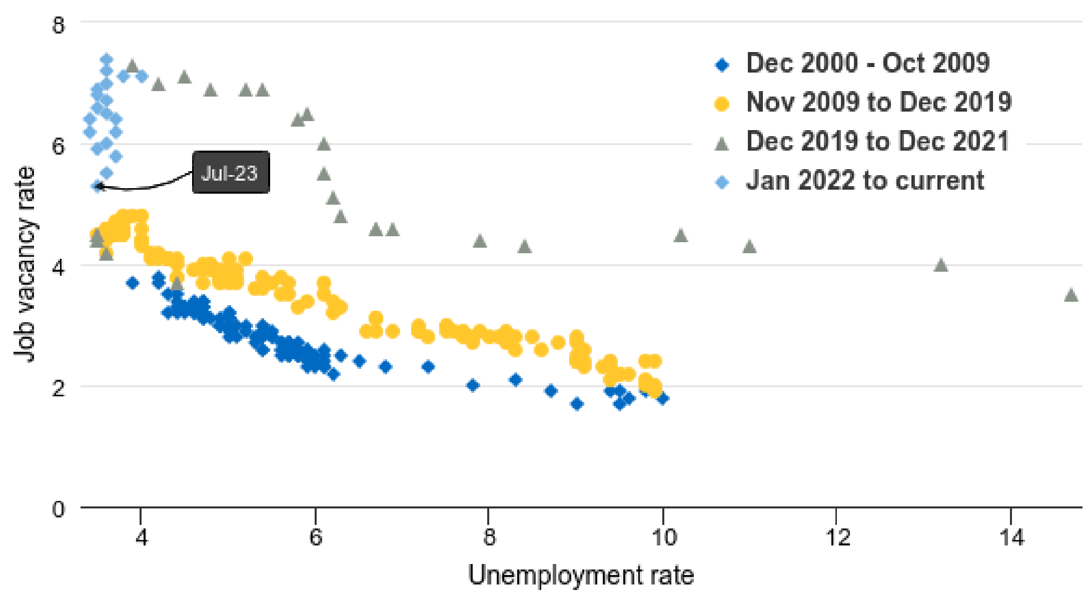
After the inflation scare of the last two years, we think the BoC will be much more cautious about reverting to rate cuts. And near-term interest rate risks are still tilted to the upside. But if job losses start to pile up for heavily indebted households, there are risks that a mild economic downturn will turn into something more painful. As a base-case, we don't expect rate cuts until the second half of 2024, when the BoC is fully convinced that core inflation is on a steady path back to that 2% target.

Strong U.S. consumers mean a hawkish Fed

In the U.S., recent data suggests consumers are still spending despite higher interest rates. Excluding auto, core retail sales jumped by 0.9% in July, giving Q3 GDP growth a sizable boost. Job growth also remains strong over the summer despite an uptick in the August unemployment rate.

Officials at the U.S. Fed—including Chair Powell at the annual Jackson Hole symposium—continue to emphasize their readiness to move rates higher, and keep them there if necessary to get inflation under control. Still, broader inflation pressures have shown enough signs of easing to allow the Fed to be patient. Indeed, its own "supercore" CPI measure was trending below pre-pandemic levels over the summer on a three-month annualized basis. We expect the Fed to keep its funds steady in the 5.25% to 5.5% range while waiting to see elevated interest rates slow economic growth and cool overheated labour markets.

U.S. Beveridge Curve shifting lower



Source: Bureau of Labor Statistics, RBC Economics Research

There are still reasons to expect a much weaker economic backdrop to emerge in the U.S. Excess savings built up over the pandemic have now largely been depleted. The household savings rate is running around 3.5%—well below pre-pandemic levels—and the unemployment rate in August jumped 0.3%. A sharp pull-back in job demand has been largely painless so far. Job openings were exceptionally high relative to unemployment a year ago, so declines over 2023 have happened without a persistent rise in the jobless rate. But the Beveridge curve (measuring the ratio between the job opening rate and the unemployment rate) has now corrected to levels more consistent with pre-pandemic levels. That means any further reduction in labour demand is most likely to lead to higher unemployment from now on.

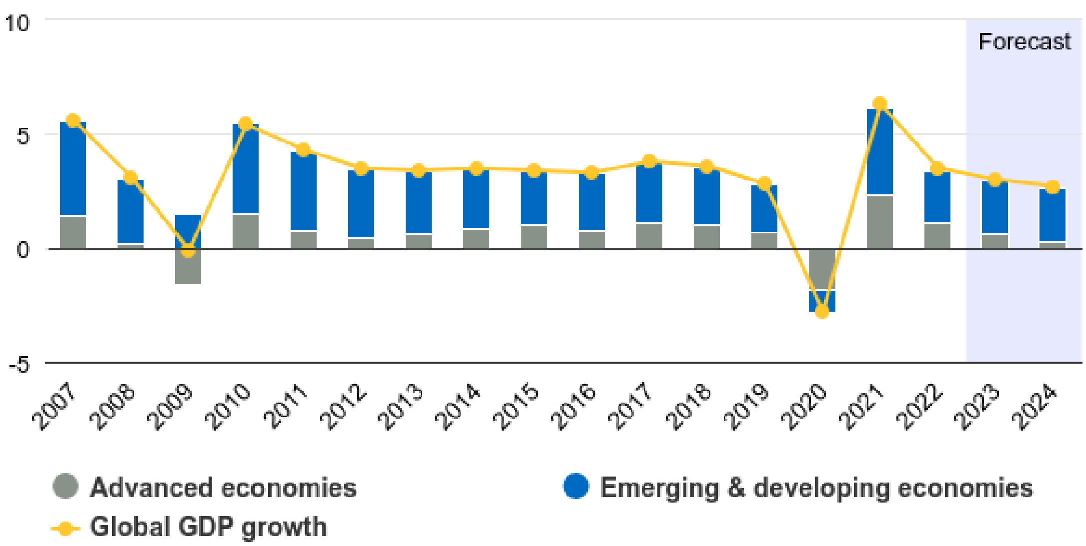
The Fed won't hesitate to push interest rates higher should inflation pressures re-surface. But we think there are enough early signs of softening to render additional interest rate hikes unnecessary. The Fed Funds range is expected to stay at currently restrictive levels, until the second quarter of 2024 when the persistently low inflation allows for a pivot.

Elsewhere, inflation is still dictating policy

In the Euro Area, Q2 GDP growth came in close to expectations. But outlook into the third quarter has softened considerably, according to recent survey data. Manufacturing activities remain depressed by slowing global consumer goods demand. And a shaky Chinese economy is also adding to the list of economic headwinds. August brought early signs that a softening good demand is starting to spread into services sectors too, with the HCOB services PMI dipping below 50 for the first time this year, signaling an outright contraction in activity. Although the official unemployment rate stayed at decade-low levels in August, details in the PMI releases suggest job growth in the area is losing steam. Against that outlook, we revised our GDP tracking for the second half of 2023 lower, and now expect a 0.1% quarterly decline in output in Q3.

Elevated interest rates weigh on global growth

Global GDP growth and ppt contributions



Source: International Monetary Fund, RBC Economics

With Q3 core inflation on track to meet the ECB's latest June projections, and data elsewhere softening more than expected, we think the ECB will opt to hold the deposit rate at current levels tomorrow. However, it will likely maintain a hawkish bias and set the table for rates to go higher if necessary.

In the UK, output growth in the second quarter came at 0.2%. That is slightly above but not far off BoE's forecast for a 0.1% increase. However, like the Euro Area, PMI surveys are suggesting more softening in activity heading into Q3, leading us to revise our forecast to a 0.2% quarterly contraction in output in the same quarter. Headline inflation in the U.K. dropped sharply in July thanks to a cap on household utility prices, and labour market conditions are also starting to deteriorate. Employment declined by 207,000 on a three-month basis in July. Despite weaker data on labour markets, the BoE's hands are tied by reacceleration in two of the key metrics they've highlighted as important to their decisions: services inflation and private sector wage growth. Sticky service-sector price pressures leave little option for the BoE but to move the Bank rate higher (to 5.5%) at their next meeting later this month.

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	4.75	5.00	5.00	5.00	5.00	4.50	4.00
Three-month	0.60	2.08	3.58	4.23	4.34	4.90	5.10	4.95	4.90	4.85	4.35	3.85
Two-year	2.27	3.10	3.79	4.06	3.74	4.58	4.50	4.25	4.00	3.70	3.50	3.35
Five-year	2.39	3.10	3.32	3.41	3.02	3.68	3.75	3.50	3.30	3.15	3.05	3.00
10-year	2.40	3.23	3.16	3.30	2.90	3.26	3.50	3.25	3.00	2.90	2.85	2.85
30-year	2.37	3.14	3.09	3.28	3.02	3.09	3.35	3.15	3.00	3.00	3.00	3.00
United States												
Fed funds midpoint	0.37	1.62	3.12	4.37	4.87	5.12	5.38	5.38	5.38	5.13	4.63	4.13
Three-month	0.52	1.72	3.33	4.42	4.85	5.43	5.35	5.28	5.23	4.93	4.43	3.93
Two-year	2.28	2.92	4.22	4.41	4.06	4.87	4.95	4.70	4.35	3.90	3.50	3.25
Five-year	2.42	3.01	4.06	3.99	3.60	4.13	4.35	4.10	3.85	3.60	3.40	3.30
10-year	2.32	2.98	3.83	3.88	3.48	3.81	4.20	4.00	3.85	3.70	3.55	3.50
30-year	2.44	3.14	3.79	3.97	3.67	3.85	4.30	4.20	4.10	4.05	4.00	4.00
United Kingdom												
Bank rate	0.75	1.25	2.25	3.50	4.25	5.00	5.50	5.50	5.50	5.50	5.50	5.50
Two-year	1.36	1.85	4.29	3.71	3.42	5.27	5.10	5.00	4.95	4.90	4.60	4.25
Five-year	1.40	1.88	4.40	3.62	3.33	4.66	4.40	4.25	4.15	4.10	3.90	3.60
10-year	1.60	2.22	4.08	3.67	3.47	4.39	4.25	4.00	3.95	3.80	3.60	3.50
30-year	1.77	2.59	3.82	3.95	3.82	4.42	4.25	4.00	4.00	3.90	3.65	3.50
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	3.27	3.40	3.25	3.20	3.15	3.00	2.75
Five-year	0.37	1.09	1.98	2.58	2.30	2.58	2.70	2.60	2.60	2.50	2.30	2.20
10-year	0.55	1.36	2.12	2.57	2.28	2.39	2.60	2.55	2.50	2.35	2.25	2.10
30-year	0.67	1.63	2.10	2.46	2.35	2.38	2.45	2.40	2.30	2.25	2.10	2.00
Australia												
Cash target rate	0.10	0.85	2.35	3.10	3.60	4.10	4.10	4.35	4.35	4.35	4.35	3.85
Two-year	1.78	2.73	3.43	3.41	2.97	4.18	3.90	3.90	3.70	3.50	3.30	3.20
10-year	2.84	3.67	3.89	4.05	3.30	4.03	4.20	4.10	4.10	4.00	3.80	3.70
New Zealand												
Cash target rate	1.00	2.00	3.00	4.25	4.75	5.50	5.50	5.50	5.50	5.00	4.50	4.00
Two-year swap	3.27	4.06	4.76	5.36	5.01	5.46	5.40	5.20	4.50	4.25	4.00	3.90
10-year swap	3.38	4.10	4.50	4.78	4.27	4.46	4.75	4.40	4.25	4.00	3.90	3.85

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*	2.6	3.6	2.3	-0.1	2.6	-0.2	-0.5	-0.5	0.3	1.4	2.0	2.6	5.0	3.4	1.0	0.6
United States*	-1.6	-0.6	3.2	2.6	2.0	2.1	3.0	-0.5	-1.5	0.3	1.5	2.0	5.9	2.1	2.1	0.4
United Kingdom	0.5	0.1	-0.1	0.1	0.1	0.2	-0.2	0.1	0.0	0.1	0.2	0.2	7.6	4.1	0.3	0.3
Euro area	0.7	0.8	0.3	-0.1	0.1	0.1	-0.1	0.0	0.0	0.1	0.1	0.2	5.6	3.4	0.4	0.2
Australia	0.6	0.7	0.7	0.7	0.4	0.4	0.2	0.1	0.3	0.4	0.5	0.6	5.2	3.7	1.8	1.2

*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	3.5	3.6	3.0	2.9	2.3	1.6	1.5	3.4	6.8	3.8	2.1
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.6	3.3	2.7	2.5	2.0	1.8	4.7	8.0	4.2	2.2
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.9	4.2	2.5	2.7	2.3	2.6	9.1	7.6	2.9
Eurozone	6.1	8.0	9.3	10.0	8.0	6.2	5.0	3.5	3.3	3.1	2.9	2.7	2.6	8.4	5.7	3.0
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.2	4.0	3.6	3.6	3.4	3.4	2.9	6.6	5.5	3.5

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	1.32	1.35	1.38	1.39	1.39	1.35	1.31
EUR/USD	1.11	1.05	0.98	1.07	1.09	1.09	1.07	1.04	1.03	1.02	1.05	1.08
GBP/USD	1.32	1.22	1.11	1.21	1.24	1.27	1.23	1.17	1.13	1.11	1.15	1.20
USD/JPY	121	136	145	132	133	144	147	150	152	154	150	145
AUD/USD	0.75	0.69	0.64	0.68	0.67	0.67	0.63	0.62	0.61	0.60	0.61	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	1.44	1.44	1.44	1.43	1.42	1.42	1.41
GBP/CAD	1.64	1.57	1.51	1.63	1.67	1.68	1.66	1.61	1.57	1.54	1.56	1.57
CAD/JPY	97	105	105	97	98	109	109	109	109	111	111	111
AUD/CAD	0.94	0.89	0.89	0.92	0.91	0.88	0.85	0.86	0.85	0.83	0.82	0.81

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