RBC Economics & Thought Leadership

# Financial Markets Monthly

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# Central banks hit "hopeful pause" on rate hikes

Robust economic data seemed to bring sunnier days in July. For the most part, global equity indices inched higher as recession fears eased.

And yet, U.S. banks continue to report tighter lending standards and slower commercial & industrial loan demand—a sign businesses are growing more cautious. What's more, a downgrade to U.S. credit ratings by Fitch in early August softened markets even as oil prices rallied on expectations that a global energy supply deficit will deepen in 2024.

The good news: inflation has shown further signs of slowing—albeit in varying degrees across regions. That's reducing the urgency of central banks to push interest rates higher even as economic growth continues to be stronger than expected. Indeed, despite improved market sentiment, yield curves are still steeply inverted on expected interest rate cuts in 2024 and beyond.

Slower inflation has been helped by lower energy prices, which may not last. Oil prices have already moved higher in recent weeks and could continue to rise. But broader inflation pressures have shown signs of slowing, particularly in the U.S. and Canada. U.K. inflation trends have been stickier, though the latest June data brought a welcome reprieve.

## Overview



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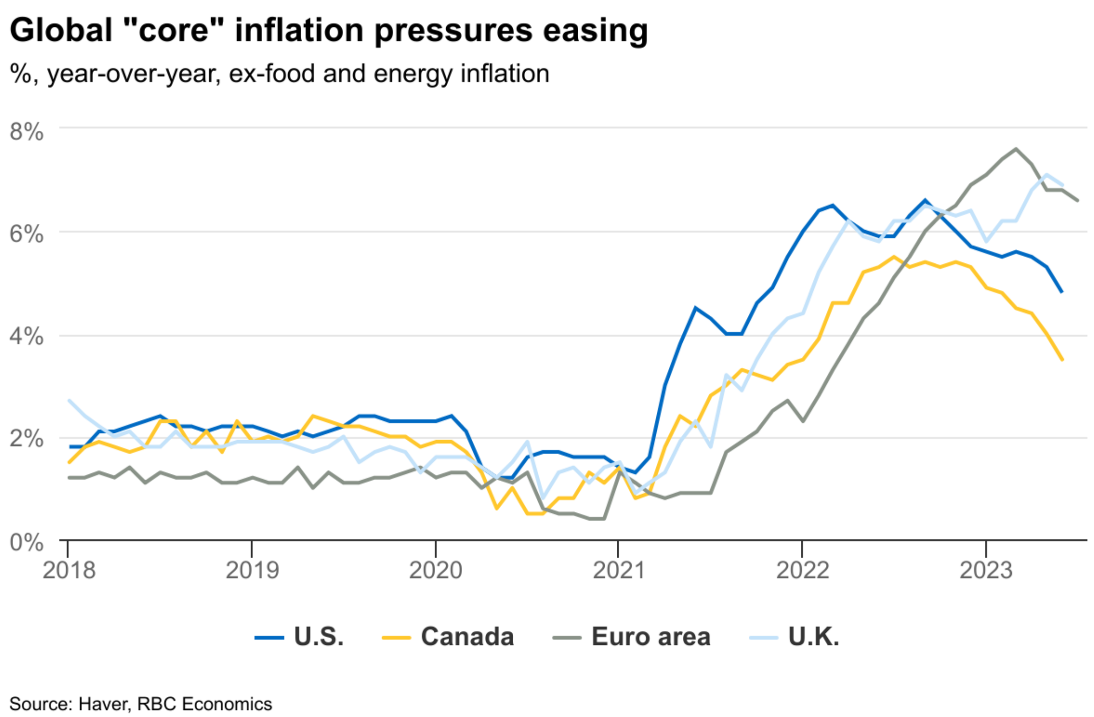
# Central bank bias

| Central bank | Current policy rate (latest move) | Next move | |
|---|---|---|---|
| **BoC** | **5.00%** +25 bps in Jul-23 | **+0 bps** in Sep-23 | The BoC followed up its hike in June with another 25 bp move in July. Since then, economic data has been in line with our forecast that economy will soften enough for the BoC to resume its pause in September. |
| **Fed** | **5.25-5.50%** +25 bps in Jul-23 | **+0 bps** in Sep-23 | Significantly improved inflation trends have taken pressures off the Fed to respond immediately to the resilient growth backdrop. 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 | Mildly improving (but still elevated) inflation trends weakening labour market data are welcoming news for the BoE, who's expected 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 | A dovish pivot from ECB President Lagarde in the July meeting, alongside weaker survey data in the euro area suggest the ECB will move to the sidelines by keeping rates at currently restrictive levels. |
| **RBA** | **4.1%** +0 bps in Aug-23 | **+0 bps** in Sep-23 | Weaker than expected inflation and retail sales data for Q2 allowed the RBA to pause in July and August. We think that the current cycle may be nearing a completion, with one more hike somewhere in Q4 expected. |

# Easing global inflation trends allow central banks to hit pause

The question remains just how long softer inflation prints can be sustained against a still-resilient macro backdrop. And while central banks would prefer not to hike interest rates further, they are also clearly willing to do so if needed to bring inflation fully and sustainably under control.



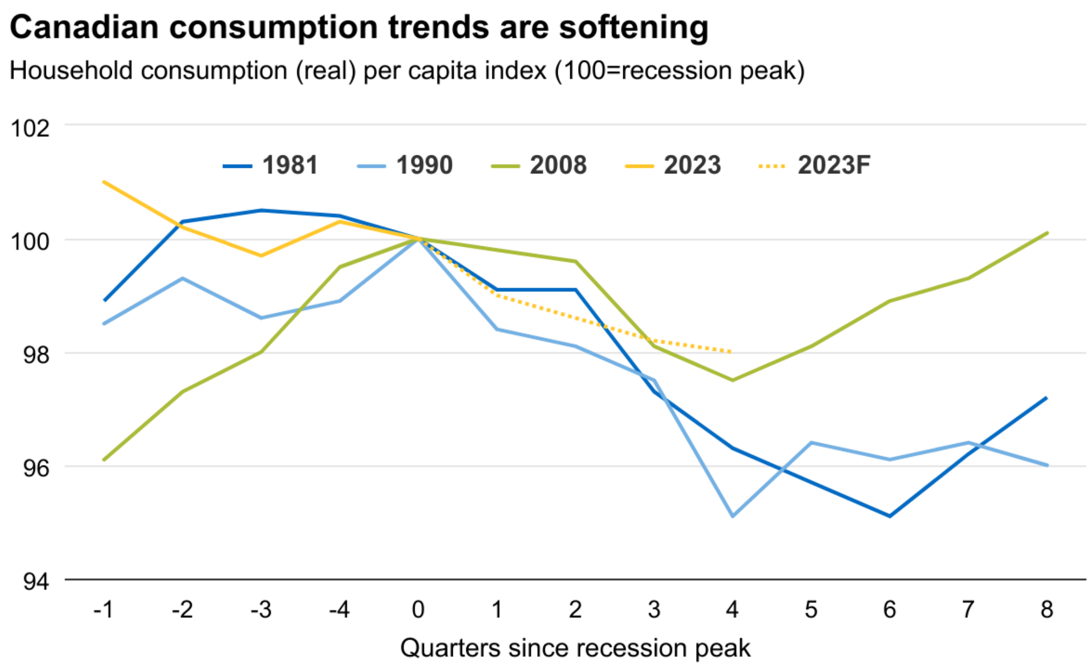

The U.S. Fed, the Bank of Canada and the European Central Bank moved in lockstep in July, raising policy rates by 25 basis points. But all have signaled that any further changes will depend on the data. Interest rates are already at levels most central banks would view as 'restrictive' (ie. sufficient to slow the economy and inflation pressures going forward.) And the impact of current rate hikes continues to ripple through economic growth data and labour markets with a lag. Indeed, we look for GDP growth to slow further, with declines in Canada and the U.S. starting in the second half of the year (beginning in Q3 in Canada and now Q4 in the United States). In that context, most central banks have moved toward a 'hopeful' pause in the current hiking cycle.

Absent a large reacceleration in price pressures, we expect the BoC, Fed, and ECB to leave their policy rates unchanged for the rest of 2023. We look for one additional 25 basis point hike to the Bank of England's Bank Rate. And we don't expect a shift to rate cuts until Q2/2024 for the Fed; and the second half of next year for the BoC. The BOE and the ECB will likely hold rates steady through next year.

# Canadian economy softening despite record population growth

Surging population growth has complicated efforts to track the health of the Canadian economy. Canada added nearly 230,000 new consumers aged 15 and older to its population in Q1 and overall, consumer demand remains strong. But on a per-person basis it's softening. And there are signs that headwinds from higher interest rates are having a more significant impact on household purchasing power and spending. Though GDP edged higher in Q2 (according to preliminary estimates), it nevertheless declined in June (-0.2%.)

Meantime, early signs of softening in labour markets suggest further weakness is in the pipeline. Employment growth may have risen in Q2, but it edged lower in two of the last three months. And the combination of a drift downward in labour demand (job openings) and upward in labour supply (still-booming population growth) has begun to push the unemployment rate higher. Canadian labour market data is notoriously volatile. But a 0.5 percentage point increase in the jobless rate over the last three months to July is the biggest jump (outside of the pandemic) since the early days of the 2008/09 recession.



Source: Statistics Canada, RBC Economics

Spending on discretionary services remains firm. However, 'real' growth (excluding price impacts) flattened out in the sectors most affected by pent-up demand following the pandemic, like restaurant spending. And spending on goods is softening too. Retail sale volumes in Q2 are tracking 2% (annualized) below Q1 levels. Auto sales edged lower in early summer despite improved supply. And imports of consumer goods are running almost 10% below where they were last fall.

Household purchasing power is already being stretched by higher prices and rising debt servicing costs. Until now, firm labour markets helped cushion the impact on consumer spending and the broader economy. But high household debt levels mean Canadians are vulnerable to a long-expected softening in labour markets. And it looks like that softening may have already begun.

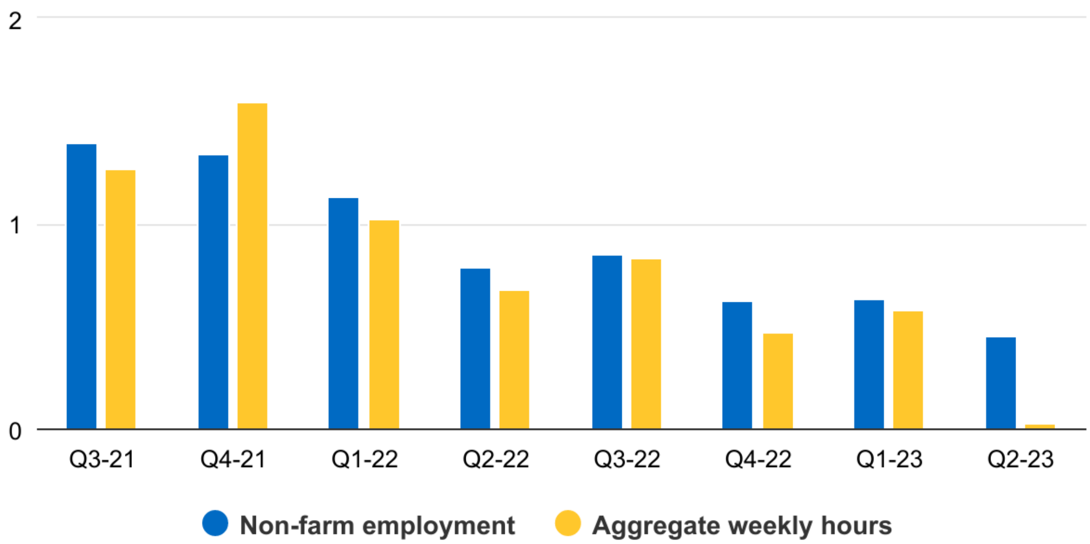
# A bumpy landing is still more likely than a soft one in the U.S.

In the U.S., broadly easing inflation pressures are playing out against a resilient consumer and labour market backdrop. This has increased talk of a possible "soft-landing" for the economy, where inflation slows to the Fed's 2% objective—without a significant increase in unemployment.

We still think that's unlikely. Well-anchored, longer run inflation expectations have probably played a bigger role in the initial moderation of CPI than is commonly appreciated. But the Fed isn't likely to view slower inflation growth as sustainable without softer consumer demand and labour markets.

**U.S. job markets are weakening under the surface**

%, quarter to quarter




Source: Bureau of Labour Statistics, RBC Economics

And there are still signs that the U.S. economy is weakening, despite resilient activity in 2023. U.S. employment growth has been firm, but hours worked were essentially unchanged in Q2, and they declined in July. Job openings continue to trend lower. Households' liquid assets including cash and time deposits have fallen outright in every consecutive quarter since Q1 2022. The depletion of the excess savings stockpile that was built up over the pandemic means much less financial cushion moving forward. And headwinds like the restart of student loan repayments still loom over many households. High interest rates have made borrowing to support current spending increasingly inaccessible. Growth momentum has been firmer than expected and Q3 GDP is likely to post another increase. But early signs suggest there's more softening in economic activity to come. We look for GDP growth to dip into negative territory later this year.

We look for economic growth in the UK and Euro Area to hold in positive territory. But that growth won't be strong enough to prevent an uptick in unemployment rates. And in both regions, softer PMI survey data into the summer has flagged the risk of declines in GDP growth.

# 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 | 3.60 | 3.50 | 3.30 | 3.15 | 3.05 | 3.00 |
| **10-year** | 2.40 | 3.23 | 3.16 | 3.30 | 2.90 | 3.26 | 3.15 | 3.00 | 2.90 | 2.85 | 2.80 | 2.80 |
| **30-year** | 2.37 | 3.14 | 3.09 | 3.28 | 3.02 | 3.09 | 3.05 | 3.00 | 2.95 | 2.90 | 2.90 | 2.90 |
| **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 | 4.75 | 4.60 | 4.25 | 3.80 | 3.40 | 3.15 |
| **Five-year** | 2.42 | 3.01 | 4.06 | 3.99 | 3.60 | 4.13 | 4.15 | 4.00 | 3.80 | 3.55 | 3.35 | 3.25 |
| **10-year** | 2.32 | 2.98 | 3.83 | 3.88 | 3.48 | 3.81 | 3.95 | 3.90 | 3.75 | 3.60 | 3.45 | 3.40 |
| **30-year** | 2.44 | 3.14 | 3.79 | 3.97 | 3.67 | 3.85 | 4.15 | 4.15 | 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 | 4.05 | 4.10 | 4.00 | 3.90 | 3.70 | 3.60 |
| **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 | 5.25 | 5.00 | 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 | 3.1 | 0.5 | -0.5 | -0.5 | 0.3 | 1.4 | 2.0 | 2.6 | 5.0 | 3.4 | 1.3 | 0.6 |
| United States* | -1.6 | -0.6 | 3.2 | 2.6 | 2.0 | 2.4 | 1.5 | -0.5 | -1.5 | 0.3 | 1.5 | 2.0 | 5.9 | 2.1 | 2.0 | 0.2 |
| United Kingdom | 0.5 | 0.1 | -0.1 | 0.1 | 0.1 | 0.0 | 0.2 | 0.1 | 0.0 | 0.1 | 0.2 | 0.2 | 7.6 | 4.1 | 0.3 | 0.5 |
| Euro area | 0.6 | 0.8 | 0.4 | -0.1 | 0.0 | 0.3 | 0.1 | 0.1 | 0.0 | -0.1 | 0.1 | 0.2 | 5.4 | 3.4 | 0.6 | 0.2 |
| Australia | 0.6 | 0.8 | 0.6 | 0.6 | 0.2 | 0.2 | 0.0 | 0.1 | 0.3 | 0.4 | 0.6 | 0.6 | 5.2 | 3.7 | 1.4 | 1.0 |

*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 | 3.1 | 2.6 | 2.5 | 1.9 | 1.7 | 1.6 | 3.4 | 6.8 | 3.6 | 1.9 |
| United States | 8.0 | 8.6 | 8.3 | 7.1 | 5.8 | 4.0 | 3.2 | 2.6 | 2.2 | 1.9 | 1.9 | 2.0 | 4.7 | 8.0 | 3.9 | 2.0 |
| 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 | 4.7 | 3.0 | 2.8 | 2.6 | 2.6 | 2.7 | 2.6 | 8.4 | 5.5 | 2.7 |
| Australia | 5.1 | 6.1 | 7.3 | 7.8 | 7.0 | 6.0 | 4.8 | 4.1 | 3.7 | 3.8 | 3.9 | 3.4 | 2.9 | 6.6 | 5.4 | 3.7 |

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 | 1.37 | 1.35 | 1.33 | 1.31 |
| EUR/USD | 1.11 | 1.05 | 0.98 | 1.07 | 1.09 | 1.09 | 1.07 | 1.04 | 1.04 | 1.07 | 1.11 | 1.15 |
| GBP/USD | 1.32 | 1.22 | 1.11 | 1.21 | 1.24 | 1.27 | 1.22 | 1.13 | 1.16 | 1.19 | 1.23 | 1.28 |
| USD/JPY | 121 | 136 | 145 | 132 | 133 | 144 | 147 | 150 | 147 | 145 | 142 | 140 |
| AUD/USD | 0.75 | 0.69 | 0.64 | 0.68 | 0.67 | 0.67 | 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 | 1.44 | 1.44 | 1.44 | 1.42 | 1.44 | 1.48 | 1.51 |
| GBP/CAD | 1.64 | 1.57 | 1.51 | 1.63 | 1.67 | 1.68 | 1.64 | 1.56 | 1.58 | 1.61 | 1.64 | 1.67 |
| CAD/JPY | 97 | 105 | 105 | 97 | 98 | 109 | 109 | 109 | 107 | 107 | 107 | 107 |
| AUD/CAD | 0.94 | 0.89 | 0.89 | 0.92 | 0.91 | 0.88 | 0.90 | 0.91 | 0.89 | 0.86 | 0.84 | 0.81 |

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