Financial Markets Monthly

October 2024

Don't stop me now – rate cuts to multiply from the BoC, ECB and BoE

Like Freddie Mercury sang in the iconic Queen song, "the world, I'll turn it inside out," major central banks are well on the path of undoing years of tight monetary policy.

Highlights:

- The stronger-than-expected U.S. payrolls report for September left the economy on track for a "soft landing," and reduced urgency for the Federal Reserve to repeat a 50-basis point rate cut in November or December.
- Downside risks remain, but there are several reasons to think the U.S. economic slowdown next year will be contained, including an exceptionally wide government budget deficit that continues to support growth.
- The Fed will likely pause its rate-cutting cycle at 4 to 4.25% if that soft landing materializes.
- Canada's economy continues to underperform with below-trend growth rate and rising unemployment rate. With inflation already within the target range and expected to head lower still, there's little in the way to stop the Bank of Canada from making faster and larger rate cuts.
- As a result, we updated our forecast to expect two back-to-back 50 bps reductions in the overnight rate in October and December before a return to slower 25 bps cuts at every meeting after. We expect the overnight rate will reach 2% by July 2025.
- We expect both the European Central Bank and the Bank of England to cut interest rates by 25 bps at every meeting until May 2025, contingent on domestic inflation pressures continuing to slow.
- **Issues in focus:** How soft will Canada's economy get? A normalized Beveridge curve, slower population and trend productivity growth means a dimmer outlook for the economy into 2025.

Overview

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Forecast changes:

U.S. outlook: *Big payrolls surprise but few forecast changes*

The latest U.S. payroll employment report for September was surprisingly strong, reducing the odds that the economy is heading towards a hard landing.

The strong jobs data takes the pressure off the Fed to keep churning out jumbo rate cuts, but it doesn't negate the central bank's (or market) concerns about downside risks to growth. The unemployment rate is still higher than a year ago, and most other labour market data (job openings, layoffs) continue to gradually soften. Meanwhile, inflationary pressures are muted and still broadly trending towards the target.

Therefore, our outlook for the U.S. economy and Fed policy is little changed over the last month. We're still expecting output growth to slow in the year ahead, the unemployment rate will rise marginally, leading the Fed to cut rates by 25 bps at each meeting from November to January.

Canada outlook: *BoC to respond to weaker growth, inflation with larger rate cuts*

Unlike the U.S., Canada's economy continues to deteriorate at a pace faster than markets or the BoC anticipate. Q3 GDP growth is tracking around at an annualized 1%, in line with our assumptions a month ago, but well below the BoC's forecast of 2.8% growth back in July and potential GDP growth of 2.3%. Against a backdrop of still large population growth in the same quarter, that would also likely mark another decline in per-capita real GDP.

What's even more concerning is that there is little evidence that the economy is close to turning a corner. Hiring demand continued to cool through the summer with job openings plunging below where it was before the pandemic. Moving into 2025, a significant slowing in immigration and population growth remains a key headwind **(see below issues in focus for more details on how soft we expect the economy to get).**

In the near-term, we expect the deterioration in labour markets and the broader economy will persist, GDP growth will slow further, and the unemployment rate will rise more into early next year. Meantime, inflation pressures should continue to slow and could even drop closer to the lower end of BoC's 1%-3% target in 2025. We expect that will prompt faster and larger interest rate cuts from the BoC, by 50 bps in October and December even if the Fed reverts to more "normal" 25 bps reductions and fewer cuts overall.

Beyond this year, we think the BoC will resort back to cutting by 25 bps until the overnight rate reaches 2%. That's below the 3% terminal rate we previously forecasted. Lower interest rates will help to limit further weakening in labour markets and allow for a recovery to begin likely in the second half of next year.

Euro area and U.K. outlook: *More aggressive easing path*

In the euro area, early purchasing managers indices suggest a slower pace of output growth in Q3. Growth in domestic demand already softened over the first half of the year, but that was camouflaged by strength in net exports to leave GDP growth at robust levels. We now see GDP growth softening to just half of the ECB's latest forecasts in September at 0.1% in Q3 and Q4 with external demand, particularly from China, weakening and no pickup in domestic spending and investment.

That softer growth outlook should allow more room for the ECB to cut interest rates even against the backdrop of still-elevated wage growth and tight labour markets. We now expect the ECB will cut the deposit rate by 25 bps at every meeting from October to reach 2.25% by April 2025.

Our BoE forecast has also been updated to show a more aggressive easing path. GDP growth in the U.K. was very strong during the first half of the year and is expected to be broadly resilient in the second half. We're also seeing slowing wage growth and expect that to ease services inflation, because more of the input costs in the sector go to workers' wages. Given that outlook, we now expect the BoE to cut at every meeting going forward and lower the bank rate to 3.25% by May 2025.

Central bank bias:

<table>
<tr><th>Central bank</th><th>Current policy rate</th><th>Next decision</th></tr>
<tr><td>BoC</td><td>4.25%
-25 bps in Sep/24</td><td>-50 bps
Oct/24</td></tr>
<tr><td colspan="3">In September, the BoC cut the overnight rate by a third consecutive 25 bps, while governor Tiff Macklem delivered dovish comments that highlighted downside risks to growth and inflation. Later at a forum, Macklem followed up by talking of the need to see growth pick up in order to “stick the landing.” We think ongoing weakening in activities means the BoC is ready for a 50-bps cut in October.</td></tr>
<tr><td>Fed</td><td>4.75-5.00%
-50 bps in Sep/24</td><td>-25 bps
Nov/24</td></tr>
<tr><td colspan="3">The Fed delivered a larger 50 bps cut in September, the first cut of the cycle. Comments from Governor Jerome Powell, however, reinforced that the larger cut was not a response to expectations for a recession, but rather the beginning of a "recalibration" cycle. Recent labour market data corroborates that view. We expect smaller cuts from the Fed moving forward, starting with a 25-bps reduction in November.</td></tr>
<tr><td>BoE</td><td>5.00%
0 bps in Sep/24</td><td>-25 bps
Nov/24</td></tr>
<tr><td colspan="3">The BoE MPC voted 8-1 in favour of holding the bank rate unchanged at 5% in September and voted unanimously to maintain the pace of quantitative tightening in the next year. The latest comments from Governor Andrew Bailey were a slight departure from the gradual approach. He said the BoE could be “a bit more aggressive” with lowering rates. We expect a 25-bps cut in November.</td></tr>
<tr><td>ECB</td><td>3.50%
-25 bps in Sep/24</td><td>-25 bps
Oct/24</td></tr>
<tr><td colspan="3">As widely expected, the ECB lowered the deposit rate by 25 bps in September, while emphasizing no pre-commitment to a particular path of easing. Recent comments from ECB members highlighted leading indicators that point to softening growth momentum over the second half of the year and accompanying disinflationary pressures. We expect the ECB to cut by 25 bps again in their meeting in October.</td></tr>
<tr><td>RBA</td><td>4.35%
0 bps in Sep/24</td><td>0 bps
Nov/24</td></tr>
<tr><td colspan="3">Persistent inflation pressures are still holding the RBA from joining global peers in the easing cycle. In September, the central bank held the cash rate at 4.35% as expected. August’s inflation readings after the meeting showed some improvement, although risks remain as labour markets stay tight and wage growth stays elevated. We maintain our view that the RBA will not cut until February 2025.</td></tr>
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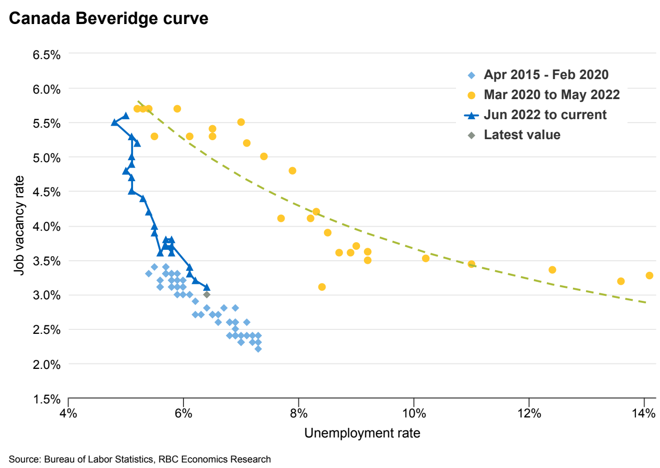
Issues in focus: How soft will Canada's economy get?

1. A "normalized" Beveridge curve means labour market deterioration could accelerate in Canada.

The main driver of the downgrade to our projections for the Canadian economy is a continued rapid decline in job openings, which when plotted together with the unemployment rate makes up the Beveridge curve.



The Beveridge curve (the ratio between the job vacancy rate and the unemployment rate) has a unique shape. It's convex—meaning steeper at the top when the job vacancy is high relative to unemployment, and flatter at the bottom after the vacancy rate comes lower. This suggests the further hiring demand pulls back and job openings fall, the faster the unemployment rate will rise.

Like the U.S., labour market trends in Canada have also seen material changes from the pandemic. That means (as depicted in the chart above) the Beveridge curve has moved a lot. First, it shifted outward, reflecting the abnormal trends during the pandemic. And when hiring demand first started to slow in 2022, the level of job vacancies was abnormally high relative to the unemployment rate.

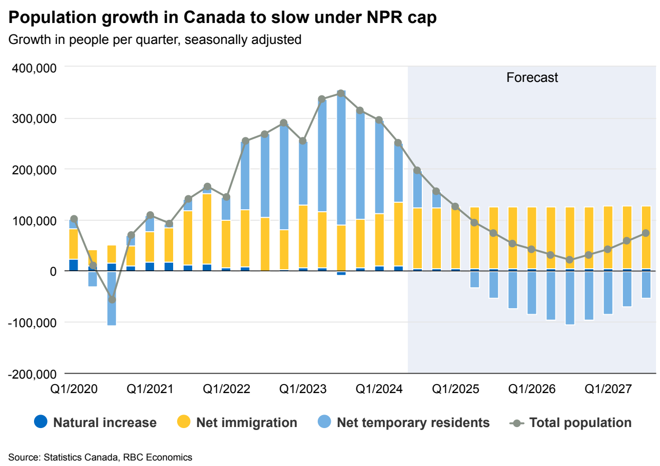
But, that relationship between job openings and the unemployment rate has now normalized with the curve shifting back to the trend line pre-pandemic. A lot of this reflects a decline in job openings that were never likely going to be filled, because of an acute labour shortage at the time. More importantly, we're now back at the old curve and on the flatter portion with no signs that openings will stop declining anytime soon.

The BoC rate cuts should help with the recovery in household spending, which should, in time, spur more hiring as labour demand from businesses picks up in 2025. Still, the slowdown appears to have a little more room to dive than we previously assumed.

2. *Slower population growth will weigh on GDP growth ahead*

In the past two years, we've seen a surge in newcomers, adding over three million consumers to the Canadian economy over the last four years. It has kept growth GDP above water, even as demand on a per-person basis weakens substantially due to elevated interest rates.

That rate of population growth is widely seen as unsustainable. Supply of housing and some public services in Canada have struggled to keep up with a bigger population and the federal government is set to sharply reduce the number of non-permanent residents arriving (which has driven most of the upside surprise in population) to lower their share of the population from over 7% currently, to 5% by 2027.



That goal implies a very aggressive drop—about 30% in the number of non-permanent residents by 2027, which could be a shock to businesses that to some extent rely on international workers, and universities that rely on international tuitions to effectively subsidize education for local students.

It would also suggest the pool of non-permanent residents will have to stop growing as soon as the first half of 2025, before starting to decline outright. That translates to just a 1.3% increase in the population in 2025, half of the 2.8% rise expected this year, before dropping to 0.4% on average in 2026 and 2027.

Lowering the rate of population growth won't do much to our forecast of the unemployment rate or GDP per capita. Those rates are largely agnostic to changes in population because newcomers increase both demand and supply in the economy. But it does mean less revenue in total, and less growth in the economy's productive capacity, because the number of available workers is increasing less.

We expect potential GDP growth (growth in the maximum level of GDP sustainable over the longer run without adding to inflation pressures) to slow to 1.4% in 2025 from 2.4% in 2024. Read more here on how lower population growth will impact the economy.

3. *Labour productivity growth to remain slow*

With population growth slowing, the Canadian economy will need to rely more on productivity growth to drive growth in both GDP and potential GDP. Unfortunately, the economy does not have a great track record on productivity growth—not just since the pandemic—but when measured over decades (more on Canada's long-standing productivity challenges here).

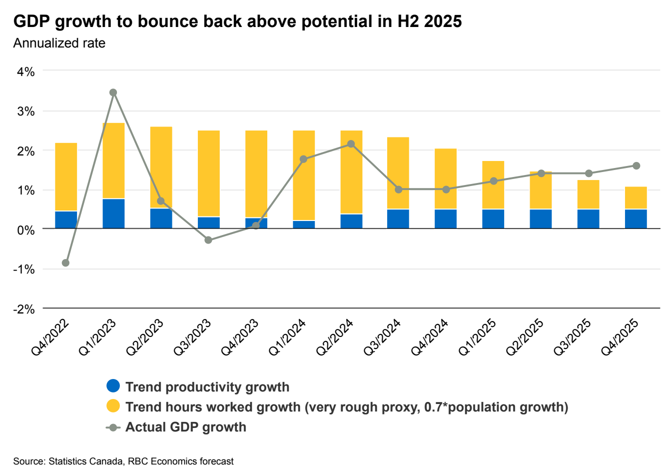
Still, there are some reasons to expect the recent trends will improve. In April, the BoC assumed a rebound in trend labour productivity, reverting from declining this year to adding about 0.8% to potential GDP in 2025, attributing some of the weakness over the last two years to delays in fully utilizing the skills of new arrivals.

Headwinds, however, remain to that optimistic outlook. For one, there aren't enough indications of a turnaround in business investment to significantly boost productivity growth. Real investment in non-residential structures, machinery, and equipment in Q2 was still almost 5% below a year ago.

Interest rates are coming down, lowering the cost of investments, but businesses are contending with growing uncertainties over taxes, regulations and immigration policies given upcoming elections in Canada and the U.S. Softening economic conditions in the world's largest economies and wars in the Middle East also add another layer of volatility to commodity prices and supply chains.

4. *The output gap is expected to widen until the second half of 2025, lowering inflation pressures.*

Still, inflation is expected to keep easing. Year-over-year growth consumer prices in August slowed back to the BoC's 2% inflation target—marking a faster return than was feared when price growth hit an 8% high two years ago.



The slowing benefitted a bit from lower global energy prices, which have since moved higher due to conflicts in the Middle East. But, the underperforming economy is raising risks that underlying price growth will ease to below the target range. Governor Macklem confirmed after the rate cut in September that policymakers are just as worried about undershooting the inflation target as overshooting it.

By our count, the economy has been growing below its potential rate for seven of the last eight quarters. That has opened a negative output gap—meaning demand in the economy has fallen below its production capacity, precipitating more slowing in price growth in the future.

With that, we expect the BoC will need to cut the overnight rate faster to move down to the neutral zone more quickly than we previously expected, before getting to a stimulative 2%.

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	3.25	2.75	2.25	2.00	2.00
Three-month	4.34	4.90	5.07	5.04	4.99	4.64	3.94	2.95	2.55	2.20	2.00	2.00
Two-year	3.74	4.58	4.87	3.88	4.22	3.99	2.92	2.75	2.45	2.10	1.95	2.00
Five-year	3.02	3.68	4.25	3.17	3.58	3.51	2.74	2.60	2.40	2.20	2.15	2.20
10-year	2.90	3.26	4.03	3.10	3.52	3.50	2.95	2.90	2.75	2.60	2.50	2.50
30-year	3.02	3.09	3.81	3.02	3.41	3.39	3.13	3.05	2.95	2.85	2.75	2.75
United States												
Fed funds midpoint	4.88	5.13	5.38	5.38	5.38	5.38	4.88	4.38	4.13	4.13	4.13	4.13
Three-month	4.85	5.43	5.55	5.40	5.45	5.48	4.73	4.20	4.00	4.05	4.10	4.10
Two-year	4.06	4.87	5.03	4.23	4.66	4.71	3.66	4.00	4.20	4.25	4.25	4.15
Five-year	3.60	4.13	4.60	3.84	4.28	4.33	3.58	3.75	3.80	3.85	3.80	3.70
10-year	3.48	3.81	4.59	3.88	4.27	4.36	3.81	3.95	4.00	4.00	3.95	3.85
30-year	3.67	3.85	4.73	4.03	4.41	4.51	4.14	4.25	4.30	4.25	4.15	4.05
United Kingdom												
Bank rate	4.25	5.00	5.25	5.25	5.25	5.25	5.00	4.50	4.25	3.75	3.75	3.75
Two-year	3.42	5.27	4.91	3.98	4.17	4.23	3.97	3.70	3.60	3.75	3.90	4.00
Five-year	3.33	4.66	4.53	3.46	3.84	4.03	3.85	3.60	3.50	3.55	3.60	3.65
10-year	3.47	4.39	4.46	3.54	3.95	4.17	4.00	3.75	3.70	3.75	3.85	3.95
30-year	3.82	4.42	4.92	4.14	4.49	4.67	4.54	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	3.00	2.50	2.25	2.25	2.25
Two-year	2.66	3.27	3.20	2.40	2.83	2.82	2.09	2.00	2.10	2.15	2.15	2.15
Five-year	2.30	2.58	2.79	1.94	2.32	2.48	1.97	1.85	1.95	2.10	2.15	2.25
10-year	2.28	2.39	2.85	2.03	2.29	2.50	2.14	2.00	2.10	2.20	2.25	2.30
30-year	2.35	2.38	3.05	2.27	2.46	2.69	2.46	2.35	2.40	2.50	2.60	2.70
Australia												
Cash target rate	3.60	4.10	4.10	4.35	4.35	4.35	4.35	4.35	4.10	3.85	3.60	3.60
Two-year	2.96	4.21	4.09	3.71	3.76	4.17	3.64	3.70	3.70	3.70	3.65	3.60
10-year	3.30	4.02	4.49	3.95	3.97	4.31	3.97	4.20	4.20	4.15	4.05	3.90
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.25	4.25	4.00	3.50	3.50	3.50
Two-year swap	5.01	5.46	5.69	4.63	4.78	4.95	3.56	3.70	3.75	3.50	3.60	3.75
10-year swap	4.27	4.46	5.13	4.12	4.35	4.48	3.87	3.85	3.90	3.95	3.95	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	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada*	3.9	3.8	1.8	-0.9	3.4	0.7	-0.3	0.1	1.8	2.1	1.0	1.0	1.2	1.4	1.4	1.6	5.3	3.8	1.2	1.0	1.3
United States*	-1.0	0.3	2.7	3.4	2.8	2.5	4.4	3.2	1.6	3.0	2.5	1.2	1.0	1.2	1.5	1.5	6.1	2.5	2.9	2.6	1.5
United Kingdom	0.7	0.3	0.1	0.3	0.1	0.0	-0.1	-0.3	0.7	0.5	0.3	0.3	0.3	0.3	0.3	0.3	8.6	4.8	0.3	0.9	1.3
Euro area	0.4	0.9	0.5	-0.1	0.0	0.1	0.0	0.1	0.3	0.2	0.1	0.1	0.2	0.3	0.3	0.3	6.2	3.4	0.5	0.6	0.8
Australia	0.9	0.9	0.1	0.7	0.5	0.5	0.3	0.2	0.2	0.2	0.5	0.4	0.6	0.7	0.8	0.9	5.5	3.9	2.0	1.2	2.5

*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	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	2.8	2.7	2.1	1.8	1.9	1.6	1.5	1.5	3.4	6.8	3.9	2.4	1.6
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.2	3.2	3.2	2.6	2.5	2.1	2.0	2.3	2.3	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	3.5	2.1	2.3	2.6	2.6	2.4	2.5	2.3	2.6	9.1	7.3	2.6	2.5
Euro area	6.1	8.0	9.3	10.0	8.0	6.2	5.0	2.7	2.6	2.5	2.2	2.4	2.2	2.2	2.2	2.1	2.6	8.4	5.4	2.4	2.2
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.4	4.1	3.6	3.8	2.9	3.0	2.8	2.6	3.0	3.0	2.9	6.6	5.6	3.3	2.9

Sources: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics, RBC Capital Markets

Currency outlook

US dollar cross rates, 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
USD/CAD	1.35	1.32	1.35	1.32	1.35	1.37	1.35	1.40	1.41	1.43	1.42	1.41
EUR/USD	1.09	1.09	1.06	1.11	1.08	1.07	1.11	1.08	1.09	1.10	1.11	1.12
GBP/USD	1.24	1.27	1.22	1.27	1.26	1.26	1.34	1.29	1.27	1.25	1.25	1.26
USD/JPY	133	144	149	141	151	161	144	149	149	147	143	139
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.67	0.69	0.69	0.70	0.69	0.68	0.68

Canadian dollar cross rates

	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	1.47	1.44	1.43	1.46	1.46	1.47	1.51	1.51	1.54	1.57	1.58	1.58
GBP/CAD	1.67	1.68	1.65	1.68	1.71	1.73	1.81	1.80	1.79	1.79	1.77	1.77
CAD/JPY	98	109	110	107	112	117	106	106	106	103	101	99
AUD/CAD	0.91	0.88	0.87	0.90	0.88	0.91	0.93	0.97	0.99	0.99	0.97	0.96

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