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Thought Leadership

Financial Markets Monthly

October 2023

Taking the long way home

September marked another month of mixed economic data prints alongside sharp selloff in bond markets. The yield curve is still inverted less than it was after U.S. and Canadian 10-year government bond yields jumped ~50 basis points in September. The increase in yields at the long end of the curve came despite both the Fed and the BoC skipping a policy rate hike at their latest meetings. Expectations for rate cuts have been pared back from earlier in the year, but both central banks are still expected to shift to reductions in interest rates next year, and longer -run implied inflation rates haven't changed significantly. The recent rise in term yields has been driven by markets demanding a higher term premium, alongside ongoing debate about how much higher the long-run 'neutral' level of central bank policy rates might be compared to pre-pandemic levels.

We have argued before that there are good reasons to think that an era of unusually cheap money has come to an end, and that central banks will need to maintain interest rates at higher levels than over the decade pre-pandemic to keep inflation pressures in check. That doesn't mean interest rates will stay at today's levels – most central bankers still view the level of interest rates currently as 'restrictive.' But markets have also been penciling in fewer interest rate cuts beyond the next year on the expectation that interest rates will have to stay higher for longer.

Overview

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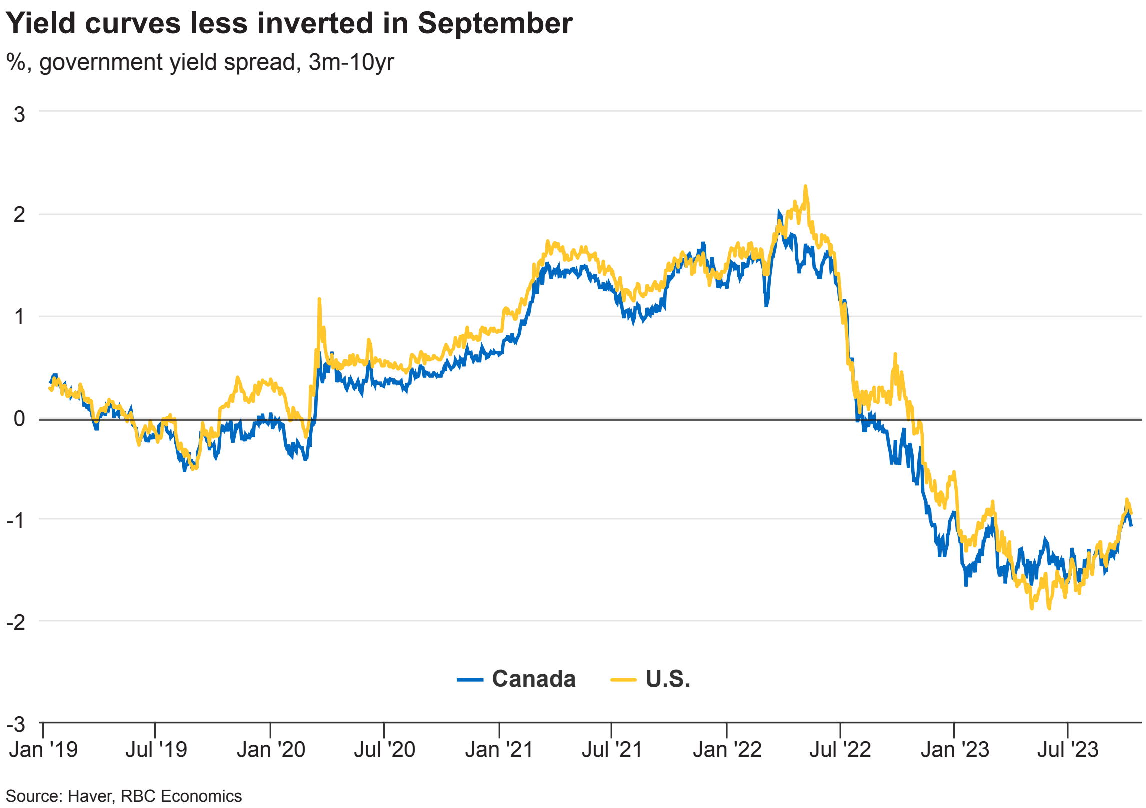
Central banks (near-term) are highly data dependent

For now, the aggressive run-up in interest rates since early 2022 means central banks are no longer in catch up mode and additional interest rate moves are highly data dependent. There are still signs that higher interest rates are working to slow economic growth with a lag. That is true in some regions more than in others – unemployment rates in Canada and the U.K. have begun to edge higher and GDP growth in the Euro area has been looking sluggish. The U.S. economy remains a standout, with resilient consumer spending leaving GDP growth tracking a strong increase in Q3 and strong labour market data through September making a significant slowdown in Q4 look less likely.



Inflation readings have looked better in the U.K. and Euro area, and broader inflation pressures in the United States have shown substantial [signs](#) of easing. Canada has been an outlier with few signs that broader inflation pressures have slowed in recent months. But the BoC is well aware that inflation lags the economic cycle and should slow with the unemployment rate rising and GDP growth slowing. GDP in Canada declined slightly in Q2 and is on track for another dip in Q3. And those small declines look much larger on a per-capita basis once controlling for surging population growth.

Central bank bias

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

The BoC left the overnight rate steady at 5% in September amid a slowing growth and labour market backdrop. Domestic inflation pressures are still persisting in Canada, but we continue to expect a softer economy will slow inflation pressures and leave the BoC on pause for the rest of 2023.

Fed	5.25-5.50% +0 bps in Sep-23	0 bps in Nov-23

The Fed skipped another interest rate hike in September with softening inflation readings offsetting resilient consumer demand and labour markets. We see the Fed pausing rates at currently elevated levels until 2024.

BoE	5.25% +0 bps in Sep-23	0 bps in Nov-23

Inflation data in the U.K. more recently surprised to the downside but wage growth remain elevated. Still, weaker growth and labour market data should be enough to convince that domestic price pressures will keep receding. We don't expect more tightening from the BoE this year.

ECB	4.00% +25 bps in Sep-23	0 bps in Oct-23

Survey data out of the euro area continue to suggest weakening activities, for both manufacturing and service sectors in Q3. There have also been early signs of labour demand cooling off. We expect the ECB to be moving to the sidelines and keep rates steady at its meeting later this month.

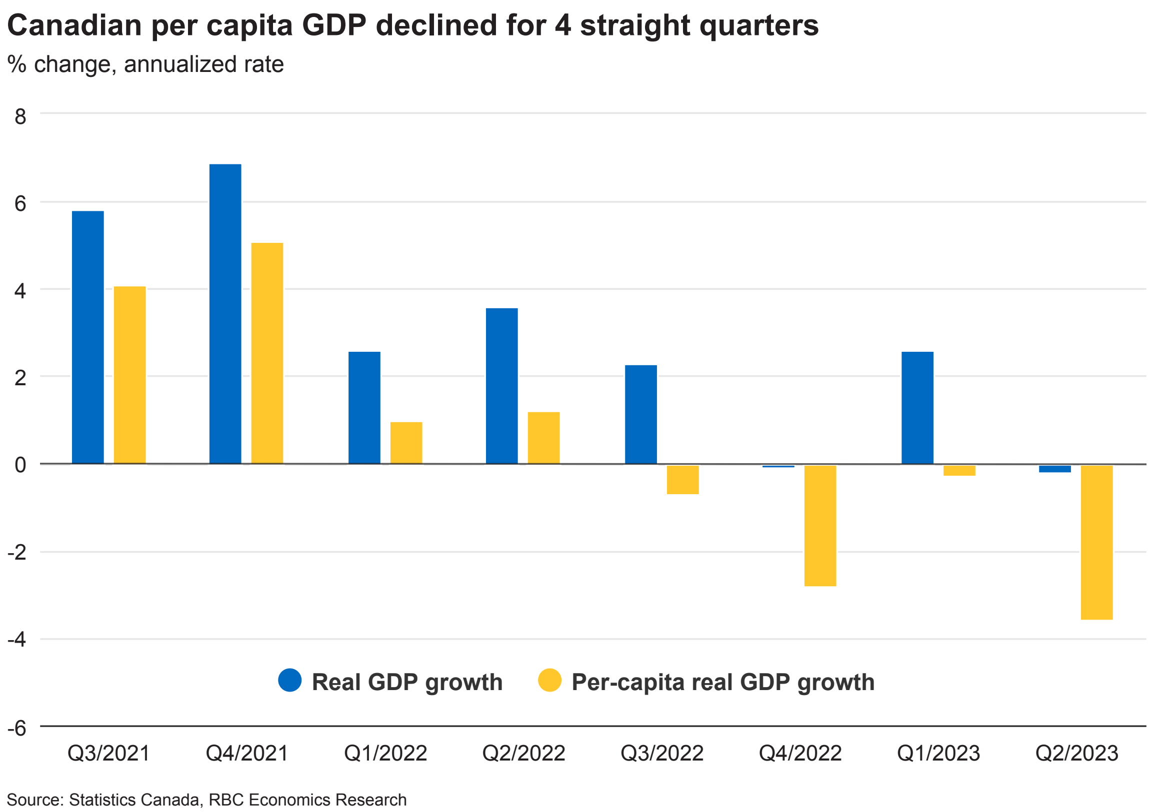
RBA	4.1% +0 bps in Oct-23	0 bps in Nov-23

As expected, the cash rate was kept at 4.1% in RBA's October meeting with the statement reiterating a tightening bias amid risks associated with sticky domestic service inflation. The level of uncertainties in data releases has left us retaining our call for another hike, later in Q4.

Softer growth data leaving the BoC on hold

We look for the BoC to remain on hold for the rest of this year, with softer economic data arguing that higher interest rates aren't needed even with inflation continuing to surprise on the upside. Headline Canadian price growth is down sharply from peak levels last year, but the BoC's preferred 'core' measures have been running at a 4 ½% annualized rate over the last three months, still well above the BoC's 2% inflation target.

But inflation lags the economic cycle and output growth has started to weaken. The 0.2% (annualized) dip in GDP in Q2 was a much larger decline (-3 ½%) when measured on a per-capita basis (more on this in the box below). The unemployment rate has increased half a percent from the spring and the sharp rise in term bond yields – 10-year yields hit levels not seen since before the 2008/09 financial crisis – has already tightened financial conditions further since the BoC's last interest rate decision in September.



U.S. Fed also on hold, but for different reasons

The U.S. Fed looks to be on hold for the opposite reason – with easing inflation pressures allowing policymakers to move to the sidelines despite an exceptionally resilient macroeconomic growth backdrop. GDP growth is tracking above 3% for Q3, the highest rate since Q4 2021, underpinned by firm consumer spending. Solid readings for labour markets through September also make a significant slowdown in growth in Q4 look less likely. But domestic inflation pressures in the U.S. were dropping lower earlier in the spring and have remained muted since, disconnecting from an overheating economic backdrop and allowing the Fed to be patient and wait for the cumulative impact of higher interest rates over time to cool the economy.

Fed officials are still concerned that the slowing in inflation pressures observed to-date won't last if consumer spending continues to run hot, but we continue to think that conditions are softening under the surface. Job openings have continued to shrink, on balance, eating into excess labour demand, and the unemployment rate is still very low but ticked higher over August and September. We expect GDP growth to slow, although we are no longer expecting a decline in output in Q4 2023.

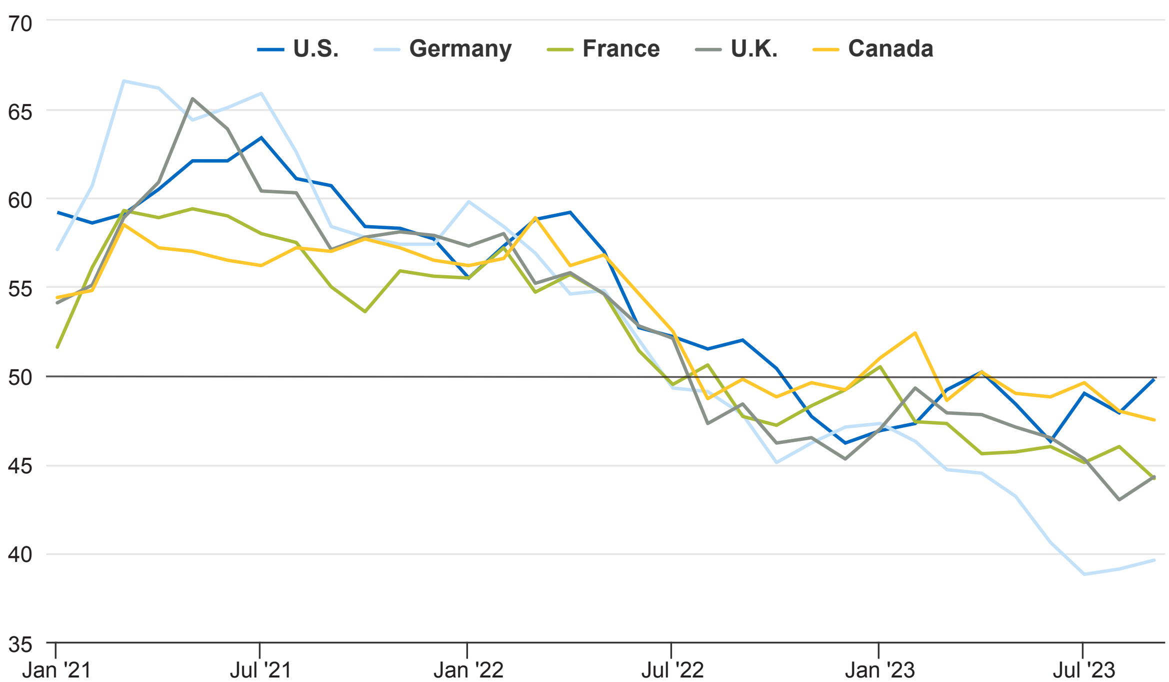
Softer macro conditions keeping BoE and ECB on the sideline

September saw both the ECB and BOE attempt to strike a balanced tone while delivering their latest rate decisions. The BOE went for a hawkish hold, persuaded by weakening economic backdrop from the PMI readings and a downside surprise in August inflation data, especially in the closely-watched services sub-component. Much like Canada, labour market conditions in the UK continue to deteriorate with the unemployment rate edging higher on a 3m/3m basis and employment outright declining in August. Wage growth was still persisting at elevated levels but should start to trend lower as well once weaker activities feed through. All told, we expect the BOE to remain on hold and keep the Bank Rate steady at 5.25% through the rest of next year.

In the euro area, the ECB in September delivered a dovish hike despite softer PMI readings that would suggest a contraction in GDP in Q3. Headline labour market statistics are still showing resilience. But inflation surprised on the downside in September and softer economic growth will help to cool labour markets over time. The ECB's September rate hike was already a very close call. With data since mostly pointing to softer macroeconomic conditions, we expect the ECB to maintain the depo rate at 4% through the end of 2024.

Global manufacturing outlook still soft

Manufacturing Purchasing Managers Index (below 50 = contraction)



Source: Haver, RBC Economics

how should surging population be factored into the reading of macro indicators?

Recently reported demographics data suggested another blockbuster increase in Canadian population in the second quarter of 2023. Combined with what was already a substantial gain over the three quarters before that, population in Canada grew by 1,200,000, or 3% just over the past year.

The surge in population growth complicates the interpretation of macroeconomic variables. Each new arrival is also an additional consumer that adds to economy-wide demand, but new arrivals are also filling open job postings and adding to the economy's production (GDP) capacity.

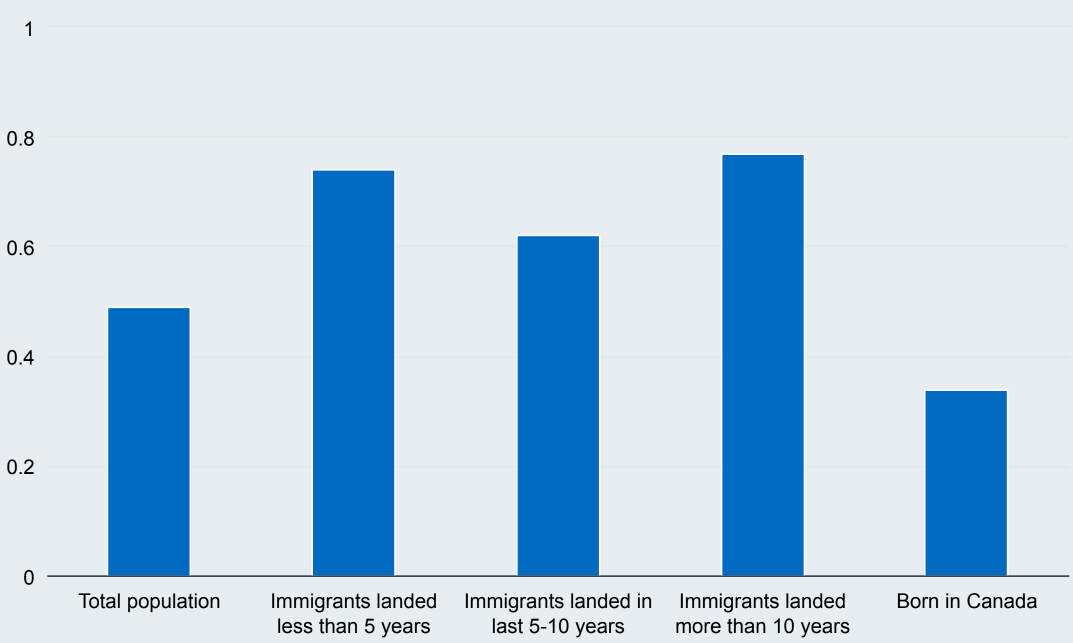
Rising population has been concealing the extent of softening in the Canadian macroeconomic backdrop. StatCan last month reported that real output was essentially flat in the second quarter of 2023, after posting a larger 2.6% annualized increase in Q1. That is a very small decline by historical standards, but was a much larger drop (-3 ½%) on a per-person basis – and marked the fourth consecutive per-capita decline.

Similarly, a surge in available labour supply means it takes larger employment gains to prevent the unemployment rate from rising. The unemployment rate has increased 0.5 percentage points since April, despite job growth averaging a historically strong 28k per month since then because the size of the labour force has increased more. Job openings have been declining at the same time, suggesting that the balance of supply and demand in labour markets has been shifting more significantly in favour of hirers and away from workers.

And while the vast majority of population growth has come from immigration, softening in labour markets has been more widespread. Unemployment has increased significantly for recent arrivals, but has also risen for those who have been residents of Canada for longer, including the population that is born in Canada. That suggests there is more to the weakness than simply having trouble absorbing new arrivals into the work force.

Canada unemployment rate increase is broadly based

Change in unemployment rate (%) since April, 3-month rolling average, seasonally adjusted by RBC



Source: Statistics Canada, RBC Economics

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	5.07	5.00	4.95	4.85	4.35	3.85
Two-year	2.27	3.10	3.79	4.06	3.74	4.58	4.87	4.50	4.20	3.85	3.60	3.40
Five-year	2.39	3.10	3.32	3.41	3.02	3.68	4.25	3.90	3.60	3.40	3.35	3.30
10-year	2.40	3.23	3.16	3.30	2.90	3.26	4.03	3.80	3.65	3.50	3.40	3.35
30-year	2.37	3.14	3.09	3.28	3.02	3.09	3.81	3.70	3.65	3.60	3.60	3.55
United States												
Fed funds midpoint	0.37	1.62	3.12	4.37	4.87	5.12	5.37	5.38	5.38	5.13	4.63	4.13
Three-month	0.52	1.72	3.33	4.42	4.85	5.43	5.55	5.30	5.23	4.93	4.43	3.93
Two-year	2.28	2.92	4.22	4.41	4.06	4.87	5.03	4.80	4.55	4.05	3.70	3.40
Five-year	2.42	3.01	4.06	3.99	3.60	4.13	4.60	4.40	4.20	3.85	3.65	3.50
10-year	2.32	2.98	3.83	3.88	3.48	3.81	4.59	4.50	4.40	4.20	4.05	3.95
30-year	2.44	3.14	3.79	3.97	3.67	3.85	4.73	4.70	4.65	4.55	4.50	4.45
United Kingdom												
Bank rate	0.75	1.25	2.25	3.50	4.25	5.00	5.25	5.25	5.25	5.25	5.25	5.25
Two-year	1.36	1.85	4.29	3.71	3.42	5.27	4.91	5.00	4.95	4.90	4.75	4.50
Five-year	1.40	1.88	4.40	3.62	3.33	4.66	4.53	4.50	4.35	4.10	4.00	3.80
10-year	1.60	2.22	4.08	3.67	3.47	4.39	4.46	4.50	4.40	4.30	4.25	4.25
30-year	1.77	2.59	3.82	3.95	3.82	4.42	4.92	5.00	4.90	4.75	4.75	4.75
Euro area*												
Deposit Rate	-0.50	-0.50	0.75	2.00	3.00	3.50	4.00	4.00	4.00	4.00	4.00	4.00
Two-year	-0.08	0.64	1.78	2.76	2.66	3.27	3.20	3.25	3.25	3.15	3.00	2.75
Five-year	0.37	1.09	1.98	2.58	2.30	2.58	2.79	2.90	3.00	2.85	2.75	2.60
10-year	0.55	1.36	2.12	2.57	2.28	2.39	2.85	3.00	3.15	3.00	2.90	2.90
30-year	0.67	1.63	2.10	2.46	2.35	2.38	3.05	3.10	3.25	3.10	3.00	3.00
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	4.11	3.90	3.75	3.60	3.50	3.45
10-year	2.84	3.67	3.89	4.05	3.30	4.03	4.48	4.50	4.55	4.40	4.30	4.15
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	5.69	5.50	5.20	4.80	4.30	3.80
10-year swap	3.38	4.10	4.50	4.78	4.27	4.46	5.13	5.05	4.80	4.60	4.40	4.25

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	5.01	3.44	1.0	0.6
United States*	-2.0	-0.6	2.7	2.6	2.2	2.1	3.5	0.5	-1.0	-1.0	1.0	1.5	5.80	1.94	2.2	0.4
United Kingdom	0.5	0.1	-0.1	0.1	0.3	0.2	-0.2	0.1	0.0	0.1	0.2	0.2	8.67	4.35	0.5	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	5.58	3.39	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	5.21	3.69	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	3.8	3.4	3.4	2.7	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	2.9	2.7	2.3	2.1	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	4.96	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	1.24	1.28	1.37	1.35	1.35	1.32	1.35	1.38	1.39	1.39	1.35	1.31
EUR/USD	1.10	1.04	0.97	1.06	1.08	1.09	1.05	1.04	1.03	1.02	1.05	1.08
GBP/USD	1.31	1.21	1.11	1.20	1.23	1.27	1.22	1.17	1.13	1.11	1.15	1.20
USD/JPY	121.4	135.6	144.7	131.8	132.7	144.4	149.4	150	152	154	150	145
AUD/USD	0.74	0.69	0.64	0.68	0.67	0.66	0.64	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	1.43	1.44	1.43	1.42	1.42	1.41
GBP/CAD	1.64	1.57	1.51	1.63	1.67	1.68	1.65	1.61	1.57	1.54	1.56	1.57
CAD/JPY	97	105	105	97	98	109	110	109	109	111	111	111
AUD/CAD	0.94	0.89	0.89	0.92	0.91	0.88	0.87	0.86	0.85	0.83	0.82	0.81

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