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Ease on down the road – Fed shifting gears as inflation slows

Highlights:

- Softening U.S. labour markets and lower inflation leave the Fed on track to kick off an easing cycle starting in September, one of the last major central banks to do so.
- We continue to expect, as a base the U.S will avoid a technical recession, but that growth will slow, the unemployment rate will rise mildly and the Fed will continue its easing cycle over the coming quarters before pausing at a 4% - 4.25% rate by mid-year 2025.
- In Canada, the BoC delivered a third consecutive rate cut in September and continues to emphasize through communications that the risks to inflation and the economy are to the downside. We expect the BoC will continue to cut by 25 bps every meeting until the overnight rate reaches 3%.
- Softening global goods demand is continuing to drag on manufacturing sector activities, contributing to underperformance in the German economy relative to the U.K. and other countries in the euro area.
- We hold our expectation for a gradual and shallow easing cycle from both BoE and ECB, and expect them to continue to lower rates at every-other-meeting before reaching a total of 100bps reduction each.

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August's U.S. jobs report showed the unemployment rate ticking lower. That may have calmed fears that a gradual slowdown in U.S. labour markets is accelerating imminently– but there are still clear signs of cooling. Indeed, as hiring demand scales back persistently and inflation pressures broadly subside, it is increasingly obvious that interest rates in the U.S. don't need to be at levels this high. We expect the Fed will kick off a gradual easing cycle with a 25-bps cut in their meeting next week.

The pace and magnitude of further reductions beyond September will depend on the pace and magnitude of the slowdown in the economy – and while U.S. consumer spending growth doesn't look sustainable at current rates, a large government budget deficit is continuing to add an unusual amount of fiscal stimulus and will keep a floor under growth. We look for GDP growth to slow but remain positive in the coming quarters.

In Canada the economic backdrop has continued to soften with unemployment rising and inflation drifting lower. GDP growth in Q3 looks poised to undershoot the BoC's forecast in July, further enlarging excess supply in the economy. Current interest rates even after three rate cuts still look too high comparing to a dimming economic outlook - we expect the BoC will keep cutting rates at a 25-bps every meeting pace until a 3% terminal is reached by Q2 2025. That likely won't be enough to spur a significant rebound in activity, but it will help arrest the downward momentum.

Contrasting softer performance in Canada are solid growth momentum in the U.K. that looks to be extending into Q3. Although the strong numbers for the first half of this year could be partially exaggerating the strength in underlying domestic demand. Survey data suggests that other services-oriented economies in the euro area including France and Spain are also seeing expansion in activities, while growth in Germany still looks the most depressed, weighed down by external factors such as soft demand from China.

With focus from both the ECB and the BoE increasingly shifting from inflation to the growth backdrop, relatively solid momentum in large parts of Europe and the U.K. is expected to keep both central banks on a shallow cutting path. We expect both will go at a slower pace compared to the BoC and the Fed, cutting rates every other meeting (that means the ECB is expected to cut this week while the BoE will stay on hold this month and cut again in November) until reaching 100 bps worth of reduction from each in total for this cycle.

Central bank bias

Central bank	Current policy rate	Next decision
BoC	**4.25%** -25 bps in Sep/24	**-25 bps** Oct/24

September saw the BoC deliver a third consecutive rate cut as expected. That still leaves the overnight rate at 'restrictive' levels – particularly compared to a softening economic growth backdrop that's expected to keep pushing inflation lower. Governor Macklem in his comments focused on those downside risks, opening the door for more aggressive easing. For now, we expect another 25-bps cut in October.

Central bank	Current policy rate	Next decision
Fed	**5.25-5.50%** 0 bps in Jul/24	**-25 bps** Sep/24

In his recent speech Fed Governor Waller spelled out the need for interest rates to be moving lower in order to preserve growth in the economy That cements expectations for a first 25-bps rate cut at the meeting next week. Beyond then, a gradual slowing in the labour market is expected to keep the Fed on the steady path of easing. We think they will cut by 25 bps in every meeting until March 2025 (inclusive).

Central bank	Current policy rate	Next decision
BoE	**5.00%** -25 bps in Aug/24	**0 bps** Sep/24

Data releases in the U.K. since the first BoE rate cut in August have shown a healthy combination of solid momentum in output growth and more progress in cooling wage/domestic inflation. Real household spending in Q2 was still below levels a year ago but is set to rebound further given growth in real income over the last year. We hold our forecast that the BoE will cut rates once more this year in November.

Central bank	Current policy rate	Next decision
ECB	**3.75%** 0 bps in Jul/24	**-25 bps** Sep/24

With most ECB speakers' endorsement, a second 25 bps rate cut in September from the central bank looks like a done deal. Focus will be on how the ECB guides future decisions especially amid mixed data prints on growth, labour markets and inflation. We think the central bank will maintain a meeting-by-meeting, data-dependent approach, and expect them to cut only once more this year in December.

Central bank	Current policy rate	Next decision
RBA	**4.35%** 0 bps in Aug/24	**0 bps** Sep/24

The soft Q2 GDP data showed an outright contraction in household spending which may bring some relief to the RBA in terms of rebalancing demand and supply and what that implies for inflation moving forward. Measures for key wage and underlying inflation have shown more signs of easing lately but remain too high. We continue to expect the RBA will lag the global easing cycle and start cutting later in 2025.

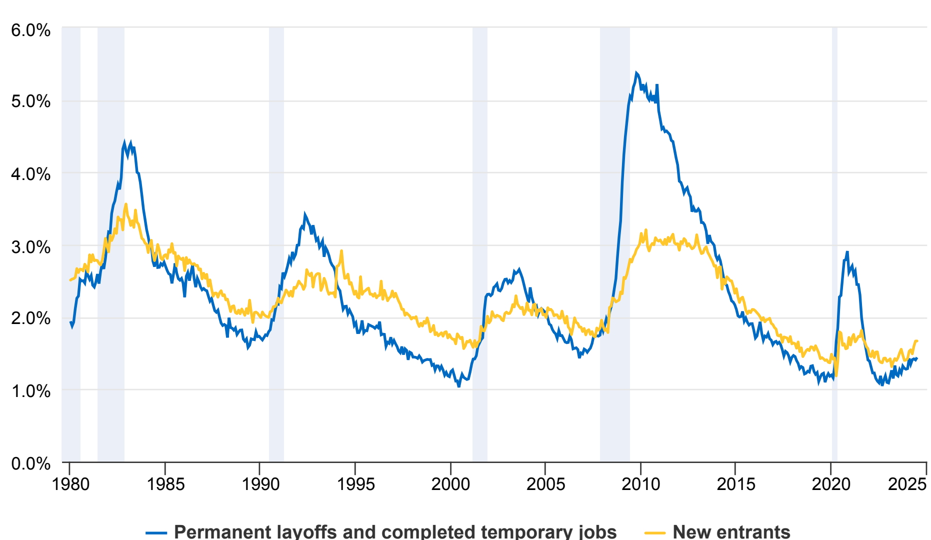
U.S. labour markets continuing to (gradually) cool

The August employment report helped calm fears that labour markets are crumbling. But they are still gradually cooling on the back of a persistent slowing in hiring demand that began more than a year ago.

Following up on the data, Fed Governor Waller in his speech last week (the last public communication from Fed policymakers before they enter their blackout period ahead of the September policy decision) spelled out the Fed's intention to cut rates, and attributed most of the rise in the unemployment rate to the supply side factors as immigration boosts growth in the labour force.

But demand side factors also are at play – hiring demand has clearly slowed with job openings continuing to plunge. Latest estimates for payroll employment growth on a three-month average basis eased to just half of where it was at the beginning of the year. Stronger momentum at the beginning of the year is also likely overstated, early annual benchmark estimates from the BLS saw the second largest downward revision on record, by 818k. Permanent layoffs although not surging have also been trending persistently higher.

Permenant layoffs in the U.S. are edging higher

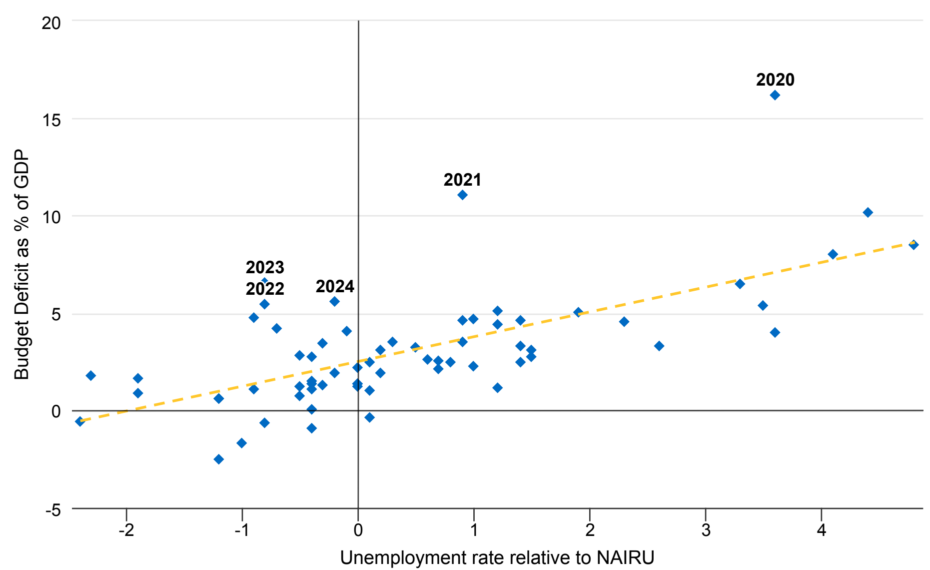


Source: Bureau of Labor Statistics, RBC Economics

Some of the slowing in hiring could be tied to uncertainty about global trade policy and the tax/regulatory backdrop ahead of the upcoming election in November. But those worries aren't likely to dissipate immediately after the election. Overall, we continue to expect the unemployment rate in the U.S. to move gradually higher into 2025, to levels that can still be considered historically low.

Support from U.S. consumers might fade, but not government spending

To be sure, U.S. labour markets are softening but don't look to be on the verge of collapsing, and broader economic growth has remained firm, at least in part supported by tailwinds from a massive government budget deficit that looks increasingly to be the new normal. The presidential election is looming, but early consensus is that the budget deficit will likely increase under either a Harris or Trump presidency.



Indeed, the size of the budget deficit is already unusually large at this stage in the economic cycle – historically deficits of this size (as a percent share of GDP) have only come when the country is in war or economic crisis, and never when the unemployment rate is this low. That unusually large fiscal tailwind underpins our assumption that growth in the U.S. economy will slow but won't falter, and the Fed will begin a shallow cutting cycle to land the fed funds at 4%-4.25% by Q2 2025.

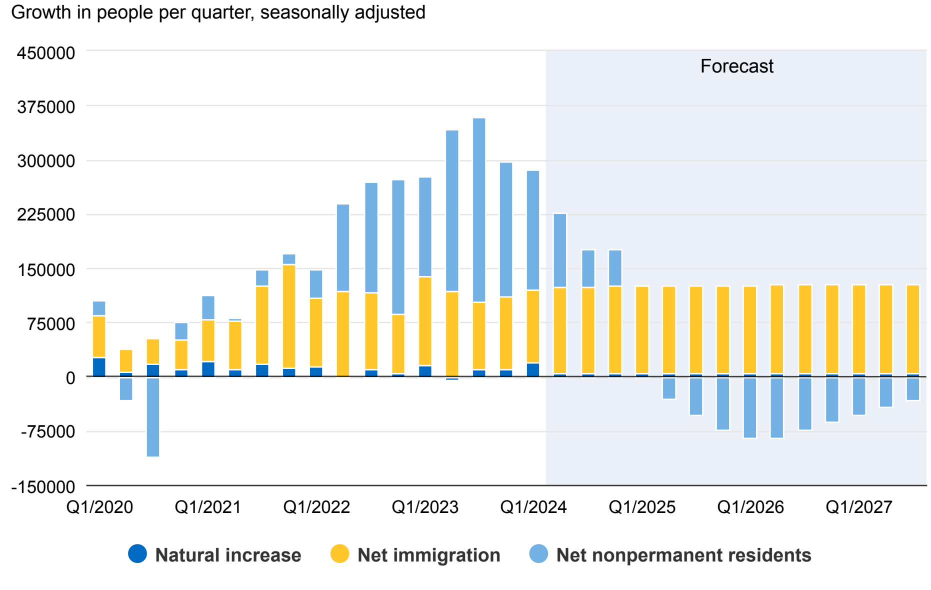
Risks to that outlook are tilted to the downside, especially with labour market conditions already looser than pre-pandemic, and measures of excess labour demand are pointing to very little slack in the jobs market. Labour markets have already largely 'normalized' and Fed Chair Powell has been clear that further deterioration would not be welcomed by policy makers. Going forward, further deterioration in employment conditions could trigger a more aggressive cutting cycle from the Fed than the one we're currently expecting.

Softening economic backdrop in Canada could prompt more/ larger rate cuts from BoC

In Canada, data from August into early September saw economic conditions continuing to weaken. Growth in GDP was slightly faster than expected in Q2 but still paled against a larger increase in population, leaving output growth on a per-person basis once again lower than where it was in the prior quarter. The level of real per-capita GDP, after seeing persistent declines over the past two years, has now dropped to levels below the end of 2016.

Outside of a jump in mortgage interest costs that is a direct result of earlier BoC rate hikes, inflation in Canada has been running right around the 2% inflation target since January. And the unemployment rate has done more than 'normalize' in Canada – the 6.6% unemployment rate in August is up more than a full percentage point from a year ago and pre-pandemic levels.

An increasingly soft economic backdrop is arguing for more easing from the BoC. We expect the BoC will continue to cut interest rates gradually at a 25 basis points per-meeting pace until hitting 3% before mid-year 2025 – but the comments from the BoC have reaffirmed that more aggressive cuts, and potentially a lower terminal rate for the cutting cycle, could follow should the economy soften more than we expect and lead inflation to undershoot the 2% target (not in our base case).



Still, ongoing rate cuts should support a rebound in consumer spending as the burden of debt-servicing eases. On the other hand, population growth that has offset a lot of the per-capita slowing in the economy in the past is set to slow in 2025. The government's commitment is to lower the ratio of net temporary residents to 5% from ~7% currently by 2027. That implies a sharp (more than 20%) decline in the number of temporary residents although the details are less clear as to how that could be reached.

Changes in immigration policy are not the only ones that Canadian businesses have to deal with. Also recently announced were trade tariffs targeting specific products import from China, as well as a collapse in the confidence-and-supply agreement that could trigger an early election. All these challenges could work to disincentivize business hiring and investment, weighing on growth into 2025.

Solid growth backdrop in (most of) Europe and the U.K. limit rate cuts

After an initial rate cut from the BoE at the beginning of August, data outturn in the U.K. has been more positive than expected. Real GDP growth in Q2 was stronger at 0.6% although half of it was driven by government spending. Household consumption in the meantime, grew mutedly and were not meaningfully different from levels a year ago, suggesting the fundamental spending power among household has not rebounded as fully.

Still, survey data showed activities further expanding early in Q3. And recovery in real household income should continue to support growth in spending. The positive economic outlook is expected to keep a floor under the U.K. labour market, but could also draw concerns that recent slower inflation trends (recent data has pointed to further slowing in wage and core services inflation measures) won't continue. We think the BoE will stay nimble and cautious of the upside risk and expect them to conduct a shallow easing cycle.

Data out of the euro area paints a picture that's slightly more mixed. For one, divergence between softer manufacturing output and recovering services sector activities is persisting and underpinning gaps in performances amongst member countries. Wage growth has moderated but the labour market backdrop remains tight. More importantly, core services inflation readings are showing less progress than expected, and look set to overshoot ECB's implied forecast for Q3.

With a second interest rate cut from the ECB meeting this week all but guaranteed, focus will be on any shift in guidance garnering future decisions. Given the lack of progress on domestic core inflation, we expect the meeting-by-meeting, data-dependent framework will be retained and don't see the ECB hint at more frequent rate cuts. Moving forward and similar to the BoE, we think solid economic recovery amongst a wide swath of European countries outside of Germany will bring out a shallow cutting cycle from the ECB.

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	3.75	3.25	3.00	3.00	3.00
Three-month	4.34	4.90	5.07	5.04	4.99	4.64	4.05	3.55	3.20	3.00	3.00	3.00
Two-year	3.74	4.58	4.87	3.88	4.22	3.99	3.10	2.95	2.90	2.75	2.90	3.00
Five-year	3.02	3.68	4.25	3.17	3.58	3.51	2.85	2.75	2.85	2.90	2.90	3.00
10-year	2.90	3.26	4.03	3.10	3.52	3.50	3.00	2.85	2.90	2.95	3.00	3.10
30-year	3.02	3.09	3.81	3.02	3.41	3.39	3.15	3.00	3.00	3.05	3.10	3.15
United States												
Fed funds midpoint	4.88	5.13	5.38	5.38	5.38	5.38	5.13	4.63	4.13	4.13	4.13	4.13
Three-month	4.85	5.43	5.55	5.40	5.45	5.48	4.95	4.45	4.00	4.05	4.10	4.10
Two-year	4.06	4.87	5.03	4.23	4.66	4.71	3.80	4.00	4.20	4.25	4.25	4.15
Five-year	3.60	4.13	4.60	3.84	4.28	4.33	3.60	3.75	3.80	3.85	3.80	3.70
10-year	3.48	3.81	4.59	3.88	4.27	4.36	3.80	3.95	4.00	4.00	3.95	3.85
30-year	3.67	3.85	4.73	4.03	4.41	4.51	4.05	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	4.75	4.50	4.25	4.25	4.25
Two-year	3.42	5.27	4.91	3.98	4.17	4.23	3.75	3.70	3.60	3.75	3.90	4.00
Five-year	3.33	4.66	4.53	3.46	3.84	4.03	3.75	3.60	3.50	3.55	3.60	3.65
10-year	3.47	4.39	4.46	3.54	3.95	4.17	3.90	3.75	3.70	3.75	3.85	3.95
30-year	3.82	4.42	4.92	4.14	4.49	4.67	4.60	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	3.25	3.00	3.00	3.00	3.00
Two-year	2.66	3.27	3.20	2.40	2.83	2.82	2.50	2.50	2.50	2.60	2.70	2.80
Five-year	2.30	2.58	2.79	1.94	2.32	2.48	2.20	2.20	2.15	2.20	2.20	2.25
10-year	2.28	2.39	2.85	2.03	2.29	2.50	2.35	2.20	2.20	2.20	2.25	2.30
30-year	2.35	2.38	3.05	2.27	2.46	2.69	2.50	2.50	2.50	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	3.70	3.80	3.70	3.70	3.65	3.60
10-year	3.30	4.02	4.49	3.95	3.97	4.31	4.05	4.25	4.25	4.20	4.10	3.90
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.25	4.50	4.25	3.75	3.50	3.50
Two-year swap	5.01	5.46	5.69	4.63	4.78	4.95	3.80	3.85	3.75	3.60	3.60	3.60
10-year swap	4.27	4.46	5.13	4.12	4.35	4.48	3.80	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	1.5	1.6	1.6	1.8	1.8	5.3	3.8	1.2	1.1	1.6
United States*	-2.0	-0.6	2.7	2.6	2.2	2.1	4.9	3.4	1.4	3.0	1.5	1.2	1.0	1.2	1.5	1.5	5.8	1.9	2.5	2.5	1.4
United Kingdom	0.5	0.1	-0.1	0.1	0.2	0.0	-0.1	-0.3	0.7	0.6	0.3	0.3	0.3	0.3	0.3	0.3	8.7	4.3	0.1	1.1	1.3
Euro area	0.4	0.9	0.5	-0.1	0.0	0.1	0.0	0.1	0.3	0.2	0.3	0.4	0.4	0.4	0.4	0.4	6.2	3.4	0.5	0.8	1.5
Australia	0.9	0.9	0.1	0.7	0.5	0.5	0.3	0.2	0.2	0.2	0.6	0.4	0.6	0.7	0.8	1.0	5.5	3.9	2.0	1.3	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	2.3	2.1	2.2	1.8	1.8	1.8	3.4	6.8	3.9	2.5	1.9
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.2	3.2	3.2	2.6	2.3	1.9	1.7	2.1	2.1	4.7	8.0	4.1	2.8	2.0
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	2.1	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	3.0	3.1	3.0	2.7	3.0	3.0	2.9	6.6	5.6	3.4	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	1.37	1.38	1.38	1.38	1.37	1.36
EUR/USD	1.09	1.09	1.06	1.11	1.08	1.07	1.10	1.08	1.09	1.10	1.11	1.12
GBP/USD	1.24	1.27	1.22	1.27	1.26	1.26	1.29	1.26	1.25	1.25	1.25	1.26
USD/JPY	133	144	149	141	151	161	144	147	149	147	143	139
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.67	0.67	0.68	0.69	0.70	0.71	0.71

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	1.50	1.49	1.50	1.52	1.52	1.52
GBP/CAD	1.67	1.68	1.65	1.68	1.71	1.73	1.77	1.73	1.73	1.73	1.71	1.71
CAD/JPY	98	109	110	107	112	117	105	107	108	107	104	102
AUD/CAD	0.91	0.88	0.87	0.90	0.88	0.91	0.91	0.94	0.95	0.97	0.97	0.97

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

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