FINANCIAL MARKETS MONTHLY

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Oh, inverted world

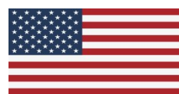
In March, the yield curve jumped from analysts' chartbooks into the headlines and recession chatter grew louder. In both Canada and the US, long-term yields fell below short-term yields for the first time since 2007. The yield curve has earned its reputation as a recession predictor, inverting several months before each of the last three US downturns. Its record in Canada is a bit spottier, sending a few false signals over the years. But sustained periods of yield curve inversion were followed by recessions in the early-1990s and again in 2008.

What's behind the recent flattening and ultimate inversion of the yield curve? In the US, the spread between long- and short-term rates has narrowed steadily over the last year. That initially reflected long-term yields failing to keep up with Fed rate hikes—as we usually see in a tightening cycle. But toward the end of last year, 10-year yields fell sharply as equity markets declined and investors flocked to safety. More recently, a dovish shift from the Fed has weighed on Treasury yields. In fact, it was the March FOMC meeting, combined with some disappointing global data, that finally pushed the curve to inversion. Similar factors have been at play in Canada, though with global developments having greater influence than domestic monetary policy.

As of early April, 10-year yields in Canada and the US were back (slightly) above their 3-month counterparts. But investors are still betting that the Fed and Bank of Canada are more likely to cut rates than hike. We don't think we're at that point, but the pendulum has swung enough that we're now forecasting both central banks are finished raising rates, at least through 2020. And we now see the ECB and Bank of England delaying rate hikes until the middle of next year. For the Reserve Bank of Australia, it looks like rate cuts are on the horizon.

Central bank near-term bias

The BoC maintained a mild tightening bias in March, though Governor Poloz's recent comments simply reiterated the need for below-neutral rates. We think economic activity will pick up over the remainder of this year, but not enough to pull the central bank from the sidelines.



The Fed's latest dot plot (surprisingly) showed a majority of policymakers don't think rates will need to rise this year. With the central bank sounding increasingly dovish, our forecast now assumes they'll hold rates steady through next year.

The BoE outlook remains Brexit-contingent, and we're still seeking clarity on how that will unfold. With a lengthier delay looking more likely, we now see the BoE on hold until mid-2020.

The euro area is off to a slow start this year, though we've seen some green shoots and fiscal policy should provide support. But until activity picks up and inflation (or inflation expectations) move meaningfully higher, it's hard to see the ECB moving their deposit rate above zero.

A softening domestic backdrop and challenging global outlook (including less tightening from other central banks) have underpinned a dovish shift from the RBA. We expect rate cuts later this year.

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Highlights

▲ US and Canadian yield curves (10-year vs. 3-month) both inverted in late-March, sparking recession fears.

▲ We think some structural and global factors make the yield curve a less accurate recession predictor at present.

▲ US GDP growth appears to have slowed in Q1, though that's not unusual and we expect a pickup going forward.

▲ With the Fed once again sounding surprisingly dovish, we think they've moved to the sidelines for an extended period.

How concerned should we be about yield curve inversion?

As noted off the top, yield curve inversion has been an accurate recession predictor in the US, flagging each of the last three downturns. But there are reasons to think it might not be as reliable this time around. A number of global and structural factors (think quantitative easing, savings demand, low inflation) have put downward pressure on long-term interest rates. The term premium on 10-year Treasury yields is estimated to be negative, and at its lowest on record. Investors are actually *paying* to lock their money up for longer—not a normal state of affairs. At the short end, previous periods of yield curve inversion have coincided with restrictive monetary policy. That's not the case now. Even after a 225 basis points of hikes, the fed funds rate remains at the low end of most neutral estimates.

The circumstances of today's yield curve inversion are different from past episodes, suggesting we should use a degree of caution in extrapolating historical patterns. That said, we shouldn't be dismissive of recession risk. Both the US and Canadian economies are in the late stages of their business cycles, with the former appearing to already be operating beyond its longer-run capacity limits. At this point, it's more likely that growth will surprise to the downside than the upside. But while economic data have been mixed, we don't think the recent loss of momentum is the start of a more significant slowdown.

US economy off to its usual slow start

The US economy has a track record of starting the year slowly—issues with seasonal adjustment acting as the main factor—and 2019 should be no different. This time around, a government shutdown early in the year also weighed on growth. And in a replay of last year, it looks like consumer spending lost momentum in the first quarter. Retail sales still haven't fully recovered from December's sharp slowdown, with wintry weather in some parts of the country likely behind some of the unexpected weakness in February (housing starts also appeared to be weighed down by the weather). As was the case in 2018, we expect household spending will strengthen in the second quarter. A strong labour market and rising wages continue to support incomes, and households have plenty of savings to deploy. However, it's hard to see consumer spending repeating last year's growth with the stimulative effect of tax cuts fading and confidence having rolled over from its multi-decade highs. With business investment also losing its tax cut tailwind, we think the days of 3% GDP growth are behind us.

FOMC manages yet another dovish surprise

The Fed's about-face continued in March. Having hiked in December then dropped their tightening bias in January, investors were braced for a steady rate decision and cautious tone. But the FOMC's policy statement and updated projections were even more dovish than expected. Most notable was a shift in their dot plot, which now shows a majority of FOMC members (11 of 17) think the current rate setting will remain appropriate through the end of 2019. December's dot plot had shown a median of two rate hikes were expected. Their growth and inflation forecasts were marked down alongside, and the unemployment rate was revised slightly higher. The dot plot median still shows one hike in 2020, but markets are predicting the opposite with a rate cut priced in by early next year.

We're taking the middle ground, now expecting the Fed will hold rates steady through 2020. Based on the Fed's projections, it looks like growth and/or inflation will have to surprise to the upside to see a rate hike this year. While we expect a rebound in economic activity in Q2, we don't think it will be strong enough for growth to top the Fed's forecasts. The recent loss of momentum in core inflation also raises the bar for a hike. At the same time, we don't see conditions warranting a reversal of the recent tightening. Our forecast assumes a soft landing, with growth slowing closer to the economy's longer-run trend into next year. With the economy already running beyond its longer-run capacity limits, we don't think that should prompt rate cuts from the Fed, particularly since monetary policy isn't overly restrictive at this stage.

Canada's January GDP leads to a sigh of relief

After declines in three of the final four months of 2018, we would have been happy just to see a return to growth in January. In the event, GDP came in well ahead of expectations, advancing 0.3%—the best pace in eight months. Growth was broadly based with gains in 18 of 20 sectors. Energy and mining was more or less the only source of weakness, which was fully expected as Alberta's mandatory production cuts took effect in the month. We think January was the low water mark for the oil and gas sector—higher prices and shrinking production curtailments should at least see activity stabilize from here. Meanwhile, the non-energy economy had a strong start to the year, making up for underwhelming growth toward the end of 2018. We're wary of over-interpreting a single month of data, but January's GDP supports our view that the economy's recent soft patch will ultimately prove transitory. We might not be out of the woods yet—wintry weather appears to have held back housing activity in February, and some workers lost hours due to the conditions—but we maintain our view that growth will rebound to 2% in the coming quarters after averaging just half that pace in Q4/18 and Q1/19.

As with the US, our forecast for continued economic expansion goes against the yield curve's recessionary signal. The yield curve has a bit less predictive power in Canada, likely because Canadian rates (particularly for longer maturities) are more heavily influenced by global factors. For instance, when the US yield curve inverted ahead of their 2001 downturn, Canada's yield curve inverted in sympathy but there was no recession north of the border. We think this latest yield curve inversion also reflects global factors (many of the same issues noted earlier), including shifting Fed policy. For what it's worth, Governor Poloz called the recent inversion "innocent" and confirmed the BoC is not forecasting a recession.

Federal budget holds the line on deficit spending

The federal government's election-year budget came with $21 billion in new spending over the next five fiscal years. Their deficit profile was little changed, however, as those initiatives were financed by positive fiscal developments since their last plan. The new measures, many of which were telegraphed ahead of time, include funding for training and education, help for first-time homebuyers, and money for low-income seniors. There is some additional money for infrastructure, aimed at getting funds already committed out the door. But on the whole, we don't see this latest budget providing much more of a boost to GDP than we thought going in. As for the housing measures, we think they will provide temporary relief at best for first-time homebuyers struggling to enter the market. They could also distort sales in the coming months, keeping would-be buyers on the sidelines until they take effect in September. Any delayed purchases would fuel stronger activity in the fall.

BoC Governor Poloz not ringing the alarm bell

In the wake of Canada's solid GDP report, Governor Poloz said recent data have been consistent with the BoC's expectation that the economy's period of below-potential growth will be temporary. While global growth has slowed more than expected, and Canada is feeling the effects, Poloz also noted clear signs the country is adjusting to domestic and global challenges. But while his tone was relatively upbeat, there was no mention of the tightening bias we saw in March's policy statement. Poloz simply reiterated that the outlook continues to warrant a below-neutral policy rate. Our forecast assumes the economy will rebound somewhat in the coming quarters, but that growing business investment and exports won't be enough to sustain above-trend growth amid a slowing household sector. Without the economy pushing clearly beyond its capacity limits—and generating more inflationary pressure—its hard to see the BoC raising rates further, particularly when the global tightening cycle is losing momentum. Our forecast now assumes the overnight rate will be held steady through next year. If anything, we think risks are still tilted toward a hike, not the cut markets are partially pricing in.

Highlights

▲ Canadian GDP surprised to the upside in January after declines in three of the prior four months.

▲ While the energy sector has been a source of weakness, Canada's non-energy economy is growing near a 2% pace.

▲ The federal government's latest budget included some new spending measures but did little to change our growth forecast.

▲ Governor Poloz sounded upbeat compared to his global counterparts, but he made no mention of a tightening bias.

Highlights

▲ Brexit remains up in the air after an agreement couldn't be reached by the March 29 deadline.

▲ Uncertainty has weighed on the UK economy, but labour market trends remain positive.

▲ The euro area should get a boost this year from expansionary fiscal policy in a few major countries.

▲ A softening global and domestic backdrop are likely to spell easing from the RBA.

Brexit disarray continues to cloud the UK outlook

The March 29 Brexit deadline came and went, with UK parliament still unable to agree on how the country should extract itself from the EU. An extension to April 12 means the UK will leave without a deal in just over a week unless alternative arrangements can be made. The only consensus in parliament seems to be that a no-deal Brexit is not the way to go, so while that is the default option at this stage, we continue to expect it will ultimately be avoided. But the alternatives are not entirely clear. PM May's deal could be voted on for a fourth time, having been defeated by narrowing margins over the last three votes. Its passage would likely still see the UK out by May 22, avoiding European parliamentary elections. Otherwise, it looks like a longer extension will be needed. A general election might follow, leaving it up to a new group of legislators to find a way forward.

All of this uncertainty is weighing on the UK economy—the composite PMI for March points to activity effectively stagnating ahead of the original Brexit deadline. GDP figures haven't been as dire, but year-over-year growth is now running at its slowest pace since 2013. Capacity constraints may also be a factor in the economy's slowdown since 2017. Despite surveys pointing to a decline in hiring intentions, job growth remains strong and unemployment is now below 4% for the first time since the mid-1970s. That backdrop underpins the Bank of England's "gradual and limited" tightening bias, which remains contingent on a smooth Brexit transition. With the UK supposed to have sorted things out by March 29, we thought the BoE could begin gradually raising rates this summer. But with a longer extension looking more likely, we now think Brexit uncertainty will keep the central bank on hold until the middle of next year, with only one rate increase envisioned by the end of 2020.

Euro area data sending mixed signals

Recent survey data point to the euro area struggling to regain momentum after growth slowed over the second half of 2018. The manufacturing sector remains under pressure, particularly in Germany where the industry's PMI fell deeper into contractionary territory in April. French and Italian manufacturing readings are also underwater. It looks like a softer global industrial sector and slowing global trade are weighing particularly heavily on European manufacturers. Services industries are faring a bit better, with Germany actually leading the way in that respect. And hard data have been a bit more positive, with decent industrial production and retail sales figures so far this year. On balance, we think the euro area grew at a sub-trend 0.2% pace again in Q1. We expect a pickup in activity over the second half of the year, helped by a more supportive fiscal stance in Germany, France and Italy. Monetary policy is also set to remain stimulative, with the ECB deploying a new round of long-term financing, maintaining a sizeable balance sheet, and keeping the deposit rate below zero. They have ruled out hikes until 2020, and we now see them holding rates steady until the middle of next year. Any tightening thereafter should be very gradual. It's hard to see the ECB moving rates back into positive territory unless they are confident inflation is heading toward their target. There has been little evidence of that recently, and investors remain doubtful with longer term inflation expectations at least 1/2 percentage point below target.

RBA gradually shifting toward an easing bias, rate cuts expected

The Reserve Bank of Australia's dovish shift continued at the beginning of April with some subtle but notable changes to their policy statement. The final paragraph, largely unchanged since they stopped easing in 2016, now hints at the central bank potentially becoming more active to support growth and achieve their inflation target. They also noted weaker global trade and investment, and a softening domestic backdrop led by challenges in the household sector. We've noted global developments are key for the RBA, and given the loss of momentum in the global tightening cycle and slowing growth, we wouldn't be surprised to see the central bank shifting to an easing bias in May. We think actually lowering rates remains contingent on developments in the labour market. While the official unemployment rate has declined recently, underemployment remains elevated and job growth has slowed. We expect unemployment will begin to rise amid sub-trend growth, prompting the RBA to lower their cash rate over the second half of this year.

Interest rate outlook

%, end of period

	Actuals					Forecast						
	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
Canada												
Overnight	1.25	1.25	1.50	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Three-month	1.10	1.26	1.59	1.64	1.67	1.65	1.65	1.65	1.65	1.65	1.65	1.65
Two-year	1.78	1.91	2.21	1.86	1.55	1.70	1.70	1.75	1.80	1.80	1.80	1.80
Five-year	1.97	2.07	2.34	1.89	1.52	1.75	1.80	1.90	1.95	2.00	2.00	2.05
10-year	2.09	2.17	2.43	1.97	1.62	1.85	1.95	2.05	2.15	2.25	2.25	2.30
30-year	2.23	2.20	2.42	2.18	1.89	2.10	2.20	2.25	2.35	2.45	2.45	2.45
United States												
Fed funds**	1.75	2.00	2.25	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
Three-month	1.73	1.93	2.19	2.45	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
Two-year	2.27	2.52	2.81	2.48	2.27	2.40	2.45	2.50	2.55	2.55	2.55	2.60
Five-year	2.56	2.73	2.94	2.51	2.23	2.40	2.50	2.60	2.70	2.75	2.75	2.85
10-year	2.74	2.85	3.05	2.69	2.41	2.55	2.65	2.75	2.90	3.00	3.05	3.15
30-year	2.97	2.98	3.19	3.02	2.81	2.95	3.00	3.10	3.20	3.40	3.50	3.65
United Kingdom												
Bank rate	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00
Two-year	0.82	0.72	0.82	0.75	0.63	0.70	0.70	0.75	0.85	1.00	1.00	1.00
10-year	1.34	1.28	1.57	1.27	0.99	1.20	1.25	1.35	1.40	1.50	1.55	1.55
Euro area												
Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.20	-0.10
Two-year	-0.59	-0.69	-0.55	-0.59	-0.60	-0.55	-0.55	-0.50	-0.45	-0.35	-0.30	-0.20
10-year	0.50	0.31	0.47	0.25	-0.07	0.20	0.35	0.45	0.50	0.60	0.75	0.75
Australia												
Cash target rate	1.50	1.50	1.50	1.50	1.50	1.50	1.25	1.00	1.00	1.00	1.00	1.00
Two-year	2.00	2.00	2.02	1.89	1.47	1.35	1.25	1.25	1.25	1.25	1.35	1.50
10-year	2.60	2.63	2.67	2.32	1.78	1.85	1.90	1.90	2.05	2.15	2.25	2.40
New Zealand												
Cash target rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Two-year swap	2.21	2.14	2.02	1.96	1.62	1.75	1.70	1.60	1.60	1.60	1.70	1.80
10-year swap	3.06	3.02	2.89	2.64	2.15	2.15	2.20	2.25	2.30	2.35	2.45	2.60
Yield curve*												
Canada	31	26	22	11	7	15	25	30	35	45	45	50
United States	47	33	24	21	14	15	20	25	35	45	50	55
United Kingdom	52	56	75	52	36	50	55	60	55	50	55	55
Eurozone	109	100	102	84	53	75	90	95	95	95	105	95
Australia	60	63	65	43	31	50	65	65	80	90	90	90
New Zealand	85	88	87	68	53	40	50	65	70	75	75	80

* Two-year/10-year spread in basis points, **Top of 25 basis point range

Source: Reuters, RBC Economics Research

Central bank policy rate

%, end of period

		Current	Last	
United States	Fed funds	2.25-2.50	2.00-2.25	December 19, 2018
Canada	Overnight rate	1.75	1.50	October 24, 2018
United Kingdom	Bank rate	0.75	0.50	August 1, 2018

		Current	Last	
Eurozone	Deposit rate	-0.40	-0.30	March 10, 2016
Australia	Cash rate	1.50	1.75	August 3, 2016
New Zealand	Cash rate	1.75	2.00	November 10, 2016

Source: Bloomberg, Reuters, RBC Economics Research

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	2017	2018	2019F	2020F
Canada*	1.3	2.6	2.0	0.4	1.2	2.0	2.0	1.8	1.8	1.7	1.7	1.6	3.0	1.8	1.5	1.8
United States*	2.2	4.2	3.4	2.2	1.5	2.7	2.2	1.8	1.8	1.8	1.7	1.5	2.2	2.9	2.4	1.9
United Kingdom	0.1	0.4	0.7	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.3	1.8	1.4	1.3	1.6
Euro area	0.4	0.4	0.1	0.2	0.2	0.3	0.4	0.4	0.3	0.4	0.3	0.3	2.5	1.8	1.1	1.4
Australia	1.1	0.8	0.3	0.2	0.7	0.6	0.7	0.7	0.6	0.5	0.6	0.7	2.4	2.8	2.1	2.5

*annualized

Inflation outlook

% change, year-over-year

	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	2017	2018	2019F	2020F
Canada*	2.1	2.3	2.7	2.0	1.6	1.8	1.5	2.0	2.1	2.1	2.3	2.2	1.6	2.3	1.7	2.2
United States*	2.2	2.7	2.6	2.2	1.6	1.9	1.8	2.0	2.2	2.0	2.2	2.2	2.1	2.4	1.8	2.1
United Kingdom	2.7	2.4	2.5	2.3	1.9	1.9	1.7	1.7	2.2	2.1	2.1	2.1	2.7	2.5	1.8	2.1
Euro area	1.3	1.7	2.1	1.9	1.4	1.2	0.8	1.0	1.2	1.4	1.4	1.4	1.5	1.8	1.2	1.4
Australia	1.9	2.1	1.9	1.8	1.5	1.7	1.8	1.8	2.1	2.1	2.1	2.1	1.9	1.9	1.7	2.1

Source: Statistics Canada, Bureau of Economic Analysis, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics Research

Inflation tracking

Inflation Watch

	Measure	Current period	Period ago	Year ago	Three-month trend	Six-month trend
Canada	CPI ex food & energy[1]	Feb	0.2	2.0	2.5	1.9
United States	Core PCE[1,2]	Jan	0.1	1.8	1.9	1.7
United Kingdom	All-items CPI	Feb	0.5	1.9	-0.1	2.0
Euro area	All-items CPI[1]	Mar	0.1	1.4	0.0	1.2
Australia	Trimmed mean CPI[1]	Q4	0.4	1.8	N/A	N/A
New Zealand	All-items CPI	Q4	0.1	1.9	N/A	N/A

1 Seasonally adjusted measurement.
2 Personal consumption expenditures less food and energy price indices.

Source: Statistics Canada, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics Research

Currency outlook

Level, end of period

	Actuals				Forecast							
	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
Canadian dollar	1.29	1.31	1.29	1.36	1.34	1.34	1.34	1.35	1.35	1.36	1.36	1.37
Euro	1.23	1.17	1.16	1.15	1.12	1.10	1.13	1.15	1.15	1.17	1.18	1.18
U.K. pound sterling	1.40	1.32	1.30	1.28	1.30	1.26	1.28	1.31	1.31	1.33	1.34	1.34
Chinese Renminbi	6.3	6.6	6.9	6.9	6.8	7.0	7.3	7.4	7.5	7.5	7.6	7.7
Japanese yen	106.3	110.8	113.7	109.7	111.0	113.0	117.0	120.0	119.0	118.0	117.0	116.0
Australian dollar	0.77	0.74	0.72	0.70	0.71	0.69	0.68	0.67	0.67	0.67	0.66	0.66

Canadian dollar cross-rates

	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4
EUR/CAD	1.59	1.53	1.50	1.56	1.50	1.47	1.51	1.55	1.55	1.59	1.60	1.62
GBP/CAD	1.81	1.73	1.68	1.74	1.75	1.69	1.72	1.76	1.76	1.81	1.82	1.84
CAD/CNY	4.86	5.04	5.32	5.04	5.07	5.22	5.41	5.48	5.56	5.51	5.59	5.62
CAD/JPY	82.4	84.3	88.1	80.4	82.8	84.3	87.3	88.9	88.1	86.8	86.0	84.7
AUD/CAD	0.99	0.97	0.93	0.96	0.95	0.92	0.91	0.90	0.90	0.91	0.90	0.90

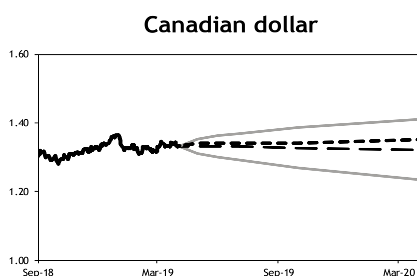
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics Research

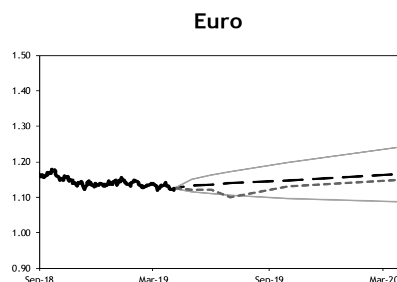
RBC Economics outlook compared to the market

The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.

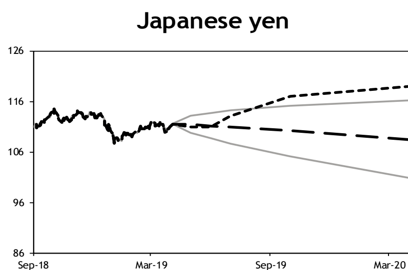
Canadian dollar



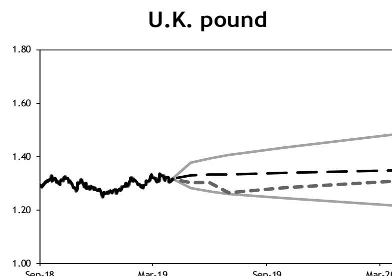
Euro



Japanese yen



U.K. pound

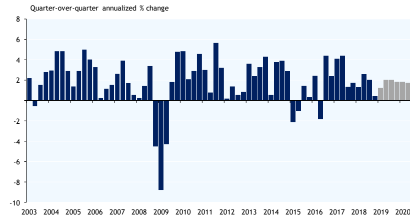


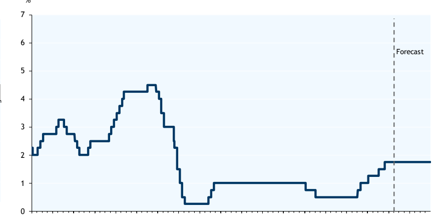
Central bank watch

Bank of Canada

Canadian GDP was stronger than expected in January with the non-energy economy growing at a solid clip. That supports the BoC's view that the recent slowdown should be transitory.

While activity looks set to pick up later this year, we don't think growth will be robust enough to put upward pressure on inflation, or to move the BoC from the sidelines.

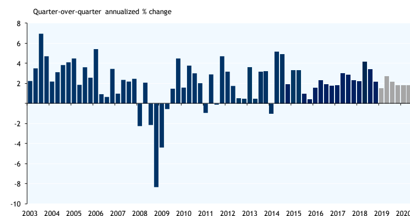


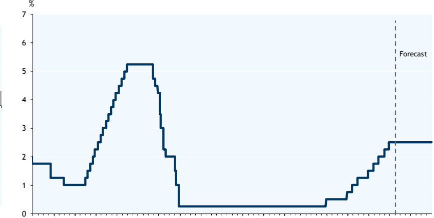


Federal Reserve

In a now-familiar pattern, US GDP growth appears to have slowed in Q1. We expect the economy will rebound in Q2, though the days of 3% growth are likely behind us.

It looks like growth and/or inflation will have to surprise to the upside for the Fed to hike again. We don't see that happening, and are now assuming a steady fed funds rate through 2020.

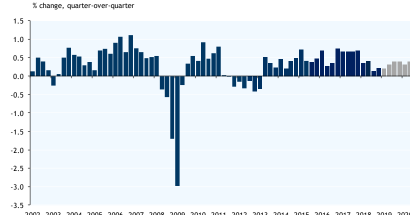


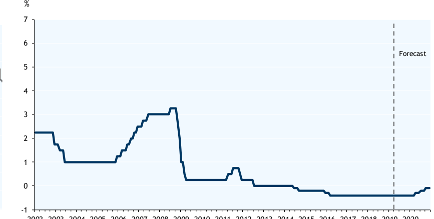


European Central Bank

Euro area surveys have disappointed, particularly for the manufacturing sector, though hard data have been a bit more encouraging. We expect another quarter of 0.2% GDP growth in Q1.

Until growth is strong enough to put inflation on a track toward their target, the ECB will continue to provide ample stimulus. We expect very gradual rate hikes will begin in mid-2020.

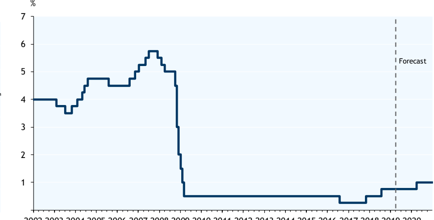




Bank of England

The UK economy is growing at a sub-trend pace amid Brexit uncertainty. But that hasn't stopped businesses from adding headcount, pushing unemployment to fresh, multi-decade lows.

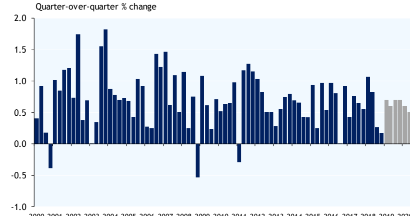
The BoE's tightening bias remains unchanged, but ongoing Brexit uncertainty has the central bank stuck on the sidelines. We think their next rate hike won't come until the middle of 2020.

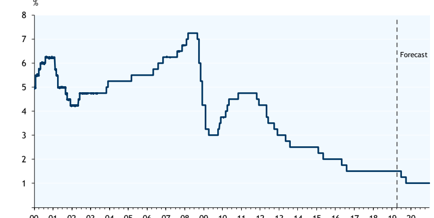


Reserve Bank of Australia

A slowing household sector and global headwinds will likely keep the Australian economy growing at a sub-trend pace this year. That will challenge the labour market, which has held up well so far.

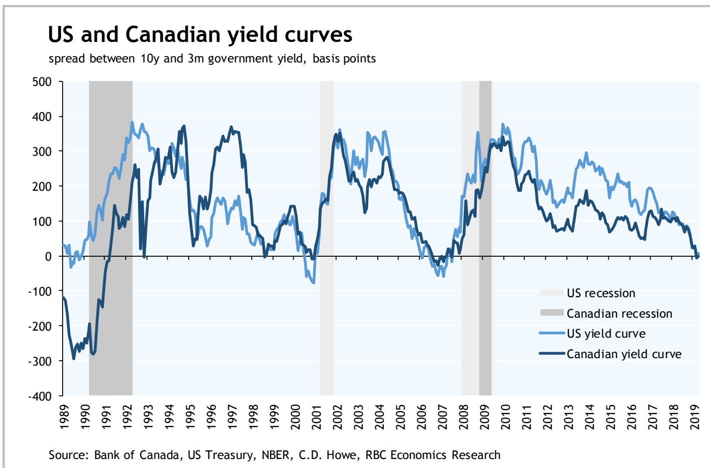
The RBA sounded more dovish in April, seeming to lay the groundwork for an easing bias. We think they'll lower the cash rate over the second half of this year as the jobs picture deteriorates.



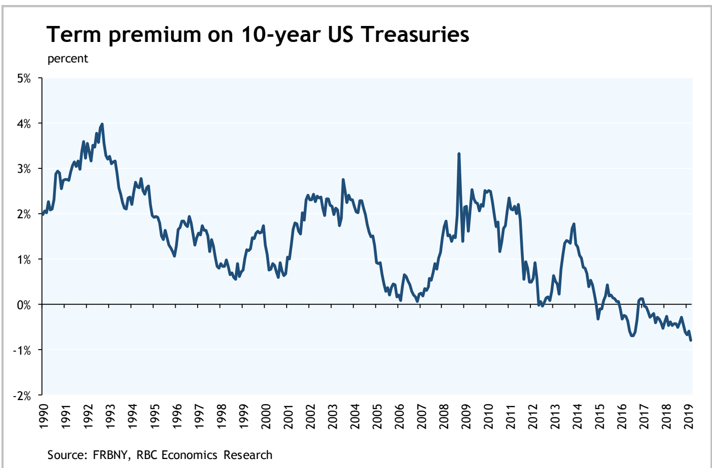


A closer look at yield curve inversion

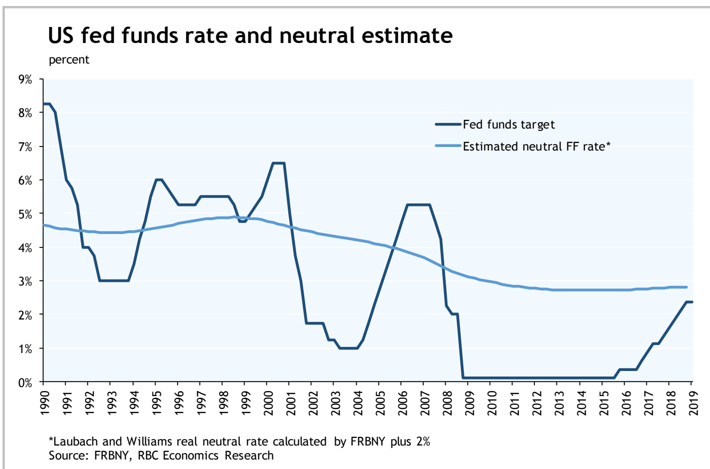
The yield curve has inverted ahead of each of last three US recessions. It's not as reliable a predictor in Canada, briefly inverting several times without a subsequent recession. However, sustained periods of inversion have been followed by downturns.



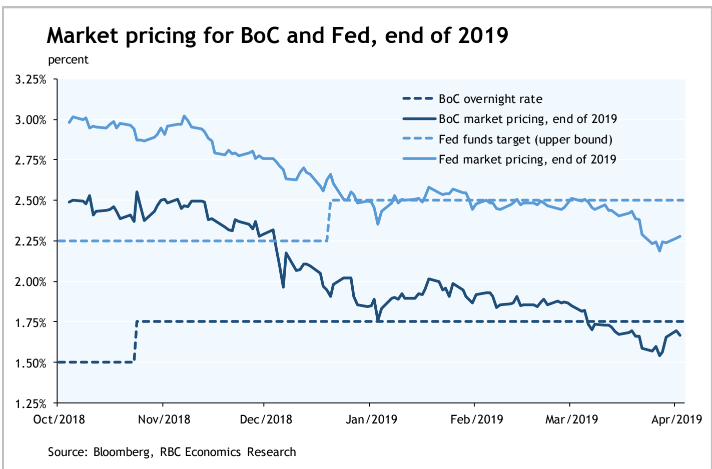
We think the yield curve might not be as accurate a recession predictor as it was in the past. A number of global and structural factors have put downward pressure on term premiums (investor compensation for lending longer-term), contributing to a flatter yield curve.



Past periods of yield curve inversion coincided with restrictive monetary policy (fed funds above its neutral rate). But we don't think that's the case now, in the US or Canada. Fed funds is at the lower end of most neutral estimates, and the BoC's overnight rate is below their assumed 2.5-3.5% neutral range.



Yield curve inversion reflects investor expectations that the next moves from the BoC and Fed will be to lower their policy rates. A 25 basis point fed funds cut is expected by the end of this year (compared with two hikes previously priced in) while odds are tilted toward a BoC cut (three hikes expected as of last October).



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