Equities have been on a roller coaster ride for the last two months, while global growth concerns, market jitters and less hawkish central bankers have pushed bond yields sharply lower since early-November. Those same growth concerns, along with rising supply, have weighed heavily on oil prices. Two key international meetings over the last week held the prospect of some reprieve. First, a Trump-Xi dinner at the G20 summit raised hopes that the US and China might negotiate a truce in their escalating trade war, which has become a key risk to the global outlook. A US pledge to delay a scheduled tariff increase in exchange for concessions from China initially cheered investors, though sentiment soured with the realization that the two countries were far apart on what was actually agreed upon. US tariff hikes appear to have been postponed for 90 days while the two superpowers work toward an agreement. Another round of tariff threats from Trump provided an inauspicious start to the process and prompted a renewed selloff in equity markets.

After the G20 meeting, it was OPEC’s December 6-7 gathering that drew attention. Producers (including Russia) agreed to cut output by 1.2 million barrels per day in an effort to better balance the global oil market. The cut was seen as substantial enough to send oil prices to a two-week high. The move will be welcomed in Canada, where the Alberta government has grown increasingly frustrated by falling oil prices—particularly for domestic crude. They were in no mood to wait for OPEC, announcing their own mandatory supply cut of 325 thousand barrels per day that will kick in next year. The decision pushed Canadian heavy oil prices to two-month highs, even before OPEC’s decision pushed global benchmarks higher.

A “materially weaker” energy sector and potentially more room for non-inflationary growth point to the Bank of Canada shifting to the sidelines for a couple months. We still think rates are moving higher next year, but likely not until Q2.

Fed officials have sounded a bit more dovish lately but a December rate hike still looks very likely, and we think markets are vastly underestimating tightening next year with just one hike priced in.

We don’t think the Bank of England will get much clarity on Brexit in time for their December meeting. A smooth Brexit could see a rate hike as soon as February, but there are significant risks around that forecast.

An extended soft patch in economic data has investors pushing back expectations for the first rate hike. We continue to see rates moving higher in the second half of next year, but at a snail’s pace.

Tightening credit conditions and slowing global growth had the Reserve Bank of Australia sounding a bit more dovish. We continue to expect they’ll remain on the sidelines well into next year.
Financial market volatility spikes as investors worry about the global recovery. Data reports have erred on the weak side. However, there were many one-off factors that curtailed activity.

As these factors ease, growth will accelerate. The US recession was deeper than was previously reported and GDP output stands 0.4 pp below its pre-recession peak.

---

### Highlights

- Q4 is shaping up to be another solid quarter for consumer spending.
- The Fed is sounding a bit more cautious as interest rates approach their estimated ‘neutral’ range...
- ...but we think markets are underestimating the pace of tightening next year.

---

### US slowdown? Tell that to consumers

A flattening yield curve and a few soft data points have raised concerns that the US economy is heading for a slowdown. Sure, we are likely to see some moderation in GDP growth after the best back-to-back quarterly gains in four years. But it’s hard to see much evidence that the economy has shifted to a below-trend pace of growth. Most importantly, consumer spending—about 2/3 of GDP—continues to look very healthy. Personal spending picked up strongly in October and early retail indicators point to a solid start to the holiday shopping season. Rising wages and continued job gains are supporting incomes, and confidence doesn’t seem to have been dented much by recent equity market volatility. Lower gasoline prices (down some 15% since mid-October) are also leaving a bit more money in pocketbooks. The stimulative effect of lower income taxes is set to fade somewhat next year. But consumers still have room to spend. The household savings rate remains north of 6%—well above the 3–4% rates seen late in the last expansion. All told, we see consumer spending growing at a healthy 2.5% pace next year, just short of this year’s 2.7% gain.

### A slightly more cautious Fed, but hikes will continue in 2019

Market volatility and concerns about slowing growth had investors watching remarks from Fed officials even more closely than usual. Chairman Powell’s comment that interest rates are now close to the range of ‘neutral’ estimates (2.5–3.5%) was seen as dovish—particularly when contrasted with his earlier view that policy is still a long way from neutral. Investors saw that, and similar comments from his colleagues, as indicating the Fed might soon hit pause on their tightening cycle. Minutes of the FOMC’s last meeting reinforced that sentiment. Policymakers discussed changing their forward guidance to reflect data dependence rather than indicating further gradual rate increases should be expected.

Markets are now pricing in just one full rate hike next year following a move in December. We think that is an over-reaction. Yes, the fed funds rate will be near the bottom of the ‘neutral’ range after a hike in December (to 2.25–2.50%). But the FOMC’s median estimate for neutral is 3%, and there is little precedent for the Fed hitting the brakes as soon as they get there. In fact, they raised fed funds at least 100 basis points above neutral in past tightening cycles. We think the Fed is right to emphasize data dependence as they get closer to the neutral rate. But the data points to above-trend growth in an economy that is already operating at or beyond full capacity. Core inflation has been well-behaved at 2%, but we think prices will eventually respond to capacity pressures and rising wages. Our forecast continues to assume quarterly rate hikes next year. While risk is skewed toward slightly less tightening, we think market pricing will have to play catch-up in 2019.

### Canadian domestic spending fell flat in Q3...

Canada’s economy grew at a 2% annualized pace in Q3, matching market expectations and coming in slightly ahead of the Bank of Canada’s forecast. But that was where the good news ended. Domestic spending was flat quarter-over-quarter for the first time in more than two years as consumer spending growth slowed further and the residential sector remained a drag on activity. More troubling was a pullback in business investment following more than a year of consistent gains. Less contribution from households is to be expected given rising rates and regulatory changes. But the pullback in business investment flies in the face of the BoC’s Business Outlook Survey pointing to stronger capital spending. There have been some positive developments for the investment outlook since Q3—less trade uncertainty (at least within North America) and government incentives to encourage capital spending. But at the same time, lower oil prices challenge the energy sector capex outlook. On balance, the much-hoped-for rotation toward stronger business investment and exports looks a bit less certain than it did a few months ago.
...and growth isn’t likely to pick up in the near-term...
After a number of good new stories for Canada—including an updated trade deal with the US and Mexico and a major LNG export facility getting the green light—the tide seems to have turned lately. Most significantly, lower oil prices have dealt a blow to Alberta’s economic outlook. After climbing above US$75/barrel in early-October, the WTI benchmark price has fallen sharply, hitting $50 toward the end of November. The impact on Canada’s oil sector has been exacerbated by steep discounts on Canadian heavy oil. Elevated inventories and lack of export capacity saw WCS oil trading for less than $20 through much of November. And unlike during past periods of steep discounts on heavy oil, Canadian light and synthetic oil prices have also been impacted. The Alberta government, facing sharply lower royalty revenues, responded with the dramatic step of mandating production cuts. Producers will have to lower output by 325 thousand barrels per day starting in January. Those curtailments will be pared back when inventories reach more normal levels, and should end altogether late next year.

While WCS prices rallied on the news, production cuts will likely reduce Canadian GDP growth by 0.1-0.2% next year. Much of that drag will show up in the first quarter, setting up for a slow start to 2019. And it looks like that will follow a soft end to this year.

...making a January rate hike unlikely
The Bank of Canada held rates steady in December with a predictably dovish tone that contrasted sharply with October’s hawkish hike. Lower oil prices were front and centre with the statement noting energy sector activity will likely be “materially weaker” than expected. The bank also noted signs of less growth momentum heading into Q4, hinting at a markdown to their current GDP forecast of 2.3%. And given downward revisions to historical growth, they raised the possibility that the economy might have a bit more room for non-inflationary growth than previously thought. The statement did contain some balancing comments. Policymakers attributed Q3’s weak business investment to trade uncertainty and remained optimistic on the non-energy capex outlook given USMCA, accelerated depreciation and capacity constraints. And once again there was mention of two-sided risks around trade policy, even if there are signs that trade tensions are “weighing more heavily” on the global economy. But those mitigating factors weren’t enough to keep the Canadian dollar from selling off sharply after the statement.

The BoC maintained their tightening bias, still indicating rates will eventually need to rise to a neutral range (2.5-3.5% by their estimate). But their list of factors that will determine the pace of rate hikes has grown longer to include oil price developments, business investment and the economy’s capacity limits. Even if we get some progress on those issues between now and January (for instance, higher oil prices and a strong Q4 Business Outlook Survey), it looks like the bank will be marking down their growth and inflation forecasts at their next meeting. Given their data dependent mantra, it’s hard to see Governing Council raising rates at the same time. We think they’ll hit the pause button until Q2 when they have a better idea of how the economy is adapting to another oil price downturn. They’ll likely be hoping for more clarity on the global trade backdrop by then as well. While it looks like rate hikes will come a bit later than expected, our forecast continues to call for two rate increases next year, which would bring the overnight rate to 2.25% by year end.

Highlights

▲ Canada’s Q3 growth matched consensus but there was little to like in the details.

▲ Oil production cuts are set to weigh on GDP growth early next year.

▲ The BoC shifted from hawkish to dovish in just six weeks...

▲ ...leading us to push back our expectations for the timing of their next rate hike.
Businesses and the BoE waiting for clarity on Brexit

Recent data provide further evidence that the UK economy’s Q3 pickup was a one-off. Survey readings have deteriorated sharply over the last two months as key Brexit deadlines come into sharper focus. Outside of the immediate post-referendum decline, November’s composite PMI was the weakest in six years. The services index saw a particularly steep drop with firms noting subdued consumer and business spending. There were reports that some companies are holding off on key decisions amid growing Brexit uncertainty. The manufacturing sector provided some offset, but that may have reflected businesses building inventories to guard against potential supply disruptions in the event of a ‘no deal’ Brexit. Deteriorating sentiment points to Q4 GDP growth slowing sharply from the previous quarter’s 0.6% pace.

While the economy’s ups and downs over the second half of the year are certainly being watched by the Bank of England, Brexit remains the key driver of their upcoming policy decisions. The divorce deal that was agreed to with the EU will be voted on in parliament on December 11, but securing its passage appears to be an uphill battle. If the bill fails, PM May has up to three weeks to decide on next steps. There is range of possible outcomes, including amendments to the deal, a no-confidence vote that triggers fresh elections, extension (or potentially withdrawal) of Article 50, or even a second referendum. A damaging ‘no deal’ Brexit also remains an option. We doubt the BoE will have enough clarity on the outcome to make any policy moves at their December 20 meeting. But they’ll likely indicate the economic backdrop—including low unemployment and rising wages—warrants higher rates if a ‘smooth’ Brexit can be achieved. We continue to expect a February rate in that event, but acknowledge the odds of that outcome have narrowed.

Euro area’s Q4 rebound unlikely to impress

We expect euro area GDP growth will pick up following Q3’s disappointing 0.2% gain, but recent survey data suggest any rebound in Q4 will be modest. Some of the previous quarter’s weakness reflected transitory issues in the German auto industry that contributed to that country’s GDP declining for the first time in three and a half years. But soft manufacturing PMIs in Q4 suggest the industrial sector’s challenges have continued. Another sub-50 composite reading in Italy point to that country’s slowdown extending into Q4. Meanwhile, labour disruptions in France could keep the previous quarter’s stronger activity from being repeated. On balance we expect GDP growth of around 0.3% in Q4—just half the pace seen in 2017, which will likely represent the high-water mark for euro area growth this cycle. Softer activity indicators have led markets to push back expectations for the first rate hike by the ECB. Our forecast continues to assume the central bank will begin raising rates in Q3 2019, consistent with their current forward guidance. However, we see the tightening cycle pausing once the deposit rate is out of negative territory in 2020.

Australia’s Q3 GDP disappoints, challenging the RBA’s outlook

Australian GDP fell short of expectations in Q3 with a quarterly increase of just 0.3%, the slowest in two years. Net exports and government spending were the largest contributors to growth, and we expect strength in those areas will continue in 2019. And while business investment was disappointing, non-mining capex intentions point to a pickup in the coming quarters. But one of the key headwinds we see for 2019, a softer household sector, was evident in Q3. Consumer spending grew at its slowest rate in five years and a further decline in the savings rate (to its lowest in a decade) limits the scope for a pickup next year. We think that challenges the Reserve Bank of Australia’s above-trend growth outlook, which they reiterated in December prior to the Q3 GDP release. Other comments by the RBA leaned slightly dovish—they noted tightening financial and credit conditions, and a growing impact from global trade tensions. We think those factors, along with labour market developments (which have been quite positive) will shape the policy outlook next year. At present, we see the RBA remaining on the sidelines well into 2019.
## Interest rate outlook

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* Two-year/10-year spread in basis points, **Top of 25 basis point range
Source: Reuters, RBC Economics Research

## Central bank policy rate

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Source: Bloomberg, Reuters, RBC Economics Research
Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

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*annualized

Inflation outlook

% change, year-over-year

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Inflation tracking

Inflation Watch

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

Currency outlook

Level, end of period

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Canadian dollar cross-rates

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<td>GBP/CAD</td>
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<td>CAD/CNY</td>
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<td>CAD/JPY</td>
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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.
Central bank watch

Bank of Canada
Lack of momentum heading into Q4, transitory factors, and oil sector weakness all point to Canadian GDP growth moderating in the current quarter. The BoC is likely to lower their growth and inflation forecasts in January. We expect they’ll remain cautious early next year as the economy continues to adjust to lower oil prices and higher interest rates. The next hike will likely be put off until Q2.

Federal Reserve
We expect another quarter of above-trend growth in Q4, once again led by consumer spending. Fiscal stimulus will start to fade next year, but we still expect a solid 2.5% GDP gain in 2019. The Fed is putting more emphasis on data dependence, but we don’t think that necessarily means they’ll slow the pace of tightening. Our forecast assumes four hikes next year after a December move.

European Central Bank
Survey data point to another quarter of relatively modest euro area growth, even if activity does pick up from Q3’s 0.2% pace. The European Central Bank will likely be marking down their growth forecasts in December given recent softness in economic data. But we still think they’re on track to begin raising interest rates in the second half of next year.

Bank of England
A sharp decline in UK PMI readings point to a slowdown toward the end of the year. We expect Q4 GDP growth will come in at just half the previous quarter’s unexpectedly strong pace. The BoE is likely to remain sidelined by Brexit uncertainty again in December. A range of potential outcomes following Parliament’s Dec 11 vote make forecasting the next policy move difficult.

Reserve Bank of Australia
Australia’s economy was buoyed by net exports and government spending in Q3, but a slowdown in consumer spending helped limit overall growth to a disappointing 0.3% pace. We think the RBA’s forecast for above-trend growth looks a bit optimistic given a lesser contribution from the household sector. We don’t see the central bank raising rates until late next year.
Oil, yields and equities have all been under downward pressure

Equity markets have been on a roller coaster over the last two months. Both the US and Canadian benchmark indices closed slightly higher in November but are down nearly 10% from late-September. The US S&P 500 is roughly flat on the year while Canada’s TSX is still in the red.

The same global growth concerns that have weighed on equity markets have pushed oil prices lower. Growing US supply has also been a major factor, as has limited export capacity from Western Canada. Both OPEC and the Alberta government announced supply cuts in an effort to better balance oil markets.

Market jitters, growth concerns and less hawkish central bankers have pushed government bond yields sharply lower. The 10-year US Treasury yield has fallen 30 basis points in the last month and Canadian yields are down even more. The Canadian 10-year is close to where it started 2018, despite three BoC rate hikes.

Fed officials are expected to emphasize data dependence as the fed funds rate gets toward the range of ‘neutral’ estimates (2.5-3.5%). Along with growth concerns, that has led markets to price in much less tightening next year. Just one full rate hike is expected in 2019 following a likely move in December.