RBC ECONOMICS | **RESEARCH**

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Momentum, uncertainty carried into 2017

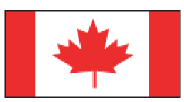
Economic data continued to surprise to the upside early this year as a number of advanced economies entered 2017 with solid momentum. Strength has been most notable in the UK where the economy continues to defy expectations for a slowdown following June's Brexit vote. The euro area has similarly seen no fallout from the referendum with growth having picked up toward the end of 2016 and sentiment improving further in January. With European growth on a better-than-expected trajectory over the second half of last year, we have revised up our 2017 growth forecasts to roughly 1½% for both economies. On this side of the pond, US GDP growth was close to trend in Q4/16 but broad-based strength in domestic demand made for a more encouraging report than the headline suggested.

With that momentum comes lingering uncertainty—political risk in particular continues to cloud the outlook. While our US forecast assumes a ½ ppt lift from fiscal policy, specific details have not yet been announced; meanwhile, the Trump administration's protectionist rhetoric highlights a key downside risk to the outlook. Political risk will also be front and centre in Europe this year with general elections in several major euro area economies at a time when the currency bloc's recovery is finally gaining momentum. And while activity in the UK has held up well in the face of Brexit uncertainty, headwinds will only strengthen as the government pursues a 'hard' exit from the EU.

Positive economic data have offset uncertainty thus far, with the addition of a decent earnings season to date helping boost the S&P 500 to fresh all-time highs while the MSCI World Index also picked up throughout January to near-record levels. Government bond yields moved higher, particularly in Europe, while currency markets deviated from the post-election trend with the US dollar falling by more than 2% on a trade-weighted basis since the start of the year.

Central bank near-term bias

Three-months out, policy rate



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While Governor Poloz noted that the BoC could lower rates if downside risks materialize, there was little evidence of an easing bias in January's rate announcement and the Bank left growth forecasts largely unchanged.

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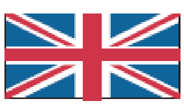
The Fed made few changes to its policy statement in February and provided little hint on the timing of the next rate hike. We expect the Committee will hold off on tightening until June when there is greater clarity on fiscal and trade policies under the new administration.



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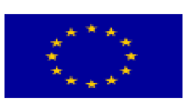
The BoE is likely to maintain a neutral bias in the near-term given surprising momentum in the UK economy over the second half of last year. We continue to expect further easing as Brexit weighs on activity but a change in monetary policy is likely to be held off until 2018.



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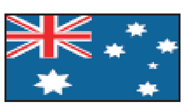
Calls for the ECB to taper asset purchases have increased as headline inflation rises; however, with underlying price pressure remaining subdued, we think the ECB will be comfortable proceeding with QE through the end of this year as planned.



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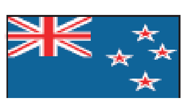
The RBA is likely to lower growth forecasts in February following a disappointing Q3/16 outturn; along with a forecast for subdued inflation, we think there is an implicit bias to further ease policy this year.



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The RBNZ shifted into neutral after cutting rates in November; we don't expect an implicit easing bias will return as soon as February given the improving trend in inflation, although policymakers are likely to express discomfort with currency strength given further NZD appreciation.

Inside...

Josh Nye
Economist
416-974-3979
josh.nye@rbc.com

Highlights

▲ Headline US GDP growth slowed in Q4/16 despite domestic demand picking up in the quarter.

▲ The US consumer will once again be a significant driver of economic activity in 2017.

▲ The Fed noted improving business and consumer sentiment but otherwise made few changes in February's policy statement…

▲ …disappointing those looking for additional forward guidance.

US GDP growth slowed to end 2016 but underlying details firm

The advance estimate of US Q4/16 GDP showed growth slowing to 1.9% from 3.5% in the previous quarter. Much of the slowdown reflected a swing in net trade as exports unwound some of Q3/16's 10% increase (that was driven by a temporary jump in food exports) and imports picked up alongside stronger domestic spending. Consumer spending growth remained strong at 2.5% and residential investment jumped 10%, resuming a longer-term upward trend that was interrupted in the previous two quarters. Business investment rose at its fastest pace in more than a year. All told, a slight acceleration in domestic demand made for a stronger GDP report than the headline would suggest. Our forecast assumes domestic strength will persist in 2017 amid a strong labour market, elevated business and consumer sentiment, and still-accommodative financial conditions. We have also incorporated a fiscal boost from expected corporate and personal income tax cuts that are assumed to add ½ percentage point to growth over the next two years; however, the Trump administration has yet to provide a more detailed fiscal blueprint since taking office, so the impact of fiscal changes remains highly uncertain.

Consumers to lead growth again in 2017

The US consumer has been a strong contributor to economic activity in recent years, adding an average of 2 percentage points to annual growth since 2014. We expect that trend will persist in 2017 amid a number of supportive factors for households. Labour market conditions continued to strengthen throughout 2016—as evident in the unemployment rate falling by 0.3 percentage points over the course of last year (to below the Fed's longer-run estimate). Upward pressure on wages as companies struggled to fill job openings resulted in average hourly earnings growth picking up to its best pace in the current cycle. Employment growth is expected to slow this year due to tighter labour market conditions; however, higher wages will help supplement aggregate income growth. A strong jobs market and earnings growth contributed to consumer confidence surging to a cycle high at the end of 2016. Also buoyed by wealth effects from rising equity markets and home prices, we expect consumer spending will rise by 2½% in 2017, thus accounting for nearly three quarters of GDP growth this year.

Fed continues to sound optimistic but no change in guidance

The Fed held rates steady at their first meeting of 2017, issuing a policy statement that made only minor changes relative to December's missive. The tone on economic activity remained positive as the labour market and economy continued to strengthen, while recent improvement in consumer and business sentiment was also mentioned. Inflation was noted to have increased (with less emphasis on the deflationary impact of energy and import prices), and although market-based inflation expectations have continued to rise since the December meeting, the statement repeated that such measures remain low. Overall, there was little to indicate a change in the Committee's consensus that a gradual withdrawal of stimulus will be appropriate this year—recall the Fed's December 'dot plot' indicated three rate hikes would likely be appropriate in 2017. The timing of the next hike will be influenced by both economic and policy developments, with uncertainty regarding the latter likely to keep the Fed from raising rates as soon as the next meeting in March.

There was no change in the Committee's forward guidance on fed funds or the balance sheet, disappointing anyone expecting recent Fed-speak on reinvestment policy might make its way into the statement. The official guidance remains that reinvestment of principal payments from the Fed's balance sheet holdings will continue until normalization of the fed funds rate is "well under way." We see that as consistent with the Committee beginning to taper reinvestment in the fourth quarter of 2017. With the Fed allowing the balance sheet to gradually run down as assets mature rather than selling holdings, the impact on market rates is expected to be fairly limited. Our forecast assumes 10-year UST yields will rise to 3% by the end of this year from around 2.5% currently.

Canada's October slowdown proved temporary…

Canada's economy rebounded in November with a stronger-than-expected 0.4% increase in monthly GDP more than retracing the unexpected 0.2% decline (previously reported as -0.3%) recorded in October. Goods-producing industries led the way, with manufacturing, construction and oil extraction rebounding from declines in the previous month. The services sector also recorded a solid 0.2% gain following three months of more subdued increases. Given the upside surprise and prior month's revision, we have revised up our Q4/16 GDP growth forecast to 1.8% from 1.5% (the latter matching the Bank of Canada's latest projection). The quarterly expenditure detail will be bit messy due to an outsized inventory drawdown and the reversal of a one-time jump in imports and business investment, but we expect a number of underlying trends will become apparent and continue in 2017. Those trends—another solid contribution from consumer spending supplemented by fiscal stimulus and a turnaround in energy sector investment—are expected to result in GDP growth accelerating to 1.8% this year from 1.3% in 2016. As in the Bank of Canada's latest forecast, this shift to above-trend growth will help gradually absorb spare capacity in the economy.

…and an impressive streak of job growth continued

In contrast with sub-trend GDP growth last year, job gains were relatively strong throughout 2016 averaging 19,000 per month. The latter half of the year in particular saw robust employment growth with gains exceeding 35,000 in four of the last five months. While it remains the case that job growth in 2016 was weighted toward part-time positions (even with December's surge in full-time employment), persons working part-time for economic reasons declined as a share of employment for a second consecutive year. The unemployment rate, at 6.9% in December, is now little changed relative to the period before the oil price shock as improvement in provinces such as BC, Ontario and Quebec has offset deteriorating conditions in energy-producing provinces. However, the Bank of Canada's broader measure of labour market slack indicates a bit more slack than the official unemployment rate would suggest and weak wage growth supports the conclusion that the economy remains short of full employment. While spare capacity will likely keep wage growth from accelerating significantly in the near-term, we expect continued job growth (while short of the recent pace) will support aggregate incomes in 2017, fueling another year of above-2% growth in consumer spending.

"Uncertainty" is the Bank of Canada's new watchword

The Bank of Canada left monetary policy unchanged in January and made only minor tweaks to GDP forecasts; growth of 2.1% this year and next is still expected to close the output gap around mid-2018 (recall that pushing out that goalpost in October left the Governing Council contemplating a rate cut). However, the Bank highlighted an unusually high degree of uncertainty in the economic outlook, particularly with regard to US policy. Governor Poloz caused a bit of a stir when he noted that the Bank could ease monetary policy further if downside risks materialize (a comment that briefly sent the Canadian dollar tumbling) but otherwise there was little hint of an implicit policy bias and risks to the inflation outlook were once again deemed balanced. We expect the Bank will maintain a neutral, if not slightly cautious, stance in the near-term given the degree of slack in the economy, even amid growing evidence of the economy's recovery from the oil price shock and sustained momentum in non-commodities industries.

While the Bank highlighted significant uncertainty regarding future US policy changes, the Governing Council saw some form of fiscal stimulus as likely enough to incorporate into their updated forecast. The Bank assumes corporate and personal income tax cuts will raise US GDP by ½ percentage point by 2018—similar to the add we have incorporated in our own forecast. They noted, however, that US stimulus only translates into a modest 0.1 percentage point boost to Canadian growth over the next two years, with the response dampened by competitiveness issues as well as tighter financial conditions since the US election. On the former, both a lower US corporate tax rate and recent appreciation of the Canadian dollar were seen limiting the competitiveness of Canada's exporters. Holding its own against a strengthening US dollar, the Canadian dollar has appreciated by nearly 7% on an ex-USD trade-weighted basis since November, and even more so against key competitors in the US import market such as Mexico.

Highlights

- ▲ Canadian GDP rebounded by 0.4% in November after an unexpected slowdown in the prior month.
- ▲ Robust job figures over the second half of 2016 likely overstate improvement in labour market conditions.
- ▲ The BoC made only minor changes to their growth projections but emphasized an unusually high degree of uncertainty, particularly regarding US policy.
- ▲ The BoC assumed ½ ppt of fiscal stimulus in the US through 2018, though they only see that adding 0.1 ppt to Canadian GDP growth.

Highlights

▲ Given unexpectedly strong momentum post-referendum, we have revised up our 2017 UK growth forecast to 1.6%; the BoE expects a 2% rise.

▲ Economic activity picked up in the euro area toward the end of 2016; that momentum prompted us to revise our growth forecast higher to 1.5% this year.

▲ A downward revision to the growth forecast and expectations of subdued inflation should lend the upcoming RBA meeting a dovish tone.

▲ The RBNZ will likely be pleased with an improving inflation trend at their first rate-setting meeting since easing policy in November.

Upside surprises continue as UK referendum impact yet to show

UK GDP growth once again surprised to the upside with a 0.6% non-annualized increase in Q4/16 matching the pace of the previous two quarters. The report provides further evidence that the economy, on balance, has yet to be adversely impacted by the June Brexit vote. The GDP report also confirmed the signal from survey data, which showed the UK's composite PMI rising to a 1½ year high in December, having increased in each month since the immediate post-referendum decline in July. We continue to expect the Brexit process will weigh on the economy over the coming year, although given solid momentum to start 2017, the impact is likely to come later than previously anticipated and we have revised up our forecast for GDP growth this year to 1.6% from 1.2%. With the economy forecast to continue growing at a decent pace over the first half of the year, the Bank of England is likely remain firmly in neutral—indeed, despite upgrading their growth forecast, the BoE maintained a neutral bias in February and reiterated that monetary policy can respond in either direction. We continue to expect another round of quantitative easing and a further Bank Rate cut as the economy slows, but our forecast now assumes those changes will be held off until 2018.

Calls for ECB to trim stimulus as growth, inflation picks up

The flash estimate of euro area Q4/16 GDP showed growth picking up to 0.5%, at the upper end of the range that has generally prevailed since the recovery began in 2013. Strengthening activity toward the end of last year had been flagged by survey data, with the euro area composite PMI hitting a post-recession high in December. The flash PMI was little changed in January, which along with another solid reading in economic sentiment in the month suggests the economy has carried solid momentum into 2017. Our forecast continues to assume euro area growth will slow modestly this year relative to the 1.7% gain recorded in 2016 as political uncertainty weighs on the economic outlook. However, given the strengthening in activity toward the end of last year we have revised our 2017 GDP growth forecast to 1.5% from 1.3% previously. The latest inflation data also surprised to the upside, with headline prices rising 1.8% in the year to January, the fastest rate in nearly four years. The acceleration is likely to add to calls, particularly from Germany, for the ECB to begin tapering monetary policy stimulus. However, much of the recent increase has been driven by energy prices, with core inflation remaining below 1% and little changed over the last 18 months. Until underlying price growth begins to pick up more significantly, we expect the ECB will stand by their December decision to extend the asset purchase program to the end of this year.

RBA likely to lower growth forecasts in February

The Reserve Bank of Australia will issue updated economic projections following their first rate-setting meeting of the year on February 7. Their inflation forecast is unlikely to change with the annual rate of headline inflation in Q4/16 matching expectations at 1.5%, although following an unexpected decline in Q3/16 GDP, the RBA will likely trim their forecast for economic growth. A downward revision to growth along with a forecast for inflation to remain at the bottom of the RBA's 2-3% target range over the forecast horizon is consistent with a mild, implicit easing bias. We think the RBA is unlikely to act on that bias in the near term, particularly given greater focus on financial stability concerns under the new governor. However, if inflation remains stubbornly low (core measures have been steady at 1.5% for a year now and leading indicators, such as wage growth, remain benign) we still see scope for an additional rate cut in the RBA's protracted easing cycle.

New Zealand inflation firming but NZD strength still a concern

New Zealand's inflation rate jumped to 1.3% in Q4/16, marking the first time in two years that headline inflation has been within the RBNZ's target range. While much of the increase in the year-over-year rate reflected rising energy prices and base effects, there was some evidence of a firming in underlying inflationary pressure with nontradable inflation having picked up to 2½% in the second half of 2016. Tradables inflation remains in negative territory, however, and will continue to be held in check by a strong New Zealand dollar even as energy prices rise. The currency's strength was a persistent source of discomfort for the RBNZ last year, and that concern is unlikely to have faded with the trade-weighted exchange rate sitting more than 4% above their projection for the current quarter. The positive trend in inflation will likely keep the RBNZ from expressing an outright easing bias in their February 9 policy statement (the first since the cash rate was lowered last November), but we expect they will continue to note that currency depreciation is needed.

Interest rate outlook

%, end of period

	Actuals				Forecast							
	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
Canada												
Overnight	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25
Three-month	0.45	0.48	0.53	0.46	0.50	0.50	0.55	0.60	0.65	0.85	1.15	1.40
Two-year	0.54	0.52	0.52	0.80	0.75	0.85	0.95	1.05	1.20	1.40	1.60	1.80
Five-year	0.67	0.57	0.62	1.15	1.05	1.30	1.55	1.85	2.05	2.30	2.45	2.60
10-year	1.23	1.06	1.00	1.80	1.70	1.90	2.15	2.45	2.60	2.80	2.95	3.10
30-year	2.00	1.72	1.66	2.35	2.30	2.45	2.70	2.95	3.05	3.20	3.30	3.45
United States												
Fed funds**	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.25	1.50	1.75	2.00	2.25
Three-month	0.21	0.26	0.29	0.51	0.55	0.90	0.90	1.10	1.40	1.65	1.90	2.10
Two-year	0.73	0.58	0.77	1.25	1.20	1.40	1.55	1.80	2.05	2.30	2.50	2.70
Five-year	1.21	1.01	1.14	2.00	1.90	2.10	2.25	2.45	2.65	2.90	3.00	3.15
10-year	1.78	1.49	1.60	2.55	2.40	2.65	2.80	3.00	3.15	3.40	3.50	3.60
30-year	2.61	2.30	2.32	3.15	3.00	3.20	3.35	3.50	3.60	3.75	3.80	3.85
United Kingdom												
Bank rate	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.10	0.10	0.10	0.10
Two-year	0.45	0.13	0.13	0.08	0.20	0.20	0.20	0.20	0.05	0.10	0.15	0.15
10-year	1.43	0.89	0.76	1.24	1.40	1.60	1.75	1.90	2.00	2.10	2.25	2.30
Euro area												
Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
Two-year	-0.48	-0.61	-0.69	-0.78	-0.70	-0.65	-0.55	-0.50	-0.50	-0.50	-0.50	-0.50
10-year	0.15	-0.11	-0.12	0.21	0.20	0.35	0.50	0.60	0.65	0.65	0.70	0.75
Australia												
Cash target rate	2.00	1.75	1.50	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.50	1.50
Two-year	1.89	1.59	1.55	1.86	1.70	1.50	1.60	1.75	1.75	2.00	2.00	2.25
10-year	2.49	1.98	1.91	2.76	2.80	2.95	3.20	3.40	3.55	3.90	4.05	4.15
New Zealand												
Cash target rate	2.25	2.25	2.00	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.75	1.75
Two-year swap	2.19	2.22	1.96	2.50	2.20	1.90	1.90	2.00	2.10	2.20	2.30	2.40
10-year swap	2.97	2.65	2.41	3.58	3.50	3.70	3.90	4.10	4.30	4.70	4.90	5.00
Yield curve*												
Canada	69	54	48	100	95	105	120	140	140	140	135	130
United States	105	91	83	130	120	125	125	120	110	110	100	90
United Kingdom	98	76	63	116	120	140	155	170	195	200	210	215
Eurozone	63	50	57	99	90	100	105	110	115	115	120	125
Australia	60	39	36	90	110	145	160	165	180	190	205	190
New Zealand	78	43	45	108	130	180	200	210	220	250	260	260

* 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	0.50-0.75	0.25-0.50	December 15, 2016
Canada	Overnight rate	0.50	0.75	July 15, 2015
United Kingdom	Bank rate	0.25	0.50	August 4, 2016

		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

	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	2015	2016F	2017F	2018F
Canada*	2.7	-1.3	3.5	1.8	1.9	1.8	1.6	2.0	2.1	2.5	1.9	1.7	0.9	1.3	1.8	2.1
United States*	0.8	1.4	3.5	1.9	2.3	2.1	2.5	2.4	2.4	2.3	2.0	2.0	2.6	1.6	2.3	2.3
United Kingdom	0.3	0.6	0.6	0.6	0.4	0.4	0.2	0.2	0.4	0.5	0.5	0.5	2.2	2.0	1.6	1.6
Euro area	0.5	0.3	0.4	0.5	0.4	0.3	0.3	0.3	0.4	0.4	0.4	0.4	1.9	1.7	1.5	1.5
Australia	1.0	0.6	-0.5	1.1	0.8	0.5	0.6	0.6	0.6	0.6	0.7	0.6	2.4	2.4	2.4	2.5
New Zealand	0.7	0.7	1.1	0.6	0.7	0.8	0.8	0.6	0.6	0.6	0.6	0.6	2.5	3.3	3.0	3.6

*annualized,

Inflation outlook

% change, year-over-year

	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	2015	2016	2017F	2018F
Canada	1.5	1.6	1.2	1.4	2.1	2.4	2.7	2.7	2.3	2.2	2.2	2.2	1.1	1.4	2.5	2.2
United States	1.1	1.0	1.1	1.8	2.5	2.4	2.6	2.2	2.1	2.1	2.2	2.2	0.1	1.3	2.4	2.2
United Kingdom	0.3	0.4	0.7	1.2	2.1	2.5	2.4	2.4	2.3	2.3	2.2	2.1	0.0	0.7	2.4	2.2
Euro area	0.0	-0.1	0.3	0.7	1.9	1.8	1.6	1.5	1.3	1.4	1.4	1.4	0.0	0.2	1.7	1.4
Australia	1.3	1.0	1.3	1.5	2.3	2.6	2.6	2.7	2.7	2.6	2.6	2.5	1.5	1.3	2.5	2.6
New Zealand	0.4	0.4	0.4	1.3	1.0	1.0	1.2	1.5	1.6	1.7	1.8	1.8	0.3	0.6	1.2	1.7

Source: Statistics Canada, Bureau of Labor Statistics, Bank of England, European Central Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, RBC Economics Research

Inflation tracking

Inflation Watch

	Measure	Current period	Period ago	Year ago	Three-month trend	Six-month trend
Canada	Core CPI (CPIX)[1]	Dec	0.2	1.6	0.4	1.4
United States	Core PCE[1,2]	Dec	0.1	1.7	1.3	1.6
United Kingdom	All-items CPI	Dec	0.5	1.6	2.5	2.1
Euro area	All-items CPI[1]	Jan	0.2	1.8	2.0	1.5
Australia	Trimmed mean CPI[1]	Q4	0.4	1.6	N/A	N/A
New Zealand	All-items CPI	Q4	0.4	1.3	N/A	N/A

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

Source: Statistics Canada, US Bureau of Labor Statistics, Bank of England, European Central Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, RBC Economics Research

Currency outlook

Level, end of period

	Actuals				Forecast							
	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
Canadian dollar	1.30	1.29	1.31	1.34	1.35	1.38	1.38	1.38	1.37	1.36	1.35	1.33
Euro	1.14	1.11	1.12	1.05	1.02	1.00	0.98	0.96	0.98	1.00	1.02	1.04
U.K. pound sterling	1.44	1.33	1.30	1.24	1.15	1.15	1.16	1.16	1.18	1.20	1.23	1.25
New Zealand dollar	0.69	0.71	0.73	0.69	0.71	0.72	0.73	0.74	0.74	0.74	0.75	0.75
Japanese yen	112.6	103.2	101.3	117.0	120.0	118.0	115.0	110.0	105.0	107.0	108.0	109.0
Australian dollar	0.77	0.75	0.77	0.72	0.74	0.74	0.73	0.72	0.72	0.72	0.73	0.73

Canadian dollar cross-rates

	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
EUR/CAD	1.48	1.43	1.48	1.41	1.38	1.38	1.35	1.32	1.38	1.36	1.38	1.38
GBP/CAD	1.87	1.72	1.70	1.66	1.55	1.59	1.60	1.60	1.62	1.64	1.66	1.67
NZD/CAD	0.90	0.92	0.96	0.93	0.96	0.99	1.01	1.02	1.01	1.01	1.01	1.00
CAD/JPY	86.6	79.9	77.2	87.0	88.9	85.5	83.3	79.7	76.6	78.7	80.0	82.0
AUD/CAD	1.00	0.96	1.01	0.97	1.00	1.02	1.01	0.99	0.99	0.98	0.99	0.97

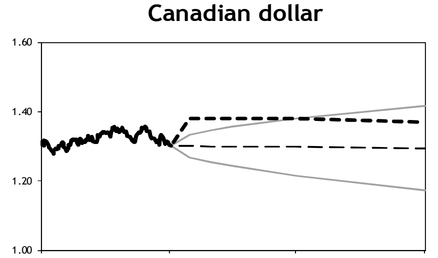
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics Research

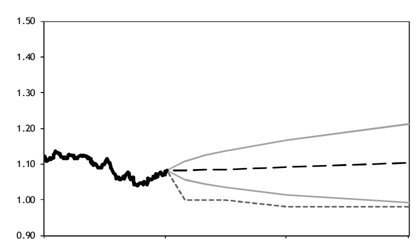
RBC Economics outlook compared to the market

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.

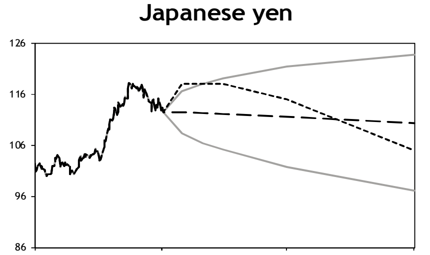
Canadian dollar



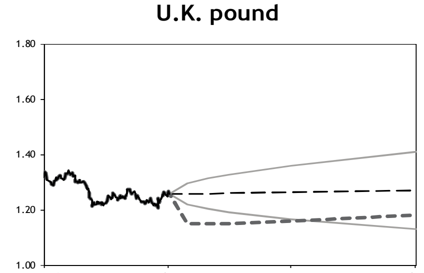
Euro



Japanese yen



U.K. pound

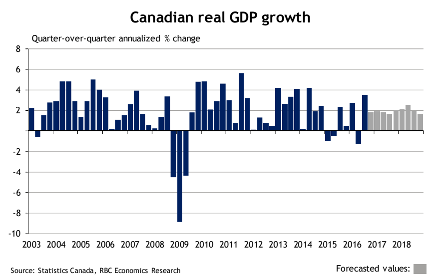


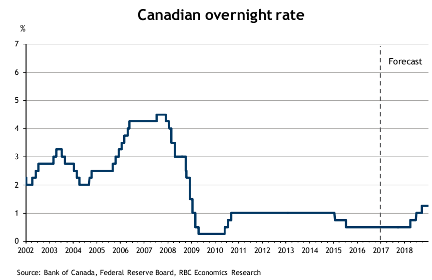
Central bank watch

Bank of Canada

Canada's economy rebounded by more than expected in November, prompting us to revise up our Q4/16 growth forecast to 1.8%. The economy is expected to continue expanding at a modestly above-trend pace this year.

The BoC emphasized an unusual degree of uncertainty in their latest economic outlook; we expect a cautious tone will be maintained in the near-term even amid growing evidence of a shift to above-trend activity.

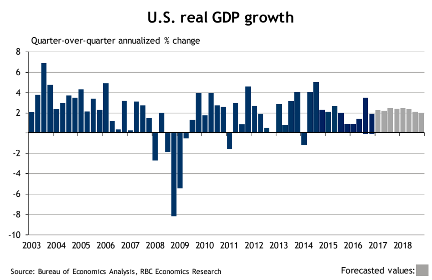


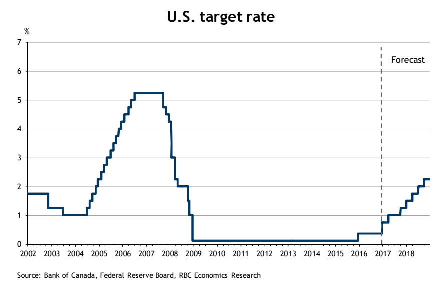


Federal Reserve

US GDP growth slowed to a 1.9% annualized pace in Q4/16 although broad-based improvement in domestic spending made for a better report than the headline suggested. A solid domestic economy is expected to lift GDP growth to 2.3% this year.

Solid economic data and rising inflation and wages argue for the Fed to continue gradually normalizing monetary policy this year. We expect the next rate hike will come in June.

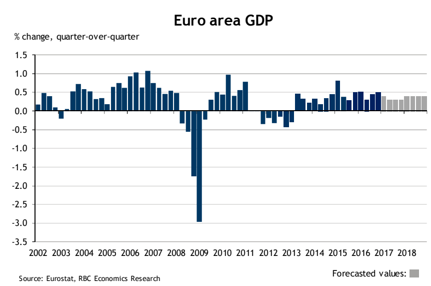


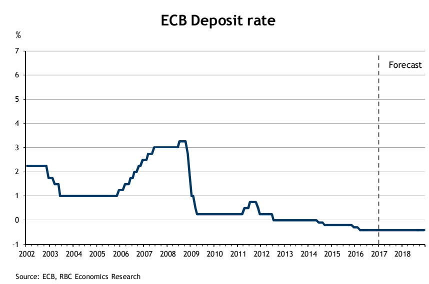


European Central Bank

Euro area GDP growth strengthened in Q4/16, confirming the signal from survey indicators that showed growing momentum late last year and into 2017. We expect growth will slow only modestly to 1.5% this year from 1.7% in 2016.

Despite improving economic conditions, subdued underlying inflation supports the ECB's decision to extend asset purchases to the end of this year.

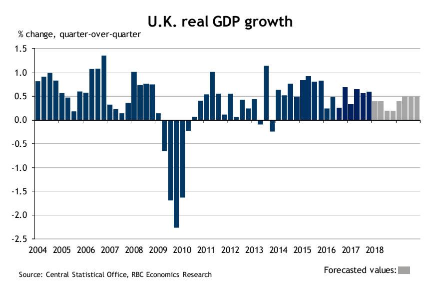


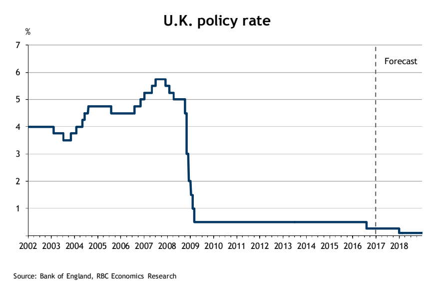


Bank of England

Another 0.6% GDP gain in Q4/16 indicates the UK economy has not slowed since the Brexit referendum. Given momentum heading into 2017, we have upgraded our growth forecast to 1.6%.

The BoE also upgraded their growth outlook but made few changes to inflation projections. They maintained a neutral stance, with policy potentially responding in either direction depending on how economic conditions evolve as Brexit unfolds.

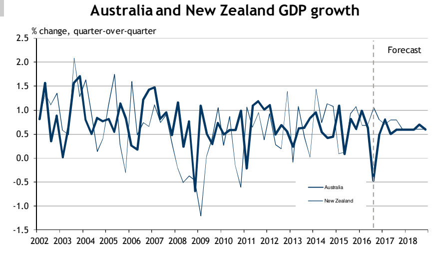


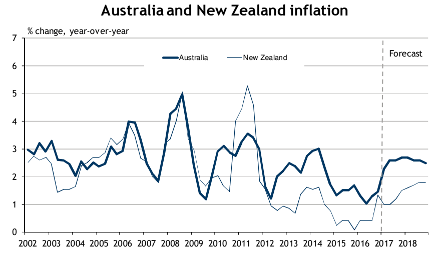


Australia and New Zealand

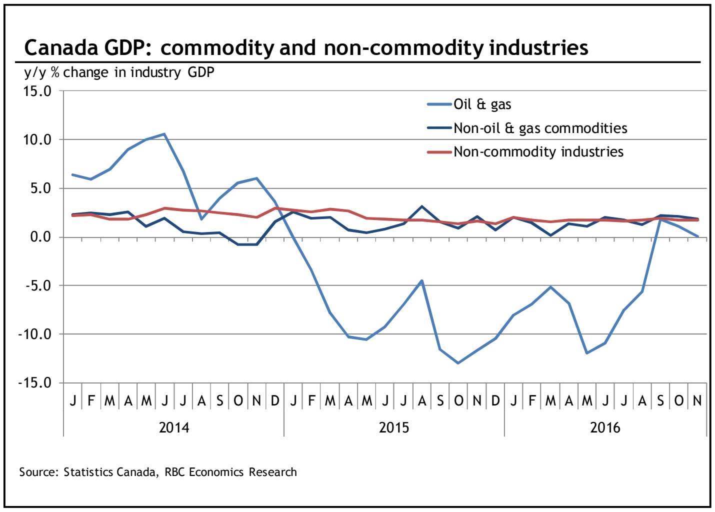
While Australia's economy looks set to rebound from Q3/16's unexpected decline, conditions don't appear strong enough to meet the RBA's 3% growth forecast for this year, leaving scope for an additional rate cut.

The RBNZ will likely be pleased with solid economic growth and firming inflation, although a stubbornly strong currency should leave policymakers less than comfortable when they reconvene in February.

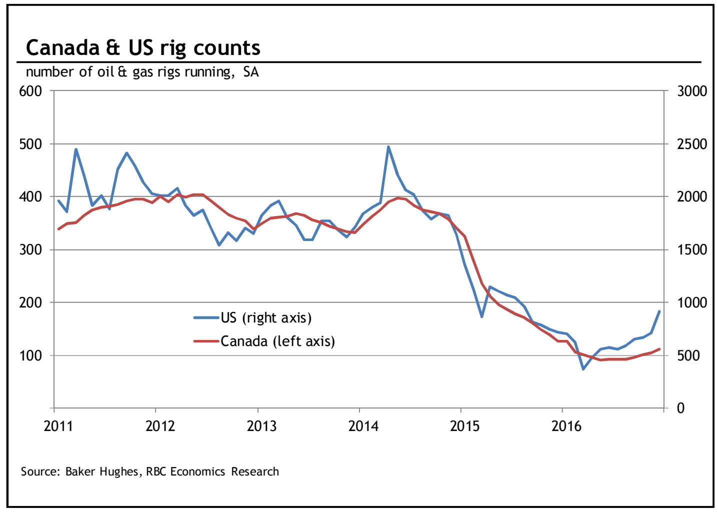




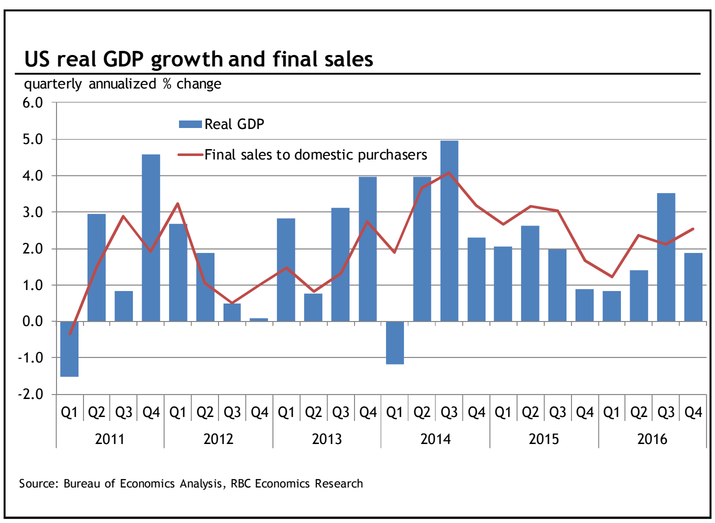
Canadian GDP rebounded in November and non-commodity industries continue to grow at a solid 1.8% y/y pace. With the drag from the energy sector easing and fiscal stimulus set to ramp up, overall growth is expected to shift higher in 2017.



With oil price sustaining above US$50/barrel recently, drilling activity has begun to pick up in both Canada and the US. For Canada in particular, less drag from the energy sector will be an important factor in stronger economic growth this year.



While headline US GDP growth slowed in Q4/16, improving residential and business investment along with another solid quarter of consumer spending spurred domestic demand growth to its strongest pace in more than a year.



Improving sentiment in the UK and euro area translated into solid GDP growth in both economies in Q4/16. Given momentum heading into 2017, we have revised up our growth forecast for both economies this year.