

Inside...

FINANCIAL MARKETS MONTHLY

January 6, 2017

Overview

..... page 1

Interest rate outlook

..... page 5

Economic outlook

..... page 6

Currency outlook

..... page 7

Central bank watch

..... page 8

US domestic spending picked up toward the end of 2016

..... page 9

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

Diverging trajectories (redux)

Financial markets continued to digest Trump’s election victory, with hopes for fiscal policy stimulus boosting US equity indices to record highs in December and contributing to a further selloff in Treasuries. Even with some reversal in the final week of 2016, the S&P 500 closed the year nearly 5% above its pre-election level and 10-year UST yields were up by more than 50 basis points. Those moves were despite a lack of further clarity on potential changes in US fiscal policy—markets also seemed to dismiss downside risks from protectionist trade measures. A decent run of economic data contributed to improving risk sentiment, with US domestic spending appearing to have gained some momentum toward the end of the year while the unemployment rate hit a fresh cycle low in November. The Fed gave the economy a vote of confidence in December by raising rates for the first time in a year, and the Committee also expects to tighten policy a bit faster in 2017 than previously projected, even with potential fiscal changes doing little to shift their growth projections.

International markets were less influenced by US gyrations than in November. Gilt and Bund yields both fell over the course of the month to retrace a good portion of their post-US election bounce as the ECB’s extension of its asset purchase program underlined the fact that the accommodative monetary policy isn’t leaving Europe anytime soon. The Bank of Canada toned down the dovish rhetoric at their final meeting of 2016 but were keen to emphasize they won’t be raising rates alongside the Fed. Even so, GoC 10-year yields remained nearly 50 basis points above pre-election levels. Meanwhile, oil prices hit their highest levels since mid-2015 as markets see OPEC and some non-members following through on a commitment to cap output.

Central bank near-term bias

Three-months out, policy rate



The BoC made no hint of an easing bias in December but went to great lengths to highlight policy divergence between the Canada and the US. We see the Bank remaining on the sidelines this year as the Fed tightens.



We expect the Fed will continue with a gradual pace of tightening this year, holding off on the next rate hike until the second quarter when there is a bit more clarity around US fiscal policy.



We continue to expect the BoE will opt for another round of quantitative easing and further rate cut later this year, although with the UK economy carrying some momentum into 2017, policy changes will take time to materialize.



The ECB’s extension of asset purchases to December keeps them firmly in easing mode, and we don’t expect there will be much talk of tapering this year with inflation forecast to remain below target for some time.



The RBA sounded a bit more dovish toward the end of the year, consistent with recent evidence that the domestic economy is losing steam. We continue to expect a final rate cut later this year.



The RBNZ shifted to a neutral bias in November, and while our forecast assumes one more rate cut in the current easing cycle, we don’t expect any policy change when they reconvene in February.

Highlights

▲ While headline growth is forecast to slow in Q4/16 relative to Q3/16, we expect domestic spending picked up.

▲ Above-trend growth this year will keep downward pressure on the unemployment rate and we look for headline inflation to exceed 2% as energy prices rise.

▲ The Fed raised rates for the first time in a year in December—we expect a slightly faster pace in 2017 with two hikes.

▲ The Fed's updated 'dot plot' showed a faster pace of tightening in 2017, a shift Chair Yellen downplayed at her press conference.

US domestic economy closed out 2016 with solid momentum

US Q3/16 GDP growth was revised up to 3.5% in the final estimate, representing an even sharper improvement relative to gains averaging 1.1% over the first half of the year. Domestic spending is now estimated to have grown by just over 2% in the quarter, little changed from Q2/16's pace, while overall activity was boosted by temporary increases in exports and inventories. A reversal in the contribution from net trade likely weighed on GDP growth in the final quarter of 2016, although we expect stronger domestic spending will keep the economy growing at an above-trend 2.1% annualized pace. Consumer spending was a bit sluggish to start Q4/16, but with a solid increase in September providing a good jumping off point, the hurdle is low for consumption to record another above-2% gain in the quarter. We also expect the slowdown in personal spending will prove transitory given a solid labour market and income growth as well as decade-high consumer confidence readings. December's cycle-high auto sales provide early evidence of such. Also bolstering prospects for domestic demand are reports on capital goods shipments and orders that point to equipment investment ending a four quarter streak of declines, as well as recent gains in home sales and starts that should help retrace some of the previous two quarters' weakness in residential investment.

Expect further progress on the Fed's objectives this year

Our forecast assumes the US economy will chug along at an above-trend pace in 2017, fuelled by the same factors boosting growth in Q4: solid consumer spending, rising residential investment, and a shift to stronger business investment following a weak 2016. The forecast also assumes fiscal stimulus will provide a lift to growth later this year although we continue to await details on the extent of any corporate and personal income tax cuts, and equally importantly, how they will be funded, to better calibrate the boost. For now we have plugged in a placeholder ½ percentage point add from fiscal stimulus over the next two years, boosting growth by 0.1 ppt in 2017 and 0.4 ppts in 2018 on an annual average basis. Above-potential growth this year is expected to be accompanied by solid employment gains and further downward drift in the unemployment rate, which already closed 2016 below the Fed's longer-run estimate of full employment. A tight labour market should keep upward pressure on wage growth and support core CPI inflation at or above 2% throughout 2017. On top of that, rising energy prices are expected to push headline inflation closer to 2½% this year. As it becomes increasingly clear that the Fed is reaching its objectives, we expect they will pick up the pace of tightening a bit relative to the single rates hikes seen in each of the last two years.

Yellen downplays a more hawkish 'dot plot'

2016's lone rate hike came at the last meeting of the year—a move that was unanimously expected following a run of positive economic data, particularly on the labour market, and earlier indications from Committee members that a hike would soon be appropriate. The decision itself was unanimous, with the policy statement noting solid job gains, a lower unemployment rate, and the considerable increase in market-based inflation expectations (albeit to still-low levels) since the previous meeting. Otherwise, there were few changes to the statement and no additional forward guidance was provided beyond the standard note that rate hikes are expected to be gradual and the fed funds rate is likely to remain accommodative for an extended period.

The most notable change in the Fed's updated economic projections was in the 'dot plot', which showed members now see three rate hikes as appropriate next year, up from two previously. Markets saw that as a hawkish development, although Chair Yellen tried to downplay the shift at her press conference. The expectation for a slightly faster pace of tightening was despite little change in growth projections, even as about half of Committee members incorporated some form of expansionary fiscal policy. Minutes of the meeting indicated significant uncertainty regarding the size (and even direction) of the impact of any potential fiscal policy changes, although Committee members did see upside risks to the outlook as having increased. There is a risk that the Fed will have to raise rates more quickly if the unemployment rate falls sharply below its longer run level, but for now we expect the Fed will tighten only gradually with two rate hikes in 2017 before picking up the pace further in 2018.

Canada's economy stumbled to start Q4/16

Canadian GDP surprised on the downside with a 0.3% decline in October, falling well short of market expectations for a flat reading and retracing a sizeable portion of September's 0.4% gain. The decline was concentrated in goods-producing industries, particularly manufacturing and mining, although services growth of just 0.1% was also disappointing in light of earlier-reported gains in retail and wholesale trade. We expect the poor start to the fourth quarter was more volatility than trend, and while we await data on the final months of the year, our forecast assumes a modest rebound in November and December that would leave Q4 growth close to the Bank of Canada's latest forecast of 1.5%. While not an inspiring pace, growth in that ballpark is consistent with the Bank's assessment of trend growth in the economy and would likely be enough to keep the Governing Council from seriously considering a rate cut early this year.

While Q4/16 is shaping up to be a lacklustre end to a lacklustre year, there is reason to be optimistic that growth will pick up in 2017. The drag from the energy sector is finally abating—oil and gas activity is now rising on a year-over-year basis, and with oil prices expected to remain above US\$50/barrel this year, that trend is likely to continue. Meanwhile, the much larger non-commodities sector, which is already growing at a near-trend pace, is expected to get a boost as fiscal stimulus ramps up and exporters benefit from a strengthening US economy. With energy headwinds giving way to fiscal tailwinds, we look for Canadian GDP growth to pick up to 1.8% this year following an expected 1.3% increase in 2016. That said, we remain cognizant of downside risks—rising US protectionism might threaten export growth, the add from fiscal stimulus could again fall short of expectations, and the extent of the policy-driven slowdown in housing remains to be seen.

BoC highlights US-Canada divergence...

The Bank of Canada's December meeting turned out to be a non-event, with one of the more brief statements in recent memory giving little indication of policy bias just weeks after Governor Poloz indicated the Bank considered a rate cut. Perhaps in response to financial markets increasing odds that the Bank would raise rates in 2017, the statement went to some lengths to highlight monetary policy divergence between Canada and the US, contrasting the "significant amount of economic slack" in Canada with tighter conditions south of the border. We agree that the BoC will not have to follow the Fed with higher policy rates this year, and expect a relatively cautious tone will be maintained in early-2017 as uncertainty lingers regarding exports, housing, and the impact of fiscal stimulus.

While the Bank won't be moving alongside the Fed, higher policy rates in the US will have an impact on financial conditions in Canada. Rising US term yields will put upward pressure on Canadian interest rates (we see 10-year GoC yields rising to 2.45% by the end of 2017), tightening financial conditions even as the Bank holds monetary policy steady. Some offsetting easing will come from associated Canadian dollar depreciation, but on net the Bank is likely to see conditions tightening this year. It should be kept in mind that this tightening is associated with a strengthening US economy that will benefit Canadian exporters beyond the direct support coming from currency depreciation. On balance, it is hard to make the case that the Bank of Canada needs to offset this tightening in financial conditions by easing domestic monetary policy.

...which should keep downward pressure on CAD in early-2017

The start of 2016 was marred by volatility and the Canadian dollar was no exception, depreciating sharply as oil prices plummeted early in the year before recovering significantly as oil prices rebounded and markets pared back expectations for rate hikes from the Fed. We expect 2017 will be a less interesting year for the currency—our forecast assumes a gradual depreciating trend relative to the US dollar will persist over the first half of the year as monetary policy divergence between Canada and the US remains a dominant theme. We look for the Canadian dollar to slip to 72.5 US cents around mid-year before the currency's other major driver, oil prices, provides greater offset (we expect WTI will rise toward US\$60/barrel toward the end of 2017) and policy divergence becomes less pronounced with the BoC beginning to shift to an implicit tightening bias.

▲ October's 0.3% GDP decline is expected to prove temporary, but nonetheless dents Q4/16 growth prospects.

▲ We expect growth will pick up to 1.8% in 2017 as the energy sector begins to contribute positively and fiscal stimulus is ramped up.

▲ The BoC highlighted policy divergence between Canada and the US just one week before the Fed raised rates.

▲ We expect the Canadian dollar will continue its depreciating trend early this year before balancing out somewhat in the second half of 2017.

Highlights

▲ The UK's composite PMI has increased in each of the last five months after dropping sharply below 50 in July.

▲ With euro area growth expected to slow to a more trend-like pace in 2017, we don't expect the ECB will talk tapering this year.

▲ Australia's 0.5% decline in Q3/16 GDP reflected broad-based weakness and should prompt the RBA to revise down its 2017 growth forecast.

UK economy rolling into 2017

The third estimate of UK Q3 GDP growth was revised up to 0.6% (non-annualized) from 0.5%, now matching the previous quarter's pace and indicating no slowdown in the UK economy following June's surprise Brexit vote. Consumer spending was once again the main source of growth, although some recent softening in employment indicators and an expected squeeze on real incomes as inflation picks up will likely see consumption growth slow somewhat in 2017. Purchasing managers' index (PMI) data have continued to strengthen since the Brexit-related swoon in July (December's composite hit a 1½ year high), pointing to little loss of momentum toward the end of 2016. Hard data have been more mixed, however, with an unexpected decline in industrial production in October offsetting an increase in services output. On balance, we continue to expect growth moderated to 0.3% in Q4/16. We look for annual growth to slow to 1.1% in 2017 from close to 2% in 2016, reflecting the aforementioned slowdown in consumer spending as well as a decline in business investment amid uncertainty about the UK's trading relationship with the EU post-Brexit. A widening output gap is expected to put downward pressure on underlying inflation, even as headline inflation is pushed above the Bank of England's 2% target amid rising import and energy prices. Balancing those opposing forces, the Bank has struck a neutral tone, noting that monetary policy can respond in either direction. However, we expect they will ultimately be disappointed by the economy's performance this year, and with the latest round of asset purchases close to winding down, we see the Bank opting for another round of QE in mid-2017 along with a further cut in the Bank Rate to 0.10%.

ECB not ready to talk tapering

The euro area economy appears to have maintained decent momentum toward the end of 2016 with improving PMI reports over the past three months culminating in a one-year-high composite reading in December. The recent increase has been relatively broad-based—continued strength in Germany and Spain has been accompanied by indications of a pickup in laggards France and Italy. That said, we don't see the improvement as substantial enough to break the euro area out of its recent growth trend path and thus we expect another 0.3% increase in Q4/16 GDP. That would leave annual growth at 1.6% in 2016, down slightly from 2015's 1.9% gain. Our forecast assumes a further slowdown to a trend-like 1.3% pace in 2017 as consumer spending and business investment face headwinds from rising energy prices, still-elevated unemployment, and political uncertainty. Economic slack should keep underlying inflationary pressure muted, even with rising energy prices pushing headline inflation above 1% for the first time since 2013. Acknowledging that it will still be some time before inflation returns to its target on a sustained basis, the ECB extended its asset purchase program by nine months (to at least December 2017) while relaxing some of the conditions on purchases and holding the deposit rate at -0.40%. The extension was longer than markets expected, but offset somewhat by a slower pace of buying (€60bn compared with the €80bn pace continuing until March) that ECB President Draghi was keen to emphasize did not amount to tapering. We expect modest growth in 2017 will keep the ECB firmly in easing mode and see any talk of tapering asset purchases as unlikely this year.

Australia's economy unexpectedly contracted in Q3/16

Australian GDP fell by a non-annualized 0.5% in Q3/16, well short of market expectations that had already been marked down amid weak data leading up to the release. The first quarterly contraction since 2011 reflected across-the-board weakness, with the only gains coming from consumer spending and inventories. The former grew at its slowest pace in two and a half years, even as the household savings rate slipped to its second-lowest in nearly a decade. With housing, business investment, and government spending all contracting, domestic demand also fell 0.5%. While the headline and most details were soft, there were a few bright spots in the report as key nominal and income measures continued their recent turnaround. In particular, Australia's terms of trade rose for a second consecutive quarter, providing further evidence that the drag from weaker commodity prices is abating. We expect these themes will persist in 2017, with weak domestic demand being offset somewhat by an improving export sector. Against this backdrop we expect the RBA to maintain a cautious tone, with growth forecasts likely to be revised lower following the weak Q3 outturn. We continue to see the odds tilted in favour of one final rate cut in this easing cycle.

Interest rate outlook

%, end of period

	<i>Actuals</i>				<i>Forecast</i>							
	<u>16Q1</u>	<u>16Q2</u>	<u>16Q3</u>	<u>16Q4</u>	<u>17Q1</u>	<u>17Q2</u>	<u>17Q3</u>	<u>17Q4</u>	<u>18Q1</u>	<u>18Q2</u>	<u>18Q3</u>	<u>18Q4</u>
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	0.10	0.10	0.10	0.10	0.10	0.10
Two-year	0.45	0.13	0.13	0.08	0.20	0.20	0.05	0.10	0.10	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	1.50	1.50	1.60	1.60	1.60	1.70	1.80	1.90
10-year	2.49	1.98	1.91	2.76	2.55	2.65	2.95	3.10	3.25	3.50	3.65	3.80
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	1.90	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	2.85	2.95	3.20	3.35	3.50	3.80	4.00	4.20
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	170	180	190	200	210	215
Eurozone	63	50	57	99	90	100	105	110	115	115	120	125
Australia	60	39	36	90	105	115	135	150	165	180	185	190
New Zealand	78	43	45	108	95	105	130	135	140	160	170	180

* 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

		<u>Current</u>	<u>Last</u>				<u>Current</u>	<u>Last</u>	
United States	Fed funds	0.50-0.75	0.25-0.50	December 15, 2016	Eurozone	Deposit rate	-0.40	-0.30	March 10, 2016
Canada	Overnight rate	0.50	0.75	July 15, 2015	Australia	Cash rate	1.50	1.75	August 3, 2016
United Kingdom	Bank rate	0.25	0.50	August 4, 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

	<u>16Q1</u>	<u>16Q2</u>	<u>16Q3</u>	<u>16Q4</u>	<u>17Q1</u>	<u>17Q2</u>	<u>17Q3</u>	<u>17Q4</u>	<u>18Q1</u>	<u>18Q2</u>	<u>18Q3</u>	<u>18Q4</u>	<u>2015</u>	<u>2016F</u>	<u>2017F</u>	<u>2018F</u>
Canada*	2.7	-1.3	3.5	1.5	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	2.1	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	0.3	0.3	0.1	0.1	0.1	0.4	0.4	0.5	0.5	2.2	2.0	1.1	1.2
Euro area	0.5	0.3	0.3	0.3	0.4	0.3	0.2	0.2	0.4	0.4	0.4	0.4	1.9	1.6	1.3	1.5
Australia	1.0	0.6	-0.5	0.4	0.7	0.7	0.8	0.7	0.5	0.7	0.8	0.7	2.4	2.8	2.5	2.7
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

	<u>16Q1</u>	<u>16Q2</u>	<u>16Q3</u>	<u>16Q4</u>	<u>17Q1</u>	<u>17Q2</u>	<u>17Q3</u>	<u>17Q4</u>	<u>18Q1</u>	<u>18Q2</u>	<u>18Q3</u>	<u>18Q4</u>	<u>2015</u>	<u>2016F</u>	<u>2017F</u>	<u>2018F</u>
Canada	1.5	1.6	1.2	1.4	2.2	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	1.6	1.5	1.4	1.2	1.3	1.4	1.4	1.4	0.0	0.2	1.4	1.4
Australia	1.3	1.0	1.3	1.4	2.2	2.6	2.5	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	0.9	1.0	1.0	1.2	1.5	1.6	1.7	1.8	1.8	0.3	0.5	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

	<u>Measure</u>	<u>Current period</u>	<u>Period ago</u>	<u>Year ago</u>	<u>Three-month trend</u>	<u>Six-month trend</u>
Canada	Core CPI (CPIX) ¹	Nov	0.0	1.5	0.4	1.8
United States	Core PCE ^{1,2}	Nov	0.0	1.6	1.5	1.7
United Kingdom	All-items CPI	Nov	0.2	1.2	2.1	1.8
Euro area	All-items CPI ¹	Dec	0.3	1.1	1.6	1.4
Australia	Trimmed mean CPI ¹	Q3	0.4	1.7	N/A	N/A
New Zealand	All-items CPI	Q3	0.3	0.4	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	1.33	1.35	1.38	1.38	1.38	1.37	1.36	1.35	1.33
Euro	1.14	1.11	1.12	1.04	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	0.70	0.71	0.72	0.73	0.74	0.74	0.74	0.75	0.75
Japanese yen	112.6	103.2	101.3	118.0	120.0	118.0	115.0	110.0	105.0	107.0	108.0	109.0
Australian dollar	0.77	0.75	0.77	0.74	0.74	0.74	0.73	0.72	0.72	0.72	0.73	0.73

Canadian dollar cross-rates

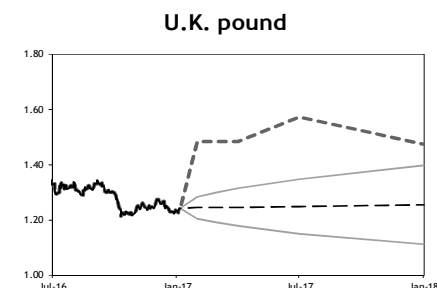
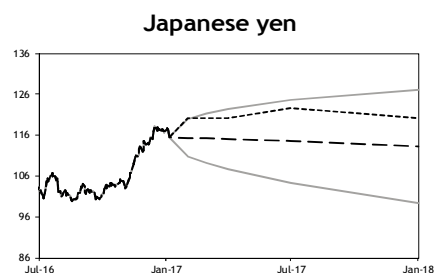
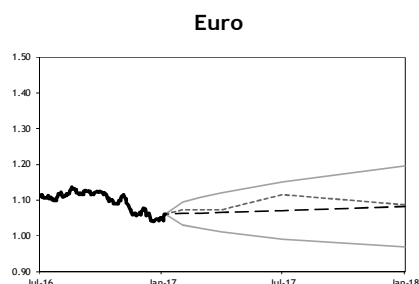
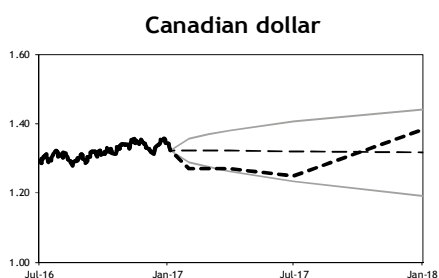
	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
EUR/CAD	1.48	1.43	1.48	1.38	1.38	1.38	1.35	1.32	1.38	1.36	1.38	1.38
GBP/CAD	1.87	1.72	1.70	1.65	1.55	1.59	1.60	1.60	1.62	1.64	1.66	1.67
NZD/CAD	0.90	0.92	0.96	0.93	0.96	0.99	1.01	1.02	1.01	1.01	1.01	1.00
CAD/JPY	86.6	79.9	77.2	88.7	88.9	85.5	83.3	79.7	76.6	78.7	80.0	82.0
AUD/CAD	1.00	0.96	1.01	0.98	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

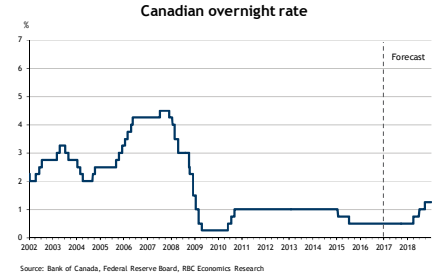
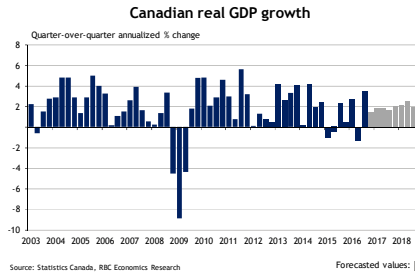
The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.



Bank of Canada

The Canadian economy started Q4/16 on a sour note with GDP falling 0.3% in October. We expect the decline will prove temporary, with a rebound in November and December helping eke out near-trend growth in the quarter.

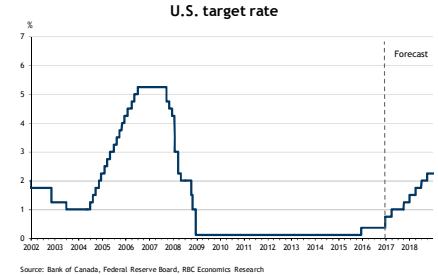
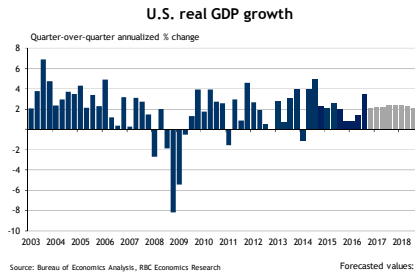
The Bank of Canada will likely maintain a cautious tone early this year given the economy's recent stumble and a number of uncertainties in the economic outlook.



Federal Reserve

US Q4/16 GDP growth likely slowed relative to the third quarter's 3.5% gain, but we expect the details will be better with a broad-based increase in domestic spending.

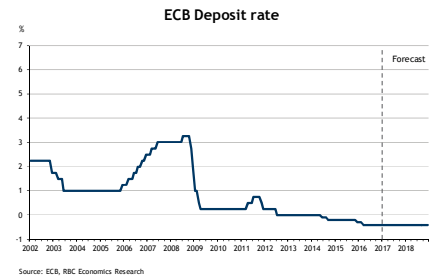
The Fed, like the rest of us, remains uncertain about the potential size and impact of fiscal policy changes. While the Committee has highlighted upside risks to growth, we don't see the Fed deviating from a gradual tightening path this year.



European Central Bank

Euro area PMI readings improved broadly toward the end of 2016 but we don't expect Q4/16 growth will break out of the 0.3% rate seen in the prior two quarters.

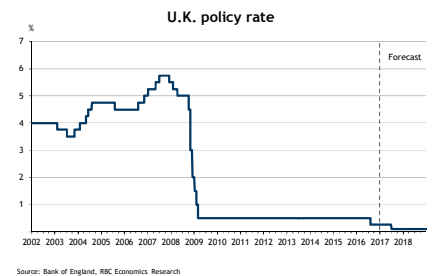
The ECB extended its asset purchase program to December 2017, providing more stimulus than markets expected even though the pace of purchases will be reduced after March.



Bank of England

UK PMI readings have improved consistently since their sharp, post-Brexit decline, but hard data have been a bit more mixed. We continue to expect growth slowed to 0.3% in Q4/16.

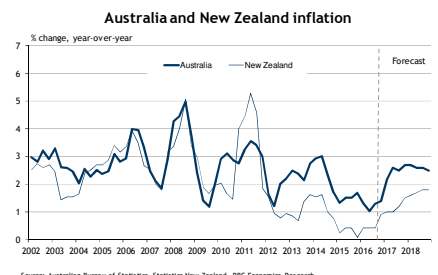
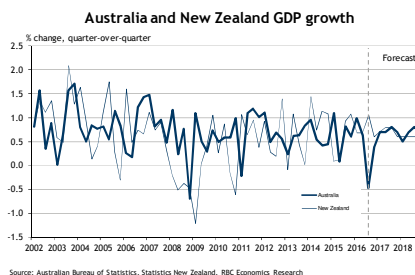
Despite decent momentum heading into 2017, we continue to forecast the UK economy will slow this year, prompting another round of asset purchases by the BoE and a Bank Rate cut to 0.10%.



Australia and New Zealand

Australia's unexpected decline in Q3/16 GDP, and indications that the domestic economy is losing a degree of momentum, will likely result in the RBA lowering their 2017 growth estimate.

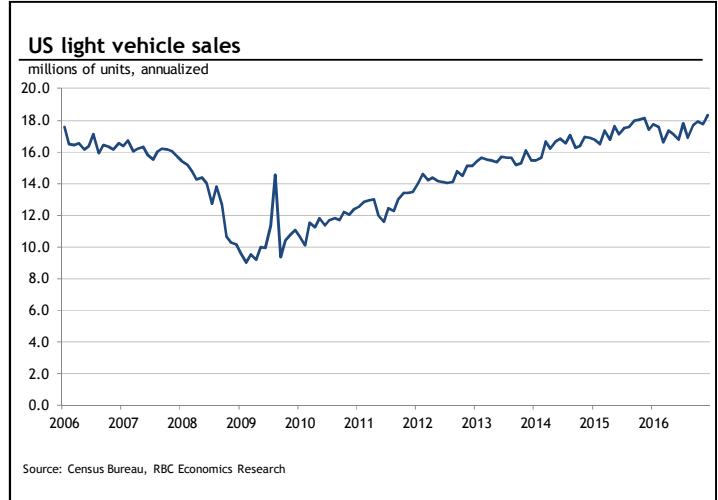
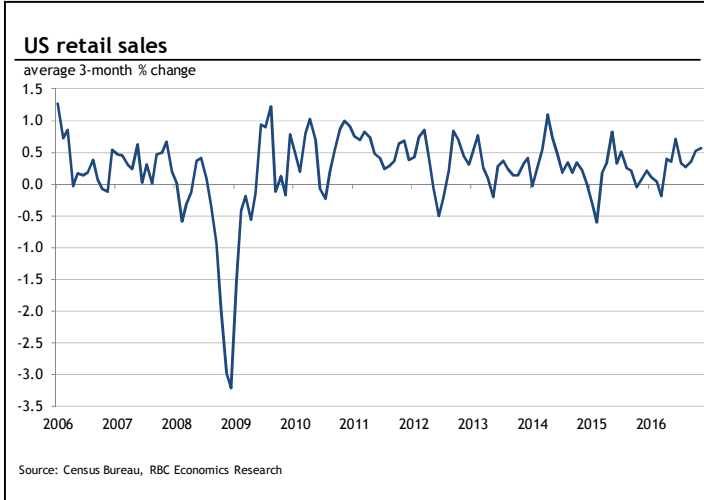
New Zealand's solid Q3/16 GDP growth (+1.1%, matching the best in two years) is likely to keep the RBNZ in neutral when they reconvene in February.



US domestic spending picked up toward the end of 2016

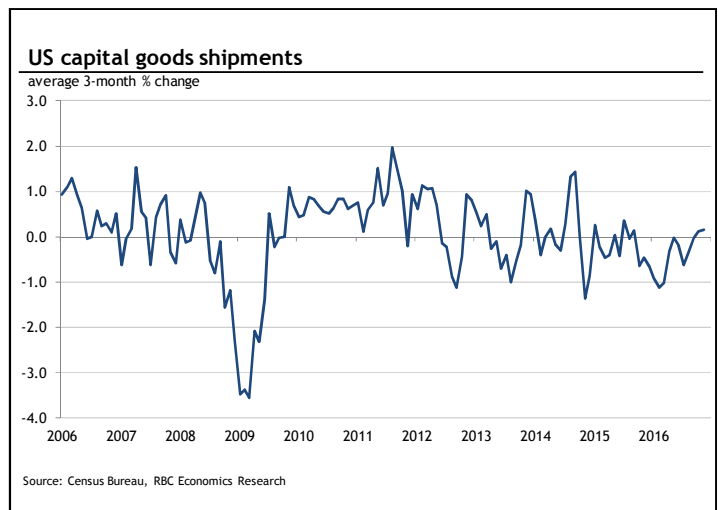
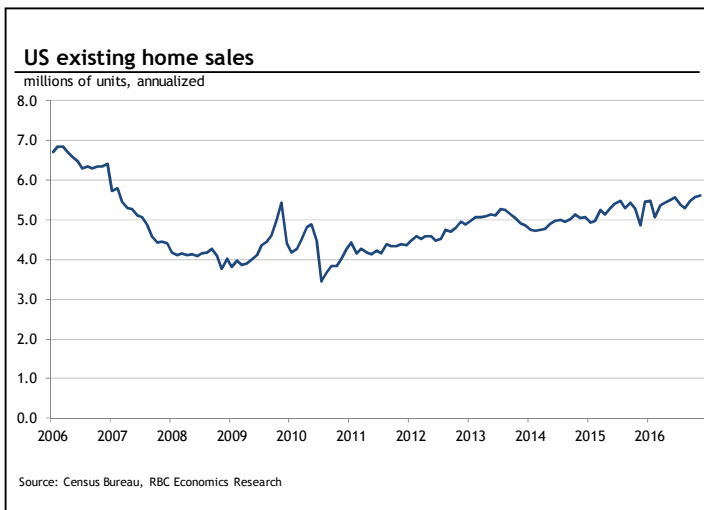
US retail sales growth picked up in the three months to November, reflecting a strong labour market, solid wage growth and rising consumer confidence.

US motor vehicle sales hit a decade-high 18.3 million annualized units in December, providing early evidence that consumer spending continued to rise at the end of 2016.



Existing home sales recorded a fresh cycle high in November, and with housing starts also up strongly quarter-to-date, residential investment likely made a solid contribution to growth in Q4/16.

Equipment investment also appears to be picking up after four consecutive quarters of declines. Capex shipments rose in the three months to November and a deteriorating capital goods trade balance also points to stronger domestic investment.



The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.

©Registered trademark of Royal Bank of Canada.

©Royal Bank of Canada.

