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Central bankers set to revoke insurance?

A new consensus among central bankers came to light this week: low interest rates have successfully put the economy on firmer footing, tempering the need for extraordinary monetary policy stimulus. At a meeting in Sintra, Portugal, the European Central Bank’s Draghi and Bank of Canada’s Poloz lauded their banks’ aggressive rate cuts as underpinning a pickup in economic activity. Even the Bank of England’s Carney, who just weeks earlier voted to maintain the current policy stance, outlined the conditions that could tilt the scales in favour of reducing monetary stimulus. Fed Chair Yellen wasn’t present, but the central bank’s action earlier in June spoke for itself. The Fed raised rates for the third time in six months and laid out the details of a plan to begin shrinking their balance sheet.

Central bankers’ remarks elicited a strong reaction in financial markets which raced to price in rate increases in Canada this year and upped the chances of a Bank of England hike by June 2018. In turn, the Canadian dollar, euro and sterling rallied against the US dollar. Over recent weeks, the most notable change in tone came from Bank of Canada with officials laying the groundwork for the reduction in policy stimulus in speeches and interviews. In Sintra, the Governor took the opportunity to reiterate that the rate cuts implemented to combat the oil price shock “look as though they have done their job.” This bold statement alongside the recent run of stronger-than-expected data underpinned our decision to revise our forecast and we now expect the BoC to raise the policy rate when they meet next on July 12, 2017. We think another hike is likely to follow in October 2017.

Central bank near-term bias

Three-months out, policy rate



Broadly-based growth and improving business sentiment fueled a hawkish turn from the Bank of Canada. With lower rates having “done their job” we see the bank removing 2015’s rate cuts with increases in both July and October this year.



Consistent with the Fed’s cautious approach to shrinking their balance sheet, we think they will pause rate hikes in September to announce tapering. We look for a gradual tightening to resume in December.



Three of eight Bank of England voters in June were in favour of removing last year’s 25 basis point rate cut. But Governor Carney noted now is not the time to begin adjusting policy. We agree that rates should be on hold this year amid headwinds facing the sizeable consumer sector.



The European Central Bank is sounding more upbeat on the economy and is increasingly confident that inflation will eventually return to target. But with limited price pressure as yet, the bank remains committed to stimulating the economy.



Recent improvement in Australia’s labour market and an apparent end to the global easing cycle raise the bar for further RBA rate cuts. Domestic data will have to disappoint to see the central bank lower rates this year.



The Reserve Bank of New Zealand seemed comfortably in neutral in June. We don’t see monetary policy being adjusted over the forecast horizon as inflation returns only gradually to target.

Highlights

▲ Consumer spending growth moderated in Q1 but the slowdown wasn't nearly as significant as initially reported.

▲ The Fed's June rate hike was fully expected and changes to their economic projections were minor.

▲ With inflation slowing, doubt emerges whether the Fed is right to continue with rate hikes.

▲ We think limited slack in the economy will eventually feed through into rising prices, making further withdrawal of accommodation prudent.

Further evidence the US economy picked up in Q2

The US economy's slowdown to start 2017 was less dramatic than previously thought. Q1 GDP growth was revised up to 1.4% in the third estimate, twice the pace signaled in the first or advance report. Consumption growth in particular was stronger than initially estimated but still slowed relative to average gains of 3% over most of last year. We think consumer spending returned to that stronger pace in Q2 as households continue to reap the benefits of rising incomes. That should be supplemented by further gains in business capex. Durable goods shipments disappointed in May but rising equipment imports and stronger activity in the energy sector remain consistent with increasing non-residential investment. Solid contributions from the consumer and business sectors alongside a reversal of the previous quarter's inventory pullback are expected to boost GDP growth to 3.0% in Q2. We think above-trend growth will be sustained in the second half of the year, even with fiscal stimulus not providing the hoped-for lift to activity. Like the IMF, we now see little prospect of tax cuts and infrastructure spending boosting the US economy this year.

No surprise as the Fed raised rates in June...

The Fed raised rates for the third time in six months in June, lifting the range for the fed funds rate to 1.00-1.25%. The move was fully expected and the central bank made few waves with their policy statement and updated projections. There were further details on the Committee's plan to begin normalizing the balance sheet, a process they said is likely to start this year. The Fed is going to great lengths to prime markets for a change in their reinvestment policy, likely with 2013's 'taper tantrum' in mind. Their cautious approach is consistent with our view that the central bank will take a pass on raising rates in September when we expect the change in reinvestment policy will be announced. The pace of tapering they outlined is quite conservative, implying less upward pressure on term interest rates than previously expected. We now see the 10-year UST yield rising to 2.65% by the end of 2017 rather than 3%. The latter is just above this year's highs seen in March.

...but slowing inflation has markets doubting further hikes

Just hours ahead of the Fed announcing their latest move on rates, May's CPI report showed inflation falling short of expectations for a third consecutive month. Less upward pressure from energy prices left headline inflation below 2% for the first time in six months. Meanwhile, ex food and energy inflation dipped to a two-year low of 1.7%. Falling oil prices and disappointing inflation readings have contributed to market-based inflation expectations falling back to pre-election levels. The Fed's hike set against a softening inflation backdrop and slow growth to start the year has led some market observers to question whether the central bank will continue to raise rates. In our view, however, the Fed is right to continue gradually removing monetary policy accommodation. Keep in mind that inflation is just one half of the central bank's dual mandate. The other half, maximum employment, is by several measures already being achieved. The unemployment rate is now below the previous cycle's lows and a broader indicator of slack has declined sharply year-to-date. Wage growth, currently at 2.5%, hasn't picked up much this year but as we saw in the last cycle wages can rise fairly rapidly amid tight labour market conditions.

As for inflation, it often lags the cycle and even the latest readings show the Fed isn't far from its 2% objective. The recent downward trend is surprising, though as Chair Yellen emphasized in her press conference, one-off factors have been responsible for some of the slowing. And we are with the Chair in continuing to expect that limited economic slack will translate into upward pressure on prices. Given monetary policy's lagged impact on the economy, that argues for raising rates before inflation accelerates above 2%. It is also worth keeping in mind that policy remains quite stimulative—rate hikes to date have left the fed funds below its neutral level. We think the Fed's pause in September will give policymakers time to confirm that inflation is indeed moving higher. That would help convince markets that further removal of accommodation is indeed warranted.

Canada's economy keeps on rolling

Canadian GDP rose 0.2% in April to build on a 0.5% increase in March. There was further evidence of broadening growth across sectors with 14 of 20 industries posting an increase in the month and all but three seeing higher output relative to a year ago. The report also pointed to continued recovery in the energy sector, supporting the bank's contention that adjustment to lower oil prices is largely complete. Solid momentum to start the quarter supports our forecast for a 2.7% annualized gain in Q2 GDP. That would be consistent with the Bank of Canada's view that growth slowed relative to Q1's outsized 3.7% increase but remained above trend.

BoC survey shows rising business confidence

The Bank of Canada's latest Business Outlook Survey showed broad-based improvement in business sentiment in Q2. Expected future sales growth and hiring intentions both rose with the latter easily hitting a record high. Investment intentions dipped but from a very strong Q1 reading. And encouraging comments from the bank suggest that firms have "become more focused on expanding capacity to accommodate stronger demand." Consistent with the need to expand capacity, the share of businesses saying they would have difficulty meeting an unexpected increase in demand rose sharply as did the reported intensity of labour shortages. The survey will have increased the Bank of Canada's confidence that an upward trend in business investment can be sustained even as uncertainty around US trade policy clouds the outlook.

Bank of Canada's full court press points to July hike

Last month we discussed a subtle shift by the Bank of Canada that we thought might be the first step in policymakers adopting a tightening bias. The bank's change in tone since then has been much more dramatic than anticipated. Their rapid transition toward tightening began in earnest with Senior Deputy Governor Wilkins's speech on June 12. She once again emphasized that growth in the economy has broadened across sectors and regions and noted policymakers "will be assessing whether all of the considerable monetary policy stimulus presently in place is still required." Wilkins was dismissive of lower inflation readings, noting some transitory factors are weighing on prices and emphasizing that inflation lags the cycle, meaning recent slowing likely reflects earlier widening in economic slack. And while she continued to express concern about US trade policy, "life goes on" and the central bank has to make decisions in the meantime.

Wilkins's hawkish tone led markets to re-evaluate the timing of the bank's first rate hike. Investors jumped at the prospect of higher interest rates, putting upward pressure on the Canadian dollar. In subsequent interviews, Governor Poloz didn't push back against rising odds of a move this year. Rather, he doubled down on the hawkish rhetoric by noting that the bank's 'insurance' cuts have done their job and policymakers will need to consider raising rates now that excess capacity is being steadily eroded. We think the economic backdrop supports such a move. Strong growth over the last three quarters has absorbed a good deal of slack in the economy, and while more moderate gains are expected going forward, we see activity continuing at an above-trend pace. Business investment is increasing alongside improving sentiment and exporters appear to be taking the upcoming NAFTA renegotiation in stride.

We think financial stability concerns are also behind the bank's shift in tone. Following the latest Financial System Review, Governor Poloz noted that Canada's improving economic backdrop is reducing the conflict between needing accommodative monetary to support growth and not wanting to exacerbate imbalances. With macroeconomic and financial stability objectives now lining up, it appears the central bank wants to get started with a gradual tightening cycle rather than risk having to raise rates more rapidly when inflationary pressure begins to build. Our updated forecast now assumes the Bank of Canada will remove their 'insurance' cuts over the second half of this year, raising rates in both July and October. We then see a pause as the bank evaluates the impact of that tightening before restarting the process to gradually remove accommodation in 2018. Less monetary policy divergence relative to the US will support the Canadian dollar. We think CAD will strengthen further over the second half of this year, rising as high as 79 US cents as the Bank of Canada moves on rates.

▲ A decent start to the quarter is consistent with Canada's economy growing at a 2.7% annualized pace in Q2.

▲ The BoC's survey of businesses showed strong hiring and investment intentions.

▲ The Bank of Canada took a hawkish turn in June, signaling rate hikes might begin as soon as July.

▲ We now expect the BoC will reverse the 50 basis points of 'insurance' cuts over the second half of this year.

Highlights

▲ The Bank of England's latest meeting ended with a narrow 5-3 decision not to raise rates.

▲ ECB President Draghi's upbeat comments on the economy were seen as hawkish but we think the bank will continue easing into next year via asset purchases

▲ Australia's strong job growth indicates the economy isn't as weak as growth over the first half of the year implies.

▲ The RBNZ's tone was little changed in June as the central bank appears to be happy with its current stance.

Bank of England divided on stimulus removal

UK survey data generally improved in April and May. Manufacturing sentiment strengthened while services activity saw more modest gains, consistent with headwinds facing consumer-oriented sectors. On balance, we expect GDP growth picked up to 0.4% in Q2 from 0.2% in Q1, although that would remain below the trend seen in recent years. We think softer conditions, particularly negative income growth that will weigh on household spending, argue for the Bank of England to keep monetary policy stimulative. That stance is becoming increasingly difficult, however, with inflation rising even more rapidly than expected to 2.9% in May. The unemployment rate is also at historic lows. With limited economic slack and rising inflation being balanced against Brexit-related headwinds, some BoE policymakers now see less need for stimulus. The central bank's latest rate decision unexpectedly showed three of eight members voting for a hike. Governor Carney tried to distance himself from those hawkish members, noting that now is not the time to begin adjusting policy given mixed signals on spending and investment. But in a subsequent appearance, Carney didn't completely rule out reversing last year's rate cut. Our forecast assumes the central bank will hold policy steady this year as growth shifts to a slower pace. But given upward pressure on inflation from exchange rate pass-through and some policymakers' discomfort with higher readings, we might continue to see dissent against a steady rate verdict.

ECB sounding more optimistic but still far from tightening

The euro area's economic recovery picked up steam in Q1 as growth spread across the currency bloc. Survey data point to broadly-based improvement continuing and we look for a 0.4% increase in Q2 GDP. With less political uncertainty following several pro-EU election results, particularly in France, we think stronger business investment will help sustain that above-trend pace over the second half of the year. The European Central Bank is sounding increasingly confident in the economic outlook. In recent comments, ECB President Draghi seemed more convinced that inflation will eventually return to target. However, we think markets went too far in interpreting his remarks as hawkish. The ECB remains committed to keeping monetary policy highly stimulative until there is evidence of self-sustaining inflation. Despite an improving growth backdrop, there is no sign of that yet—core inflation remains close to 1%, as it has over the last three years, thanks to significant excess capacity. As such, we continue to expect the central bank will add further stimulus with asset purchases being extended into next year. We think an exit from negative policy rates will be held off until after the ECB's bond-buying tapers off.

Will the RBA swim against the global tide?

Australia's economy got off to a slow start this year with GDP growth slipping to just 0.3% in Q1. The impact of Cyclone Debbie ruled out a quick rebound and we think activity was close to flat in Q2. The pace of increase over the first half of the year isn't reflective of the economy's underlying growth pulse. Indeed, the labour market has performed well over that stretch with solid gains in full-time employment helping push the unemployment rate down to a four-year low in May. Underutilization remains elevated, however, leaving both wages and unit labour costs subdued. The recent data should bolster the Reserve Bank of Australia's confidence in the labour market, which has been the focus of policymakers' more dovish comments recently. But we think that it will be soft wage and inflation dynamics that impact monetary policy more significantly. Until there is evidence that reduced slack is feeding through to rising inflation, we see risk that the RBA lowers the cash rate in the face of a soft domestic backdrop.

RBNZ remains firmly in neutral

The Reserve Bank of New Zealand held monetary policy steady as expected just a month after refreshing their economic forecasts. The statement continued to note a positive growth outlook despite a softer-than-expected Q1 GDP figure. Rhetoric on inflation was unchanged with gradual increases in wages and non-tradable goods prices expected to return the headline rate to target over the medium term. Even the central bank's comments on the currency lacked their usual strength. The RBNZ once again concluded that "numerous uncertainties remain and policy may need to adjust accordingly." But we see their comfort with the current policy stance as consistent with a central bank that will be on hold through next year.

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	0.75	1.00	1.00	1.00	1.25	1.50
Three-month	0.45	0.48	0.53	0.46	0.52	0.65	0.85	1.10	1.10	1.15	1.35	1.60
Two-year	0.54	0.52	0.52	0.80	0.75	1.08	1.20	1.40	1.50	1.60	1.85	2.10
Five-year	0.67	0.57	0.62	1.15	1.12	1.35	1.50	1.75	1.90	2.05	2.25	2.45
10-year	1.23	1.06	1.00	1.80	1.62	1.71	1.85	2.05	2.25	2.45	2.65	2.85
30-year	2.00	1.72	1.66	2.35	2.30	2.12	2.25	2.45	2.70	3.00	3.15	3.25
United States												
Fed funds**	0.50	0.50	0.50	0.75	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50
Three-month	0.21	0.26	0.29	0.51	0.76	1.04	1.05	1.30	1.55	1.80	2.05	2.30
Two-year	0.73	0.58	0.77	1.25	1.27	1.38	1.60	1.85	2.05	2.35	2.55	2.70
Five-year	1.21	1.01	1.14	2.00	1.93	1.85	2.05	2.25	2.45	2.65	2.85	3.00
10-year	1.78	1.49	1.60	2.55	2.40	2.27	2.45	2.65	2.85	3.00	3.20	3.40
30-year	2.61	2.30	2.32	3.15	3.02	2.82	2.95	3.15	3.30	3.45	3.60	3.75
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	0.12	0.36	0.20	0.15	0.05	0.10	0.15	0.15
10-year	1.43	0.89	0.76	1.24	1.14	1.25	1.50	1.60	1.70	1.85	1.95	2.00
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	-0.74	-0.58	-0.55	-0.50	-0.50	-0.50	-0.50	-0.50
10-year	0.15	-0.11	-0.12	0.21	0.33	0.44	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	1.50	1.50	1.25	1.25	1.25	1.50	1.50
Two-year	1.89	1.59	1.55	1.86	1.76	1.73	1.60	1.50	1.50	1.75	1.75	2.00
10-year	2.49	1.98	1.91	2.76	2.70	2.51	2.65	2.75	2.95	3.20	3.40	3.70
New Zealand												
Cash target rate	2.25	2.25	2.00	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75
Two-year swap	2.19	2.22	1.96	2.50	2.31	2.27	2.20	2.20	2.30	2.30	2.30	2.40
10-year swap	2.97	2.65	2.41	3.58	3.41	3.21	3.55	3.75	3.95	4.20	4.30	4.50
Yield curve*												
Canada	69	54	48	100	87	63	65	65	75	85	80	75
United States	105	91	83	130	113	89	85	80	80	65	65	70
United Kingdom	98	76	63	116	102	89	130	145	165	175	180	185
Eurozone	63	50	57	99	107	102	105	110	115	115	120	125
Australia	60	39	36	90	94	78	105	125	145	145	165	170
New Zealand	78	43	45	108	110	94	135	155	165	190	200	210

* Two-year/10-year spread in basis points, **Top of 25 basis point range, ***Rates as of June 29, 2017

Source: Reuters, RBC Economics Research

Central bank policy rate

%, end of period

		Current	Last				Current	Last	
United States	Fed funds	1.00-1.25	0.75-1.00	June 15, 2017	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>2016</u>	<u>2017F</u>	<u>2018F</u>
Canada*	2.8	-1.4	4.2	2.7	3.7	2.7	2.1	2.0	2.1	1.9	1.7	1.7	0.9	1.5	2.7	2.0
United States*	0.8	1.4	3.5	2.1	1.4	3.0	2.5	2.4	2.4	2.3	2.0	2.0	2.6	1.6	2.3	2.3
United Kingdom	0.2	0.6	0.5	0.7	0.2	0.4	0.2	0.2	0.4	0.5	0.5	0.5	2.2	1.8	1.6	1.6
Euro area	0.5	0.3	0.4	0.5	0.6	0.6	0.4	0.4	0.4	0.4	0.4	0.4	1.9	1.7	2.0	1.7
Australia	0.9	0.7	-0.4	1.1	0.3	0.1	1.1	0.8	0.8	0.6	0.6	0.6	2.4	2.5	1.9	2.9
New Zealand	0.7	0.8	0.8	0.4	0.5	0.8	0.8	0.6	0.6	0.6	0.6	0.6	2.5	3.1	2.6	2.6

*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>2016</u>	<u>2017F</u>	<u>2018F</u>
Canada	1.5	1.6	1.2	1.4	1.9	1.4	1.7	1.7	1.5	2.3	2.3	2.5	1.1	1.4	1.7	2.2
United States	1.1	1.0	1.1	1.8	2.5	1.9	2.1	2.0	1.8	2.4	2.2	2.1	0.1	1.3	2.1	2.1
United Kingdom	0.3	0.4	0.7	1.2	2.1	2.7	2.9	3.0	2.8	2.7	2.6	2.5	0.0	0.7	2.7	2.6
Euro area	0.0	-0.1	0.3	0.7	1.8	1.6	1.6	1.5	1.4	1.3	1.3	1.3	0.0	0.2	1.6	1.3
Australia	1.3	1.0	1.3	1.5	2.1	2.3	2.4	2.6	2.7	2.7	2.4	2.3	1.5	1.3	2.3	2.5
New Zealand	0.4	0.4	0.4	1.3	2.2	2.3	2.3	2.3	1.7	1.7	1.8	1.8	0.3	0.6	2.3	1.8

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	CPI ex food & energy ¹	May	0.1	1.4	0.6	1.6
United States	Core PCE ^{1,2}	May	0.1	1.4	0.8	1.5
United Kingdom	All-items CPI	May	0.4	2.9	4.4	2.8
Euro area	All-items CPI ¹	May	-0.1	1.4	0.8	1.9
Australia	Trimmed mean CPI ¹	Q1	0.5	1.9	N/A	N/A
New Zealand	All-items CPI	Q1	1.0	2.2	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	1.33	1.30	1.27	1.30	1.31	1.32	1.35	1.33
Euro	1.14	1.11	1.12	1.05	1.07	1.14	1.10	1.07	1.05	1.06	1.08	1.12
U.K. pound sterling	1.44	1.33	1.30	1.24	1.26	1.30	1.24	1.15	1.17	1.22	1.26	1.32
New Zealand dollar	0.69	0.71	0.73	0.69	0.70	0.73	0.73	0.72	0.71	0.70	0.69	0.69
Japanese yen	112.6	103.2	101.3	117.0	111.4	112.0	107.0	103.0	100.0	102.0	104.0	106.0
Australian dollar	0.77	0.75	0.77	0.72	0.76	0.77	0.77	0.76	0.75	0.74	0.73	0.73

Canadian dollar cross-rates

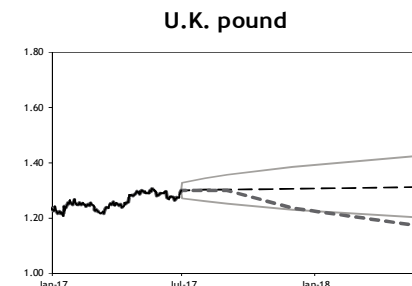
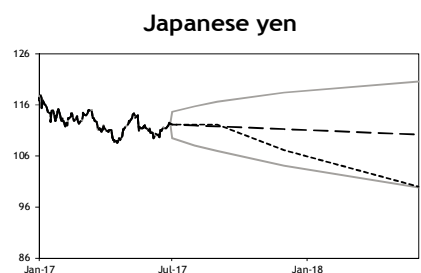
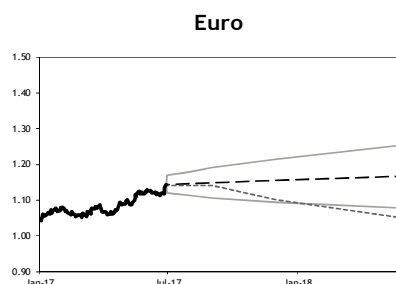
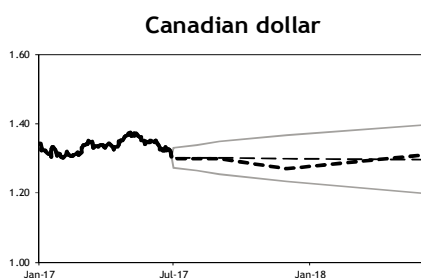
	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
EUR/CAD	1.48	1.43	1.48	1.41	1.42	1.48	1.40	1.39	1.42	1.40	1.46	1.49
GBP/CAD	1.87	1.72	1.70	1.66	1.67	1.68	1.57	1.50	1.53	1.61	1.70	1.75
NZD/CAD	0.90	0.92	0.96	0.93	0.93	0.95	0.93	0.94	0.93	0.92	0.93	0.92
CAD/JPY	86.6	79.9	77.2	87.0	83.7	86.3	84.3	79.2	76.3	77.3	77.0	79.7
AUD/CAD	1.00	0.96	1.01	0.97	1.02	1.00	0.98	0.99	0.98	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

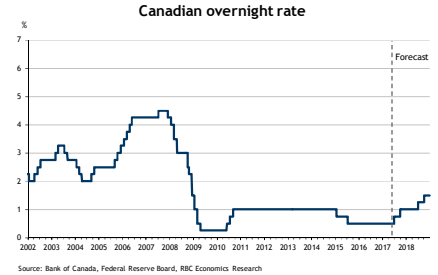
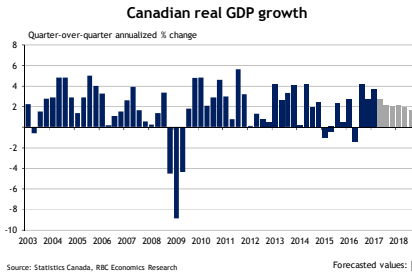
The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.



Bank of Canada

A 0.2% increase in April GDP following a 0.5% gain in March points to above-trend growth continuing in Q2. With broadly-based growth including recovery in the energy sector, the Bank of Canada seems ready to remove some accommodation.

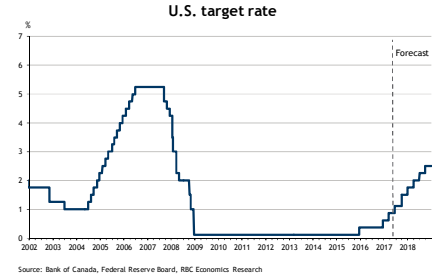
Senior members of the BoC's Governing Council have been out in force with hawkish rhetoric. Their shift in tone has us expecting two rate hikes over the second half of the year, reversing 2015's cuts.



Federal Reserve

Indications of a rebound in Q2 GDP growth—we are monitoring a 3% gain—and further tightening in the labour market prompted another rate hike from the Fed in June.

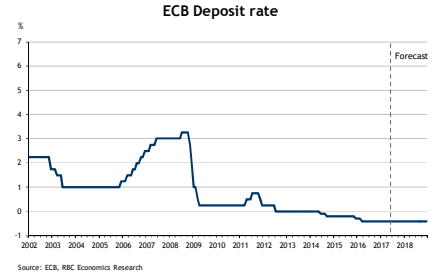
The Fed revealed further details of their plan to begin gradually shrinking the balance sheet. We think they will pause rate hikes in September when the start to tapering will be announced. Look for rate hikes to resume in December.



European Central Bank

We think the euro area's broadly-based growth continued in Q2 with GDP rising 0.4%. But with excess capacity only being absorbed gradually, inflationary pressure remains muted.

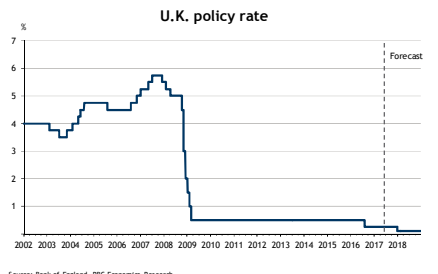
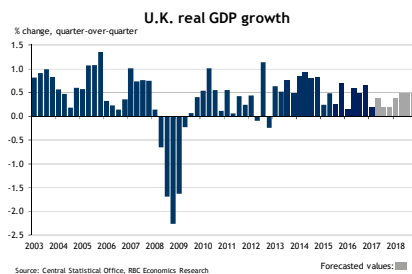
The ECB's more confident tone has markets eyeing an exit from highly accommodative monetary policy. However, the ECB is committed to providing stimulus until inflation picks up, meaning high rates are beyond our forecast horizon.



Bank of England

Some improvement in survey data points to UK GDP growth picking up to 0.4% in Q2 although that would remain below recent years' trend.

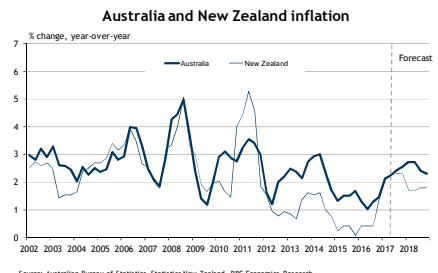
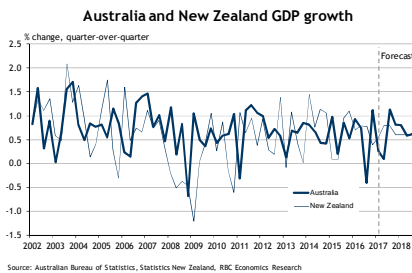
The Bank of England is divided on whether last year's rate cut, made in the wake of the Brexit vote, is still needed to boost the economy. We think slower consumer spending argues for maintaining accommodation and expect rates will remain on hold over the second half of the year.



Australia and New Zealand

Australia's slow GDP growth over the first half of 2017 partly reflects transitory factors and is in contrast with an improving labour market. Domestic conditions remain soft though and inflation is muted, keeping a rate cut from the RBA on the table.

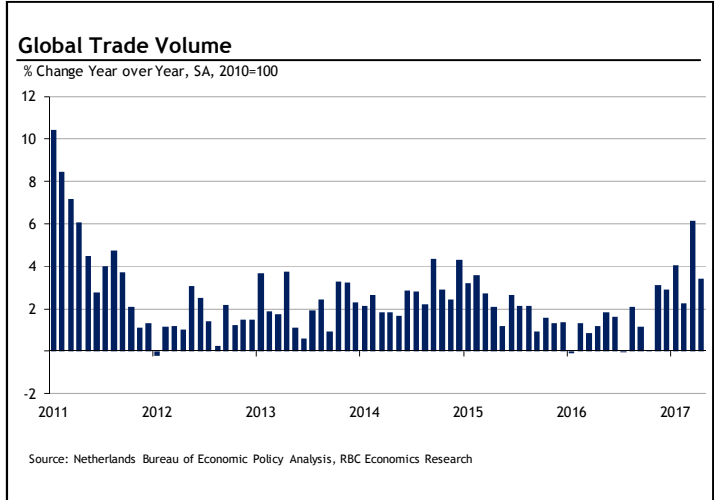
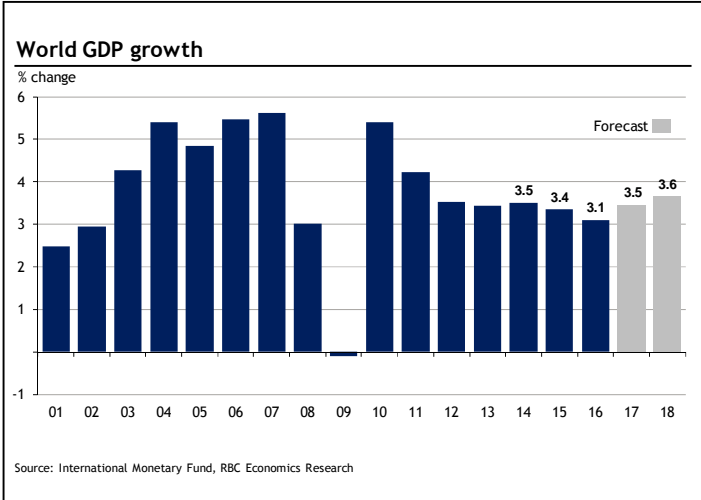
The Reserve Bank of New Zealand remains confident that a solid growth outlook will help inflation return sustainably to target over the medium term. We continue to expect the central bank will be on hold through the end of 2018.



Markets see less need for monetary policy stimulus amid stronger global activity

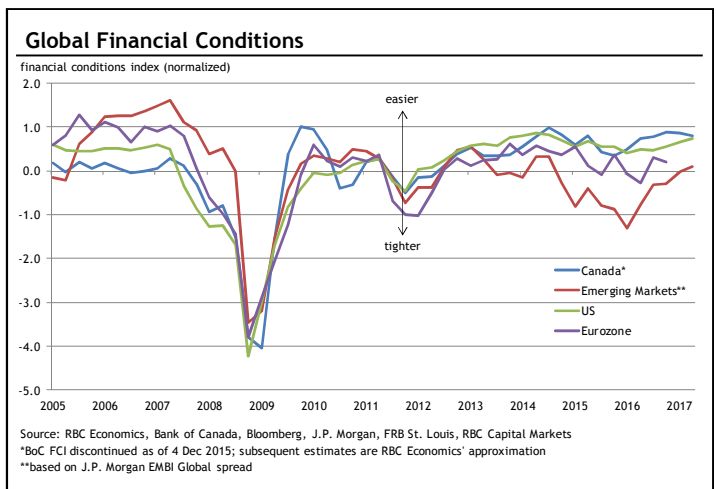
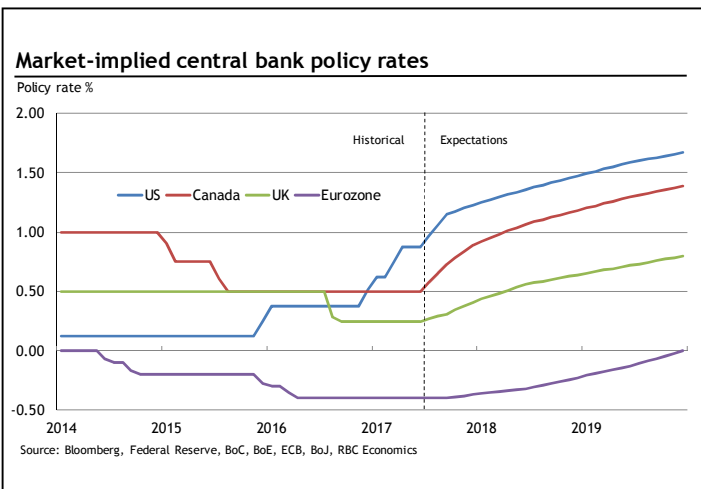
Improvement across a number of economies over the first half of 2017 supports expectations that global growth will pick up to 3.5% this year following a disappointing 3.1% increase in 2016.

Even global trade flows, which have disappointed in recent years, are picking up in 2017. That should help boost export activity in trade-intensive economies like Canada.



Given strengthening economic activity, markets are beginning to eye an exit from the highly accommodative monetary policy of recent years. The Fed and BoC in particular are seen raising rates in the second half of 2017.

Tighter monetary policy in Canada and the US follows years of easing financial conditions. Global financial conditions will remain accommodative even as rates rise gradually.



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