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Sticking to the script

Lack of inflation remains a central theme even as activity continues to pick up in a number of advanced economies. Canada is enjoying one of the strongest periods of growth in years, yet most measures of underlying inflation have done nothing but decline in 2017. The euro area's recovery is gaining momentum but core price growth remains stuck in the same range we've seen for three years, well below the European Central Bank's target. Even as the US economy closes in on full employment there is little evidence of price pressure with ex food and energy inflation at or below 2%. Headline inflation rates are also coming off recent highs as the boost from rising energy prices begins to fade. WTI is struggling to breach \$50 per barrel despite OPEC extending output cuts for another nine months. Oil prices are now below year-ago levels. At the same time, concerns that stimulative fiscal policy will boost US inflation continue to fade as the Trump administration fails to gain traction with policy proposals.

Subdued inflation has allowed central banks to stick to their scripts. The Fed continues to tighten monetary policy only gradually despite unemployment now sitting below longer run levels. The Bank of Canada is sounding more confident about the economic backdrop but doesn't look set to begin removing accommodation in the near-term. And while the European Central Bank is no longer flagging the potential for lower rates, their forward guidance still points to asset purchases and negative interest rates extending into next year. With central banks in no rush to remove accommodation and inflation expectations reversing course somewhat, yields on government bonds continued to slip from highs seen earlier this year. Meanwhile, ample liquidity and improving corporate earnings are boosting equity markets to fresh highs.

Central bank near-term bias

Three-months out, policy rate



The Bank of Canada's latest policy statement balanced risks to the outlook with encouraging economic data. If the data hold up we look for the central bank to shift toward a tightening bias ahead of rate hikes expected in the first half of next year.



Inflation remains well-behaved but labour market conditions continue to tighten rapidly. On balance, that argues for gradual withdrawal of stimulus to continue. Expect the Fed to raise rates again in June.



The Bank of England is likely to remain in neutral this year as they evaluate the tradeoff between above-target inflation and sub-trend growth. We continue to see potential for further easing next year as a widening output gap limits inflation prospects over the medium term.



The European Central Bank tweaked its policy guidance in June, no longer flagging risk of further rate cuts. However, key commitments to stick with asset purchases and a negative rate policy point to stimulus continuing to flow into next year.



With Australia's economy losing momentum early this year, the central bank is starting to sound less optimistic on the domestic outlook. We continue to expect disappointing growth will result in a Q4 rate cut.



Markets are pricing in odds of a rate hike next year. However, with the Reserve Bank of New Zealand looking through a recent jump in inflation, we expect monetary policy will be on hold through 2018.

Highlights

▲ A rebound in consumer spending is expected to lift US GDP growth to 3% in Q2.

▲ Slower employment growth reflects limited labour market slack, not softer economic conditions.

▲ An ultra-low 4.3% unemployment rate should keep the Fed in tightening mode in June.

▲ We think the Fed will start shrinking their balance sheet in September.

US second quarter rebound taking shape

US first quarter GDP growth was revised slightly higher to a 1.2% annualized pace from 0.7% in the advance reading. Consumer spending was stronger than previously estimated but still recorded the weakest quarterly increase in years. We remain of the view that the slowdown reflects transitory factors. Data for the second quarter to date point to consumer spending growth rebounding to 3%. That would be more consistent with a solid backdrop for households: aggregate payrolls are up more than 4% from last year and confidence readings are the highest in 15 years. Even with growth in residential and business investment expected to slow relative to Q1's double-digit gains, a rebound in consumer outlays should boost domestic spending in the second quarter. And with the previous quarter's percentage point drag from inventories not likely to be repeated, we think overall GDP growth will pick up to 3% in Q2. That would complete a familiar pattern of softer Q1 output followed by a rebound in activity, which may reflect so-called residual seasonality.

Disappointing payrolls? Think again

US employment growth fell short of expectations with 138k jobs added in May. Downward revisions to prior months added to the disappointment and yields on 10-year US Treasuries fell to multi-month lows following the release. Payroll gains have exceeded 200k in just two of the past eight months and average growth of 121k in the three months to May is the slowest since 2012. We think a closer look at the jobs data, however, shows market disappointment is misplaced. Even with recent slowing, employment growth remains above the historically modest pace of labour force growth. New entrants are easily being absorbed into the employment pool, pushing the unemployment rate down to a cycle low of 4.3% in May. Broader measures of slack have declined even more significantly in recent months, indicating the lower unemployment rate isn't due to discouraged workers giving up on their job search.

We think slower payroll gains reflect the economy reaching full employment rather than a weakening economic backdrop—and markets will have to adjust their expectations. Our forecast assumes average job growth of less than 150k per month over the second half of this year will be enough to hold the unemployment rate at decade-lows. Those tight labour market conditions should keep upward pressure on wages, softening the downward impact on aggregate incomes as employment growth moderates.

Slower job growth won't derail Fed tightening

Despite shortfalls in the latest employment and inflation readings, markets continue to attach nearly 90% odds to a Fed rate hike in June. We think that interpretation is correct and expect official rates will be raised for the third time in six months at the upcoming meeting. Minutes of the Fed's May confab indicated most participants thought another rate increase would "soon be appropriate" but wanted further evidence that slow growth at the start of the year was just a blip. Recent data releases have reinforced our expectation for a rebound, and the Atlanta Fed's 'nowcast' similarly sees GDP growth picking up above 3% in Q2. With activity returning to an above-trend pace and the unemployment rate well below their longer run estimate, we expect the Fed will take the long view on inflation. That is, notwithstanding a recent dip in core inflation readings, policymakers are likely to continue with a gradual tightening cycle rather than risk falling behind the curve when limited slack does put more upward pressure on prices.

Minutes of the latest meeting also revealed a bit more detail on plans to begin shrinking the Fed's balance sheet. The Committee's favoured approach is to gradually increase the dollar amount of securities that are allowed to run off in a given month, thus slowly phasing out reinvestment until the balance sheet is normalized. This predictable approach should help markets adjust to less buying from the Fed. However, we continue to expect the central bank will pause its tightening cycle when the change in reinvestment policy is officially announced—September in our view—in order to gauge market reaction. We expect the cumulative impact of two more rate hikes this year and the Fed beginning to phase out reinvestment will put upward pressure on government yields, with the 10-year Treasury ending 2017 around 3%.

Canada's Q1 GDP confirms a strong start the year...

Canada's Q1 GDP report confirmed a strong start to the year with output rising an annualized 3.7%. The gain reflected a broadly-based increase in domestic spending, which rose at its fastest pace in seven years. Consumer spending accelerated as aggregate incomes rose on the back of strong job growth and households spent a larger share of their paycheques. Both residential and nonresidential investment recorded double-digit increases, combining for one of the best gains since the recession. The only source of disappointment in Q1 was little change in export activity, which essentially flat-lined since mid-2015. April's international trade report provided some early evidence that export growth is picking up in the second quarter, although the increase was once again driven by rising energy shipments. Non-energy export volumes were flat on the month and remained below year-ago levels. There is hope, however, for a positive trend to emerge: world trade growth has picked up this year and the US industrial sector is gaining momentum. Weakness in both of those drivers of trade was likely a factor keeping Canada's economy from fully enjoying the benefits of a weaker currency last year.

...with good momentum heading into Q2...

We don't think Canada's recent pace of GDP growth—average annualized gains of 3.5% over the last three quarters—can be sustained. In particular, double-digit increases in both residential and nonresidential investment in the first quarter look unlikely to persist. We see the former switching to a drag on growth as tighter housing regulations weigh on both construction and resales. Meanwhile, business investment is expected to continue to strengthen, albeit at a more moderate pace. Even with less support from private investment, however, we think Canada's economy will continue to run at an above-trend pace over the remainder of the year. Activity has hit some speed bumps in the current quarter—a production outage at an oil sands facility and a construction strike in Quebec are expected to shave half a percentage point off growth in Q2. Nonetheless, a 0.5% increase in March GDP shows the economy had solid momentum heading into the quarter. Even accounting for transitory headwinds, we have revised up our Q2 forecast to 2% from 1.5% previously.

...prompting a subtle shift from the Bank of Canada

The Bank of Canada left rates unchanged in May and kept their statement fairly brief, as has been the case at meetings between the quarterly Monetary Policy Reports. Even so, there were a few changes in language that suggested policymakers are becoming less firm in their neutral policy bias. The bank sounded more optimistic on the economic outlook, noting signs of improving global growth and a rebound in the US economy following a slow start to the year. Importantly, Canada's adjustment to lower oil prices is seen as "largely complete" and household-driven growth has become more broadly based. Some of the recent dip in inflation was attributed to transitory factors, although the statement continued to note that subdued underlying inflation and wage growth are signaling slack in the economy. However, the bank no longer described that slack as "material", consistent with indications that excess capacity is gradually being absorbed. Their latest projections had the economy reaching full capacity by this time next year, and we think growth is on track to meet that forecast.

There was also a subtle shift at the end of the statement as the bank noted current monetary policy stimulus is appropriate "at present". That seems to suggest policymakers might begin contemplating a withdrawal of stimulus if the data holds up. The central bank remains attuned to risks emanating from the US, including pending NAFTA renegotiations that could weigh on exports and business investment. However, a recent pickup in both energy and non-energy business investment as well as strengthening in some of the drivers of export activity should support an improving trend in both sectors. We agree that US protectionism presents a significant risk to the outlook, but given the lengthy process of trade negotiations, policy uncertainty could linger for some time. Keeping interest rates at ultra-low levels over that period risks overheating the economy. As such, we expect the central bank will soon be dropping hints that tighter monetary policy is not far off. Our forecast remains for a hike in the first half of 2018, while markets are pricing in close to 1/3 odds that tightening starts later this year.

▲ Canada's economy has grown at an annualized 3.5% pace over the last three quarters, the strongest run since 2011.

▲ We expect above-trend growth will continue with a 2% gain in Q2, even accounting for transitory headwinds.

▲ The Bank of Canada says the economy's adjustment to lower oil price is "largely complete".

▲ We think the central bank might begin contemplating higher rates if the data holds up.

Highlights

▲ UK growth has slowed in 2017 as rising inflation leaves consumers with declining real wages.

▲ The euro area's economic recovery is gaining momentum as laggards France and Italy are seeing activity pick up.

▲ Australia's economy is growing at its slowest year-over-year rate in nearly a decade.

▲ New Zealand's central bank doesn't see the recent jump in inflation lasting beyond this year.

UK growth shifting into a lower gear...

The UK economy saw an even more pronounced slowdown in Q1 than previously estimated with GDP growth revised down to 0.2% from the earlier-reported 0.3% non-annualized increase. The slow start to 2017 reflected the smallest contribution from consumer spending in more than two years as household incomes were squeezed by rising inflation and slowing wage growth. That combination is set to remain a headwind in the coming quarters. However, even with consumer-facing services industries seeing softer activity, purchasing managers' index readings for the economy as a whole improved on balance in April and May. We see growth picking up slightly to 0.4% in Q2, although that would still be a sub-trend pace consistent with increasing slack in the economy. We think softer conditions argue for the Bank of England to hold monetary policy steady amid above-target inflation. Headline inflation rose to 2.7% in May and is expected to remain close to 3% over the second half of the year. Over the medium term, however, the central bank sees inflation moderating to just above 2%. And their forecast relies on a smooth Brexit process, an assumption we think is a bit optimistic particularly with political uncertainty rising in the wake of June's general election. We look for the balance of above-target inflation and slowing growth to shift in favour of the latter, leading to further easing from the central bank early next year.

...as the euro area continued to build momentum in Q2

Euro area GDP growth picked up to 0.6% in Q1, marking the second largest gain in the ongoing recovery. The increase was once again broadly based with decent contributions from the currency bloc's four largest economies although Germany and Spain remained standouts. Recent purchasing managers' index data point to the recovery continuing to gain momentum in Q2. We look for another 0.6% increase in current quarter GDP with France and Italy expected to pick up the pace. The former should benefit from reduced political uncertainty following centrist Emmanuel Macron's victory in the presidential election. The result is also important for the European Union as a whole, with another victory for a pro-Europe candidate reducing the tail risk of EU disintegration and paving the way for increased cooperation among members. That is expected to bolster consumer and business sentiment and help strengthen the euro area's resurgence. The currency bloc will also continue to be supported by accommodative monetary policy. The European Central Bank softened its easing bias somewhat in June, no longer indicating that interest rates might be lowered further. However, the central bank's forward guidance continued to reinforce our expectation that asset purchases and negative interest rates will continue into next year.

Australia's economy softened further in Q1

Australia's economy continued to grow at a sub-trend pace to start the year. The first quarter's 0.3% increase left GDP up just 1.7% from a year ago, the weakest pace since 2009. Inventories provided a boost in the quarter, while domestic spending was led by consumers who spent more of their take-home pay, pushing the savings rate to a multi-year low. Residential investment declined in a sign of things to come as the housing upswing seen over the last three years is coming to an end. A stretched savings rate and residential slowdown highlight headwinds facing the household sector, which has been a strong contributor to economic activity in recent years. On balance, we expect output growth will struggle at a sub-trend pace and fall short of the Reserve Bank of Australia's GDP projections this year. Indeed, the central bank sounded less optimistic on the domestic outlook in their latest policy statement. We continue to expect a disappointing economic backdrop will prompt one more rate cut from policymakers later this year.

RBNZ on hold for the foreseeable future

The Reserve Bank of New Zealand made only minor changes to their economic projections in May, taking into account softer-than-expected GDP over the second half of 2016 and an unexpected jump in inflation to start this year. Output growth is forecast to be slightly stronger into 2018 to make up for last year's shortfall. Meanwhile, the recent jump in inflation was attributed to a transitory rise in the price of traded goods and is expected to wash out by this time next year. Inflation is only seen returning to 2% on a sustained basis in 2019. On balance, developments since the previous forecast were "considered to be neutral for the stance of monetary policy". The RBNZ continues to project the cash rate will be on hold through mid-2019. Markets are still pricing in odds that rates will rise next year, but it looks like the central bank will be more cautious in withdrawing accommodation. Our forecast assumes a steady cash rate through 2018.

Interest rate outlook

%, end of period

	<u>Actuals</u>					<u>Forecast</u>						
	<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	0.52	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	0.75	0.90	1.05	1.20	1.40	1.60	1.80
Five-year	0.67	0.57	0.62	1.15	1.12	1.05	1.35	1.65	1.95	2.25	2.45	2.60
10-year	1.23	1.06	1.00	1.80	1.62	1.55	1.90	2.25	2.55	2.80	2.95	3.10
30-year	2.00	1.72	1.66	2.35	2.30	2.15	2.45	2.80	3.00	3.20	3.30	3.45
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	1.00	1.05	1.30	1.55	1.80	2.05	2.30
Two-year	0.73	0.58	0.77	1.25	1.27	1.40	1.60	1.90	2.15	2.40	2.60	2.80
Five-year	1.21	1.01	1.14	2.00	1.93	1.85	2.15	2.50	2.65	2.90	3.05	3.20
10-year	1.78	1.49	1.60	2.55	2.40	2.30	2.65	3.00	3.15	3.40	3.50	3.60
30-year	2.61	2.30	2.32	3.15	3.02	2.95	3.20	3.50	3.60	3.75	3.80	3.90
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	0.15	0.20	0.15	0.05	0.10	0.15	0.15
10-year	1.43	0.89	0.76	1.24	1.14	1.35	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	-0.65	-0.55	-0.50	-0.50	-0.50	-0.50	-0.50
10-year	0.15	-0.11	-0.12	0.21	0.33	0.35	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	1.50	1.50	1.25	1.25	1.25	1.50	1.50
Two-year	1.89	1.59	1.55	1.86	1.76	1.70	1.60	1.50	1.50	1.75	1.75	2.00
10-year	2.49	1.98	1.91	2.76	2.70	2.50	2.85	3.10	3.25	3.60	3.70	3.90
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	2.20	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	3.30	3.75	4.10	4.25	4.60	4.60	4.70
Yield curve*												
Canada	69	54	48	100	87	80	100	120	135	140	135	130
United States	105	91	83	130	113	90	105	110	100	100	90	80
United Kingdom	98	76	63	116	102	120	130	145	165	175	180	185
Eurozone	63	50	57	99	107	100	105	110	115	115	120	125
Australia	60	39	36	90	94	80	125	160	175	185	195	190
New Zealand	78	43	45	108	110	110	155	190	195	230	230	230

* 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	0.75-1.00	0.50-0.75	March 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	2.0	2.1	2.0	2.1	2.2	1.9	1.7	0.9	1.5	2.6	2.1
United States*	0.8	1.4	3.5	2.1	1.2	3.0	2.5	2.4	2.4	2.3	2.0	2.0	2.6	1.6	2.2	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	0.7	0.8	0.8	0.6	0.6	0.6	0.6	0.6	2.5	3.1	2.8	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	1.6	2.2	2.3	2.1	2.5	2.2	2.1	1.1	1.4	2.0	2.2
United States	1.1	1.0	1.1	1.8	2.5	2.3	2.5	2.3	2.0	2.3	2.2	2.2	0.1	1.3	2.4	2.2
United Kingdom	0.3	0.4	0.7	1.2	2.1	2.7	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	2.2	2.4	2.5	2.5	2.4	2.3	1.5	1.3	2.2	2.4
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	Core CPI (CPIX) ¹	Apr	0.0	1.3	2.0	1.1
United States	Core PCE ^{1,2}	Apr	0.2	1.5	1.6	1.6
United Kingdom	All-items CPI	Apr	0.4	2.7	3.7	2.5
Euro area	All-items CPI ¹	May	-0.1	1.4	0.7	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	1.38	1.39	1.40	1.38	1.36	1.35	1.33
Euro	1.14	1.11	1.12	1.05	1.07	1.08	1.06	1.04	1.02	1.06	1.08	1.12
U.K. pound sterling	1.44	1.33	1.30	1.24	1.26	1.24	1.19	1.15	1.16	1.22	1.26	1.32
New Zealand dollar	0.69	0.71	0.73	0.69	0.70	0.72	0.73	0.74	0.74	0.74	0.75	0.75
Japanese yen	112.6	103.2	101.3	117.0	111.4	110.0	107.0	103.0	100.0	102.0	104.0	106.0
Australian dollar	0.77	0.75	0.77	0.72	0.76	0.75	0.73	0.72	0.72	0.72	0.73	0.73

Canadian dollar cross-rates

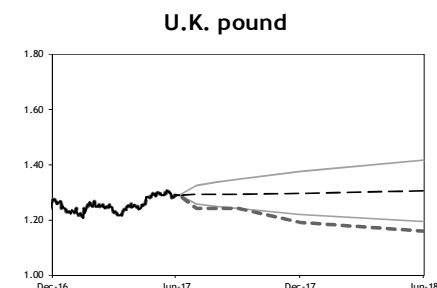
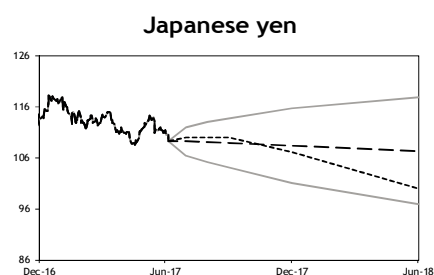
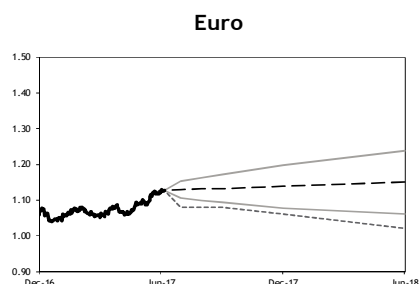
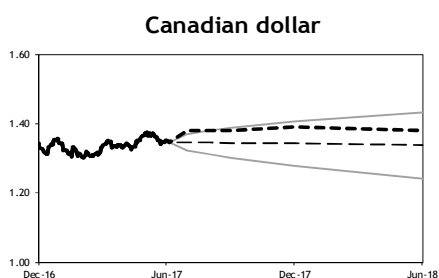
	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
EUR/CAD	1.48	1.43	1.48	1.41	1.42	1.49	1.47	1.46	1.42	1.44	1.46	1.49
GBP/CAD	1.87	1.72	1.70	1.66	1.67	1.71	1.66	1.61	1.60	1.66	1.70	1.75
NZD/CAD	0.90	0.92	0.96	0.93	0.93	0.99	1.01	1.04	1.02	1.01	1.01	1.00
CAD/JPY	86.6	79.9	77.2	87.0	83.7	79.7	77.0	73.6	72.5	75.0	77.0	79.7
AUD/CAD	1.00	0.96	1.01	0.97	1.02	1.04	1.01	1.01	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

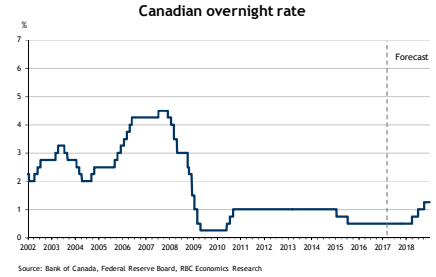
The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.



Bank of Canada

A 3.7% increase in Q1 GDP nearly matched the Bank of Canada's forecast. Absent transitory factors, growth would be on track for their 2.5% Q2 projection.

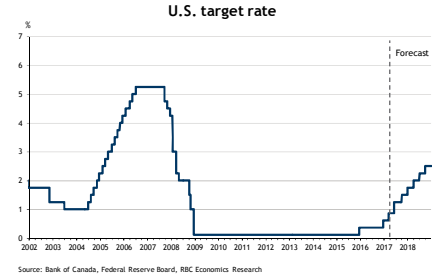
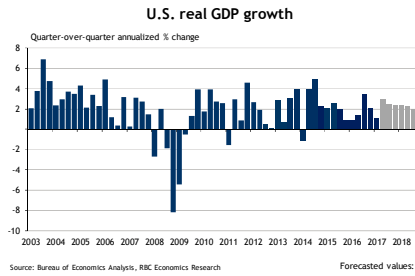
The central bank sees Canada's adjustment to lower oil prices as "largely complete". With their 'insurance' rate cuts no longer necessary, we expect the BoC to start setting the stage for an eventual exit from ultra-low interest rates.



Federal Reserve

The Fed is looking for evidence that Q1's slow-down was transitory. We are monitoring a solid 3% rebound in Q2 GDP that should ease fears about a soft start to the year.

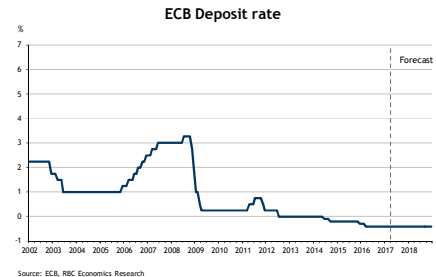
Minutes of the Fed's May meeting indicated most Committee members think another rate hike will "soon be appropriate". Given a further dip in the unemployment rate, we don't see policymakers waiting past the next meeting in June.



European Central Bank

The euro area's economic recovery is broadening and picking up pace. However, inflationary pressure remains muted with core prices stuck in a three year range close to 1%.

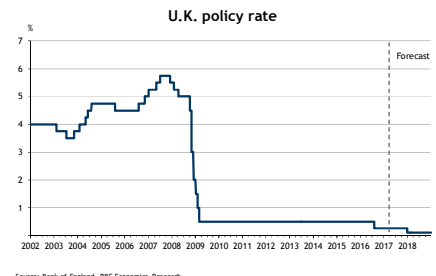
The European Central Bank tweaked their forward guidance but continue to signal accommodative monetary policy will extend into 2018. The central bank will keep providing stimulus until there are signs of a sustainable pickup in inflation.



Bank of England

The UK economy has lost some momentum but inflation is now running faster than the Bank of England's 2% target. Both Brexit-related effects create a policy dilemma for the central bank.

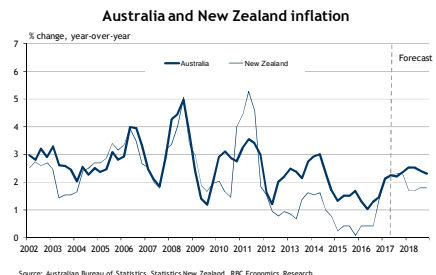
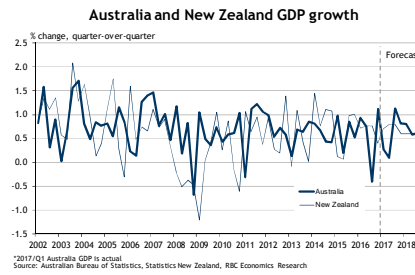
The Bank of England maintained a neutral policy stance in May and their updated forecasts suggest less pressure to respond to above-target inflation. We think monetary policy will remain on hold for the remainder of the year.



Australia and New Zealand

The Reserve Bank of New Zealand sounded a bit more cautious on the domestic outlook, consistent with the economy's slow start to the year. We see growth continuing to disappoint, setting up for one more rate cut later this year.

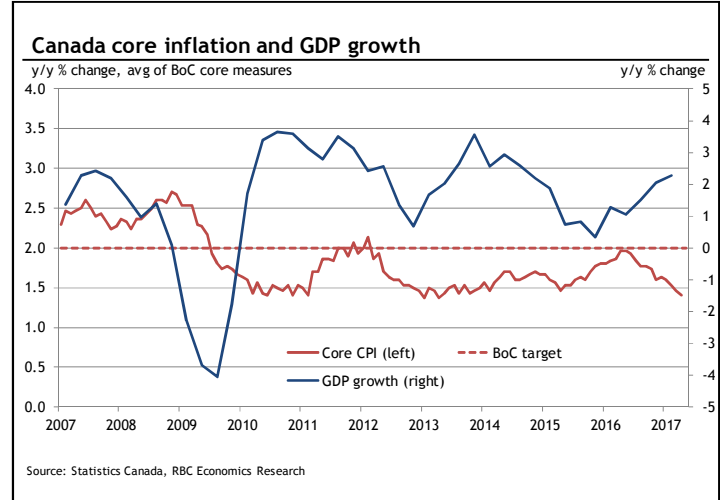
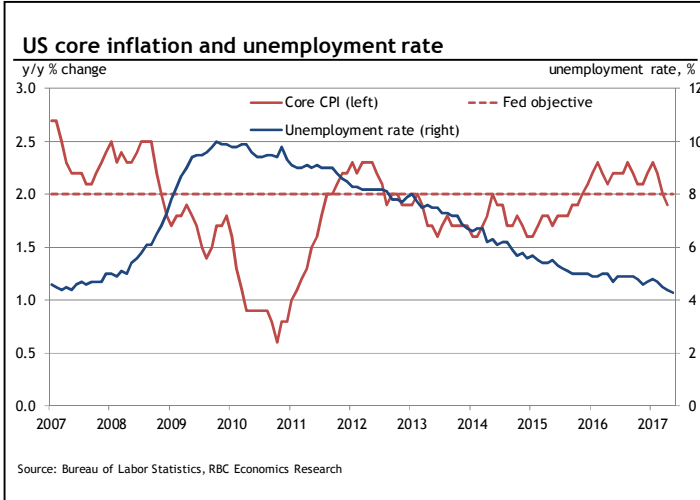
The Reserve Bank of New Zealand maintained a positive growth outlook despite slightly slower activity late last year. With underlying inflation expected to rise only gradually, however, we don't see stimulus being withdrawn over our forecast horizon.



O inflation, where art thou?

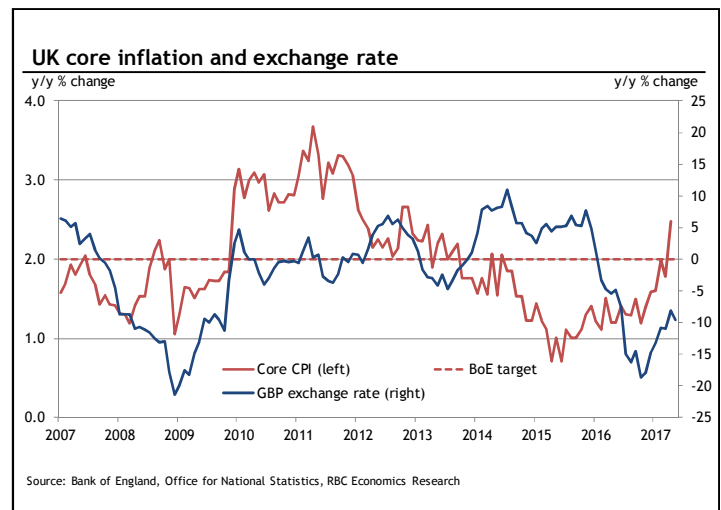
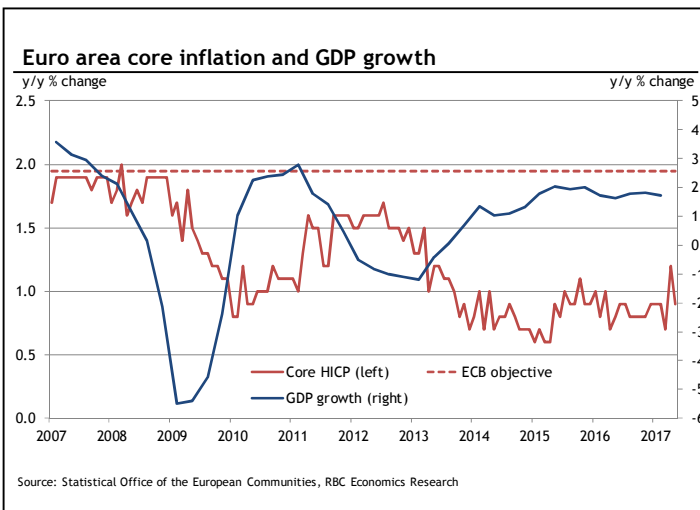
Despite the US unemployment rate falling below the previous cycle's lows, core inflation has struggled to hold above the Fed's 2% objective. Nonetheless, the Fed will continue to gradually raise rates to avoid falling behind the curve on inflation.

Canada's economy has grown strongly over the last three quarters, but the Bank of Canada's preferred measures of core inflation have continued to decline in early-2017. The central bank sees this as evidence of lingering economic slack.



The euro area's economic recovery is gathering momentum but core inflation remains mired at around 1%. The European Central Bank will want to see this measure moving higher before beginning to remove accommodation.

The UK has seen a pickup in core inflation, although that largely reflects exchange rate depreciation over the last year rather than limited economic slack. The Bank of England is likely to look through this currency-driven spike in import prices.



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