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FINANCIAL MARKETS MONTHLY

June 8, 2018

One of these things is not like the other

This weekend's G7 leaders' summit will be a tense affair. The group is already being referred to as the 'G6-plus-one' after the US treasury secretary was censured by his counterparts at an earlier meeting of the club's finance ministers. The latter expressed their "unanimous concern and disappointment" over the Trump administration's protectionist trade policies. Their rebuke came shortly after Canada and the EU's exemptions from steel and aluminum tariffs were allowed to expire. With Japan already facing the same levies, all three are readying retaliatory measures against the US. China, while not part of the G7, would likely second their concerns. Just when it looked like progress was being made in tariff negotiations, the US administration renewed its threat to impose levies on $50 billion of Chinese tech imports. All of these moves might simply be negotiating tactics as Trump seeks more advantageous trading arrangements for the US. But tit-for-tat measures risk devolving into a broader trade war that could weigh on all of the economies involved. This comes at a time when most of the G7 is seeing activity pick up following a slow start to the year. How tariff talks evolve could be key to whether Q2's momentum is sustained over the second half of 2018

While Trump will certainly be the odd one out, he won't be the only populist at the table. He is joined this time around by Italy's Giuseppe Conte, a nonpartisan political freshman who became prime minister just days ago. He takes over following a fractious period in Italian politics. Concerns about a constitutional crisis, or fresh elections that would hand even more power to populist parties, had investors off-loading Italian bonds in favour of safe havens like German debt. An eventual solution helped spreads come down from recent highs. But investors continue to shy away from Italian debt thanks to some controversial economic proposals by the new gov-

Central bank near-term bias

The Bank of Canada made some unexpectedly hawkish changes in May's policy statement that hint at a near-term rate hike. We think they're ready to move in July as long as incoming data cooperate.

Minutes from the Fed's latest meeting suggested a rate hike is at hand, with a move on June 13 looking likely. We'll be watching the 'dot plot' to see if consensus shift toward our call for two more rate hikes over the second half of this year.

The Bank of England took a pass on raising rates in May after Q1's soft growth numbers. Given evidence activity is picking up in the current quarter, we now think they'll increase the bank rate in August.

Italy's political drama caused volatility in financial markets, but we don't think that will keep the European Central Bank from announcing changes to their QE program. We think they'll unveil plans to taper purchases by the end of this year at either their June or July policy meeting.

The Reserve Bank of Australia sounded a bit more dovish in their latest policy statement, reinforcing our expectation the cash rate will remain on hold this year.

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Highlights

▲ The US economy's Q2 rebound is looking even stronger than we previously thought.

▲ The US unemployment rate in May matched its lowest level since 1969.

▲ Businesses are noting upward pressure on input costs, particularly for products being hit with import tariffs.

▲ The Fed looks set to raise their policy rate again in June.

erning parties, which could run afoul of European budget rules. We think the near-term threat to Italy's economy is less significant than some might fear, and an 'Italexit' scenario remains unlikely.

US Q2 rebound unfolding…

After a slower start to the year, particularly for the consumer, the anticipated rebound in US GDP growth is taking shape. And it looks like Q2 will be even stronger than we previously thought. Recent consumer spending data have confirmed our suspicion that the slowdown earlier this year was transitory. Business investment is on track to make another solid contribution to growth. Even exporters are getting in on the action—a narrowing in the US trade deficit over the last two months points to net trade providing the largest add to growth since 2013. Putting it all together, we have revised up our Q2 GDP growth forecast to 3.8%, which would mark the fastest quarterly pace in three years. Protectionist trade policies represent a downside risk to both business investment and exports, but unless tit-for-tat tariffs escalate more significantly we don't anticipate the headwind will be significant. For now we think growth will remain close to the 3% mark over the second half of this year.

…while the labour market continues to tighten

After nearly a year of 3% GDP growth, it's easy to forget that Q1's 'disappointing' 2.2% growth was still above the economy's longer-run trend rate. That is reflected in the jobs data, where an average monthly increase of more than 200k through May represents the best start in three years. With gains coming in well ahead of underlying labour force growth, the unemployment rate fell 0.3 percentage points year-to-date and at 3.8% in May, matched its lowest level since 1969. Tight labour market conditions have been reflected in anecdotal reports as well—the Fed's latest *Beige Book* noted "difficulty filling positions across skill levels." There were reports of higher wages being offered to attract talent, but overall wage increases remained modest. That was reinforced by May's wage numbers. Average hourly earnings growth ticked higher, but at 2.7% still haven't broken out of the range seen over the last two years.

Wage pressure has been slow to pick up, but the *Beige Book* noted that rising input costs, labour shortages and strong demand were putting upward pressure on prices in a number of industries. On material costs, steel, aluminum and lumber—all of which have been subject to tariffs by the Trump administration—were singled out. With steel and aluminum levies now also being applied to Canada, Mexico and the EU, rising material costs could become more pervasive. That would fit with our thesis that tariffs are more likely to harm US consumers and producers than they are to help the industries being protected.

Fed set to hike in June with all eyes on the 'dot plot'

The Fed is widely expected to raise the target range for the fed funds rate by 25 basis points at their next meeting on June 13. Minutes from their latest meeting indicated most participants thought it would "likely soon be appropriate" to continue removing accommodation. Recent data, including May's stellar jobs report, support a hike coming next week and attention is likely to focus on the Fed's updated projections. There is some scope for modest upward revisions to growth and inflation forecasts this year, and some room for a downward revision to the unemployment projection. But as usual, it will be the 'dot plot' that grabs most attention. Recall that the committee was closely divided on whether three or four total rate hikes would be appropriate this year. With policymakers sounding more confident their inflation target will be met on sustained basis, we think consensus will shift to four hikes. We'll also have an eye on the 2019 dots to see if the committee sees the policy rate rising above the 3.0% 'neutral' rate. Recent comments from some Fed officials have indicated monetary policy will likely need to become restrictive at some point—a view that fits with our forecast for once-a-quarter hikes to continue next year. We see the fed funds rate ending 2019 in a 3.25-3.50% range.

Canada's economy also picking up after a slow start to 2018

Canada's economy hit a soft patch in Q1 with GDP growth slipping to just 1.3%, Consumer spending and housing, stalwarts of the current cycle, accounted for much of the loss of momentum. The slowdown in housing has proven more persistent than anticipated, suggesting higher interest rates and more stringent qualifying requirements are restraining and not just shifting the timing of sales. Consumer spending, on the other hand, is expected to pick up going forward. Recent moderation in consumer credit points to rising interest rates having an impact on household spending, but we think a solid labour market and rising wages will partially offset that headwind. A recovery in retail sales in the last two months supports that thesis. With consumers getting back in the game, we think overall growth will rebound to an above-trend 2.4% pace in Q2. March's GDP release showed the economy had good momentum heading into the current quarter, with a 0.3% monthly increase building on February's 0.4% gain.

Bank of Canada changing its tune…

As expected, the Bank of Canada left monetary policy unchanged at the end of May. But the meeting was hardly a non-event, with some notable changes giving the policy statement an unexpectedly hawkish tone. The Governing Council's mantra has been that they would be "cautious" in future adjustments to monetary policy, but that key word was left out of May's statement in favour of a "gradual" approach to tightening. Their bias was also strengthened by noting "higher interest rates will be warranted" without adding "over time" as they have in the past. And surprisingly there was no mention of maintaining "some monetary policy accommodation" over the medium term. That last change seems to be a significant deviation from earlier indications that the policy rate is likely to remain below the BoC's 'neutral' range of 2.5-3.5% for some time as the economy faces headwinds from trade uncertainty, competitiveness issues and high household debt.

The bank also sounded a bit more sanguine about trade uncertainty in May. In his progress report, Deputy Governor Leduc rehashed some of the points from an earlier speech by Senior Deputy Governor Wilkins on embracing uncertainty. The message—that policymakers need to take uncertainty into account but can't be paralyzed by it—suggests the bank won't necessarily sit on the sidelines amid tariff threats and protracted trade talks.

…but July isn't a done deal

While the Bank of Canada is no fan of forward guidance, their change in tone seemed to signal a near-term rate hike. But monetary policy remains data dependent, so a number of upcoming releases will have to cooperate for rates to move higher on July 11 as we expect. We've already seen some evidence that the economy picked up momentum heading into Q2, and we think April's GDP data will reinforce that. The bank's next *Business Outlook Survey* will also be key. Policymakers were encouraged by the recent improvement in investment and services exports. A positive signal from business on investment intentions and foreign demand—even in the face of trade uncertainty—would reinforce the BoC's tightening bias.

The bank's more hawkish policy statement was issued just days before the US waived Canada's exemption from steel and aluminum tariffs. The Canadian government is responding with tariffs on a variety of US imports that will take effect in July. Will these tit-for-tat measures derail a planned rate hike? We don't think so at this stage. The bank won't have been blindsided by the tariffs as an extension of Canada's exemption, which was tied to progress in Nafta negotiations, looked unlikely at the time of their policy meeting. And while the steel and aluminum industries are likely to feel some pain, the overall impact on Canadian GDP and exports should be contained.

Highlights

▲ Canadian GDP growth disappointed in Q1 but we're already seeing signs of a pickup in Q2.

▲ The Bank of Canada ditched their "cautious" mentality in May.

▲ BoC Deputy Governor Leduc revived talk of policymakers taking uncertainty in stride as they make policy decisions.

▲ Steel and aluminum tariffs should have a limited impact on the broader economy. We will be more concerned if tit-for-tat measures escalate.

Highlights

▲ The UK economy looks like it will rebound in Q2, but activity lost to bad weather in Q1 might not be made up in full.

▲ Recent PMI data point to a pickup in euro area growth in Q2, but not necessarily to last year's pace.

▲ With Italy's political situation calming down somewhat, we think the ECB will soon announce plans to taper QE.

▲ Australian GDP growth surprised to the upside in Q1 but we don't think that strength will persist.

Bank of England watching for Q2 rebound

The UK economy had a disappointing start to the year, and how it recovers in Q2 will be key in upcoming monetary policy deliberations. We are with the Bank of England in thinking Q1's slowdown was partly weather related. And while that lost activity won't necessarily be made up in Q2, a return to more trend-like growth of 0.4% in the current quarter is expected. Recent data provide some support for that view—retail sales rebounded nicely in April after wintry weather kept shoppers at home in March. PMI readings also improved in April and May, though the quarter-to-date average is only slightly better than Q1's. That suggests a bit more 'wood to chop' if growth is to rebound to 0.4%.

In contrast with activity data, jobs numbers indicate the economy had a decent start to 2018. Employment growth picked up in the first three months of the year and the unemployment rate fell to 4.2% in March from 4.4% last December. Wage growth is also trending higher, and inflation slowed from the 3% rate seen earlier this year, meaning real pay growth is back in positive territory. That's a good sign for consumers that have been held back by currency-driven inflation since the Brexit referendum. After the Bank of England took a pass on raising rates in May, we shifted our focus to the August meeting. Recent evidence of a pickup in Q2 growth and further tightening in the labour market have improved our confidence that rates will move higher this summer. We'll be closely watching the BoE's June 21 meeting for hints they're getting ready to act on their tightening bias.

Italy's drama won't derail ECB taper plans

A number of transitory factors, from adverse weather to labour market disruptions, weighed on the euro area economy in Q1. We expect growth will rebound to 0.6% in Q2 as some of those temporary headwinds abate. Recent survey data are consistent with activity recovering relative to Q1 but suggest a modest slowing relative to last year. Some of that slowing likely reflects less scope to absorb excess capacity in the economy following three years of above-trend growth. Look no further than the labour market, where the unemployment rate fell to 8.5% in April, the lowest rate since 2008. The jobless rate is now close to some estimates of full employment, though we caution that labour market reforms may have shifted that bogey. Modest wage growth—with early signs of higher pay settlements only beginning to emerge—indicates there is room for hiring to continue.

Nonetheless, we continue to think the European Central Bank is on track to announce changes to their asset purchase program in either June or July. Despite markets expressing some concern about Italy's economic outlook, we think a decision to phase out QE by the end of this year will be taken in stride. We'll be closely watching June's PMI data to see if Italy's political uncertainty is affecting the country's economy, or the broader euro area. But at this stage we don't see it derailing the currency bloc's ongoing expansion, or the ECB's plans to gradually normalize monetary policy.

RBA sounding a bit more dovish

While all of the G7 economies had a slower start to the year, that trend didn't extend to Australia where GDP growth jumped to 1% in Q1 from a 1/2% average pace over the second half of 2017. The year-over-year rate accelerated to 3.1%, the best in nearly two years, though that is more or less in line with the economy's longer-run trend. And we caution that Q1's impressive pace isn't likely to persist this year. Strength in net exports and public spending should continue, but we think softer Q1 consumer spending is a taste of things to come. Alongside a weakening housing market, households won't be a significant driver of growth—making it difficult for the Australian economy to return to full employment. That sentiment was echoed in the Reserve Bank of Australia's latest policy statement, where they no longer indicated their growth forecast should reduce spare capacity in the economy. They also dropped an earlier reference to improving labour market conditions. These changes are consistent with inflation and wage trends remaining subdued for longer than expected—reinforcing our view that the RBA is likely to remain on the sidelines this year with the cash rate steady at 1.50%.

Interest rate outlook

%, end of period

	Actuals					Forecast						
	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
Canada												
Overnight	0.50	0.50	1.00	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.25
Three-month	0.52	0.71	1.00	1.06	1.10	1.20	1.45	1.65	1.90	2.15	2.15	2.15
Two-year	0.75	1.10	1.52	1.69	1.78	1.95	2.15	2.30	2.50	2.50	2.40	2.30
Five-year	1.12	1.40	1.75	1.87	1.97	2.15	2.35	2.55	2.75	2.80	2.75	2.65
10-year	1.62	1.76	2.10	2.04	2.09	2.35	2.55	2.75	2.90	3.00	3.00	2.90
30-year	2.30	2.14	2.47	2.27	2.23	2.50	2.75	2.90	3.05	3.15	3.15	3.10
United States												
Fed funds**	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.50
Three-month	0.76	1.03	1.06	1.39	1.73	1.90	2.15	2.35	2.65	2.90	3.15	3.35
Two-year	1.27	1.38	1.47	1.89	2.27	2.50	2.65	2.80	3.00	3.25	3.40	3.55
Five-year	1.93	1.89	1.92	2.20	2.56	2.80	2.95	3.10	3.25	3.45	3.55	3.65
10-year	2.40	2.31	2.33	2.40	2.74	3.00	3.15	3.30	3.45	3.60	3.70	3.75
30-year	3.02	2.84	2.86	2.74	2.97	3.35	3.50	3.60	3.70	3.75	3.80	3.85
United Kingdom												
Bank rate	0.25	0.25	0.25	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.25
Two-year	0.12	0.36	0.46	0.45	0.82	0.75	0.80	0.95	1.00	1.05	1.10	1.15
10-year	1.14	1.26	1.38	1.19	1.34	1.50	1.60	1.75	2.00	2.10	2.20	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	-0.30	-0.20
Two-year	-0.74	-0.57	-0.69	-0.63	-0.59	-0.65	-0.60	-0.50	-0.50	-0.50	-0.40	-0.30
10-year	0.33	0.47	0.47	0.43	0.50	0.65	0.70	0.80	1.00	1.05	1.25	1.25
Australia												
Cash target rate	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	2.00	2.00	2.00
Two-year	1.76	1.78	1.94	2.00	2.00	2.10	2.25	2.40	2.50	2.60	2.60	2.60
10-year	2.70	2.60	2.84	2.63	2.60	2.75	3.05	3.30	3.70	4.10	4.10	4.05
New Zealand												
Cash target rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00
Two-year swap	2.31	2.32	2.19	2.20	2.21	2.30	2.40	2.50	2.60	2.75	2.80	2.80
10-year swap	3.41	3.35	3.24	3.13	3.06	3.40	3.50	3.60	3.75	3.85	4.10	4.25
Yield curve*												
Canada	87	66	58	35	31	40	40	45	40	50	60	60
United States	113	93	86	51	47	50	50	50	45	35	30	20
United Kingdom	102	90	92	74	52	75	80	80	100	105	110	115
Eurozone	107	104	116	106	109	130	130	130	150	155	165	155
Australia	94	82	90	63	60	65	80	90	120	150	150	145
New Zealand	110	103	105	93	85	110	110	110	115	110	130	145

* Two-year/10-year spread in basis points, **Top of 25 basis point range

Source: Reuters, RBC Economics Research

Central bank policy rate

%, end of period

		Current	Last	
United States	Fed funds	1.50-1.75	1.25-1.50	March 21, 2018
Canada	Overnight rate	1.25	1.00	January 17, 2018
United Kingdom	Bank rate	0.50	0.25	November 2, 2017

		Current	Last	
Eurozone	Deposit rate	-0.40	-0.30	March 10, 2016
Australia	Cash rate	1.50	1.75	August 3, 2016
New Zealand	Cash rate	1.75	2.00	November 10, 2016

Source: Bloomberg, Reuters, RBC Economics Research

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	2016	2017	2018F	2019F
Canada*	4.0	4.6	1.7	1.7	1.3	2.4	2.1	1.8	1.8	1.7	1.7	1.7	1.4	3.0	2.0	1.8
United States*	1.2	3.1	3.2	2.9	2.2	3.8	2.8	2.8	1.8	2.4	2.2	1.8	1.5	2.3	2.9	2.4
United Kingdom	0.3	0.2	0.5	0.4	0.1	0.4	0.3	0.4	0.3	0.4	0.3	0.4	1.9	1.8	1.3	1.4
Euro area	0.6	0.7	0.7	0.7	0.4	0.6	0.5	0.5	0.4	0.4	0.4	0.4	1.8	2.5	2.2	1.9
Australia	0.3	1.0	0.5	0.5	1.0	0.8	0.7	0.6	0.7	0.7	0.8	0.9	2.6	2.2	2.7	2.8
New Zealand	0.7	0.9	0.6	0.6	1.0	0.8	0.8	0.7	0.7	0.7	0.7	0.7	4.0	2.9	3.4	2.9

*annualized

Inflation outlook

% change, year-over-year

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	2016	2017	2018F	2019F
Canada	1.9	1.3	1.4	1.8	2.1	2.6	2.8	2.5	2.2	2.2	2.1	2.1	1.4	1.6	2.5	2.1
United States	2.5	1.9	2.0	2.1	2.2	2.7	2.6	2.2	1.8	1.9	2.0	2.2	1.3	2.1	2.4	2.0
United Kingdom	2.2	2.8	2.8	3.0	2.7	2.5	2.6	2.5	2.3	2.2	2.2	2.0	0.6	2.7	2.6	2.2
Euro area	1.8	1.5	1.4	1.4	1.3	1.3	1.4	1.4	1.4	1.4	1.5	1.5	0.2	1.5	1.4	1.5
Australia	2.1	1.9	1.8	1.9	1.9	2.2	2.2	2.2	2.3	2.5	2.6	2.7	1.3	1.9	2.1	2.5
New Zealand	2.1	1.7	1.9	1.6	1.1	2.0	2.1	2.0	2.0	2.0	2.0	2.0	0.6	1.9	2.0	2.0

Source: Statistics Canada, Bureau of Economic Analysis, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics Research

Inflation tracking

Inflation Watch

	Measure	Current period	Period ago	Year ago	Three-month trend	Six-month trend
Canada	CPI ex food & energy[1]	Apr	0.0	1.8	2.2	2.2
United States	Core PCE[1,2]	Apr	0.2	1.8	2.3	1.9
United Kingdom	All-items CPI	Apr	0.4	2.4	1.8	2.4
Euro area	All-items CPI[1]	May	0.5	1.9	1.8	1.9
Australia	Trimmed mean CPI[1]	Q1	0.5	1.9	N/A	N/A
New Zealand	All-items CPI	Q1	0.5	1.1	N/A	N/A

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

Source: Statistics Canada, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics Research

Currency outlook

Level, end of period

	Actuals					Forecast						
	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
Canadian dollar	1.33	1.30	1.25	1.26	1.29	1.30	1.28	1.28	1.26	1.26	1.27	1.28
Euro	1.07	1.14	1.18	1.20	1.23	1.20	1.16	1.18	1.20	1.22	1.24	1.26
U.K. pound sterling	1.26	1.30	1.34	1.35	1.40	1.35	1.27	1.27	1.29	1.31	1.33	1.35
New Zealand dollar	0.70	0.73	0.72	0.71	0.72	0.71	0.73	0.71	0.69	0.69	0.69	0.69
Japanese yen	111.4	112.4	112.5	112.7	106.3	107.0	109.0	111.0	113.0	115.0	118.0	120.0
Australian dollar	0.76	0.77	0.78	0.78	0.77	0.76	0.75	0.73	0.73	0.73	0.73	0.73

Canadian dollar cross-rates

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
EUR/CAD	1.42	1.48	1.47	1.51	1.59	1.56	1.48	1.51	1.51	1.54	1.57	1.61
GBP/CAD	1.67	1.69	1.67	1.70	1.81	1.75	1.63	1.62	1.63	1.65	1.69	1.73
NZD/CAD	0.93	0.95	0.90	0.89	0.93	0.92	0.93	0.91	0.87	0.87	0.88	0.88
CAD/JPY	83.7	86.7	90.2	89.6	82.4	82.3	85.2	86.7	89.7	91.3	92.9	93.8
AUD/CAD	1.02	1.00	0.98	0.98	0.99	0.99	0.96	0.93	0.92	0.92	0.93	0.93

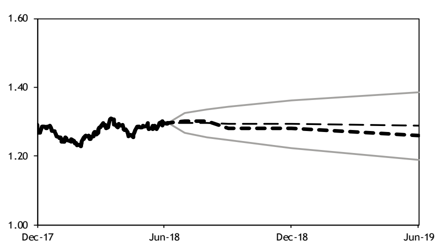
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics Research

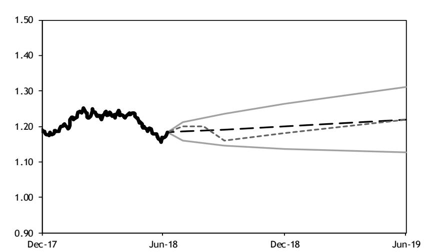
RBC Economics outlook compared to the market

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

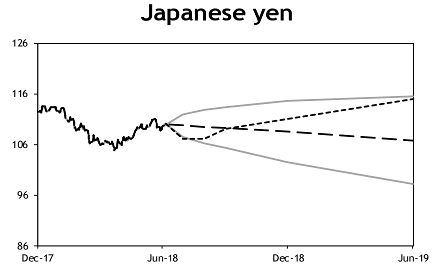
Canadian dollar



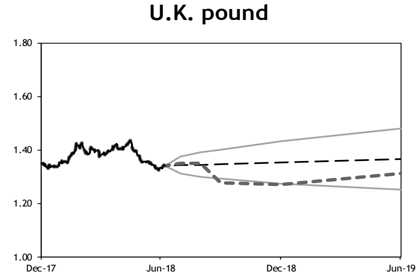
Euro



Japanese yen



U.K. pound

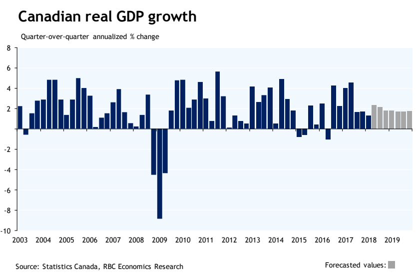


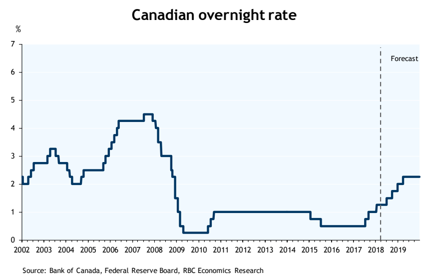
Central bank watch

Bank of Canada

GDP gains of 0.4% and 0.3% in February and March, respectively, indicate solid momentum for the Canadian economy heading into Q2. Growth over the first half of the year should be fairly close to the Bank of Canada's 2% expectation.

The BoC's forward guidance points to a July rate hike. A positive Q2 *Business Outlook Survey* and April GDP report would reinforce that view.

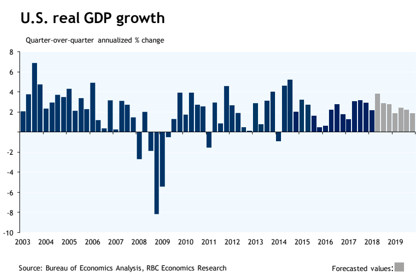


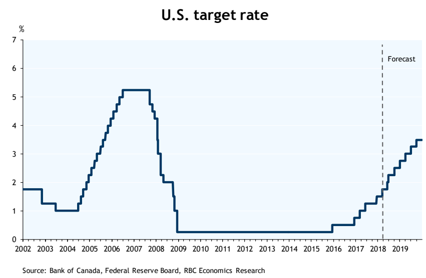


Federal Reserve

It looks like US GDP growth is rebounding strongly in Q2, potentially lending some upside risk to the Fed's 2018 forecast. The unemployment rate has already hit their year end forecast of 3.8%.

A June rate hike is largely baked in the cake, so market reaction could hinge on the Fed's updated 'dot plot'. We think consensus will shift to a total of four rate hikes this year, matching our forecast.

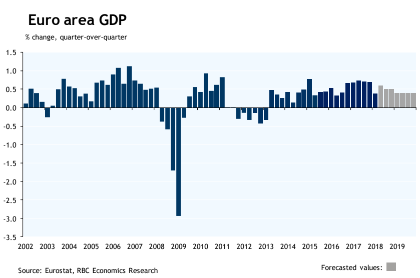


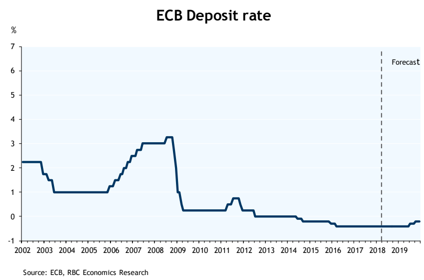


European Central Bank

Recent data point to GDP growth picking up to 0.6% in Q2, above the economy's longer-term trend but a bit short of the pace seen last year. Growth will be harder to come by as some euro area economies reach capacity limits.

We think the ECB will take another step toward ending QE by announcing asset purchases will be tapered off by the end of this year.

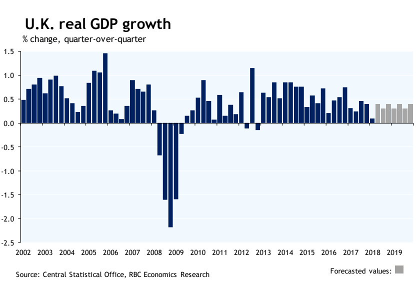


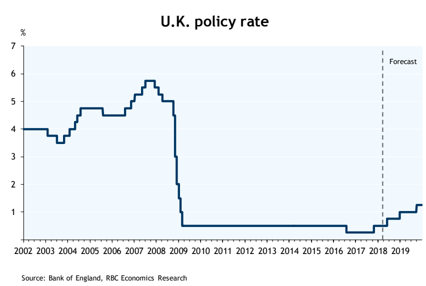


Bank of England

We're seeing some evidence of a Q2 rebound after the UK economy was weighed down by bad weather early this year. The labour market has continued to improve, with the unemployment rate hitting fresh multi-decade lows.

After taking a pass on raising rates in May, we think firmer economic data will lead the Bank of England to act on their tightening bias in August.

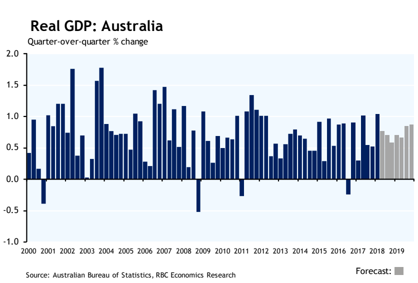


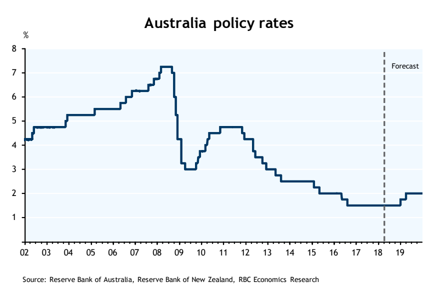


Australia

Australian GDP growth jumped to 1% in Q1, double the average pace seen over the second half of 2017. But year-over-year growth of 3.1% isn't much better than the economy's longer-run trend.

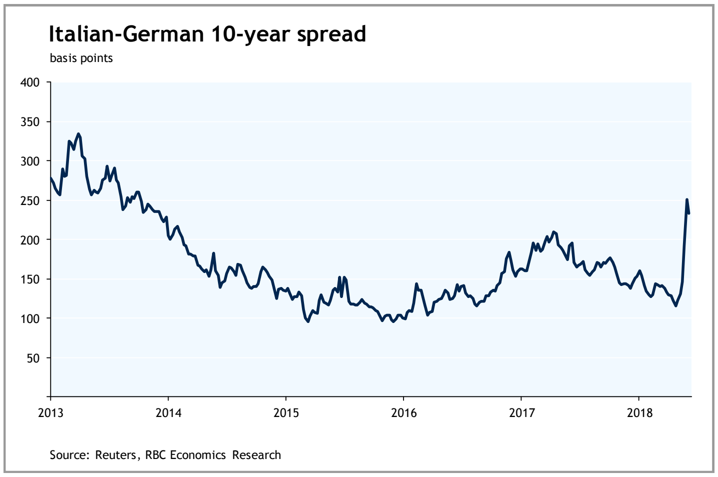
The RBA implied trend-like growth won't absorb spare capacity in the economy. That points to limited upward pressure on wages and inflation, which should keep the central bank sidelined this year.



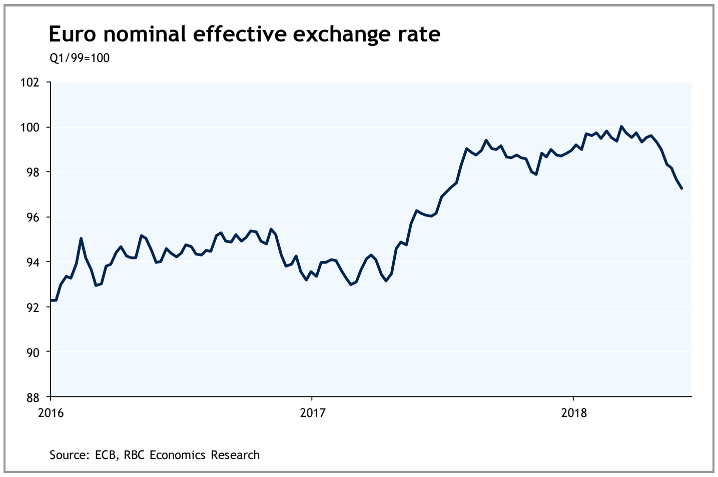


Italy's political drama

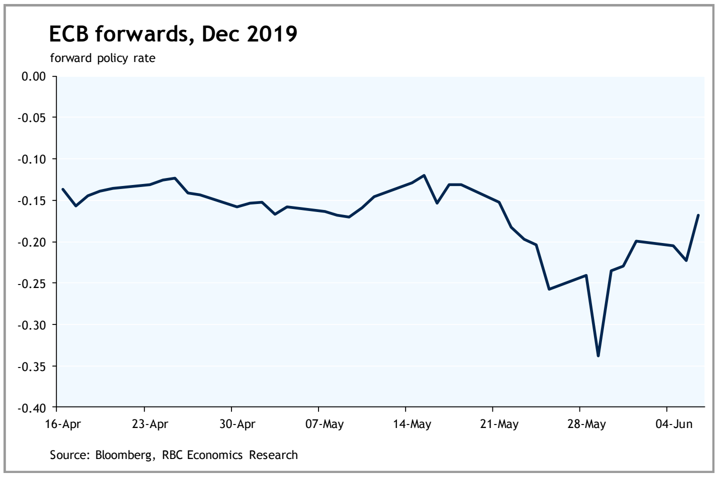
The spread between Italian and German government bond yields widened significantly in May, reaching its highest level since Europe's debt crisis. Spreads have come down a bit over the last week but remain elevated.



The common currency also suffered as investors sold Italian bonds and fretted about the new government's Euroscepticism. The new prime minister says euro exit is not on the policy agenda, but the currency remains nearly 3% below recent highs.



Concerns about the Italian economy had investors questioning whether the ECB will follow through with an expected tapering plan and eventual rate hikes. With the situation calming down, markets returned to pricing in very modest rate hikes by the end of next year—in line with our forecast.



Survey data for both Italy and the euro area as a whole have softened so far this year after improving steadily in 2017. Readings continue to point to above-trend growth in the currency bloc, but we'll be watching June's surveys for any impact on sentiment from Italy's political drama.