Inside...

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Full steam ahead (but watch for icebergs)

We are two months into 2017 and economic data continue to signal good momentum in advanced economies—much to the relief of forecasters following years of "serial disappointment". Europe in particular is seeing its share of upside surprises. Economic sentiment in the euro area remains at cycle highs and purchasing managers' index readings broke above recent ranges in February. Somewhat unexpectedly, the greatest improvement has been seen in France—despite heightened political risk. While the recent trend in the data is encouraging, we remain wary that uncertainty surrounding a number of elections could dampen economic activity. UK data have remained strong early in the year after the economy dramatically outperformed expectations in H2/16 post-referendum. Indicators have been a bit more balanced in Canada—growth and employment numbers have been strong but underlying details (weak investment and flat non-energy exports) continue to highlight challenges facing the economy. The Bank of Canada remains cautious given risks posed by potential changes in US policy.

A strong US outlook, with upside surprises on employment and inflation, seems to have shifted the Fed toward a 'sooner than later' mentality on monetary policy—comments from a number of Committee members point to a March rate hike. Markets took that shift in stride, with US Treasury yields remaining within recent ranges while equity markets continued to rally (to record highs for the S&P 500 and MSCI World Index on March 1) despite the expectations of tighter monetary policy. The prospect of fiscal stimulus in the US continues to buoy stocks even as details remain sparse and challenges for the passage of policy changes rise, while investors seemingly dismiss downside risks from protectionist trade policies.

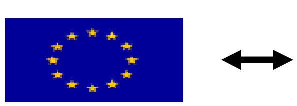
Central bank near-term bias

Three-months out, policy rate

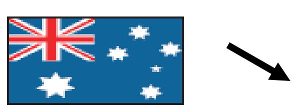
The BoC maintained a cautious tone in March despite stronger-than-expected growth and inflation. The Bank continues to contrast slack in Canada with tighter conditions in the US, signaling to markets that they are not ready to follow the Fed with higher rates.

A chorus of Fed speakers talking up a near-term hike points to the Fed raising rates again in March. We look for two additional hikes this year, which would be consistent with the Fed's consensus from December.

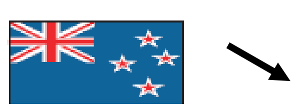
We expect the BoE will maintain a neutral policy stance, looking through the currency- and energy-driven increase in inflation while continuing to monitor the economy for signs of a negative impact from Brexit uncertainty.



Inflation hit the ECB's 2% target in February, but with little evidence of accelerating core prices, we expect policymakers will stand behind asset purchases and, for now, maintain an easing bias.



The RBA's latest forecasts impart an implicit easing bias, though increased emphasis on financial stability raises the bar for further easing. We continue to forecast one more rate cut given the risk that growth and inflation further disappoint.



The RBNZ maintained an easing bias in February and remains uncomfortable with NZD's strength. We look for one final rate cut in May to cap off an extended easing cycle.

Highlights

▲ The second estimate of US Q4/16 GDP showed consumers were once again the main driver of stronger domestic spending.

▲ Both consumer and business sentiment indicators have improved strongly since the election.

▲ Energy prices have been responsible for much of the increase in US inflation, but core prices are also firming.

▲ Fed speakers have been out in force talking up the odds of a March rate hike.

US set for steady but more balanced growth in Q1/17

The second estimate of US Q4/16 GDP growth was unchanged at 1.9%, with an upwardly revised gain in consumer spending offset by weaker business investment and government outlays. It remains the case that domestic spending ratcheted up relative to the previous quarter, although the increase was less broadly-based than previously reported as households did even more of the heavy lifting. Early indicators are pointing to a more balanced growth profile in Q1/17. While the previous quarter's downward revision to business investment indicates less momentum heading into 2017, rising capital goods imports and a nascent recovery in capex shipments paint a more positive picture. As well, a strong upward trend in rig counts, albeit from a low base, indicates energy sector investment is picking up after a period of sharp declines. That should help offset the slowdown in consumer spending flagged by January's disappointing PCE report. While we expect the recent dip will prove transitory (particularly the decline in utilities spending related to mild winter weather), we have trimmed our Q1/17 consumption forecast to 1½%—just half the pace recorded in the past two quarters. Even tracking a less robust contribution from the consumer, GDP growth is expected to hold fairly steady at 2% in the first quarter.

The positive outlook for both consumer spending and business investment is reflected in the sharp improvement in sentiment indicators since the election. Consumer confidence picked up further in February, not only reaching a post-recession high but also exceeding the previous cycle's peak. Meanwhile, small business optimism remained at a decade high to start the year after having surged in December. Both groups are likely encouraged by talk of personal and corporate income taxes cuts, with the prospect of deregulation also contributing to business sentiment. It now falls to the government to follow through on those expectations, though recent indications are that tax reform won't come before late-summer. Our forecast continues to assume stimulus will add ½ percentage point to US GDP growth over the next two years, though potential delays to implementation of tax changes raise the risk that most of that boost falls in 2018.

Inflation is not just an energy story

US CPI inflation jumped to a five-year high of 2.5% in January, having trended up from a year-over-year rate of just 0.8% last July as energy prices flipped from a source of disinflation to a positive contributor. Higher inflation does not simply reflect commodity price gyrations; core inflation also firmed to match a cycle-high in January. That is despite continued disinflation stemming from core commodities, which likely reflects a strong US dollar weighing down import prices. More domestically-influenced price measures, such as services ex shelter, have trended higher for more than a year, suggesting underlying price pressures have firmed somewhat. The Fed's preferred PCE inflation measure also picked up (January's headline was the highest since October 2012) but hasn't put the Fed's inflation forecast in jeopardy as of yet. Nonetheless, we think there is enough evidence of gradually rising inflation to justify further withdrawal of stimulus this year.

Fed priming markets for a March hike

Chair Yellen's semi-annual testimony to Congress in mid-February didn't rock the boat but provided a good summary of what seems to be the growing consensus among Committee members regarding the monetary policy outlook. Yellen indicated that further removal of accommodation would likely be appropriate at upcoming meetings and that waiting too long to raise rates would be "unwise". Similarly, minutes of the FOMC's February meeting noted many participants thought a rate hike would be appropriate "fairly soon"—and that was before upside surprises in the latest employment and inflation reports. More recent comments suggest the Fed is increasingly leaning toward a March hike, taking advantage of the opportunity provided by a decent run of data, upbeat sentiment and market stability. This hawkish shift lifted the odds of a rate hike at the coming meeting more than enough for the Committee to make a move without unsettling markets. Progress toward the Fed's objectives has for some time warranted tighter monetary policy, and with increasing evidence of a 'sooner than later' mentality among the Committee, we now expect a 25 basis point rate hike at the March meeting to 0.75% to 1.0%. Further tightening this year is forecast result in the range for fed funds ending 2017 at 1.25% to 1.5%.

Canada closed out 2016 with a strong GDP gain

Canada's economy grew at a stronger-than-expected 2.6% annualized rate in Q4/16, building on the previous quarter's upwardly revised 3.8% gain that partially reflected a rebound in energy sector output following the Alberta wildfires. Households continued to be a significant source of growth with both consumer spending and residential investment rising strongly. Business investment was disappointing; beyond the unwind of a one-off increase in structures investment in the previous quarter, machinery and equipment investment posted a second consecutive double-digit decline. Fewer imported capital goods contributed to a large decline in imports, leaving a sizeable add to growth from net trade. Government investment posted another solid gain, rising at an average pace of 5% over the second half of the year. Stronger public investment spending seems to suggest the federal government hasn't been as slow rolling out infrastructure spending as previously feared. The upcoming federal budget (expected in March) should provide something of a progress report on stimulus efforts thus far. We think new spending measures will be limited although the continued deployment of stimulus announced in last February's budget is still set to boost Canada's economy this year.

Monthly detail behind the quarterly increase showed a solid 0.3% gain in December GDP. An above-trend increase in goods producing industries, particularly utilities and construction, supplemented another steady rise in services output in the month. The increase provides a strong jumping off point for the first quarter, though with potential for some of the gain (particularly in utilities) to be unwound, we have left our Q1/17 growth forecast unchanged at 1.9%. The composition is expected to be more favourable than in the previous quarter with domestic demand picking up to a 2% pace after averaging less than 1% over the second half of last year.

CAPEX survey disappoints again in 2017

Statistics Canada's annual CAPEX survey provided a first look at capital spending intentions for 2017 and the results were disappointing. Private sector capex is expected to fall 1.6% this year—an improvement relative to the double-digit declines recorded in each of the last two years but hardly a vote of confidence from businesses. Less pronounced weakness in 2017 largely reflects a gradually improving energy sector outlook, with oil and gas investment expected to edge up by 2% following declines of more than 30% in each of the last two years. Our own tracking of energy companies' spending plans and analyst projections points to a somewhat stronger increase, so there may be scope for an upside surprise from that sector. Manufacturing, however, remains a source of weakness with intentions showing a further decline in investment in that sector this year after a disappointing slowdown in 2016. While the 2017 decline is concentrated in commodity-related manufacturing industries, intentions outside of those sectors were up only slightly. All told, the CAPEX survey and a weaker-than-expected Q4 number prompted us to trim our forecast for business investment in 2017—rather than providing a modest add to growth, we see private capex acting as a small drag this year.

BoC firmly on the sidelines while Fed continues to tighten

The Bank of Canada's February rate announcement was one of shortest in recent memory. As expected, the overnight rate was left unchanged and the Bank provided no hint of a policy bias while continuing to emphasize a large degree of uncertainty in the outlook. The statement took note of January's stronger-than-expected inflation print, but indicated that the increase in prices reflected temporary factors (particularly the introduction of carbon pricing schemes in Ontario and Alberta) that policymakers would look through in setting rates. Recent data flow was seen as consistent with their expectation that growth is improving and they acknowledged upside risk to their 1.5% forecast for Q4/16 GDP (though the actual increase of 2.6% still likely exceeded their expectations). The Bank also noted strong employment growth but cited weak wages and hours worked as evidence of persistent excess capacity in the economy. They continued to contrast slack in Canada with much tighter conditions south of the border, perhaps trying to keep markets from further pricing in higher policy rates in Canada (odds of a rate hike this year currently sit around 40%) alongside expected tightening by the Fed.

Highlights

▲ Canada's strong increase in Q4/16 GDP exceeded market expectations.

▲ Government investment figures suggest the federal infrastructure spending began to flow in H2/16.

▲ A disappointing CAPEX survey showed further declines in manufacturing investment and only a modest rebound in oil & gas.

▲ There was little change in tone from the BoC in a terse policy statement on March 1.

Highlights

▲ Slowing U.K. wage growth and accelerating inflation suggest a squeeze on consumers' purchasing power.

▲ Financial markets are responding to political risk in Europe but economic momentum is unwavering.

▲ The RBA struck a neutral tone but their lacklustre growth and inflation forecasts suggest a mild easing bias.

▲ The NZD is little changed from two years ago despite an extended easing cycle from the RBNZ.

BoE not expected to shift out of neutral as inflation picks up

UK GDP growth was revised up to 0.7% in Q4/16, marking an even stronger end to the year than previously estimated, although revisions to earlier quarters left growth for 2016 as a whole (1.8%) at a slightly slower pace. It remains the case that economic activity over the second half of the year was the strongest since 2014—certainly a surprising result given uncertainty triggered by June's Brexit vote. There continue to be few signs of a loss of momentum early this year although PMI readings did come off the boil somewhat in January with the composite index slipping from December's 1½ year high supporting our forecast for a 0.4% rise in Q1/17. We still see clouds on the horizon, however, with a drop in business investment at the end of last year potentially reflecting more uncertainty on the part of firms than sentiment indicators suggest. We continue to expect slower consumer and business spending will limit this year's GDP increase to 1.6%. A softening growth outlook should increase the BoE's tolerance for above-target inflation—indeed, indications that policymakers won't respond to a temporary, currency-driven increase in inflation have led markets to claw back tightening priced in for this year. We expect the central bank will remain in neutral as it continues to track implications of the UK's pending EU exit.

Euro area sentiment yet to falter amid political uncertainty

The euro area composite PMI broke out of its recent range in February, rising to the highest level in nearly six years. While hard data remain sparse for 2017, survey indicators point to some early upside risk to our forecast for GDP growth to hold steady at 0.4% in the first quarter. The stronger PMI reading partially reflected further improvement in France's composite index, which was in contractionary territory as recently as mid-2016. The pickup comes despite uncertainty surrounding the coming presidential election which has pushed 10-year French government bond spreads (relative to German Bunds) to their highest levels since 2012. The upcoming vote in France is just one of several elections in major euro area economies in the coming year. Our forecast assumes heightened political uncertainty will weigh on economic activity somewhat in 2017 (GDP growth slowing to 1.5% from 1.7% in 2016) although thus far the currency bloc's recovery hasn't shown signs of slowing. The ECB will take stock of the economy's momentum, as well as recent inflation developments, at its March 9 meeting. While headline inflation has picked up strongly in recent months (hitting the ECB's 2%target in February) nearly all of the increase reflects rising energy prices while core inflation is parked below 1%. We expect the ECB will continue noting a lack of underlying inflationary pressure, justifying a highly accommodative monetary policy stance and, for now, ignoring calls to soften the central bank's easing bias.

RBA strikes balanced tone amid debt concerns

The Reserve Bank of Australia's first meeting of 2017 yielded a balanced policy statement and an unchanged rate decision. There was no hint of an easing bias although the RBA's updated forecast, which lowered near-term growth and only shows inflation returning to the middle of their 2-3% target range in two years' time, suggests policymakers will have limited tolerance for downside surprises on activity and inflation. Weighing against further easing, however, is the central bank's increased emphasis on financial stability under Governor Lowe. In his semi-annual testimony on monetary policy, Lowe seemed to favour tolerating a period of sub-trend inflation over exacerbating household indebtedness by loosening policy. That leaves a fairly high hurdle to clear for our forecast for one more rate cut in May though we continue to see risk of easing amid an underwhelming outlook for growth and inflation.

Currency strength remains a source of frustration for the RBNZ

At their first rate-setting meeting in three months, the Reserve Bank of New Zealand surprised markets somewhat by maintaining a mild easing bias. The RBNZ continued to jawbone the currency, noting that the New Zealand dollar's rise has contributed to firmer financial conditions and that a decline in the exchange rate is needed. The central bank's frustration came with NZD trading close to its 2015 highs on a trade-weighted basis despite a cumulative 175 basis points of easing in the cash rate since then. The stubborn and stronger-than-expected currency led policymakers to revise their inflation forecast lower, with CPI not expected to return to 2% until mid-2019. While the RBNZ's easing bias wasn't backed up by their policy rate projection (which shows no further easing), we continue to see scope for one more rate cut in the current easing cycle.

Interest rate outlook

%, end of period

	Actuals				Forecast							
	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
Canada												
Overnight	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25
Three-month	0.45	0.48	0.53	0.46	0.50	0.50	0.55	0.60	0.65	0.85	1.15	1.40
Two-year	0.54	0.52	0.52	0.80	0.75	0.85	0.95	1.05	1.20	1.40	1.60	1.80
Five-year	0.67	0.57	0.62	1.15	1.15	1.30	1.55	1.85	2.05	2.30	2.45	2.60
10-year	1.23	1.06	1.00	1.80	1.70	1.90	2.15	2.45	2.60	2.80	2.95	3.10
30-year	2.00	1.72	1.66	2.35	2.40	2.45	2.70	2.95	3.05	3.20	3.30	3.45
United States												
Fed funds**	0.50	0.50	0.50	0.75	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	0.70	1.00	1.05	1.30	1.55	1.80	2.05	2.30
Two-year	0.73	0.58	0.77	1.25	1.30	1.45	1.60	1.90	2.15	2.40	2.60	2.80
Five-year	1.21	1.01	1.14	2.00	1.90	2.10	2.25	2.50	2.65	2.90	3.05	3.20
10-year	1.78	1.49	1.60	2.55	2.40	2.65	2.80	3.00	3.15	3.40	3.50	3.60
30-year	2.61	2.30	2.32	3.15	3.00	3.20	3.35	3.50	3.60	3.75	3.80	3.90
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	0.20	0.20	0.20	0.20	0.05	0.10	0.15	0.15
10-year	1.43	0.89	0.76	1.24	1.40	1.60	1.75	1.90	2.00	2.10	2.25	2.30
Euro area												
Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40
Two-year	-0.48	-0.61	-0.69	-0.78	-0.70	-0.65	-0.55	-0.50	-0.50	-0.50	-0.50	-0.50
10-year	0.15	-0.11	-0.12	0.21	0.20	0.35	0.50	0.60	0.65	0.65	0.70	0.75
Australia												
Cash target rate	2.00	1.75	1.50	1.50	1.50	1.25	1.25	1.25	1.25	1.25	1.50	1.50
Two-year	1.89	1.59	1.55	1.86	1.70	1.50	1.60	1.75	1.75	2.00	2.00	2.25
10-year	2.49	1.98	1.91	2.76	2.80	2.95	3.20	3.40	3.55	3.90	4.05	4.15
New Zealand												
Cash target rate	2.25	2.25	2.00	1.75	1.75	1.50	1.50	1.50	1.50	1.50	1.75	1.75
Two-year swap	2.19	2.22	1.96	2.50	2.20	1.90	1.90	2.00	2.10	2.20	2.30	2.40
10-year swap	2.97	2.65	2.41	3.58	3.50	3.70	3.90	4.10	4.30	4.70	4.90	5.00
Yield curve*												
Canada	69	54	48	100	95	105	120	140	140	140	135	130
United States	105	91	83	130	110	120	120	110	100	100	90	80
United Kingdom	98	76	63	116	120	140	155	170	195	200	210	215
Eurozone	63	50	57	99	90	100	105	110	115	115	120	125
Australia	60	39	36	90	110	145	160	165	180	190	205	190
New Zealand	78	43	45	108	130	180	200	210	220	250	260	260

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

Source: Reuters, RBC Economics Research

Central bank policy rate

%, end of period

		Current	Last	
United States	Fed funds	0.50-0.75	0.25-0.50	December 15, 2016
Canada	Overnight rate	0.50	0.75	July 15, 2015
United Kingdom	Bank rate	0.25	0.50	August 4, 2016

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

Source: Bloomberg, Reuters, RBC Economics Research

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	2015	2016F	2017F	2018F
Canada*	2.7	-1.2	3.8	2.6	1.9	1.8	1.6	2.0	2.1	2.5	1.9	1.7	0.9	1.4	2.0	2.1
United States*	0.8	1.4	3.5	1.9	2.0	2.2	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	0.6	0.7	0.4	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	0.4	0.4	0.3	0.3	0.3	0.4	0.4	0.4	0.4	1.9	1.7	1.5	1.5
Australia	1.1	0.8	-0.5	1.1	0.7	0.7	0.8	0.7	0.7	0.7	0.6	0.6	2.4	2.5	2.6	2.8
New Zealand	0.7	0.7	0.8	0.6	0.7	0.8	0.8	0.6	0.6	0.6	0.6	0.6	2.5	3.1	2.9	2.6

*annualized,

Inflation outlook

% change, year-over-year

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

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

Inflation tracking

Inflation Watch

	Measure	Current period	Period ago	Year ago	Three-month trend	Six-month trend
Canada	Core CPI (CPIX)[1]	Jan	0.4	1.7	1.1	1.2
United States	Core PCE[1,2]	Jan	0.3	1.7	1.3	1.6
United Kingdom	All-items CPI	Jan	-0.5	1.8	2.0	2.0
Euro area	All-items CPI[1]	Feb	0.1	2.0	2.9	1.7
Australia	Trimmed mean CPI[1]	Q4	0.4	1.6	N/A	N/A
New Zealand	All-items CPI	Q4	0.4	1.3	N/A	N/A

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

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

Currency outlook

Level, end of period

	Actuals				Forecast							
	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
Canadian dollar	1.30	1.29	1.31	1.34	1.35	1.38	1.38	1.38	1.37	1.36	1.35	1.33
Euro	1.14	1.11	1.12	1.05	1.02	1.00	0.98	0.96	0.98	1.00	1.02	1.04
U.K. pound sterling	1.44	1.33	1.30	1.24	1.20	1.15	1.16	1.16	1.18	1.20	1.23	1.25
New Zealand dollar	0.69	0.71	0.73	0.69	0.71	0.72	0.73	0.74	0.74	0.74	0.75	0.75
Japanese yen	112.6	103.2	101.3	117.0	112.0	110.0	107.0	103.0	100.0	102.0	104.0	106.0
Australian dollar	0.77	0.75	0.77	0.72	0.74	0.74	0.73	0.72	0.72	0.72	0.73	0.73

Canadian dollar cross-rates

	16Q1	16Q2	16Q3	16Q4	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4
EUR/CAD	1.48	1.43	1.48	1.41	1.38	1.38	1.35	1.32	1.38	1.36	1.38	1.38
GBP/CAD	1.87	1.72	1.70	1.66	1.62	1.59	1.60	1.60	1.62	1.64	1.66	1.67
NZD/CAD	0.90	0.92	0.96	0.93	0.96	0.99	1.01	1.02	1.01	1.01	1.01	1.00
CAD/JPY	86.6	79.9	77.2	87.0	83.0	79.7	77.5	74.6	73.0	75.0	77.0	79.7
AUD/CAD	1.00	0.96	1.01	0.97	1.00	1.02	1.01	0.99	0.99	0.98	0.99	0.97

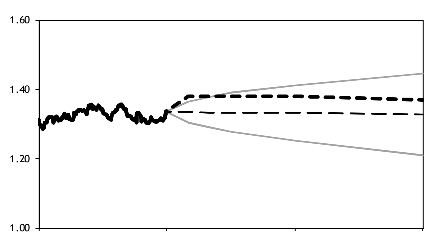
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics Research

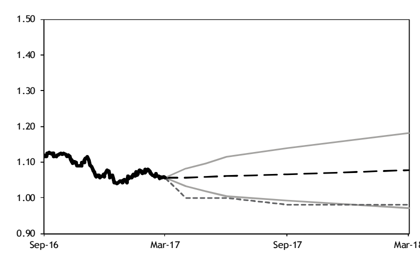
RBC Economics outlook compared to the market

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

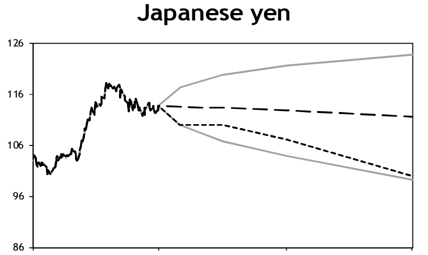
Canadian dollar



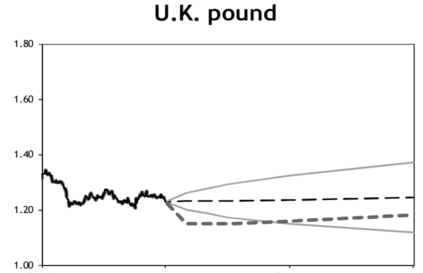
Euro



Japanese yen



U.K. pound

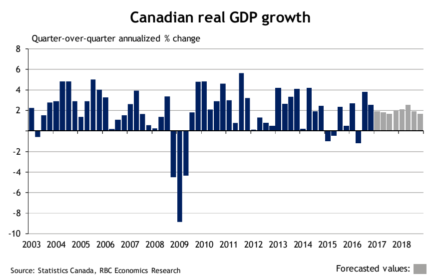


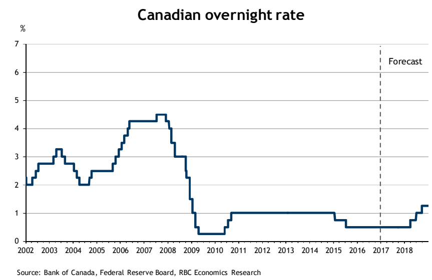
Central bank watch

Bank of Canada

Canada's economy surprised to the upside with a 2.6% annualized increase in Q4/16 GDP. Consumer spending remained a driving force, while disappointing business investment contributed to a decline in imports.

The BoC's tone was little changed in March's brief policy statement. Uncertainty surrounding US policy and lingering competitiveness issues are keeping the Bank cautious amid generally improving data.

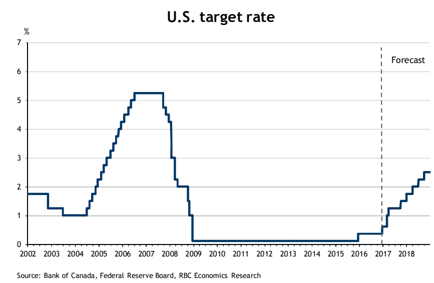




Federal Reserve

Early indicators point to US GDP growth remaining relatively steady at 2% in Q1/17. A more balanced composition of growth is expected after consumers were the dominant force in H2/16.

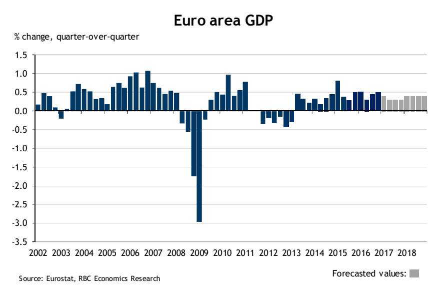
Solid economic data, including rising employment and inflation, and buoyant sentiment from investors, consumers and businesses are providing the Fed with an opportunity to raise rates in March.

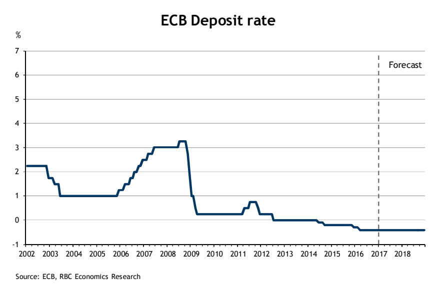


European Central Bank

Strong PMI data raises the prospect of another quarter of firm growth, but while we await more hard data on Q1/17 we continue to forecast a 0.4% GDP gain.

The ECB will take note of improving economic momentum and rising inflation at their March 9 meeting but we don't expect any changes in policy or forward guidance at this stage.

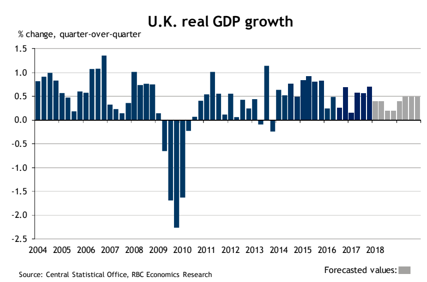


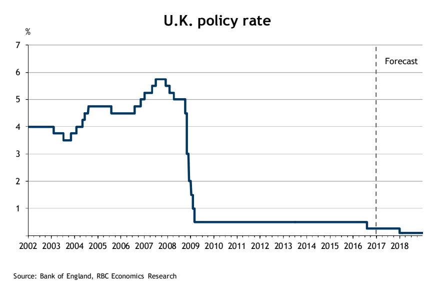


Bank of England

The UK economy finished 2016 with good momentum (Q4/16 GDP +0.7%) and recent PMI data point to decent growth continuing, albeit at a more modest 0.4% pace in Q1.

The BoE should continue to look through rising inflation given the transitory effects of higher energy and import prices—expect a neutral policy stance to be maintained in the near-term.

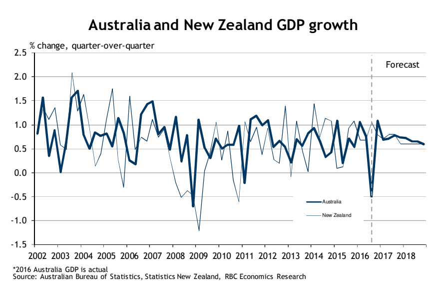


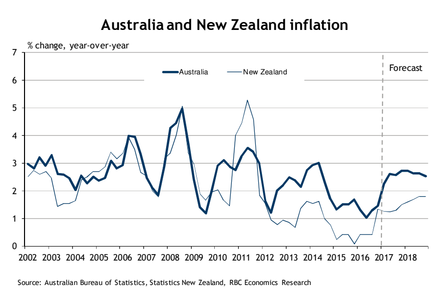


Australia and New Zealand

Australia's economy rebounded from the previous quarter's 0.5% decline with GDP rising 1.1% in Q4/16. However, underlying details point to the risk that activity and inflation disappoint to the downside relative to the RBA's expectations.

The RBNZ sounded cautiously optimistic in their latest policy statement, but a stubbornly strong currency and limited tolerance for downside surprises on inflation make it more likely than not that the central bank will act on its easing bias in May.





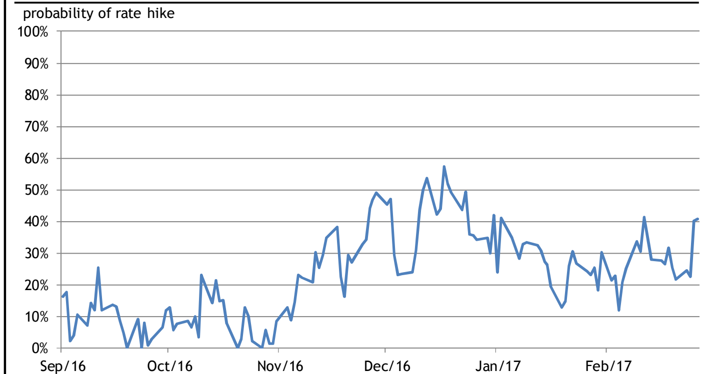
Markets reacting (or not) to monetary policy and political risk

Indications from Fed officials that a near-term rate hike is likely have seen markets increasingly price in a move in March. That shift hasn't led to a selloff in USTs, with 10-year yields remaining range bound.

Ten-year yields hold steady even as markets anticipate March hike

Source: Bloomberg, US Treasury Department, RBC Economics Research

A tightening Fed has markets eyeing Bank of Canada policy moves. While the Bank has been keen to emphasize greater slack relative to the US, odds of a higher overnight rate remain non-trivial.



Market odds of a BoC hike by December 2017

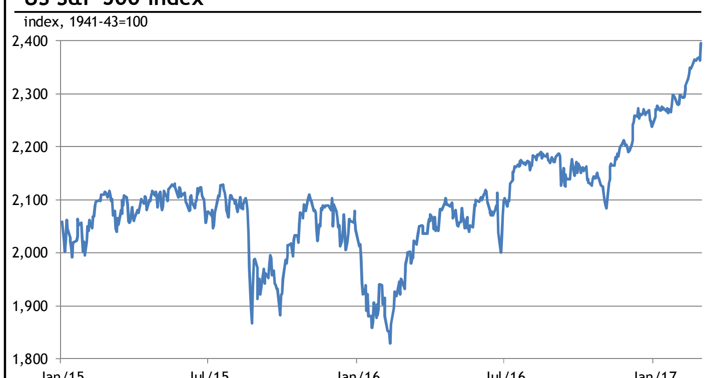
Source: Bloomberg, RBC, Economics Research

While there was no sign of political uncertainty in France's strong PMI readings, government bond spreads are pricing in risk around the upcoming French election.

10-year French-German government spread

Source: Reuters, RBC Economics Research

Political uncertainty also clouds the US outlook, although markets' focus on potential fiscal stimulus rather than downside risks has pushed equity indices to record highs.



US S&P 500 index

Source: Wall Street Journal, RBC Economics Research