FINANCIAL MARKETS MONTHLY

May 4, 2018

Divergence re-emergence

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The theme of policy divergence between the Federal Reserve and its G10 counterparts took a backseat last year amid an upswing in global growth that had a number of other central banks raising rates, or at least contemplating an end to years of extraordinary stimulus. But the divergence narrative made a bit of a comeback in April with help from some dovish central bankers. The Bank of Canada, having more or less kept up with the Fed by raising rates three times over the past year, appears reluctant to continue that trend amid concerns about US trade policy and competitiveness challenges. We still think the data makes the case for less accommodation, but the BoC's extra dose of caution prompted us to remove one of the rate hikes from our forecast this year. Expectations for the Bank of England have also shifted after Governor Carney indicated the upcoming meeting isn't the only opportunity to raise interest rates. A surprisingly soft Q1 GDP report didn't help the case for a near-term hike. Our forecast still assumes the BoE will raise rates on May 10, but the decision looks like a close call.

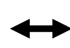
Those developments contrast with a Fed tightening cycle that appears to be in cruise control. Rising inflation, better-than-expected GDP growth, and plenty of fiscal stimulus are finally convincing policymakers—and investors—that a total of three rate hikes might not be enough this year. A higher inflation premium and anticipated increase in borrowing requirements also helped drive 10-year Treasury yields temporarily above 3% for the first time in four years. More attractive interest rates had investors buying the US dollar with the greenback erasing its year-to-date losses in April. With the BoC not keeping pace with the Fed's tightening cycle, we see a slightly weaker Canadian dollar persisting this year.

Central bank near-term bias

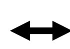
The BoC is more confident in their tightening bias but they continue to dwell on a number of headwinds. Given their cautious tone, we think the next rate increase will be put off until July, six months after the last move.

The Fed's latest policy statement wasn't as hawkish as some were looking for, but the committee sounded increasingly confident that their inflation target will be met on a sustained basis. We think they'll continue raising interest rates once a quarter, with the next move expected in June.

Between dovish comments from Governor Carney and disappointing Q1 growth, investors have pushed back their expectations for BoE tightening. We still see scope for a move in May but the decision will be a close one.



The ECB isn't likely to change their forward guidance on the future of QE until June or July. We think a brief extension of net purchases to the end of 2018 will leave a rate increase off the table until the middle of next year.



A softening trend in employment growth, which points to limited wage pressures ahead, reinforced the RBA's neutral bias in April. We think they'll remain on the sidelines throughout 2018.

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

Highlights

▲ US Q1 GDP came in above expectations despite some seasonal adjustment issues that weighed on growth.

▲ The Fed's preferred inflation gauge jumped back to around 2% after a transitory price decline last year fell out of the calculation.

▲ Rising inflation and energy prices have put upward pressure on market-based inflation, which the Fed is still characterizing as "low".

▲ The Fed's latest policy statement wasn't as hawkish as some were looking for though didn't really dent the odds of a rate hike in June.

US economy slowed less than expected in Q1

The US economy's Q1 slowdown wasn't as significant as feared with GDP posting a 2.3% annualized increase to start the year. That is down from the recent 3% pace, but in a quarter that has been plagued by seasonal adjustment issues, still represents the fastest Q1 increase in three years. Those seasonal quirks were evident in consumer spending, with the weakest gain in nearly five years in part reflecting a change in the timing of tax refunds for some households that has shifted spending patterns. But that slowdown was partially offset by another broadly-based increase in business investment, including inventories. And net trade provided a surprising add to growth thanks to a sizeable narrowing in the trade deficit late in the quarter. So even without much support from the household sector, GDP still came in 1/2 percentage point above its longer run growth rate. March's personal spending data confirmed US consumers haven't put away their wallets this year. We think a rebound in Q2 consumption, as households start to spend more of their tax refunds, will push GDP growth back above a 3% pace.

Inflation a factor in bond market moves

Perhaps the bigger takeaway from March's consumer spending report was a jump in the PCE deflator, the Fed's preferred inflation gauge. The increase in year-over-year core inflation from 1.6% to 1.9% was largely due to last March's decline in wireless telephone services dropping out of the calculation. But price growth was running at a 2.5% annualized pace in Q1, indicating the recent trend has also picked up somewhat. That rate isn't enough to cause panic at the Fed, but it certainly reinforces some committee members' views that inflation risks are increasingly skewed to the upside.

Markets have taken notice of the recent pickup in price growth. The inflation premium baked into 10-year Treasury yields has risen by 20 basis points since the start of 2018. Higher oil prices have been a factor in that move. Declining inventory levels and heightened geopolitical risks have pushed WTI oil prices up to nearly $70 per barrel for the first time since late-2014. The increase in breakeven inflation accounts for about 1/3 of the 10-year yield's march to 3% this year. Inflation has arguably been behind some of the move in real yields as well. Growing confidence that the Fed's 2% target will be met (or even surpassed) on a sustained basis has boosted market expectations for monetary policy tightening. Like the Fed, investors are now roughly split on whether three or four total rate hikes will be warranted this year.

Fed takes a pass in May, consistent with gradual tightening

In keeping with their guidance that interest rates will increase only gradually, the Fed held monetary policy steady at the beginning of May following a rate hike at the previous meeting. Most of the changes to the policy statement represented a mark-to-market of recent data. With the advance Q1 GDP report in hand, the Fed confirmed consumer spending growth moderated while business investment continued to grow strongly. There was no mention of seasonal distortions being behind the consumer slowdown, but that issue was flagged in the March minutes so we doubt policymakers are overly concerned. The committee acknowledged inflation has moved close to their 2% objective but still characterized market-based inflation measures as low. That is somewhat surprising with 10-year breakevens now close to their longer run median. At the same time, however, they dropped the previous reference to "monitoring inflation developments closely." We think that is a nod to increased confidence that their inflation objective will be met on a sustained basis after spending much of the last few years below 2%. Our forecast continues to assume the Fed will raise rates in June. They didn't provide an explicit signal in that direction, but arguably didn't need to with markets already almost fully priced for a move at the upcoming meeting.

Canada's economy rebounded in February…

The rebound in Canadian GDP in February was even stronger than expected with a 0.4% increase easily erasing January's disappointing 0.1% decline. Oil and gas output rose as temporary shutdowns eased, though that was offset by further pullback in the real estate industry. Both moves were largely anticipated. Outside of volatility in those sectors, growth was stronger and more broadly-based in February. As with Canada's jobs numbers, these data seem to confirm that the economy's slow start to the year was only transitory. On balance, we think the monthly figures are consistent with the economy expanding at a trend-like 1.8% pace in Q1.

…but spending details are looking a bit soft

While it looks like GDP increased at a trend-like pace in Q1, we think domestic demand made a much smaller contribution to activity early this year. Recall that even with headline growth slowing to 1.6% in the second half of last year, domestic spending still increased at a 4% rate. We are now seeing some payback from that unsustainable strength. Revised retail sales data point to consumer spending slowing sharply. At the same time, housing likely shaved 1/2 percentage point from growth in Q1 after tighter mortgage rules were implemented in January. Business investment also lost a bit of steam to start 2018, though some of that reflected M&E purchases having been pulled forward into late-2017 before a change in emissions regulations took effect.

With the Bank of Canada having raised interest rates three times over the past year, some slowing in consumer spending and housing was to be expected. But the first quarter's drop-off in those sectors looks overstated. Rising debt service costs will certainly take a bite out of households' disposable income but that shouldn't be enough to slam the brakes on spending. Given solid fundamentals of low unemployment, steady job gains and rising wages, we are confident that consumption growth will rebound from Q1's forecasted 1/2% pace. That said, we aren't likely to see anything close the average gains of more than 3% seen last year. Meanwhile, the sharp pullback in Q1 home sales won't be repeated going forward as most local markets appear to be adjusting to higher qualifying rates. Homebuilding activity has also held up fairly well in the face of softer resales, helping to offset some of the decline in real estate activity.

Bank of Canada not in a rush to raise rates

The Bank of Canada left the overnight rate unchanged at 1.25% for a second consecutive meeting in April. Despite the steady decision being almost universally expected, the Canadian dollar still sold off thanks to Governor Poloz's cautious tone. While maintaining a tightening bias, he seemed to put additional emphasis on a number of headwinds including competitiveness challenges, concerns about trade policy, and high household debt. An upward revision to the economy's potential growth rate, which means more room to expand without generating inflationary pressure, was also seen as a dovish development—even as growth forecasts were revised higher alongside.

The meeting provided little clarity on when we might expect another rate hike. Governing Council noted increasing confidence in their tightening bias, but stopped short of signaling a near-term move. That was despite rising inflation and wage growth, and a fairly positive Business Outlook Survey—the latter flagged by Deputy Governor Lane as an "important indicator" ahead of April's decision. We said last month that we still liked the odds of a rate hike before mid-year, but their recent tone doesn't seem to point to a move at May's meeting. Our forecast now assumes just two more rate hikes over the second half of this year, and another two in 2019 (still 100 basis points of cumulative tightening). A continuation of recent inflation trends and a pickup in domestic spending in Q2, particularly in business investment, would boost our confidence that the next rate increase will come in July. Along with the change in our BoC call, we have revised our forecast for the Canadian dollar. We now see it ending the year at 78 US cents (close to current levels) rather than the modest rally we expected previously.

Highlights

- ▲ Canadian GDP rebounded 0.4% in February after a 0.1% decline in the prior month.
- ▲ We think Q1 GDP growth was close to trend, but with less support from domestic spending than in H2/17.
- ▲ While higher interest rates will continue to weigh on household finances, consumer spending is expected to bounce back a bit in Q2.
- ▲ The Bank of Canada is in no rush to act on their tightening bias.

Highlights

▲ UK GDP growth slowed to just 0.1% in Q1, and the statistics agency downplayed the impact of severe winter weather.

▲ UK survey data point to only a modest rebound in Q2 GDP.

▲ Euro area GDP growth slowed to 0.4% in Q1, with some weather effects also at play.

▲ Softer employment growth points Australia's unemployment rate continuing to trend sideways.

BoE meeting in May now looks like a close call

Over the last month, a rate hike at the Bank of England's next meeting on May 10 has gone from a foregone conclusion to a much more finely balanced decision. Some of that reflects a more dovish tone from Governor Carney. He threw cold water on expectations for a near-term move by noting that May isn't the BoE's only opportunity to raise rates. Softer economic data also pushed the odds lower. While survey indicators were pointing to a slow start to the year for the UK economy, Q1's 0.1% GDP gain still represented a sizeable shortfall relative to expectations. Adding to the disappointment, the Office for National Statistics downplayed the impact of bad weather, noting the effect was small and narrowly-based. The construction sector provided much of the drag on growth—with some of that decline coming before the worst weather hit—and fully offset a gain in the much larger services sector. Industrial production actually got some help from wintry conditions as energy production rose. Other data have been more balanced if not slightly underwhelming, The unemployment rate declined further in February and is now back below the BoE's longer-run estimate. But wage growth and inflation were slightly lower than expected. More important for the upcoming decision will be whether the central bank views Q1's slowdown as temporary. April's PMI data suggests a relatively modest rebound in Q2, which could give the BoE additional pause.

Euro area Q1 slowdown looks temporary

The euro area economy was also impacted by colder-than-usual temperatures early this year. Q1 GDP growth slowed to 0.4% from the 0.7% pace seen through much of last year. That moderation was concentrated in Northern Europe where the weather effect was most acute, with labour disruption in France also weighing on activity. This slowdown won't have come as a surprise to the European Central Bank—it was flagged by survey indicators toward the end of the quarter, and President Draghi noted transitory factors were likely to blame. Early PMI data for Q2 are consistent with growth of 0.6%, supporting the idea that the dip in Q1 growth will be short-lived. Outside of weather disruptions, the euro area economy continued to improve with the unemployment rate edging lower again in Q1. Inflation remains low but some very early evidence of stronger wage growth should reinforce the idea that less monetary policy stimulus will be needed over time. The ECB's latest meeting didn't result in any changes in policy or forward guidance. Instead, it looks like they'll start laying out plans for an eventual end to net QE purchases at their next meeting in June, or perhaps July. We think the change in guidance will reinforce market expectations, and our own, that the ECB isn't likely to begin raising interest rates before mid-2019.

Offsetting inflation and jobs data keep RBA in neutral

Australia's core inflation unexpectedly moved higher in Q1, averaging 2% for the first time since 2015. The report represented an upside surprise relative to the Reserve Bank of Australia's previous forecast, but they downplayed the miss in their policy statement noting recent inflation data were "in line with expectations." Indeed, while they raised their forecast for underlying inflation in the near-term, they still see it stuck at the lower end of their 2-3% target band into 2020. And offsetting the upside surprise on inflation, labour market data has softened in recent months. Trend employment growth has slowed significantly this year, keeping the unemployment rate steady at 5-1/2%. Having previously looked for a further decline in the jobless rate, the RBA's updated forecast now shows the current level of labour market slack persisting throughout 2018. That reinforces the central bank's expectation that wage growth will remain low "for a while yet." On balance, we think the RBA's revised forecasts are consistent with the central bank remaining on hold into 2019. If anything their tightening cycle could be delayed relative to what our current forecast suggests.

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	0.75	0.75	0.75	1.00	1.00	1.00	1.25
Two-year	0.12	0.36	0.46	0.45	0.82	0.80	0.85	0.95	1.00	1.05	1.10	1.15
10-year	1.14	1.26	1.38	1.19	1.34	1.75	1.85	1.90	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	95	100	95	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
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	4.4	1.5	1.7	1.8	2.4	2.1	1.8	1.8	1.7	1.7	1.7	1.4	3.0	2.1	1.8
United States*	1.2	3.1	3.2	2.9	2.3	3.1	2.8	2.8	1.8	2.4	2.2	1.8	1.5	2.3	2.8	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	1.2	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	0.5	0.8	0.7	0.4	0.8	0.8	0.7	0.6	0.7	0.7	0.8	0.9	2.6	2.3	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	2.1	2.0	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	2.1	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	2.6	2.6	2.5	2.3	2.2	2.2	2.0	0.6	2.7	2.7	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	2.4	2.5	2.6	1.3	1.9	2.3	2.3
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]	Mar	0.2	1.9	2.8	2.1
United States	Core PCE[1,2]	Mar	0.2	1.9	2.5	1.9
United Kingdom	All-items CPI	Mar	0.1	2.5	0.8	2.4
Euro area	All-items CPI[1]	Apr	0.1	1.2	1.5	1.8
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	1.32	1.26	1.27	1.29	1.31	1.33	1.35
New Zealand dollar	0.70	0.73	0.72	0.71	0.72	0.73	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	1.71	1.61	1.62	1.63	1.65	1.69	1.73
NZD/CAD	0.93	0.95	0.90	0.89	0.93	0.95	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

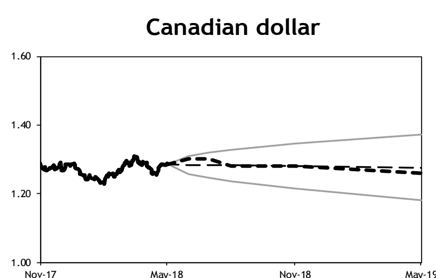
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics Research

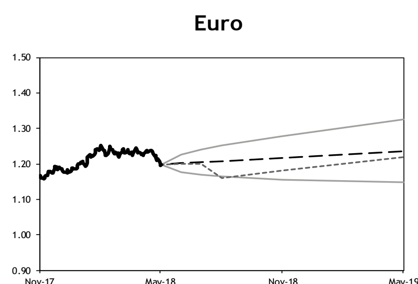
RBC Economics outlook compared to the market

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.

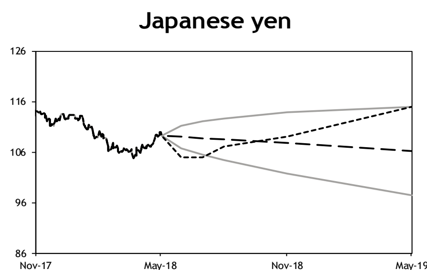
Canadian dollar



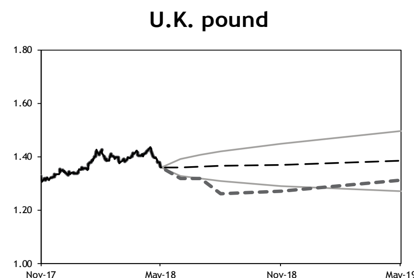
Euro



Japanese yen



U.K. pound

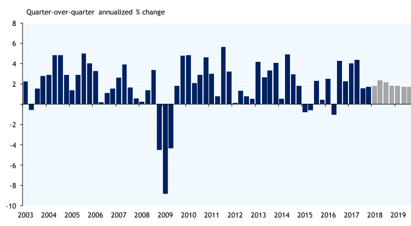


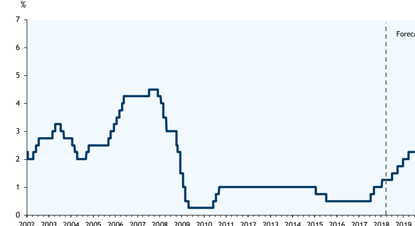
Central bank watch

Bank of Canada

Thanks to a solid rebound in February GDP, Q1 growth is now tracking around 1.8%—right on the BoC's revised estimate of potential growth and stronger than their 1.3% forecast for Q1.

We don't think a modest upside surprise on Q1 growth will sway the BoC in May, but it should reinforce their tightening bias. We think they'll next raise rates in July, six months after the last hike.

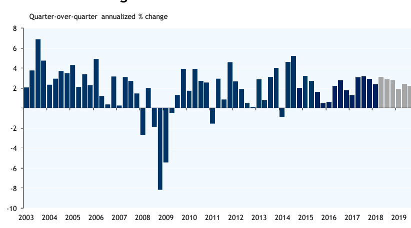


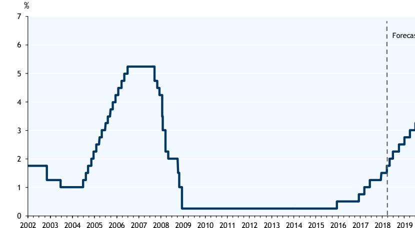


Federal Reserve

The Fed's latest policy statement was mostly a mark-to-market on recent GDP and inflation data. They didn't seem to disappointed with slower Q1 growth, likely due to familiar seasonal adjustment issues.

Their May 2 policy statement was a bit less hawkish than expected, but with a June rate hike already priced in by markets, the Fed didn't really need to talk up a move.

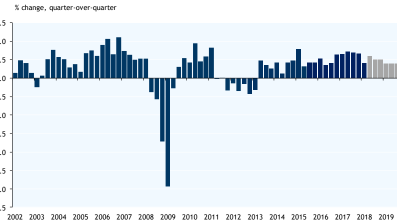


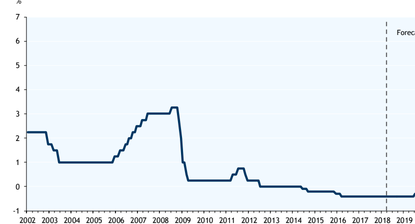


European Central Bank

A modest slowdown in Q1 GDP growth won't have come as a surprise to the ECB given some transitory factors that weighed on activity. April's PMI data point to growth returning to an above-trend pace.

The ECB will discuss the future of QE over the summer. We expect a three month extension that will be more about the timing of rate hikes than providing additional stimulus through purchases.

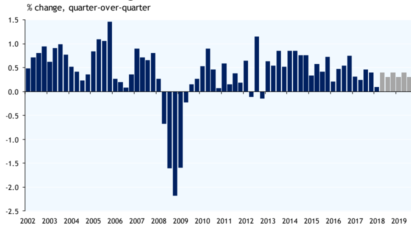


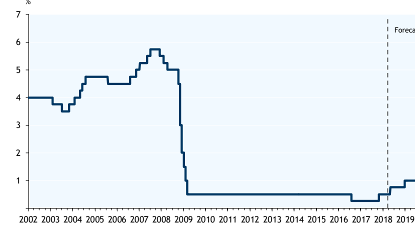


Bank of England

UK GDP growth slowed more than expected in Q1, and while weather had some effect, it didn't account for all of the weakness. PMI data point to a relatively modest rebound in Q2.

Soft GDP data and a downside surprise on inflation won't have the BoE rushing to raise rates. We still expect a hike in May but the decision looks like a much closer call than it did a month ago.

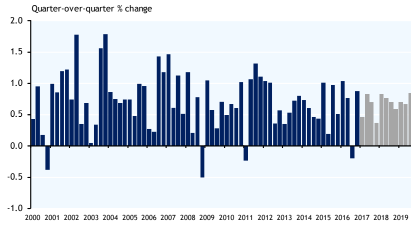


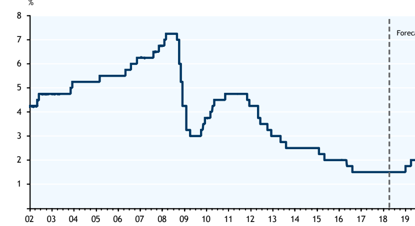


Australia

Offsetting surprises in inflation and labour market data kept the RBA firmly in neutral in May.

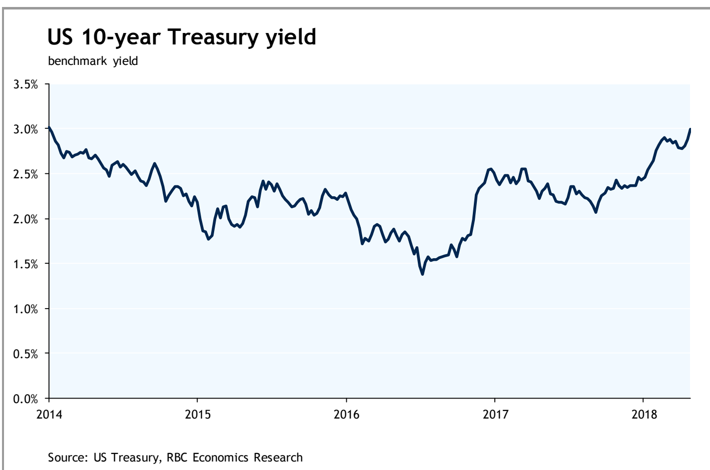
Inflation and wage growth have troughed but the upward trend will be slow, particularly with job gains doing little to absorb labour market slack. We continue to expect the RBA will remain on the sidelines this year.



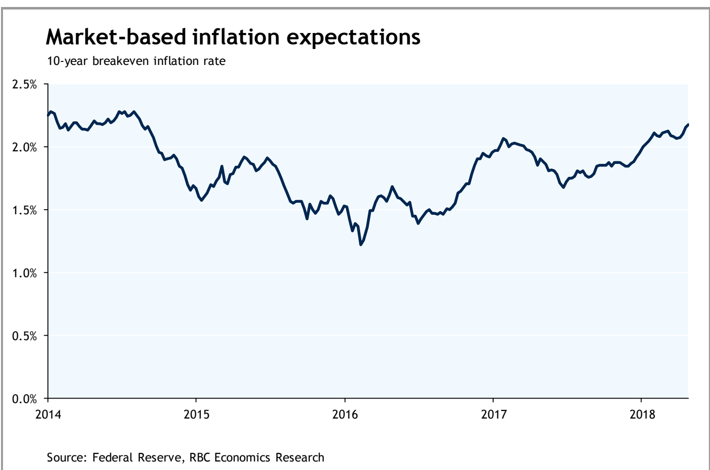


US 10-year yields challenging 3%

10-year US Treasury yields temporarily hit 3% for the first time since 2014 in late-April before rallying slightly at the turn of the month. Yields have more than doubled from their mid-2016 trough and are up more than 50 basis points year to date.

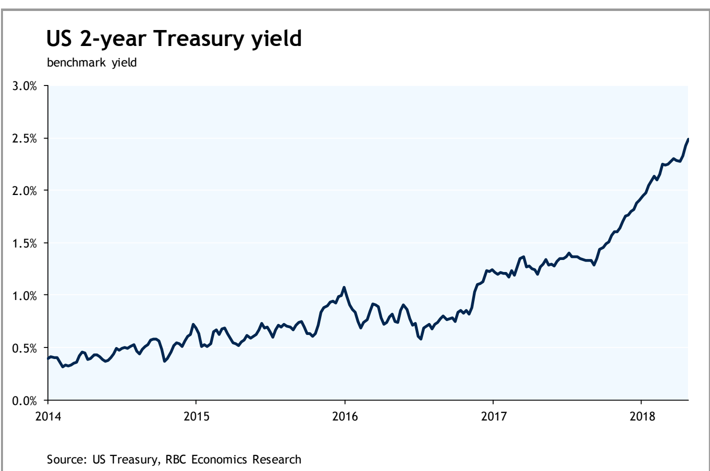


About 20 basis points of the increase in yields this year is due to a rising inflation premium. The markup on nominal bonds (the ones yielding 3%) relative to inflation-indexed bonds hit its highest level since 2014.



Breakeven inflation rates have closely followed oil prices since the latter plunged in 2014. With WTI prices at their highest levels in years (nearly $70 per barrel) it's no surprise that investors are asking for a bit more inflation compensation.

It isn't just longer-term yields that are moving higher. The dramatic increase in 2-year Treasury yields reflects markets starting to buy into the Fed's 'dot plot' forecast that calls for steady rate hikes not just this year, but in 2019 as well.



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