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FINANCIAL MARKETS MONTHLY

October 10, 2018

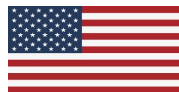
Let's make a deal

Canada, the US and Mexico pushed through plenty of 'deadlines' in their year-long Nafta talks, and we thought October 1 would be much of the same. But that date seems to have been more important to the US side than we appreciated, with Lighthizer and team dropping some of their more contentious demands in order to secure an eleventh hour deal. Canada made some concessions as well, particularly in opening up supply managed sectors a bit more. But relative to some of the low points in negotiations, the Canadian side can take this as a win. The newly-minted USMCA keeps a favoured dispute resolution mechanism in place, and Canada was able to join Mexico in securing an exemption from potentially punitive auto tariffs. The US had plenty to lose from higher North American trade barriers, but it is Canadian and Mexican companies that will be breathing the biggest sigh of relief. We think reduced trade uncertainty is the biggest takeaway from this new deal.

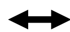
UK negotiators will be hoping their Brexit talks with the EU also reach an agreeable conclusion, and one that is palatable to lawmakers back home. They don't have the luxury of successive deadlines—if an agreement isn't in place by March 29, 2019 (which likely means a deal reached later this year), the UK will crash out of the EU without a transition period or an agreement on future trading relations. BoE Governor Carney recently warned of the dire economic consequences of a no-deal Brexit, including rising unemployment and falling home prices. Until the central bank has more clarity on how Brexit will unfold, we think they'll stick to the sidelines. Meanwhile, a fresh trade deal gives the Fed and Bank of Canada one more reason to continue gradually raising interest rates.

Central bank near-term bias

Solid economic data over the summer supports the Bank of Canada raising rates later this month. The USMCA deal reduces trade uncertainty, but we don't see it shifting the BoC's gradual approach to tightening. October's hike will likely be the last this year.



US monetary policy remains accommodative —even if the Fed's statement no longer says so. A strong economic backdrop continues to argue for higher rates, and we expect an increase at December's meeting.



Recent data support the Bank of England's tightening bias, but we doubt they'll act on it before Brexit is sorted out. We expect a hike early next year as long as the BoE's 'smooth' Brexit assumption plays out.

The European Central Bank seems to be in cruise control, with asset purchases being tapered further this month and set to end (on net) in January. Rate hikes remain nearly a year away and will be very gradual.

The Reserve Bank of Australia continues to take a glass half full approach, helped by solid GDP growth and declining unemployment. But they admit wages and inflation will likely be slow to follow, arguing for steady rates well into next year.

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

Highlights

▲ Even with US unemployment at a nearly 50-year low, job growth remains close to a 200k per month pace.

▲ Wage growth continues to pick up very gradually despite labour shortages.

▲ US Treasuries sold off throughout September and in early-October, with 10-year yields hitting multi-year highs.

▲ A change in language in the Fed's policy statement grabbed some attention, but their approach to tightening hasn't changed.

US labour market continues to impress…

Recent data on US consumer spending, business investment, and government outlays point to another quarter of broadly-based GDP growth. Even with net trade likely acting as a sizeable drag (more than retracing the previous quarter's increase) we think the economy expanded by an annualized 3% in Q3. That above-trend growth is consistent with a labour market that continues to impress. Even as a nearly 50-year low in unemployment points to a dearth of available workers, US job growth is humming along near the 200k per month mark. Job openings are at cycle highs and hiring intentions in non-manufacturing industries just hit a new record. Consumers are reporting jobs are plentiful and they expect those conditions to persist.

Despite this strength, US wages are rising only gradually. September's 2.8% average hourly earnings growth was right where it started the year. We should get to 3% soon, but even that rate hardly points to excess inflationary pressure. That doesn't seem to bother the Fed, though. Chair Powell called the US economic outlook "remarkably positive" and noted the current period of very low unemployment and stable inflation (which he expects will continue) is historically unique.

…as yields climb to multi-year highs

US Treasuries sold off throughout September and in early October with 10-year yields hitting a seven-year high of more than 3.20%. Real yields are rising while implied inflation expectations remain at or below highs seen earlier this year. The US economy's persistent strength seems to have investors thinking the current cycle has plenty of legs. That sentiment was expressed by Fed Chair Powell, who recently said, "there's no reason to think that this cycle can't continue for quite some time." His comment that rates might eventually rise above 'neutral' levels—a view we've expressed for some time, but that markets have been slow to price in—also contributed to the selloff. Even the usually dovish head of the Chicago Fed recently advocated for rates to eventually rise to a slightly restrictive setting.

The rise in longer-term yields wasn't matched at the short end. So the curve-flattening trend seen throughout this year that has cause so much consternation among market watchers has stalled. We don't see the yield curve inverting over the next year. The combination of investors pricing in more significant Fed tightening, inflation expectations creeping higher, and plenty of supply to fund government deficits should keep upward pressure on longer-term yields. We see US 10-year yields ending this year at 3.30% and continuing to rise throughout 2019.

Fed's pared down statement causes some confusion

September's rate hike came as no surprise, though a change in the Fed's policy statement caught investors off guard and seemed to cause a bit of confusion. The longstanding reference to monetary policy remaining accommodative was removed, which markets took as a dovish development. But in his press conference, Chair Powell clarified that monetary policy *is* still accommodative—certainly relative to the Committee's 'neutral' estimates that range from 2.5-3.5%. He noted the previous language had "run its useful life" and the shift didn't reflect a change in the Fed's approach to raising rates. That was backed up by a little-changed 'dot plot' that continued to flag another hike this year and three increases in 2019. The only notable forecast change was an upward revision to GDP growth this year and next—a nod to the US economy's considerable momentum even as it pushes beyond longer run capacity limits. With little need for monetary policy accommodation at this point, we see the Fed continuing to raise rates once a quarter through the end of next year.

Canada's Q3 slowdown might not materialize

Canada's economy beat expectations in July with GDP rising a trend-like 0.2%. We thought a shutdown at a major oil sands facility would dent the resources sector, but Statistics Canada noted the affected company was able to shift production and limit the hit. Manufacturing, transportation and wholesale industries all made solid contributions to growth in the month. Gains in those industries coincide with an improving Canadian trade balance and stronger US industrial sector. A better-than-expected start to the quarter prompted us to revise up our Q3 growth forecast. We now look for a 2.3% annualized increase that would be closer to the average pace seen over the first half of the year. But at the same time, a smaller hit to energy sector GDP points to a smaller rebound and we revised our Q4 forecast down by 1/2 percentage point. All told, we should see less volatility in near-term GDP, with slightly above-trend growth likely to carry us into 2019. Expect a similar revision to the Bank of Canada's growth forecast, which prior to July's GDP report also called for a Q3 slowdown.

More on the USMCA…

The United States-Canada-Mexico Agreement that is set to replace Nafta came with few surprises. Canada's most significant concession was greater US access to the dairy market. That was largely expected with similar quotas given up in CETA and CPTPP negotiations. And it was likely essential to securing a deal given Trump's loud complaints about supply management. Canada also agreed to stricter rules of origin in the auto sector, including a clause for higher-wage labour that the Canadian side seemed to have no issue with. In return, Canadian negotiators were able to hold some red lines—most significantly keeping Chapter 19's dispute resolution largely intact—and were assured of an exemption from punitive auto tariffs threatened by the US side (at least up to a specified limit well above current production levels). Section 232 tariffs on steel and aluminum will remain in place for now, but it looks like negotiators are working to resolve that issue as well.

While USMCA provides welcome relief from much of the trade uncertainty facing Canadian businesses, we aren't rushing to revise our growth forecasts higher. Our assumption has been that Nafta would remain in place until any deal was reached, and that threats on auto tariffs would remain just that. An agreement came sooner than we were anticipating, and should release some pent up business investment. But we don't think that will be enough to move the needle much on GDP growth, with a slowdown in the consumer and housing sectors remaining the dominant force behind a more moderate pace of increase this year and next.

…which won't change BoC's approach to tightening

In their latest forecast, the Bank of Canada estimated current tariffs and trade uncertainty would lower Canadian GDP by 2/3 per cent by the end of 2020. With a successful outcome in Nafta negotiations, it is reasonable to expect they'll trim that downward adjustment. But Governor Poloz has said he'll want to see how firms react to trade developments (whether positive or negative) before potentially changing the course of monetary policy. With discussions for the upcoming Business Outlook Survey having wrapped up in September, the BoC might have to wait until December to see if business sentiment gets a boost from the trade deal. And even if companies do respond by increasing investment, that could raise both current and potential output, resulting in a limited impact on capacity pressures and inflation. So at this point we see little reason for the BoC to change their gradual approach to tightening. We look for a rate hike later this month but then see the central bank holding steady until early next year.

Highlights

▲ Canada's July GDP report was stronger than expected, prompting us to revise up our Q3 growth forecast…

▲ …but that implies less of a Q4 rebound. On net our growth forecast over the second half of the year is little changed.

▲ The new USMCA deal greatly reduces trade uncertainty for Canadian businesses, but doesn't change our forecasts significantly.

▲ The BoC will be pleased that a trade deal has been secured, but we don't see it changing their gradual approach to raising rates.

Highlights

▲ We have revised up our Q3 UK GDP growth forecast to 0.6% from 0.3% previously.

▲ Political uncertainty and tighter financial conditions seem to be weighing on Italy's economy…

▲ …but solid growth in Germany and France should provide some offset.

▲ Australia's strong economic growth is expected to feed through only gradually to wages and inflation.

UK economy pushing ahead despite Brexit worries

The UK economy continues to grow at a solid pace despite persistent uncertainty over Brexit. Output was flat in August, held back by a decline in construction activity, but upward revisions to prior months left growth tracking a slightly stronger pace. Given earlier momentum, we have revised up our Q3 growth forecast to 0.6% from 0.3% previously. We continue to expect more trend-like gains going forward, which would align with the moderation in job growth in recent months. Multi-decade low unemployment might be restraining the pace of hiring, while at the same time putting upward pressure on wages. The Bank of England likely sees recent data as consistent with their forward guidance that gradual rate hikes will be needed over the medium term. But in the near term we think monetary policy will be driven more by Brexit developments than the broader economic backdrop. There have been some positive comments from EU negotiators ahead of the October 17-18 European Council meeting, and there are reports of progress on the key Irish border issue. Still, we might have to wait until a special Council meeting in November to see a deal approved. And even if that hurdle is cleared, May's Chequers plan remains a tough sell with some in her party who favour a 'hard' Brexit. The risk of a no-deal Brexit remains significant and is likely to keep monetary policy on hold until greater clarity emerges.

Diverging trajectories to leave euro area on an even keel

After an encouraging, broadly-based pickup in euro area GDP growth, the latest data point to growing divergence among the currency bloc. Italy is the most significant example, where political wrangling and a potential budget showdown with the EU have led to wider spreads on Italian debt (10-year yields more than 300 basis points higher than Germany). The combination of uncertainty and tighter financial conditions is weighing on sentiment, with the country's composite PMI hitting a two-year low in August. While deteriorating borrowing conditions haven't spread to others in the currency bloc, Spain has also seen sentiment start to falter after more than a year of solid economic growth. That contrasts with the bloc's two largest economies, Germany and France, where PMIs point to solid growth in Q3. France in particular is expected to see activity pick up as a number of transitory factors that weighed on growth over the first half of the year have dissipated. All told, we think strength in the 'core' should be enough to offset Italy's slowdown, leaving euro area growth at a healthy 0.5% pace heading into 2019. That should result in further improvement in the labour market, with euro area unemployment flirting with 8% for the first time in a decade. These conditions should see the ECB follow through with its plans for a very gradual shift toward policy normalization. Asset purchases will be cut in half this month and net purchases are set to end at the start of next year. That said, rate hikes remain nearly a year away and should be limited to start.

Slow wage growth and inflation to keep the RBA sidelined

The Reserve Bank of Australia's latest policy statement had only minor tweaks, and did little to change our expectation that the cash rate will be held steady for another year. The central bank took note of some tightening in financial conditions but didn't seem fazed by the independent mortgage rate hikes from several banks. The RBA also remarked on recent strength in GDP growth—Q2's 3.4% year-over-year increase is the best since 2012. That contributed to a positive view of labour market conditions, with unemployment remaining above longer run levels but "trending lower." However, they noted that the follow-through to rising wages is likely to be slow, as the international experience has shown. It's difficult to see underlying inflation picking up above the lower end of the RBA's 2-3% target range anytime soon. So even as growth looks likely to continue at a healthy 3% clip, we don't see the central bank shifting policy anytime soon. They once again noted that low rates are "continuing to support the Australian economy," and we think that will remain the case well into 2019.

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	1.26	1.59	1.65	1.90	2.15	2.15	2.15
Two-year	0.75	1.10	1.52	1.69	1.78	1.91	2.21	2.30	2.45	2.45	2.40	2.35
Five-year	1.12	1.40	1.75	1.87	1.97	2.07	2.34	2.45	2.55	2.65	2.70	2.70
10-year	1.62	1.76	2.10	2.04	2.09	2.17	2.43	2.60	2.70	2.80	2.90	2.95
30-year	2.30	2.14	2.47	2.27	2.23	2.20	2.42	2.70	2.80	2.90	3.00	3.00
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	1.93	2.19	2.35	2.65	2.90	3.15	3.35
Two-year	1.27	1.38	1.47	1.89	2.27	2.52	2.81	2.90	3.00	3.25	3.40	3.55
Five-year	1.93	1.89	1.92	2.20	2.56	2.73	2.94	3.10	3.25	3.45	3.55	3.65
10-year	2.40	2.31	2.33	2.40	2.74	2.85	3.05	3.30	3.45	3.60	3.70	3.75
30-year	3.02	2.84	2.86	2.74	2.97	2.98	3.19	3.50	3.65	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	0.72	0.82	0.95	1.00	1.05	1.10	1.15
10-year	1.14	1.26	1.38	1.19	1.34	1.28	1.57	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	-0.69	-0.55	-0.50	-0.50	-0.50	-0.40	-0.30
10-year	0.33	0.47	0.47	0.43	0.50	0.31	0.47	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	1.50	1.50	1.50	1.75
Two-year	1.76	1.78	1.94	2.00	2.00	2.00	2.02	2.10	2.20	2.25	2.35	2.50
10-year	2.70	2.60	2.84	2.63	2.60	2.63	2.67	2.80	2.85	3.00	3.20	3.35
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	1.75
Two-year swap	2.31	2.32	2.19	2.20	2.21	2.14	2.02	2.25	2.30	2.35	2.40	2.55
10-year swap	3.41	3.35	3.24	3.13	3.06	3.02	2.89	3.10	3.15	3.30	3.50	3.65
Yield curve*												
Canada	87	66	58	35	31	26	22	30	25	35	50	60
United States	113	93	86	51	47	33	24	40	45	35	30	20
United Kingdom	102	90	92	74	52	56	75	80	100	105	110	115
Eurozone	107	104	116	106	109	100	102	130	150	155	165	155
Australia	94	82	90	63	60	63	65	70	65	75	85	85
New Zealand	110	103	105	93	85	88	87	85	85	95	110	110

* 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				Current	Last	
United States	Fed funds	2.00-2.25	1.75-2.00	September 26, 2018	Eurozone	Deposit rate	-0.40	-0.30	March 10, 2016
Canada	Overnight rate	1.50	1.25	July 11, 2018	Australia	Cash rate	1.50	1.75	August 3, 2016
United Kingdom	Bank rate	0.75	0.50	August 1, 2018	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	1.4	2.9	2.3	2.1	1.9	1.7	1.7	1.7	1.4	3.0	2.1	2.0
United States*	1.8	3.0	2.8	2.3	2.2	4.2	3.0	2.8	1.8	2.4	2.2	1.8	1.6	2.2	2.9	2.5
United Kingdom	0.4	0.3	0.4	0.4	0.1	0.4	0.6	0.4	0.3	0.4	0.3	0.4	1.8	1.7	1.3	1.5
Euro area	0.7	0.7	0.7	0.7	0.4	0.4	0.5	0.5	0.4	0.4	0.4	0.4	1.9	2.5	2.1	1.8
Australia	0.4	0.7	0.7	0.7	1.1	0.9	0.6	0.8	0.7	0.6	0.8	0.8	2.6	2.2	3.3	3.0
New Zealand	0.8	0.8	0.6	0.6	0.5	1.0	0.9	0.8	0.8	0.8	0.8	0.8	4.0	2.8	2.8	3.3

*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	2.3	2.8	2.7	2.4	2.7	2.4	2.3	1.4	1.6	2.5	2.4
United States	2.5	1.9	2.0	2.1	2.2	2.7	2.7	2.7	2.4	2.6	2.6	2.5	1.3	2.1	2.6	2.5
United Kingdom	2.2	2.8	2.8	3.0	2.7	2.4	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	1.7	2.1	1.8	1.9	1.7	1.6	1.5	0.2	1.5	1.7	1.7
Australia	2.1	1.9	1.8	1.9	1.9	2.1	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	1.5	1.9	1.6	1.6	1.6	1.6	1.7	0.7	1.9	1.6	1.6

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]	Aug	0.2	2.3	2.2	2.0
United States	Core PCE[1,2]	Aug	0.0	2.0	1.8	2.1
United Kingdom	All-items CPI	Aug	0.7	2.7	2.4	2.3
Euro area	All-items CPI[1]	Sep	0.2	2.1	2.2	2.2
Australia	Trimmed mean CPI[1]	Q2	0.5	1.9	N/A	N/A
New Zealand	All-items CPI	Q2	0.4	1.5	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	1.31	1.29	1.29	1.28	1.27	1.28	1.28
Euro	1.07	1.14	1.18	1.20	1.23	1.17	1.16	1.12	1.10	1.10	1.13	1.16
U.K. pound sterling	1.26	1.30	1.34	1.35	1.40	1.32	1.30	1.26	1.24	1.22	1.24	1.25
New Zealand dollar	0.70	0.73	0.72	0.71	0.72	0.68	0.66	0.66	0.64	0.63	0.63	0.63
Japanese yen	111.4	112.4	112.5	112.7	106.3	110.8	113.7	115.0	117.0	119.0	122.0	125.0
Australian dollar	0.76	0.77	0.78	0.78	0.77	0.74	0.72	0.70	0.68	0.67	0.67	0.67

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	1.53	1.50	1.44	1.41	1.40	1.45	1.48
GBP/CAD	1.67	1.69	1.67	1.70	1.81	1.74	1.68	1.62	1.58	1.55	1.59	1.60
NZD/CAD	0.93	0.95	0.90	0.89	0.93	0.89	0.85	0.85	0.82	0.80	0.81	0.81
CAD/JPY	83.7	86.7	90.2	89.6	82.4	84.3	88.1	89.1	91.4	93.7	95.3	97.7
AUD/CAD	1.02	1.00	0.98	0.98	0.99	0.97	0.93	0.90	0.87	0.85	0.86	0.86

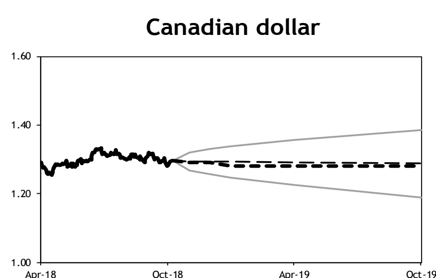
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics Research

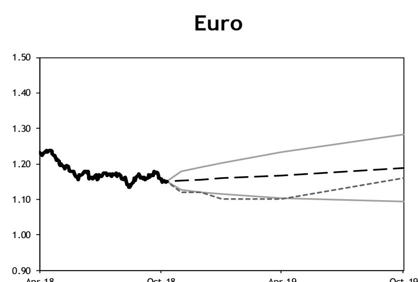
RBC Economics outlook compared to the market

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.

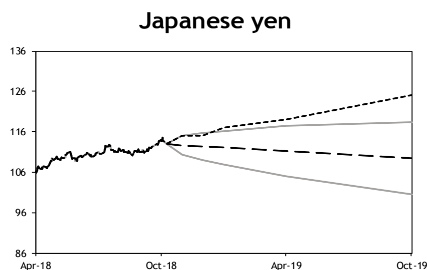
Canadian dollar



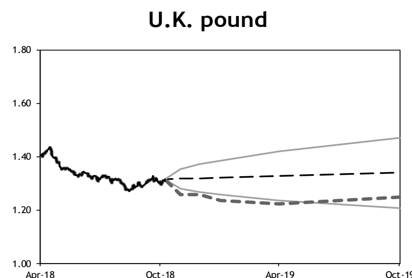
Euro



Japanese yen



U.K. pound

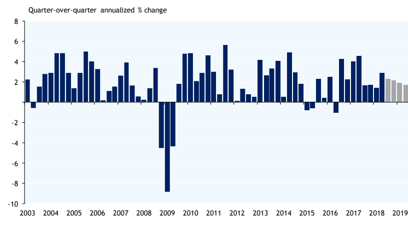


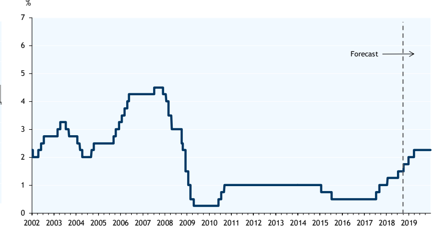
Central bank watch

Bank of Canada

July GDP was stronger than expected as an oil sands shutdown had only a limited impact on production. That points to stronger Q3 GDP growth, but also less of a rebound in Q4.

A solid run of data should see the BoC raise rates again in October. USMCA could prompt an upward revision to their growth forecasts, but shouldn't change their gradual approach to tightening.

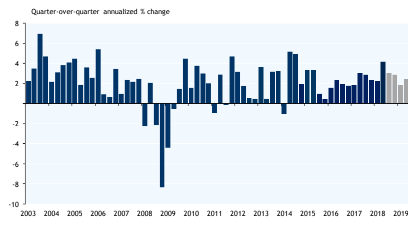


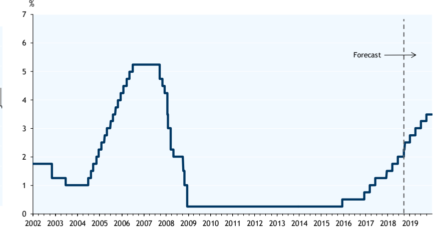


Federal Reserve

Fiscal stimulus continues to boost spending by consumers, businesses and government. The US economy is likely to grow at a 3% pace over the second half of the year.

Recent comments from Fed officials point to further rate hikes and a move to slightly restrictive monetary policy. We continue to expect once-a-quarter rate increases through next year.

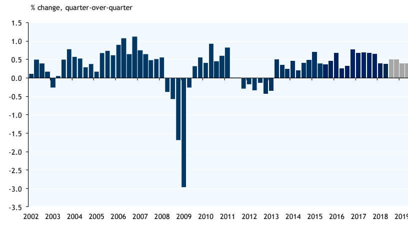


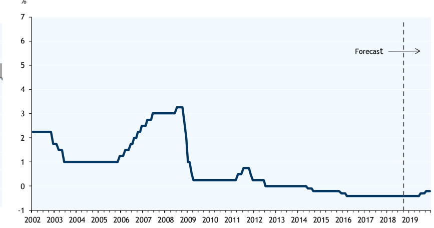


European Central Bank

Survey data point to slower growth in Italy but solid gains in Germany and France. We expect those offsetting forces will keep the euro area growing at a 0.5% pace over the second half of 2019.

The ECB remains on course to end net asset purchases at the beginning of 2019. We expect it will be few more quarters before they begin gradually raising rates from negative levels.

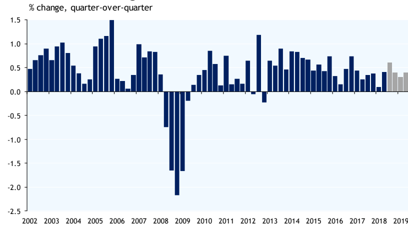


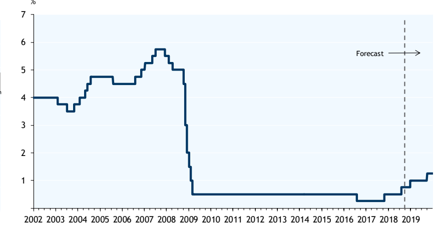


Bank of England

Despite flat August GDP, upward revisions to prior months leave us tracking a 0.6% increase in Q3 GDP—twice the pace previously expected.

The economic backdrop supports the BoE's tightening bias—as long as their assumption of a 'smooth' Brexit comes to fruition. Until they have greater clarity on the future UK-EU relationship, the central bank will likely remain on hold.

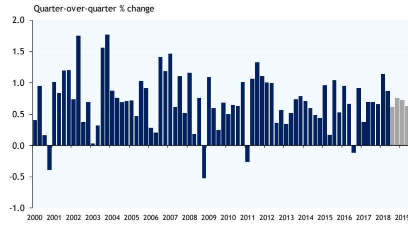


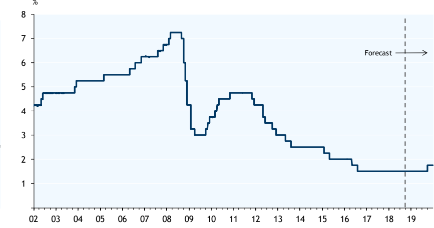


Australia

Australian GDP growth is expected to continue at a 3% pace even as consumers and housing face some headwinds.

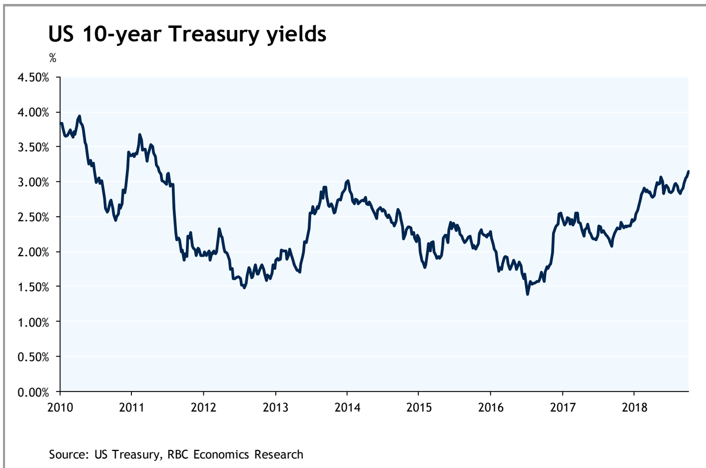
Unemployment is trending lower but remains above the RBA's estimate of full employment. And international experience has shown wage growth can be slow to follow absorption of slack. That should keep the RBA sidelined well into next year.



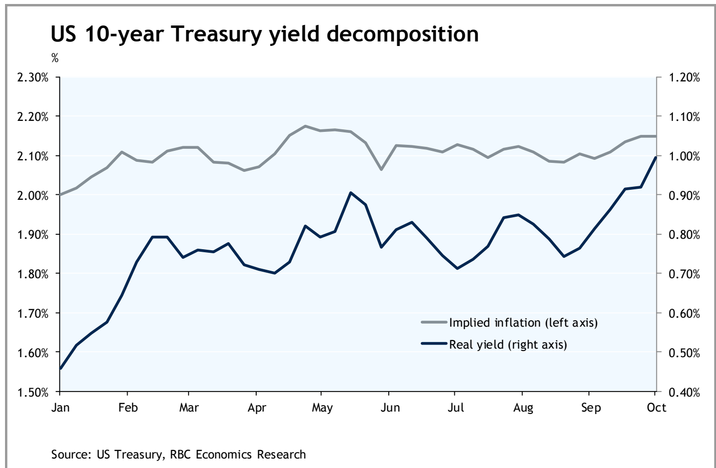


US 10-year Treasury yields hit a seven-year high

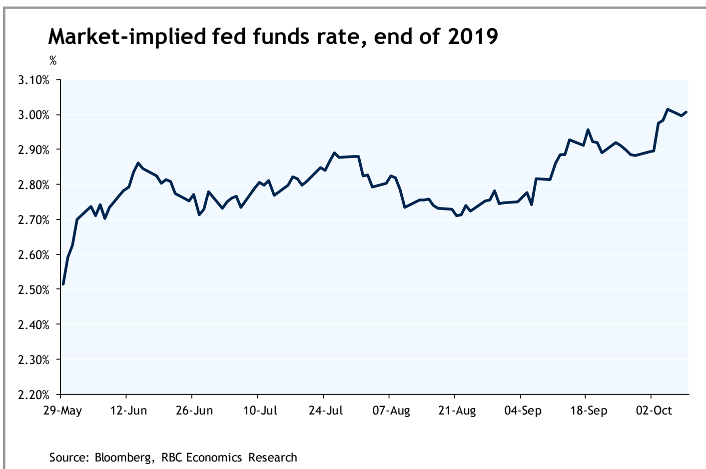
US 10-year Treasury yields struggled to break consistently above the 3% mark for much of this year. That changed over the last two months with yields surging some 40 basis points from mid-August lows. At just over 3.20%, the 10-year yield is the highest we've seen since 2011.



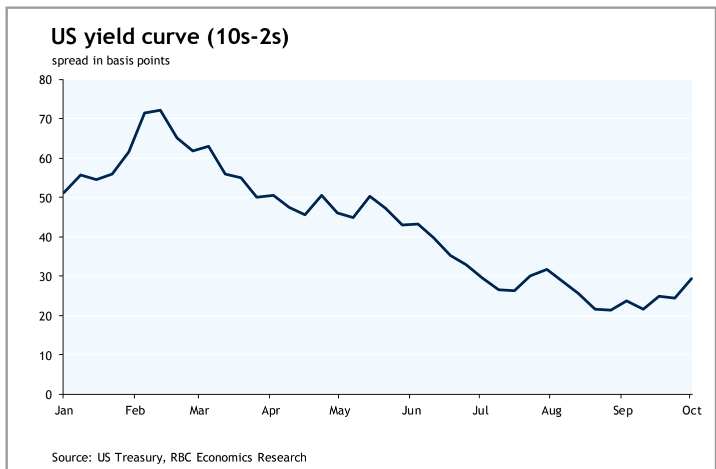
The increase in 10-year yields has largely reflected higher real yields. Market-implied inflation has drifted slightly higher but at ~2.15% isn't breaking new ground. Breakeven inflation remains below pre-crisis levels as wages and inflation have been slow to pick up this cycle.



Rising real yields reflect shifting market expectations for Fed policy. Two rate hikes over the summer, a dot plot that calls for more tightening, and some hawkish comments from Fed officials have boosted market expectations for the policy rate. Two additional hikes in 2019 have been priced in since late-May.



The rise in longer-term bond yields has paused the yield curve flattening trend that caused plenty of consternation among market watchers. We don't see the curve inverting (and signaling a recession) over the next year, though it will likely remain flat in this late stage of the cycle.



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