RBC Economics & Thought Leadership

Financial Markets Monthly

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Stayin' Alive: The U.S. labour market is weakening, not faltering

Highlights:

- More central banks are committing to cutting interest rates from elevated levels.
- The equities selloff since mid-July may have been exacerbated by a softening U.S. labour market but economic fundamentals in the U.S. have not crumbled.
- We continue to expect a normalization and not recession in the U.S., and the U.S. Federal Reserve will cut interest rates slowly this year by 25 basis points in each September and December.
- Persistent wage and price pressures will lead the European Central Bank and Bank of England to take a cautious approach to easing. We expect the BoE to stand pat in September, while the ECB cuts by another 25 bps.
- The Canadian economy remains weaker than most. That together with a muted housing market response to initial interest rate cuts is clearing the way for more. We expect the Bank of Canada to cut by 25 bps in September and November.

Overview

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The number of central banks shifting to interest rate cuts has continued to grow over the last month. The BoE joined the club in August, and the Fed looks increasingly likely to follow with an initial cut in September. The ECB held rates unchanged in July after cutting in June. The BoC continued with a second consecutive reduction in July and looks on track to cut again in September.

Still, the initial shift to cuts has lacked the urgency often associated with the start of prior easing cycles. Economies have, for the most part, softened enough to lower upside inflation risks but haven't broken in a way that would cause central banks to panic. Even in Canada, where we continue to think a weaker economic backdrop justifies more rate cuts than in other regions, the pace of cuts (25 basis points per meeting) to kick off the easing cycle is more moderate than easing cycles in the past.

Central banks have collectively emphasized a focus away from individual data readings as a driver of interest rate decisions, to the totality of the data. That's in part to guide markets away from overreacting to every data release. That hasn't really worked. Just days after the Fed's July meeting, a softer-than-expected U.S. employment report for July combined with broader concern about high stock valuations and leveraged positions had sent equity markets and bond yields plummeting.

Markets have since calmed but worries continue over the U.S. jobs markets softening too quickly. The U.S. unemployment rate at 4.3% in July is still low, but an upward trend like that observed over the last year has never ended this quickly. For now, we continue to think underlying labour market data details argue for further gradual unwinding in the jobs market as more likely than a sharp contraction. Given that outlook, we hold our forecast that the Fed will cut by 50 bps this year, with 25 bps reductions expected in each of the September and December meetings.

Central bank bias

<table>
<tr><th>Central bank</th><th>Current policy rate</th><th>Next decision</th></tr>
<tr><td>BoC</td><td>4.50%
-25 bps in Jul/24</td><td>-25 bps
Sep/24</td></tr>
<tr><td colspan="3">The BoC is expected to continue cutting interest rates by 25 basis points in September and October after delivering two consecutive rate cuts in June and July. Governor Tiff Macklem in July highlighted downside economic risks and excess supply in the economy as indications that inflation should continue to slow. Another slower-than-potential GDP increase in Q2 should continue to widen the output gap.</td></tr>
<tr><td>Fed</td><td>5.25-5.50%
0 bps in Jul/24</td><td>-25 bps
Sep/24</td></tr>
<tr><td colspan="3">Easing in U.S. inflation data has been coupled with an ongoing slowdown in the labour market that suggests downside economic risks may be gathering momentum. We think it’s still too early to call for anything beyond the normalizing of economic trends, especially given solid domestic demand backed by strong government spending. We expect a first 25 bps cut from the Fed in September.</td></tr>
<tr><td>BoE</td><td>5.00%
-25 bps in Aug/24</td><td>0 bps
Sep/24</td></tr>
<tr><td colspan="3">The BoE cut rates in August while suggesting a shift to a new framework that’s less data-dependent and more judgment-driven. To a certain extent, that was already exercised in August after a series of disappointing consumer price index prints showed a lack of easing in services inflation in the summer. We expect only one more rate cut from the BoE this year in November.</td></tr>
<tr><td>ECB</td><td>3.75%
0 bps in Jul/24</td><td>-25 bps
Sep/24</td></tr>
<tr><td colspan="3">The ECB held rates steady in July as expected while emphasizing (similar to the BoE) a shift to broader growth and inflation trends with less focus on individual data releases. Moving forward, we think the central bank will keep on the path to lower rates long as there aren’t any significant upside surprises in inflation. We expect another cut at each of the September and December meetings.</td></tr>
<tr><td>RBA</td><td>4.35%
0 bps in Aug/24</td><td>0 bps
Sep/24</td></tr>
<tr><td colspan="3">The downside CPI release in Q2 was enough to keep the Reserve Bank of Australia on hold in August. But comments from Governor Bullock continued to err on the hawkish side, dismissing market pricing for a rate cut this year. We think the cash rate has reached its peak in this cycle but continue to expect the RBA to lag the global easing cycle both in terms of timing and magnitude. We expect a first cut in Q2 2025.</td></tr>
</table>

The bottom hasn't fallen out of the U.S. labour market, yet

U.S. inflation data has continued to trend lower in the summer and expectations have continued to moderate. Five-year implied inflation rates from Treasury Inflation-Protected Securities dipped below the Fed's 2% inflation objective for the first time in early August since January 2021.

Treasury market implied inflation eases below 2%

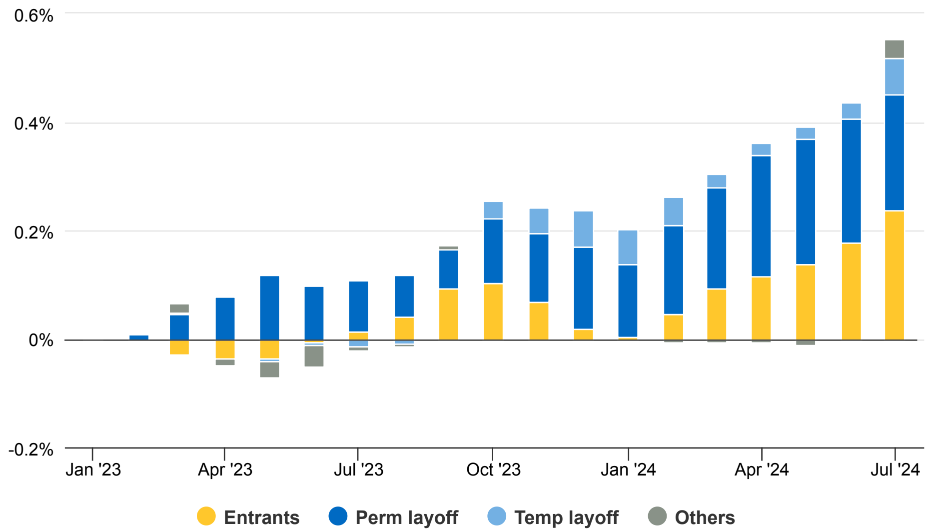
Source: Haver, RBC Economics

The recent acceleration in the unemployment rate has been significant, triggering the so-called Sahm rule (a 0.5 percentage point increase in the three-month average from its low of the last 12 months) that historically only happens during U.S. recessions. But the labour market data is less worrying beneath the surface.

For one, the unemployment rate has increased but is still low. At 4.3%, it's around what Fed policymakers view as long-run "normal" levels. The drivers of the increase have also been different than usual, coming from longer job searches for labour market entrants that contributed to 40% of the rise in the unemployment rate to-date. Data outside of the household survey largely supports the view of a gradual rebalancing in the market. Payroll employment growth remains positive and weekly initial jobless claims continue to inch gradually higher.

Entrants into U.S. labour market pushing unemployment up

Contribution to increase in unemployment rate since January 2023, 3-month average



Source: Bureau of Labor Statistics, RBC Economics

There are downside risks lurking. Consumer delinquencies and business bankruptcies have both continued to rise into the summer. Permanent job losses have been a smaller share of rising unemployment to-date but have still been gradually increasing. A larger and more persistent drop in equity prices could spill over to dampen consumer confidence and curb their spending. But markets have calmed significantly following the Friday of the July payroll employment report and are still sharply higher on a year-to-date basis.

Overall, the bottom hasn't yet fallen out of the U.S. economy. Easing wage growth is also helping to confirm that labour markets have rebalanced and reinforces that inflation is more likely to continue to drift lower. We expect the Fed will start cutting rates in their next meeting with a 25-basis point reduction in September and a second cut following in December.

Resilient jobs and inflation to put the brakes on ECB, BoE rate cuts

Economic conditions in the euro area look to have softened slightly heading into Q3 after another solid 0.3% expansion in gross domestic product in Q2. Part of this is due to persistently subdued manufacturing activities as demand from key export markets slows, especially from China. That's in line with ECB's quarterly bank lending survey that showed still-gloomy loan demand from firms in Q2, contrasting with an increase in demand for consumer credit and housing loans.

The U.K. economy is slightly different in that it's on track to deliver another outsized GDP increase in Q2. Purchasing managers' indices suggest that momentum has been carried over to Q3 as well with both service and manufacturing activities continuing to expand in July. Moving forward, a stronger economic backdrop is expected to continue to translate into strength in the labour market. The latest labour force survey already flagged higher employment in the three months to June, and a drop in the unemployment rate.

The downside is that a tight labour market could add to upside wage pressure, extending the run of persistently firm services inflation. Cautious of those risks, we think the ECB and the BoE will both be slow to cut interest rates with the ECB having already opted to forego a second consecutive cut in July. We look for the ECB and BoE to ease at a once-a-quarter pace before reaching policy rates of 3% and 4.25%, respectively, later in 2025.

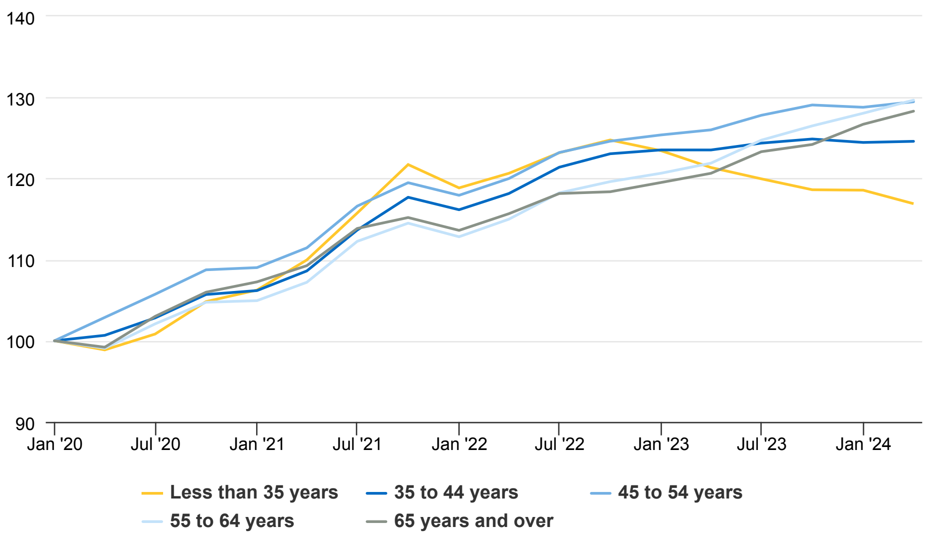
Young Canadians bear the brunt of labour market woes

In Canada, a persistent weakening in the economy and labour market is still paving the way for the BoC to cut rates more aggressively than most other advanced economies. The unemployment rate has increased by 1.6 percentage points in Canada since summer 2022 and per-capita GDP is now back closer to lower levels a decade ago. That kind of backdrop is tough to characterize as a "soft landing."

Forward-looking indicators are suggesting the labour market will likely get worse before it gets better. Job vacancies remain on the downtrend in the summer. Both investment and hiring intentions remained historically weak in Q2, according to businesses surveyed by the BoC. Our forecast is for the unemployment rate to rise to a peak of 6.7% by the end of this year, up from 6.4% currently before gradually declining in 2025.

Younger Canadian households actively deleveraging

Mortgage balance per household by age, indexed, Q4-2019 = 100



Source: Statistics Canada, RBC Economics

What's different this time is how young Canadians—or those under age 35—have shouldered the lion's share of the rise in the unemployment rate. That coupled with higher interest rates has led them to see some of the largest increases in the debt servicing ratio among all age groups. Not surprisingly, these younger households were also the only ones to have reduced their mortgage balances over the past year and a half.

With prime first-time homebuyers under significant stress from the labour market downturn, new mortgage lending has slowed substantially. And BoC rate cuts have done little to help. Minutes from the last monetary policy decision in July detailed how concerns about an upward spiral in the housing market have eased. That means one less hurdle on the path to lower interest rates that still look too restrictive when compared to a softening labour market and declining per-capita GDP. We expect the BoC to cut rates by 25 bps at each of the September and October meetings, to leave the overnight rate at 4% by the end of 2024.

Interest rate outlook

Policy rates and government bond yields, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
Canada												
Overnight rate	4.50	4.75	5.00	5.00	5.00	4.75	4.25	4.00	3.75	3.25	3.00	3.00
Three-month	4.34	4.90	5.07	5.04	4.99	4.64	4.10	3.95	3.60	3.20	3.00	3.00
Two-year	3.74	4.58	4.87	3.88	4.22	3.99	3.40	3.25	2.90	2.75	2.90	3.00
Five-year	3.02	3.68	4.25	3.17	3.58	3.51	3.10	3.00	2.85	2.90	2.90	3.00
10-year	2.90	3.26	4.03	3.10	3.52	3.50	3.15	3.00	2.90	2.95	3.00	3.10
30-year	3.02	3.09	3.81	3.02	3.41	3.39	3.25	3.05	3.00	3.05	3.10	3.15
United States												
Fed funds midpoint	4.87	5.12	5.37	5.37	5.37	5.37	5.13	4.88	4.63	4.38	4.38	4.38
Three-month	4.85	5.43	5.55	5.40	5.45	5.48	4.96	4.70	4.50	4.28	4.35	4.36
Two-year	4.06	4.87	5.03	4.23	4.66	4.71	4.50	4.60	4.65	4.75	4.80	4.70
Five-year	3.60	4.13	4.60	3.84	4.28	4.33	4.10	4.25	4.20	4.25	4.20	4.10
10-year	3.48	3.81	4.59	3.88	4.27	4.36	4.15	4.30	4.25	4.20	4.15	4.05
30-year	3.67	3.85	4.73	4.03	4.41	4.51	4.40	4.60	4.55	4.45	4.35	4.25
United Kingdom												
Bank rate	4.25	5.00	5.25	5.25	5.25	5.25	5.00	4.75	4.50	4.25	4.25	4.25
Two-year	3.42	5.27	4.91	3.98	4.17	4.23	3.75	3.70	3.60	3.75	3.90	4.00
Five-year	3.33	4.66	4.53	3.46	3.84	4.03	3.75	3.60	3.50	3.55	3.60	3.65
10-year	3.47	4.39	4.46	3.54	3.95	4.17	3.90	3.75	3.70	3.75	3.85	3.95
30-year	3.82	4.42	4.92	4.14	4.49	4.67	4.60	4.50	4.50	4.60	4.70	4.85
Euro area*												
Deposit Rate	3.00	3.50	4.00	4.00	4.00	3.75	3.50	3.25	3.00	3.00	3.00	3.00
Two-year	2.66	3.27	3.20	2.40	2.83	2.82	2.50	2.50	2.50	2.60	2.70	2.80
Five-year	2.30	2.58	2.79	1.94	2.32	2.48	2.20	2.20	2.15	2.20	2.20	2.25
10-year	2.28	2.39	2.85	2.03	2.29	2.50	2.35	2.20	2.20	2.20	2.25	2.30
30-year	2.35	2.38	3.05	2.27	2.46	2.69	2.50	2.50	2.50	2.50	2.60	2.70
Australia												
Cash target rate	3.60	4.10	4.10	4.35	4.35	4.35	4.35	4.35	4.35	4.10	3.85	3.85
Two-year	2.96	4.21	4.09	3.71	3.76	4.17	4.00	4.10	4.05	4.00	4.10	4.10
10-year	3.30	4.02	4.49	3.95	3.97	4.31	4.30	4.50	4.40	4.30	4.20	4.00
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.25	4.75	4.50	4.00	3.75	3.75
Two-year swap	5.01	5.46	5.69	4.63	4.78	4.95	4.10	4.15	4.05	3.90	3.90	3.90
10-year swap	4.27	4.46	5.13	4.12	4.35	4.48	4.15	4.20	4.15	4.15	4.15	4.05

Sources: Refinitiv, BoC, Fed, BoE, ECB, RBA, RBNZ, RBC Economics, RBC Capital Markets | *German government bond yields

Economic outlook

Real GDP, quarter-over-quarter percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada*	3.9	3.8	1.8	-0.9	3.4	0.7	-0.3	0.1	1.7	1.4	1.4	1.5	1.6	1.6	1.8	1.8	5.3	3.8	1.2	1.0	1.6
United States*	-2.0	-0.6	2.7	2.6	2.2	2.1	4.9	3.4	1.4	2.8	2.0	1.2	1.8	1.8	1.8	1.8	5.8	1.9	2.5	2.6	1.8
United Kingdom	0.5	0.1	-0.1	0.1	0.2	0.0	-0.1	-0.3	0.7	0.6	0.3	0.3	0.3	0.3	0.3	0.3	8.7	4.3	0.1	1.0	1.3
Euro area	0.6	0.9	0.4	-0.1	0.0	0.1	0.0	0.0	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	6.0	3.5	0.5	0.8	1.5
Australia	0.8	0.9	0.1	0.8	0.6	0.4	0.2	0.3	0.1	0.4	0.6	0.5	0.6	0.6	0.7	0.8	5.5	3.9	2.0	1.6	2.7

*annualized

Inflation, year-over-year percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada	5.8	7.5	7.2	6.7	5.1	3.5	3.7	3.2	2.8	2.7	2.3	2.1	2.2	2.0	1.9	1.8	3.4	6.8	3.9	2.5	2.0
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.2	3.2	3.2	2.6	2.4	2.0	1.8	2.0	2.1	4.7	8.0	4.1	2.9	2.0
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.2	3.5	2.1	2.3	2.6	2.6	2.4	2.5	2.3	2.6	9.1	7.3	2.6	2.5
Euro area	6.1	8.0	9.3	10.0	8.0	6.2	5.0	2.7	2.6	2.5	2.1	2.4	2.2	2.2	2.2	2.1	2.6	8.4	5.4	2.4	2.2
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.4	4.1	3.6	3.8	3.0	3.1	3.0	2.7	3.0	3.0	2.9	6.6	5.6	3.4	2.9

Sources: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics, RBC Capital Markets

Currency outlook

US dollar cross rates, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
USD/CAD	1.35	1.32	1.35	1.32	1.35	1.37	1.39	1.40	1.41	1.42	1.41	1.40
EUR/USD	1.09	1.09	1.06	1.11	1.08	1.07	1.09	1.08	1.09	1.10	1.11	1.12
GBP/USD	1.24	1.27	1.22	1.27	1.26	1.26	1.28	1.26	1.25	1.25	1.25	1.26
USD/JPY	133	144	149	141	151	161	145	147	151	147	143	139
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.67	0.67	0.66	0.67	0.68	0.68	0.69

Canadian dollar cross rates

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
EUR/CAD	1.47	1.44	1.43	1.46	1.46	1.47	1.51	1.51	1.54	1.56	1.57	1.57
GBP/CAD	1.67	1.68	1.65	1.68	1.71	1.73	1.78	1.76	1.77	1.78	1.76	1.76
CAD/JPY	98	109	110	107	112	117	105	105	107	104	101	99
AUD/CAD	0.91	0.88	0.87	0.90	0.88	0.91	0.93	0.92	0.94	0.97	0.96	0.97

Sources: Federal Reserve Board, Bank of Canada, RBC Economics, RBC Capital Markets