RBC Economics & Thought Leadership

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It's hard to leave (higher rates) when you can't find the door (to lower inflation)

Highlights:

- Upside inflation surprises year-to-date in the U.S. will keep the Fed on the sidelines for now – we continue to expect the first cut to the fed funds target in December, contingent on both growth and inflation gradually and persistently slowing.
- The Fed's still hopeful that inflation can cool even if the economy doesn't. But we think persistent unwinding in price pressures won't come without some slowing in the economy.
- In Canada, slowing growth momentum is reaffirming our call for a rate cut from the BoC in June.
- The ECB and BoE are both expected to start easing around the summer as well, but at a slower pace after.

Overview

A third consecutive inflation setback in the U.S. in March proved powerful enough to throw pricing for most Fed rate cuts this year out of the window. It also ended a streak of equity market gains, with the S&P 500 in April recording its first monthly decline in six months. Bond yields climbed back towards peak levels that were seen late last summer, and the US dollar regained some strength.

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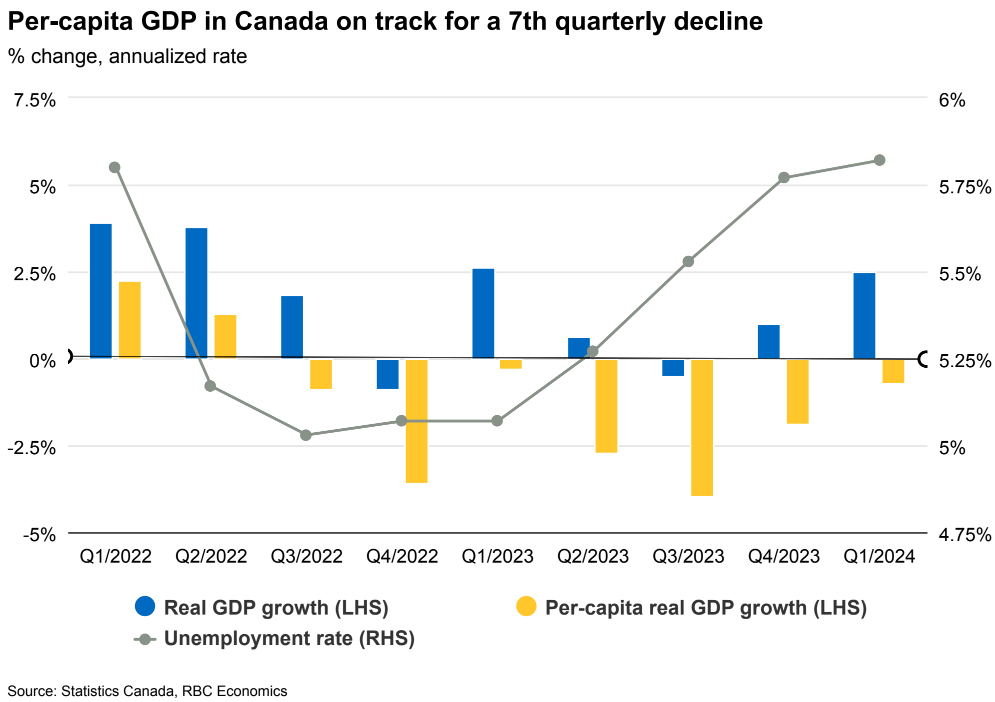
Markets have since calmed down somewhat over early May, after dovish comments made by Fed chair Powell at the interest rate announcement at the beginning of the month. Despite waning confidence that inflation is slowing, the Federal Reserve stuck with the script that what's needed is more time, not more rate hikes, for price pressures to sustainably slow. We are less convinced that inflation will slow without some softening in the economy, and expect readings for both GDP growth and price gains will start to moderate in the quarters ahead. Contingent on that outlook, we expect the Fed will do nothing and wait until December (past November's elections) to make a first cut in the fed funds target range.



The decision to pivot to interest rate cuts this year for the Bank of Canada should be easier. The Canadian economy still looks weak compared to other regions. A jump in Canadian GDP in January appears to have quickly faded with output in Q1 as a whole tracking a seventh consecutive decline on a per-capita basis and early reports pointing to a softening in output in March. As labour markets continue to weaken and inflation readings in Canada also come lower, all ducks seem to be in a row for the Bank of Canada to start cutting the overnight rate as soon as June, with 100 basis points of total cuts expected for this year.

Stuck in the middle are the euro area and the U.K., where progress on inflation have been slower than expected in Q1 while GDP growth is showing signs of strengthening. That's arguing for a more gradual easing cycle from the ECB and the BoE. We expect both the ECB and the BOE will start to move rates lower this summer, but with a more moderate pace of cuts after than expected out of the BoC.

Central bank bias

<table>
<tr><th>Central bank</th><th>Current policy rate</th><th>Next decision</th></tr>
<tr><td>BoC</td><td>5.00%
+0 bps in Apr/24</td><td>-25 bps
Jun/24</td></tr>
<tr><td colspan="3">The BoC as expected left the overnight rate unchanged in April while leaving options open to (although not committing to) a cut in June. Data releases over the last month have pointed to further softening in economic growth and inflation. Governor Macklem in his recent comments said the central bank is “getting closer” to lowering the policy interest rate. We continue to expect a first move at its next meeting in June.</td></tr>
<tr><td>Fed</td><td>5.25-5.5%
+0 bps in May/24</td><td>0 bps
Jun/24</td></tr>
<tr><td colspan="3">The U.S. Fed as widely expected held interest rates unchanged at its policy announcement in May, while acknowledging the progress with inflation stalled in recent months. The tone of chair Powell’s comments erred on the dovish side, saying directly it’s "unlikely that the next policy move will be a hike." Contingent on inflation reversing back lower over the year we expect the Fed will start cutting in December.</td></tr>
<tr><td>BoE</td><td>5.25%
+0 bps in May/24</td><td>0 bps
Jun/24</td></tr>
<tr><td colspan="3">The BoE in May held interest rates steady as expected, with the vote split shifting to a more dovish 7-2 (7 members favouring a hold and 2 favouring a cut) from 8-1 in the last meeting. The MPC outlined its expectations that inflation will return to target over the very near-term before trending higher from energy base effects. Contingent on that outlook, we expect a first cut form the BoE will come later in August.</td></tr>
<tr><td>ECB</td><td>4.00%
+0 bps in Apr/24</td><td>0 bps
Jun/24</td></tr>
<tr><td colspan="3">The ECB at its April meeting left the deposit rate unchanged at 4% alongside dovish messaging that easing in monetary policy will be warranted as long as incoming data reaffirms broadly slowing inflation pressures. That’s in line with our own view that the ECB will cut the deposit rate at its next meeting June, before resorting to a slower, every-other-meeting pace after.</td></tr>
<tr><td>RBA</td><td>4.35%
+0 bps in May/24</td><td>0 bps
Jun/24</td></tr>
<tr><td colspan="3">The RBA held the main interest rate unchanged at its meeting in May, while maintaining a near neutral bias. Governor Bullock made the explicit comment that “rates are at the right level” but said the RBA is watching for upside risks. Given a potentially higher nominal rate of neutral interest rate, we expect the RBA will be cutting later in 2025, and at a much slower pace after (we expect just two cuts for the whole year.)</td></tr>
</table>

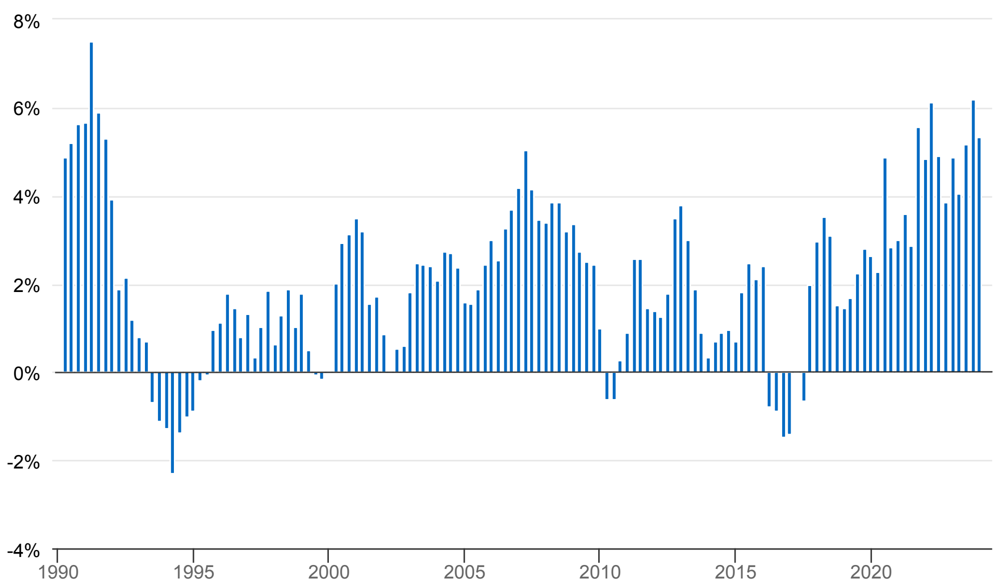
Weakening Canadian economy is arguing for lower interest rates

The case for the BoC to pivot to interest rate cuts soon is relatively straight forward. Evidence is continuing to build that domestic demand is dwindling in the face of persistently elevated borrowing costs, and that's limiting the pace of price growth. Businesses have repeatedly reported a loss of pricing power, as a weakening demand backdrop adds to competitive pressures and pushes bankruptcies higher. That's all suggesting that ongoing easing in price pressures will persist, and the case for interest rate cuts from the BoC is building.

To be sure, that doesn't mean inflationary risks in Canada have fully receded. When testifying in front of Senate and the House of Commons last week, Governor Macklem highlighted a few scenarios where pressures could resurface. Higher energy prices due to heightened global tensions is one. Although not something within the central bank's control, energy expenses still account for a big chunk of consumer spending, so any larger increases will have implications on growth, and are unlikely to be looked through by the BoC completely. Domestically, it's home prices and wage growth that are on BoC's mind. Housing market activity in Canada has remained somewhat subdued in early 2024 but a rebound akin to the one

Elevated wage growth, low productivity pushing labour costs higher in Canada

Year-over-year growth rate, unit labour cost



Source: Statistics Canada, RBC Economics

Finally, higher wage growth relative to productivity growth is driving up unit labour costs (labour cost per unit of output), which in the long run can add to inflationary pressures. But broadly receding labour demand and higher unemployment rate will continue to exert downward momentum on wage growth in the periods ahead. Already, wage growth measured from company payrolls has been showing clearer signs of slowing than growth in average hourly earnings in the timelier monthly labour force survey. Overall, we continue to expect the softer economic growth and inflation backdrop in Canada justifies a more aggressive BoC monetary policy response than in other regions.

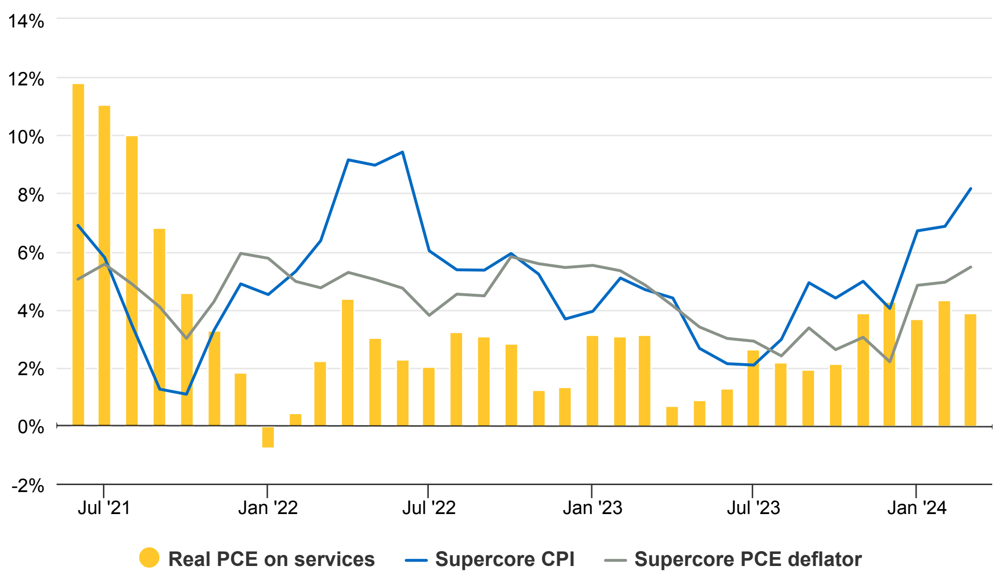
Slowing in U.S. labour markets likely a prerequisite for slower inflation pressures

The Federal Reserve is in a much tougher spot when it comes to arguing for interest rate cuts. Slowing inflation readings last year despite a very strong economic backdrop raised hopes that price pressures could ease without a significant deterioration in the broader economic growth backdrop. Even with CPI readings reaccelerating year-to-date in 2024, the Federal Reserve seems reluctant about giving up hope for a very soft landing.

We continue to expect that slowing in inflation pressures will come, but only alongside slower domestic demand, especially for services, and softening labour markets. Moderations in global supply chain constraints mean prices for tradeable goods (outside of food and energy) are already outright lower than they were a year ago. Instead, recent upsides on inflation can be entirely attributed to domestically produced and consumed services, where demand remains ultra-resilient. In March, the Fed's "supercore" measure that's designed to get a gauge at inflation pressures idiosyncratically driven by domestic services consumption rose to over 8% on a three-month annualized basis, double the read of end of last year.

Services inflation heating up in the U.S. amid strong spending

Annualized % change, three-month rolling average



Source: U.S. Bureau of Labor Statistics, RBC Economics

Fed chair Powell had pointed to a slew of alternative indicators including lower job openings and quits rates, and a deceleration in wage growth as evidence that tight labour market conditions are unwinding – arguing that the level of interest rates is 'restrictive' (and doesn't need to move outright higher.) The pace of hiring itself has remained robust but is powered by gains in healthcare, social assistance and the government that are less likely to reflect cyclical trends in the jobs market. A softening in hiring demand combined with slower wage growth means moderations in households income growth ahead. That and already depleted pandemic savings continue to underpin our expectation that U.S. consumers will start to gradually reduce their spending over the rest of the year, slowing inflation pressures before the Fed can pivot to interest rate cuts in December.

To be sure, factors that have helped insulate households from sky-high interest rates over the last two years, including ultra-long mortgage terms and government support (in the forms of cancelled outstanding student loans) could very well continue to act as tailwinds for growth in the U.S. We anticipate the Fed will stay mindful of those trends, and move at a slower pace in 2025 after that first cut in December.

ECB and BoE stuck in the middle

Somewhere stuck in the middle between underperformance in Canada and resilience in the U.S. are euro area and the U.K. In both regions, economic conditions appear to be recovering at a faster pace than previously expected in early 2024 after bottoming out over the second half of last year. GDP growth in the euro area in Q1 2024 came in stronger than we anticipated at 0.3%, with the gain relatively broad-based but led by southern European countries thanks to stronger tourism activity. In the U.K., monthly GDP readings are pointing to a Q1 gain of similar size, but with the increase likely slightly more balanced across manufacturing and services sectors. Early PMI data for April has pointed to the momentum, especially with services activities carrying over to the start to the second quarter. We have revised our growth forecast for both regions higher for the rest of the year.

Echoing those developments are progress on the inflation front that started to stall a bit more later in Q1 in both regions. Services inflation remains very elevated in the U.K. The readings are lower for the euro area although the trend was for it to have outright reaccelerated in Q1. That however, proved of little concern to the ECB, who at its April meeting sent off a clear easing bias by outlining criteria that would allow for a reduction in tight monetary policy soon. All told, we continue to expect both central banks will deliver a first cut this summer, (the ECB in June and the BoE later in August) before moving at a slower once-every-other-meeting pace after. Stronger than expected output growth and lack of progress on services inflation seen out in Q1 should warrant a more cautious approach in this easing cycle, especially given the cautionary tell of surging inflation in the U.S.

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	4.65	4.10	3.95	3.60	3.20	3.00	3.00
Two-year	3.74	4.58	4.87	3.88	4.22	3.95	3.60	3.25	2.90	2.75	2.90	3.00
Five-year	3.02	3.68	4.25	3.17	3.58	3.50	3.25	3.00	2.85	2.90	2.90	3.00
10-year	2.90	3.26	4.03	3.10	3.52	3.45	3.25	3.00	2.90	2.95	3.00	3.10
30-year	3.02	3.09	3.81	3.02	3.41	3.40	3.25	3.05	3.00	3.05	3.10	3.15
United States												
Fed funds midpoint	4.88	5.13	5.38	5.38	5.38	5.38	5.38	5.13	4.88	4.63	4.63	4.63
Three-month	4.85	5.43	5.55	5.40	5.45	5.36	5.23	4.93	4.75	4.53	4.60	4.65
Two-year	4.06	4.87	5.03	4.23	4.66	4.95	4.95	4.90	4.80	4.70	4.70	4.75
Five-year	3.60	4.13	4.60	3.84	4.28	4.60	4.60	4.45	4.35	4.35	4.40	4.50
10-year	3.48	3.81	4.59	3.88	4.27	4.45	4.40	4.30	4.25	4.30	4.40	4.50
30-year	3.67	3.85	4.73	4.03	4.41	4.55	4.45	4.50	4.55	4.60	4.70	4.80
United Kingdom												
Bank rate	4.25	5.00	5.25	5.25	5.25	5.25	4.75	4.25	4.00	3.75	3.75	3.75
Two-year	3.42	5.27	4.91	3.98	4.17	4.40	4.30	4.15	4.00	3.90	4.00	4.00
Five-year	3.33	4.66	4.53	3.46	3.84	3.90	3.80	3.60	3.50	3.55	3.60	3.65
10-year	3.47	4.39	4.46	3.54	3.95	4.00	3.90	3.75	3.70	3.75	3.85	3.95
30-year	3.82	4.42	4.92	4.14	4.49	4.70	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	2.75	2.50	2.50
Two-year	2.66	3.27	3.20	2.40	2.83	2.70	2.70	2.60	2.50	2.40	2.30	2.30
Five-year	2.30	2.58	2.79	1.94	2.32	2.40	2.30	2.20	2.15	2.20	2.20	2.25
10-year	2.28	2.39	2.85	2.03	2.29	2.40	2.35	2.20	2.20	2.20	2.25	2.30
30-year	2.35	2.38	3.05	2.27	2.46	2.60	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	4.10	3.85	3.85	3.85
Two-year	2.96	4.21	4.09	3.71	3.76	4.10	4.00	3.95	3.75	3.85	3.90	4.00
10-year	3.30	4.02	4.49	3.95	3.97	4.30	4.25	4.10	4.00	4.05	4.15	4.20
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.50	5.00	4.50	4.50	4.50	4.50
Two-year swap	5.01	5.46	5.69	4.63	4.78	4.95	4.80	4.65	4.60	4.70	4.75	4.80
10-year swap	4.27	4.46	5.13	4.12	4.35	4.50	4.45	4.40	4.35	4.45	4.55	4.65

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	2.6	0.6	-0.5	1.0	2.5	1.4	1.4	1.8	1.8	1.8	2.0	2.1	5.3	3.8	1.1	1.3	1.8
United States*	-2.0	-0.6	2.7	2.6	2.2	2.1	4.9	3.4	1.6	2.5	1.0	1.2	1.8	1.8	1.8	1.8	5.8	1.9	2.5	2.4	1.6
United Kingdom	0.5	0.1	-0.1	0.1	0.2	0.0	-0.1	-0.3	0.2	0.1	0.2	0.2	0.3	0.3	0.3	0.3	8.7	4.3	0.1	0.2	1.1
Euro area	0.6	0.8	0.5	0.0	0.0	0.1	-0.1	-0.1	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	5.9	3.5	0.5	0.7	1.5
Australia	0.5	0.8	0.2	0.8	0.6	0.5	0.3	0.2	0.2	0.4	0.6	0.7	0.8	0.8	0.8	0.7	5.6	3.8	2.1	1.4	2.9

*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	2.8	2.2	1.9	2.0	1.9	1.9	1.8	3.4	6.8	3.9	2.4	1.9
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.2	3.2	3.4	3.1	2.8	2.2	1.8	1.9	1.9	4.7	8.0	4.1	3.1	1.9
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.2	3.5	2.8	2.9	2.7	2.2	1.7	1.9	1.8	2.6	9.1	7.3	3.2	1.9
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	3.7	3.2	3.3	3.2	3.1	3.1	3.0	2.9	6.6	5.6	3.5	3.1

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	1.06	1.05	1.07	1.08	1.08	1.09	1.08
GBP/USD	1.24	1.27	1.22	1.27	1.26	1.25	1.22	1.23	1.23	1.21	1.21	1.19
USD/JPY	133	144	149	141	151	158	160	162	162	160	158	156
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.64	0.65	0.66	0.67	0.67	0.68	0.68

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	1.45	1.45	1.50	1.52	1.53	1.54	1.51
GBP/CAD	1.67	1.68	1.65	1.68	1.71	1.71	1.69	1.72	1.73	1.72	1.71	1.66
CAD/JPY	98	109	110	107	112	115	116	116	115	113	112	111
AUD/CAD	0.91	0.88	0.87	0.90	0.88	0.88	0.90	0.92	0.94	0.95	0.96	0.95

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