Financial Markets Monthly

November 2024

Running up that bill— U.S. growth gains, debt pains

Highlights:

- It's still too early to know the precise impact of the U.S. election's outcome on the economy. Persistently large fiscal deficit is expected to lead to higher U.S. growth in 2025. Growth in Canada is revised lower due to harsher-than-expected new cuts to immigration targets.
- We continue to expect there will be more interest rate cuts from the Bank of Canada than the U.S. Federal Reserve as the gap between the economic backdrops persists (with Canada underperforming the U.S.).
- In the U.K., the Autumn Budget was reset for looser fiscal policy. We expect the Bank of England to move slightly slower to a higher terminal rate. Disinflationary pressures in the euro area will allow the European Central Bank to keep cutting before tight labour markets lead them to pause above neutral.
- **Issue in focus:** The U.S. fiscal deficit is substantial relative to the resilient state of the economy. Government spending will continue to add to growth, but it may come at the cost of higher inflation, interest rates, and less savings for the future.

Overview

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Forecast changes: Stronger U.S., weaker Canada adds to growth divergence

U.S.: A new administration will bolster GDP and inflation

The impact of the Nov. 5 election remains uncertain as we await more detailed policy proposals and timelines, along with the final House of Representatives votes. That said, we're expecting slower immigration, trade disruptions, and a continued sizeable government budget deficit that is more likely to rise.

Overall, this results in slightly stronger U.S. gross domestic product growth— back-loaded and more in 2026 and beyond. The addition of more fiscal stimulus (large government deficits) to an economy that doesn't need it (output gap above zero) means the Fed will need to keep interest rates higher for longer to keep inflation under control (read more in issues in focus below).

In recent data, inflation trends have proved slightly stickier than expected, but U.S. labour markets are tracking broadly in line with our prior expectations of gradually weakening. In October, the payroll employment gain was weak, heavily distorted by hurricanes and a strike in the manufacturing sector. But, the unemployment rate, which is less impacted by disruptions, continues to edge gradually higher. We still expect the Fed to cut by 25 basis points in December.

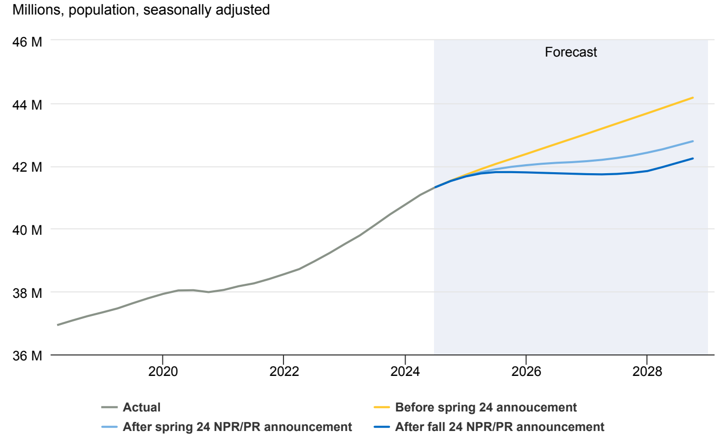
Canada: U.S. election outcome and new immigration caps lower GDP growth

There are two important changes to our Canadian forecasts this month.

First, the Canadian economy is more likely to be negatively impacted by the new U.S. policies. We don't expect Canada to be a direct target for trade disruptions by the next U.S. administration, but significant U.S. tariffs on imports from China, Mexico, and other parts of the world would have negative spillover effects on Canada. In addition, U.S. corporate tax cuts would reduce Canada's competitiveness.

Population growth in Canada set to slow dramatically

Millions, population, seasonally adjusted



Source: Statistics Canada, RBC Economics

Second, economic growth will slow from the federal government's aggressive cuts to [immigration targets](), sharply reducing population growth over the next three years. That could help [narrow Canada's housing gap](), but it will slow GDP growth, accelerate population aging, and add to a growing government funding gap for public services like healthcare.

Overall, the Canadian economy continues to underperform other advanced economies. The unemployment rate has surprisingly edged lower over the last two months, but it is still up 0.8 percentage points from a year ago, and more likely to move higher with hiring demand (job openings) continuing to fall.

Rates outlook: Widening BoC and Fed policy gap driven by diverging economic growth

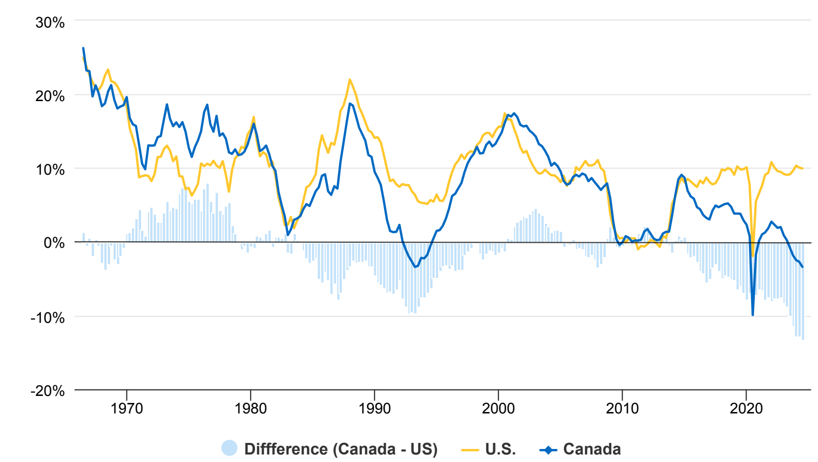
We continue to expect a widening gap in the policy rates of the BoC and the Fed to be driven by an unprecedented divergence in per-capita economic growth.

The outcome of the U.S. election increases the odds that the gap widens in the near term with the Fed needing to respond to a resilient economy and the inflationary impact of a large government budget deficit by keeping interest rates higher than they otherwise would. Meanwhile, the BoC will be pressured to respond with lower interest rates to a much softer Canadian economy.

We have maintained our outlook that the BoC will cut the overnight rate to 2% by the end of 2025, while the Fed pauses earlier with the fed funds range at a still restrictive 4% to 4.25%.

Record Canadian GDP underperformance stretching on

5-year percent change in per-capita real GDP



Source: Statistics Canada, Bureau of Economics Analysis, RBC Economics

Fiscal spending to slow BoE rate cuts, ECB outlook unchanged

In the U.K., the Autumn Budget saw additional spending and a higher deficit averaging 1.2% of GDP per year on average between 2025/26 and 2028/29. Early estimates from the Office of Budget Responsibility pinned the impact at more than 0.5% GDP growth each year over the same fiscal period, adding to inflation while limiting the pace of BOE interest rate cuts in the year ahead.

Policymakers made clear that interest rates are still likely to move lower but at a gradual pace after cutting the bank rate by 25 bps in November. We expect the BoE will maintain the slower one-cut per quarter pace until a higher terminal rate of 4% is reached by Q3 2025.

GDP data in the euro area surprised to the upside in Q3, but that isn't likely to prevent additional rate cuts from the European Central Bank, because inflation has also continued to slow. It should, however, ease concerns about the state of the economy and suggest the path to lower policy rates will remain gradual and limited.

We expect the ECB will keep cutting by 25 bps per meeting before reaching a 2.25% deposit rate by the end of Q2 2025, keeping in mind that Europe's largest economy Germany has a large manufacturing sector that is more susceptible to inflationary pressures stemming from trade disruptions.

Central bank bias:

<table>
<tr><th>Central bank</th><th>Current policy rate</th><th>Next decision</th></tr>
<tr><td>BoC</td><td>3.75%
-50 bps in Oct/24</td><td>-50 bps
Dec/24</td></tr>
<tr><td colspan="3">The BoC quickened the pace of easing and cut the overnight rate by a larger 50 bps in October. The move came amid growing signs of softening in the economy and labour markets with little indication of a turnaround in Q3 activities as was previously expected (by the BoC). We think inflation risks are still tilted to the downside and expect another 50 bps rate cut in December.</td></tr>
<tr><td>Fed</td><td>4.50-4.75%
-25 bps in Nov/24</td><td>-25 bps
Dec/24</td></tr>
<tr><td colspan="3">The Fed delivered a 25-bps rate cut in November amid signs of a resilient economy and stickier than expected inflation. Chair Jerome Powell reiterated that policy is still on a path back to neutral (implying more rate cuts are ahead), but the pace and target remain uncertain and are highly data-dependent. We see only two more (25 bp) rate cuts from the Fed before they hit a pause after January 2025.</td></tr>
<tr><td>BoE</td><td>4.75%
-25 bps in Nov/24</td><td>0 bps
Dec/24</td></tr>
<tr><td colspan="3">BoE policymakers voted 8-1 in favour of a 25 bps rate cut in November. The revised monetary policy report saw upgrades to GDP and inflation forecasts thanks to looser fiscal spending unveiled in the Autumn Budget. Policymakers kept an easing bias, but cautioned for a gradual approach to policy making. We think a cut in December is off the table, and the BoE is likely to resume easing in February.</td></tr>
<tr><td>ECB</td><td>3.25%
-25 bps in Oct/24</td><td>-25 bps
Dec/24</td></tr>
<tr><td colspan="3">The ECB lowered the deposit rate by 25 bps in October to 3.25%, and took note of recent softening in the economy while maintaining their flexible and data-dependent decision-making. Reuters reported some discussions about bigger rate cuts to stimulative levels. We think that's unlikely given the resilient labour market and economic backdrop. We expect the ECB will cut again by 25 bps in December.</td></tr>
<tr><td>RBA</td><td>4.35%
0 bps in Nov/24</td><td>0 bps
Dec/24</td></tr>
<tr><td colspan="3">Persistent inflation pressures are still holding the Reserve Bank of Australia from joining global peers in the easing cycle. The cash rate was held at 4.35% in November. The macro forecast was mostly revised lower, which underpinned a shift in the policy bias toward neutral. We think the RBA will need to see more cooling in labour markets and core inflation before a first expected cut in February.</td></tr>
</table>

Issues in focus: Elevated U.S. government spending is expansionary, inflationary and consequential

The U.S. government budget deficit is unusually large relative to this point in the economic cycle. It's keeping inflation higher than otherwise would be the case, and preventing larger interest rate cuts from the Fed.

A large budget deficit helps support the economy in the near term by adding more direct spending and/or boosting household and business spending through transfers or tax cuts. But, that growth is borrowed from some point in the future when the bill comes due to be paid by higher taxes or lower spending.

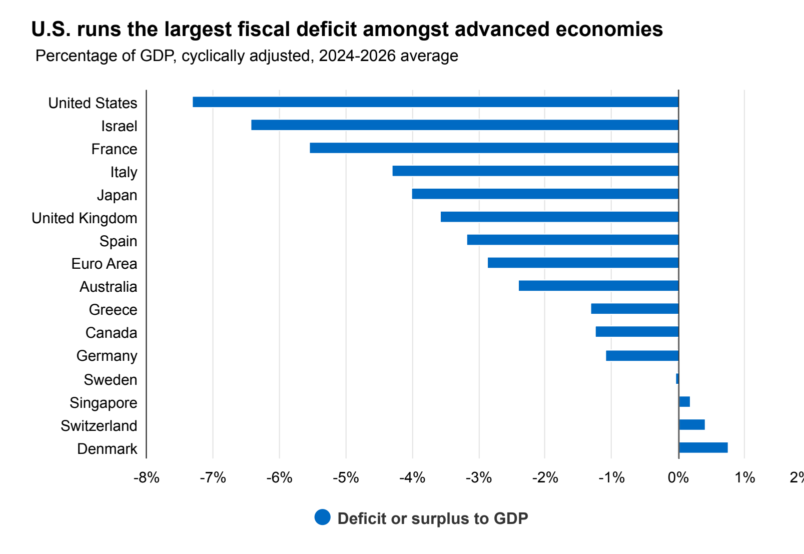
That kind of economic stimulus makes sense when the economy is weak, and support is needed. But the U.S. economy is currently still running in excess demand, and the Fed is actively trying to get inflation back under control.

Large amounts of government spending against that backdrop are unusual historically. They're also preventing the Fed from cutting rates as much as otherwise would be the case, because of the need to push back against the inflationary impact of the deficit. This is the key reason that we expect the Fed will not be able to cut the fed funds target rate below 4% in the year ahead.

U.S. budget deficit is massive, unusual for this point in economic cycle

At almost US$2 trillion or 6.4% of GDP in fiscal year 2024, the U.S. government deficit is larger than any other year when the economy was not in a recession or a major war.

The only other advanced economy tracked by the International Monetary Fund with a higher deficit-to-GDP ratio in 2024 than the U.S. is Israel, where expenditures are high due to ongoing conflicts.



Over the next three years, the IMF expects the U.S. government will continue to lead the pack in deficits, despite having among the strongest economies. On a cyclically adjusted basis (which takes into account that deficits should be smaller when the economy is strong), the U.S. deficit is running more than twice the euro area and the U.K.'s, and four times Canada's.

It will grow even larger under new U.S. administration

Running a large deficit when the economy doesn't need it can add to inflation pressures more than GDP growth. It's like pushing on a string. It increases demand— but not the economy's capacity to supply—so GDP doesn't rise much further, but prices do.

The impact of the re-election of Trump on deficits is still uncertain. Talk on a campaign trail can be cheap, while what's implemented as policy is usually different. But directionally, the Republican's sweep appears to control all three branches of government, which means there's a risk the budget deficit gets bigger.

The U.S. deficit was already set to rise regardless of who won the White House. A huge and rising chunk of deficit spending is coming from mandatory outlays on social security, Medicare, and Medicaid programs as the population ages. We've noted before that the present value of unfunded liabilities from those mandatory programs adds up to US$78 trillion in current dollars—nearly three times the size of GDP.

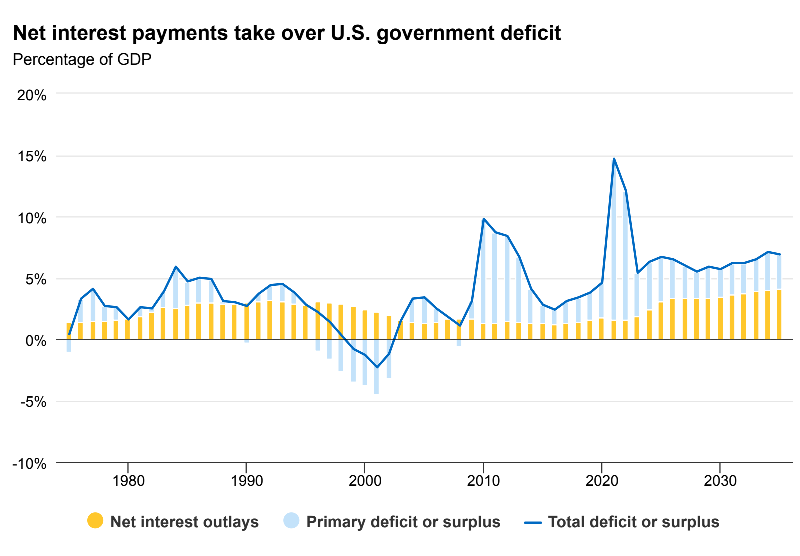
As mandatory spending continues to rise, it will soak up an increasing share of government revenue, effectively all of it by the mid-2030s, according to CBO projections. That means spending on other important functions such as defence, law enforcement, infrastructure and education will all have to be done through more borrowing.

Large deficits add to interest payments that add back to deficits

When the bill from higher deficits comes due in the form of reduced economic growth in the future is an open question. As much as concerns about the lack of fiscal restraints have grown, the odds of the U.S. government defaulting on its debt are extremely low.

Recent auctions of government treasuries continue to be met with solid demand. For now, investors seem happy to fund the spending of the U.S. government at a premium return.

But, the cost of making payments on growing debt is already rising as resilient economic growth and sticky inflation limit the Fed's ability to lower interest rates. Interest payments on the U.S. debt totalled more than US$1 trillion over the last 12 months. For the first time on record, the government spent more on interest on debt than on defence over the last year.



By 2034, the CBO projects that 60% of the deficit (about 4% of the size of U.S. GDP) will be accounted for by net interest outlays alone—that is before any additions to the deficit from future governments.

Deficits now mean less flexibility later were the economy to slow sharply.

Even the U.S. treasury's annual financial statements explicitly say that the budget deficit is not "sustainable." From the 2023 financial report, the debt-to-GDP ratio is on track to hit 100% in 2024, 200% by 2047, and 531% by 2098.

The U.S. economy is still the strongest in the world, and a relatively low tax base means there is room to raise additional revenues through higher taxes. But politically, there is little motivation to do that in the near term. Raising additional revenue (i.e. Increasing taxes) becomes much more challenging if the economy were to enter a downturn, which is when higher budget deficits are often needed.

Of course, higher interest rates amid elevated borrowing also means there is more "room" for monetary policy to respond to a weaker economy with interest rate cuts. But, it has its limits. Recessions, typically, benefit from a targeted response to address specific economic challenges, inequities of impact, and more that are not possible to address with a blunt tool like interest rate changes.

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	3.25	2.75	2.25	2.00	2.00
Three-month	4.34	4.90	5.07	5.04	4.99	4.64	3.94	2.95	2.55	2.20	2.00	2.00
Two-year	3.74	4.58	4.87	3.88	4.22	3.99	2.92	2.95	2.60	2.30	2.20	2.10
Five-year	3.02	3.68	4.25	3.17	3.58	3.51	2.74	2.95	2.75	2.65	2.55	2.45
10-year	2.90	3.26	4.03	3.10	3.52	3.50	2.95	3.15	2.95	2.90	2.80	2.80
30-year	3.02	3.09	3.81	3.02	3.41	3.39	3.13	3.15	3.05	3.00	3.00	3.00
United States												
Fed funds midpoint	4.88	5.13	5.38	5.38	5.38	5.38	4.88	4.38	4.13	4.13	4.13	4.13
Three-month	4.85	5.43	5.55	5.40	5.45	5.48	4.73	4.20	4.03	4.08	4.13	4.22
Two-year	4.06	4.87	5.03	4.23	4.66	4.71	3.66	4.20	4.40	4.50	4.70	4.85
Five-year	3.60	4.13	4.60	3.84	4.28	4.33	3.58	4.10	4.30	4.40	4.55	4.65
10-year	3.48	3.81	4.59	3.88	4.27	4.36	3.81	4.25	4.40	4.45	4.55	4.60
30-year	3.67	3.85	4.73	4.03	4.41	4.51	4.14	4.45	4.55	4.60	4.70	4.75
United Kingdom												
Bank rate	4.25	5.00	5.25	5.25	5.25	5.25	5.00	4.75	4.50	4.25	4.00	4.00
Two-year	3.42	5.27	4.91	3.98	4.17	4.23	3.97					
Five-year	3.33	4.66	4.53	3.46	3.84	4.03	3.85					
10-year	3.47	4.39	4.46	3.54	3.95	4.17	4.00			Under Review		
30-year	3.82	4.42	4.92	4.14	4.49	4.67	4.54					
Euro area*												
Deposit Rate	3.00	3.50	4.00	4.00	4.00	3.75	3.50	3.00	2.50	2.25	2.25	2.25
Two-year	2.66	3.27	3.20	2.40	2.83	2.82	2.09	2.00	2.10	2.15	2.15	2.15
Five-year	2.30	2.58	2.79	1.94	2.32	2.48	1.97	1.85	1.95	2.10	2.15	2.25
10-year	2.28	2.39	2.85	2.03	2.29	2.50	2.14	2.00	2.10	2.20	2.25	2.30
30-year	2.35	2.38	3.05	2.27	2.46	2.69	2.46	2.35	2.40	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	3.60	3.60
Two-year	2.96	4.21	4.09	3.71	3.76	4.17	3.64	4.00	3.80	3.70	3.65	3.60
10-year	3.30	4.02	4.49	3.95	3.97	4.31	3.97	4.50	4.60	4.60	4.65	4.65
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.25	4.25	4.00	3.50	3.50	3.50
Two-year swap	5.01	5.46	5.69	4.63	4.78	4.95	3.56	3.80	3.75	3.50	3.60	3.75
10-year swap	4.27	4.46	5.13	4.12	4.35	4.48	3.87	4.15	4.30	4.40	4.55	4.60

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	1.8	2.1	1.0	1.0	1.1	1.2	1.1	1.2	5.3	3.8	1.2	1.0	1.2
United States*	-1.0	0.3	2.7	3.4	2.8	2.5	4.4	3.2	1.6	3.0	2.8	2.4	1.0	1.5	1.8	2.0	6.1	2.5	2.9	2.8	1.9
United Kingdom	0.7	0.3	0.1	0.3	0.1	0.0	-0.1	-0.3	0.7	0.5	0.3	0.3	0.3	0.3	0.3	0.3	8.6	4.8	0.3	0.9	1.3
Euro area	0.5	0.9	0.6	-0.1	0.0	0.1	0.0	0.1	0.3	0.2	0.4	0.1	0.2	0.3	0.3	0.3	6.3	3.6	0.5	0.7	1.0
Australia	0.9	0.9	0.1	0.7	0.5	0.5	0.3	0.2	0.2	0.2	0.5	0.4	0.6	0.7	0.8	0.9	5.5	3.9	2.0	1.2	2.2

*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	2.0	1.7	1.9	1.6	1.5	1.6	3.4	6.8	3.9	2.3	1.7
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	2.1	1.9	2.2	2.3	4.7	8.0	4.1	2.9	2.1
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.2	3.5	2.1	2.1	2.6	2.6	2.4	2.5	2.3	2.6	9.1	7.3	2.6	2.6
Euro area	6.1	8.0	9.3	10.0	8.0	6.2	5.0	2.7	2.6	2.5	2.2	2.4	2.2	2.2	2.2	2.1	2.6	8.4	5.4	2.4	2.4
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.4	4.1	3.6	3.8	2.8	3.0	2.8	2.6	3.0	3.0	2.9	6.6	5.6	3.3	3.3

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

Currency outlook

U.S. 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	1.35	1.40	1.42	1.43	1.42	1.41
EUR/USD	1.09	1.09	1.06	1.11	1.08	1.07	1.11	1.06	1.02	1.02	1.03	1.05
GBP/USD	1.24	1.27	1.22	1.27	1.26	1.26	1.34	1.29	1.28	1.24	1.23	1.24
USD/JPY	133	144	149	141	151	161	143	155	160	158	155	150
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.67	0.69	0.66	0.65	0.64	0.64	0.66

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	1.50	1.48	1.45	1.46	1.46	1.48
GBP/CAD	1.67	1.68	1.65	1.68	1.71	1.73	1.80	1.81	1.81	1.78	1.74	1.74
CAD/JPY	98	109	110	107	112	117	106	111	113	110	109	106
AUD/CAD	0.91	0.88	0.87	0.90	0.88	0.91	0.93	0.92	0.92	0.92	0.91	0.93

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