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Shrinking runway for a soft landing

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June was yet another tough month for equities with the S&P 500 recording an 8.4% decline to cap off its worst first half of the year since 1970. The bond market didn't fare quite as poorly as recession fears ultimately drove a more traditional risk off trade in the second half of the month. 10-year Treasury yields took a round trip, spiking to 3.5% mid-month before dropping back below 3% by the end of June. The market continues to look for aggressive near-term rate hikes despite growth concerns—a simple recipe for yield curve inversion—with central banks only seen pausing or reversing course once red-hot inflation is under control. Recession fears have helped key commodity prices come down from earlier highs but firming domestic price pressures, accelerating wages and rising inflation expectations suggest policymakers still have their work cut out to return inflation to target.

Indeed, it was rising inflation expectations and yet another upside surprise on CPI that prompted the Fed's quick pivot to a 75 bp hike in June. Those same developments north of the border should see a similar response from the BoC in July. The RBA upped the pace of its tightening cycle in June and July and we look for 50 bp hikes by the BoE and ECB in August and September, respectively. We previously expected central banks would hike rates to more neutral levels before pausing and assessing the impact of their actions. But we no longer think the Fed and BoC have that luxury. We expect they'll err on the side of more aggressive action, risking an economic downturn (now our base case for 2023) rather than decades of inflation targeting credibility. Other central banks aren't likely to go quite as far though the UK and euro area are more exposed to other headwinds—sharply rising energy prices and war in Ukraine—that sug-

Central bank near-term bias



Another upside surprise on inflation, rising inflation expectations and a more aggressive Fed will all contribute to the BoC accelerating its tightening cycle. We now look for 75 bp hikes in July and September with the overnight rate hitting 3.25% later this year.



Minutes of the Fed's July meeting suggest a 50 or 75 bp hike is most likely in September—we look for the latter as the Fed seeks to remove accommodation as quickly as possible. We now see the fed funds rate rising to 3.25-3.50% by year end.



We think the BoE will also opt for a larger hike (50 bps) in August as the UK's inflation outlook continues to worsen. We see Bank Rate rising to 2.50% by year end, around the upper end of most neutral estimates.



The ECB is expected to begin to move away from negative rates with a 25 bp hike in July and a larger 50 bp move in September. We think the ECB will aim to get to neutral (1.50%) by mid-2023 even with the currency bloc likely to slip into recession over the winter.



The RBA is also removing accommodation in short order, having hiked by 50 bps at a second consecutive meeting in July. We see the cash rate rising to 2.85% by year end.



Highlights

▲ Rising inflation and inflation expectations led the Fed to hike by 75 bps in June...

▲ ...and that same combination is expected to prompt a 75 bp hike by the BoC in July.

▲ We now see both the Fed and BoC taking policy rates into restrictive territory...

▲ ...as they prioritize inflation credibility over growth concerns.

gest a slowdown is now more likely than not. Recession isn't inevitable but it's starting to look as if a lot has to go right for these economies to avoid giving back at least some of the gains made in what has been a historically rapid economic recovery.

Fed and BoC accelerating their tightening cycles (again)

Having previously ruled out a 75 bp hike, the Fed unexpectedly pivoted just days before its June meeting, letting it be known that a larger move was on the table following another strong CPI reading and a worrying rise in inflation expectations. With the fed funds rate still a ways below most neutral estimates, we think another 75 bp hike is in store in July. Inflation could rise toward the 9% mark in June and is likely to remain stubbornly high in Q3 before beginning to soften toward year end. We think that will keep the Fed in tightening mode and look for a 50 bp hike in September and two more 25 bp increases in the fourth quarter, leaving the fed funds rate at 3.25-3.50% by year end. That's in line with the dot plot median from June's meeting and slightly above current market pricing. Treasury yields have come down sharply on recession fears and we expect the yield curve will remain flat or slightly inverted over the second half of the year, particularly as growth begins to slow toward year end. Yields are likely to move lower next year with some steepening as potential fed cuts (already priced in for H2/23) come into view amid rising unemployment and a gradually improving inflation outlook.

Even before the Fed's pivot to a 75 bp hike in June, the BoC opened the door to such a move saying it was prepared to act more forcefully if necessary. The Fed's larger hike increased the odds of the BoC following suit in July and we think such a move was cemented by a strong CPI print and signs of rising inflation expectations. May's headline inflation surprised to the upside for a fifth straight month with the strongest month-over-month (seasonally adjusted) increase on record going back to 1992. Ex food and energy inflation was also firm and all three of the BoC's core measures accelerated. Shortly after, the BoC's quarterly surveys showed longer-term inflation expectations among both businesses and consumers moved higher in the second quarter. We think that provides a clear signal to the BoC that monetary policy stimulus needs to be removed in short order to get inflation under control and keep expectations in line with its 2% target. We previously saw the bank pausing its tightening cycle at 2.75%—within its assumed neutral range—but now think it will resort to restrictive policy, lifting the overnight rate to 3.25% by year end.

Is the US in a recession? Not yet...

With the US economy contracting in the first quarter and some forecasters looking for a further decline in Q2 (e.g. the Atlanta Fed's nowcast at -2.1%), is the world's largest economy already in a recession? We don't think so. Our forecast assumes the US will avoid a second consecutive quarter of negative GDP (a "technical" recession) with our latest Q2 tracking at +1.0%. Even a second quarter decline wouldn't in our view be sufficient to call a recession as a broader set of indicators don't look recessionary at this point. Domestic demand rose a healthy 2.0% in Q1 and we expect a further gain in Q2 with consumer spending and business investment continuing to expand. The job market, too, is hardly signaling a downturn. The unemployment rate fell in Q1 and is on track for a further decline in Q2 despite a modest increase in initial claims. Note the NBER has never called a recession without the jobless rate rising in the first or second quarter of the slowdown. We think it's more likely than not that the US will be in a recession sometime in the next year, but we don't think that's the case just yet.



Still, the US economy is losing momentum and odds have shifted toward a recession sometime in the next year. Consumer spending declined in May for the first time this year as softer goods spending more than offset ongoing gains in services. High inflation continues to eat into wage gains with real disposable income now little better than its pre-pandemic level. Households have tapped some of their pandemic-era savings but negative wealth effects from declining bond and equity markets are offsetting the tailwind from excess savings. Consumers are also feeling more pessimistic about future economic prospects—the forward-looking component of consumer confidence fell to a nine-year low in June. And with the housing market turning over, another of the key drivers of the US's economic recovery is beginning to wane. We look for domestic demand to lose momentum toward the end of this year, ultimately giving way to economic contraction in the first half of next year. That's likely to push the unemployment rate higher from its current, 50-year low which we think will be necessary to return inflation to target in 2024. The 1.3 ppt increase in the jobless rate we expect by the end of next year would be at the mild end of historical recessions.

Canada's economy to lose steam, recession expected in 2023

Canada's year-to-date growth streak reportedly came to an end in May with StatCan's 'flash' GDP posting a 0.2% decline due to a pullback in the goods sector. But with the economy having carried good momentum to that point, we continue to look for a solid 4.5% increase in Q2 GDP. We also expect decent growth over the summer months as travel and tourism demand continues to recover and commodities sectors get a boost from higher global prices, notwithstanding some recent softening.

But we think that momentum will be difficult to sustain as 2022 comes to a close. With Canada's economy operating beyond its longer-run capacity limits and unemployment at record lows, there's little room on the supply side for above-trend growth to continue. On the demand side, housing activity is already softening—a trend we expect will continue given the eye-watering increase in mortgage rates this year—and falling real estate asset values (alongside weaker financial markets) will begin to reverse some of the wealth buildup seen during the pandemic. Rising inflation is chipping away at households' purchasing power with real average hourly earnings now below pre-pandemic levels. And consumer confidence has fallen significantly since last summer, returning to late-2020 levels.

We see these headwinds extending into 2023, and the impact of rising debt servicing costs on Canada's highly indebted household sector will only continue to build next year. A softer global growth backdrop will also weigh on Canada's economy. The World Bank cut its global growth forecast to around 3% this year and next—generally considered the borderline for a global recession—and we think some of Canada's key trading partners, including the US, will be in recession next year. In this environment we think it will be difficult for Canada to avoid a downturn of its own and we now look for GDP to decline in the middle quarters of next year, limiting annual growth to less than 1% in 2023. As with the US we look for Canada's historically low jobless rate to rise by nearly 1.5 ppts by the end of 2023, on the mild end of past recessions.

Highlights

▲ We think the US economy will avoid a "technical" recession in H1/22...

▲ ...but think a downturn is coming in early 2023 as higher prices and rate hikes impact the consumer and housing sectors.

▲ Canada's economy is expected to lose momentum later this year...

▲ ...and slip into recession in the middle quarters of 2023.



Highlights

- ▲ UK GDP is expected to be negative in Q2 though some temporary factors were at play.
- ▲ Energy prices continue to rise rapidly in the UK and Europe—the former will see a sharp jump in regulated prices in October.
- ▲ The euro area is expected to slip into a mild recession over the winter months.
- ▲ Australia's economy is seen avoiding recession but growth is likely to slow materially in 2023.

Euro area headed for a winter slowdown

Euro area PMIs pointed to a significant slowing in momentum in both manufacturing and services industries in June. The former was due in part to falling export demand (firms cited the war in Ukraine and disruptions in China) while the latter reflected a fading bounce from post-pandemic reopening. Retail sales volumes are tracking a second consecutive quarterly decline in Q2 and consumer confidence has fallen toward lows seen in the early stages of the pandemic and the 2012 debt crisis. A staggering 42% increase in energy prices from a year ago continues to put upward pressure on inflation which climbed to 8.6% year-over-year in June. The ECB is expediting its move away from negative rates and we now expect a 25 bp hike in July to be followed by a larger 50 bp increase in September. Removal of stimulus (the ECB just ended net asset purchases under its APP) combined with growth fears has put upward pressure on peripheral bond spreads but news of an anti-fragmentation tool in the works by the ECB seems to have capped spreads for now. Nonetheless, tightening financial conditions will add to the headwind from the euro area's terms of trade shock and we now see the currency bloc slipping into recession over the winter. Annual GDP growth in 2023 is expected to be close to flat. Our forecast assumes no major disruptions to energy supply—a cut-off of gas imports from Russia remains a risk and could result in a more severe downturn.

UK economy looks set to flatline

UK GDP declined for a second consecutive month in April with the end of the government's Test and Trace program acting as a sizeable drag on activity. Lack of momentum early in the quarter points to a negative GDP print in Q2 and we look for a 0.3% non-annualized decline. We expect some bounce back in the third quarter but it's likely to be modest with forward looking indicators softening in the latest round of PMI data. As in other economies, multi-decade high inflation (9% in April and May) is acting as a headwind for households. The toll of a 70% year-over-year increase in electricity, gas and fuel prices is only set to worsen later this year with the next round of semi-annual regulated price increases in October. A worsening inflation backdrop has led us to add hikes to our BoE profile—we now look for a larger 50 bp increase in August and see further increases taking Bank Rate to 2.50% (around the upper end of neutral) by year end. Tightening financial conditions and rising utility costs—notwithstanding some government support for lower-income households—are expected to cause UK GDP growth to flatline over the winter. We're now tracking an annual GDP gain of less than half a percent in 2023.

Rapid RBA hikes to slow rate-sensitive sectors

The RBA hiked by 50 bps at a second consecutive meeting, lifting the cash rate to 1.35% in July (just 15 bps below its pre-pandemic level). We think there's more to come with the central bank following the global trend of rapid policy normalization and we look for further 50 bp hikes in August and September. We see the cash rate rising to 2.85% by November—around the upper end of the RBA's assumed 2-3% neutral range. A more accelerated tightening cycle suggests greater softening in interest-rate sensitive sectors than we previously assumed and we've trimmed our GDP growth forecasts for both 2022 and 2023. At this stage we don't expect a recession in Australia though growth is likely to slow materially and we see the unemployment rate rising to 4.3% by the end of next year from a historically low 3.7% at the end of this year.

Interest rate outlook

%, end of period

	Actual						Forecast					
	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>
Canada												
Overnight	0.25	0.25	0.25	0.25	0.50	1.50	3.00	3.25	3.25	3.25	3.25	3.00
Three-month	0.09	0.15	0.12	0.16	0.60	2.08	3.10	3.15	3.15	3.15	3.00	2.70
Two-year	0.23	0.45	0.53	0.95	2.29	3.09	3.10	3.15	3.00	2.90	2.75	2.60
Five-year	0.99	0.98	1.11	1.26	2.41	3.11	2.90	2.80	2.75	2.70	2.50	2.40
10-year	1.56	1.39	1.51	1.43	2.40	3.23	2.90	2.75	2.70	2.70	2.55	2.45
30-year	1.99	1.84	1.99	1.68	2.38	3.14	2.85	2.75	2.75	2.75	2.65	2.60
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.38	1.63	2.88	3.38	3.38	3.38	3.13	2.88
Three-month	0.03	0.05	0.04	0.06	0.52	1.72	2.90	3.35	3.35	3.35	3.05	2.75
Two-year	0.16	0.25	0.28	0.73	2.28	2.92	3.00	3.00	2.90	2.75	2.50	2.40
Five-year	0.92	0.87	0.98	1.26	2.42	3.01	3.00	3.00	2.80	2.65	2.55	2.50
10-year	1.74	1.45	1.52	1.52	2.32	2.98	3.00	2.90	2.80	2.70	2.65	2.60
30-year	2.41	2.06	2.08	1.90	2.44	3.14	3.10	2.95	2.85	2.80	2.75	2.75
United Kingdom												
Bank rate	0.10	0.10	0.10	0.25	0.75	1.25	2.00	2.50	2.50	2.75	2.75	2.75
Two-year	0.11	0.07	0.40	0.68	1.36	1.85	2.25	2.65	2.55	2.50	2.50	2.50
Five-year	0.40	0.33	0.62	0.82	1.40	1.88	2.25	2.55	2.45	2.40	2.50	2.50
10-year	0.85	0.72	1.02	0.97	1.60	2.22	2.50	2.80	2.70	2.60	2.50	2.50
30-year	1.40	1.24	1.37	1.12	1.77	2.59	2.75	3.00	3.10	3.00	2.90	2.90
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	0.25	1.00	1.25	1.50	1.50	1.50
Two-year	-0.69	-0.67	-0.69	-0.64	-0.08	0.64	1.25	1.35	1.50	1.50	1.50	1.50
Five-year	-0.62	-0.59	-0.56	-0.45	0.37	1.09	1.50	1.65	1.60	1.60	1.55	1.50
10-year	-0.29	-0.20	-0.21	-0.18	0.55	1.36	1.75	1.80	1.75	1.70	1.65	1.55
30-year	0.26	0.30	0.29	0.20	0.67	1.63	1.90	2.00	1.90	1.85	1.80	1.75
Australia												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.85	2.35	2.85	2.85	2.85	2.85	2.60
Two-year	0.08	0.06	0.04	0.54	1.78	2.73	2.75	2.60	2.60	2.50	2.25	2.00
10-year	1.74	1.49	1.49	1.67	2.84	3.66	3.30	3.10	3.10	3.10	3.05	2.85
New Zealand												
Cash target rate	0.25	0.25	0.25	0.75	1.00	2.00	3.00	3.50	3.50	3.50	3.25	3.00
Two-year swap	0.46	0.78	1.39	2.16	3.27	4.06	4.00	3.80	3.60	3.30	3.00	2.75
10-year swap	1.95	1.87	2.21	2.62	3.38	4.10	4.20	4.10	3.90	3.60	3.30	3.05
Yield curve***												
Canada	133	94	98	48	11	14	-20	-40	-30	-20	-20	-15
United States	158	120	124	79	4	6	0	-10	-10	-5	15	20
United Kingdom	74	65	62	29	24	37	25	15	15	10	0	0
Eurozone	40	47	48	46	63	72	50	45	25	20	15	5
Australia	166	143	145	113	106	93	55	50	50	60	80	85
New Zealand	149	109	82	46	11	4	20	30	30	30	30	30

*Midpoint of 25 basis point range, **Yields refer to German government bonds, *** Two-year/10-year spread in basis points,

Source: Reuters, RBC Economics

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>	<u>2021</u>	<u>2022F</u>	<u>2023F</u>
Canada*	4.4	-3.1	5.3	6.6	3.1	4.5	2.5	1.2	0.5	-0.5	-0.5	0.2	4.5	3.7	0.8
United States*	6.3	6.7	2.3	6.9	-1.5	1.0	1.8	0.8	-0.3	-0.4	0.0	0.5	5.7	2.0	0.3
United Kingdom	-1.2	5.6	0.9	1.3	0.8	-0.3	0.3	0.0	0.1	0.1	0.2	0.2	7.4	3.4	0.4
Euro Area	-0.1	2.2	2.2	0.3	0.3	0.2	0.2	-0.3	-0.2	0.2	0.3	0.3	5.4	2.6	0.1
Australia	1.8	0.8	-1.8	3.6	0.8	0.3	0.8	0.6	0.5	0.3	0.2	0.2	4.8	3.5	1.8

*annualized

Inflation outlook

% change, year-over-year

	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>	<u>2021</u>	<u>2022F</u>	<u>2023F</u>
Canada	1.4	3.3	4.1	4.7	5.8	7.5	7.3	6.3	5.0	3.3	2.6	2.5	3.4	6.7	3.3
United States	1.9	4.8	5.3	6.7	8.0	8.5	8.1	6.2	4.3	2.3	1.6	2.0	4.7	7.7	2.5
United Kingdom	0.6	2.0	2.8	4.9	6.2	8.9	9.2	9.5	8.2	5.5	5.0	3.3	2.6	8.5	5.5
Euro Area	1.1	1.8	2.8	4.6	6.1	8.0	8.5	8.6	7.1	4.3	3.8	3.3	2.6	8.0	4.6
Australia	1.1	3.8	3.0	3.5	5.1	6.3	6.6	6.7	5.7	4.8	4.7	4.3	2.9	6.7	4.3

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

Currency outlook

Level, end of period

	<u>Actuals</u>						<u>Forecast</u>					
	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>
Canadian dollar	1.26	1.24	1.27	1.26	1.25	1.29	1.29	1.31	1.32	1.33	1.34	1.34
Euro	1.17	1.19	1.16	1.14	1.11	1.05	1.02	1.00	0.97	1.00	1.03	1.06
U.K. pound sterling	1.38	1.38	1.35	1.35	1.31	1.22	1.16	1.11	1.07	1.10	1.14	1.18
Japanese yen	111	111	111	115	122	136	137	140	140	138	136	134
Australian dollar	0.76	0.75	0.72	0.73	0.75	0.69	0.70	0.69	0.69	0.70	0.70	0.71

Canadian dollar cross-rates

	<u>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>
EUR/CAD	1.47	1.47	1.47	1.44	1.38	1.35	1.32	1.31	1.28	1.33	1.38	1.42
GBP/CAD	1.73	1.71	1.71	1.71	1.64	1.57	1.50	1.46	1.41	1.46	1.53	1.58
CAD/JPY	88	90	88	91	97	105	106	107	106	104	101	100
AUD/CAD	0.95	0.93	0.92	0.92	0.94	0.89	0.90	0.90	0.91	0.93	0.94	0.95

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

Charts we're watching

Treasuries sold off sharply in early June and the curve flattened as the Fed accelerated its tightening cycle and validated lofty rate hike expectations. But growing recession fears saw the rise in yields reverse with the curve flattening further and eventually inverting in July. We see ~3% 10-year yields and a flat to inverted curve continuing in the second half of the year.

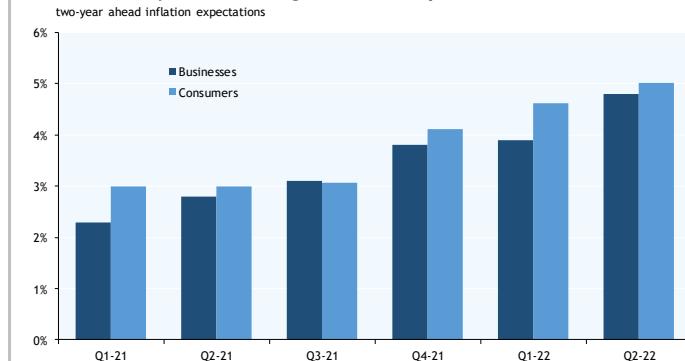
US Treasury yields are down, curve flattening



Source: US Treasury, RBC Economics

Rising inflation expectations were a key driver of the Fed's decision to increase the size of rate hikes. The BoC had its own evidence of that in its Q2 business and consumer surveys, which showed sharply rising near-term inflation expectations and (perhaps more worryingly) a drift higher in longer-term expectations. We expect 75 bp hikes from the BoC in July and Sept.

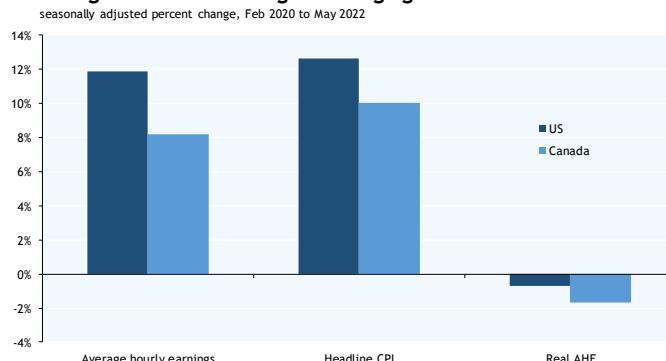
BoC surveys show rising inflation expectations



Source: Bank of Canada, RBC Economics

While wage growth has accelerated, it's failing to keep up with sharply rising inflation. Firm nominal wage gains relative to pre-pandemic bely flat to lower inflation-adjusted wages. We expect this will be a headwind to consumer spending—a key driver of growth in the past two years—going forward.

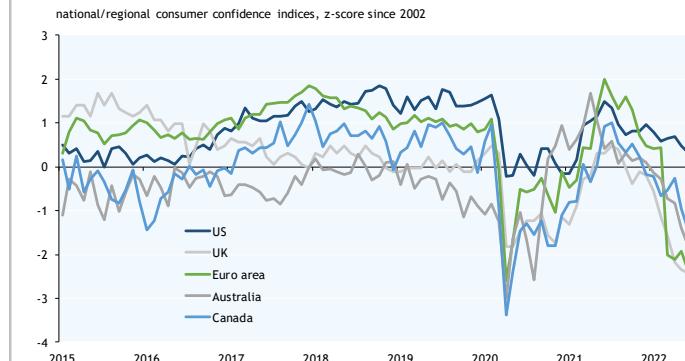
Rising inflation is eating into wage gains



Source: StatCan, BLS, RBC Economics

Accelerating inflation—particularly for staples like food and energy—combined with rising interest rates, volatile/declining equity markets and geopolitical uncertainty is denting consumer sentiment in many countries. We see this continuing into 2023, making recession our base case in several economies we track.

Consumer confidence has taken a u-turn



Source: The Conference Board, GfK NOP, EC, Westpac-Melbourne Institute, CBoC, RBC Economics