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Vaccines, restrictions driving near-term divergence

Early-2021 trends of rising government bond yields and strong equity markets continued in March. 10-year US Treasury yields were up 80 basis points in the first quarter and are now 120 bps above last summer's lows, an increase that's nearly on par with 2013's taper tantrum (though the latter occurred in just half the time). Higher yields didn't prevent the S&P 500 from crossing the 4,000 mark for the first time in its history, and a recent RBC Capital Markets survey found half of US investors are still bullish or very bullish despite high valuations. The common denominator is an improving economic backdrop as vaccine distribution ramps up and fiscal and monetary stimulus continue to flow. The IMF recently upgraded its global growth forecast by half a percent in 2021 and 0.2 percentage points in 2022, led by stronger expansion in advanced economies.

But for some the near-term outlook is clouded by a third wave of COVID-19 infections. A number of European countries and several Canadian provinces are once again tightening restrictions to combat the spread of variants. The opposite is true in the US and UK where significantly faster vaccine rollout and (in the UK) strict containment measures have thus far kept a third wave at bay. Even so, fixed income investors are taking a bit of a breather in early April, waiting to see the direction of case counts and restrictions.

While much of the selloff in longer-term bonds is likely behind us, we see yields continuing to drift higher (with the curve flattening) over the course of 2021. That will continue to be led by the US where significant fiscal stimulus is adding to the economy's momentum. The Fed has done little to push back against rising yields though we expect it will adopt a more hawkish tone later this year as robust growth materializes, setting it up to be first out of the gate

Central bank near-term bias

We expect the BoC will taper its asset purchases in April alongside upgraded economic projections. The latter should point to rate hikes in 2022 (as our forecast assumes) thought the BoC might dance around that point to keep from sounding too hawkish.

The Fed made some substantial forecast upgrades in March but most FOMC members still aren't penciling in a rate hike before 2023. We expect that will change if the economy grows in line with expectations.

The BoE's March meeting was a dress rehearsal for May when forecasts will be updated to account for vaccines and re-opening, more supportive fiscal policy, and higher bond yields. The MPC hasn't sounded too concerned about the latter.

The ECB followed up its words with actions in March, pushing back against rising bond yields by accelerating its pace of asset purchases over the coming quarter. The central bank is leveraging flexibility in its QE program to keep financial conditions accommodative.

The RBA also stepped up asset purchases to combat rising bond yields in late-February, but its April meeting was far less eventful. May's should be more interesting when new forecasts will take into account stronger economic data but less support for the labour market.

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Highlights

▲ US containment measures have gradually eased since late-January.

▲ Job growth accelerated in March but the labour market recovery still has a long way to go.

▲ Following a US$1.9 trillion stimulus package earlier this year, Biden is proposing US$2 trillion in infrastructure spending over 10 years.

▲ The Fed's forecasts suggest it will meet its inflation and employment objectives by 2023, if not sooner.

with rate hikes in 2022. The US's emergence as a growth leader—it saw one of the IMF's biggest forecast upgrades—has supported the US dollar, which rose for a third straight month and posted its strongest gain in a year in March. We expect the dollar will continue to appreciate over the course of 2021.

US largely avoiding third wave as vaccinations ramp up

The strong vaccine rollout in the US is starting to pay dividends. About one third of the population has received at least one vaccine dose and the daily pace of vaccinations has accelerated to nearly one per hundred people. President Biden plans to make vaccines available to every American adult in the coming weeks and doubled his target for vaccines administered to 200 million in his first 100 days. More widespread immunization has helped case growth flatten out at about one quarter of its early-2021 peak, even with containment measures having eased since January (now the least restrictive since the early days of the pandemic by some measures). While some states are seeing an uptick in COVID-19 cases, the US has thus far been spared from a third wave at the national level.

The re-opening allowed by lower case counts was evident in the latest payroll figures. The US economy added more than 900,000 jobs in March, the strongest monthly increase since August. Most industries saw gains though the leisure and hospitality sector accounted for more than one third of the increase in private employment. PMI data suggest hiring in both manufacturing and non-manufacturing industries will remain robust in the months ahead. Hiring plans among small businesses have also firmed with job openings at a record high though reports of difficulty finding qualified applicants have increased as well. The labour market recovery still has a long way to go with employment down 8.4 million from pre-pandemic levels in March. We expect more of those jobs will return in the coming months amid GDP gains averaging 7% in Q2 and Q3. Growth is seen closer to trend in 2022, though the Biden Administration's proposed 10-year, US$2 trillion "infrastructure" plan (which goes well beyond infrastructure investment) lends some upside risk, offset in part by planned corporate tax changes to fund new spending.

Fed's dot plot disconnect

The Fed made few changes to its policy statement in March, simply noting an uptick in economic indicators after a period of moderation in the pace of recovery. But that belied a substantial improvement in the FOMC's assessment of the economic outlook. Its median GDP growth forecast for 2021 (on a Q4/Q4 basis) was lifted by more than 2 percentage points to 6.5% and growth is projected to remain above trend in 2022 and 2023. The unemployment rate is seen hitting 4.5% by the end of this year and 3.5% by the end of 2023. With the economy projected to be running with excess demand after this year, core PCE inflation is expected to remain at or above the Fed's 2% objective over the next several years, rather than below that mark as projected in December.

Nonetheless, the Committee's assessment of the appropriate fed funds rate (the 'dot plot') only saw a minor shift forward in rate hike expectations with the median still projecting no rate increases by the end of 2023. The disconnect between that and strong economic projections—which in our view easily meet the Fed's maximum employment and average inflation targeting goals—suggests the FOMC is using the dot plot as more of a communication tool than a true projection of the most likely policy path. In his post-meeting press conference, Chair Powell said the Committee wants to see "actual data rather than just a forecast" before re-assessing the policy outlook—a view echoed by the meeting minutes. So we think the market, now pricing in a rate hike by the end of 2022, is right to not take the dot plot at face value. We expect the Fed's tone will shift as strong data roll in and we continue to look for a rate hike in the first half of next year.

Canadian economy's resilience will be tested again

Canada's economy continued to show surprising resilience to rising case counts and tightening restrictions early this year. GDP increased by 0.7% month-over-month in January (firmer than StatCan's preliminary estimate) despite lockdown measures being at their height in the country's two largest provinces. Early data suggest economic activity increased for a tenth consecutive month in February. Renewed restrictions and even lockdowns in some provinces in April will put Canada's growth streak at risk, though containment measures have once again been targeted at the kind of high-contact service sector activity that is already exceptionally weak. The rest of the economy has continued to grow. Still, we've knocked down our Q2 growth forecast slightly (to +3.5% annualized) which largely offsets assumed stronger performance in Q1—GDP for 2021 as a whole is still seen increasing by 6.3%.

While tighter restrictions will be key to controlling the third wave of COVID-19, vaccine distribution is essential to preventing a fourth wave and ensuring the economy can begin re-opening on a more sustained basis over the summer. About 17% of the population has received at least one jab, and while the pace of vaccinations has picked up in recent weeks to about 1 in 200 people per day, that's still significantly slower than leaders like the US and UK. Canada's pace should accelerate further in the coming weeks with the country on track to receive 44 million doses by the end of June—enough to provide the entire adult population with at least one dose, and about a third fully vaccinated with two. We expect more widespread immunity and broader re-opening will help GDP growth accelerate to a 6-7% annualized pace over the second half of the year.

Federal government to lay out next phase of fiscal support

The federal government will unveil its first full budget in more than two years on April 19. Its Fall Economic Statement late last year projected a $382 billion deficit (17.5% of GDP) in the fiscal year just-ended, shrinking to a $121 billion shortfall (5.2% of GDP) in the current fiscal year that began April 1. We expect the latter will increase as the government further extends some of its support programs to help households and businesses cope with ongoing restrictions. The deficit will also be boosted by the inclusion of fiscal stimulus—the federal government announced but didn't budget for $70-100 billion (3-4% of GDP) in "targeted stimulus" over the next three years to support the recovery. That level of stimulus no longer seems necessary and we expect the economy will return to full capacity next year without the additional fiscal boost. If the government is sticking to that stimulus figure, we expect it will focus on initiatives like child care, skills and training, and digital and green infrastructure—policies that should help boost potential GDP over time. We'll incorporate any new spending into our growth forecasts as details emerge—for now fiscal stimulus is another source of upside risk.

BoC to taper bond buying, upgrade growth forecasts

The Bank of Canada's April policy decision will come hot on the heels of the government's budget. We expect the central bank will reduce its asset purchases to $3 billion per week from $4 billion currently. Unlike October's taper when maturities were extended to keep the level of stimulus the same, we think the upcoming reduction in purchases will amount to less support for the GoC market. However, a slower pace of bond buying will coincide with less issuance in the current fiscal year—a reduction in supply that will offset lower BoC demand and limit upward pressure on yields. The BoC's clear communication about a potential taper should also limit market indigestion.

Highlights

▲ Early data suggest Canada's economy grew throughout the second wave…

▲ …but a third wave and renewed restrictions will hurt growth momentum.

▲ The federal budget will likely include $70-100 billion in stimulus over three years, but our current projections suggest that level of spending isn't needed.

▲ We expect the BoC will taper its bond-buying program in April but positive net purchases are likely to continue through much of the year.

Highlights

▲ The UK's leading vaccine rollout and is allowing it to begin easing restrictions.

▲ The UK's services sector is perking up while the euro area's continues to stagnate.

▲ The ECB is accelerating bond buying to keep financial conditions accommodative.

▲ The BoE's meeting minutes attributed rising bond yields to improving growth prospects and fiscal support, particularly in the US.

Still, the BoC will have its work cut out to not appear too hawkish, as we see this taper coming alongside a substantial upgrade in economic projections that could bring forward the timing of the bank's first rate hike. As noted above, Canada's economy has shown surprising resilience since the BoC's January forecast (it assumed a 2.5% annualized decline in Q1 GDP) and vaccine timelines have accelerated, boosting growth prospects over the second half of the year. We are projecting a 6.3% increase in 2021 GDP, substantially stronger than the bank's 4.0% estimate, meaning the economy should return to full capacity significantly sooner than 2023 as the BoC has projected. That said, the bank will also be reassessing potential growth in April which could keep it from bringing forward its rate hike guidance and appearing overly hawkish. The BoC might also temper its optimism by noting uncertainty around the third wave and risks surrounding vaccine rollout and effectiveness. That could help keep markets in check, where two rate hikes are already priced in for 2022.

UK opening up…

The UK remains among the global leaders in vaccine distribution with nearly half of its population having received at least one dose and daily vaccinations reaching 0.8 per 100 population in late-March. Vaccine supply dipped in early-April but the government says it's still on track to have all adults immunized by the end of July. The EU's rollout has been significantly slower, with just 13-14% of the population in major countries receiving at least one dose. Both supply and distribution issues are hindering the inoculations, and while the former is likely to ease in the current quarter as deliveries ramp up, resolving distribution issues will be key to hitting the EU's goal of vaccinating 70% of the population by end of June.

While the UK's vaccine push has been impressive, its tough restrictions have arguably played a greater role in reducing case growth to a six-month low. That is allowing for some easing of containment measures, with the hope that more widespread immunity will prevent another significant wave of infections. Restrictions came at an economic cost—we expect GDP fell by about 4% in Q1—but should pay off with a stronger recovery in the coming quarters and we look for growth to average more than 4% in Q2 and Q3. Re-opening prospects led to a sharp increase in the UK's services PMI in March with the employment sub-index pointing in the direction of job growth for the first time in a year.

…while Europe shuts down again

The euro area is a much different story with several major economies once again going into lockdown in an effort to slow a third wave of COVID-19 infections. We think the currency bloc saw a second straight quarter of economic contraction in Q1, and new containment measures add downside risk to the already modest recovery we were expecting in Q2. PMIs point to ongoing stagnation in the services sector (even with surveys pre-dating some new restrictions) but robust manufacturing activity, particularly in Germany. With the euro area running behind the UK in vaccinations, a similar pickup in services activity might have to wait a few more months.

With a long way yet to go in the euro area's recovery and a history of sub-target inflation, it wasn't surprising to see the ECB pushing back against rising bond yields amid the global selloff early this year. It followed those words with action in March, announcing a significant increase in asset purchases over the next quarter (within its existing PEPP purchase envelope) in order to maintain favourable financing conditions. The Bank of England, like the Fed and BoC, has sounded more comfortable with an increase in bond yields driven by improving fundamentals. Its March meeting was far less eventful with no policy changes and a more detailed assessment of the economic outlook being put off until May's MPR.

Interest rate outlook

%, end of period

	Actual					Forecast						
	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
Canada												
Overnight	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50
Three-month	0.21	0.20	0.12	0.06	0.09	0.15	0.20	0.20	0.25	0.25	0.50	0.55
Two-year	0.42	0.29	0.25	0.20	0.23	0.30	0.40	0.45	0.60	0.75	0.90	1.10
Five-year	0.59	0.37	0.36	0.39	0.99	1.05	1.15	1.20	1.25	1.35	1.45	1.55
10-year	0.70	0.53	0.57	0.68	1.56	1.55	1.60	1.65	1.70	1.75	1.80	1.85
30-year	1.31	0.99	1.11	1.21	1.99	1.90	1.95	1.95	2.00	2.05	2.10	2.10
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.38	0.63	0.63
Three-month	0.11	0.16	0.10	0.09	0.03	0.15	0.20	0.25	0.40	0.55	0.70	0.75
Two-year	0.23	0.16	0.13	0.13	0.16	0.20	0.40	0.60	0.90	1.10	1.30	1.50
Five-year	0.37	0.29	0.28	0.36	0.92	1.20	1.35	1.45	1.50	1.60	1.70	1.80
10-year	0.70	0.66	0.69	0.93	1.74	1.80	1.90	2.00	2.05	2.10	2.15	2.20
30-year	1.35	1.41	1.46	1.65	2.41	2.40	2.45	2.50	2.60	2.60	2.60	2.60
United Kingdom												
Bank rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Two-year	0.13	-0.08	-0.02	-0.16	0.11	0.05	0.10	0.15	0.20	0.20	0.25	0.25
Five-year	0.20	-0.06	-0.06	-0.08	0.40	0.40	0.45	0.50	0.60	0.65	0.70	0.85
10-year	0.34	0.17	0.23	0.20	0.85	0.85	0.90	1.00	1.05	1.15	1.20	1.35
30-year	0.82	0.64	0.78	0.76	1.40	1.35	1.50	1.65	1.80	1.85	1.90	2.00
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Two-year	-0.69	-0.69	-0.70	-0.71	-0.69	-0.60	-0.60	-0.60	-0.60	-0.60	-0.55	-0.50
Five-year	-0.65	-0.70	-0.71	-0.74	-0.62	-0.55	-0.55	-0.50	-0.50	-0.45	-0.40	-0.30
10-year	-0.48	-0.45	-0.53	-0.58	-0.29	-0.25	-0.20	-0.15	-0.05	0.05	0.15	0.20
30-year	0.03	0.01	-0.09	-0.17	0.26	0.35	0.45	0.55	0.65	0.75	0.80	0.85
Australia												
Cash target rate	0.25	0.25	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Two-year	0.24	0.25	0.16	0.08	0.08	0.10	0.10	0.10	0.10	0.10	0.10	0.15
10-year	0.77	0.87	0.84	0.97	1.74				Under review			
New Zealand												
Cash target rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Two-year swap	0.52	0.19	0.05	0.27	0.46	0.60	0.70	0.80	0.90	1.00	1.05	1.10
10-year swap	0.92	0.72	0.50	0.97	1.95				Under review			
Yield curve***												
Canada	28	24	32	48	133	125	120	120	110	100	90	75
United States	47	50	56	80	158	160	150	140	115	100	85	70
United Kingdom	21	25	25	36	74	80	80	85	85	95	95	110
Eurozone	21	24	17	13	40	35	40	45	55	65	70	70
Australia	53	62	68	89	166							
New Zealand	40	53	45	70	149							

*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

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	2019	2020	2021F	2022F
Canada*	-7.5	-38.5	40.6	9.6	6.0	3.5	7.0	6.0	3.5	3.0	2.5	1.8	1.9	-5.4	6.3	4.1
United States*	-5.0	-31.4	33.4	4.1	7.0	6.0	8.5	4.0	1.9	1.9	1.8	1.8	2.2	-3.5	6.2	3.3
United Kingdom	-2.9	-19.0	16.1	1.0	-4.1	4.7	3.8	2.4	0.5	0.4	0.4	0.4	1.4	-9.9	5.0	6.0
Euro Area	-3.7	-11.7	12.4	-0.6	-1.1	2.2	1.9	1.3	0.6	0.4	0.4	0.4	1.3	-6.8	4.1	3.7
Australia	-0.3	-7.0	3.4	3.1	1.2	0.7	1.1	0.9	0.8	0.7	0.4	0.4	1.9	-2.4	4.7	3.0

*annualized

Inflation outlook

% change, year-over-year

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	2019	2020	2021F	2022F
Canada	1.8	0.0	0.3	0.8	1.5	2.9	1.9	1.4	1.7	2.0	2.0	1.9	1.9	0.7	1.9	1.9
United States	2.1	0.4	1.2	1.2	1.9	3.6	2.8	2.7	2.2	1.9	2.0	2.2	1.8	1.2	2.7	2.0
United Kingdom	1.7	0.7	0.6	0.6	0.7	1.8	1.9	2.3	2.0	1.8	1.8	1.8	1.8	0.9	1.7	1.9
Euro Area	1.1	0.2	0.0	-0.3	1.1	1.4	1.7	2.1	1.1	1.4	1.3	1.4	1.2	0.3	1.6	1.3
Australia	2.2	-0.3	0.7	0.9	1.1	3.6	2.5	2.2	2.1	2.1	2.2	2.2	1.6	0.8	2.3	2.2

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

	Actuals					Forecast						
	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
Canadian dollar	1.41	1.36	1.33	1.27	1.26	1.26	1.27	1.28	1.29	1.30	1.30	1.30
Euro	1.10	1.12	1.17	1.22	1.17	1.16	1.15	1.14	1.13	1.12	1.13	1.14
U.K. pound sterling	1.24	1.24	1.29	1.37	1.38	1.32	1.29	1.25	1.22	1.19	1.20	1.20
Japanese yen	108	108	105	103	111	107	103	100	102	104	106	108
Australian dollar	0.61	0.69	0.72	0.77	0.76	0.77	0.76	0.75	0.74	0.73	0.73	0.73

Canadian dollar cross-rates

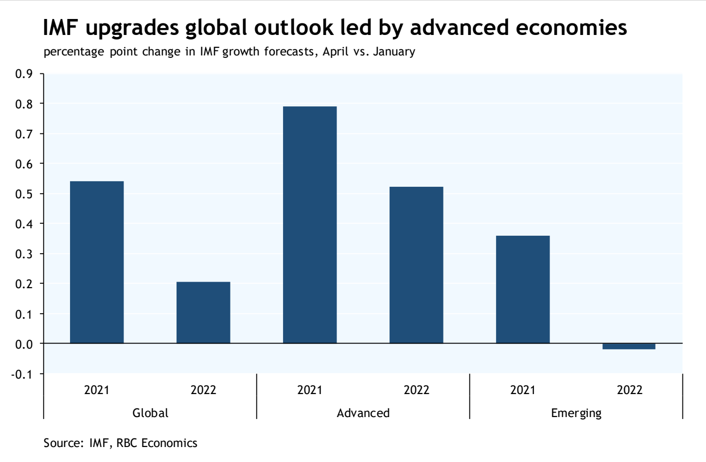
	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
EUR/CAD	1.55	1.53	1.56	1.55	1.47	1.46	1.46	1.46	1.46	1.46	1.47	1.48
GBP/CAD	1.75	1.68	1.72	1.74	1.73	1.66	1.64	1.60	1.57	1.55	1.56	1.56
CAD/JPY	76.5	79.5	79.2	81.1	88.1	84.9	81.1	78.1	79.1	80.0	81.5	83.1
AUD/CAD	0.86	0.94	0.95	0.98	0.95	0.97	0.97	0.96	0.95	0.95	0.95	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.

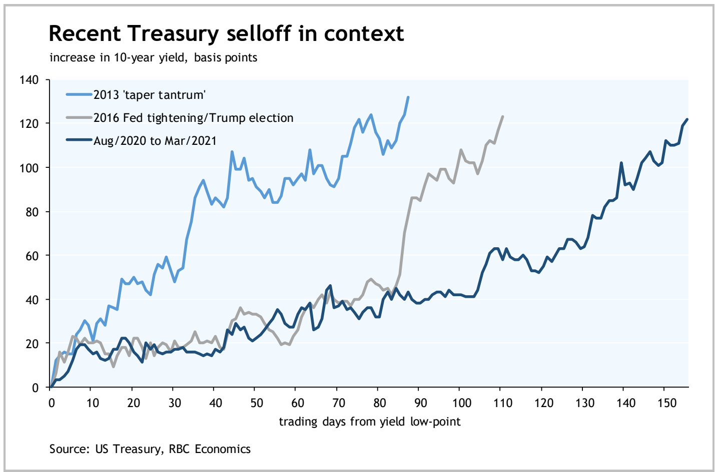
Source: Bloomberg, RBC Economics

Stimulus, vaccines boosting growth prospects (for some more than others)

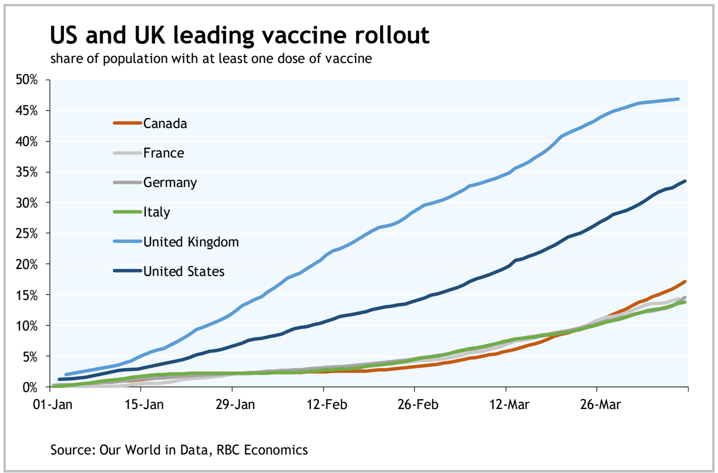
The IMF upgraded its global growth forecasts once again in April. Advanced economies, particularly the US, accounted for much of the upward revision. Strong economic data, vaccine progress, and ongoing fiscal and monetary support are contributing to brighter growth prospects.



An improving growth outlook and inflation concerns continued to put upward pressure on government bond yields. 10-year US Treasury yields increased by 120 basis points since last August, one of the larger (albeit slower) selloffs in recent years. We expect a further, modest increase in yields as 2021 progresses.



Fiscal stimulus is helping the US economy, but so is a growing vaccine push that has allowed for some easing in restrictions over the past few months. The UK is also a vaccine leader and is now re-opening its economy after a period of harsh lockdowns.



Canada and Europe have some catching up to do in their vaccine rollouts, and for now have to rely on restrictions to control a third wave of COVID-19. Increasing shipments in Q2 should help the pace of vaccinations pick up in the coming months.