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Challenging start to a (hopefully) better 2021

The vaccination race has kicked off with the US and UK leading the G7 in jabs while Canada and a number of European countries are off to a slower start. Inoculations can't come soon enough as outbreaks continue to intensify in many regions, straining healthcare systems and necessitating some of the harshest lockdowns since last spring. The UK, dealing with a new, fast-spreading strain of the virus, is facing a significant setback in its already lagging economic recovery. The euro area likely lost ground as well toward the end of 2020 and some restrictions are being extended to ensure recent flattening in case growth is sustained. Ongoing containment measures will slow Canada's recovery, while a more measured tightening in restrictions and some fresh fiscal stimulus should keep the US economy growing.

2021 has brought some notable political transitions. The UK and EU finally agreed to a trade deal that will allow quota- and tariff-free (but not entirely frictionless) goods trade, preventing a Brexit cliff-edge at the start of the year. And despite some deeply troubling scenes in Washington, Congress's certification of the Electoral College vote put Joe Biden one step closer to his January 20 inauguration. Democrat wins in two Senate runoffs early this year strengthened Biden's hand, though a narrow 50-50 split (VP Harris will act as tie-breaker) could still present challenges for the most ambitious aspects of the new administration's agenda. Nonetheless, the prospect of more fiscal stimulus and larger budget deficits prompted a moderate selloff in the U.S. Treasury market, with 10-year yields rising above 1% for the first time since last March. Market-based inflation expectations rose above 2% for the first time since 2018, with rising oil prices contributing to the increase. Saudi Arabia's unilateral production cut pushed WTI up to a ten-month high of more than US$50 per barrel.

Central bank near-term bias

→ The BoC's updated growth forecasts should show a slow start to 2021, but ultimately stronger activity as vaccinations ramp up earlier than previously expected. Nonetheless, we expect a relatively cautious tone in January emphasizing low rates will be in place throughout the year.

→ The Fed's December dot plot continued to suggest years of low rates ahead, despite upgraded economic projections. But we could see tapering of asset purchases later this year given the latest guidance and recent comments from some Fed officials.

↘ Lockdowns will set back the UK's already lagging economic recovery, strengthening the case for additional BoE support. We continue to forecast a bank rate cut (into negative territory) in February, though there's some risk of a later move.

→ With the ECB having announced a number of new measures in December—including additional QE and longer-term lending—we think the central bank will remain on the sidelines in the coming months.

→ We expect the RBA will hold its cash rate and yield curve target at 0.1% though we could see additional stimulus in the form of a QE extension beyond April.

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Highlights

▲ US containment measures have only tightened gradually despite accelerating case growth and record hospitalizations.

▲ US employment fell in December for the first time since April, but other indicators improved.

▲ Lawmakers finally agreed on another round of stimulus cheques and additional unemployment benefits.

▲ The Fed wants to see "substantial progress" toward its inflation and employment objectives before tapering QE.

US outbreak worsening, vaccine rollout slower than hoped

The US's most severe wave of COVID-19 yet continued to intensify around the turn of the year. Daily case growth rebounded to a record high following the holiday season and national hospitalizations are more than double the rates seen during the spring and summer waves. Some states have further tightened restrictions with IHS's weekly tracking of containment measures edging up to its highest level since June, though overall restrictions are nowhere near last spring's levels. The US is among the global leaders in vaccine distribution to date but is nonetheless falling short of plan. Health officials expected to vaccinate 20 million Americans by the end of December and another 20-25 million in January, but only 5.9 million (1.8% of the population) received their first shots as of January 7. Incoming President Biden is hoping to get vaccine rollout back on track, pledging to distribute 100 million shots in his first 100 days.

A worsening wave of COVID-19 infections won't be fully evident when Q4 GDP is released later this month. We're still expecting a 5% annualized increase that would leave economic activity just 2.2% below its year-ago level—that is, retracing much of the 10% peak-to-trough decline seen through Q2/20. Economic indicators heading into the New Year have been mixed. Consumer spending fell in November for the first time since April, though weekly spending data suggests that trend didn't continue in December. Employment and aggregate hours worked declined in December for the first time in eight months, though the ISM services index showed a surprising increase (manufacturing activity also strengthened). Combined with added stimulus early this year (see below) we expect only a moderate slowdown in the US's economic recovery early this year and are penciling in a 2.5% annualized increase in Q1/21 GDP.

US lawmakers pass fresh stimulus, with more to come?

In late December, Congress and the Trump Administration finally agreed on a $900 billion COVID-19 relief bill alongside $1.4 trillion to fund government agencies through September 2021 and avoid a partial federal government shutdown. New stimulus measures included $600 cheques for many Americans (phased out for those with higher incomes), $300 weekly top-ups to unemployment insurance and an extension of federal unemployment programs through mid-March, as well as funding to revive the Paycheck Protection Program with forgivable loans targeted toward small businesses with substantial revenue declines. Stimulus checks and UI top-ups are about half the size of those provided under last year's CARES Act, which contributed to a 10% (non-annualized) increase in personal disposable income in Q2/20. We should see a smaller boost to incomes in Q1/21, and a more modest increase in consumer spending with household savings likely to increase. Democrats (and even President Trump) were pushing for larger, $2,000 stimulus cheques but Senate Republicans were not on board. That should change after Democrats won both of Georgia's runoffs, leaving a 50-50 split in the Senate and incoming VP Kamala Harris holding the deciding vote. Yet another round of stimulus cheques would make for an even stronger recovery as vaccinations ramp up and restrictions are eased.

Fed upgrades forecasts but still sees low for long policy rate

The final FOMC meeting of 2020 saw the Fed sharpen its forward guidance on QE, saying asset purchases will continue until there is "substantial further progress" toward the committee's maximum employment and inflation objectives. There was some speculation that the Fed might extend the average maturity of its Treasury purchases to provide incremental stimulus in the face of near-term downside risks. However, stronger-than-expected growth toward the end of last year and earlier-than-anticipated vaccine rollout saw the Fed revise up its GDP forecasts substantially arguing against the need for additional monetary policy support (the Fed has also argued that fiscal policy is better positioned to provide quick, targeted support). The FOMC now sees the US unemployment rate falling to 5% by the end of this year and close to its longer run rate by the end of 2022. Core PCE inflation should be close to 2% in late-2022 as well. Even with forecasts that suggest a substantial, if not, full economic recovery over the next two years, the Fed's dot plot continues to suggest fed funds will be held at its current, near-zero level at least through 2023 (5 of 17 FOMC members think an earlier hike will be warranted). While we think rate hikes are off the table in 2021, "substantial progress" in the recovery will likely see the Fed begin tapering its asset purchases later this year.

Canada's road to recovery getting bumpier

Toward the end of 2020, Canada's economy was subject to a tug-of-war between sectors that are most exposed to containment measures and those that can maintain business-as-usual (or close to it) in the face of tightening restrictions. StatCan's preliminary estimate suggests the latter won the battle in November with GDP reportedly rising 0.4% month-over-month, marking a seventh straight gain. We think that figure—which is subject to revision—looks a bit strong but we've nonetheless revised our Q4/20 growth forecast higher to +4.5% (annualized). That said, it looks like a further pullback in hard-hit services sectors more than offset growth in the rest of the economy in December, with employment falling for the first time since April thanks to declines in hospitality and arts and entertainment. Hours worked also slipped lower and we expect to see a dip in GDP in the final month of 2020.

This loss of momentum will likely extend into early-2021 with a number of provinces keeping lockdowns in place (including school closures) and in some cases tightening restrictions further (Quebec introducing the first province-wide curfew). We now expect economic activity will flat-line in the first quarter. With stronger growth in Q4/20, our forecast for the level of GDP is little changed on net. A ramp up of vaccinations over the first half of the year key remains key to growth accelerating in Q2 and beyond. About 230,000 Canadians (0.6% of the population) received their first vaccine dose as of January 7, but distribution will have to ramp up to meet the government's target of 3 million doses (8% of the population) by the end of the first quarter.

BoC likely to boost forecasts but will remain cautious

The BoC flagged similar near-term forecast changes at its December meeting, noting signs of stronger-than-expected growth Q4/20 but a softer start to 2021. Immediate downside risks have arguably intensified given case trends and containment measures. The key development in the BoC's January forecasts, though, will be earlier-than-anticipated vaccine distribution. Recall the BoC's October forecasts assumed the virus would run its course by mid-2022. But with some Canadians already getting a jab and the government projecting the entire population can be vaccinated by the end of September, widespread inoculation looks set to occur a few quarters earlier than the BoC thought. So while our pre-vaccine growth profile was similar to the bank's, we're now expecting economic activity will ramp up more significantly as 2021 progresses, with the economy returning to full capacity by the second half of 2022.

Even if the BoC makes similar forecast revisions, we think it will hold onto December's relatively cautious tone amid near-term risks. Given the bank's forward guidance—the overnight rate will be held steady at its current level until the economy is

Highlights

▲ Canadian GDP increased further in November despite tightening restrictions…

▲ …but we think that growth streak ended in December, making for a weak handoff to 2021.

▲ Canadian employment also declined in December for the first time in eight months.

▲ Upward revisions to the BoC's forecasts, on net, should mean an earlier return to full capacity.

Highlights

▲ A late-December Brexit deal prevented a cliff-edge for UK-EU trade.

▲ Harsh lockdown measures likely to see UK GDP decline for a second straight quarter to start 2021.

▲ Europe has had a bit more success containing COVID-19 outbreaks…

▲ …but health authorities in some countries are nonetheless keeping tighter restrictions in place early this year.

back at full capacity—an earlier closing of the output gap should bring forward the timing of the first rate hike. But the BoC has plenty of time to massage market expectations around lift-off, and the key message that monetary policy will be highly accommodative for the foreseeable future is likely to remain in place. We also expect no changes to asset purchases in January, though we think further calibration of purchases will be required by mid-year—likely after the federal government has laid out its budget and debt issuance plans for the coming fiscal year.

Brexit done but UK's COVID-19 outbreak intensifying

The UK and EU struck a trade deal just days before the Brexit transition period ended on December 31. The agreement allows for quota- and tariff-free goods trade but says little about services (some key financial services arrangements have been extended and talks on equivalency rules are continuing). Border checks will cause some friction but won't be nearly as disruptive as a no-deal scenario. The more significant economic impact of Brexit is likely to be felt over years as more limited Single Market access trim's the UK's long-run growth prospects. A more pressing concern is the country's intensifying COVID-19 outbreak. A new, more infectious strain of the virus has seen case counts accelerate over the past month, pushing hospitalizations to a record high. That has necessitated fresh lockdown restrictions—the most severe since last spring—that are expected to last at least through mid-February. We think November's lockdown pushed UK GDP 1.2% lower (non-annualized) in Q4/20 and that trend is likely to accelerate early this year with a 4.2% decline expected in Q1.

While we should see a return to growth in Q2 and beyond as vaccinations ramp up—about 1.3 million people (nearly 2% of the population) have already received their first dose, and the government is hoping to reach 14 million by mid-February—the economy will have a deep hole to climb out of. Ongoing fiscal support (including another extension to the government's furlough program) and excess consumer savings of at least £100 billion will help, but we think the BoE will want to provide some additional monetary policy stimulus. We've long expected an eventual bank rate cut below zero, and markets are increasingly coming around to that idea. We're still penciling in a move in February, though with the BoE set to release a report on negative rates sometime next month, it could be a bit longer before we see a rate cut.

Europe's lockdowns capping case growth but risks remain

Tighter containment measures in November pushed the euro area services PMI to its lowest level since May, and December's reading suggested further albeit more modest contraction toward the end of the year. We think euro area GDP declined by 2.3% (non-annualized) in Q4/20, dragged down by sectors that rely on close personal contact and are thus more impacted by containment measures. Europe's lockdowns have been more successful than the UK's with case growth generally slowing in December. However, health authorities are being cautious and some countries are maintaining more significant restrictions in January. We're looking for a return to positive growth (+1%) in Q1 but risks are skewed to the downside. The faster-spreading UK strain is not yet prevalent on the continent—and travel restrictions are in place—but there's a risk that the mutation will eventually spread in Europe, necessitating a more extended period of tight restrictions. The euro area's vaccination campaigns have been off to a relatively slow start with inoculation rates across the currency bloc lagging the UK. Even as vaccinations ramp up, we expect a long road to recovery (euro area GDP not returning to pre-pandemic levels until mid-2022) will keep the ECB in stimulus mode. Recall the central bank increased the size of its QE program and extended purchases until March 2022 at its December meeting. We're not expecting any further moves in the near-term.

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	0.15	0.15	0.20	0.20	0.25	0.25	0.50	0.55
Two-year	0.42	0.29	0.25	0.20	0.30	0.30	0.35	0.35	0.55	0.75	0.90	1.10
Five-year	0.59	0.37	0.36	0.39	0.50	0.60	0.70	0.80	0.95	1.05	1.20	1.35
10-year	0.70	0.53	0.57	0.68	0.75	0.90	1.00	1.05	1.15	1.25	1.35	1.50
30-year	1.31	0.99	1.11	1.21	1.30	1.40	1.45	1.50	1.60	1.65	1.75	1.85
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	0.10	0.15	0.20	0.25	0.40	0.55	0.70	0.75
Two-year	0.23	0.16	0.13	0.13	0.20	0.25	0.40	0.60	0.85	1.00	1.25	1.50
Five-year	0.37	0.29	0.28	0.36	0.50	0.60	0.75	1.00	1.05	1.15	1.30	1.55
10-year	0.70	0.66	0.69	0.93	1.05	1.15	1.20	1.25	1.30	1.40	1.50	1.65
30-year	1.35	1.41	1.46	1.65	1.70	1.75	1.75	1.80	1.85	1.90	1.95	2.00
United Kingdom												
Bank rate	0.10	0.10	0.10	0.10	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15	-0.15
Two-year	0.13	-0.08	-0.02	-0.16	-0.25	-0.20	-0.20	-0.20	-0.20	-0.20	-0.15	-0.10
Five-year	0.20	-0.06	-0.06	-0.08	-0.20	-0.15	-0.15	-0.15	-0.10	0.00	0.10	0.15
10-year	0.34	0.17	0.23	0.20	0.00	0.10	0.15	0.20	0.25	0.35	0.50	0.75
30-year	0.82	0.64	0.78	0.76	0.60	0.65	0.75	0.85	0.95	1.10	1.25	1.40
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	-0.65	-0.60	-0.60	-0.60	-0.60	-0.60	-0.55	-0.50
Five-year	-0.65	-0.70	-0.71	-0.74	-0.75	-0.65	-0.55	-0.50	-0.50	-0.45	-0.40	-0.30
10-year	-0.48	-0.45	-0.53	-0.58	-0.60	-0.50	-0.40	-0.35	-0.30	-0.25	-0.15	0.00
30-year	0.03	0.01	-0.09	-0.17	-0.05	0.10	0.25	0.35	0.40	0.50	0.60	0.70
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	0.05	0.05	0.05	0.05	0.10	0.20	0.25	0.25
10-year	0.77	0.87	0.84	0.97	0.90	0.95	1.00	1.05	1.00	1.10	1.20	1.35
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	0.25	0.25	0.25	0.25	0.30	0.35	0.40	0.45
10-year swap	0.92	0.72	0.50	0.97	0.95	1.00	1.05	1.10	1.10	1.20	1.30	1.45
Yield curve*												
Canada	28	24	32	48	45	60	65	70	60	50	45	40
United States	47	50	56	80	85	90	80	65	45	40	25	15
United Kingdom	21	25	25	36	25	30	35	40	45	55	65	85
Eurozone	21	24	17	13	5	10	20	25	30	35	40	50
Australia	53	62	68	89	85	90	95	100	90	90	95	110
New Zealand	40	53	45	70	70	75	80	85	80	85	90	100

* Two-year/10-year spread in basis points, **Top of 25 basis point range

Source: Reuters, RBC Economics Research

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	2019	2020F	2021F	2022F
Canada*	-7.3	-38.1	40.5	4.5	0.0	6.5	8.5	7.5	4.0	3.0	2.5	1.8	1.9	-5.5	4.8	4.8
United States*	-5.0	-31.4	33.4	5.0	2.5	4.0	6.5	4.0	1.9	1.9	1.8	1.8	2.2	-3.4	4.6	3.0
United Kingdom	-3.0	-18.8	16.0	-1.2	-4.2	4.7	3.8	2.3	0.5	0.4	0.4	0.4	1.4	-10.4	2.7	5.9
Euro Area	-3.7	-11.7	12.5	-2.3	1.0	3.0	1.2	0.6	0.5	0.4	0.3	0.3	1.3	-7.2	5.0	2.8
Australia	-0.3	-7.0	3.3	1.9	1.0	0.6	1.0	0.7	0.7	0.8	0.6	0.6	1.9	-2.8	3.5	3.0

*annualized

Inflation outlook

% change, year-over-year

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	2019	2020F	2021F	2022F
Canada*	1.8	0.0	0.3	0.9	0.9	1.7	1.3	1.1	1.4	2.0	2.0	2.0	1.9	0.7	1.3	1.8
United States*	2.1	0.4	1.2	1.2	1.6	3.0	2.2	2.2	2.0	2.1	2.1	2.1	1.8	1.2	2.3	2.1
United Kingdom	1.7	0.7	0.6	0.7	0.7	1.4	1.4	1.6	1.7	1.8	1.8	1.9	1.8	0.9	1.3	1.8
Euro Area	1.1	0.2	0.0	-0.3	0.2	0.5	0.9	1.4	1.1	1.4	1.3	1.4	1.2	0.3	0.8	1.3
Australia	2.2	-0.3	0.7	0.9	1.1	3.5	2.4	2.1	2.1	2.1	2.1	2.0	1.6	0.9	2.1	2.0

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 Research

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	1.28	1.28	1.29	1.30	1.31	1.32	1.32	1.33
Euro	1.10	1.12	1.17	1.23	1.18	1.16	1.15	1.14	1.13	1.12	1.13	1.14
U.K. pound sterling	1.24	1.24	1.29	1.36	1.27	1.23	1.21	1.19	1.16	1.15	1.16	1.18
Japanese yen	108	108	105	103	100	98	97	98	99	100	101	102
Australian dollar	0.61	0.69	0.72	0.77	0.74	0.72	0.70	0.69	0.68	0.67	0.67	0.67

Canadian dollar cross-rates

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
EUR/CAD	1.55	1.53	1.56	1.57	1.51	1.48	1.48	1.48	1.48	1.48	1.49	1.52
GBP/CAD	1.75	1.68	1.72	1.73	1.62	1.58	1.56	1.54	1.53	1.52	1.54	1.56
CAD/JPY	76.5	79.5	79.2	81.0	78.1	76.6	75.2	75.4	75.6	75.8	76.5	76.7
AUD/CAD	0.86	0.94	0.95	0.98	0.95	0.92	0.90	0.90	0.89	0.88	0.88	0.89

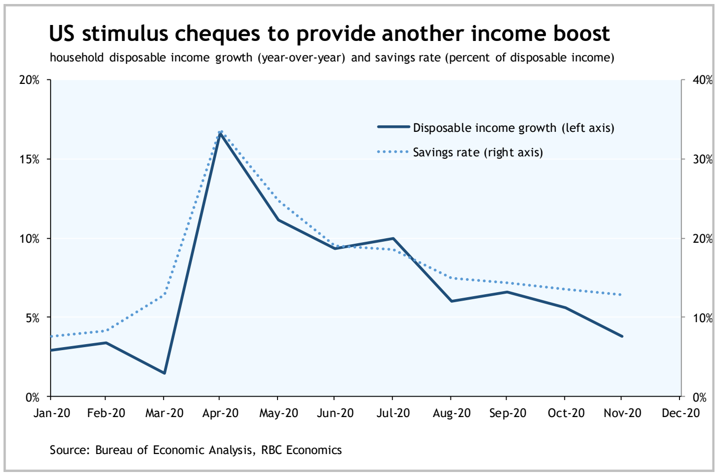
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

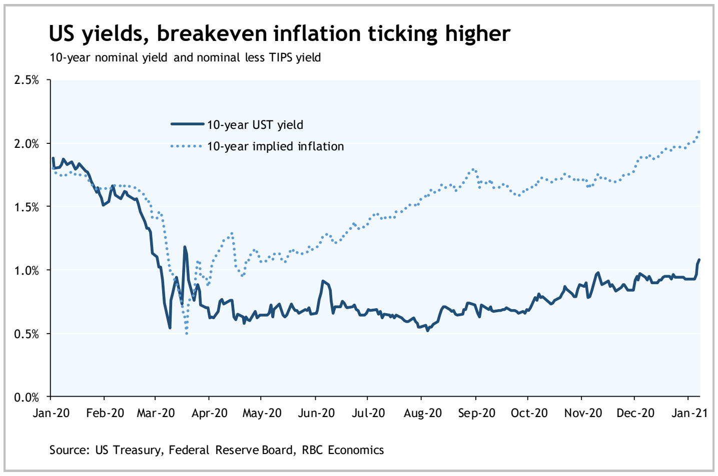
Source: Bloomberg, RBC Economics Research

US stimulus, higher oil prices lifting bond yields

Last year's US stimulus cheques coincided with a significant increase in household savings. We expect a similar pattern this time around as containment measures continue to limit spending opportunities. Households in the US and a number of other countries are sitting on a pile of cash that should support the recovery as restrictions are eased.

Democrat wins in both of Georgia's Senate run-offs strengthened Biden's hand and increased the odds of even more stimulus in 2021. The prospect of stronger growth and larger deficits pushed US Treasury yields higher. Rising market-based inflation expectations also contributed to the increase in nominal yields.





Rising oil prices have been a factor in rising breakeven inflation. Crude was climbing late last year amid improving global growth prospects. Fearing that growth hiccups would trim oil demand early this year, Saudi Arabia announced a unilateral 1 mb/d production cut for February and March that boosted prices.

Vaccine distribution will be key to economic recovery in 2021. The US and UK—which are experiencing some of the worst global outbreaks—are off to a good start but still have plenty of work to do to meet ambitious targets. Canada and major European economies have seen a slower early rollout.