

July 8, 2021

rbc.com/economics

Central bank divergence re-emerging

After a stubbornly dovish March FOMC meeting—strong growth forecasts accompanied by a flat dot plot and no taper talk—we thought a more balanced tone from the US central bank was just a matter of time. And the Fed indeed changed its tune in June, signaling rates will indeed have to rise in 2023 given strong growth and above-target inflation (a growing number of participants even see rates moving up next year). Policymakers also began discussing tapering plans and we continue to expect more details will be revealed later this summer before QE starts to be scaled back around the turn of the year.

The Fed's shift gave the US dollar a boost with the trade-weighted index now up nearly 3% year-to-date. The Canadian dollar is down by about 3 US cents since the start of June even as oil prices continue to firm. Rates markets also recognized the Fed's change in tone with 2-year Treasury yields rising to their highest level in more than a year. The long end of the curve, however, has seen a surprisingly strong rally due in part to expectations that the Fed will be less tolerant of high inflation—10-year breakeven inflation is down by 1/4 percent from May's highs even as oil prices have generally firmed. We think the rally at the long end is overdone and look for yields to move higher over the second half of this year as expectations for a 2022 rate hike continue to build (we're now expecting Fed liftoff in Q4/22).

Rising US yields should push borrowing costs higher in other geographies, including the UK and euro area where we don't expect rate hikes next year. The ECB's increased emphasis on symmetric 2% inflation (even if it isn't adopting average inflation targeting) suggests it will remain on the sidelines for an extended period. The RBA also looks set to keep rates on hold through 2022 but will taper its QE program later this year. We expect the BoC will continue slowing its bond buying and will look relatively aggressive with two rate hikes in 2022.

Central bank near-term bias



We expect the BoC will further taper its asset purchases in July but leave its forward guidance on rate hikes (not until H2/22 at the earliest—in line with our forecast) unchanged.



The Fed started to discuss tapering in June and those conversations should continue over the summer but we don't expect tapering to begin until the turn of the year. We now see rate hikes as a late-2022 prospect.



The BoE noted strong near-term growth and inflation should prove temporary, and it won't raise rates until most spare capacity is absorbed. We think the bank rate will be held steady through the end of 2022.



Following its strategic review the ECB is putting more emphasis on the symmetry of its 2% inflation objective, making rate hikes a distant prospect. QE will remain a key policy tool, even if PEPP is wound down as scheduled next year.



The RBA isn't extending its yield curve control target (giving it more flexibility to eventually raise rates) and will buy bonds at a slower weekly pace under its third QE program. We see less stimulus but no rate hikes next year.

Overview

..... page 1

United States

..... page 2

Canada

..... page 3

UK, Europe & Australia

..... page 4

Interest rate outlook

..... page 5

Economic & FX outlook

..... page 6

Charts we're watching

..... page 7



Highlights

▲ The Fed revised up its 2021 growth and inflation projections in June...

▲ ...and signaled rates will have to rise sooner than it previously indicated.

▲ We continue to look for the Fed to begin scaling back its QE purchases around year-end.

▲ Job growth accelerated in June and we look for strong payroll reports in the coming months with most physical distancing measures having been lifted.

Fed shifts away from persistent dovishness...

The Fed's June meeting was widely seen as hawkish though in our view it marked more of an end to persistent dovishness rather than outright hawkishness. We've said for some time that the Fed would need to change its tone on tapering and rate hikes this summer although June's shift came a bit sooner than we anticipated in the wake of disappointing payroll reports in April and May. The most significant development was a change in the dot plot with a majority of participants now expecting at least two rate hikes will be appropriate by the end of 2023. Back in April, most thought fed funds would remain at its current level into 2024. And 7 of 18 now expect rates will have to increase next year, up from four previously. This shift came alongside upgraded macroeconomic projections with the median 2021 GDP growth forecast revised 1/2 ppt higher and this year's headline PCE inflation forecast marked up by 1 ppt. Inflation is expected to remain slightly above 2% over the medium term while the unemployment rate is seen falling below the Fed's long-run estimate by the end of next year.

...and starts to discuss eventual QE tapering

June's meeting was also when the Fed, in Chair Powell's words, began "talking about talking about tapering" asset purchases. While he noted "substantial further progress" toward the Fed's policy goals—its condition for tapering—is still a ways off, progress is expected to continue and will be re-evaluated at coming meetings. We continue to look for the Fed to provide a more explicit signal on tapering and potentially provide additional details (e.g. whether MBS purchases will be tapered before Treasuries, given strength in housing) in the coming months, either at its late-August Jackson Hole conference or September's policy meeting. We think the central bank will begin reducing purchases around year-end.

The Fed's shift led markets to reassess the timing of rate hikes, pushing short-term yields higher. The long end of the curve has continued to rally, however, as markets see the Fed as less tolerant of inflation overshoots. The resultant yield curve flattening was in line with the trend we've been expecting, but again happened sooner than we thought and looks a bit overdone at this stage. We've shifted our forecast for the Fed's first rate hike to Q4/22 (still slightly ahead of market expectations) but still see 10-year yields returning to a year-to-date high of around 1.75% by the end of 2021.

Solid payrolls should add to the central bank's confidence

Payrolls surprised to the upside in June after two months of disappointing gains. A reported 850,000 increase was the strongest increase in a year with leisure and hospitality accounting for half of the gain in private employment. The jobless rate actually ticked higher in June (the household survey showed little change in employment) but there was an encouraging increase in prime-age labour force participation, which remains below its pre-pandemic level.

Given high levels of job openings and reports of labour shortages, there has been concern that generous unemployment insurance top-ups are keeping Americans from returning to work, particularly in lower-paying positions. Half of US states have now opted out of federal top-ups, and there is some evidence of lower jobless claims in those that left the program. That dynamic should support further job gains over the summer (the federal program ends in September), as will growing availability of child care. However, health concerns could also be influencing decisions about a return to work. Vaccine hesitancy remains an issue with only 55% of the US population having received at least one dose (most of those are fully vaccinated). Case counts and hospitalizations remain low but some states are seeing an increase in infections and under-vaccination increases the risk of another wave of cases in the fall and winter.



Bank of Canada likely to taper again in July

The Bank of Canada's upcoming meeting isn't likely to make the splash that the Fed did in June—the bank's April meeting did that—but we expect further tweaks to its QE program with bond purchases likely tapered to \$2 billion per week from \$3 billion currently. While June's policy statement simply reiterated that asset purchase decisions will be guided by Governing Council's assessment of the strength and durability of the recovery, Deputy Governor Lane's subsequent speech noted the economy won't need as much QE stimulus over time if the recovery evolves in line with or stronger than the BoC's projections—and that Governing Council expected to learn more “in the coming weeks” to help inform its assessment.

In that regard, we think recent activity data have been in line with the BoC's April forecasts. The latest GDP figures support the bank's call for Q2 GDP growth to moderate to a 3.5% annualized pace, assuming a return to growth in June. Domestically, virus and vaccine developments have been almost unambiguously positive since April's MPR—from accelerated vaccine rollout and strong uptake, to the slowest case growth since last summer—which should support an acceleration in growth over H2/21. Improving business confidence in the Q2 BOS and other early indicators (including RBC's consumer spending tracker) also point to a pickup in activity heading into the second half of the year. With the recovery evolving in line with the bank's expectations, we think conditions have been met for a further taper in July. Meanwhile, limited changes to GDP growth forecasts should leave the bank's timeline for the economy returning to full capacity (and rates beginning to rise) in H2/22 intact. We don't expect any change in forward guidance on the overnight rate and continue to forecast two rate hikes in H2/22.

Inflation forecasts on the rise... again

One area that could see more substantial forecast revisions is inflation. Headline CPI averaged 3.5% in April and May, ahead of the bank's 2.9% Q2 projection. And further strength in oil prices (WTI is US\$10-15/bbl higher than assumed in the April MPR) suggests inflation will remain stronger than the BoC's 2.2% end of year forecast—we revised our Q4/21 projection higher to 3.4%. The Q2 Business Outlook Survey showed widespread expectations that both input and output prices would increase at a faster pace, and one third of respondents think inflation will be above 3% over the next two years. However, the bank noted that price pressures are largely expected to be temporary, and the accompanying consumer survey showed households' inflation expectations remain well-anchored over the medium term. So while the BoC will likely be revising its near-term inflation forecasts higher in July—and might sound a bit more concerned about upside risks—we think it will continue to view this period of above-target inflation as transitory and not necessitating an earlier policy response.

We continue to keep an eye on upside risks to the inflation outlook, including one noted in the April MPR: the potential for stronger-than-expected household spending. RBC's consumer tracker points to strong growth in June in sectors that were impacted by restrictions during the third wave. The BoC's consumer survey showed signs of pent-up demand (some consumers wanting to catch up on missed purchases) and respondents that accumulated excess savings since the start of the pandemic plan to spend about one third of those funds over the next two years. That suggests some upside risk to our consumer spending projection (and the BoC's) that assumes most consumption will be financed by disposable income, not drawing down excess savings. A stronger rebound in spending, particularly in hard-hit services industries, could outpace companies' ability to re-hire and ramp up capacity. Indeed, the bank's Business Outlook Survey showed many businesses would have difficulty meeting an unexpected increase in future demand—potentially result in demand-pull inflation alongside cost-push price increases.

Highlights

▲ Economic indicators have been in line with the BoC's April forecast...

▲ ...which should set up for a further tapering of its QE program in July.

▲ The BoC will be marking up its inflation forecasts in July but will likely still view the increase as transitory.

▲ The BoC's latest consumer survey showed some plan to spend excess savings in the next two years—a potential upside risk to the consumer outlook.



Highlights

▲ UK GDP looks to have picked up strongly in the second quarter as the economy began to re-open.

▲ The UK government is beginning to phase out its furlough program.

▲ Vaccines and gradual re-opening likely saw the euro area return to growth in Q2.

▲ Australian lockdowns will make for a bumpy recovery but don't significantly change the overall outlook.

UK re-opening despite rising case counts

Despite a sharp increase in coronavirus cases in the UK that shows no signs of abating, the government still plans to lift most remaining physical distancing measures in England on July 19 (delayed from June 21). So far the country's broad vaccine coverage has prevented a commensurate increase in hospitalizations alongside rising case counts. Partial re-opening is already spurring a strong recovery in the second quarter with PMI readings across sectors sitting at or close to multi-year highs. We've marked up our Q2 GDP growth forecast to 5.5% (non-annualized) though that would still leave activity nearly 4% below its pre-pandemic level. We expect further, above-trend gains over the second half of the year will close that gap though a return to full capacity remains a more distant prospect.

The BoE also revised its Q2 growth forecast higher in June and marked up its inflation projection. However, above-3% inflation is expected to prove transitory and the bank sees both growth and inflation 'falling back' in the medium term. Labour market developments remain front of mind with the government beginning to phase out its Coronavirus Job Retention Scheme—employers must cover a larger share of wages this summer before the scheme closes at the end of September. Some 6% of the UK workforce remains on furlough and it will take time to get a sense of post-CJRS layoffs. That should leave the BoE with a relatively cautious tone near-term, and we continue to think rates are on hold through the end of 2022.

Euro area vaccine campaign gathering steam

Europe continues to lag the UK in vaccinations and re-opening though progress is being made with vaccine distribution picking up in June. PMI readings have continued to move higher across the euro area's largest economies—particularly in the previously-lagging services sector—as re-openings gets underway. Retail trade also increased strongly in May, supporting a return to positive GDP growth in Q2 after declines in the prior two quarters. Base effects and higher energy prices have lifted euro area inflation to the ECB's target but the increase is expected to be transitory as the central bank continues its long battle against disinflation. Achieving its inflation goals will be an even longer process with the central bank putting greater emphasis on symmetric 2% inflation following its strategic review, even if it didn't move as forcefully toward average inflation targeting as some expected. Rate hikes remain a distant prospect and markets appear ambitious even in pricing a modest rate increase in 2023. The ECB is maintaining a stepped-up pace of bond buying under its PEPP program in Q3 but we see purchases starting to be scaled back later this year. However, we think the ongoing Asset Purchase Program combined with slower issuance will help keep yields relatively low even as PEPP is phased out in 2022.

RBA delivers promised policy tweaks

The RBA circled its July meeting for potential policy tweaks and delivered on that by announcing plans to begin gradually reducing monetary stimulus. As expected, the central bank opted not to extend its Apr-24 yield curve control target to Nov-24, giving it a bit more flexibility when it comes to eventually raising the cash rate (still not seen until 2024 according to the Governor, though he indicated that's not set in stone). The RBA also announced a third round of QE will follow the current program when it expires, but with the pace of purchases reduced to A\$4 billion per week from A\$5 billion currently (that pace will be re-evaluated again in November). Further tapering will depend on the evolving outlook but we think it will ultimately leave the third QE program in the A\$70-100 billion range—about what we were expecting prior to the meeting. The central bank didn't sound overly concerned about fresh snap lockdowns in a number of Australian cities, and we agree that while restrictions will make for a bumpy recovery (and further COVID-19 outbreaks remain a risk amid slow vaccine rollout) they don't significantly impact the economy's overall growth trajectory. Australian GDP eclipsed its pre-pandemic level in the Q1 though an extended period of above-trend gains is needed to absorb labour market slack and generate the sustained wage growth and inflation the RBA wants to see before raising rates. We continue to think the market is overpriced for a move next year.



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	0.75
Three-month	0.21	0.20	0.12	0.06	0.09	0.15	0.20	0.20	0.25	0.30	0.55	0.80
Two-year	0.42	0.29	0.25	0.20	0.23	0.45	0.40	0.50	0.70	0.85	1.05	1.20
Five-year	0.59	0.37	0.36	0.39	0.99	0.98	1.05	1.20	1.35	1.45	1.55	1.65
10-year	0.70	0.53	0.57	0.68	1.56	1.39	1.50	1.70	1.80	1.90	1.95	2.00
30-year	1.31	0.99	1.11	1.21	1.99	1.84	2.00	2.10	2.20	2.25	2.30	2.30
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38
Three-month	0.11	0.16	0.10	0.09	0.03	0.05	0.01	0.05	0.05	0.10	0.25	0.60
Two-year	0.23	0.16	0.13	0.13	0.16	0.25	0.30	0.45	0.60	0.80	1.00	1.20
Five-year	0.37	0.29	0.28	0.36	0.92	0.87	0.95	1.20	1.30	1.45	1.60	1.80
10-year	0.70	0.66	0.69	0.93	1.74	1.45	1.55	1.75	1.85	2.00	2.10	2.20
30-year	1.35	1.41	1.46	1.65	2.41	2.06	2.15	2.30	2.40	2.50	2.55	2.55
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	0.07	0.10	0.15	0.20	0.20	0.25	0.25
Five-year	0.20	-0.06	-0.06	-0.08	0.40	0.33	0.45	0.50	0.60	0.65	0.70	0.85
10-year	0.34	0.17	0.23	0.20	0.85	0.72	0.90	1.00	1.05	1.15	1.20	1.35
30-year	0.82	0.64	0.78	0.76	1.40	1.24	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	-0.67	-0.60	-0.60	-0.60	-0.60	-0.55	-0.50
Five-year	-0.65	-0.70	-0.71	-0.74	-0.62	-0.59	-0.55	-0.50	-0.50	-0.45	-0.40	-0.30
10-year	-0.48	-0.45	-0.53	-0.58	-0.29	-0.20	-0.20	-0.15	-0.05	0.05	0.15	0.20
30-year	0.03	0.01	-0.09	-0.17	0.26	0.30	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	0.06	0.10	0.10	0.10	0.10	0.40	0.50
10-year	0.77	0.87	0.84	0.97	1.74	1.49	1.50	1.65	1.85	2.00	2.15	2.30
New Zealand												
Cash target rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.75
Two-year swap	0.52	0.19	0.05	0.27	0.46	0.78	0.80	0.90	1.10	1.20	1.30	1.35
10-year swap	0.92	0.72	0.50	0.97	1.95	1.87	1.80	1.95	2.00	2.15	2.25	2.40
Yield curve***												
Canada	28	24	32	48	133	94	110	120	110	105	90	80
United States	47	50	56	80	158	120	125	130	125	120	110	100
United Kingdom	21	25	25	36	74	65	80	85	85	95	95	110
Eurozone	21	24	17	13	40	47	40	45	55	65	70	70
Australia	53	62	68	89	166	143	140	155	175	190	175	180
New Zealand	40	53	45	70	149	109	100	105	90	95	95	105

*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>20Q1</u>	<u>20Q2</u>	<u>20Q3</u>	<u>20Q4</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>2019</u>	<u>2020</u>	<u>2021F</u>	<u>2022F</u>
Canada*	-7.9	-38.0	41.7	9.3	5.6	3.5	7.0	5.5	3.5	3.0	2.5	1.8	1.9	-5.3	6.3	4.0
United States*	-5.0	-31.4	33.4	4.3	6.4	9.5	7.0	3.0	2.5	2.5	2.0	2.0	2.2	-3.5	6.5	3.5
United Kingdom	-2.8	-19.5	16.9	1.3	-1.6	5.5	2.4	1.6	0.4	0.4	0.4	0.4	1.4	-9.8	7.4	4.8
Euro Area	-3.8	-11.5	12.6	-0.6	-0.3	1.4	2.0	1.4	0.6	0.4	0.4	0.4	1.3	-6.7	4.5	3.6
Australia	-0.3	-7.0	3.5	3.2	1.8	0.6	0.9	0.8	0.8	0.7	0.5	0.4	1.9	-2.4	5.2	2.9

*annualized

Inflation outlook

% change, year-over-year

	<u>20Q1</u>	<u>20Q2</u>	<u>20Q3</u>	<u>20Q4</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>2019</u>	<u>2020</u>	<u>2021F</u>	<u>2022F</u>
Canada	1.8	0.0	0.3	0.8	1.4	3.4	3.7	3.4	2.7	2.2	2.3	2.5	1.9	0.7	3.0	2.4
United States	2.1	0.4	1.2	1.2	1.9	4.6	4.3	4.0	3.5	2.1	1.9	2.2	1.8	1.2	3.7	2.4
United Kingdom	1.7	0.7	0.6	0.6	0.6	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	1.8	1.6	2.2	1.3	1.3	1.4	1.4	1.2	0.3	1.6	1.4
Australia	2.2	-0.3	0.7	0.9	1.1	3.9	3.0	2.7	2.6	2.3	2.2	2.2	1.6	0.8	2.7	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

	<u>Actuals</u>					<u>Forecast</u>						
	<u>20Q1</u>	<u>20Q2</u>	<u>20Q3</u>	<u>20Q4</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>
Canadian dollar	1.41	1.36	1.33	1.27	1.26	1.24	1.24	1.25	1.26	1.27	1.27	1.27
Euro	1.10	1.12	1.17	1.22	1.17	1.19	1.17	1.14	1.13	1.12	1.13	1.14
U.K. pound sterling	1.24	1.24	1.29	1.37	1.38	1.38	1.34	1.28	1.24	1.22	1.23	1.23
Japanese yen	108	108	105	103	111	111	107	105	107	108	110	112
Australian dollar	0.61	0.69	0.72	0.77	0.76	0.75	0.75	0.74	0.74	0.73	0.73	0.73

Canadian dollar cross-rates

	<u>20Q1</u>	<u>20Q2</u>	<u>20Q3</u>	<u>20Q4</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>
EUR/CAD	1.55	1.53	1.56	1.55	1.47	1.47	1.45	1.43	1.42	1.42	1.44	1.45
GBP/CAD	1.75	1.68	1.72	1.74	1.73	1.71	1.67	1.60	1.56	1.55	1.56	1.56
CAD/JPY	76.5	79.5	79.2	81.1	88.1	89.6	86.3	84.0	84.9	85.0	86.6	88.2
AUD/CAD	0.86	0.94	0.95	0.98	0.95	0.93	0.93	0.93	0.93	0.93	0.93	0.93

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

Market reaction to the Fed's "hawkish" shift

The Fed's "hawkish" shift in June—particularly the dot plot that now calls for a median of two hikes in 2023—led to some repricing of short-term Treasuries with 2-year yields rising to their highest level since the early stages of the pandemic. Market pricing for the first fed funds hike has been brought forward into early-2023 but we're still ahead of that expecting a Q4/22 hike.

Markets think the Fed is now less inclined to tolerate persistently high inflation (beyond meeting its average inflation target) and implied inflation has fallen from multi-year highs seen in May. As a result, 10-year Treasury yields are at their lowest level since February. We think the rally looks excessive and expect yields will move back to 2021's highs (1.75%) by year end.

Fed shift triggered front-end selloff

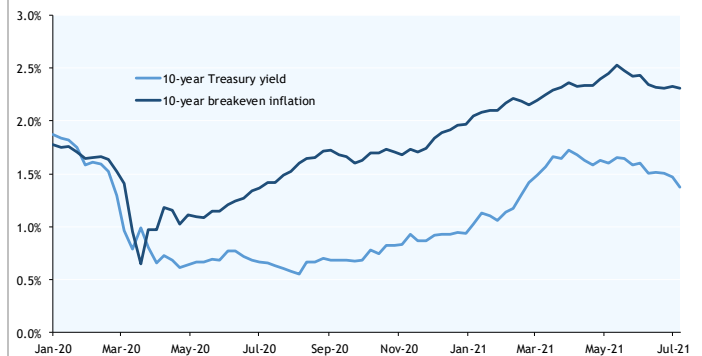
2-year Treasury yield, weekly average



Source: US Treasury, RBC Economics

US market-implied inflation coming off earlier highs

DXY index (Jun-6-01=100) and USD/CAD, weekly averages



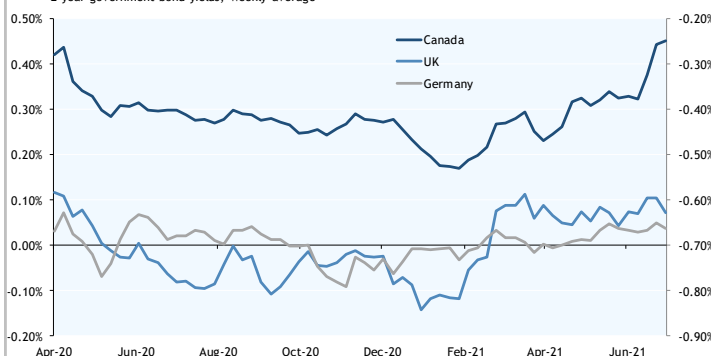
Source: US Treasury, Federal Reserve, RBC Economics

The Fed's shift is seen as giving more room for the BoC to raise rates without triggering significant C\$ appreciation. We continue to expect two rate increases in the second half of 2022. Front-end rates in the UK and euro area remain low with the BoE and ECB looking much less likely to hike next year.

We'd been waiting for a less dovish Fed to reverse some of the US dollar's losses and that process began in June. Persistent Canadian dollar appreciation has started to unwind despite a further increase in oil prices. We expect the Canadian dollar will end 2021 close to the 80 US cent mark (USD/CAD at 1.25).

Canadian 2-year yields also rising; Europe & UK well anchored

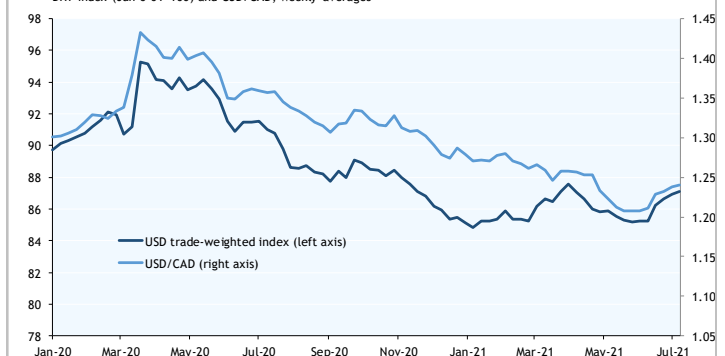
2-year government bond yields, weekly average



Source: Refinitiv, RBC Economics

USD staring to reverse a year of depreciation

DXY index (Jun-6-01=100) and USD/CAD, weekly averages



Source: Wall Street Journal, RBC Economics