RBC Economics

Financial Markets Monthly

March 4, 2022

rbc.com/economics

More uncertainty, more inflation

Simmering geopolitical tensions in Eastern Europe boiled over on February 24 with Russia's unprovoked invasion of Ukraine thrusting the continent into what some are calling its worst crisis since WWII. Equity markets plunged and prices for key commodities produced in the region jumped higher with WTI trading above US$100/bbl for the first time since 2014. As fighting intensified, G7 powers dialed up their response including unprecedented sanctions on Russia's central bank and restricting some commercial banks' access to essential global payments infrastructure. The ruble lost a quarter of its value while global investors fled to safety, pushing advanced economy bond yields lower. Oil and gas prices have continued to rise sharply to multi-year highs even as energy trade continues to be largely spared from sanctions. Volatility in both equity and bond markets remains elevated.

The situation remains fluid and much could change in the coming days and weeks, for better or for worse. At this stage the bulk of our forecast revisions are in Europe, which is most directly exposed to the conflict given its trade links and reliance on imported Russian oil and gas. But higher commodity prices will be felt globally, adding to inflation that is already uncomfortably high—we've revised 2022 inflation forecasts higher by 1/2 to 1 ppt, and even more in Europe. Geopolitical uncertainty, slower global growth, and persistent price pressures complicate the withdrawal of monetary policy stimulus. But with policy rates having been held near zero into the advanced stages of economic recovery, we think the BoC (which hiked in early-March), Fed and BoE will remain on the path of removing accommodation, notwithstanding geopolitical uncertainty. It's the ECB's tightening cycle that we see being delayed with QE now likely to continue throughout 2022 and rate hikes being put off until early next year.

Central bank near-term bias

↗ Geopolitical uncertainty didn't stop the BoC from raising rates in March and we expect a follow-up move in April when the central bank will likely be revising it growth and inflation forecasts higher.

↗ Chair Powell made clear that the Fed will be raising rates in March, by 25 bps rather than 50 bps. He called for a series of rate hikes which we think suggests consecutive increases at the next three meetings. We now see 125 bps of hikes over the course of 2022.

↗ Recent BoE officials have suggested the central bank remains on track to hike again in March. We expect the pace of rate increases will slow thereafter with UK GDP taking a hit from the conflict in Europe.

→ The ECB has had to reverse its hawkish shift as Russia's invasion of Ukraine looks set to shave nearly 1 ppt off euro area growth this year. We no longer expect a rate increase in 2022 and think QE will continue for much of the year.

→ Geopolitical uncertainty and the RBA's focus on domestic over global inflationary pressures leaves it comfortably on the sidelines in the near term. We continue to expect a hike in Q3.

Josh Nye | Senior Economist | 416-974-3979 | josh.nye@rbc.com

Highlights

▲ The euro area has the most direct trade exposure to Russia…

▲ …including significant dependence on imported Russian oil and gas.

▲ Additional inflationary pressure from higher food and energy prices will hurt consumers…

▲ …with wages struggling to keep up in the near-term despite low unemployment.

Direct trade links matter more for Europe

Of the economies we forecast, the euro area has by far the greatest bilateral trade flows with Russia. Imports from Russia amounted to 0.9% of GDP over the past year and are heavily skewed toward energy. The country is Europe's most significant supplier of oil and gas and some major economies are particularly exposed—about two-thirds of Germany's natural gas imports and one-third of imported oil comes from Russia. That dependence is a key reason the energy sector has been spared from the most severe sanctions thus far, though some buyers are voluntarily boycotting Russian oil and gas. Near-term futures for European natural gas have more than doubled year-to-date and Brent crude is more than 40% higher. The latter wasn't helped much by a coordinated but underwhelming release of crude oil reserves by IEA member countries (60 million barrels, or less than a day's worth of non-OPEC production) nor by OPEC+ sticking with its schedule to unwind production cuts only gradually. There remains risk that prices climb even further if sanctions are expanded to include energy trade, or if Russia withholds exports in retaliation for existing sanctions and the West's support for Ukraine.

On the non-energy side, the euro area's exports to Russia amount to about 0.75% of GDP. That might not seem like much, but the potential scale of contraction is significant given sanctions, payment disruptions, a collapsing ruble, and a voluntary shift away from doing business with Russia. With most of those exports being manufactured goods (rather than globally-traded commodities) quickly pivoting to other buyers will be challenging. Exposure to Eastern European countries that are even more Russia-dependent also hurts the currency bloc's trade outlook. The other economies we forecast will be less directly impacted. Exports to Russia amount to just 0.2% of UK GDP and mere basis points in Canada, the US and Australia. The UK will face some noticeable spillover effects due to its integration with Europe, but it's hard to see direct trade channels having much of an impact on growth in the other countries.

Higher prices are a growing headwind for consumers

An increase in energy prices isn't the only inflationary impact of the Russia-Ukraine conflict. The two countries account for roughly one-quarter of global wheat and barley exports and 14% of corn exports. Russia is also a major supplier of some base metals and fertilizers. Higher prices for these commodities will add to already-elevated inflation across advanced economies. Food and energy together represent 20-25% of CPI baskets and are currently contributing more than 2 ppts to headline inflation in Canada, the US, UK and euro area. We now see Canadian inflation averaging 4.4% this year (up from 3.8% previously) while US CPI is expected to average 5.8%, a full percentage point stronger than previously thought. We now expect inflation to average nearly 7% in the UK this year and almost 6% in the euro area. While core measures won't be impacted as much, persistently high headline readings add to the risk that longer-term inflation expectations drift higher.

While we've consistently noted upside risk to our consumer spending forecasts given pent-up savings, the potential drag from rising prices is growing. Excess savings in Canada and the US (over and above pre-pandemic savings trends) amounts to slightly more than 12% of GDP but is concentrated in the hands of higher-income households. Lower-income cohorts who spend a greater share of their incomes on essentials have less of a buffer and will feel more pain from rising food and energy prices. Americans at the lower end of the wage distribution have seen strong pay growth but consumer sentiment in that income cohort has moved in the opposite direction as prices have increased. Canada has yet to see such robust wage growth in lower-paying industries despite reports of labour shortages. Strong labour market conditions across the economies we monitor should keep upward pressure on wages but pay growth will struggle to keep up with rising prices in the near-term, potentially denting consumer confidence. Again, the euro are looks more exposed due to its lagging wage growth even as unemployment falls to new lows.

Some positives for commodity producers

Canada is a net exporter of a number of the commodities that have seen sharp price increases due to the Russia-Ukraine conflict. That will help Canada's terms of trade (export relative to import prices) build on last year's record 14% gain. Stronger incomes will mostly accrue to commodity producers and governments—Alberta is returning to surplus even with conservative oil price estimates—with some positive effects for domestic investors (the TSX is flat year-to-date compared with an 8% decline in the S&P 500). But spillover in the form of stronger business investment could be limited. A recent survey of investment intentions (conducted when oil prices averaged close to US$80/bbl late last year) showed oil and gas capex is expected to remain 14% below its pre-pandemic level in 2022, and about half of what it as prior to the 2014-16 oil price shock. We're not convinced US$100/bbl oil will change that narrative given ongoing infrastructure challenges and uncertainty about future demand. Nonetheless, higher commodity prices still provide a meaningful offset to inflation-induced drag on Canada's consumer sector.

The US's shale boom dramatically reduced its net imports of crude oil. Producers will benefit from rising prices but as with Canada the investment response to earlier price increases was underwhelming. Rig counts are on the rise but remain well below pre-pandemic levels, and production is still more than one million barrels per day lower. The country has been a net exporter of natural gas for several years and will benefit from rising LNG export prices (North American natural gas prices haven't risen nearly as much as in Europe). But on balance we think the inflationary hit to consumers offsets windfall profits for the US commodity sector.

Keeping an eye on financial conditions

Government bond yields have been in a tug-of-war between falling real yields (reflecting growth concerns and demand for safe assets) and rising inflation premia, with US 5-year breakeven inflation hitting a record high. Markets have trimmed rate hike expectations in the UK and Europe but the front-end of the curve has been less volatile in Canada and the US with the BoC and Fed suggesting they'll stick with tightening plans. Sovereign spreads in the euro area have been well-behaved, helped by the continent's unified response to Russian aggression as well as expectations that the ECB will remain more active with QE. We've lowered our near-term forecasts for German government bond yields but made limited changes in other jurisdictions.

Any easing in financial conditions from lower-risk free rates is being more than offset by higher corporate bond spreads and falling equity markets. That's particularly true in Europe, adding to the continent's growth headwinds. A depreciating euro, now at its lowest level since mid-2020, is only providing modest support, while commodity currencies have held up well despite growing risk aversion. We maintain our year-end forecasts for EUR/USD (1.08, down from 1.10 currently) and USD/CAD (1.27, close to spot).

A big hit to European growth; others less impacted

Adding up the impacts of a sharp fall in the euro area's direct trade with Russia, spillover through the bloc's trade with Eastern Europe, the effect of rising food and energy prices on spending and confidence, and some tightening in financial conditions, we've lowered our 2022 euro area GDP forecast by 0.8 ppts to 2.8%. That dents the UK economy's near-term outlook, and we now expect 3.9% GDP growth in 2022 down from 4.4% previously. Our US GDP growth forecast is little changed at this stage. In Canada, indications that the economy surprisingly didn't contract during the Omicron wave prompted us to mark our Q1 GDP growth forecast higher, building on an unexpectedly strong increase in Q4/21. We think some of that growth has been pulled forward from upcoming quarters, but on balance our 2022 GDP growth forecast rises to 4.3% from 4.0% previously.

Highlights

▲ As an exporter of food and energy, Canada will see a terms of trade boost from rising commodity prices.

▲ The US is less dependent on energy imports than it was a decade ago.

▲ Falling equity markets and rising corporate bond spreads have tightened financial conditions.

▲ Our early assessment is that euro area GDP growth could be nearly 1 ppt lower due to the Russia-Ukraine conflict.

Highlights

▲ The BoC hiked in March and is likely to do so again in April.

▲ Powell teed up a March rate hike and we now expect 125 bps of hikes by the Fed this year.

▲ The ECB is reversing its recent, hawkish pivot and is unlikely to pull back on policy support in the near-term.

▲ The market continues to price in aggressive BoE hikes despite the central bank's push-back in February.

BoC stays the course with March hike with the Fed set to follow

As expected, the BoC followed through on raising its policy rate in March despite noting "the unprovoked invasion of Ukraine by Russia is a major new source of uncertainty." After a close call not to hike in January, there appeared to be a low bar to raise rates which was easily cleared by recent economic data and positive COVID developments. The BoC noted risks to global growth and financial market volatility related to the Russia-Ukraine conflict, but was clearly concerned about the inflationary impact of rising commodity prices, lending the statement a slightly hawkish tone. The bank said inflation will be higher than previously expected in the near-term, which increases the risk that longer-run inflation expectations will drift higher.

With the BoC likely revising its 2022 inflation and growth forecasts higher, we expect a follow-up hike in April. Depending on how financial conditions evolve in the interim, the bank could also begin shrinking its balance sheet. After April we look for the BoC to shift to once-a-quarter rate hikes (i.e. July and October) though we see some risk that rate increases are even more front-loaded. Regardless of the near-term cadence, we think the BoC will pause its tightening cycle at the low end of "neutral" (1.75-2.75%) given high household debt levels, housing's increased sensitivity to rates, and other forms of tightening (QT and a Fed that is likely to take its rate hiking cycle further in 2023). That said, if CPI remains above the BoC's target range throughout 2023, there's risk that monetary policy will have to go further to rein in inflation.

In comments to Congress in early-March, Chair Powell endorsed a 25 bp rate hike at the Fed's upcoming meeting and said the central bank will "proceed carefully" in light of geopolitical developments that are already affecting commodity prices and could have an impact on spending. He poured cold water on a 50 bp hike in March, emphasizing the Fed "will not add uncertainty with our moves," but still called for a series of rate increases this year. We think that suggests a faster pace of tightening to start the cycle—a risk we've been flagging—than we previously assumed. As such, we've added a May rate hike to our forecast (i.e. three consecutive hikes starting in March) and now expect five 25 bp increases over the course of 2022. Powell said the Fed will not finalize its balance sheet plans in March, so a QT announcement could be put off until July. We've made only minor changes to our UST yield forecasts.

ECB to put off tightening until 2023, no change to BoE & RBA calls

Europe's greater exposure to the Russia-Ukraine conflict is forcing a turnaround by the ECB after its hawkish shift earlier this year. The ECB's chief economist said euro area GDP could be reduced by 0.3-0.4 ppts this year, and that looks like an underestimate given developments since his comments. We think that makes the ECB more likely to look through a further, commodity-driven increase in inflation. Last month we moved our call for ECB rate hikes forward into 2022 but we now see liftoff being delayed until early next year. And rather than ending QE around mid-year, we think the central bank will keep that program up throughout 2022 in an effort to offset some of the recent tightening in European financial conditions.

The BoE's reaction function to Russia-Ukraine developments is a bit more complicated than in North America given the UK's greater exposure to Europe. That said, recent comments from BoE officials suggest inflation remains a key concern, so we continue to expect the central bank will opt for a third consecutive rate hike at its March meeting. We've maintained that the market is over-priced for further tightening and see the pace of rate hikes being dialed down going forward, with the next increase not coming until August.

As expected, the RBA held its policy rate steady in March and made no announcement on shrinking its balance sheet (that could come in May). The central bank called the Russia-Ukraine conflict a "major new source of uncertainty" though we'd note that Australia has very little direct trade exposure to Russia and the vast majority of its trade with Europe is imports rather than exports. The country's status as a net energy exporter (including significant quantities of LNG) also acts as a buffer against the impact of rising food and energy prices. That said, we think geopolitical uncertainty plays into the RBA's patient approach to raising rates. While global developments will push inflation higher, the RBA remains focused on domestically-driven price pressures and wage growth. We continue to expect the RBA will begin raising its cash rate in the third quarter.

Interest rate outlook

%, end of period

	Actual				Forecast							
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
Canada												
Overnight	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.50	1.75	1.75	1.75
Three-month	0.09	0.15	0.12	0.16	0.60	0.85	1.10	1.30	1.50	1.65	1.70	1.70
Two-year	0.23	0.45	0.53	0.95	1.35	1.40	1.50	1.65	1.80	1.90	1.95	2.00
Five-year	0.99	0.98	1.11	1.26	1.60	1.70	1.75	1.85	1.95	2.00	2.05	2.10
10-year	1.56	1.39	1.51	1.43	1.80	1.90	1.95	2.00	2.05	2.10	2.15	2.20
30-year	1.99	1.84	1.99	1.68	2.05	2.10	2.15	2.20	2.25	2.30	2.30	2.30
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.38	0.88	1.13	1.38	1.63	1.88	2.13	2.38
Three-month	0.03	0.05	0.04	0.06	0.35	0.88	1.13	1.40	1.65	1.90	2.15	2.40
Two-year	0.16	0.25	0.28	0.73	1.50	1.65	1.80	1.95	2.05	2.20	2.30	2.40
Five-year	0.92	0.87	0.98	1.26	1.85	1.95	2.10	2.20	2.25	2.30	2.35	2.40
10-year	1.74	1.45	1.52	1.52	2.00	2.05	2.15	2.25	2.35	2.40	2.45	2.45
30-year	2.41	2.06	2.08	1.90	2.25	2.30	2.35	2.40	2.45	2.45	2.50	2.50
United Kingdom												
Bank rate	0.10	0.10	0.10	0.25	0.75	0.75	1.00	1.00	1.00	1.25	1.25	1.25
Two-year	0.11	0.07	0.40	0.68	1.25	1.20	1.30	1.30	1.40	1.40	1.40	1.40
Five-year	0.40	0.33	0.62	0.82	1.30	1.30	1.35	1.40	1.45	1.55	1.55	1.55
10-year	0.85	0.72	1.02	0.97	1.40	1.45	1.50	1.55	1.65	1.75	1.75	1.75
30-year	1.40	1.24	1.37	1.12	1.50	1.55	1.55	1.60	1.70	1.75	1.75	1.75
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.25	0.00	0.25	0.25
Two-year	-0.69	-0.67	-0.69	-0.64	-0.65	-0.50	-0.40	-0.20	0.15	0.20	0.30	0.30
Five-year	-0.62	-0.59	-0.56	-0.45	-0.30	-0.20	-0.10	0.10	0.40	0.45	0.50	0.50
10-year	-0.29	-0.20	-0.21	-0.18	0.05	0.15	0.25	0.40	0.60	0.60	0.65	0.65
30-year	0.26	0.30	0.29	0.20	0.30	0.40	0.45	0.50	0.60	0.65	0.70	0.70
Australia												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.10	0.50	0.75	1.00	1.25	1.25	1.25
Two-year	0.08	0.06	0.04	0.54	0.90	1.10	1.30	1.50	1.60	1.70	1.75	1.80
10-year	1.74	1.49	1.49	1.67	2.25	2.20	2.30	2.45	2.55	2.60	2.60	2.60
New Zealand												
Cash target rate	0.25	0.25	0.25	0.75	1.00	1.50	2.00	2.25	2.50	2.75	2.75	2.75
Two-year swap	0.46	0.78	1.39	2.16	2.65	2.75	2.85	2.90	3.00	3.10	3.10	3.10
10-year swap	1.95	1.87	2.21	2.62	3.00	3.05	3.05	3.10	3.05	3.10	3.10	3.10
Yield curve***												
Canada	133	94	98	48	45	50	45	35	25	20	20	20
United States	158	120	124	79	50	40	35	30	30	20	15	5
United Kingdom	74	65	62	29	15	25	20	25	25	35	35	35
Eurozone	40	47	48	46	70	65	65	60	45	40	35	35
Australia	166	143	145	113	135	110	100	95	95	90	85	80
New Zealand	149	109	82	46	35	30	20	20	5	0	0	0

*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

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021	2022F	2023F
Canada*	4.8	-3.6	5.5	6.7	3.5	5.5	4.5	2.3	2.2	2.0	1.8	1.8	4.6	4.3	2.6
United States*	6.3	6.7	2.3	7.0	2.5	3.0	2.5	2.5	2.0	1.8	1.7	1.5	5.7	3.6	2.1
United Kingdom	-1.2	5.6	1.0	1.0	0.7	0.5	0.4	0.3	0.5	0.4	0.4	0.4	7.5	3.9	1.7
Euro Area	-0.2	2.2	2.3	0.3	0.4	0.2	0.3	0.6	0.4	0.4	0.4	0.4	5.2	2.8	1.7
Australia	1.9	0.8	-1.9	3.4	0.8	1.9	0.9	0.7	0.7	0.4	0.5	0.4	4.7	4.0	2.8

*annualized

Inflation outlook

% change, year-over-year

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021	2022F	2023F
Canada	1.4	3.3	4.1	4.7	5.3	5.2	4.1	3.1	2.4	2.2	2.3	2.4	3.4	4.4	2.3
United States	1.9	4.8	5.3	6.7	7.6	6.5	5.3	3.8	2.5	2.2	2.3	2.6	4.7	5.8	2.4
United Kingdom	0.6	2.0	2.8	4.9	5.8	8.1	7.4	6.3	4.6	2.5	2.2	2.2	2.6	6.9	2.9
Euro Area	1.1	1.8	2.8	4.6	5.5	5.9	5.9	5.8	4.6	4.3	3.8	3.3	2.6	5.8	4.0
Australia	1.1	3.8	3.0	3.5	4.2	4.4	4.4	3.8	3.1	2.9	2.7	2.6	2.9	4.2	2.9

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			
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
Canadian dollar	1.26	1.24	1.27	1.26	1.26	1.27	1.27	1.27	1.28	1.30	1.32	1.34
Euro	1.17	1.19	1.16	1.14	1.11	1.10	1.09	1.08	1.07	1.08	1.08	1.09
U.K. pound sterling	1.38	1.38	1.35	1.35	1.32	1.28	1.21	1.19	1.18	1.19	1.20	1.21
Japanese yen	111	111	111	115	112	113	115	117	118	119	120	120
Australian dollar	0.76	0.75	0.72	0.73	0.72	0.70	0.68	0.67	0.67	0.67	0.67	0.67

Canadian dollar cross-rates

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
EUR/CAD	1.47	1.47	1.47	1.44	1.40	1.40	1.38	1.37	1.37	1.40	1.43	1.46
GBP/CAD	1.73	1.71	1.71	1.71	1.67	1.62	1.54	1.51	1.51	1.54	1.58	1.62
CAD/JPY	88	90	88	91	89	89	91	92	92	92	91	90
AUD/CAD	0.95	0.93	0.92	0.92	0.91	0.89	0.86	0.85	0.86	0.87	0.88	0.90

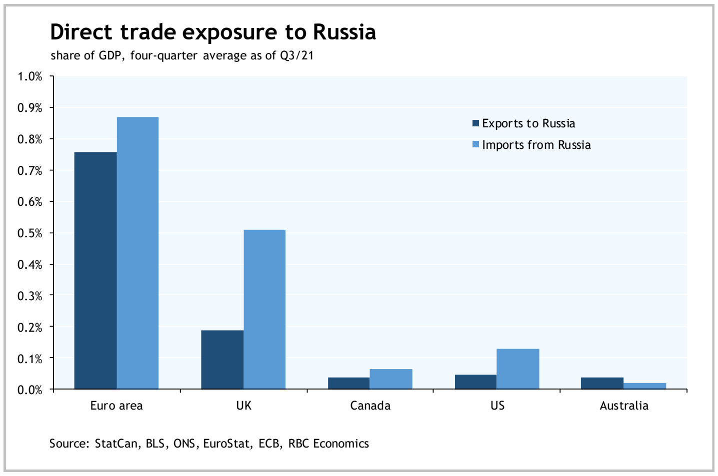
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

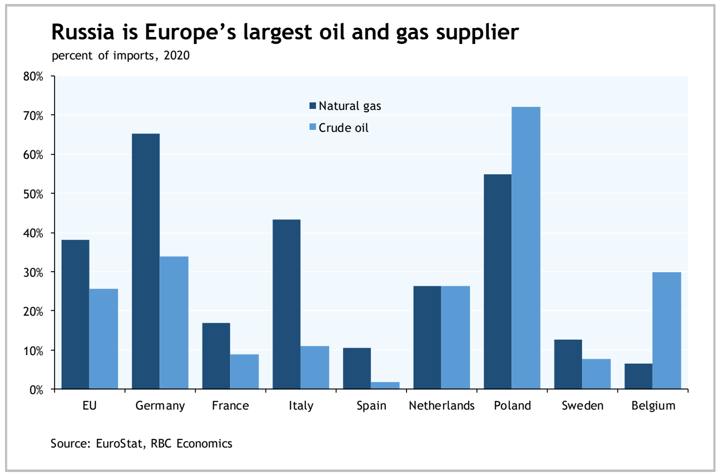
Source: Bloomberg, RBC Economics

Russia-Ukraine impact in charts

Of the countries we monitor, the euro area has by far the greatest direct trade exposure to Russia. It will be hard to quickly pivot to new buyers for manufactured exports, while energy imports are becoming much more costly. The currency bloc's exposure to Eastern European EMs also adds to the potential trade hit.

Russia is Europe's top supplier of natural gas and oil. While energy has largely been spared from sanctions thus far, some buyers are voluntarily turning away from Russia, adding to price pressure. Near-term natural gas futures in Europe have more than doubled year-to-date.





Rising oil and gas prices aren't the only inflationary impact of the conflict. Exports of grains and base metals (and thus their prices) are also impacted. Additional upward pressure on food and energy prices comes as those components are already making an outsized contribution to inflation in advanced economies.

Rising breakeven inflation is putting upward pressure on bond yields but that has been more than offset by lower real yields amid growth concerns and demand for safe assets. Nominal yields are slightly lower on net but other aspects of financial conditions have tightened.