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Inflation prospects prompt bond market reset

Government bonds sold off in February as investors digested a confluence of factors that look set to push inflation higher and could test central banks' commitments to keep interest rates low for an extended period. In the near-term, rising commodity prices, higher shipping costs, and input shortages are set to push goods inflation higher. Meanwhile, accelerating vaccine rollout in most advanced economies is focusing attention on eventual re-opening in hard-hit services industries, where pent-up demand and a pile of savings could see demand recover faster than supply. That concern is particularly salient in the US where a $1.9 trillion stimulus package will add significantly to households' purchasing power. US market-implied inflation (over the next five years) hit its highest level in a decade, nearing 2.5% in early-March.

The response from policymakers will depend on whether the increase in inflation is viewed as transitory. At this stage we don't think rising input costs and potential pockets of excess demand will result in a sustained upward shift in inflation rates in most economies—with the usual caveat that inflation expectations must remain well-anchored. We expect central banks will look through higher and in some cases above-target inflation over the coming year. Investors appear to share that view—an increasing spread between 5- and 2-year yields, for instance, suggests central banks are more likely to eventually raise interest rates but prospects of near-term hikes remain limited.

Nonetheless, we think some central banks will hike rates sooner than markets are anticipating. Beyond a temporary, near-term jump in headline inflation, we expect a return to full capacity in the US and Canadian economies will help sustain near- or even above-target inflation in 2022. We see both the Fed and BoC raising rates modestly next year, earlier than their current guidance suggests. In other economies that have more slack to work through—the UK, euro area

Central bank near-term bias

Stronger-than-expected GDP growth through the second wave should see the BoC revising its 2021 growth forecast significantly higher in April. We expect the central bank will taper its QE program at that meeting but reiterate that rate hikes are a more distant prospect.

We think the Fed will also have to revise its 2021 growth forecast significantly higher in March. A faster-than-expected return to full employment will test the central bank's commitment to an extended period of ultra-low interest rates.

The UK economy had a slow start to 2021 but impressive vaccine distribution should see activity pick up as lockdown measures are eased. The UK has a long road to recovery but it appears unlikely the BoE will try to speed up the process with negative rates.

The ECB has verbally pushed back against rising bond yields, seeking to limit any pre-emptive tightening in financial conditions. If words aren't enough, the central bank can use flexibility within its QE program to keep financial conditions accommodative.

The RBA defended its 3-year yield target and even moved some QE purchases forward to keep markets functioning smoothly. It has already announced a second round of QE and we think a third is likely in pursuit of full employment and on-target inflation.

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Highlights

▲ Strong manufacturing orders are bumping up against supply chain issues and rising input costs.

▲ WTI is expected to remain above $60 per barrel; base effects will push energy inflation sharply higher in Q2.

▲ The Fed's latest Beige Book was mixed on whether retailers and manufacturers are able to pass on higher prices to their customers.

▲ There is a risk that services inflation will accelerate later this year if a pickup in demand outpaces supply.

and Australia—interest rates will be held at current levels over our forecast horizon with QE programs continuing for the foreseeable future. We've already seen some of those central banks push back against rising bond yields with words (ECB) and actions (RBA).

Producers flagging higher input costs, supply chain pressures

The latest round of manufacturing PMIs flagged rising input costs, growing order backlogs and longer supplier delivery times. The increasing prevalence of those issues over the past few months reflects a number of factors. Commodity prices have increased sharply—Bloomberg's commodity price index is up about 15% over the past three months. Oil prices hit their highest level in more than a year in February with WTI crossing the US$60 per barrel mark. RBC's commodity strategists see the start of a strong cycle for the global oil market with both rising demand and tight supply (a rare combination in recent years) supporting prices. WTI is expected to average US$61.50 and US$63 per barrel this year and next, respectively. But it's not just an oil story—industrial metals prices are up more than 40% from a year ago amid growing demand and in some cases limited supply. Beyond the manufacturing space, strong homebuilding is pushing building material costs higher and some agricultural prices are on the rise.

Manufacturers have also noted a pickup in global demand as constrained services spending continues to support goods purchases. But that demand is running up against shipping delays, with well-documented container shortages driving transportation costs higher. Input shortages are also an issue, most notably for semiconductors used in a wide range of products from electronics to vehicles. The latter has already resulted in temporary production cuts by some automakers.

The key question is whether rising input costs will be passed onto consumers. Energy prices see fairly direct pass-through to end users, so higher fuel costs (particularly relative to a year ago when prices were declining sharply) will be a key contributor to rising near-term inflation. In Q2, for instance, we think headline CPI will exceed 3% year-over-year in Canada and the US. Pass-through of higher input costs more generally is far from assured. Competitive forces have kept a lid on goods price inflation for decades and that could remain the case in 2021. Some surveys, though, suggest producers and businesses are more willing to pass on price increases to their customers. But in any case, we don't think input cost-driven inflation will be sustained. Energy prices will remain firm but aren't expected to accelerate further, goods demand should normalize as services spending increases, and we don't think supply shortages and higher shipping costs will be sustained (at least not to the current degree) as the recovery progresses.

Will re-opening see services surge?

Beyond near-term increases in goods price inflation, there are concerns that economic re-opening could see demand for services temporarily outpacing supply. Limited spending opportunities and generous government benefit programs have seen households (in aggregate) accumulate a pile of savings worth 5-10% of GDP in some economies. The extent to which that money is spent will be a key determinant of consumer spending and inflation as COVID-19 restrictions are lifted. Our forecasts (and most others, it appears) generally assume household savings rates will normalize as the recovery progresses but remain above pre-pandemic levels—a typical post-recession pattern. That means households will spend a greater share of their income relative to last year but won't run down accumulated savings to a significant degree (which would result in a negative savings rate).

Some excess savings has likely already been directed toward investments like housing and equities (evidenced by rising home prices and record stock markets). And households appear to have used some of their savings to pay down debt—particularly higher-interest borrowing like credit cards. However, balance sheet data still shows a good deal of savings sitting in bank accounts. Households might be holding onto more cash for precautionary reasons, but there is certainly risk that a chunk of that money will be spent when opportunities arise. Households might not need two haircuts, but dining out more than usual, getting some extra travel in, or doing more in-person shopping could test capacity limits in sectors that have a lot of rehiring to do, and where some permanently closed businesses will need to be replaced by new entrants. If a surge in spending were to outpace supply, services inflation would likely accelerate, at least temporarily. To be clear, though, our base case forecast is for a strong but manageable pickup in demand as restrictions are gradually lifted which should cap increases in services prices.

Biden adding fuel to the fire

The aforementioned risks are most significant in the US where additional fiscal stimulus is on the way. President Biden's $1.9 trillion stimulus plan was passed by the House of Representatives (without Republican support) and is now working its way through the Senate. Much of that stimulus money will be directed toward households, including $1,400 cheques for most Americans (on top of the $600 cheques that went out at the start of this year), child benefit payments, an extension of expanded unemployment benefits through the end of August (the previous extension is set to expire mid-March) and increasing UI top-ups. Funding will also go to vaccines and testing, education, and state and local governments. The stimulus package has been criticized for its size (equivalent to about 9% of US GDP) and we share concerns about over-stimulating an economy that will likely have plenty of its own momentum as COVID-19 restrictions are lifted. But Treasury Secretary (and former Fed Chair) Yellen has stressed the need to "go big" with stimulus to help get the economy back to full employment.

Another round of fiscal stimulus combined with stronger-than-expected momentum to start the year (particularly in consumer spending which received a boost from January's stimulus cheques) has us lifting our 2021 GDP growth forecast to 6.2% from 4.6% previously. The Biden administration's accelerated vaccine rollout—enough supply for all adults to be vaccinated by the end of May—should also mean stronger growth in late-spring and summer. We now expect US GDP will return to pre-pandemic levels next quarter, with the output gap closing in the second half of the year. A stimulus-driven shift into excess demand should keep core inflation at or above 2%. So while we think the Fed will look through above-3% headline inflation in the coming months, we expect it will start raising rates next year when underlying inflation is sustained closer to target. The US yield curve has steepened in recent months but we expect some flattening later this year when markets begin to price rate hikes into shorter-term yields.

Canada's economy resilient through second wave

Canada's economy has also surprised to the upside in recent months. Q4 GDP rose an annualized 9.6%, significantly stronger than the 4.5% increase the BoC assumed in January. And StatCan's preliminary estimate for January (+0.5%) was surprisingly robust given lockdown measures that were in place in Canada's two largest provinces throughout the month. With those restrictions easing, we should see further growth in February and March. Given the economy's resilience through the second wave of COVID-19, we've marked up our Q1 GDP growth forecast to 4.5% from flat previously. That would be a significantly stronger outcome than the BoC's forecasted 2.5% decline.

We think growth will continue to firm in the coming quarters as vaccine rollout finally accelerates. The government's goal has been to vaccinate all willing Canadians by the end of September, though with new vaccine approvals and changing dosing regimens, the entire adult population could receive at least a first dose a few months sooner. We've lifted our 2021 growth forecast to 6.3% from 4.9% previously and now see the

Highlights

▲ Biden's $1.9 trillion stimulus plan will add to excess savings (in the $1.5 trillion range) households accumulated in 2020.

▲ The US economy could get back to full capacity this year—and push beyond that in 2022.

▲ Canada's economy managed positive growth in December and January even as restrictions increased.

▲ The BoC said it will taper asset purchases if growth is in line with expectations.

Highlights

▲ The Fed and BoC have taken rising bond yields in stride, attributing the moves to an improving outlook…

▲ …while others like the ECB and RBA have pushed back against tightening financial conditions.

▲ The UK and euro area should see a return to growth in Q2 as restrictions are eased.

▲ Australia saw a less significant decline in 2020 GDP relative to the other economies we track.

economy returning to full capacity in the first half of next year. As with the Fed, we think the BoC will look through a temporary increase in headline inflation (above its 1-3% target band) this year. But with rate hikes being tied to the closing of the output gap, we think the BoC will raise rates sooner than their current guidance suggests (2023). Before then, strong growth should see the central bank beginning to taper its asset purchases in April.

With markets beginning to price in some eventual removal of accommodation, Canadian government bond yields have increased by more than their US equivalents this year. But we ultimately think that trend will be reversed as stronger US growth and eventually more tightening by the Fed see the US leading any further selloff in government bonds. That should be a catalyst for the Canadian dollar to give back some of its recent strength over the second half of the year. Our forecast assumes the Canadian dollar will slip from 79 US cents currently to 77 cents by the end of 2021.

Other economies face a longer road to full capacity

While we see the Fed and BoC raising rates next year, liftoff is a more distant prospect for the other central banks we monitor. The UK is seeing a sluggish start to the year thanks to extended lockdowns—we're expecting a 4% non-annualized decline in Q1 GDP that would leave activity more than 10% below pre-pandemic levels. A relatively speedy vaccine rollout (30% of the UK population received at least one dose as of early-March) should make for a solid recovery beyond the current quarter. We're forecasting 4.5% annual growth in 2021 followed by a 6% gain next year. But that would only see GDP returning to pre-pandemic levels toward the end of 2022, let alone absorbing excess capacity in the economy. We think inflation will remain below the BoE's 2% target next year after a temporary increase in 2021. So while talk of negative rates in the UK has quieted down, we don't see the BoE raising rates in our forecast horizon.

The euro area has also been hampered by lockdowns and we expect a second straight quarterly decline in Q1 GDP. The continent has been slow to ramp up vaccinations, even accounting for later approvals—only slightly more than 5% of the population in major European countries has received at least one dose. Still, we should see a return to growth in Q2 as restrictions are eased, and further gains over the second half of the year when vaccines are more widely distributed. We're forecasting 4.1% growth this year and 3.7% in 2022 but still see the economy operating below full capacity by the end of next year. After a temporary boost in inflation to slightly more than 2% by the end of 2021, we expect euro area inflation will settle back below the ECB's target range—as was the case for several years pre-pandemic. Fighting a long battle against low inflation, it's not surprising the ECB has been more vocal in pushing back against recent increases in longer-term interest rates. That includes President Lagarde who said the central bank will ensure financial conditions do not tighten prematurely. If words aren't enough, we think the ECB will use flexibility within its QE program to work against upward pressure on bond yields.

Australia's economy grew at a stronger-than-expected pace toward the end of last year with a 3.1% non-annualized increase in Q4 GDP. The country's relative success in containing COVID-19 paid off with output contracting by 2.4% in 2020 as a whole—easily the least severe decline among economies we track. With momentum continuing early this year, we think Australian GDP will return to its pre-pandemic level in the current quarter. That said, it will take a number of years of above-trend growth to get the economy back to full employment, boost wages and keep inflation sustainably in the RBA's 2-3% target range. In March, the central bank reiterated its conditional commitment to keep the cash rate low until at least 2024. It maintained its yield curve control target (and purchased bonds in support of that target) and pushed back against rising yields further out the curve by bringing forward some QE purchases. The RBA has already announced a second round of asset purchases will follow the current program and we think a third round of QE is likely later this 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	0.50
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	0.40	0.45	0.60	0.75	0.90	1.10
Five-year	0.59	0.37	0.36	0.39	0.85	1.05	1.15	1.20	1.25	1.35	1.45	1.55
10-year	0.70	0.53	0.57	0.68	1.35	1.40	1.45	1.50	1.60	1.65	1.75	1.80
30-year	1.31	0.99	1.11	1.21	1.80	1.85	1.90	1.90	2.00	2.00	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	0.10	0.15	0.20	0.25	0.40	0.55	0.70	0.75
Two-year	0.23	0.16	0.13	0.13	0.15	0.20	0.40	0.60	0.90	1.10	1.30	1.50
Five-year	0.37	0.29	0.28	0.36	0.75	1.20	1.35	1.45	1.50	1.60	1.70	1.80
10-year	0.70	0.66	0.69	0.93	1.35	1.45	1.55	1.65	1.75	1.85	1.95	2.00
30-year	1.35	1.41	1.46	1.65	2.35	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	0.05	0.05	0.10	0.15	0.20	0.20	0.25	0.25
Five-year	0.20	-0.06	-0.06	-0.08	0.35	0.40	0.45	0.50	0.60	0.65	0.70	0.85
10-year	0.34	0.17	0.23	0.20	0.75	0.85	0.90	1.00	1.05	1.15	1.20	1.35
30-year	0.82	0.64	0.78	0.76	1.30	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	-0.65	-0.60	-0.60	-0.60	-0.60	-0.60	-0.55	-0.50
Five-year	-0.65	-0.70	-0.71	-0.74	-0.60	-0.55	-0.55	-0.50	-0.50	-0.45	-0.40	-0.30
10-year	-0.48	-0.45	-0.53	-0.58	-0.30	-0.25	-0.20	-0.15	-0.05	0.05	0.15	0.20
30-year	0.03	0.01	-0.09	-0.17	0.25	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	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.15
10-year	0.77	0.87	0.84	0.97	1.60	1.55	1.60	1.65	1.75	1.85	2.00	2.10
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	0.45	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	1.85	1.85	1.90	1.95	2.05	2.20	2.35	2.45
Yield curve***												
Canada	28	24	32	48	105	110	105	105	100	90	85	70
United States	47	50	56	80	120	125	115	105	85	75	65	50
United Kingdom	21	25	25	36	70	80	80	85	85	95	95	110
Eurozone	21	24	17	13	35	35	40	45	55	65	70	70
Australia	53	62	68	89	150	145	150	155	165	175	190	195
New Zealand	40	53	45	70	140	125	120	115	115	120	130	135

*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	4.5	5.0	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	4.5	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	1.7	3.1	2.1	1.6	1.8	2.0	2.1	2.0	1.9	0.7	2.1	2.0
United States*	2.1	0.4	1.2	1.2	1.8	3.4	2.7	2.6	2.3	2.0	2.1	2.2	1.8	1.2	2.6	2.2
United Kingdom	1.7	0.7	0.6	0.6	0.7	1.3	1.4	1.5	1.7	1.8	1.8	1.9	1.8	0.9	1.2	1.8
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	1.28	1.28	1.29	1.30	1.31	1.32	1.32	1.33
Euro	1.10	1.12	1.17	1.22	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	1.37	1.34	1.29	1.26	1.23	1.19	1.17	1.18	1.18
Japanese yen	108	108	105	103	103	100	97	98	99	100	101	102
Australian dollar	0.61	0.69	0.72	0.77	0.78	0.77	0.76	0.75	0.74	0.73	0.73	0.73

Canadian dollar cross-rates

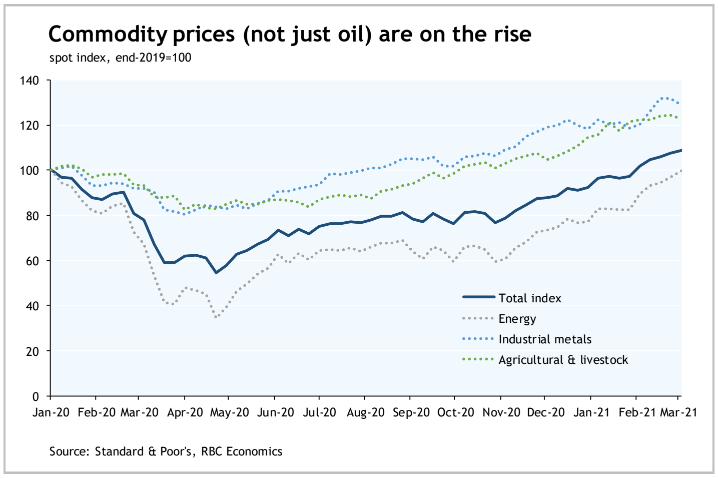
	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
EUR/CAD	1.55	1.53	1.56	1.55	1.51	1.48	1.48	1.48	1.48	1.48	1.49	1.52
GBP/CAD	1.75	1.68	1.72	1.74	1.72	1.65	1.63	1.59	1.56	1.54	1.55	1.56
CAD/JPY	76.5	79.5	79.2	81.1	80.5	78.1	75.2	75.4	75.6	75.8	76.5	76.7
AUD/CAD	0.86	0.94	0.95	0.98	1.00	0.99	0.98	0.98	0.97	0.96	0.96	0.97

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.

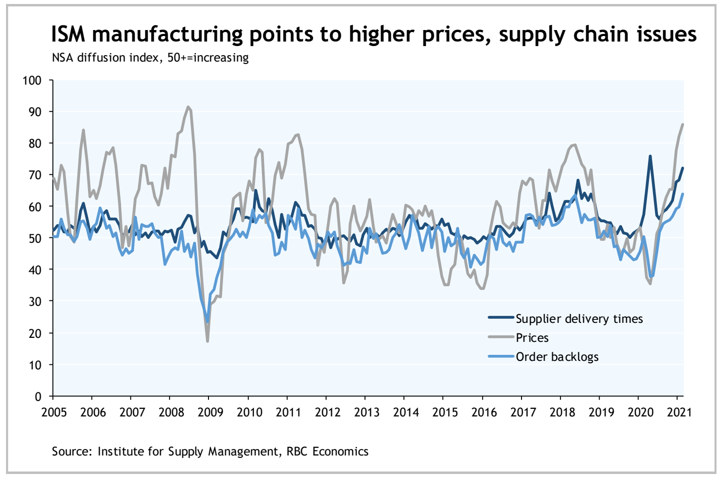
Source: Bloomberg, RBC Economics

Inflation on the rise but central banks won't overreact

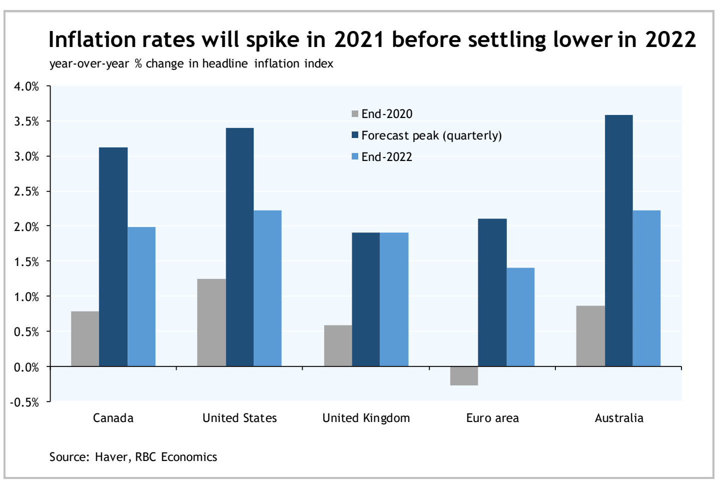
Rising commodity prices will be a key driver of near-term inflation trends. Oil prices continue to climb steadily and low year-ago comparables will push headline inflation readings higher. Other commodity prices, from metals to crops, have also increased and could see some pass-through to consumer prices.



In addition to rising input prices, manufacturers have flagged higher shipping costs and shortages of inputs that are limiting their ability to meet growing demand. Order backlogs are rising as a result. The chart below is for the US but equivalent surveys in Canada and Europe are telling the same story.



We expect inflation will jump above 3% in some economies, and there are upside risks depending on how fast services activity recovers. We think central banks will look through this temporary spike in headline readings but firmer underlying inflation should see the Fed and BoC raising rates in 2022.



Longer-term government bond yields have rise by more than 50 basis points year-to-date in many economies. Investors are seeking a higher inflation premium and also see an eventual end to ultra-low interest rates. Central banks' reactions to rising borrowing costs have varied.