

May 6, 2021

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Central banks on different wavelengths

Despite generally positive economic data, particularly out of the US, the bond market entered a consolidation phase in April, putting an end to the persistent selling seen since the start of the year. Some of the fundamentals behind rising yields haven't changed—recovery prospects remain bright and inflation continues to be a concern with commodity prices rising further and market-based measures of inflation expectations creeping higher. But with the Fed maintaining a dovish tone in the face of these developments—it still isn't 'talking about talking about' tapering its QE program—yields can only rise so much.

We think the world's most influential central bank will have to change its tune before long, as the US economy should get back to full capacity in short order as restrictions continue to be lifted, and there's plenty of policy support and pent up savings to keep growth above trend and stimulate inflation. Even Treasury Secretary (and former Fed Chair) Yellen acknowledged rates might have to rise somewhat to keep the economy from over-heating. A string of solid payroll reports and higher inflation prints in the coming months should put pressure on the Fed to re-evaluate the current level of monetary policy support, and we expect the conversation around QE will intensify over the summer ahead of a tapering announcement by year end.

While investors are waiting for signals from the Fed, the Bank of Canada is going its own way, tapering its QE program in April and indicating rates might have to increase next year. A relatively hawkish BoC helped push the Canadian dollar to a more than three-year high at the start of May and we've marked our near-term forecast for the currency slightly higher. However, we still see the Canadian dollar's strength fading later this year as the Fed begins to discuss policy normalization. We now expect both the BoC and Fed will raise policy rates by 50 basis points in 2022, while the other central banks we monitor are likely to remain on hold.

Central bank near-term bias



As expected, the BoC tapered its QE program in April and we expect bond buying will slow further in H2/21. The bank also signaled rates could start rising next year and we've added a second rate hike (both in H2/22) to our forecast.



The Fed maintained a dovish tone on monetary policy despite an improving economic backdrop and expectations for robust growth. We expect its tone will change in the coming months as strong data rolls in, and look for a QE taper announcement before year end.



The BoE upgraded its growth forecasts significantly in May, though an announced tapering of its weekly asset purchases was more for technical reasons than to adjust the stance of monetary policy.



The ECB has increased the pace of asset purchases under its PEPP program and will decide in June whether to continue at this pace beyond the current quarter. In any case, the central bank has said it can increase or decrease the PEPP envelope based on an evolving outlook.



The RBA sounded relatively hawkish in May and will decide in the July whether to extend yield curve control and/or undertake another round of asset purchases. We expect a third QE program will be announced, but likely at a smaller size or slower pace than the current round.



Highlights

▲ US GDP growth accelerated in Q1 and we expect a 10% annualized gain in Q2.

▲ Another round of stimulus cheques drove a significant jump in personal income in March.

▲ About 1/3 of the US population is fully vaccinated but the pace of immunization is trending lower.

▲ The Fed remained dovish in April and we don't expect a significant change in tone at the June meeting.

US recovery accelerating

US GDP growth picked up to a 6.4% annualized pace in Q1/21 with consumer spending, housing, and business investment all recording annualized gains of 10-11%. Consumer spending benefited from a late-quarter surge as another round of stimulus cheques helped lift personal income 21% month-over-month in March. Even with households saving more than one quarter of their disposable income, inflation-adjusted spending hit a record high in the month. That's not the only sector that ended Q1 with a head of steam—both new orders and shipments of capital goods reached record highs in March and housing starts jumped to a fresh cycle high.

The Q1 increase brought economic output within 1% of its pre-pandemic level, a mark that should easily be eclipsed in Q2. Given momentum heading into the quarter, ongoing easing of containment measures, and plenty of pent-up demand, we've marked our Q2 growth forecast higher to 10.5% (annualized). Consumer spending, particularly in high-touch services industries, will remain a key driver of growth, supported by more than US\$2 trillion in excess savings. If households deploy more of that cash pile than we've assumed, growth (and likely inflation) will be even stronger in the coming quarters.

But there are downside risks to the outlook as well, including vaccine hesitancy. The US has been among the global leaders in vaccine rollout, with 44% of its population having received a single dose and 32% fully vaccinated. However, the daily pace of vaccinations peaked in mid-April and has declined consistently since then. If the US isn't able to reach herd immunity (thought to require about 70% of the population vaccinated) it could remain vulnerable to further waves of COVID-19, particularly while the virus continues to circulate globally. So far, though, US case growth has continued to trend lower (now the slowest since early-October) even as containment measures continue to be relaxed.

Still waiting for a change in Fed guidance

At its late-April meeting, the Fed provided a rosier assessment of the economic backdrop, noting stronger activity and employment indicators and signs of improvement in sectors most affected by the pandemic. The policy statement no longer described risks to the outlook as "considerable." However, there was no change in the Fed's forward guidance on rate hikes or asset purchases, and at his press conference Chair Powell maintained that the committee wasn't yet 'talking about talking about' tapering QE.

We continue to think the economic outlook tees up for asset purchases to be tapered later this year and for rate hikes to start in 2022. But the central bank wants to see data confirming a strong economic rebound, and evidence that the virus threat is in the rear-view mirror, before signaling it will eventually begin removing accommodation. We expect payroll reports ahead of the Fed's June meeting will show a solid pace of hiring as restrictions continue to be eased. But we might have to wait until Jackson Hole in late-August or the Fed's September meeting for a real change in tone on monetary policy.

Third wave another test for Canada's economy

Canada's GDP growth streak extended to 11 months with a 'flash' estimate of +0.9% in March building on a 0.4% increase in February. The former marks the strongest monthly gain since August, with activity picking up in response to easing restrictions between the country's second and third waves of COVID-19. Job growth was also strong during that virus lull with 562,000 positions added in February and March, bringing employment within 1.5% of its pre-pandemic level. We expect some of those job gains will be given back in April with containment measures having tightened in many provinces and a record number of patients in critical care units necessitating an extended period of restrictions.



But the economy's steady growth through COVID's second wave—thanks to ongoing government support, and many sectors having adapted to the pandemic—suggests we won't see much if any pullback in headline GDP during this third wave, even as activity in high-touch services industries slows. We've marked down our Q2 growth forecast slightly but still expect the economy to post a 2.5% annualized gain on top of Q1's 6.5% increase. Growth is expected to accelerate in the second half of the year when containment measures are eased on a more sustained basis. Canada's vaccine rollout has picked up over the past month (daily doses per capita now close to the US's pace) and more than one third of Canadians have received at least one shot.

Bank of Canada tapers QE, advances rate hike timing

The Bank of Canada came across as hawkish at its April meeting, establishing itself as one of the first advanced economy central banks to begin gradually scaling back accommodation (or at least the pace at which stimulus is being added). In addition to tapering its bond buying program to \$3 billion per week from \$4 billion previously—a move that was largely expected—the bank also signaled it might raise rates sooner than previously indicated. Both changes were attributed to an improving economic outlook (we think technical factors also played a role in tapering QE) with the BoC revising its 2021 GDP growth forecast up to 6.5% from 4.0% previously. The economy is now seen reaching full capacity, and inflation returning to 2% on a sustained basis, in the second half of 2022. The bank has committed to keeping the overnight rate at its current level until then, so moving that point forward (from “into 2023”) was a clear signal that rates could rise next year.

We've been assuming the BoC will raise its policy rate in Q3/22, and are now looking for a second rate hike in Q4/22. While high household debt will likely keep the BoC from raising rates too quickly, we think the bank will want to avoid falling behind the curve with the economy running at full capacity and inflation above its 2% midpoint target. Our forecast now assumes inflation excluding food and energy prices will be around 2.5% in 2022. More immediately, if the recovery evolves as expected, we think the BoC will continue tapering its QE program in the second half of 2021, eventually shifting to reinvestment-only around the turn of the year. That should see the bank's share of GoC bond holdings peak below 50% in late-2021.

Canadian dollar firing on all cylinders

The Canadian dollar rose to its highest level in more than three years in early-May, closing in on 82 US cents. The currency's latest jump was due in part to the divergent tones (and actions) from the BoC and Fed, which pushed Canada-US short-term interest rate spreads sharply higher and saw the Canadian dollar gain 2 cents in the week between the two central banks' meetings. Commodity prices have also pushed the currency higher with non-energy commodity prices rising another 10% in April (S&P GSCI) and oil prices holding close to a two-year high of \$65 per barrel (WTI).

We assume commodities will remain supportive but act as less of a tailwind going forward, with oil prices generally expected to hold in a \$60-65 range. Soft economic data due to Canada's third wave should contrast with strong US indicators as that economy re-opens, and that could take some shine off the loonie. But to see any real reversal of the Canadian dollar's recent strength, we think the Fed will have to catch up to the BoC's hawkishness. We expect that will eventually be the case, and a shift in tone from the Fed is key to our forecast for the Canadian dollar to slip toward 78 cents by the end of this year. But in the near term, a still-dovish Fed is likely to keep a lid on the US dollar, and we see the Canadian dollar remaining above 80 cents in the next few months.

Highlights

▲ Canadian GDP growth is likely to slow in Q2 as containment measures have tightened to combat a third wave.

▲ The BoC revised its growth forecasts significantly higher in April...

▲ ...and now sees the economy getting back to full capacity (and sustained 2% inflation) in H2/22.

▲ The BoC's relative hawkishness and rising commodity prices have pushed the Canadian dollar higher.



Highlights

▲ The UK economy is re-opening and looks poised for a solid Q2 gain after a Q1 decline in GDP.

▲ The BoE is slowing asset purchases to keep its QE program running until year end.

▲ Slower European vaccine rollout relative to the UK was reflected in April's PMI data.

▲ The RBA now sees inflation getting back to the lower end of its target range in 2023, after several years of below-target inflation.

UK's recovery to accelerate as re-opening continues

The UK's rapid vaccine rollout—more than half the population having received at least one dose—is paying dividends with some containment measures having eased in mid-April and another round of restrictions set to lift in mid-May. The UK economy was already showing signs of life as virus spread was brought under control, with retail sales rising sharply in March. Activity generally appears to have held up better than expected during the second wave, and we're forecasting a less severe contraction in Q1 GDP (-1.7% non-annualized) than previously thought. That would nonetheless leave GDP 9% below its pre-pandemic level, a far greater shortfall than the other economies we track, including the euro area (-5.5%). But we expect the UK economy will start to close that gap with its relatively early re-opening. April PMI data already show services activity increasing at its strongest pace since 2014, led by consumer services. We expect GDP growth will average about 3% (non-annualized) over the remainder of 2021, returning the economy to its pre-pandemic level early next year.

At its May meeting, the Bank of England announced it will reduce the pace of asset purchases under its QE program. This 'technical taper' was largely expected as the program's timeframe and purchase target implied bond buying would have to slow at some point. The BoE made it clear that the move "should not be interpreted as a change in the stance of monetary policy."

Euro area's services recovery lagging, but vaccines picking up

The euro area economy contracted for a second straight quarter with GDP declining 0.6% in Q1. In a reversal from the previous quarter, Germany led the pullback amid more stringent lockdown measures while France eked out a modest gain after easing some of its restrictions. France re-imposed a number of containment measures in April, but as with Italy, some success in getting the third wave under control is allowing restrictions to be eased once again. Germany has had less success reigning in case growth and is generally keeping measures in place. Europe's vaccine drive is picking up, but the continent is a couple of months behind vaccine leaders in immunization and re-opening—that was apparent in the latest survey data with the euro area's April services PMI sitting about 10 points below the UK's. We expect the euro area will see a more modest increase in Q2 GDP than in the UK, but with vaccinations picking up in Europe we look for growth to accelerate further in Q3. Our forecast assumes euro area GDP will return to its pre-pandemic level in the first half of next year.

As announced in March, the ECB has increased the pace of asset purchases under its PEPP program in an effort to keep financial conditions from tightening pre-emptively. In April, President Lagarde said financing conditions were broadly stable, and it looks like the ECB will decide in June (when it will have updated economic projections) whether the recent pace of asset purchases should be maintained beyond the current quarter.

RBA upgrades projections, key policy decisions to come

The RBA struck a relatively hawkish tone at its May meeting, taking note of a stronger-than-expected economic recovery that it expects will continue. The central bank marked its 2021 growth forecast substantially higher and trimmed its unemployment projections by a percentage point. And notwithstanding an unexpectedly soft Q1 CPI report, the RBA now sees core inflation getting back to the lower end of its 2-3% target range by mid-2023. The central bank said it will re-evaluate its current policy mix in July, deciding whether to extend its 3-year yield curve control target and/or further expand QE (the current program is set to expire in September). How the labour market fares in the coming months following the expiry of the JobKeeper program will be an important factor in whether monetary policy support is extended. At this stage, we don't see the benchmark for the RBA's yield curve control being extended (from the Apr-24 bond to the Nov-24) but think a third round of QE (perhaps smaller than the current program, or over a longer time frame) is likely.



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	0.25	0.50	0.80	
Two-year	0.42	0.29	0.25	0.20	0.23	0.30	0.40	0.45	0.60	0.75	1.00	1.20	
Five-year	0.59	0.37	0.36	0.39	0.99	1.00	1.15	1.20	1.30	1.40	1.55	1.65	
10-year	0.70	0.53	0.57	0.68	1.56	1.55	1.65	1.70	1.80	1.90	1.95	2.00	
30-year	1.31	0.99	1.11	1.21	1.99	2.10	2.15	2.20	2.30	2.30	2.30	2.30	
United States													
Fed funds*	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.38	0.63	0.63	
Three-month	0.11	0.16	0.10	0.09	0.03	0.15	0.20	0.25	0.40	0.55	0.70	0.75	
Two-year	0.23	0.16	0.13	0.13	0.16	0.20	0.40	0.60	0.90	1.10	1.30	1.50	
Five-year	0.37	0.29	0.28	0.36	0.92	1.20	1.35	1.45	1.50	1.60	1.70	1.80	
10-year	0.70	0.66	0.69	0.93	1.74	1.80	1.90	2.00	2.05	2.10	2.15	2.20	
30-year	1.35	1.41	1.46	1.65	2.41	2.40	2.45	2.50	2.60	2.60	2.60	2.60	
United Kingdom													
Bank rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	
Two-year	0.13	-0.08	-0.02	-0.16	0.11	0.05	0.10	0.15	0.20	0.20	0.25	0.25	
Five-year	0.20	-0.06	-0.06	-0.08	0.40	0.40	0.45	0.50	0.60	0.65	0.70	0.85	
10-year	0.34	0.17	0.23	0.20	0.85	0.85	0.90	1.00	1.05	1.15	1.20	1.35	
30-year	0.82	0.64	0.78	0.76	1.40	1.35	1.50	1.65	1.80	1.85	1.90	2.00	
Euro area**													
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	
Two-year	-0.69	-0.69	-0.70	-0.71	-0.69	-0.60	-0.60	-0.60	-0.60	-0.60	-0.55	-0.50	
Five-year	-0.65	-0.70	-0.71	-0.74	-0.62	-0.55	-0.55	-0.50	-0.50	-0.45	-0.40	-0.30	
10-year	-0.48	-0.45	-0.53	-0.58	-0.29	-0.25	-0.20	-0.15	-0.05	0.05	0.15	0.20	
30-year	0.03	0.01	-0.09	-0.17	0.26	0.35	0.45	0.55	0.65	0.75	0.80	0.85	
Australia													
Cash target rate	0.25	0.25	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	
Two-year	0.24	0.25	0.16	0.08	0.08	0.10	0.10	0.10	0.10	0.10	0.10	0.15	
10-year	0.77	0.87	0.84	0.97	1.74	1.80	1.85	1.90	2.05	2.10	2.20	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	0.25	0.25	0.25	
Two-year swap	0.52	0.19	0.05	0.27	0.46	0.60	0.70	0.80	0.90	1.00	1.05	1.10	
10-year swap	0.92	0.72	0.50	0.97	1.95	2.00	2.05	2.15	2.20	2.25	2.30	2.35	
Yield curve***													
Canada	28	24	32	48	133	125	125	125	120	115	95	80	
United States	47	50	56	80	158	160	150	140	115	100	85	70	
United Kingdom	21	25	25	36	74	80	80	85	85	95	95	110	
Eurozone	21	24	17	13	40	35	40	45	55	65	70	70	
Australia	53	62	68	89	166	170	175	180	195	200	210	215	
New Zealand	40	53	45	70	149	140	135	135	130	125	125	125	

*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*	-7.5	-38.5	40.6	9.6	6.5	2.5	7.5	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	4.3	6.4	10.5	5.5	3.0	1.9	1.9	1.8	1.8	2.2	-3.5	6.5	3.0
United Kingdom	-2.8	-19.5	16.9	1.3	-1.7	3.7	3.1	2.3	0.4	0.4	0.4	0.4	1.4	-9.8	6.4	5.2
Euro Area	-3.8	-11.6	12.5	-0.7	-0.6	1.4	2.0	1.4	0.6	0.4	0.4	0.4	1.3	-6.7	4.0	3.6
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

	<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	3.1	2.7	2.3	2.3	2.1	2.3	2.2	1.9	0.7	2.4	2.2
United States	2.1	0.4	1.2	1.2	1.9	3.6	2.9	2.7	2.2	1.8	2.0	2.1	1.8	1.2	2.8	2.0
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	1.4	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	3.9	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	1.26	1.28	1.29	1.30	1.30	1.30	
Euro	1.10	1.12	1.17	1.22	1.17	1.16	1.15	1.14	1.13	1.12	1.13	1.14	
U.K. pound sterling	1.24	1.24	1.29	1.37	1.38	1.32	1.29	1.25	1.22	1.19	1.20	1.20	
Japanese yen	108	108	105	103	111	107	103	100	102	104	106	108	
Australian dollar	0.61	0.69	0.72	0.77	0.76	0.77	0.76	0.75	0.74	0.73	0.73	0.73	

Canadian dollar cross-rates

	<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	1.44	1.45	1.46	1.46	1.46	1.47	1.48
GBP/CAD	1.75	1.68	1.72	1.74	1.73	1.63	1.63	1.60	1.57	1.55	1.56	1.56
CAD/JPY	76.5	79.5	79.2	81.1	88.1	86.3	81.7	78.1	79.1	80.0	81.5	83.1
AUD/CAD	0.86	0.94	0.95	0.98	0.95	0.95	0.96	0.96	0.95	0.95	0.95	0.95

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

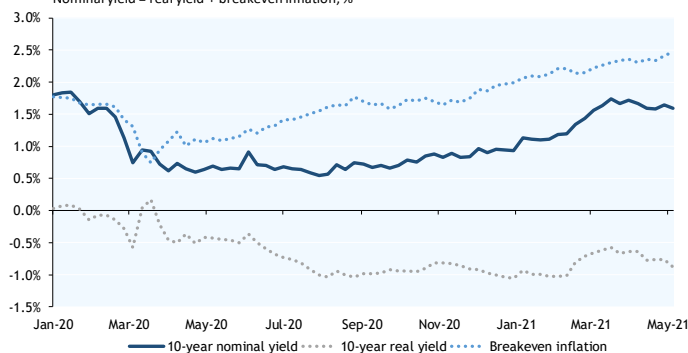
Source: Bloomberg, RBC Economics

Dovish Fed, hawkish BoC driving rates and currencies

10-year US Treasury yields posted their largest monthly decline in nine months in April, putting an end to a selloff that began last summer. The recent decline reflected lower real yields—driven in our view by a dovish tone from the Fed—while implied inflation continues to grind higher.

Rise in Treasury yields stalls as Fed remains dovish

Nominal yield = real yield + breakeven inflation, %

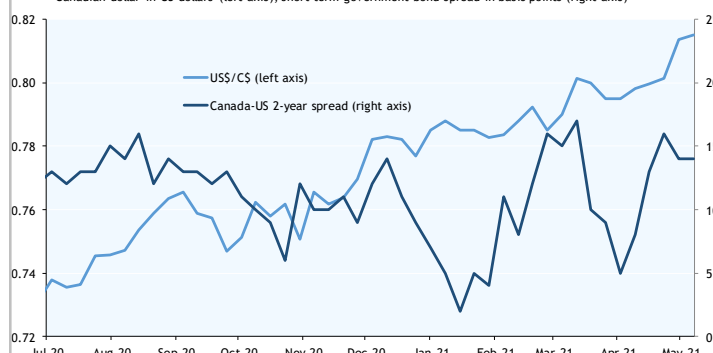


Source: US Treasury, Federal Reserve Board, RBC Economics

The Fed's dovish April meeting—still not 'talking about talking about' tapering—stood in contrast to a more hawkish tone (and actions) from the BoC a week earlier. That pushed short-term Canada-US interest rate spreads and the Canadian dollar higher.

Central bank divergence shows up in rates, currency markets

Canadian dollar in US dollars (left axis), short-term government bond spread in basis points (right axis)

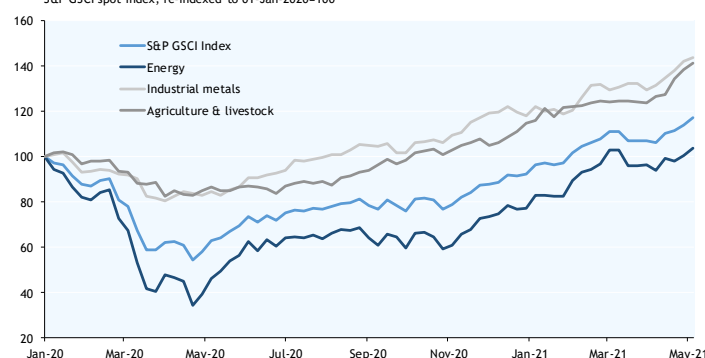


Source: Bank of Canada, US Treasury, Wall Street Journal, RBC Economics

The Canadian dollar has also benefited from rising commodity prices as re-opening boosts demand prospects. In addition to firmer oil prices, higher prices for metals, agricultural commodities, and lumber have boosted Canada's terms of trade.

Broadly-based increase in commodity prices continues

S&P GSCI spot index, re-indexed to 01-Jan-2020=100

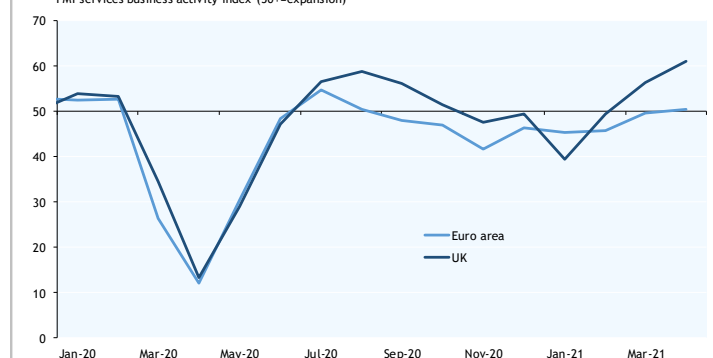


Source: Standard & Poor's, RBC Economics

Softer Q2 data in Canada, set against strong US indicators, could take some wind out of the Canadian dollar's sails. Similar data divergence is now being seen between the UK and Europe (particularly in the services sector) as the latter leads in re-opening.

Euro area lagging behind UK in services sector re-opening

PMI services business activity index (50+=expansion)



Source: IHS Markit, RBC Economics