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Central banks shuffling toward the exit

September saw a number of central banks continue to plot an exit from ultra-accommodative policies put in place during the pandemic. The Fed guided markets toward an imminent tapering announcement, and laid out a relatively abbreviated timeline to wind down net QE purchases by mid-2022. The FOMC is now evenly split on raising rates next year (we think it will) and anticipates gradual but steady rate increases in the following years. The BoE looks set to lead liftoff in the G7 and even opened the door to rate hikes before year end, although we think that isn't likely until the second quarter of 2022. Not to be outdone, the RBNZ raised rates in October and looks set do so again at upcoming meetings. The BoC could shift to reinvestment-only as soon as its next meeting while the RBA slowed but extended its QE purchases in September. The ECB will evaluate the future of its pandemic-era asset purchases later this year.

These moves come as economic data flag some loss of momentum with early re-opening gains being exhausted and recoveries reaching a more mature stage. At the same time, persistent supply chain disruptions, further increases in energy prices, and growing reports of labour shortages suggest inflation will remain above central bank targets for a more extended period than previously thought. A post-FOMC selloff saw 10-year Treasury yields rise above 1.50% for the first time in three months, driven by higher breakeven inflation. Concerns about the health of China's real estate sector caused bouts of risk aversion in recent weeks while price pressures and waning central bank support added to equity market uneasiness. The S&P 500 fell by nearly 5% in September, its largest monthly decline since March 2020. The US dollar has been in demand, hitting a year-to-date high in late-September though commodity currencies like the Canadian dollar have held their own against the greenback. We expect the US dollar will see further, modest gains against most major currencies in 2022.

Central bank near-term bias

→ With solid job growth easing concerns about softer-than-expected GDP data, we still expect the BoC will dial back its QE program to reinvestment-only in October. We think the current timeline for rate hikes (not until H2/22) remains appropriate.

→ The Fed looks set to announce tapering in November with an abbreviated timeline winding down QE by mid-2022. We think a rate hike will follow by the end of next year.

→ The BoE thinks the case for gradual rate hikes has strengthened but we still don't expect liftoff for another six months. We think markets are over-estimating the odds of a near-term hike, as well as the pace of tightening in the coming years.

→ The ECB said it will decide the fate of its pandemic-era QE program in December. Even if PEPP is phased out early next year, we think QE will be a key source of ongoing stimulus with the ECB remaining a long way from fulfilling its inflation objective on a sustained basis.

→ Macroprudential tightening relieves pressure on the RBA to adopt a more hawkish bias. The central bank reiterated its guidance in October that rate hikes are unlikely before 2024.

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Highlights

▲ US inflation-adjusted consumer spending increased by just 0.1% between April and August.

▲ Business equipment investment is surging, a positive sign for productivity growth.

▲ After the Fed's QE guidance was "all but met" in September we expect a taper announcement in November.

▲ An abbreviated taper timeline leaves the door open to a rate hike next year, though the FOMC is split on 2022 liftoff.

US recovery found a lower gear in Q3

US consumer spending flattened out over the summer with ongoing recovery in services spending offset by a further normalization in goods demand. Higher-frequency card spending data point to an uptick in September but recovery in hospitality spending remains incomplete and has lost momentum in recent weeks. The spread of the Delta variant and waning fiscal support (including expiring pandemic unemployment programs) is likely keeping some consumers cautious—confidence fell to a seven month low in September. Case counts and hospitalizations have come down from early-September highs but remain elevated on a per capita basis relative to other G7 countries. The US consumer continues to have plenty of firepower but there is no evidence yet that households are dipping into excess savings accumulated during the pandemic.

Developments outside the consumer sector have also been mixed. Capex shipments and new orders continued their unrelenting rise in July and August, suggesting business investment will make another solid contribution to GDP growth in Q3. But non-residential construction hasn't been nearly as robust and homebuilding has been unable to sustain its earlier momentum. On the fiscal side, the Senate passed a US$1 trillion infrastructure bill but its progress through the House has been delayed with some lawmakers seeking to tie it to a separate, US$3.5 trillion spending bill. The debt ceiling debate looks set to be punted to December but aside from near-term bill market impacts investors have generally looked through the Congressional stalemate.

Fed flags pending taper announcement

On balance we've trimmed our Q3 GDP growth forecast to 3% annualized from 5% previously. The Fed also marked down its 2021 growth forecast in September but still expects the unemployment rate will fall to 3.8% (below its longer-run level) by the end of next year from 4.8% currently. Its near-term inflation projections were marked higher but the increase is still viewed as transitory with inflation expected to fall back toward (but still slightly above) 2% in the medium-term.

The combination of firmer inflation readings and growing confidence in the recovery's durability (notwithstanding softer near-term growth) brought forward some FOMC members' rate hike expectations. The committee is now evenly split on whether to raise rates next year, and a median of three hikes are expected in both 2023 and 2024. More immediately, the policy statement said a moderation in the pace of asset purchases "may soon be warranted" if progress toward the Fed's inflation and employment objectives continues as expected. In his subsequent press conference, Chair Powell said a "decent" payroll report for September would likely be enough for the Fed to move forward with tapering in November. In the event, payroll growth fell short of expectations with 194,000 jobs added in September, the slowest pace year-to-date. But we think that just meets Powell's test and still lean toward the Fed announcing tapering at its next meeting.

Powell also said a gradual tapering that concludes around mid-2022 is likely to be appropriate—that would mean reducing purchases about twice as fast as in 2014. We think winding down net purchases by the middle of next year leaves the door open to the Fed raising rates by the end of 2022, as our forecast assumes and markets are now pricing. With 10-year UST yields having broken out of their recent range post-FOMC, we continue to look for a move up toward March's highs of 1.75% by year end.

Canada's services rotation continued over the summer

Statistics Canada's official estimate of July GDP came in at -0.1%, not quite as disappointing as the earlier -0.4% flash estimate that caught many forecasters off guard. Details confirmed the modest slowdown was despite a pickup in services activity as many provinces continued to ease health restrictions. But strong gains in hospitality, recreation and air travel were offset by a sizeable drop in the goods sector. While auto production remained subdued amid chip shortages, the latest decline reflected a broader slip in manufacturing, construction and utilities. The economy's loss of momentum appears to have been temporary with a flash estimate suggesting GDP rose a solid 0.7% in August, led by gains in hospitality, retail and manufacturing. Average monthly job gains of 114,000 in Q3, returning employment to its pre-pandemic level as of September, also indicate the recovery was on track over the summer.

Data in hand are consistent with our forecast for the economy to rebound in Q3 with a 4.5% annualized gain easily retracing Q2's 1.1% decline. Still, the recovery has a bit less momentum than we expected a few months ago. On the goods side, supply chain issues, an easing tailwind from housing construction, and poor crop conditions have weighed down activity more than previously anticipated. And while the recovery in services continues, our spending tracker points to some loss of momentum recently as a fourth wave of COVID-19 has delayed or even reversed some provinces' re-opening plans and businesses have had trouble hiring amid labour shortages (though recent job gains suggest the issue isn't as acute as in the US). While growth is expected to continue at an above-trend pace into 2022, we think these headwinds will keep the economy from returning to full capacity until late next year.

BoC forecast downgrades won't stop taper plan

Given these developments since the BoC's July MPR, we expect the central bank will revise its near-term GDP projections lower in October. It was previously looking for 6% growth in 2021 whereas our latest call is 5.1%. Our forecast remains consistent with the bank's guidance that economic slack will be absorbed in the second half of next year, though there's some risk that timeframe will be pushed back depending on how much of the recent growth shortfall is seen being made up in 2022. On the inflation front, Q3 CPI is tracking in line with the bank's forecast, but we think there's upside risk going forward amid persistent supply chain snarls, labour shortages and further increases in commodity prices. Given the bank's concerns about the "persistence and magnitude" of the current inflation overshoot, as well as uncertainty around the degree of spare capacity and the pace at which it will be absorbed, we think the bank will likely leave rate hikes on the table for next year.

Following its September meeting, Governor Macklem gave further details on what the reinvestment phase of the bank's QE program would look like. It plans to buy C$4-5 billion on bonds per month (including its normal primary market purchases) to cover maturing securities and keep the bank's overall holdings steady over time. The decision on when to shift to reinvestment from the current C$2 billion per week pace will be based on the "strength and durability" of the recovery. While recent growth figures call that into question, we think more positive signals from the labour market—something the bank has been focusing on to a greater extent this cycle—tip the scales in favour of a move to reinvestment in October.

Hawkish BoE focuses on improving labour market

Having exhausted early re-opening gains, the UK economy grew at its slowest pace in five months in July. Recent PMI data also suggest the recovery geared down in Q3. The manufacturing sector in particular appears to be losing momentum amid ongoing material shortages and slow supplier delivery times—global issues that have been exacerbated domestically by Brexit-related border delays and labour shortages. Those factors have contributed to rising inflation which matched a nine-year high of 3.2% in August. Rising energy prices will push inflation even further above the BoE's target in the com-

Highlights

▲ After three declines in the prior four months, Canadian GDP rose a solid 0.7% in August.

▲ Job gains have been more consistent with employment returning to its pre-pandemic level in September.

▲ The BoC looks set to downgrade its growth forecasts in October, potentially impacting its forward guidance.

▲ Strong job gains and more persistent inflation will likely tip the scales in favour of further tapering (to reinvestment-only) in October.

Highlights

▲ Brexit is exacerbating supply chain disruptions and labour shortages in the UK.

▲ An improving labour market could see the BoE raise rates ahead of other G7 central banks.

▲ Despite currently-elevated inflation readings, the ECB is still a long way from achieving its target on a sustained basis.

▲ An accelerated vaccine rollout should see Australia's lockdown measures ease in the coming months.

ing months and could act as a headwind to consumer spending. Given these developments we've lowered our growth forecasts for the second half of 2021 by half a percent on average, but still see output returning to its pre-pandemic level by year end.

Labour market indicators have been more encouraging with the number of employees on furlough continuing to fall and redundancies remaining limited even as government support is phased out. The BoE keyed in on these developments in September, seeing a stronger case for modest policy tightening over its forecast horizon. Adding to that hawkishness, the MPC raised the prospect of hiking rates before the end of its QE program later this year. We think that was an attempt to reinforce the policy rate as its main tool—at least initially—for policy tightening rather than to flag an imminent rate hike. But markets took the latter view and priced in greater probability of near-term liftoff. Subsequent comments from Governor Bailey made the case for a more patient approach, and we continue to think the BoE will hold off on raising rates until next May. In addition to overestimating the odds of a near-term move, we think the market is overpriced for rate hikes over the bank's tightening cycle. Given its guidance on policy sequencing, we see the BoE switching to 'quantitative tightening' (i.e. shrinking its balance sheet) as its main policy lever once the bank rate rises to 0.5%.

ECB to keep policy highly accommodative despite inflation spike

Euro area PMI data are also flagging some loss of momentum in recent months though not to the same extent as in the UK where a reopening-driven growth surge came slightly earlier. We expect euro area GDP growth will moderate only slightly to 1.9% non-annualized in Q3 from 2.2% in Q2. Employment indices point to ongoing improvement in the jobs backdrop and the number of employees on shortened hours schemes continues to fall, though the official unemployment rate (now back to pre-pandemic levels) still understates labour market slack. We expect that slack will continue to be absorbed in 2022 albeit at a more gradual pace once economic output returns to its pre-pandemic level toward the end of this year.

Euro area inflation rose above 3% in September for the first time since 2008 and we expect price growth will remain elevated in the near-term thanks to a sharp increase in energy prices. This pickup is still seen as transitory, though, and we expect inflation will fall back below 2% in the second half of next year. We think the ECB remains a long way from achieving its inflation target on a sustained basis—recall the central bank wants to see inflation hitting 2% and staying there by the mid-point of its projection horizon before it begins to raise interest rates. The ECB said it will decide on the future of its asset purchase programs in December. Even if it phases out its pandemic-era QE program (PEPP) next March, as appears likely, we think its ongoing asset purchase program (APP) will take on a more important role, including potentially adopting some of the flexibility currently provided by PEPP.

Expecting a more gradual recovery after Australia's lockdowns

Australia's economy likely saw a sharp slowdown in Q3 (we're forecasting a 3.4% non-annualized GDP decline) amid extended lockdowns in the country's largest states. We expect rapid progress on vaccinations—two thirds of the population have now received at least one dose—will allow for an easing of restrictions in the coming months. However, we think the rebound in activity will be more gradual than after previous lockdowns amid lingering restrictions, concerns about transmission, and the impact of shutdowns on business confidence. We look for a partial recovery in Q4 (+1.8%) with output not returning to its pre-lockdown level until early next year. Similarly, the RBA doesn't see the economy returning to its pre-Delta trend until the second half of next year. It opted to maintain its key policies in October, including a stepped-down pace of asset purchases (A$4 billion per week) that it will maintain at least through February. We think recent tightening in macroprudential regulations to rein in credit growth reduces pressure on the RBA to dial back its monetary policy support but still look for a gradual tapering of asset purchases over the course of 2022.

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	0.12	0.20	0.25	0.30	0.55	0.80
Two-year	0.42	0.29	0.25	0.20	0.23	0.45	0.53	0.45	0.70	0.85	1.05	1.20
Five-year	0.59	0.37	0.36	0.39	0.99	0.98	1.11	1.10	1.35	1.45	1.55	1.65
10-year	0.70	0.53	0.57	0.68	1.56	1.39	1.51	1.60	1.80	1.90	1.95	2.00
30-year	1.31	0.99	1.11	1.21	1.99	1.84	1.99	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	0.04	0.05	0.05	0.10	0.25	0.60
Two-year	0.23	0.16	0.13	0.13	0.16	0.25	0.28	0.45	0.60	0.80	1.00	1.20
Five-year	0.37	0.29	0.28	0.36	0.92	0.87	0.98	1.20	1.30	1.45	1.60	1.80
10-year	0.70	0.66	0.69	0.93	1.74	1.45	1.52	1.75	1.85	2.00	2.10	2.20
30-year	1.35	1.41	1.46	1.65	2.41	2.06	2.08	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	0.25	0.25	0.50
Two-year	0.13	-0.08	-0.02	-0.16	0.11	0.07	0.40	0.10	0.15	0.25	0.35	0.50
Five-year	0.20	-0.06	-0.06	-0.08	0.40	0.33	0.62	0.45	0.50	0.65	0.75	0.85
10-year	0.34	0.17	0.23	0.20	0.85	0.72	1.02	0.85	1.00	1.15	1.20	1.35
30-year	0.82	0.64	0.78	0.76	1.40	1.24	1.37	1.35	1.65	1.75	1.80	1.90
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	-0.69	-0.60	-0.60	-0.60	-0.55	-0.50
Five-year	-0.65	-0.70	-0.71	-0.74	-0.62	-0.59	-0.56	-0.50	-0.50	-0.45	-0.40	-0.30
10-year	-0.48	-0.45	-0.53	-0.58	-0.29	-0.20	-0.21	-0.15	-0.05	0.05	0.15	0.20
30-year	0.03	0.01	-0.09	-0.17	0.26	0.30	0.29	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	0.04	0.10	0.10	0.10	0.40	0.50
10-year	0.77	0.87	0.84	0.97	1.74	1.49	1.49	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	0.75	1.00	1.00	1.25	1.25
Two-year swap	0.52	0.19	0.05	0.27	0.46	0.78	1.39	1.50	1.65	1.70	1.75	1.80
10-year swap	0.92	0.72	0.50	0.97	1.95	1.87	2.21	2.45	2.50	2.55	2.60	2.65
Yield curve***												
Canada	28	24	32	48	133	94	98	115	110	105	90	80
United States	47	50	56	80	158	120	124	130	125	120	110	100
United Kingdom	21	25	25	36	74	65	62	75	85	90	85	85
Eurozone	21	24	17	13	40	47	48	45	55	65	70	70
Australia	53	62	68	89	166	143	145	155	175	190	175	180
New Zealand	40	53	45	70	149	109	82	95	85	85	85	85

*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*	-7.9	-38.0	41.7	9.3	5.5	-1.1	4.5	6.0	4.0	5.0	4.5	2.5	1.9	-5.3	5.1	4.3
United States*	-5.1	-31.2	33.8	4.5	6.3	6.7	3.0	4.5	3.5	3.0	3.0	2.5	2.3	-3.4	5.6	3.6
United Kingdom	-2.7	-19.6	17.4	1.1	-1.4	5.5	2.0	1.5	0.7	0.4	0.4	0.4	1.7	-9.7	7.4	4.8
Euro Area	-3.5	-11.7	12.6	-0.4	-0.3	2.2	1.9	1.2	0.6	0.4	0.4	0.4	1.5	-6.5	5.1	3.6
Australia	-0.3	-7.0	3.6	3.2	1.9	0.7	-3.4	1.8	2.1	1.5	1.0	0.6	1.9	-2.4	3.4	3.7

*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	1.4	3.3	4.0	4.2	3.9	3.4	2.7	2.4	1.9	0.7	3.2	3.1
United States	2.1	0.4	1.2	1.2	1.9	4.8	5.2	5.3	4.6	3.3	2.6	2.2	1.8	1.2	4.3	3.1
United Kingdom	1.7	0.7	0.6	0.6	0.6	2.0	2.8	3.5	3.3	2.8	2.5	2.2	1.8	0.9	2.2	2.3
Euro Area	1.1	0.2	0.0	-0.3	1.1	1.8	2.8	3.7	2.4	2.3	1.8	1.8	1.2	0.3	2.4	2.1
Australia	2.2	-0.3	0.7	0.9	1.1	3.8	3.0	2.7	2.6	2.3	2.2	2.2	1.6	0.8	2.6	2.4

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	1.26	1.24	1.27	1.25	1.26	1.27	1.27	1.27
Euro	1.10	1.12	1.17	1.22	1.17	1.19	1.16	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	1.35	1.30	1.26	1.22	1.23	1.23
Japanese yen	108	108	105	103	111	111	111	105	107	108	110	112
Australian dollar	0.61	0.69	0.72	0.77	0.76	0.75	0.72	0.72	0.71	0.70	0.69	0.69

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	1.47	1.47	1.47	1.43	1.42	1.42	1.44	1.45
GBP/CAD	1.75	1.68	1.72	1.74	1.73	1.71	1.71	1.62	1.58	1.55	1.56	1.56
CAD/JPY	76	80	79	81	88	90	88	84	85	85	87	88
AUD/CAD	0.86	0.94	0.95	0.98	0.95	0.93	0.92	0.90	0.89	0.89	0.88	0.88

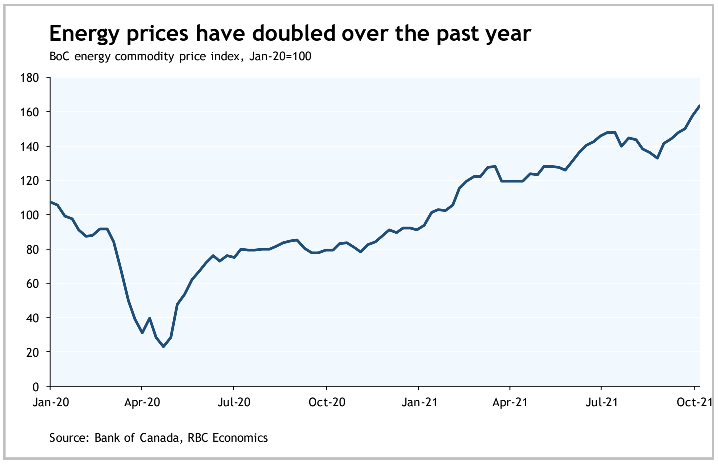
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

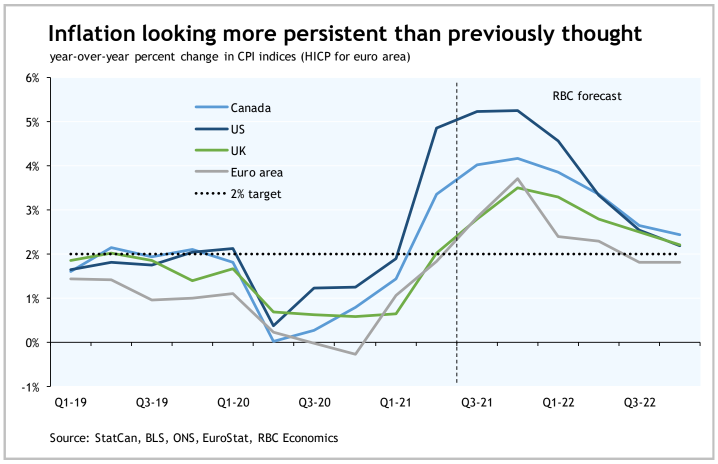
Source: Bloomberg, RBC Economics

Investors and central banks continue to keep an eye on inflation

OPEC+'s decision to continue gradually increasing production rather than boosting output to meet rising demand pushed Brent crude above US$80/bbl for the first time since 2018. An under-supplied gas market, particularly in Europe, has also driven prices sharply higher. Rising fuel costs will continue to add inflationary pressure and hurt consumers.

With energy prices continuing to rise and supply chain bottlenecks showing no signs of easing we've marked our inflation forecasts higher in North America and Europe. Central banks continue to view higher inflation as transitory but are uncertain as to how long the overshoot will persist. Higher inflation is contributing to the decision by some to wind down QE.





Rising breakeven inflation pushed longer-term government bond yields higher in recent weeks. More hawkish central banks, particularly the Fed and BoE, contributed to the rising yields. We expect further increases in Canada, the US and Germany through year end but think the UK's selloff has gone too far.

The Fed's relative dovishness earlier this year weighed on the US dollar. But with the central bank now set to begin tapering its QE program and plotting steady rate hikes after 2022, the greenback hit a year-to-date high in early October. We expect that trend will continue in 2022 with DXY rising by about 2%.