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Economic recovery delayed but not derailed

The second half of summer has seen its share of data disappointments while rising COVID cases add another layer of concern, but central banks appear to be taking these developments in stride. Fed Chair Powell didn't make waves with his late-August speech at Jackson Hole but he continued to guide markets toward a 2021 taper. Even with a lacklustre jobs report since then, we think the Fed has enough evidence of labour market recovery to begin easing off the QE pedal later this year. Australia's lockdowns failed to deter the RBA from tapering its asset purchases in September, with the central bank saying the Delta outbreak will "delay, but not derail the recovery." The Bank of Canada didn't sound overly concerned about unexpected GDP declines, saying it continues to expect the recovery will strengthen over the second half of the year. Another month of solid job growth in August seemed to support that view. The ECB also announced it would slow its bond buying in September, while the BoE is on track to finish its QE purchases by year end.

While policymakers aren't overreacting to a few data points, we're seeing strong enough headwinds to mark down our growth forecasts in Canada and the US. Supply chain issues, labour shortages and mismatches, and in some cases delayed reopening due to the Delta variant are making it difficult to sustain the recovery's brisk early pace. But we agree with the general message from central banks—these factors won't derail the recovery. We continue to expect modest rate hikes from the Fed, BoC and BoE next year, while the ECB and RBA aren't as close to liftoff and will continue with dialed-back QE in 2022. Our base case is for gradual policy tightening with financial conditions remaining broadly accommodative over our forecast horizon. But central banks will be data dependent, and elevated inflation rates and uncertainty about the persistence of price pressures continues to raise the risk that interest rates will have to rise faster than many anticipate.

Central bank near-term bias

→ The BoC didn't overreact to disappointing GDP data but downwardly-revised forecasts in October could delay its next tapering step. A slower recovery also suggests risks around our overnight rate call—two hikes in H2/22—are to the downside.

→ Despite a disappointing payroll report in August, we think the Fed's September meeting will tee up for a tapering announcement before year end. The Fed is keen to disconnect tapering from eventual rate hikes, and we don't anticipate interest rate liftoff until the end of 2022.

→ The UK's economic recovery is losing its early momentum but a better-than-expected labour market should leave the BoE on course to finish QE this year and gradually raise rates in 2022.

→ The ECB described its decision to slow PEPP purchases as recalibration rather than tapering. It opted not to extend or expand its pandemic-era QE program in September and said bigger decisions on key policies will be made in December.

→ The RBA tapered its bond buying in September but extended the program by at least three months. The current QE program could end up being larger than the past two.

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Highlights

▲ Chair Powell didn't reveal much new information regarding the Fed's tapering plans at Jackson Hole.

▲ August's job gain was well short of expectations as hiring in leisure & hospitality reportedly ground to a halt.

▲ Businesses in manufacturing and services are facing input shortages and hiring challenges.

▲ We continue to expect solid US GDP growth over H2/21 but not quite as robust as previously thought.

No big splash at Jackson Hole

Earlier this year, Fed watchers circled late-August on their calendars as a potential key point in the central bank's tapering process. But as the event approached, it became increasingly apparent that the Fed's careful and gradual communications strategy around QE—seeking to avoid a repeat of 2013's taper tantrum—limited the scope for a splashy announcement. In the event, Chair Powell's address didn't cover any new ground. He reiterated that most FOMC participants think it will be appropriate to begin reducing asset purchases this year if the economy evolves as expected. In his view, the Fed's test for "substantial further progress" toward its objectives had been met for inflation but not yet for the labour market, though strong job growth in July was a step in the right direction. Powell once again emphasized tapering is not meant to carry a signal about the timing of future rate hikes—breaking that link has helped the bond market easily digest a pending QE taper. A 1.3-1.4% trading band in recent weeks leaves 10-year Treasury yields around the middle of their year-to-date range.

August payroll report disappoints

Powell's comments put added focus on the following week's payroll report, which ended up falling well short of expectations. Only 235,000 jobs were added in August against market expectations for a gain of more than 700,000. Hiring was strong enough to push the unemployment rate down further to 5.2%, though with the labour force participation rate (including among 25-54 year olds) remaining well below its pre-pandemic peak we remain of the view that the jobless rate is underestimating labour market slack. On balance, though, we think average job gains of 644,000 in the two months since the Fed's July meeting are strong enough for the Fed to take one more step toward tapering in September, tweaking its guidance to indicate that a reduction in asset purchases might soon be appropriate. That would prime the pump for tapering before year end—as we expect, and as the Fed was signaling pre-payrolls—but certainly leaves the Fed ability to opt out if incoming data continue to disappoint. Expect policymakers to once again emphasize the higher hurdle for interest rate liftoff, which we don't expect until the end of 2022.

Delta, shortages trim H2 growth prospects

The latest economic data continue to point to solid GDP growth in Q3, but not quite as firm as previously anticipated. Consumer spending was close to flat in July, held back by a drop in goods spending that reflects both ongoing normalization (goods spending peaked at 20% above its pre-pandemic level back in March) and supply chain disruptions. The latter was most apparent in motor vehicle sales where a global shortage of semiconductors continues to crimp supply. More broadly, the latest ISM manufacturing survey shows ongoing slowing in supplier delivery times and rising order backlogs.

Services spending continued to pick up in July but remained nearly 3 ppts below its pre-pandemic level, and more recent card spending data shows some loss of momentum in August. We continue to think US consumers have the financial firepower to spend more, and restrictions on services activity (beyond travel) are fairly limited despite a sharp increase in COVID cases and hospitalizations. But this latest virus wave might be weighing on demand—consumer confidence fell to a six-month low in August—and supply is likely still a headwind, even if it isn't in the form of containment measures. Like its manufacturing counterpart, the ISM services index points to slow supplier deliveries/vendor performance and order backlogs. Rising community transmission might be keeping some would-be employees from returning to consumer-facing services jobs—leisure and hospitality reportedly saw no hiring in August despite 1.8 million job openings in the sector as of July.

Concerns about workplace safety might not be soon resolved but as Chair Powell noted in his Jackson Hole speech, other factors potentially holding back hiring should ease as schools reopen and enhanced unemployment benefits end in September. We don't see supply chain issues, labour shortages and consumer hesitancy derailing the economic recovery, but on balance we've marked down our H2/21 GDP growth forecast to slightly below 5% (annualized) on average from more than 6% previously.

Canadian GDP report throws forecasters for a loop

Canadian GDP came in well short of expectations in Q2, declining at a 1.1% annualized rate against consensus for a 2.5% gain (the latter consistent with StatCan's 'flash' estimate). On a monthly basis, declines in April and May were worse than initially reported, indicating Canada's economy was weighed down more significantly by restrictions put in place to combat a third wave of COVID-19. On an expenditure basis, consumer spending was close to flat in Q2 (as expected) but housing and exports provided more drag than we thought. The latter reflected a decline in export volumes, while higher prices for Canadian commodities pushed nominal exports slightly higher, contributing to a second consecutive current account surplus for the first time since 2008.

Perhaps even more disappointing than the Q2 figure was StatCan's flash estimate showing a 0.4% decline in July GDP—also against expectations for an increase. If confirmed, that would retrace half of June's gain and suggest significantly less re-opening momentum than anticipated (recall that many third-wave restrictions were eased in June and July). We think there's reason to discount July's flash estimate—hospitality spending is a bit of a blind spot for StatCan, and RBC's card spending data shows strong growth in July that we think should have more than offset declines in other sectors. Nonetheless, we have marked down our Q3 GDP growth forecast to 4.5% annualized from 8% previously. That also incorporates the impact of delayed reopening in some provinces amid a fourth wave of COVID infections. We think a high rate of vaccination and the use of vaccine passports will keep authorities from resorting to lockdown measures, but ongoing restrictions will still weigh on the recovery.

As is the case in the US and globally, supply chain issues are impacting Canada's economy. August's manufacturing PMI noted an increase in order backlogs and slower supplier delivery times amid input shortages and transportation bottlenecks. Again, the motor vehicle sector is being hit particularly hard—a decline in auto exports weighed on Q2 GDP and July's production was nearly one third below normal levels. With rising case counts at home and abroad potentially slowing the rotation toward services spending, there is growing risk that strong goods demand continues to run into input shortages and transportation issues in the coming quarters.

Bank of Canada didn't overreact to soft GDP data

Disappointing GDP figures put a brighter spotlight on the Bank of Canada's September meeting. But the bank didn't overreact to the softer data, noting an unexpected decline in Q2 GDP largely reflected supply chain disruptions in the export sector and normalization in housing. In a bit of data cherry-picking the statement pointed to a more than 3% increase in domestic demand (i.e. GDP excluding net trade). Moreover, there was no mention of the surprising decline in July's 'flash' GDP with the statement instead flagging solid job growth in June and July. The bank pointed out headwinds from supply bottlenecks and rising COVID cases but didn't dwell on downside risks to its July forecasts and said it continues to expect the recovery will strengthen in the second half of the year.

Despite Governing Council's sanguinity we think economic data between now and late-October need to take a dramatic turn for the better for the bank to avoid downgrading its growth projections. Any notable downward revisions would make it difficult to justify further tapering of its QE program based on the "strength and durability" of the recovery. It looks increasingly likely that the BoC won't switch to the reinvestment phase of its QE program (buying C$4-5B of bonds per month to keep its holdings roughly steady) until December or January. Disappointing growth also raises the risk that the economy doesn't reach full capacity until the end of 2022 or later, delaying interest rate liftoff. But with plenty of data on the economic reopening still to come, we're holding onto our forecast for two rate hikes in the second half of 2022. Markets are appropriately flagging some downside risk to that, pricing in about 40 bps of tightening next year.

Highlights

▲ Despite early data pointing to an increase, Canadian GDP declined in Q2 amid third wave containment measures.

▲ We think there's reason to discount StatCan's 'flash' estimate that GDP fell 0.4% in July…

▲ …and the BoC appears to be doing the same, having not mentioned July GDP in its September policy statement or progress report.

▲ The BoC highlighted job gains in June and July but said the labour market recovery remains uneven.

Highlights

▲ PMI data suggest less momentum in the UK's services sector as an early reopening boost fades.

▲ The euro area was slightly behind the UK in reopening and appears to have held onto more momentum over the summer.

▲ UK and euro area GDP are both expected to return to pre-pandemic levels in Q4.

▲ Extended lockdowns should result in a sharp decline in Q3 GDP though we see Australia's recovery getting back on track in 2022.

UK's reopening surge in the rear-view mirror

The UK economy expanded by an impressive 4.8% (non-annualized) in Q2 though growth slowed to just 0.1% in July from 1.0% in June. More recent PMI data also suggest some loss of momentum—August's services index in particular wasn't quite as robust as in past months when the initial gains from reopening were realized. Respondents noted a combination of supply (labour shortage) and demand (potentially Delta-driven) headwinds, and supply chain issues were evident in the manufacturing sector as well. While other advanced economies face similar challenges, Brexit's impact on trade and immigration flows is likely worsening those effects in the UK. We think the latest data are consistent with our forecast for GDP growth to slow to less than 3% in Q3 with the economy only returning to its pre-pandemic level in Q4.

Solid GDP growth in Q2 was accompanied by steady job gains, reducing the unemployment rate to within 1 ppt of its pre-pandemic low. The UK's furlough scheme has helped contain job losses and we'll be watching upcoming labour reports closely to see the extent to which a reduction in furlough benefits beginning in July results in redundancies. With more than half of those remaining on furlough now working at least some hours, there is downside risk to the BoE's forecast for the unemployment rate to rise above 5% later this year. As evidence of labour market resilience builds, we see the BoE dialing back some of its stimulus, raising Bank Rate to 0.5% over the course of 2022.

ECB slowing its pandemic QE purchases

In contrast to the UK, the euro area's services PMI remained firm in August with a pickup in tourism contributing to stronger activity. The manufacturing index was also solid but flagged supply chain issues which appear to be weighing on actual industrial output more than PMI data suggest. With the euro area's reopening slightly delayed relative to the UK, we see Q2's growth momentum (+2.2% non-annualized) being largely sustained in Q3 with a 1.9% gain expected. The currency bloc's GDP also isn't expected to return to its pre-pandemic level until the end of this year and fully absorbing economic slack (hours worked were still about 4% lower in Q2 as shortened hours worked schemes continue) will be a much longer process.

Having increased the pace of bond buying in its PEPP program during Q2 and Q3, the ECB announced in September it would shift to a "moderately lower" pace of net purchases while maintaining the overall envelope at €1.85T with purchases continuing until at least the end of March 2022. While the slight taper was as expected, we had seen scope for the ECB to modestly increase the envelope and extend the purchase window. The central bank continued to note that the entire PEPP envelope might not be needed to keep financial conditions sufficiently accommodative, while at the same time the program can be extended if necessary.

RBA's dovish taper sees QE extended

Australian GDP eclipsed its pre-pandemic level early this year and built on that in Q2 with a stronger-than-expected 0.7% gain. The increase, driven by solid domestic demand, provides a better starting point heading into the second half of the year when we expect extended lockdowns resulted in a sharp 3.4% contraction in Q3 GDP. Ongoing restrictions will dampen the Q4 recovery and we expect a 1.8% gain that will just get the economy back to its pre-pandemic output. But with the economy expected to build momentum heading into 2022, we see much of the recovery's step backward being made up next year.

The RBA shared a similar view on September, noting "the Delta outbreak is expected to delay, but not derail, the recovery." The central bank followed through on its guidance by tapering bond purchases to A$4B per week from A$5B previously, though the move was more dovish than hawkish as the RBA said purchases will continue at that pace until at least mid-February 2022, three months longer than previously indicated. Even if the RBA resumes tapering after from that point (following the BoC's example) its third QE program could be significantly larger than QE1 and QE2. As with other central banks that are beginning to taper pandemic-era QE, the RBA's move isn't meant to signal any forthcoming interest rate liftoff. September's policy statement reiterated that rate hikes shouldn't be expected before 2024, with that guidance being reinforced by ongoing yield curve control.

Interest rate outlook

%, end of period

	Actual						Forecast					
	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
Canada												
Overnight	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75
Three-month	0.21	0.20	0.12	0.06	0.09	0.15	0.20	0.20	0.25	0.30	0.55	0.80
Two-year	0.42	0.29	0.25	0.20	0.23	0.45	0.35	0.45	0.70	0.85	1.05	1.20
Five-year	0.59	0.37	0.36	0.39	0.99	0.98	0.90	1.10	1.35	1.45	1.55	1.65
10-year	0.70	0.53	0.57	0.68	1.56	1.39	1.30	1.60	1.80	1.90	1.95	2.00
30-year	1.31	0.99	1.11	1.21	1.99	1.84	1.90	2.10	2.20	2.25	2.30	2.30
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38
Three-month	0.11	0.16	0.10	0.09	0.03	0.05	0.01	0.05	0.05	0.10	0.25	0.60
Two-year	0.23	0.16	0.13	0.13	0.16	0.25	0.30	0.45	0.60	0.80	1.00	1.20
Five-year	0.37	0.29	0.28	0.36	0.92	0.87	0.95	1.20	1.30	1.45	1.60	1.80
10-year	0.70	0.66	0.69	0.93	1.74	1.45	1.55	1.75	1.85	2.00	2.10	2.20
30-year	1.35	1.41	1.46	1.65	2.41	2.06	2.15	2.30	2.40	2.50	2.55	2.55
United Kingdom												
Bank rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.50
Two-year	0.13	-0.08	-0.02	-0.16	0.11	0.07	0.10	0.10	0.15	0.25	0.35	0.50
Five-year	0.20	-0.06	-0.06	-0.08	0.40	0.33	0.35	0.45	0.50	0.65	0.75	0.85
10-year	0.34	0.17	0.23	0.20	0.85	0.72	0.75	0.85	1.00	1.15	1.20	1.35
30-year	0.82	0.64	0.78	0.76	1.40	1.24	1.20	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	-0.60	-0.60	-0.60	-0.60	-0.55	-0.50
Five-year	-0.65	-0.70	-0.71	-0.74	-0.62	-0.59	-0.55	-0.50	-0.50	-0.45	-0.40	-0.30
10-year	-0.48	-0.45	-0.53	-0.58	-0.29	-0.20	-0.20	-0.15	-0.05	0.05	0.15	0.20
30-year	0.03	0.01	-0.09	-0.17	0.26	0.30	0.45	0.55	0.65	0.75	0.80	0.85
Australia												
Cash target rate	0.25	0.25	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Two-year	0.24	0.25	0.16	0.08	0.08	0.06	0.10	0.10	0.10	0.10	0.40	0.50
10-year	0.77	0.87	0.84	0.97	1.74	1.49	1.50	1.65	1.85	2.00	2.15	2.30
New Zealand												
Cash target rate	0.25	0.25	0.25	0.25	0.25	0.25						
Two-year swap	0.52	0.19	0.05	0.27	0.46	0.78	**Forecasts under review**					
10-year swap	0.92	0.72	0.50	0.97	1.95	1.87						
Yield curve***												
Canada	28	24	32	48	133	94	95	115	110	105	90	80
United States	47	50	56	80	158	120	125	130	125	120	110	100
United Kingdom	21	25	25	36	74	65	65	75	85	90	85	85
Eurozone	21	24	17	13	40	47	40	45	55	65	70	70
Australia	53	62	68	89	166	143	140	155	175	190	175	180
New Zealand	40	53	45	70	149	109	-	-	-	-	-	-

*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	6.6	5.0	4.5	3.5	3.0	3.0	2.5	2.3	-3.4	5.8	3.8
United Kingdom	-2.8	-19.5	16.9	1.3	-1.6	4.8	2.7	1.9	0.7	0.4	0.4	0.4	1.4	-9.8	7.1	5.3
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	3.9	3.2	2.5	2.1	2.3	1.9	0.7	3.2	2.5
United States	2.1	0.4	1.2	1.2	1.9	4.8	5.0	4.1	3.3	1.8	1.4	2.2	1.8	1.2	4.0	2.2
United Kingdom	1.7	0.7	0.6	0.6	0.6	2.0	1.9	2.3	2.0	1.8	1.8	1.8	1.8	0.9	1.7	1.9
Euro Area	1.1	0.2	0.0	-0.3	1.1	1.8	2.3	2.7	2.0	1.5	1.2	1.4	1.2	0.3	2.0	1.5
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	1.24	1.25	1.26	1.27	1.27	1.27
Euro	1.10	1.12	1.17	1.22	1.17	1.19	1.17	1.14	1.13	1.12	1.13	1.14
U.K. pound sterling	1.24	1.24	1.29	1.37	1.38	1.38	1.36	1.30	1.26	1.22	1.23	1.23
Japanese yen	108	108	105	103	111	111	107	105	107	108	110	112
Australian dollar	0.61	0.69	0.72	0.77	0.76	0.75	0.75	0.74	0.74	0.73	0.73	0.73

Canadian dollar cross-rates

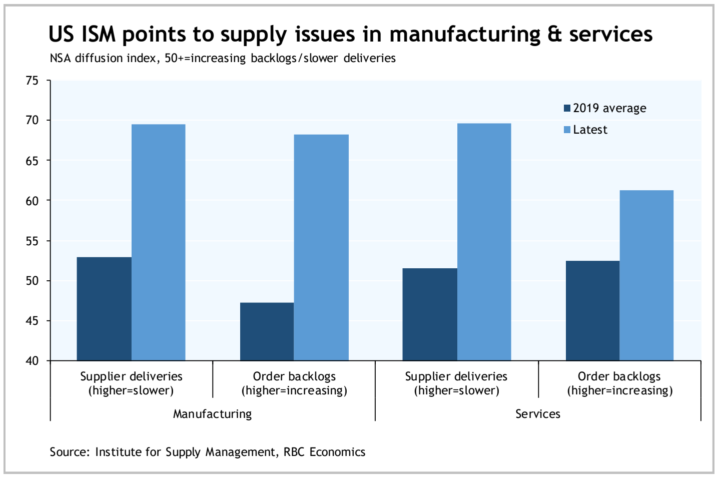
	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
EUR/CAD	1.55	1.53	1.56	1.55	1.47	1.47	1.45	1.43	1.42	1.42	1.44	1.45
GBP/CAD	1.75	1.68	1.72	1.74	1.73	1.71	1.69	1.62	1.58	1.55	1.56	1.56
CAD/JPY	76.5	79.5	79.2	81.1	88.1	89.6	86.3	84.0	84.9	85.0	86.6	88.2
AUD/CAD	0.86	0.94	0.95	0.98	0.95	0.93	0.93	0.93	0.93	0.93	0.93	0.93

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

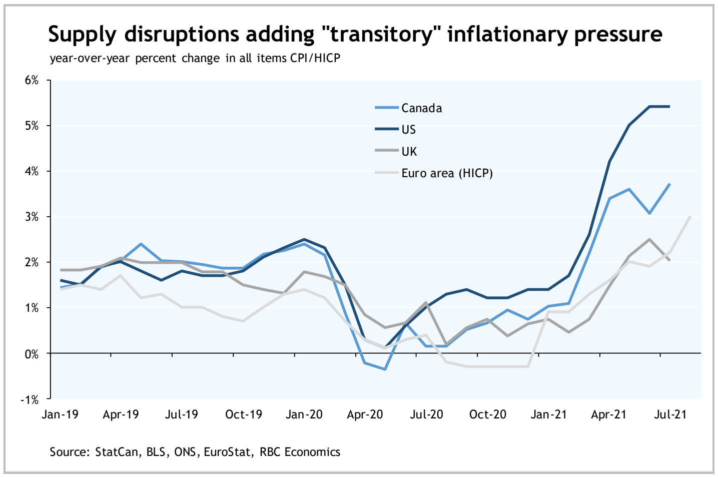
Source: Bloomberg, RBC Economics

Supply disruptions impacting economic recovery and inflation

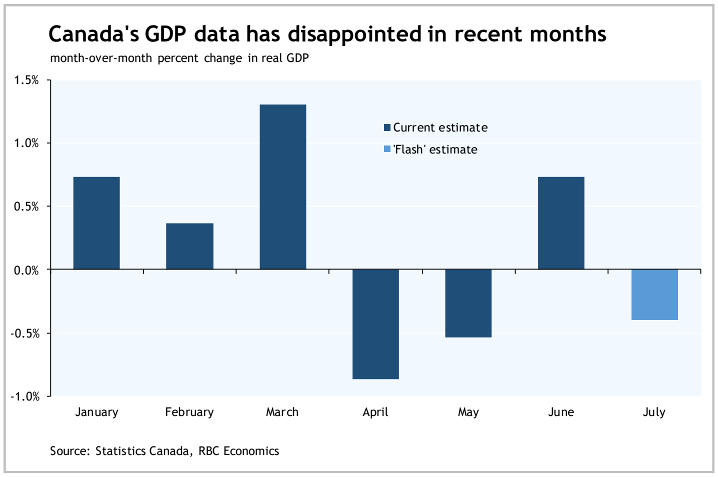
Surveys across advanced economies (like the US ISM shown below) are flagging supply chain issues in the manufacturing sector and hiring difficulties in services, resulting in rising order backlogs. While most containment measures have eased, these issues continue to impact the supply side of the economy.



Supply chain issues are pushing some goods prices higher (e.g. motor vehicles) adding to inflationary pressure from earlier increases in commodity prices. Central banks continue to view these increases as transitory, though their scale and duration are uncertain. Higher services inflation would further complicate matters but so far wage pressures appear to be contained.



Lockdowns slowed Canada's economy more than previously thought in Q2 and a decline in exports, driven in part by supply chain challenges, didn't help. Manufacturing was a weak spot again in July though we think there's reason to discount StatCan's flash GDP estimate as services spending likely rose.



US job growth disappointed in August as hiring in leisure & hospitality reportedly ground to a halt. That's despite the sector having 1.8 million job openings in July. Companies are reporting challenges filling positions but a return to school and expiring unemployment benefits could help.