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Searching for the turning point

The past month once again saw aggressive moves by a number of central banks with the Fed, ECB and BoE all hiking by 75 bps at their latest policy meetings. But there were clear indications that the pace of tightening is set to slow with policymakers putting more emphasis on the substantial rate increases already delivered and lags in monetary policy impacting economic activity and inflation. The RBA has already downshifted to 25 bp rate moves and the BoC surprised markets by dialing back to a 50 bp increase in October. Despite striking a hawkish tone, the Fed opened the door to a slower pace of tightening at upcoming meetings, while the ECB softened its language on future rate increases. We think the BoE's larger hike in November was a one-off with policymakers continuing to push back against the aggressive policy path priced into markets.

While keeping in mind that the full effects of recent tightening have yet to be felt, central banks are on the lookout for a turning point in underlying inflation. That has generally remained elusive, although the latest CPI reports in Canada and the US provide a glimmer of hope. Recent economic data has been firmer than expected though we continue to look for a softening backdrop into year end with Canada and the US likely to see only modest GDP gains in Q4 and the UK and euro area likely to record declines. Each of these economies is expected to enter recession in the coming months if they're not already there. Given our generally below-consensus economic forecasts, we think central banks will ultimately underdeliver relative to market expectations, which should see government bond yields peaking in the near-term. That said, more persistent inflation that forces policymakers to continue tightening further into 2023 remains a key risk (upside for rates, downside for growth) next year.

Central bank near-term bias

The BoC surprised consensus by dialing back to a 50 bp hike in October. In a dovish presser, Governor Macklem suggested the BoC is nearing the end of its tightening cycle and mindful of the risk of over-tightening. We expect a final 25 bp hike in December.

The Fed opened the door to a slower pace of tightening going forward but otherwise sounded hawkish with Powell saying they still have a ways to go in raising rates. We look for 50 bp hike in December and modest further tightening in Q1/23.

We think the BoE's 75 bp hike in November was a one-off and expect a return to a 50 bp pace in December. With the UK economy already slowing and the BoE pushing back against more aggressive market pricing we continue to see terminal at 3.75%.

The ECB opted for another big 75 bp hike in late-October but sounded more dovish, supporting our forecast for a slower pace of tightening in December (50 bps) and Q1/23 (25 bps per meeting).

The RBA continued to hike at a slower 25 bp pace despite an upside surprise in Q3 inflation. We look for increases of that magnitude to continue at upcoming meetings and have lifted our terminal cash rate forecast to 3.6% from 3.1% previously.

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Highlights

▲ The BoC delivered a smaller-than-expected hike in October...

▲ ...but the Canadian dollar shrugged off any disappointment and is up 2 cents from its mid-October lows.

▲ Powell and Macklem struck very different tones at their latest policy meetings...

▲ ...and we think the market is overestimating the BoC's propensity to follow a more aggressive Fed.

BoC charting its own course...

The emerging divergence between the BoC and Fed that we noted last month was fully evident in the two central banks' latest policy decisions. Ahead of a widely-expected 75 bp hike by the Fed, the BoC put its currency worries aside and surprised the market with a below-consensus 50 bp increase (in line with our forecast). The Canadian dollar actually held its own following the decision but GoCs rallied sharply with 2-year yields recording their largest single-day decline since early-2015. That move ultimately wasn't sustained as a hawkish Fed and strong jobs report pushed BoC terminal rate pricing higher. But we think the market is overestimating the BoC's propensity to follow the Fed, particularly after it charted its own course in October. While we've lifted our terminal fed funds forecast by 25 bps (to 4.75-5.00%) our BoC call is unchanged (4.00% terminal). That end-of-cycle gap would be at the higher end of the range seen in recent tightening cycles—the Fed consistently going further—whereas market pricing is at the lower end. That suggests downside risk to the Canadian dollar, in line with our forecast for further near-term depreciation.

...as the Fed remains hawkish

After front-loading rate hikes to get monetary policy into restrictive territory, both the Fed and BoC have started to put more emphasis on the amount of tightening already delivered, and the lagged effects of monetary policy on economic activity and inflation. But that was the extent of the Fed's dovish pivot in November, with Chair Powell saying the central bank still has a ways to go in raising interest rates and that it's "very premature to be thinking about pausing." While opening the door to slower pace of rate hikes as soon as December or February, Powell put greater emphasis on the committee's terminal policy rate expectations which he said moved higher since the September dot plot. He also dismissed concerns that the Fed was over-tightening. That stood in contrast to Governor Macklem's tone a week earlier, when he said the BoC is getting closer to the end of its tightening cycle and "trying to balance the risks of under- and over-tightening."

We continue to see downside risk to both central banks' GDP projections for next year. Both Powell and Macklem have noted growing risk of recession in 2023, though the BoC went a bit further in suggesting the economy is likely to stall in the coming quarters and, in the near-term, modest declines in economic activity are just as likely as modest gains. We think that's about as close as the BoC will come to calling a recession until we're actually in one. As the central bank of a small open economy, the BoC has unsurprisingly put more emphasis on a deteriorating global economic backdrop and marked down its global growth forecast by 0.4 ppts in each of the next two years. Chair Powell said the Fed is keeping close tabs on a difficult global economic backdrop—including the challenges posed by a rising US dollar—but emphasized a strong domestic economy and the need to get inflation under control.

Upcoming rate decisions hinge on key data points...

Both central banks have said they're not done tightening, and it looks like the Fed has more ground to cover before it sees interest rates as sufficiently restrictive. But just how much further rates will rise looks to be truly data dependent. Governor Macklem framed the BoC's December decision as between 25 and 50 bps, while the Fed has left both 50 bp and 75 bp increases on the table at its final meeting of the year.

The latest jobs data (in isolation) would seem to argue for larger hikes with both Canadian and US payrolls rising by more than expected in October. The former was a bigger surprise as the Canadian economy added 108,000 jobs, erasing declines seen over the summer. That said, Canadian jobs numbers are volatile and the recent trend continues to point to some loss of momentum. US payrolls weren't quite as impressive but a 261,000 gain came in solidly above market expectations for a more trend-like 200,000 increase. Unemployment rates in both countries have inched higher but remain just above cycle lows, and job vacancies are still elevated. Wages are trending in opposite directions, however, with Canadian pay growth accelerating while the US equivalent appears to have peaked. Neither country has seen much in the way of real wage growth relative to pre-pandemic levels. Surveys in both Canada and the US point to a slower pace of hiring ahead, but the BoC and Fed will likely want to see that playing out in hard data before hitting pause on their tightening cycles.

…with inflation still the decisive factor

Some of the recent divergence between BoC and Fed rhetoric can be attributed to differing inflation trends. Both countries have seen headline inflation come down from June's highs on the back of lower gasoline prices. But US core inflation continued to accelerate through September (the latest data available as of the Fed's early-November meeting) with the year-over-year rate hitting a fresh cycle high. The BoC's preferred core measures, meanwhile, moderated from their earlier peaks and monthly readings suggest less inflationary momentum—something the BoC pointed to in its dovish decision. Chair Powell lowered the bar somewhat in his November press conference, saying he doesn't think a decisive slowing in inflation is the appropriate test for the Fed to dial back the pace of rate hikes. With October's CPI report coming in softer than expected (core inflation rising at just half the monthly pace of the prior two months) we think that bar has easily been cleared and look for the Fed to slow to a 50 bp increase in December.

Both central banks will want to see these nascent signs of easing inflationary pressure continuing in the months ahead. Assuming they do, and given our below-consensus growth forecasts for 2023, we think the market is modestly over-priced for further tightening. We continue to expect the BoC will hit pause following a 25 bp hike in December. The Fed's more hawkish tone points to rate hikes continuing early next year but we expect it will be forced to sidelines by March as economic data begin to deteriorate more notably.

BoE pushes back against aggressive market pricing

Gilt yields retreated further from their recent highs as the UK's new Chancellor and Prime Minister continued to reverse their predecessors' disastrous mini-budget policy proposals. The government's key energy price cap for households will now only last until April with Treasury expected to provide less costly assistance thereafter. That could leave households more exposed to rising energy prices in 2023 though until we know the extent of future support we are treating that as an upside risk to our inflation forecast. We continue to look for a pullback in Q3 GDP with an extra bank holiday adding to signs that the economy lost momentum as the quarter progressed. Activity is expected to continue to soften in the coming quarters as policy uncertainty, rising borrowing costs (worsened by recent Gilt market volatility) and a cost of living squeeze take their toll.

Highlights

▲ Both Canadian and US jobs reports for October were stronger than expected.

▲ Real wage growth in Canada and the US remains close to zero since the start of the pandemic.

▲ Canadian inflation data shows tentative signs of slowing in core prices.

▲ US core inflation has been firmer although a downside surprise in October should allow the Fed to slow its tightening cycle in December.

Highlights

▲ The new UK government continued to reverse Truss's policies…

▲ …helping Gilt yields come down from earlier highs and taking pressure of the BoE to hike even more aggressively.

▲ Euro area GDP was stronger than expected in Q3 but surveys point to a Q4 slowdown.

▲ Australian inflation surprised to the upside in Q3 and likely hasn't peaked just yet.

Policy reversals that helped calm the Gilt market and stabilize sterling reduced pressure on the BoE to deliver a super-sized rate hike in November. The central bank still opted for a larger 75 bp increase, in line with our forecast and where consensus eventually landed, but the bigger move appears to have been a one-off. The BoE pushed back against earlier market pricing for Bank Rate to rise to around 5.25%, which it said would result in inflation falling well below target over the medium term. At the same time, however, the current 3% policy rate isn't seen as tight enough to get inflation back to target, supporting the BoE's guidance that further rate hikes "might be required." Our forecast remains in the middle ground with a 50 bp rate increase in December and a final 25 bp hike in February expected to see Bank Rate peak at 3.75%, well below the current market-implied terminal rate of around 4.60%.

ECB opts for another big hike but hints at dialing back

Euro area GDP growth was firmer than expected in Q3, rising 0.2% with gains in both Germany and Italy coming in well ahead of consensus. That was still the slowest pace of expansion in six quarters, though, and recent survey data suggest the economy is now contracting. Both manufacturing and services PMIs have drifted further below the 50 mark while consumer confidence is near a record low as intense inflation saps households' purchasing power. Euro area HICP inflation continued its unrelenting rise in October, accelerating above 10% year-over-year. Energy and food prices remain key drivers of euro area inflation although core prices have also accelerated, including services prices, suggesting the domestic economy is also generating inflationary pressure.

Seeking to tamp down price growth, the ECB raised its key policy rates by 75 bps at a second consecutive meeting in October, lifting the deposit rate to 1.50%. The statement and press conference had a dovish tone, though, with the central bank saying policy will be guided by the economic outlook as well as inflation, and hinting that rates might not need to rise above neutral. As with other central banks, ECB President Lagarde also emphasized the amount of tightening already delivered (200 bps in three months) and the lagged effect of monetary policy on the economy and inflation. After the market saw these changes as dovish, a number of hawkish ECB speakers pushed back, suggesting divisions on the extent of further tightening that is needed. We expect the ECB will slow its rate hikes with a 50 bp increase in December and two 25 bp increases early next year lifting the deposit rate to 2.50%, below market pricing that is closer to 3%. We still see risks skewed to the upside if economic conditions don't soften enough to reduce inflationary pressure both within the currency bloc and globally.

RBA nearing the end of its front-loaded tightening cycle

The RBA lifted its policy rate by 25 bps at a second consecutive meeting in November, having dialed back from 50 bp increases at the four meetings prior. Inflation remained front-and-centre in the policy statement after Q3 CPI surprised to the upside including sharp acceleration in core measures. The central bank now sees year-over-year inflation peaking around 8% later this year. That's in line with our latest forecast, and we now see inflation proving more persistent in 2023 (6.5% annual average little changed from this year's 6.6%) thanks in part to higher electricity prices. Other elements of the RBA's policy statement were on the dovish side, including a reference to slowing employment growth. And as with its global counterparts, the central bank noted the lagged impact of changes in monetary policy and pointed to having already raised rates "materially" this year. However, given the focus on inflation we now see the RBA extending its tightening cycle a bit longer than previously thought. Our updated forecast assumes 25 bp hikes at the central bank's next three policy meetings, leaving the terminal cash rate at 3.60%. That's still below market pricing, consistent with our view that GDP growth will slow further in 2023 leaving the RBA's growth forecast for next year looking too optimistic.

Interest rate outlook

%, end of period

	Actual							Forecast				
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
Canada												
Overnight	0.25	0.25	0.25	0.25	0.50	1.50	3.25	4.00	4.00	4.00	4.00	4.00
Three-month	0.09	0.15	0.12	0.16	0.60	2.08	3.58	3.90	3.90	3.90	3.90	3.90
Two-year	0.23	0.45	0.53	0.95	2.29	3.09	3.80	3.90	3.75	3.65	3.60	3.30
Five-year	0.99	0.98	1.11	1.26	2.41	3.11	3.33	3.45	3.25	3.15	3.05	2.95
10-year	1.56	1.39	1.51	1.43	2.40	3.23	3.17	3.30	3.05	2.95	2.80	2.70
30-year	1.99	1.84	1.99	1.68	2.38	3.14	3.09	3.30	3.05	2.95	2.90	2.85
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.38	1.63	3.13	4.38	4.88	4.88	4.63	4.38
Three-month	0.03	0.05	0.04	0.06	0.52	1.72	3.33	4.70	4.80	4.75	4.50	4.25
Two-year	0.16	0.25	0.28	0.73	2.28	2.92	4.22	4.50	4.25	4.10	3.85	3.65
Five-year	0.92	0.87	0.98	1.26	2.42	3.01	4.06	4.00	3.70	3.50	3.40	3.30
10-year	1.74	1.45	1.52	1.52	2.32	2.98	3.83	3.95	3.75	3.65	3.55	3.45
30-year	2.41	2.06	2.08	1.90	2.44	3.14	3.79	4.15	4.00	3.90	3.90	3.85
United Kingdom												
Bank rate	0.10	0.10	0.10	0.25	0.75	1.25	2.25	3.50	3.75	3.75	3.75	3.75
Two-year	0.11	0.07	0.40	0.68	1.36	1.85	4.29	3.50	3.25	3.00	2.90	2.80
Five-year	0.40	0.33	0.62	0.82	1.40	1.88	4.40	3.60	3.50	3.25	3.10	3.00
10-year	0.85	0.72	1.02	0.97	1.60	2.22	4.08	3.80	3.80	3.60	3.40	3.25
30-year	1.40	1.24	1.37	1.12	1.77	2.59	3.82	3.80	3.80	3.70	3.75	3.60
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	0.75	2.00	2.50	2.50	2.50	2.50
Two-year	-0.69	-0.67	-0.69	-0.64	-0.08	0.64	1.78	2.40	2.50	2.25	2.00	1.75
Five-year	-0.62	-0.59	-0.56	-0.45	0.37	1.09	1.98	2.45	2.50	2.30	2.05	1.80
10-year	-0.29	-0.20	-0.21	-0.18	0.55	1.36	2.12	2.50	2.50	2.30	2.10	1.90
30-year	0.26	0.30	0.29	0.20	0.67	1.63	2.10	2.55	2.50	2.35	2.20	2.10
Australia												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.85	2.35	3.10	3.60	3.60	3.60	3.60
Two-year	0.08	0.06	0.04	0.54	1.78	2.73	3.43	3.20	3.30	3.10	3.00	2.90
10-year	1.74	1.49	1.49	1.67	2.84	3.66	3.90	4.15	3.75	3.60	3.65	3.65
New Zealand												
Cash target rate	0.25	0.25	0.25	0.75	1.00	2.00	3.00	4.00	4.25	4.25	4.25	4.00
Two-year swap	0.46	0.78	1.39	2.16	3.27	4.06	4.76	5.20	5.00	4.50	4.00	3.70
10-year swap	1.95	1.87	2.21	2.62	3.38	4.10	4.50	4.70	4.50	4.00	3.75	3.50
Yield curve***												
Canada	133	94	98	48	11	14	-63	-60	-70	-70	-80	-60
United States	158	120	124	79	4	6	-39	-55	-50	-45	-30	-20
United Kingdom	74	65	62	29	24	37	-21	30	55	60	50	45
Eurozone	40	47	48	46	63	72	34	10	0	5	10	15
Australia	166	143	145	113	106	93	47	95	45	50	65	75
New Zealand	149	109	82	46	11	4	-26	-50	-50	-50	-25	-20

*Midpoint of 25 basis point range, **Yields refer to German government bonds, *** Two-year/10-year spread in basis points,

Source: Reuters, RBC Economics

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021	2022F	2023F
Canada*	4.4	-3.1	5.3	6.6	3.1	3.3	1.0	0.5	-0.5	-1.0	0.2	0.5	4.5	3.2	0.2
United States*	6.3	7.0	2.7	7.0	-1.6	-0.6	2.6	0.3	-1.2	-1.5	0.0	0.5	5.9	1.8	-0.2
United Kingdom	-1.2	6.5	1.8	1.6	0.7	0.2	-0.7	-0.1	-0.2	0.1	0.2	0.1	7.5	4.2	-0.4
Euro Area	-0.1	2.0	2.3	0.5	0.6	0.8	0.2	-0.5	-0.3	0.1	0.2	0.2	5.3	3.0	-0.3
Australia	1.9	0.6	-1.8	3.9	0.7	0.9	0.3	0.5	0.2	0.3	0.4	0.3	4.9	3.8	1.4

*annualized

Inflation outlook

% change, year-over-year

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021	2022F	2023F
Canada	1.4	3.3	4.1	4.7	5.8	7.5	7.2	6.7	5.4	3.2	2.6	2.2	3.4	6.8	3.3
United States	1.9	4.8	5.3	6.7	8.0	8.6	8.3	7.5	5.5	3.2	2.4	1.9	4.7	8.1	3.2
United Kingdom	0.6	2.0	2.8	4.9	6.2	9.2	10.0	9.5	8.0	4.3	2.9	1.7	2.6	8.7	4.2
Euro Area	1.1	1.8	2.8	4.6	6.1	8.0	9.3	8.6	7.1	4.3	3.8	3.3	2.6	8.0	4.6
Australia	1.1	3.8	3.0	3.5	5.1	6.1	7.3	8.0	7.3	6.8	6.4	5.6	2.9	6.6	6.5

Source: Statistics Canada, Bureau of Economic Analysis, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics

Currency outlook

Level, end of period

	Actuals							Forecast				
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
Canadian dollar	1.26	1.24	1.27	1.26	1.25	1.29	1.38	1.38	1.40	1.39	1.38	1.36
Euro	1.17	1.19	1.16	1.14	1.11	1.05	0.98	0.97	0.95	0.98	1.02	1.05
U.K. pound sterling	1.38	1.38	1.35	1.35	1.31	1.22	1.12	1.08	1.04	1.08	1.13	1.17
Japanese yen	111	111	111	115	122	136	145	150	155	147	145	143
Australian dollar	0.76	0.75	0.72	0.73	0.75	0.69	0.64	0.64	0.64	0.65	0.65	0.66

Canadian dollar cross-rates

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
EUR/CAD	1.47	1.47	1.47	1.44	1.38	1.35	1.36	1.34	1.33	1.36	1.41	1.43
GBP/CAD	1.73	1.71	1.71	1.71	1.64	1.57	1.54	1.49	1.46	1.50	1.56	1.59
CAD/JPY	88	90	88	91	97	105	105	109	111	106	105	105
AUD/CAD	0.95	0.93	0.92	0.92	0.94	0.89	0.89	0.88	0.90	0.90	0.90	0.90

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

Source: Bloomberg, RBC Economics

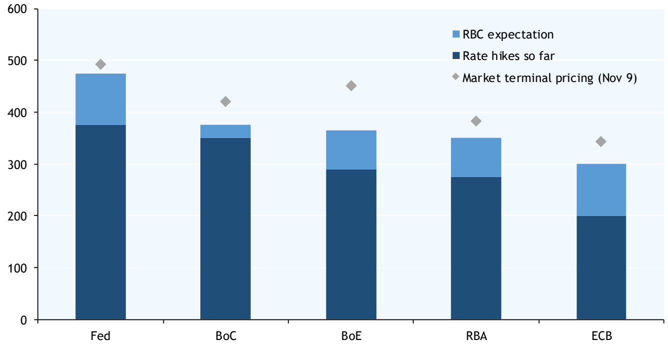
Charts we're watching

Central banks have started to put more emphasis on the amount of tightening already delivered—from 200 bps by the ECB to 375 bps by the Fed—and the lagged impact of changes in monetary policy on the economy and inflation. They're not done raising rates just yet but we think the market is generally overestimating further rate hikes.

Policy divergence between the BoC and Fed—as measured by the 2-year bond spread—intensified in October, particularly following the BoC's dovish decision (2-year yields posted their largest single-day decline since 2015). With the BoC charting its own course we could see this spread continue to tighten in the near-term.

Central banks getting closer to the end of tightening cycles

change in policy rate, basis points



Source: Refinitiv, RBC Economics

BoC-Fed policy divergence was evident in latest decisions

Canada-US 2-year government bond spread (basis points)

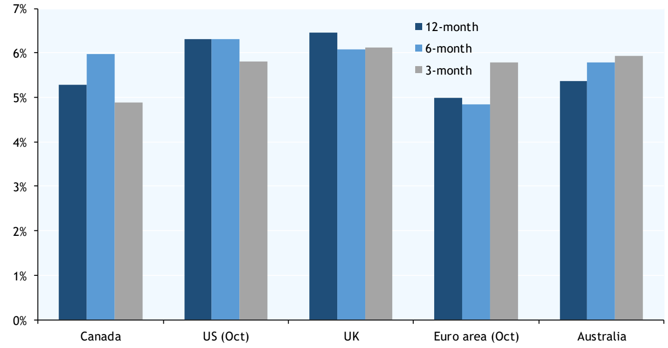
Source: Bank of Canada, US Treasury, RBC Economics

While year-over-year inflation measures are most common, indicators like the 3-month annualized change give a better indication of recent momentum. That shows some early signs of core inflation easing in Canada but less so in the US and UK. Price growth appears to be accelerating in the euro area and Australia

Canadian and US jobs reports for October were stronger than expected. Job postings remain elevated but hiring momentum is slowing and unemployment rates have ticked higher. We think jobless rates will increase in 2023 as both economies enter moderate recessions.

Keeping an eye on momentum in core inflation

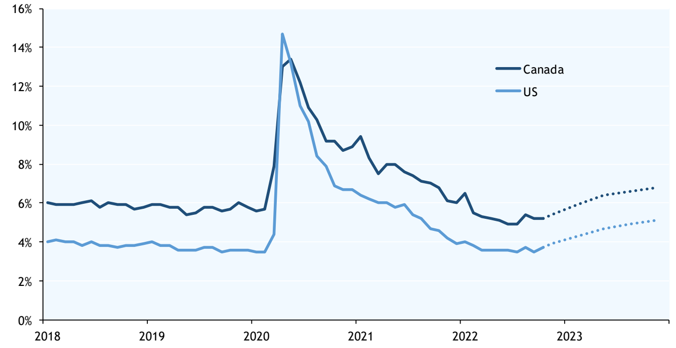
seasonally adjusted and annualized percent change in core prices as of Sep/Oct



Source: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics

Canada and US jobless rates are expected to rise in 2023

unemployment rate



Source: StatCan, BLS, RBC Economics