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## Crossing the line(s)

The early-summer rally in equities and Treasuries continued to reverse in September with stocks taking out their June lows and yields eclipsing earlier highs. By the end of September the S&P 500 was down 25% from its January peak—close to the median recession drawdown of 27%—while 10-year US Treasury yields briefly breached the 4% mark. The dual selloff continued to be a powerful catalyst for the US dollar which gained nearly 4% in September. Volatility remained elevated across asset classes in early October.

Firm US inflation data and hawkish guidance from the Fed were key drivers of the Treasury selloff, though spillover from a sharp rise in UK borrowing costs also pushed yields higher in late September. Investors didn't take kindly to the new UK government's fiscal largesse as it tacked on a number of tax cuts to what was already a massive spending commitment aimed at capping energy bills. Gilts and sterling sold off sharply, forcing the BoE to delay plans to sell some of its bond holdings and instead offer to purchase long-dated Gilts in an effort to "restore orderly market conditions." But the relief rally was short-lived and the market is looking for aggressive rate hikes by the BoE as monetary and fiscal policy push in opposite directions.

While global growth prospects have dimmed—the IMF just trimmed its global GDP forecast for 2023 to 2.7%, and even that looks optimistic—only the RBA has made a dovish pivot, surprising on the downside with a 25 bp hike in October. Other central banks continue to pile on aggressive rate increases despite growing recession concerns. We look for 75 bp hikes by the Fed, BoE and ECB at their upcoming policy meetings. We wouldn't rule out a similar move by the BoC though our base case is for a 50 bp increase in later this month.

### Central bank near-term bias



Governor Macklem continued to sound fairly hawkish in early October, which we think leaves the door open to another 75 bp rate hike. But ahead of key CPI and BOS reports we're continuing to assume the BoC will dial back to a 50 bp increase later this month.



While we think the Fed's latest forecasts look too optimistic, we see little reason to push back against its near-term tightening plans as laid out in the September dot plot. We now look for another 75 bp hike in November and a 50 bp increase in December.



The UK government's largesse has markets anticipating sharp rate hikes by the BoE to counter fiscal stimulus. We think it will respond with a 75 bp increase in November and 50 bps in December—short of the more than 200 bps (cumulatively) priced in for those two meetings.



While recent data support our forecast that the euro area entered a recession in Q3, the ECB remains focused on taming inflation and we expect another 75 bp hike later this month.



The RBA unexpectedly slowed its tightening cycle with a 25 bp hike in October. We think that will be the pace going forward as the central bank lifts its cash rate to 3.1% by year-end and holds it there in 2023.



## Highlights

▲ Markets now see fed funds peaking nearly 50 bps above the BoC's overnight rate...

▲ ...which fits with the pattern of recent tightening cycles.

▲ Canada's economy lost a bit more momentum in Q3 than we and the BoC assumed...

▲ ...and we've brought forward our forecast for a recession to begin in H1/23.

## Policy divergence adding to Canadian dollar headwinds

The BoC has kept pace with (and even led) the Fed this tightening cycle, with markets pricing similar terminal policy rates for much of this year. But expectations began to diverge in the past month amid differing trends in inflation and jobs data, and following the Fed's surprisingly hawkish dot plot in September. The fed funds rate is now seen peaking nearly 50 bps above the BoC's overnight rate. That would be well within historical patterns—the Fed hiked an additional 50 to 100 bps in each of the past three tightening cycles. We think some policy divergence is also reasonable given the Canadian economy's greater exposure to housing and higher levels of household debt. Canada-US bond spreads have tightened significantly with more attractive yields in the US contributing to a weaker Canadian dollar against the greenback.

Indeed, the Canadian dollar fell below the 76 US cent mark in September for the first time since 2020 and continued to sink from there, dropping to 73 cents by the end of the month. It remains the case—as we pointed out last month—that the Canadian dollar is up against all other G10 currencies year-to-date. So while the Canadian dollar is down more than 7% this year relative to the US dollar, it's only 2% lower on a trade weighted basis. A weaker currency represents an easing in financial conditions—supporting exports and lifting import prices and inflation—which the BoC might see conflicting with its objectives to tighten policy and slow growth and inflation. Indeed, Governor Macklem said the currency isn't providing any additional support in the BoC's fight against inflation, which could mean more rate hikes, all else equal. We continue to assume the BoC will dial back the pace of rate hikes with a 50 bp increase later this month. But the Fed's hawkishness and the currency's weakness keep a 75 bp increase on the table, and any upside surprise in key inflation and inflation expectations data between now and October 26th could tip the scales in favour of a larger move.

## Canada's economy continues to gear down

While GDP data for the first half of the year suggest Canada's economy strongly outperformed the US, more recent indicators tell a different story. Canadian employment has declined in three of the past four months (net job losses totaling 92,000) while average payroll gains south of the border have been a robust 350,000 over that period with the jobless rate remaining at the lowest levels in half a century in September. Canada's monthly core inflation edged lower in August—something the BoC will want to see more of in the coming months—but US core inflation re-accelerated. We think easing headline inflation in the US has contributed to a partial rebound in consumer confidence in recent months. But while Canada has seen a similar turnover in all items CPI, sentiment remains weak. Rate hikes are beginning to take a toll on both economies though Canadian home sales are down by one third over the past six months compared with a 20% drop in the US. And Canada has seen a more significant price correction thus far.

Canadian GDP edged up by 0.1% in July, ahead of the earlier flash estimate, though a flat advanced reading for August leaves annualized growth below 1% over the past four months. We've trimmed our Q3 growth forecast to a 1% annualized pace—half the increase the BoC projected in July, though we think they'll welcome the sub-trend pace which is needed (on a sustained basis) to better balance supply and demand and ease domestic inflationary pressure. With the economy losing a bit more momentum than we previously thought and interest rates moving higher, we've brought forward our forecast for a recession to begin in the first half of 2023 (previously the middle quarters). We see Canada's jobless rate rising to nearly 7% by the end of next year from 5.2% in September.



## Hawkish Fed cements steeper near-term policy path

We expected the September FOMC meeting would maintain the Fed's hawkish tone from August, but the central bank went a step further, flagging a steeper near-term tightening path than we and the market anticipated. The updated dot plot median shows a cumulative 125 bps of hikes over the final two meetings this year and some further, modest tightening in 2023. The committee trimmed its GDP growth projections and revised its unemployment rate forecast higher but both remain in "soft landing" territory and in our view are too optimistic. We continue to expect the US economy will slip into recession in the first half of next year with the jobless rate rising to 5% in the second half of 2023 (the Fed's Q4/23 forecast is just 4.4%).

While we think the economy will ultimately fare worse than the Fed is projecting, we see little reason to push back against its near-term tightening plans. Domestic demand growth has clearly slowed, but the labour market is showing impressive resilience. And beyond lower gasoline prices, inflationary pressure isn't letting up—July's benign core inflation print turned out to be a head fake. So the Fed's dovish pivot will have to wait. Our forecast now assumes another 75 bp hike in November followed by a 50 bp increase in December and 25 bps in February. The yield curve is likely to flatten further in the coming months with longer-term yields expected to come down amid a softening economic backdrop and easing inflation, while a still-hawkish Fed will keep the front end sticky.

## UK fiscal statement pushes Gilt yields sharply higher

The new UK government ran afoul of investors when it announced a number of tax cuts (or cancellations of planned tax increases and new levies) that will cost HM Treasury £27 billion (roughly 1% of GDP) in the upcoming fiscal year and up to £45 billion in later years. That was on top of an energy support package aimed at capping costs for households and non-domestic users that is expected to be worth £60 billion in the next six months alone. This fiscal largess combined with the government's failure to lay out a credible medium-term plan sent the Gilt market into a tailspin. 10-year yields rose 100 bps in a matter of days and longer-term Gilts were under even more pressure. That prompted the BoE to delay plans to begin selling some of its bond holdings (active QT) and launch a temporary purchase program for longer-term bonds. The latter is aimed at supporting market functioning rather than reducing borrowing costs, so after a brief relief rally in late-September, 10-year yields are back to their earlier highs. Sterling is up from its multi-decade low against the US dollar but we think that level could be retested in the coming months. Government energy support will help households but won't fix the UK's current account and budget deficits, and some currency adjustment will be needed to attract capital inflows.

The government's fiscal plan was unveiled just a day after the BoE's latest policy meeting at which it hiked Bank Rate by 50 bps to 2.25%. While it said the government's energy support program (details but not cost had already been revealed) will significantly reduce the peak in headline inflation—ostensibly necessitating less aggressive tightening—the central bank hinted that stronger demand due to fiscal support could prompt a more forceful monetary policy response. It reiterated that message following the government's announcement, with a special statement from Governor Bailey saying the BoE won't hesitate to raise rates "as much as needed" to get inflation back to target over the medium term. But we think the nearly 6% terminal rate now priced into the market (including moves of at least 100 bps at each of the remaining two meetings this

## Highlights

▲ Despite hawkish language leading up to the September FOMC meeting, an aggressive dot plots still caught the market by surprise.

▲ We think the Fed's economic projections for 2023 look too optimistic.

▲ The UK government's fiscal announcement caused significant Gilt market volatility...

▲ ...forcing the BoE to intervene and delay plans to sell some of its bond holdings.



## Highlights

▲ We've lifted our terminal Bank Rate forecast to 3.75%, still about 200 bps below current market pricing.

▲ Euro area PMI data point to a Q3 contraction as rising energy costs bite.

▲ European natural gas prices have come down from earlier highs but remain significantly above pre-invasion levels.

▲ With the RBA gearing down the pace of rate hikes, we think the central bank is nearing the end of its tightening cycle.

year) is too aggressive. We think the BoE can still send a message by ratcheting up to a 75 bp hike in November before reverting to a 50 bp increase in December. We've lifted our terminal Bank Rate forecast to 3.75% from 3% previously. While the BoE still plans to begin active QT at the end of October, we think that move could be delayed once again.

### Euro area recession likely began in Q3

Euro area manufacturing and services PMIs slipped further into contractionary territory in September, supporting our view that the currency bloc entered a recession in the third quarter. High inflation, sharply rising energy costs, economic uncertainty and softening demand were all cited as driving the slowdown. The manufacturing survey reported that production was reduced in some cases in response to higher energy prices. In the factory-intensive German economy, output levels fell at the sharpest rate since the global financial crisis (excluding pandemic-impacted months). While European natural gas prices have continued to come off their August peak, they remain twice as high as pre-Russia's invasion of Ukraine. We look for the euro area's slowdown to deepen in the coming quarters, and continue to think the ECB's staff forecasts from September are too optimistic. But with the central bank remaining laser-focused on fighting inflation (unlike in the UK, support for energy consumers isn't in the form of price caps and thus won't reduce measured inflation) we think it will opt for another 75 bp rate hike later this month. Our forecast for a 2.5% terminal rate is below market pricing for closer to 3% by mid-2023.

### RBA goes it alone with dovish pivot

The RBA bucked the global trend in October, opting for a 25 bp hike when consensus was looking for a fifth consecutive 50 bp move. While it reiterated that further rate increases should be expected, the smaller increment reflected the fact that the cash rate has been "increased substantially in a short period of time." The statement also noted the full effects of past rate hikes have yet to be felt in mortgage payments. We think this slower pace of tightening will be the new norm for the RBA with 25 bp hikes at each of its remaining two meetings this year. The central bank gearing down its tightening cycle supports our view that the cash rate is nearing its terminal value. We think our below market 3.1% call is justified by faster monetary policy transmission via variable rate mortgages, as well as Australia's high levels of household debt.



## Interest rate outlook

%, end of period

	Actual							Forecast				
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
<b>Canada</b>												
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	3.85	3.75	3.65	3.60	3.50
Five-year	0.99	0.98	1.11	1.26	2.41	3.11	3.33	3.35	3.25	3.15	3.05	2.95
10-year	1.56	1.39	1.51	1.43	2.40	3.23	3.17	3.15	3.05	2.95	2.80	2.70
30-year	1.99	1.84	1.99	1.68	2.38	3.14	3.09	3.10	3.00	2.95	2.90	2.80
<b>United States</b>												
Fed funds*	0.13	0.13	0.13	0.13	0.38	1.63	3.13	4.38	4.63	4.63	4.38	4.13
Three-month	0.03	0.05	0.04	0.06	0.52	1.72	3.33	4.35	4.60	4.50	4.25	4.00
Two-year	0.16	0.25	0.28	0.73	2.28	2.92	4.22	4.15	3.95	3.55	3.05	2.55
Five-year	0.92	0.87	0.98	1.26	2.42	3.01	4.06	3.90	3.65	3.30	2.95	2.60
10-year	1.74	1.45	1.52	1.52	2.32	2.98	3.83	3.60	3.35	3.15	2.95	2.75
30-year	2.41	2.06	2.08	1.90	2.44	3.14	3.79	3.60	3.40	3.25	3.10	2.90
<b>United Kingdom</b>												
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	4.00	3.25	3.00	2.90	2.80
Five-year	0.40	0.33	0.62	0.82	1.40	1.88	4.40	4.25	3.50	3.25	3.10	3.00
10-year	0.85	0.72	1.02	0.97	1.60	2.22	4.08	4.20	3.80	3.60	3.40	3.25
30-year	1.40	1.24	1.37	1.12	1.77	2.59	3.82	4.50	4.25	4.00	3.75	3.60
<b>Euro area**</b>												
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
<b>Australia</b>												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.85	2.35	3.10	3.10	3.10	3.10	2.85
Two-year	0.08	0.06	0.04	0.54	1.78	2.73	3.43	3.20	3.10	3.00	2.85	2.75
10-year	1.74	1.49	1.49	1.67	2.84	3.66	3.90	3.50	3.35	3.25	3.15	3.05
<b>New Zealand</b>												
Cash target rate	0.25	0.25	0.25	0.75	1.00	2.00	3.00	4.00	4.00	4.00	3.75	3.50
Two-year swap	0.46	0.78	1.39	2.16	3.27	4.06	4.76	4.60	4.40	4.00	3.60	3.20
10-year swap	1.95	1.87	2.21	2.62	3.38	4.10	4.50	4.30	4.10	3.70	3.55	3.40
<b>Yield curve***</b>												
Canada	133	94	98	48	11	14	-63	-70	-70	-70	-80	-80
United States	158	120	124	79	4	6	-39	-55	-60	-40	-10	20
United Kingdom	74	65	62	29	24	37	-21	20	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	30	25	25	30	30
New Zealand	149	109	82	46	11	4	-26	-30	-30	-30	-5	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

	<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>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>	<u>2021</u>	<u>2022F</u>	<u>2023F</u>
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	1.8	0.3	-0.8	-1.5	0.0	0.5	5.9	1.7	-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	2.2	0.5	0.7	0.8	-0.2	-0.5	-0.3	0.1	0.2	0.2	5.2	3.0	-0.4
Australia	1.9	0.6	-1.8	3.9	0.7	0.9	0.5	0.6	0.3	0.3	0.2	0.2	4.9	3.9	1.6

\*annualized

### Inflation outlook

% change, year-over-year

	<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>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>	<u>2021</u>	<u>2022F</u>	<u>2023F</u>
Canada	1.4	3.3	4.1	4.7	5.8	7.5	7.1	6.3	4.9	2.9	2.4	2.3	3.4	6.7	3.1
United States	1.9	4.8	5.3	6.7	8.0	8.6	8.2	6.7	4.8	2.6	1.8	1.9	4.7	7.9	2.7
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	7.0	7.7	6.7	5.9	5.3	4.3	2.9	6.5	5.6

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>21Q1</u>	<u>21Q2</u>	<u>21Q3</u>	<u>21Q4</u>	<u>22Q1</u>	<u>22Q2</u>	<u>22Q3</u>	<u>22Q4</u>	<u>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>
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	147	150	145	142	139
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

	<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>23Q1</u>	<u>23Q2</u>	<u>23Q3</u>	<u>23Q4</u>
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	107	107	104	103	102
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

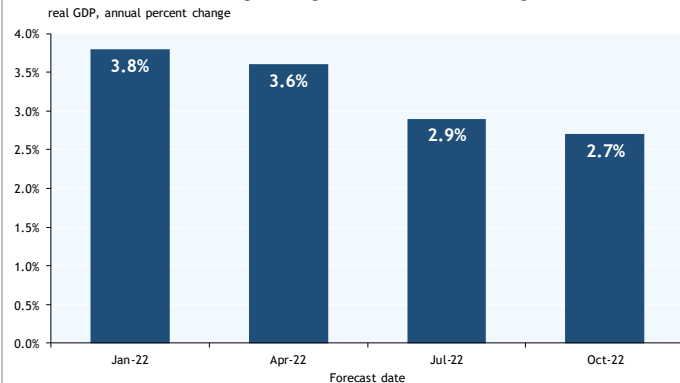
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics

## Charts we're watching

With global growth prospects dimming the IMF once again trimmed its 2023 GDP forecast. At 2.7% the latest projection is below the 3% mark typically considered a global recession. Even still we see downside risk as the IMF's projections for Canada (1.5%), the US (1.0%), UK (0.3%) and euro area (0.5%) are all optimistic relative to our own forecasts.

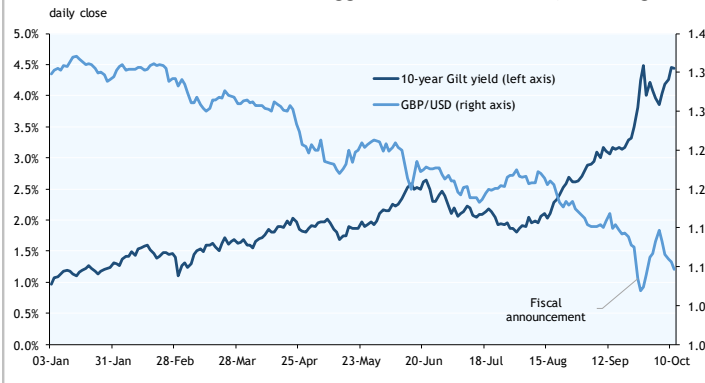
**IMF trims its 2023 global growth forecast... again**



Source: IMF, RBC Economics

The UK government's fiscal announcement, which tacked a number of tax cuts onto an already-costly energy support program, sent Sterling sharply lower and drove Gilt yields higher. The currency has stabilized but we think recent lows will be re-tested in the coming months. Yields are back at earlier highs though we think the market is over-priced for BoE tightening.

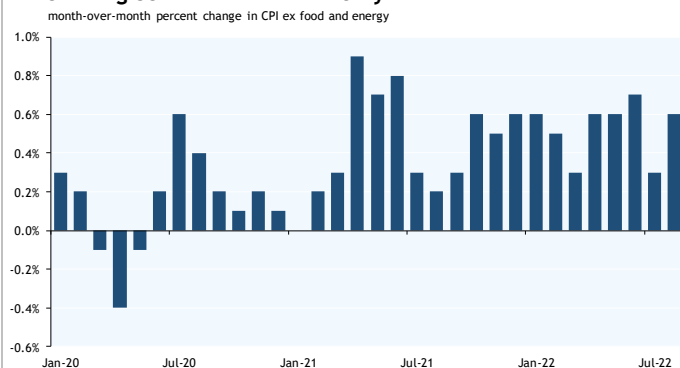
**UK fiscal announcement triggered selloff in Gilts, Sterling**



Source: Refinitiv, Wall Street Journal, RBC Economics

Rising UK yields spilled over into other markets but US Treasuries were already selling off following a disappointingly firm CPI report and hawkish Fed. While US headline inflation has slowed, core CPI re-accelerated in August. July's "modest" 0.3% monthly increase now looks like a head fake.

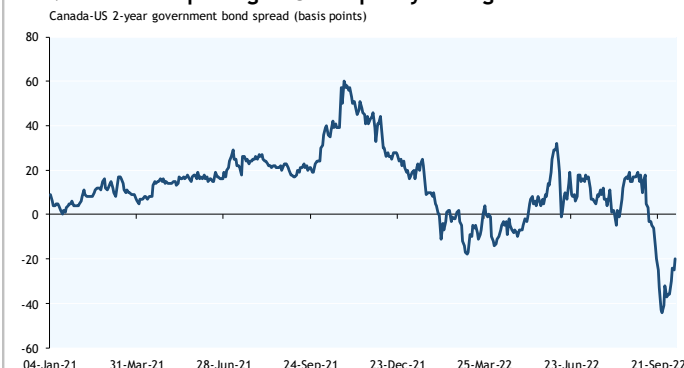
**Slowing US core inflation in July looks like a head fake**



Source: BLS, RBC Economics

A hawkish Fed combined with diverging trends in a number of economic indicators (jobs, core inflation, consumer sentiment) has the market pricing a higher terminal policy rate in the US relative to Canada. More attractive yields south of the border have put downward pressure on the Canadian dollar.

**Markets now pricing BoC-Fed policy divergence**



Source: Bank of Canada, US Treasury, RBC Economics