RBC Economics & Thought Leadership

Financial Markets Monthly

April 2024

BoC and the Fed, you gotta keep ‘em separated

Highlights:

- A resilient U.S. economy and signs of reacceleration in inflation look likely to derail Fed plans to cut interest rates by 75 basis points this year – we now look for just one 25 basis point cut in December.
- The Bank of Canada, though, still looks on track to cut rates in June.
- Beyond then, the monetary policy gap will widen with the BoC cutting deeper than the Fed. That's also against a widening macroeconomic growth and labour market gap in Canada versus the U.S.
- There are early signs of a pickup in activities in the euro area and U.K. economies, but not enough to prevent cuts from the ECB and the BOE this year as long as inflation continues to slow.

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The U.S. economy has continued to outperform other regions with GDP tracking another solid increase in Q1 and employment rising quickly despite high interest rates. More importantly, slowing inflation trends last year are showing worrying signs of reversing and reaccelerating in early 2024 - growth in the Fed's "supercore" inflation measure (core services ex-rent) doubled to 8.2% (annualized) in March relative to last December. Federal Reserve officials have so far mostly stuck with the guidance that interest rates can begin to move lower this year. But the run of stronger inflation prints makes cuts by the summer look increasingly unlikely. We now expect the Fed to cut the fed funds target range just once this year in December versus a June start we previously assumed.

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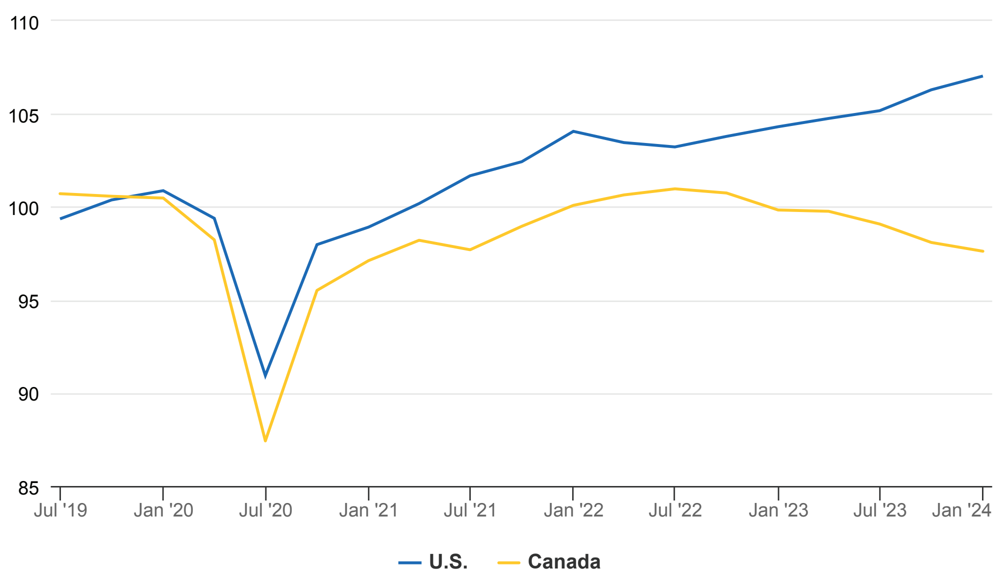
Economic activity also looks to be improving in the Euro area and the UK but from a much weaker starting point after a soft 2023. Meantime, broadly improving inflation trends in those regions are leaving our expectations unchanged from last month, that the ECB will cut rates earlier in June, to be followed by a BoE cut in August. The Canadian economic growth backdrop continues to significantly underperform. Canadian GDP is tracking stronger than the Bank of Canada (and we) were previously expecting in Q1, but still looks much less impressive when measured against surging population growth. And a rising unemployment rate – now up 1.3 percentage points from post-pandemic lows – has outpaced most other advanced economies and leaves the BoC with the strongest case of all the central banks we track to begin cutting interest rates.

Gap in U.S. vs. Canadian GDP (per-capita) widening

Per-capita GDP, Index = 100 in 2019



Source: Haver, RBC Economics

The gap in economic performance, particularly between Canada and the U.S., is increasing the odds that central bank policy decisions will need to diverge more than previously expected. We expect a growing gap between policy rates in Canada and the U.S., as weakening growth and inflation numbers prompt the BoC to cut rates before the Fed and at a more aggressive pace after. That could limit appreciation in the Canadian dollar even if, as we expect, broader demand for U.S. dollars begins to fade. But with the Canadian economy underperforming and the exchange rate less sensitive to interest rate differentials than it was in the past, the BoC should still be tolerant of any further weakening in the Canadian dollar.

Central bank bias

<table>
<tr><th>Central bank</th><th>Current policy rate
(latest move)</th><th>Next decision</th></tr>
<tr><td>BoC</td><td>5.00%
+0 bps in Apr/24</td><td>-25 bps
Jun/24</td></tr>
<tr><td colspan="3">The BoC as expected left the overnight rate unchanged in April while setting up the stage for a rate cut at its next meeting in June. Macklem in the press conference mentioned recent easing in inflation has “increased confidence that inflation will continue to come down gradually even as economic activity strengthens”. We continue to expect four cuts from the BoC this year at every meeting starting in June.</td></tr>
<tr><td>Fed</td><td>5.25-5.5%
+0 bps in Mar/24</td><td>0 bps
May/24</td></tr>
<tr><td colspan="3">Persistently strong macro and inflation data in the U.S. are posing significant risk to the Fed’s assessment that its dual mandate is coming into better balance. The urgency to move rates lower has been dissipating. And we expect a first cut later in December to be followed by two more over the first half of 2025. That’s less than the Fed’s latest March dot plot for three cuts this year.</td></tr>
<tr><td>BoE</td><td>5.25%
+0 bps in Mar/24</td><td>0 bps
May/24</td></tr>
<tr><td colspan="3">All but one member in the BoE’s MPC voted to keep the Bank Rate unchanged in March (the descent was for a cut). That’s more dovish that we expected but doesn’t in any way signal a cut. Still elevated services inflation and rising demand for both manufacturing and services activities will keep the BoE on a tight leash when it comes to upcoming rate decisions. We continue to expect a first cut in August.</td></tr>
<tr><td>ECB</td><td>4.00%
+0 bps in Mar/24</td><td>0 bps
Apr/24</td></tr>
<tr><td colspan="3">The ECB left the Deposit Rate unchanged in its March meeting with president Lagarde seemingly endorsing a rate cut in June (in line with our forecast). February’s euro area inflation data showed a lack of progress in the services components. But growth outlook also remains lackluster in Q1, and early data on wage agreements continues to signal further moderations, all pointing to more easing in price pressures to come.</td></tr>
<tr><td>RBA</td><td>4.35%
+0 bps in Mar/24</td><td>0 bps
May/24</td></tr>
<tr><td colspan="3">The RBA in March left the cash rate unchanged while continuing to inch towards a neutral stance by reigning in a very mild tightening bias. A full shift to neutral is not expected until the summer, given stronger than expected labour market data in February. Still, weakening in domestic demand and deterioration in labour markets have broadly persisted. That should drive the starting point of the easing cycle in Q4.</td></tr>
</table>

Strong U.S. inflation is lowering urgency at the Fed to cut rates

Persistently strong economic data out of the U.S. underpinned by a solid consumer demand backdrop continues to complicate the Fed's decision-making process. Buoyant equity markets, large fiscal tailwinds, and higher than expected population growth likely all played a role in propping up economic growth than otherwise expected.

That leaves a pivot to interest rate cuts this year more dependent on inflation pressures continuing to ease than in other regions. And inflation has now surprised on the upside for three straight months with underlying details pointing to a worrying broadening in price pressures that had eased significantly in 2023.

Excess demand in U.S. labour market is falling

Ratio of job openings to unemployment

Source: Bureau of Labor Statistics, RBC Economics

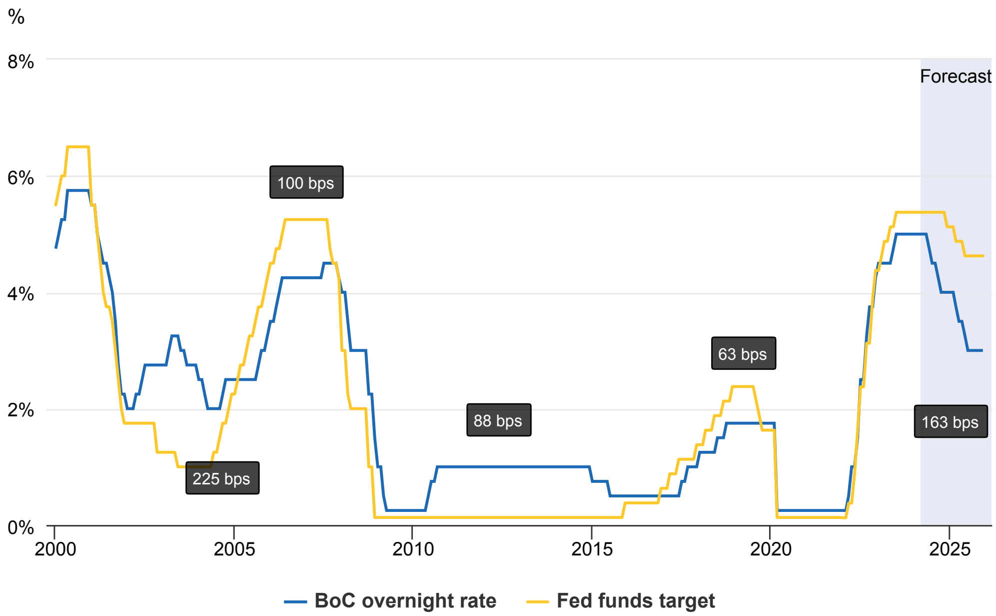
The Federal Reserve has largely, for now, stood by its assessment that risks associated with its dual mandate "continue to move into better balance". Labour markets have persistently surprised on the upside, but the Fed has pointed to lower quits rates, falling job openings, and moderating wage growth as signs that tight labour conditions are easing. And falling 'excess' demand means further declines in job openings are increasingly likely to push unemployment higher. But every additional strong inflation report is chipping away at expected Fed rate cuts this year.

We have revised up our U.S. GDP forecast this year given ongoing momentum in the demand side of the economy, but still expect a 'soft landing' where the unemployment rate edges higher from unusually low levels today, and inflation to ultimately slow alongside. But that also means inflation will be slower to subside and we now don't expect the Fed to cut rates until December.

The BoC can’t afford to play the same waiting game

A surprisingly large 0.6% surge in Canadian GDP in January has led us to revise our tracking of GDP growth in Q1 higher. But just how much of that represents an actual turnaround in activities remains debatable – over half of the January increase was driven by one-offs including the recovery from public sector strikes in Quebec in late 2023. Other measures of economic activity, including rising businesses insolvencies and surging unemployment are all still pointing to a weak economic backdrop. On an aggregate level, growth in Canadian population is also expected to slow substantially, following recent Federal government announcement to cap temporary resident arrivals. We have adjusted our GDP assumptions lower over the medium term accordingly.

BoC and Fed policy rates to diverge



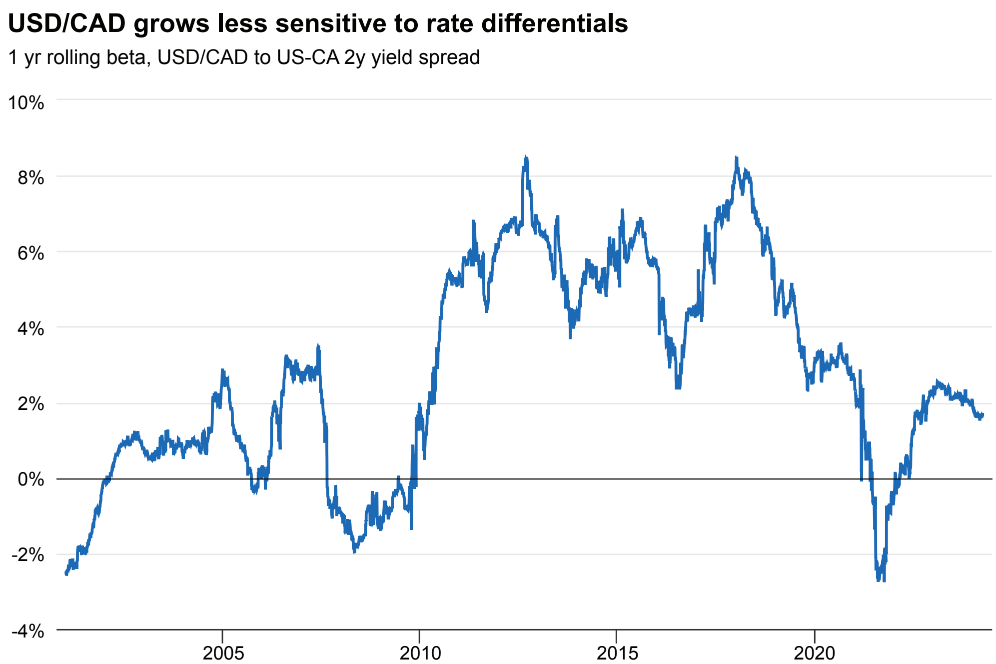
Source: Haver, RBC Economics

In an earlier iteration, we outlined how a weaker Canadian economy, but a more responsive Federal Reserve should on balance land the two central banks on a similar path for the upcoming easing cycle. A growing gap in economic performance since then warrants a divergence in those rate paths.

Already, the Bank of Canada has been unusually slow to react to a higher unemployment rate than in the past. The main reason for that is that the central bank has been badly missing the 2% inflation target. But there are growing signs that inflation readings in Canada are following economic (per-capita) growth numbers lower – closely-watched three-month annualized growth rates in the BoC’s preferred CPI trim and CPI median averaged 2.2% in February. Contingent on those trends persisting, we expect the BoC will cut rates more aggressively than the Fed beyond the starting point, both in this year and next.

Gap in policy rate and a weaker CAD more likely to be tolerated by BoC, with the economy underperforming

A more aggressive easing cycle expected from the Bank of Canada leaves our forecast for the BoC policy rate 113 basis points lower than the Fed Funds target by the end of this year. That gap will continue to widen, to 163 bps by the end of 2025. That is a large gap by historical standards, but not unprecedented. The gap in policy rates has widened in each of the last four interest rate cycles, including in the early 2000s when the gap widened substantially (to 225bps) due to Canadian economic outperformance at the time during the U.S. dot com bust.



Source: Bank of Canada, Federal Reserve Board, RBC Economics

The divergence in rate paths is likely to take some of the steam out of what's been expected to be a modestly appreciating Canadian dollar this year and next, as broader USD strength starts unwinding. But we don't expect that course to be outright reversed, especially given smaller elasticity of USD/CAD returns to term interest rate differentials since pre-pandemic 2019. Furthermore, given a long-run shift in domestic consumption to services a weakening CAD won't have as big of an impact on consumer prices as it once might have. That should limit the role it plays, when it comes to influencing BoC's monetary policy decisions in the period ahead.

ECB eyes June cut; BoE still some distance away

The ECB has been sending off clearer signals, including in its last March meeting that rate cuts are likely to start in June. Muddying that outlook are sticky services inflation readings – services HICP in the euro area has been stuck at around 4% since November last year and has shown signs of accelerating into March of 2024. Survey data in the area has broadly echoed those developments – demand for services looks to have strengthened further into Q1 as new orders rose higher. That was partially offset by weaker manufacturing activity and leave our expectation for output growth in Q1 not significantly different from 0%. Sluggish growth momentum, alongside moderating wage gains according to ECB's tracking of wage negotiations should all mean that inflation in the euro area is still more likely to ease further. We look for the ECB to start cutting rates in June, and twice more later this year that will leave the deposit rate at 3.25% by the end of 2024.

Unlike the euro area, early survey data was already pointing to a rebound in U.K. manufacturing activity in early 2024. Services activity in the meantime also remained strong. Output in January edged up 0.2% and leaves our tracking for Q1 GDP overall higher at +0.2% above last quarter. U.K. inflation data in the meantime continues to flag broad-based easing in price pressures, especially in the services component that BoE pays close attention to. The reading of services CPI itself however, at 6.1% in February was still more elevated comparing to other regions. In the BoE's March meeting, the MPC surprised with a vote split of 8-1 (8 for a hold and 1 for a cut) that was more dovish that we expected. We think easing in policy is on the horizon but continue to expect it will take longer for the majority of the committee to turn around and vote for a rate cut, and expect that to happen later in August to be followed by cuts at every meeting after will leave the bank rate 100bps lower this year.

Interest rate outlook

Policy rates and government bond yields, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
Canada												
Overnight rate	4.50	4.75	5.00	5.00	5.00	4.75	4.25	4.00	3.75	3.25	3.00	3.00
Three-month	4.34	4.90	5.07	5.04	4.99	4.65	4.10	3.95	3.60	3.20	3.00	3.00
Two-year	3.74	4.58	4.87	3.88	4.22	3.80	3.50	3.25	2.90	2.75	2.90	3.00
Five-year	3.02	3.68	4.25	3.17	3.58	3.30	3.10	3.00	2.85	2.90	2.90	3.00
10-year	2.90	3.26	4.03	3.10	3.52	3.25	3.10	3.00	2.90	2.95	3.00	3.10
30-year	3.02	3.09	3.81	3.02	3.41	3.25	3.15	3.05	3.00	3.05	3.10	3.15
United States												
Fed funds midpoint	4.88	5.13	5.38	5.38	5.38	5.38	5.38	5.13	4.88	4.63	4.63	4.63
Three-month	4.85	5.43	5.55	5.40	5.45	5.21	5.23	4.98	4.78	4.53	4.53	4.53
Two-year	4.06	4.87	5.03	4.23	4.66	5.05	5.05	4.90	4.80	4.70	4.70	4.75
Five-year	3.60	4.13	4.60	3.84	4.28	4.60	4.60	4.45	4.35	4.35	4.40	4.50
10-year	3.48	3.81	4.59	3.88	4.27	4.45	4.40	4.30	4.25	4.30	4.40	4.50
30-year	3.67	3.85	4.73	4.03	4.41	4.50	4.45	4.50	4.55	4.60	4.70	4.80
United Kingdom												
Bank rate	4.25	5.00	5.25	5.25	5.25	5.25	4.75	4.25	4.00	3.75	3.75	3.75
Two-year	3.42	5.27	4.91	3.98	4.17	4.40	4.30	4.15	4.00	3.90	4.00	4.00
Five-year	3.33	4.66	4.53	3.46	3.84	3.90	3.80	3.60	3.50	3.55	3.60	3.65
10-year	3.47	4.39	4.46	3.54	3.95	4.00	3.90	3.75	3.70	3.75	3.85	3.95
30-year	3.82	4.42	4.92	4.14	4.49	4.70	4.60	4.50	4.50	4.60	4.70	4.85
Euro area*												
Deposit Rate	3.00	3.50	4.00	4.00	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
Two-year	2.66	3.27	3.20	2.40	2.83	2.70	2.70	2.60	2.50	2.40	2.30	2.30
Five-year	2.30	2.58	2.79	1.94	2.32	2.40	2.30	2.20	2.15	2.20	2.20	2.25
10-year	2.28	2.39	2.85	2.03	2.29	2.40	2.35	2.20	2.20	2.20	2.25	2.30
30-year	2.35	2.38	3.05	2.27	2.46	2.60	2.50	2.50	2.50	2.50	2.60	2.70
Australia												
Cash target rate	3.60	4.10	4.10	4.35	4.35	4.35	4.35	3.85	3.35	3.35	3.35	3.35
Two-year	2.95	4.21	4.08	3.70	3.76	3.65	3.55	3.50	3.50	3.50	3.65	3.80
10-year	3.29	4.02	4.48	3.95	3.96	3.95	3.80	3.80	3.80	3.80	3.95	4.05
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.00	4.50	4.00	4.00	4.00	4.00
Two-year swap	5.01	5.46	5.69	4.63	4.78	4.75	4.40	4.25	4.25	4.25	4.30	4.35
10-year swap	4.27	4.46	5.13	4.12	4.35	4.40	4.30	4.25	4.30	4.45	4.50	4.60

Sources: Refinitiv, BoC, Fed, BoE, ECB, RBA, RBNZ, RBC Economics, RBC Capital Markets | *German government bond yields

Economic outlook

Real GDP, quarter-over-quarter percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada*	3.9	3.8	1.8	-0.9	2.6	0.6	-0.5	1.0	2.5	1.4	1.4	1.8	1.8	1.8	2.0	2.1	5.3	3.8	1.1	1.3	1.8
United States*	-2.0	-0.6	2.7	2.6	2.2	2.1	4.9	3.4	2.5	2.0	1.0	1.2	1.8	1.8	1.8	1.8	5.8	1.9	2.5	2.6	1.6
United Kingdom	0.5	0.1	-0.1	0.1	0.2	0.0	-0.1	-0.3	0.2	0.1	0.2	0.2	0.3	0.3	0.3	0.3	8.7	4.3	0.1	0.2	1.1
Euro area	0.6	0.8	0.5	0.0	0.0	0.1	-0.1	0.0	0.0	0.1	0.2	0.3	0.3	0.4	0.4	0.4	5.9	3.5	0.5	0.2	1.2
Australia	0.5	0.8	0.2	0.8	0.6	0.5	0.3	0.2	0.2	0.4	0.6	0.7	0.8	0.8	0.8	0.7	5.6	3.8	2.1	1.4	2.9

*annualized

Inflation, year-over-year percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada	5.8	7.5	7.2	6.7	5.1	3.5	3.7	3.2	2.9	2.8	2.3	2.0	2.0	2.0	1.9	1.8	3.4	6.8	3.9	2.5	1.9
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.2	3.2	3.3	3.0	2.8	2.3	2.0	2.0	1.9	4.7	8.0	4.1	3.1	2.0
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.2	4.3	2.8	2.9	2.7	2.2	1.7	1.9	1.8	2.6	9.1	7.3	3.2	1.9
Euro area	6.1	8.0	9.3	10.0	8.0	6.2	5.0	2.7	2.6	2.5	2.1	2.4	2.2	2.2	2.2	2.1	2.6	8.4	5.4	2.4	2.2
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.4	4.1	3.5	3.4	2.9	3.1	3.0	2.9	2.9	2.8	2.9	6.6	5.6	3.2	2.9

Sources: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics, RBC Capital Markets

Currency outlook

US dollar cross rates, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
USD/CAD	1.35	1.32	1.35	1.32	1.35	1.37	1.35	1.33	1.34	1.33	1.34	1.33
EUR/USD	1.09	1.09	1.06	1.11	1.08	1.06	1.06	1.08	1.09	1.08	1.09	1.08
GBP/USD	1.24	1.27	1.22	1.27	1.26	1.25	1.23	1.24	1.24	1.21	1.21	1.19
USD/JPY	133	144	149	141	151	150	152	154	156	154	152	150
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.64	0.65	0.66	0.67	0.69	0.70	0.72

Canadian dollar cross rates

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
EUR/CAD	1.47	1.44	1.43	1.46	1.46	1.45	1.43	1.44	1.46	1.44	1.46	1.44
GBP/CAD	1.67	1.68	1.65	1.68	1.71	1.71	1.66	1.65	1.66	1.61	1.62	1.58
CAD/JPY	98	109	110	107	112	109	113	116	116	116	113	113
AUD/CAD	0.91	0.88	0.87	0.90	0.88	0.88	0.88	0.88	0.90	0.92	0.94	0.96

Sources: Federal Reserve Board, Bank of Canada, RBC Economics, RBC Capital Markets