RBC ECONOMIC RESEARCH

FINANCIAL MARKETS MONTHLY

August 10, 2018

Pushing the pace

A slow start to the year across the G7 raised concerns that 2017's pickup in global growth would prove short-lived. Some economies rebounded strongly in the second quarter—perhaps unsustainably so—while others have fallen short of expectations. US GDP growth surged to 4% in Q2, the fastest since 2014, and Canada's economy appears to have doubled the first quarter's pace. Exports contributed to the pickup in Canada and the US though that will be hard to repeat if trade barriers continue to rise. Tariffs are hardly welcomed, but with both economies already pushing up against capacity limits, more moderate GDP growth is arguably desirable. We think the Fed and Bank of Canada are likely to continue removing accommodation over the second half of the year in an effort to keep inflationary pressure at bay.

Growth in the UK also ticked higher after a weather-related slowdown in Q1. That was enough for the Bank of England to raise rates in August for the first time this year. We think they'll hold off on further tightening until we get more clarity on the direction of Brexit talks, which as Governor Carney said, are now entering a critical phase. In the euro zone, Q2 growth fell short of expectations and the previous quarter's pace. We still think activity will strengthen over the second half of the year, but 2017's impressive increase won't be repeated.

Sustained tightening by North American central banks has been reflected in fixed income and currency markets. US 10-year Treasury yields were once again testing the 3% mark and Canadian bonds have sold off after outperforming earlier in the summer. UK and German spreads, meanwhile, continued to tighten relative to US Treasuries. The Canadian dollar has held its own recently, while the euro and sterling are at their weakest levels of the year against the resurgent US dollar.

Central bank near-term bias

A run of solid economic data has raised the prospect of the Bank of Canada raising rates again as soon as September. But we think their gradual approach to tightening will have them favouring a move in October.

The Fed's latest meeting was largely a non-event. Minor changes in the policy statement focused on the economy's 'strong' performance and seemed to tee up a September rate hike.

The Bank of England met expectations by raising rates in August though a unanimous vote was stronger than expected. Further tightening is expected to be very gradual and timing of the next move will likely be contingent on Brexit negotiations, which are entering their final stages.

July's European Central Bank meeting was one of the most uneventful in recent memory as the path of monetary policy has largely been laid out for the next year. We continue to expect a gradual rise in interest rates will be initiated in Q3/19.

The Reserve Bank of Australia was likely pleased with recent domestic data but concerned with rising global trade tensions and slower growth in China. Monetary policy looks set to remain on hold this year.

Josh Nye | Senior Economist | 416-974-3979 | josh.nye@rbc.com

Highlights

▲ Following a somewhat disappointing start to the year, US Q2 GDP growth was the strongest since 2014.

▲ Solid domestic spending is expected to keep the US economy growing at an above-trend pace over the second half of the year.

▲ Trade tensions continue to escalate, particularly between the US and China.

▲ The Fed left rates unchanged in August but all signs point to a hike in September.

US posts strongest quarterly growth in four years

Q2's advance GDP report lived up to high expectations with a 4.1% annualized increase that ranks among the fastest in the last decade. The economy was firing on all cylinders with domestic demand up almost 4%, led by a rebound in consumer spending and another solid increase in business investment. A nearly-10% rise in exports also helped, though that's not likely to be sustained amid growing trade tensions. A number of countries implemented counter-tariffs on US goods in June and July, and there was already evidence of exports tapering off toward the end of the quarter. But while trade isn't expected to provide the support it did in Q2, we think domestic spending will remain strong in the coming quarters. Both business and consumer sentiment remain near cycle highs despite the threat of higher prices posed by tariffs (and for businesses a potential pullback in external demand). We think solid gains in consumer spending and nonresidential investment will keep the economy growing at an above-trend pace (just short of 3%) over the second half of the year. That would push the US economy further into excess demand, which raises the risk of inflationary pressure picking up.

Trade tensions remain a downside risk…

Trade tensions continue to dominate headlines with both positive and negative signals from US policymakers of late. Nafta negotiations have been on hold since Mexico's July 1 presidential election but bilateral talks between the US and Mexico, focusing on the auto sector, are reportedly making progress. US proposals that seek to reduce the trade deficit in autos with Mexico have been a sticking point in Nafta talks, so a resolution of the issue would be a positive step toward a new agreement. Trilateral talks are expected to resume in August and some have speculated that a deal could be reached by the end of the month. But we note that similar optimism in May turned into disappointment when the US refused to back down on several contentious demands—and there have been few signs thus far that negotiators are giving way on issues like dispute resolution, supply management and a sunset clause.

Relations with trading partners outside North America have been mixed. An agreement with the EU to not escalate tariffs, while light on details, was a welcomed improvement in the two economic powers' recently strained relationship. The same cannot be said for US-China relations. In July the US raised tariffs on $34 billion in Chinese imports (to which China responded in kind) and this month duties on an additional $16 billion in goods will take effect. There were reports that a dialogue was opening up between the two countries in an effort to reduce tensions. But those hopes were dashed when the US threatened even more punitive tariffs on an additional $200 billion in Chinese imports.

…but won't keep the Fed from raising rates in September

The Fed's August meeting was largely a non-event with rates held steady and only minor tweaks to the policy statement reflecting the latest data. Those few changes leaned hawkish—a sign the next rate increase isn't far off. Looking ahead to September the case for a hike is, to borrow a word the Fed used five times in August, 'strong.' US GDP growth has trended steadily higher on a year-over-year basis since mid-2016 and was sitting at 2.8% in Q2. That is well above the pace of potential output growth—in an economy that is already pushing up against capacity limits. Core inflation has been close to or above the Fed's 2% objective for several months. The labour market remains strong, and while it would be a stretch to say wages are taking off, pay growth has picked up this year. As noted above, tariffs remain a downside risk to the US economy. But the Fed's scant mention of trade issues in August speaks to their limited impact thus far. Unless tensions ratchet up significantly or start to dent the outlook more noticeably we think the Fed will continue to steadily scale back accommodation. We expect two more rate increases over the second half of the year, and look for 100 basis points of hikes in 2019 as well.

Canada's economy impressed in May…

Canadian GDP rose 0.5% in May, well ahead of expectations for a 0.3% increase. Some of the strength reflected reversal of temporary factors that held growth to 0.1% in the previous month. Retail and construction activity both rebounded following weather-related declines and oil and gas output picked up after shutdowns in April. But May's growth was also broadly-based with 19 of 20 industries recording month-over-month gains—the most widespread increase in more than a decade. The strong report raised our Q2 GDP growth forecast to 3%, which would more than double the disappointing increase recorded in Q1. We think the recent pickup reflected a rebound in consumer spending after a soft start to the year, as well as less drag from housing. Exports, which were held down by temporary issues in Q1, also provided significant support (more on that below). Over the second half of the year those sectors will face headwinds from rising interest rates, tariffs and trade uncertainty. We expect GDP growth will be slightly slower on balance with an average increase of just less than 2% in Q3 and Q4. That should keep the economy from pushing too far beyond its longer run capacity—which the Bank of Canada should see as a positive development.

…and the trade deficit shrank in June despite new tariffs

June's international trade report gave us our first look at how US tariffs are impacting Canada's steel and aluminum industries. Steel exports to the US fell by more than a third, while aluminum was less impacted with shipments south of the border falling 7%. But it's worth noting that June's decline follows strong growth between February and May when tariffs were threatened but not yet implemented. So some of the drop-off may simply reflect US purchasers having stocked up in preparation for tariffs. Relative to last year, June's steel exports were down a more moderate 14% and aluminum exports were actually 10% higher. The Bank of Canada has assumed tariffs will lower steel and aluminum exports by roughly 20% over the second half of the year. If that is the case we'll likely see further declines in the coming months.

Notwithstanding lower steel and aluminum exports, June's trade report was quite impressive. Canada's trade deficit shrank dramatically on a broadly-based increase in exports. That capped off a strong quarter for exporters with volumes up a whopping 16% (annualized) in Q2, the strongest pace in four years. We now expect net trade added a full 2 percentage points to Canadian GDP growth in the second quarter.

Another surprise BoC hike in September? We don't think so

An upbeat tone from the Bank of Canada at their July meeting—when they raised rates for the fourth time in a year—improved our confidence that we'd see another hike before 2019. Recent data have also supported that call. When the central bank updated their projections in July their forecast for Q2 GDP to rise 2.8% looked ambitious. But as noted above, May's GDP reported now has us monitoring an even stronger increase. June's CPI report was also firmer than expected with headline inflation running at the fastest pace in more than six years. Upside surprises on growth and inflation have raised the prospect of the BoC hiking rates again as soon as September. That would follow the pattern seen last year when a well-telegraphed rate increase in July was followed by a more surprising move in September.

Will history repeat itself? We don't think so. Back-to-back moves would go against the bank's guidance that tightening will be gradual. Last year was also a somewhat different case as the 50 basis points of rate hikes delivered over the summer could be seen as simply reversing cuts made during the oil price downturn. So even as recent data point to less need for stimulative monetary policy, we think the BoC will be patient this time around and wait until October to raise the overnight rate. Interestingly—and in contrast to the BoC's silence last summer—two panel appearances by Governor Poloz and Senior Deputy Governor Wilkins in late-August offer an opportunity to talk up a September move if Governing Council is so inclined.

Highlights

▲ May's impressive GDP report lifted our Q2 growth forecast to 3%.

▲ Steel and aluminum tariffs weighed on exports in June, but gains in other sectors helped the trade deficit shrink significantly.

▲ A string of solid economic data have raised the prospect of back-to-back hikes from the BoC in a repeat of last summer…

▲ …but we think the central bank's gradual approach to tightening will see them hold off until October.

Highlights

▲ The BoE's August hike was expected, but the unanimous decision was not.

▲ Future BoE rate hikes will likely depend on the direction of Brexit negotiations.

▲ We continue to expect euro area GDP growth will pick up over the second half of this year—but remain short of 2017's pace.

▲ Australian employment growth is trending higher after a slow start to the year.

Bank of England raises rates in unanimous vote

The Bank of England raised rates in August for the second time in the past year, lifting Bank Rate to its highest level since 2009. The move was fully anticipated though the MPC's unanimous vote was stronger than markets expected (last November's hike saw two dissents). In their decision, policymakers noted recent economic data were in line with their forecasts from May. In particular, monthly GDP growth showed economic activity picked up in Q2, seeming to confirm the view that weakness earlier this year was largely weather-related. Labour market data have also been supportive—job growth was robust in the three months to May and the unemployment rate remains at a 40-year low, pointing to limited economic slack. Wage growth is running slightly slower than expected at this point in the cycle but the BoE seemed to put more weight on their survey of businesses that has indicated rising wage pressures. The central bank continued to signal that limited and gradual tightening will be needed over the coming years to keep inflation on target.

The outlook for further rate increases rests on the central bank's assumption for a 'smooth' outcome in Brexit negotiations. That is looking increasingly optimistic heading into what could be the final round of talks between the UK and EU. Even if an agreement between the two sides can be reached, it's not clear UK parliament would ratify the deal given dissent within PM May's own party to her soft Brexit approach. BoE Governor Carney noted in August that the likelihood of a 'no deal' Brexit scenario is "uncomfortably high." We think how negotiations evolve in the coming months will be key to when (or if) the BoE next raises rates. For now our forecast assumes another hike early next year.

Euro area's lacklustre growth continued in Q2

Euro area GDP fell short of expectations with a 0.3% increase in Q2, which is down slightly from the previous quarter's 0.4% gain. That leaves growth over the first half of the year at roughly half of 2017's pace. A slowdown in France, the currency bloc's second largest economy, was partly to blame. That reflected some temporary factors that we think will be reversed in the coming quarters. Survey data continue to point to a slightly stronger backdrop, and we expect growth will rebound to a 0.5% pace in the second half of the year. While that would still be down from last year, it represents an above-trend rate (in contrast to the first half of 2018) that should further absorb slack in the economy. Euro area inflation rose above 2% for the first time since 2012 though core inflation remains well below the European Central Bank's target. The recent, albeit modest, pickup in wage growth supports the ECB's expectation that underlying inflation will firm over the medium term. The central bank's policy path has been more or less set out for the coming months—net asset purchases will be trimmed to zero by the end of this year and rate hikes are off the table at least through next summer. If growth improves over the second half of the year as expected we think the ECB will begin raising interest rates in the third quarter of 2019.

Reserve Bank of Australia outlook little changed

The Reserve Bank of Australia held monetary policy steady in August, making it two years the cash rate has been at a record low of 1.50%. The policy statement noted economic forecasts remain unchanged with a return to above-trend growth, full employment and within-target inflation expected over the medium term. The RBA is likely more confident in their forecast for labour market slack to be gradually absorbed following the latest jobs data—hiring picked up strongly in June, suggesting a weak start to the year for employment growth was temporary. The RBA's statement was also tweaked to note slowing growth in China, an important trading partner. We expect the domestic labour market and global developments will be key to the monetary policy outlook, and with the two pulling in opposite directions we think the central bank will remain on hold for now. Our forecast assumes 50 basis points of rate hikes in the first half of 2019, but escalating trade tensions abroad raise the risk that any tightening is put off until later next year.

Interest rate outlook

%, end of period

	Actuals						Forecast					
	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
Canada												
Overnight	0.50	0.50	1.00	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.25
Three-month	0.52	0.71	1.00	1.06	1.10	1.26	1.40	1.65	1.90	2.15	2.15	2.15
Two-year	0.75	1.10	1.52	1.69	1.78	1.91	2.10	2.30	2.45	2.45	2.40	2.35
Five-year	1.12	1.40	1.75	1.87	1.97	2.07	2.25	2.45	2.55	2.65	2.70	2.70
10-year	1.62	1.76	2.10	2.04	2.09	2.17	2.35	2.60	2.70	2.80	2.90	2.95
30-year	2.30	2.14	2.47	2.27	2.23	2.20	2.45	2.70	2.80	2.90	3.00	3.00
United States												
Fed funds**	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.50
Three-month	0.76	1.03	1.06	1.39	1.73	1.93	2.15	2.35	2.65	2.90	3.15	3.35
Two-year	1.27	1.38	1.47	1.89	2.27	2.52	2.65	2.80	3.00	3.25	3.40	3.55
Five-year	1.93	1.89	1.92	2.20	2.56	2.73	2.95	3.10	3.25	3.45	3.55	3.65
10-year	2.40	2.31	2.33	2.40	2.74	2.85	3.15	3.30	3.45	3.60	3.70	3.75
30-year	3.02	2.84	2.86	2.74	2.97	2.98	3.35	3.50	3.65	3.75	3.80	3.85
United Kingdom												
Bank rate	0.25	0.25	0.25	0.50	0.50	0.50	0.75	0.75	1.00	1.00	1.00	1.25
Two-year	0.12	0.36	0.46	0.45	0.82	0.72	0.80	0.95	1.00	1.05	1.10	1.15
10-year	1.14	1.26	1.38	1.19	1.34	1.28	1.60	1.75	2.00	2.10	2.20	2.30
Euro area												
Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.20
Two-year	-0.74	-0.57	-0.69	-0.63	-0.59	-0.69	-0.60	-0.50	-0.50	-0.50	-0.40	-0.30
10-year	0.33	0.47	0.47	0.43	0.50	0.31	0.70	0.80	1.00	1.05	1.25	1.25
Australia												
Cash target rate	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	2.00	2.00	2.00
Two-year	1.76	1.78	1.94	2.00	2.00	2.00	2.20	2.25	2.30	2.50	2.60	2.60
10-year	2.70	2.60	2.84	2.63	2.60	2.63	2.90	3.15	3.30	3.60	3.85	4.00
New Zealand												
Cash target rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00
Two-year swap	2.31	2.32	2.19	2.20	2.21	2.14	2.40	2.50	2.60	2.75	2.80	2.80
10-year swap	3.41	3.35	3.24	3.13	3.06	3.02	3.50	3.60	3.75	3.85	4.10	4.25
Yield curve*												
Canada	87	66	58	35	31	26	25	30	25	35	50	60
United States	113	93	86	51	47	33	50	50	45	35	30	20
United Kingdom	102	90	92	74	52	56	80	80	100	105	110	115
Eurozone	107	104	116	106	109	100	130	130	150	155	165	155
Australia	94	82	90	63	60	63	70	90	100	110	125	140
New Zealand	110	103	105	93	85	88	110	110	115	110	130	145

* Two-year/10-year spread in basis points, **Top of 25 basis point range

Source: Reuters, RBC Economics Research

Central bank policy rate

%, end of period

		Current	Last				Current	Last	
United States	Fed funds	1.75-2.00	1.50-1.75	June 13, 2018	Eurozone	Deposit rate	-0.40	-0.30	March 10, 2016
Canada	Overnight rate	1.50	1.25	July 11, 2018	Australia	Cash rate	1.50	1.75	August 3, 2016
United Kingdom	Bank rate	0.75	0.50	August 1, 2018	New Zealand	Cash rate	1.75	2.00	November 10, 2016

Source: Bloomberg, Reuters, RBC Economics Research

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	2016	2017	2018F	2019F
Canada*	4.0	4.6	1.7	1.7	1.3	3.0	1.6	2.3	1.8	1.7	1.7	1.7	1.4	3.0	2.0	1.9
United States*	1.8	3.0	2.8	2.3	2.2	4.1	2.8	2.8	1.8	2.4	2.2	1.8	1.6	2.2	2.8	2.4
United Kingdom	0.4	0.2	0.4	0.4	0.2	0.4	0.3	0.4	0.3	0.4	0.3	0.4	1.8	1.7	1.3	1.4
Euro area	0.6	0.7	0.7	0.7	0.4	0.3	0.5	0.5	0.4	0.4	0.4	0.4	1.8	2.5	2.1	1.7
Australia	0.3	1.0	0.5	0.5	1.0	0.5	0.8	0.7	0.8	0.7	0.9	0.9	2.6	2.2	2.9	3.0
New Zealand	0.8	0.9	0.6	0.6	0.5	0.8	0.9	0.8	0.8	0.8	0.8	0.8	4.0	2.8	2.8	3.3

*annualized

Inflation outlook

% change, year-over-year

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	2016	2017	2018F	2019F
Canada	1.9	1.3	1.4	1.8	2.1	2.3	2.7	2.7	2.3	2.7	2.4	2.2	1.4	1.6	2.4	2.4
United States	2.5	1.9	2.0	2.1	2.2	2.7	2.7	2.6	2.4	2.6	2.6	2.5	1.3	2.1	2.6	2.5
United Kingdom	2.2	2.8	2.8	3.0	2.7	2.4	2.6	2.5	2.3	2.2	2.2	2.0	0.6	2.7	2.6	2.2
Euro area	1.8	1.5	1.4	1.4	1.3	1.7	1.9	1.7	1.7	1.4	1.5	1.5	0.2	1.5	1.6	1.5
Australia	2.1	1.9	1.8	1.9	1.9	2.1	2.2	2.2	2.3	2.5	2.6	2.7	1.3	1.9	2.1	2.5
New Zealand	2.1	1.7	1.9	1.6	1.1	1.5	1.9	1.6	1.6	1.6	1.6	1.7	0.7	1.9	1.6	1.6

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 Research

Inflation tracking

Inflation Watch

	Measure	Current period	Period ago	Year ago	Three-month trend	Six-month trend
Canada	CPI ex food & energy[1]	Jun	0.2	1.8	0.7	2.0
United States	Core PCE[1,2]	Jun	0.1	1.9	2.0	2.1
United Kingdom	All-items CPI	Jun	0.0	2.4	3.5	2.1
Euro area	All-items CPI[1]	Jul	0.2	2.1	3.0	2.0
Australia	Trimmed mean CPI[1]	Q2	0.5	1.9	N/A	N/A
New Zealand	All-items CPI	Q1	0.5	1.1	N/A	N/A

1 Seasonally adjusted measurement.
2 Personal consumption expenditures less food and energy price indices.

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

Currency outlook

Level, end of period

	Actuals						Forecast					
	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
Canadian dollar	1.33	1.30	1.25	1.26	1.29	1.31	1.30	1.28	1.26	1.26	1.27	1.28
Euro	1.07	1.14	1.18	1.20	1.23	1.17	1.16	1.12	1.14	1.16	1.18	1.20
U.K. pound sterling	1.26	1.30	1.34	1.35	1.40	1.32	1.27	1.20	1.23	1.25	1.27	1.29
New Zealand dollar	0.70	0.73	0.72	0.71	0.72	0.68	0.69	0.70	0.70	0.71	0.72	0.72
Japanese yen	111.4	112.4	112.5	112.7	106.3	110.8	112.0	115.0	117.0	119.0	122.0	125.0
Australian dollar	0.76	0.77	0.78	0.78	0.77	0.74	0.73	0.70	0.71	0.72	0.73	0.73

Canadian dollar cross-rates

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
EUR/CAD	1.42	1.48	1.47	1.51	1.59	1.53	1.51	1.43	1.44	1.46	1.50	1.54
GBP/CAD	1.67	1.69	1.67	1.70	1.81	1.74	1.66	1.54	1.54	1.57	1.61	1.65
NZD/CAD	0.93	0.95	0.90	0.89	0.93	0.89	0.90	0.90	0.88	0.89	0.91	0.92
CAD/JPY	83.7	86.7	90.2	89.6	82.4	84.3	86.2	89.8	92.9	94.4	96.1	97.7
AUD/CAD	1.02	1.00	0.98	0.98	0.99	0.97	0.95	0.90	0.89	0.91	0.93	0.93

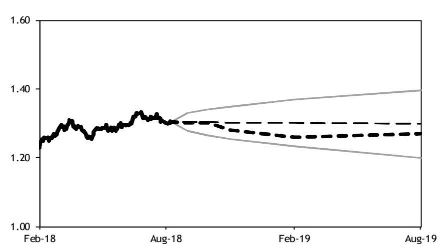
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

Source: Bloomberg, RBC Economics Research

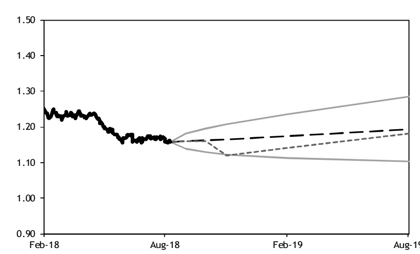
RBC Economics outlook compared to the market

The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.

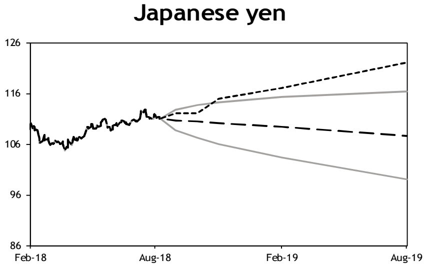
Canadian dollar



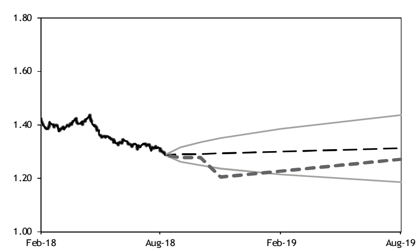
Euro



Japanese yen



U.K. pound

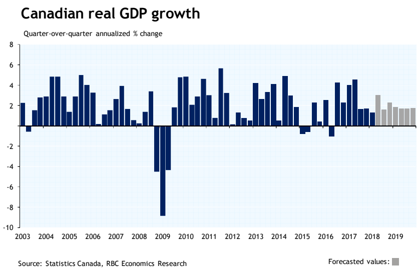


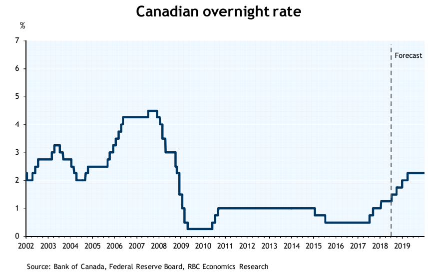
Central bank watch

Bank of Canada

With a broadly-based increase in May GDP we are now tracking 3% annualized growth in Q2. That would be a touch stronger than the BoC's forecast, and comes amid upside surprises on inflation and trade as well.

While recent data have impressed, we continue to think the BoC will wait until October to raise rates again—in keeping with their 'gradual' guidance.

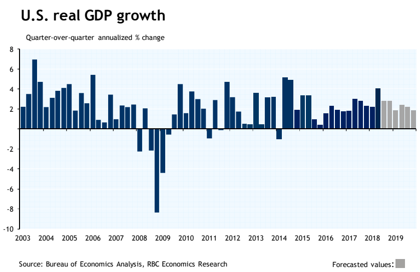


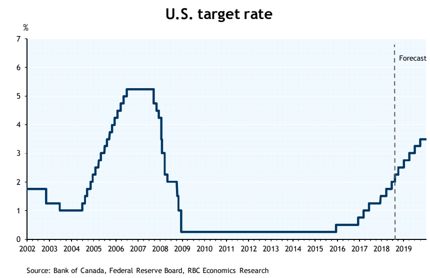


Federal Reserve

US Q2 GDP met lofty expectations with growth picking up to 4%. Gains in consumer spending, business investment and exports all contributed.

The August FOMC statement made a nod to the Q2 GDP report, noting economic activity has been rising at "strong rate." They held off on raising interest rates—in keeping with the pattern of once-a-quarter hikes—but a move in September looks very likely.

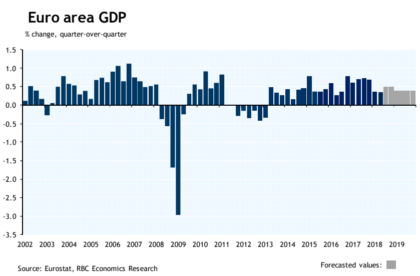


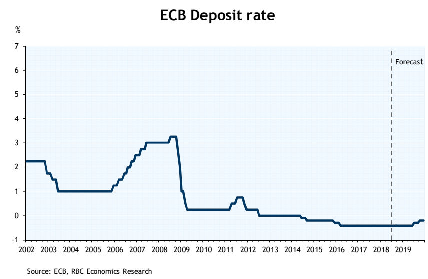


European Central Bank

The euro area's Q2 rebound didn't materialize, falling short of consensus and ECB expectations. But survey data continue to point to slightly stronger growth heading into the second half of the year.

The ECB's June policy statement largely set the course for monetary policy over the next year. Their forward guidance is consistent with our forecast for the first rate hike to come in Q3/19.

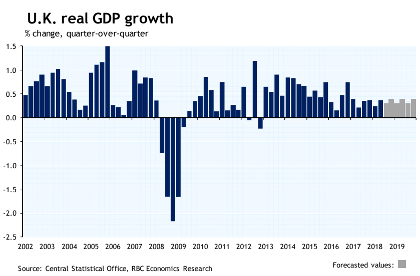


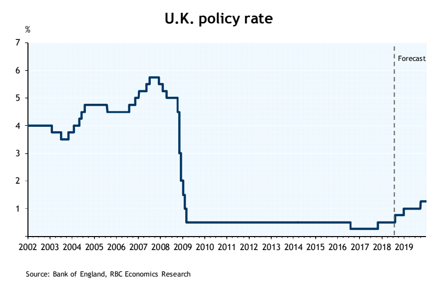


Bank of England

UK GDP growth rebounded to a 0.4% non-annualized pace in Q2, doubling Q1's weather-dampened increase.

With recent data coming in line with the BoE's forecast, they met expectations by raising rates in August. That was the first hike since November, and further increases are likely to be gradual—and contingent on Brexit negotiations.

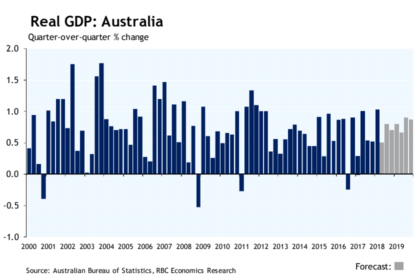


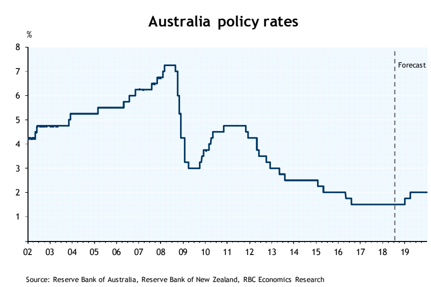


Australia

Recent data have been generally positive but the RBA saw little reason to change their forecasts. The central bank continues to expect a return to full employment and within-range inflation over the medium term.

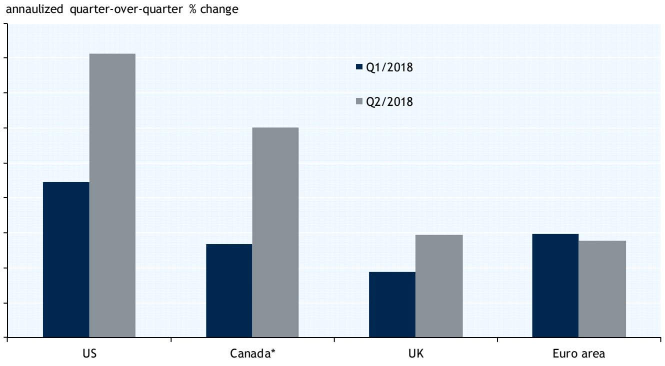
We think labour market and global developments will be key to the direction of monetary policy. With the two currently pulling in opposite directions we think the cash rate will remain on hold this year.





US economy leading the way in growth, FX and interest rates

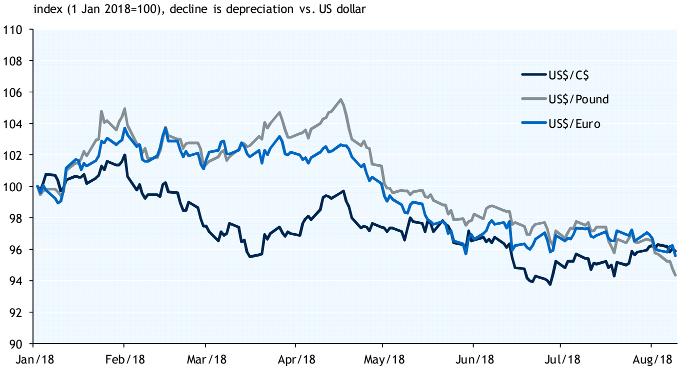
Both Canada and the US saw a strong rebound in Q2 GDP growth after disappointing Q1 gains. Activity also picked up in the UK but fell short of expectations in the euro area. With their economies at full capacity, central banks in the US, UK and Canada have all raised interest rates in recent months.



GDP growth in H1/18

*Q2/18 is RBC forecast (actual GDP data available through May)
Source: Statistics Canada, BEA, ONS, EuroStat, RBC Economics Research

The Canadian dollar, UK pound and Euro are all down 4-6% relative to the US dollar this year. But Canada's currency has rallied recently amid solid economic data and higher oil prices, while the pound and Euro have depreciated and are at year-to-date lows.



Canadian dollar, UK pound and Euro vs. US dollar

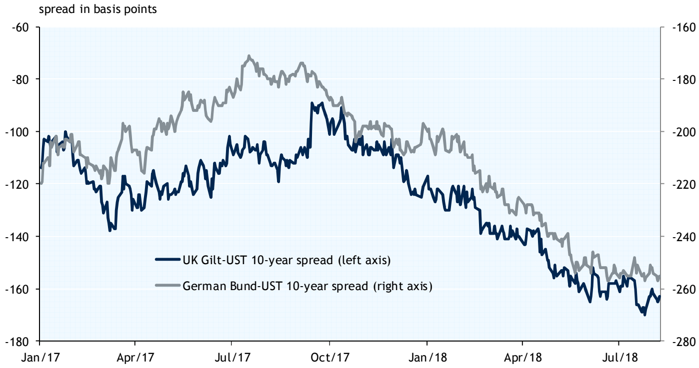
Source: Wall Street Journal, RBC Economics Research

US 10-year Treasuries were re-testing the 3% mark. Canadian yields failed to keep up when US yields rose earlier this year, but with markets increasingly convinced that the Bank of Canada will continue to raise rates, Canadian bonds have sold off alongside their US equivalents.

UST 10-year and Canada-US spread

Source: Reuters, US Treasury, RBC Economics Research

On the other hand, UK and German 10-year spreads to US Treasuries have tightened steadily this year. The Bank of England is likely to be very gradual in raising rates and the ECB is still a year from tightening, so any fixed income selloff will likely continue to be led by the US.



UK and German 10-year spreads vs. USTs

Source: Reuters, US Treasury, RBC Economics Research