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Economies and markets in wait-and-see mode

Canada and Europe continued to ramp up their COVID-19 vaccination programs in May, trying to close the gap to early leaders the US and UK. The latter countries have been able to ease restrictions more significantly and look set to post impressive GDP gains in Q2. But the virus threat remains, with a recent increase in cases in the UK underlining the challenge posed by virus variants even in countries with a relatively high rate of first doses. In the US, a persistent slowdown in daily vaccinations suggests hesitancy could be a barrier to herd immunity. Lingering concerns about the virus are likely one of a number of factors behind disappointing US job growth in April and May.

Central banks are keeping a close eye on re-opening as they evaluate how long extraordinary monetary policy support needs to remain in place. The BoC still stands out as relatively hawkish, having already begun to taper asset purchases and still guiding markets toward a rate hike in the second half of 2022. The BoE and RBA have also sounded more optimistic recently. The Fed hasn't changed its guidance on QE though some FOMC members think a taper timeline should be put forth soon and we expect those conversations will heat up this summer. The ECB, meanwhile, continues to buy bonds at a slightly faster clip to head off tighter financial conditions as other central banks begin to evaluate reducing stimulus.

Waiting to gauge the pace of re-opening and recovery as well as central bank policy, financial markets were generally in a holding pattern in May. US equities saw a modest selloff early in the month following a disappointing payroll report but were back to near-record-highs in early June. 10-year US Treasury yields are at the bottom of the 1.50-1.75% range of the past three months and breakeven inflation has been relatively steady despite strong inflation prints. The US dollar lost a bit of ground and commodity currencies including the Canadian dollar remained firm. We continue to think a US-led recovery and eventual taper talk from the Fed

Central bank near-term bias

→ The BoC struck a balanced tone in June leaving its key policies and guidance unchanged. We continue to expect a further tapering of asset purchases in Q3 and two rate hikes in the second half of next year.

→ Some FOMC members think its time to start talking about reducing QE purchases but we don't expect a change in guidance at the Fed's June meeting. The central bank might wait until its Jackson Hole gathering (late-August) to signal an eventual tapering by year end.

→ Some on the BoE's MPC have raised the prospect of rate hikes as soon as H2/22 and markets have started to price in a modest increase in that timeframe. We continue to think rates will be on hold throughout next year given the UK economy's long road to recovery.

→ The ECB increased its PEPP purchases in Q2 and will maintain that pace in Q3 to keep financial conditions accommodative. Compared with other major central banks, the ECB has a long way to go to achieve its inflation target on a sustained basis.

→ The RBA once again sounded slightly hawkish in June. We think its tone is consistent with our call for a more modest third QE program and no roll-over of its yield curve control target at July's meeting.

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Highlights

▲ The US economy remains on track for double-digit (annualized) GDP growth in Q2…

▲ …despite job gains that fell short of expectations in both April and May.

▲ Businesses are reporting growing labour shortages despite still-high unemployment…

▲ …leading some to offer hiring bonuses and higher wages to attract new workers.

will break this holding pattern, with the US likely to drive a renewed (albeit more modest) increase in government bond yields over the second half of the year and a recovery in the US dollar from recent lows.

US set for double-digit GDP growth in Q2…

US GDP growth looks set to accelerate to a 10.5% annualized pace in the second quarter, which would easily push real output above its pre-pandemic level (Q1 GDP was about 1% short). Consumers remain a key driver of growth with spending holding relatively steady in April after surging to a record high in March when another round of stimulus cheques went out. Goods spending remains robust but services growth outperformed in April and we expect that rotation will continue through the summer as health restrictions ease further. Indeed, the Fed's latest Beige Book in early-June said the impact of expanding vaccination rates was most notable in leisure travel and restaurant spending.

Housing has been another driver of the early recovery but is starting to run into supply issues—low inventory on the resale side, and labour and materials shortages on the new build side—that will limit further support from the sector. Nonresidential construction faces similar constraints, compounded by an uncertain outlook for office and retail space. But business investment otherwise remains on a solid trajectory, with shipments and new orders for capital goods increasing to fresh highs in April.

…pushing the economy closer to full capacity

We look for above-trend GDP growth to continue in the second half of the year, absorbing remaining economic slack. The US economy was able to operate above most estimates of its long-run potential pre-pandemic without generating significant inflationary pressure. But there are concerns that robust demand, rising input costs and labour shortages will combine to keep inflation above target in the current cycle. ISM indices show prices in both manufacturing and services sectors rising at their fastest pace in more than a decade. Surveys suggest businesses are increasingly passing higher input costs onto their customers. Core PCE inflation jumped above 3% in April for the first time since the early-90s, an increase not entirely attributable to base effects. Supply and demand imbalances on the goods side (in commodities, semiconductors, shipping, etc.) have put upward pressure on inflation in recent months and aren't likely to disappear anytime soon. The concern is that imbalances will spread to the services sector with a rebound in demand outstripping supply as the economy continues to re-open.

We're seeing some early evidence of that dynamic, with labour shortages emerging despite the unemployment rate remaining elevated (nearly 2 ppts above the Fed's long-run estimate) and payroll employment still 6.1 million jobs short of its pre-pandemic level. June's Beige Book indicated firms were having trouble hiring new workers and a survey of small businesses showed the share of firms getting few or no qualified applicants for job postings matched a record high in March. Some have suggested generous unemployment insurance benefits (particularly a $300 per week federal top-up under Biden's American Rescue Plan) are keeping some Americans from returning to work in lower-wage industries. Twenty-five states are ending participation in that program before it expires in September. According to the Beige Book, a growing number of firms are offering signing bonuses and raising starting wages to attract workers. Among small businesses, one third are raising worker compensation and nearly one quarter are planning to do so.

Slow start to an interesting summer for the Fed

Despite strong inflation readings and growing concern about cost pressures, we expect another FOMC meeting will come and go without any major changes to the Fed's monetary policy or forward guidance. Economic developments have been roughly in line with the forecasts laid out in March so we aren't looking for significant revisions to the summary of economic projections. We could see a few more dots shifting toward earlier rate hikes, potentially tipping the median toward a single rate increase in 2023, but even that would be catching up to the market at best. As for asset purchases, a number of FOMC members have suggested it might be time to start talking about an eventual timeline for tapering. But two months of less-than-impressive job gains likely don't represent the "substantial further progress" the Fed is seeking before beginning to scale back QE or even signal such a move. We think late-summer—at Jackson Hole or the Fed's September meeting—is more likely timing to set up for an eventual tapering announcement by year end. That would be slightly ahead of consensus for a Q1/22 taper. We continue to look for two rate hikes next year, which is also ahead of market expectations. As tapering plans and eventual rate hikes come into clearer view, we expect US Treasury yields will increase gradually over the second half of this year and into 2022.

Canada's third wave setback

April's flash GDP estimate showed Canada's economy contracting on a month-over-month basis for the first time in a year. Industries that suffered under the second wave of COVID-19—accommodation and food services, retail—unsurprisingly played a role in the latest slowdown as containment measures were tightened to combat a third wave of infections. Job losses during the third wave (Apr-May) have now roughly matched those of the second wave (Dec-Jan) though the former saw a greater pullback in full-time employment and hours worked. We expect GDP will be close to flat in May before increasing in June as restrictions ease, rounding out to a 2% annualized gain in Q2.

There has been some concern that lacklustre hiring in the early stages of the US economy's re-opening will be mirrored north of the border in the coming months. Like US unemployment insurance top-ups, Canada's temporary floor for EI payments (set to remain in place until September) might be acting as a disincentive to return to work in low-wage industries though some Canada Recovery Benefit recipients (mostly self-employed) will see their benefits reduced over the summer. The Canada Recovery Hiring Program announced in Budget 2021 should support re-hiring in hard-hit industries in the coming months. And Canada's progress in vaccinations—it now leads the G7 in share of population with at least one dose, and continues to roll out vaccines at a solid clip—should help control the spread of COVID-19, making those on the sidelines more comfortable returning to work when opportunities are available. But Canada won't be immune to labour shortages and business surveys are already pointing to difficulty finding workers in some sectors. For small businesses, shortages of skilled labour have eclipsed insufficient domestic demand as the most widespread growth headwind. That same survey showed planned wage hikes have recovered to their longer-term average but aren't at a level that would generate concerns about wage-driven inflation.

Bank of Canada strikes balanced tone in June

After making more substantial changes in April (tapering QE and advancing rate hike guidance to H2/22) the BoC left its key policies and forward guidance unchanged in June. It struck a balanced tone with modest disappointment in Q1 GDP (but solid underlying details) and signs of slower Q2 growth offset by progress on vaccines and virus containment that should set up for stronger gains in H2/21.

July's meeting could be a bit more interesting as we think the BoC will be taking a closer look at its QE program. The BoC didn't signal an imminent taper (we didn't think it would) but said decisions regarding the pace of purchases will be guided by its assessment of the strength and durability of the recovery. If incoming data aligns with the bank's forecasts we could see it reduce weekly bond buying again in July, to $2 billion per week from $3 billion currently. If not, September might serve as a backup as the bank seeks to prevent its footprint in the bond market (nearly 44% at the end of May) from becoming too large, while at the same time setting itself up to shift QE to reinvestment only well in advance of the two rate hikes we expect in H2/22.

Highlights

▲ Canadian GDP fell month-over-month in April for the first time in a year.

▲ Job losses in the third wave have roughly matched those in the second wave.

▲ Canada is also seeing some early signs of job shortages but wage hike plans remain fairly limited.

▲ The BoC didn't signal an imminent taper at its June meeting but we expect a further reduction in asset purchases in Q3.

Highlights

▲ We expect UK GDP growth of more than 3% (non-annualized) in Q2 and Q3…

▲ …though a recent uptick in cases (from low levels) is a concern.

▲ European PMI data is starting to reflect progress on vaccinations and virus containment.

▲ Australia's labour market is showing early signs of resilience to the expiry of wage subsidies.

UK re-opening continues but virus threat remains

Further easing of restrictions in the UK were evident in May's PMI data with gains recorded across all main sectors. The services index has seen a particularly stark improvement since the start of the year with respondents noting a sharp increase in output and new orders and the strongest pace of employment growth in six years. Another survey shows the share of employees on furlough (across all industries) fell to around 8% in early-May from as high as 20% earlier this year. The BoE is expecting a relatively modest increase in the unemployment rate (to 5.4% in Q3 from 4.8% in Q1) once the furlough program expires and re-hiring will need to continue over the summer to prevent more significant job losses. GDP data through March set the stage for a solid 3.7% non-annualized increase in Q2 GDP. We look for another 3% gain next quarter though a recent increase in COVID-19 cases driven by the delta variant threatens to delay the UK's next stage of re-opening (currently scheduled for June 21). The UK remains among the global leaders in vaccinations per capita and daily jabs continue at a solid pace which should make the case for further easing of restrictions as long as a nascent increase in infections doesn't gain momentum.

The BoE slowed its asset purchases in May but stressed the move was for technical reasons (to extend its QE program until the end of the year as originally planned) and didn't represent a change in monetary policy. However, recent hawkish comments from MPC members have markets pricing in a modest bank rate hike (to 0.25% from 0.1% currently) in H2/22. We continue to think such a move is unlikely with UK GDP only seen returning to its pre-pandemic level early next year and inflation expected to remain below target in the second half of 2022.

Euro area starting to ease some restrictions

Tight restrictions have helped Europe's largest economies get a third wave of COVID-19 under control, and solid progress on vaccines is allowing for a cautious re-opening. PMI data showed early evidence of recovery in the services sector, led by Spain and France. Manufacturing activity remained strong, particularly in Germany, with confidence proving resilient to rising cost pressures. We expect euro area GDP will increase by 1.4% (non-annualized) in the current quarter, fully retracing cumulative declines over the past two quarters. Growth is expected to remain robust over the second half of the year as re-opening continues, though we don't see GDP returning to its pre-pandemic level until early next year. Even with recovery plan stimulus expected to start flowing, we think the ECB will need to keep highly accommodative monetary policy in place to support growth. In June, the ECB said it would maintain its recently-accelerated pace of PEPP asset purchases in Q3 as it continues to push back against any pre-emptive tightening in financial conditions stemming from other central banks' stimulus reduction plans.

Australian GDP returns to pre-pandemic level

Australian GDP increased by 1.8% (non-annualized) in Q1, pushing activity above its pre-pandemic level. Private investment was a key driver of growth with both business capex and housing gaining momentum. Household spending remained below late-2019 levels but recent gains in services spending should continue in the coming quarters. As is the case in other countries, Australian households have accumulated excess savings over the past year that should support purchasing power going forward. And the labour market has shown early resilience to expiry of the JobKeeper wage subsidy program (at the end of March) with the unemployment rate ticking lower in April. We expect a more modest increase in Q2 GDP amid renewed lockdowns in Victoria but that slowing should be reversed in the second half of the year. The RBA's June policy statement struck a slightly hawkish tone and seemed to indicate less appetite for another round of QE once the current program expires. We continue to see scope for a potentially smaller program (A$75-100 billion) or one that spreads purchases over a longer time frame. The RBA has indicated it will evaluate the need for further QE as well as its yield curve control policy (we don't see an extension from the current Apr-24 bond to the Nov-24) at its July meeting.

Interest rate outlook

%, end of period

	Actual					Forecast						
	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
Canada												
Overnight	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75
Three-month	0.21	0.20	0.12	0.06	0.09	0.15	0.20	0.20	0.25	0.25	0.50	0.80
Two-year	0.42	0.29	0.25	0.20	0.23	0.30	0.40	0.45	0.60	0.75	1.00	1.20
Five-year	0.59	0.37	0.36	0.39	0.99	1.00	1.15	1.20	1.30	1.40	1.55	1.65
10-year	0.70	0.53	0.57	0.68	1.56	1.55	1.65	1.70	1.80	1.90	1.95	2.00
30-year	1.31	0.99	1.11	1.21	1.99	2.10	2.15	2.20	2.30	2.30	2.30	2.30
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.38	0.38	0.63	0.63
Three-month	0.11	0.16	0.10	0.09	0.03	0.15	0.20	0.25	0.40	0.55	0.70	0.75
Two-year	0.23	0.16	0.13	0.13	0.16	0.20	0.40	0.60	0.90	1.10	1.30	1.50
Five-year	0.37	0.29	0.28	0.36	0.92	1.00	1.25	1.45	1.50	1.60	1.70	1.80
10-year	0.70	0.66	0.69	0.93	1.74	1.80	1.90	2.00	2.05	2.10	2.15	2.20
30-year	1.35	1.41	1.46	1.65	2.41	2.40	2.45	2.50	2.60	2.60	2.60	2.60
United Kingdom												
Bank rate	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Two-year	0.13	-0.08	-0.02	-0.16	0.11	0.05	0.10	0.15	0.20	0.20	0.25	0.25
Five-year	0.20	-0.06	-0.06	-0.08	0.40	0.40	0.45	0.50	0.60	0.65	0.70	0.85
10-year	0.34	0.17	0.23	0.20	0.85	0.85	0.90	1.00	1.05	1.15	1.20	1.35
30-year	0.82	0.64	0.78	0.76	1.40	1.35	1.50	1.65	1.80	1.85	1.90	2.00
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
Two-year	-0.69	-0.69	-0.70	-0.71	-0.69	-0.60	-0.60	-0.60	-0.60	-0.60	-0.55	-0.50
Five-year	-0.65	-0.70	-0.71	-0.74	-0.62	-0.55	-0.55	-0.50	-0.50	-0.45	-0.40	-0.30
10-year	-0.48	-0.45	-0.53	-0.58	-0.29	-0.25	-0.20	-0.15	-0.05	0.05	0.15	0.20
30-year	0.03	0.01	-0.09	-0.17	0.26	0.35	0.45	0.55	0.65	0.75	0.80	0.85
Australia												
Cash target rate	0.25	0.25	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Two-year	0.24	0.25	0.16	0.08	0.08	0.10	0.10	0.10	0.10	0.10	0.50	0.60
10-year	0.77	0.87	0.84	0.97	1.74	1.80	1.85	1.90	2.05	2.10	2.20	2.30
New Zealand												
Cash target rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
Two-year swap	0.52	0.19	0.05	0.27	0.46	0.60	0.70	0.80	0.90	1.00	1.05	1.10
10-year swap	0.92	0.72	0.50	0.97	1.95	2.10	2.15	2.20	2.20	2.25	2.30	2.40
Yield curve***												
Canada	28	24	32	48	133	125	125	125	120	115	95	80
United States	47	50	56	80	158	160	150	140	115	100	85	70
United Kingdom	21	25	25	36	74	80	80	85	85	95	95	110
Eurozone	21	24	17	13	40	35	40	45	55	65	70	70
Australia	53	62	68	89	166	170	175	180	195	200	170	170
New Zealand	40	53	45	70	149	150	145	140	130	125	125	130

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

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	2019	2020	2021F	2022F
Canada*	-7.9	-38.0	41.7	9.3	5.6	2.0	9.0	5.5	3.0	3.0	2.5	1.8	1.9	-5.3	6.3	4.0
United States*	-5.0	-31.4	33.4	4.3	6.4	10.5	5.5	3.0	1.9	1.9	1.8	1.8	2.2	-3.5	6.5	3.0
United Kingdom	-2.8	-19.5	16.9	1.3	-1.5	3.7	3.1	2.3	0.4	0.4	0.4	0.4	1.4	-9.8	6.6	5.2
Euro Area	-3.8	-11.5	12.6	-0.6	-0.3	1.4	2.0	1.4	0.6	0.4	0.4	0.4	1.3	-6.7	4.5	3.6
Australia	-0.3	-7.0	3.5	3.2	1.8	0.6	0.9	0.8	0.8	0.7	0.5	0.4	1.9	-2.4	5.2	2.9

*annualized

Inflation outlook

% change, year-over-year

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	2019	2020	2021F	2022F
Canada	1.8	0.0	0.3	0.8	1.4	3.2	3.0	2.6	2.0	2.0	2.3	2.4	1.9	0.7	2.6	2.2
United States	2.1	0.4	1.2	1.2	1.9	4.1	3.3	3.1	2.6	1.7	2.0	2.2	1.8	1.2	3.1	2.1
United Kingdom	1.7	0.7	0.6	0.6	0.6	1.8	1.9	2.3	2.0	1.8	1.8	1.8	1.8	0.9	1.7	1.9
Euro Area	1.1	0.2	0.0	-0.3	1.1	1.6	1.6	2.2	1.3	1.3	1.4	1.4	1.2	0.3	1.6	1.4
Australia	2.2	-0.3	0.7	0.9	1.1	3.9	3.0	2.7	2.6	2.3	2.2	2.2	1.6	0.8	2.7	2.2

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

Currency outlook

Level, end of period

	Actuals					Forecast						
	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
Canadian dollar	1.41	1.36	1.33	1.27	1.26	1.20	1.22	1.25	1.26	1.27	1.27	1.27
Euro	1.10	1.12	1.17	1.22	1.17	1.20	1.17	1.14	1.13	1.12	1.13	1.14
U.K. pound sterling	1.24	1.24	1.29	1.37	1.38	1.38	1.31	1.25	1.22	1.19	1.20	1.20
Japanese yen	108	108	105	103	111	107	103	100	102	104	106	108
Australian dollar	0.61	0.69	0.72	0.77	0.76	0.77	0.75	0.74	0.74	0.73	0.73	0.73

Canadian dollar cross-rates

	20Q1	20Q2	20Q3	20Q4	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4
EUR/CAD	1.55	1.53	1.56	1.55	1.47	1.44	1.43	1.43	1.42	1.42	1.44	1.45
GBP/CAD	1.75	1.68	1.72	1.74	1.73	1.66	1.60	1.57	1.53	1.51	1.53	1.52
CAD/JPY	76.5	79.5	79.2	81.1	88.1	89.2	84.4	80.0	81.0	81.9	83.5	85.0
AUD/CAD	0.86	0.94	0.95	0.98	0.95	0.92	0.92	0.93	0.93	0.93	0.93	0.93

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

Source: Bloomberg, RBC Economics

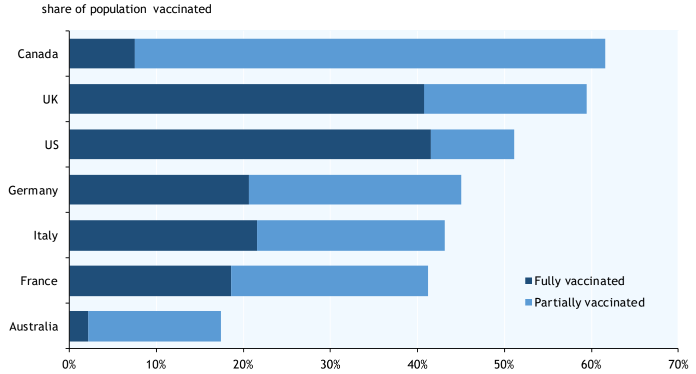
Keeping an eye on vaccines and re-opening

Canada's focus on getting first doses out to as many people as possible has put it ahead of early vaccine leaders (US and UK) in share of the population with at least one dose of a COVID-19 vaccine. With restrictions having brought the third wave under control in most provinces, re-opening is now underway.

The US's vaccine campaign is losing momentum despite only slightly more than half its population having received at least one dose. Various states are now offering incentives, hoping to get enough people vaccinated to reach herd immunity. Other countries, including those with higher vaccination rates, are still seeing a solid pace of immunization.

One dose strategy helped Canada catch up

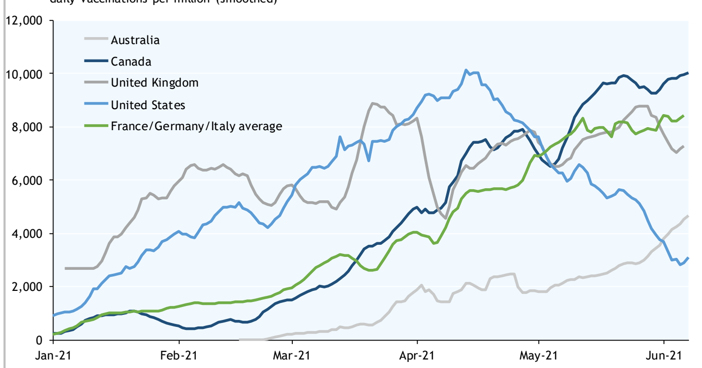
share of population vaccinated



Source: Our World in Data, RBC Economics

Pace of US vaccinations has slowed since mid-April

daily vaccinations per million (smoothed)



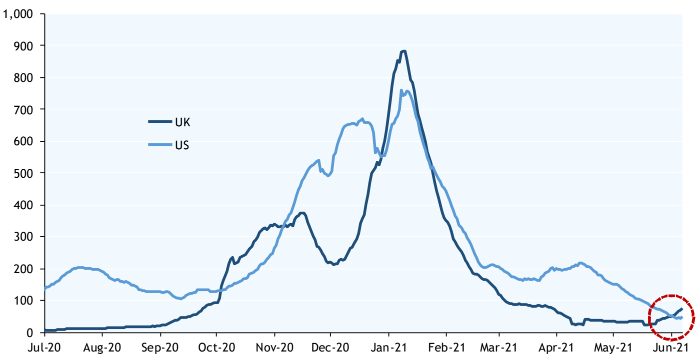
Source: Our World in Data, RBC Economics

The US has been able to ease restrictions while keeping new infections on a downward trend. The UK appeared to have the virus under control but cases are starting to increase as the delta variant spreads. That could jeopardize the next stage of economic re-opening and serves as a warning to other countries.

US payrolls disappointed in April and May with average gains falling short of Q1's pace despite continued easing of containment measures. Even with sluggish job growth, Q2 GDP growth looks set to accelerate to a 10.5% annualized pace. Stronger job gains will be needed to sustain above-trend growth in H2/21.

COVID-19 variants jeopardize next stage of UK re-opening

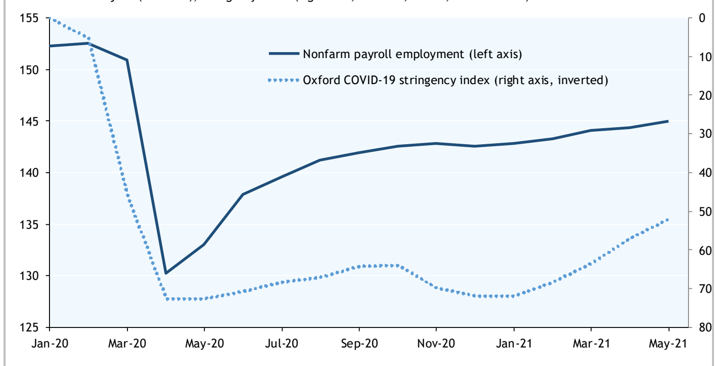
new COVID-19 cases per million (smoothed)



Source: Our World in Data, RBC Economics

US payroll growth has disappointed in early re-opening

millions of jobs (left axis), stringency index (right axis, inverted, 0=100, 100=strictest)



Source: BLS, Our World in Data, Oxford University, RBC Economics