ECONOMIC AND FINANCIAL MARKET UPDATE
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Forecasts zig; data zag

April brought a round of across the board upgrades to Canadian and US growth projections. The International Monetary Fund (IMF) upgraded its 2012 forecasts by 0.3 percentage points for both countries. The Bank of Canada upped its 2012 Canadian growth forecast, and the US Federal Reserve boosted the range for US real GDP growth by 0.2 percentage points. While this was a step in the right direction, the bottom line is that another year of moderate growth is still in the cards. These more upbeat assessments were overshadowed by a round of weak data reports out of Europe. The first release of UK real GDP showed an unexpected decline; the euro area's purchasing managers' indices slipped again, and the unemployment rate hit an all-time high. Concern about the European economies and a return of financial market stress drove investors into safe-haven markets like US Treasuries, Canadian government bonds, and German bunds. The upgrading of growth forecasts in Canada and US met some resistance following a raft of softer than expected data reports. The first print of US first-quarter 2012 real GDP showed that the economy grew at a 2.2% annualized pace, which was below market forecasts for a 2.5% increase. Canadian GDP proved to be disappointing with the economy contracting by 0.2% in February, which was contrary to expectations for an similar-sized increase in the month. While the headlines gave a jolt to markets, the details of the reports do not suggest that these trends will persist and in fact set up for even stronger gains in the second quarter than we previously projected. All told, we maintain our 2012 growth forecasts of 2.6% and 2.5% for Canada and the US, respectively.

Fed maintains position that policy will stay easy

The Fed left the fed funds target range at 0% to 0.25% in April and reiterated that exceptionally low rates are likely to be needed until late 2014. This conclusion came as no surprise to markets although the mild upgrades to the Fed's near-term economic projections dampened expectations that another round of quantitative easing is in the pipeline. In the quarterly forecast summary, policymakers raised the expected range for 2012 real GDP growth to 2.4% to 2.9% from 2.2% to 2.7%. In turn, the forecast for the unemployment rate edged down to 7.8% to 8.0% from 8.2% to 8.5%. These changes did not constitute wholesale changes to the Fed's baseline view (especially given that the growth forecasts for 2013/2014 were revised lower); therefore, they did not alter our outlook for policy.

Canadian employment jumps; GDP dips

Canada's economic data have been erratic in recent months with the economy unexpectedly contracting in February while the labour market generated a whopping 82,300 jobs in March. To be sure, February's dismal performance reflected a drop in utilities and natural gas output due to warmer than usual temperatures that will likely be reversed in the months ahead. Also weighing on growth were temporary shutdowns of potash and nickel production facilities. These factors are likely to ease, if not reverse, in March although maintenance shutdowns in various oil sand production facilities may limit the rebound. As a result, we expect only a marginal improvement in March GDP with activity likely holding steady. The weakening in February, however, was not sufficient enough to offset the strength recorded in late 2011 keeping the economy on course for a positive growth print in the first quarter of 2012.

BoC to follow a go-slow approach in reducing stimulus

The soft February real GDP report defied both RBC and the Bank of Canada's forecasts for strengthening growth in the first quarter of 2012. Following the release, we revised our forecast down to 1.8%, matching the pace recorded in the fourth quarter of 2011. At the same time, we revised up our second-quarter 2012 growth forecast to 3.1%, expecting that as the shutdowns end and weather returns to normal, we will see a reacceleration in the pace of output gains after a lull in February and March. Correspondingly, we anticipate that any backup in the unemployment rate that occurs because the economy grew at a below-trend rate between September and March will reverse. This is another reason why the Bank of Canada is unlikely to rush to temper the amount of policy stimulus and risk a further weakening in the pace of growth. As a result, we expect that the Bank will maintain the overnight rate at 1.00% until the fourth quarter of 2012 when there should be sufficient evidence of a reacceleration in domestic activity, rising export demand as the US economy picks up, and an easing in global financial market stress.