

ECONOMIC AND FINANCIAL MARKET UPDATE

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On pins and needles

Central bankers worried aloud about the outlook for the global economy vowing to use monetary policy as a tool to counter stresses in financial markets and keep their economies growing. In particular, the Federal Reserve announced that extraordinarily stimulative policy will likely be needed until late 2014 in order for its mandate of price stability and full employment to be achieved. The Bank of Canada, in its quarterly forecast update, argued that the outlook for the world economy had deteriorated and uncertainty increased since early December 2011. While growth beat expectations in the second half of 2011, the Bank projected a more moderate pace ahead reflecting global challenges, which suggests that policy will remain at its current stimulative level for the remainder of 2012. To be sure, the uncertainty about the ability of Europeans to find a credible resolution to the sovereign-debt crisis and, in the immediate-term, tackle Greece's funding requirements is weighing on confidence and keeping central bankers in a state of heightened alert. Recent economic reports, show that the global economy has been able to stay on a moderate growth path and has so far avoided another sharp decline.

IMF downgrades growth forecasts

The International Monetary Fund's (IMF) semi-annual forecast update proved a dour affair with all but the US growth forecast being revised lower for 2012. In the US, the IMF maintained its 1.8% projection for 2012, staying below the consensus forecast for a 2.2% gain this year. Heightened concerns about developments in Europe resulted in 1.6 percentage points being lopped off the 2012 forecast, which now stands at -0.5%. While most other forecasts saw smaller downgrades, the IMF's message was clear: the world economy is on fragile footing, and the 2012 global expansion is likely to be the slowest since 2009.

US economic data point to momentum being sustained

In the US, the economy accelerated in the fourth quarter of 2011, and recent reports point to this stronger momentum being maintained in early 2012. The ISM manufacturing report indicated that the manufacturing industry continued to expand in the first month of 2012. The details of the report were encouraging in showing that all components except inventories remained in expansionary territory. The US labour market surprised on the upside as non-farm payrolls rose by a sharp 243,000 in January and the unemployment rate fell to 8.3%. These indicators bode well for the quicker pace of expansion established in the fourth quarter of last year to be maintained.

Low rates warranted "at least through late 2014"

In the final analysis, the Fed concluded that in order to achieve its mandate, the very low level of the policy rate may be warranted "at least through late-2014." This extended the time horizon from mid-2013 as indicated in the previous statement. The Fed's assessment of current conditions (economy has been expanding moderately) and projections for growth (downgraded slightly from November) were partly responsible for this lower-for-longer profile especially when overlaid with the Fed's assessment that the global economy is slowing.

Data run hot and cold in Canada

Canadian GDP fell in November 2011 in part due to transitory factors that will eventually be reversed for December and January. The decline, however, was unexpected, and thus, fourth-quarter 2011 growth looks like it will be slower than we previously estimated. Specifically, we expect real GDP growth of 1.5% at an annual rate in the final quarter of 2011. This is much slower than the 3.5% gain recorded in the third quarter and echoes the pattern in the first half of the year. The one-off factors that weighed on activity late in the year will provide a much needed bump to activity when they reverse in early 2012. This pattern was also evident in the labour data with strength in the third quarter followed by a significant slowing in late 2011 and into 2012.

External risks, data make case for steady rates in 2012

The Bank of Canada reiterated its deep-seated concerns about the effect of external events on the economic outlook in its quarterly forecast update. The Bank largely maintained its growth forecasts for Canada and judged that the risks to the outlook were "roughly balanced." Heightened concerns about the global outlook, the Fed firmly on hold, and volatility in domestic data set up for the Bank to maintain the overnight rate at 1%. With our base case forecast that both the Canadian and US economies will prove stronger than the Bank expects in 2012 and that the effect of the European crisis will be contained, we expect the Bank to raise its policy rate, although it is more likely that this will occur in 2013 than any time this year.