Dawn Desjardins
Assistant Chief Economist
RBC Economics Research
dawn.desjardins@rbc.com

FINANCIAL MARKET UPDATE

December 5, 2008

Click here for the interest/exchage rate forecast table on our web site.

Financial market crisis shows limited signs of abating

The financial market crisis showed limited signs of abating in November, with Canada's stock market dropping about 5% and the U.S. benchmark S&P off 7.5%. Commodity prices swooned and credit spreads remained wide. Investors continued to run for cover, buying safer government bonds — the U.S. Treasury market posted a huge 5.4% total return and Government of Canada bonds rallied. Yields on government securities fell to the lowest level on record. LIBOR rates continued to move cautiously lower but are still elevated compared to official policy rates as the sting from the Lehman Brothers' bankruptcy keeps financial institutions worried that one of their counterparties could suffer a similar fate. It is the relatively high level of interbank funding rates that is preventing borrowing rates from falling. For the economy, the spinoff continues to be that businesses and households face both a high cost for capital and limited access to funds, which is hampering spending activity and resulting in recessions in both Canada and the United States.

U.S. recession deepens

▲ The U.S. economy is falling deeply into recession. Real GDP is expected to contract at much faster pace in the fourth quarter and the likelihood is growing that these recessionary conditions will persist through the first half of 2009. We now project the U.S. recession to run from the third quarter of 2008 to the middle of 2009, resulting in real GDP falling by 1% on average next year following this year's tepid 1.3% growth rate.

▲ As the economic news worsens and commodity prices slide, worries about a steady rise in the headline inflation rate have quickly switched to concerns about a generalized decline in prices. We expect the U.S. headline inflation rate to continue to fall in 2009 partly due to the rapid drop in energy prices, but also reflecting a steady slide in core prices.

▲ Our revised forecast calls for the U.S. headline inflation rate to average 1.2% next year, a significant decline from 2008's estimated 4.1% average pace. Core inflation, which excludes movements in energy and food prices, is forecast to slow to 1.7% on average in 2009 from this year's 2.3% as growing slack in the economy dampens pricing power.

▲ Around mid-year, the U.S. headline inflation rate is likely to briefly fall into negative territory, but this is largely a base effect because the surge in energy prices that boosted the headline index by an average 0.8% in the months of May through July 2008 will not be repeated. Our baseline assessment assumes that oil prices will rebound modestly in 2009 from current levels but remain lower than 2008's average price.

▲ The prospect that the economy will remain in a recession in the first half of next year is likely to see the Federal Reserve keep priming the pump through an additional interest rate reduction. We anticipate

that the Fed will cut the policy rate by another 50 basis points to 0.50% in December and to hold the policy rate at this level throughout next year.

▲ Interest rate markets have already priced in another 50 basis points of easing, a sustained recession and lower inflation rates. The flight to quality is likely to continue and will keep government bond yields low in 2009 although, as the worst for the economy passes and the risk of deflation fades, supply concerns will likely lead rates up in the latter part of next year.

▲ We look for the 10-year U.S. Treasury yield to remain below 3% and then gradually increase back up to 3.4% by year-end 2009. Two-year rates are forecast to linger around 1% and rise to 1.65% by year-end as the economy recovers and markets anticipate that the next move by the Fed will be a rate increase in 2010. We have modestly revised our year-end 2008 forecasts compared to our recent update.

The material contained in this report is the property of Royal Bank of Canada and may not be reproduced in any way, in whole or in part, without express authorization of the copyright holder in writing. The statements and statistics contained herein have been prepared by RBC Economics Research based on information from sources considered to be reliable. We make no representation or warranty, express or implied, as to its accuracy or completeness. This publication is for the information of investors and business persons and does not constitute an offer to sell or a solicitation to buy securities.

®Registered trademark of Royal Bank of Canada.

©Royal Bank of Canada.