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FINANCIAL MARKET UPDATE

November 6, 2009

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The turning point

The tide has turned for the global economy with U.S. real GDP posting a stronger-than-expected increase in the third quarter, the Reserve Bank of Australia (RBA) citing Australia's good economic performance as a reason for cutting the policy rate and China recording a breathtaking 8.9% increase in third-quarter output. Canada, the United Kingdom and the Eurozone have yet to produce clear indications that their economies are out of recession, but conditions are improving and we expect reports of positive growth soon. Central banks are cautious, however, with only the RBA of the major central banks we cover starting to unwind monetary policy stimulus. Given the deep hole in economic activity, it is likely to be a long time before other banks will be in a position to follow the RBA's lead, with hikes expected to come in the latter part of 2010 and continuing in 2011.

Nervousness creeps into financial markets

Investors got a bout of the jitters with global stock markets reversing course in mid-October after a sustained upward run that started in March of this year. The downdraft in stocks saw the MSCI World Stock Index trim back its October gain to just 0.65% with most of the 6.2% rise recorded in the first half of October erased. Government bond markets in Canada, the United States, the Eurozone and the United Kingdom recouped ground in the second half of the month as investors shifted back to the safety of government securities. The more certain growth momentum in Australia saw yields rise with New Zealand rates going along for the ride. All told, 10-year yields stand very close to their 2009 average outside the Antipodeans. Looking forward, we expect the movement in interest rates to be concentrated in the shorter-term maturities as the timing of central bank tightening nears with longer-term maturities staying range-bound until the spectre of inflation makes an appearance.

United States bounds out of recession

The U.S. economy grew at a 3.5% annualized pace in the third quarter backed by a rebound in consumer spending and surging residential investment. Consumer spending was largely powered by durables consumption reflecting the impact of the cash-for-clunkers rebates, but spending also increased for non-durable goods and services. In fact, these two consumption components increased at the fastest pace since the third quarter of 2007, suggesting that U.S. consumers are coming out of hiding. Residential investment also surprised to the upside, ending 14 consecutive quarters of decline. Business investment remained a weak spot as inventories were reduced again and commercial real estate investment continued to collapse. On the upside, the severe cuts to inventories set the stage for a pick-up in production as demand continues to trend higher.

Data signal recovery is under way

Positive GDP growth after four quarters of decline likely signalled the end of the recession for the U.S. economy. To be sure, the expiry of the cash-for-clunkers program will cut into spending on durables in the fourth quarter. Still, early reports on fourth-quarter activity point to another increase in output, with the ISM

manufacturing index driving solidly into expansionary territory in October and housing indicators pointing to firming sales against a shrinking inventory overhang. The hitch was in the October consumer confidence reports, which showed that households became less optimistic early in the fourth quarter, thus raising alarm bells that they could retreat again. The Fed worked to allay concerns about any tightening in monetary conditions by committing again this week to their policy of "exceptionally low levels of the federal funds rate for an extended period."

End of negative inflation rates

After falling for nine of the past 10 months, the U.S. headline inflation rate is set to return to positive territory as the sharp declines in energy prices in October through December of 2008 go unmatched. We estimate that the headline CPI inflation rate will average 1.3% in the fourth quarter, largely reflecting the movement in energy prices. Excluding energy, the rate is likely to continue on its downward trajectory. The widely-watched core measure, which removes both energy and food price movements, is forecast to average just 1% next year, the slowest pace of increase on record. The absence of inflation pressures aside from energy, supports the case for the Fed to hold the funds target in the 0.0% to 0.25% range to ensure that a more vigorous economic recovery takes hold.

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