



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 a 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.

US GDP miss belies decent domestic activity

The slowing in US real GDP growth to 2.2% in the first quarter of 2012 from 3.0% in the fourth quarter of 2011 belied a continued improvement in consumer spending momentum that began in the second half of 2011. Residential investment posted a second consecutive quarter of double-digit gains, likely reflecting the effect of a warmer than normal winter weather. Investment in residential construction is unlikely to continue at this rapid pace; however, the gradually improving labour market and signs that, even accounting for favourable weather, housing markets were stable to firmer early in the second quarter are likely to underpin consumer spending. Offsetting these gains were a sharp moderation in the pace of inventory rebuilding and a hefty drop in non-residential construction activity. Highly stimulative monetary policy and healthy business balance sheets are expected to stimulate a rebound in business investment spending in the second quarter of 2012. As a result, we upped our growth forecast to 2.8% for the second quarter of 2012 from 2.6% and maintain our call that the US economy will grow by 2.5% this year.

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 the likely course of policy.

Labour market's rocky ride

The US labour market has had a rocky ride with the pace of job gains picking up significantly in December 2011 to February 2012 and then slowing. Even with this slowing, the average pace of job gains in the six months to April was 197,000. The unemployment rate also declined more quickly than was expected, falling by 0.8 percentage points in the six-month period to 8.1%. This was partially responsible for the Fed's downward revision to its 2012 unemployment rate forecast. Some of the decline in the unemployment rate reflected reduced labour market participation; however, it was also a product of the 1.6 million jobs created since October 2011, according to the household survey. The slowing in the pace of employment gains in March and April, a historically high unemployment rate and the large percentage considered to be long-term unemployed (without work for 27 weeks or more), are serving to keep the odds slightly in favour of another round of bond purchases.

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