FINANCIAL MARKETS MONTHLY

December 12, 2014

2015 — a year of change (for some)

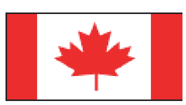
2015 is forecasted to mark a year of change for many of the economies we follow. In the US, the economy is forecasted to grow at the fastest pace in a decade, and the Federal Reserve is expected to increase its main policy rate for the first time since December 2008. The euro area economy is likely to remain weak in 2015; however, the fear of deflation is expected to subside as the European Central Bank (ECB) steps up its policy support and the euro continues to weaken. For Canada, the strengthening in the US economy and weaker Canadian dollar are expected to bolster exports sufficiently to offset the effect of lower oil prices on real gross domestic product (GDP) growth. With the economy expected to reach full production capacity mid-year, we look for the Bank of Canada (BoC) to increase the policy rate shortly thereafter. The Bank of England (BoE) is also forecasted to go forward with rate hikes in 2015, albeit at a gradual pace. Conversely, no action is expected by either the Reserve Bank of New Zealand (RBNZ) or Australia's central bank (RBA) in 2015.

Improving growth prospects to drive bond yields higher

Global bond yields dropped in the fourth quarter of 2014 on concerns about the world growth outlook generating downside risks to inflation. While the economy in some regions, including the euro area and Australia, remains under downward pressure late in 2014, the US economy continues to show strong upward momentum that we expect will continue in 2015. This underpins our expectation that the world economy will grow at a faster 3.8% pace next year following three years of growth of 3.25% and that several central banks will raise their policy rates. In keeping with this view, we expect bond yields to rebound from their recent lows to levels that are downwardly revised from our previous forecast.

Central bank near-term bias

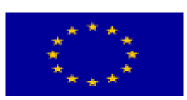
Three-months out, policy rate



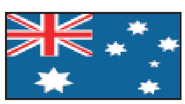
↔ The BoC sees "signs of a broadening recovery" and less slack than previously estimated but continues to view underlying inflation as below its 2% target. This left an implicit neutral bias intact despite a more hawkish tone in the latest policy statement.

↔ A strong November payrolls report and upbeat *Beige Book* could lead the Fed to alter its "considerable time" forward guidance in mid-December, reinforcing our call for a June 2015 rate hike.

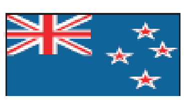
↔ BoE research shows households can handle higher rates, but with fiscal policy uncertainty and external headwinds keeping the Bank on the defensive, we continue to expect a June 2015 hike.



↔ The ECB disappointed some in December with no additional changes to the asset purchase program announced. We expect this will be remedied in the New Year with the ECB committing to purchase a broader array of private-sector assets.



↔ With significantly weaker terms of trade weighing on Australian incomes and inflation expected to moderate toward the lower end of the RBA's target range, we now expect the policy rate will be held steady throughout our forecast horizon.



↔ Inflation is sitting at the bottom of the RBNZ's 1–3% target range and is expected to rise only gradually. While the RBNZ maintains a mild tightening bias, we expect no further hikes until 2016.

Inside…

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Highlights

▲ Central banks are set to follow diverging courses in 2015.

▲ US data reports signal a strengthening in the economy's momentum.

▲ The US labour market is pumping out jobs at a rapid rate, thereby setting up for wage increases in 2015.

▲ The Fed is following its game plan to gradually return policy to normal conditions.

US economy: hitting its stride

After a sustained period of uncertain and moderate growth, the US economy finally hit its stride in 2014 with real GDP growth being sustained at an above-potential pace after a weather-related drop in the first quarter. In the second and third quarters, the economy pumped out gains of 4.6% and 3.9%, respectively. Recent reports showed strengthening labour market conditions and the Institute for Supply Management (ISM) surveys of business activity holding near cycle highs. Financial conditions remain accommodative, and coupled with the recent drop in gasoline prices, these factors are laying the groundwork for consumer spending, housing activity, and investment. Our monitoring of fourth-quarter growth suggests a mild slowing to 2.8%; however, this still represents an above-potential pace of activity, and we expect it will be followed by even stronger gains in 2015.

US labour market is hot, hot, hot

The US labour market defied expectations in 2014 with the average monthly increase in job creation rising to 240,000, the fastest clip since 1999. In turn, the unemployment rate gapped lower to stand at 5.8% in November from 6.7% at the end of 2013. In May 2014, the US economy fully recovered the jobs lost during the Great Recession. Despite this impressive performance, wage gains remain tepid with the average increase tallying just 2.1% as of November. A pickup in the number of hours worked combined with the rise in employment resulted in the index of aggregate weekly hours rising at a very strong pace in November that supports our forecast that the economy is on track to post another above-potential gain in the quarter.

The improvement in the labour market supported strong gains in housing market activity in the fourth quarter, and personal spending posted solid gains in October and November. The consumption outlook was also bolstered by the decline in gasoline prices that is providing consumers with more funds to spend. This was evident in the pace of motor vehicle sales, which ramped up to 17.2 million units at a annualized pace in November. This marked the second-fastest monthly sales pace recorded in the post-recession period.

Fed's game plan on track

The Fed's decision to wind down its quantitative easing program in late October provided no ripple effect in fixed-income markets, in part because investors were putting out fires elsewhere. The decision reflected a more positive assessment of economic conditions and a belief that in time, both the unemployment and inflation rates would reach the Fed's objectives. In the *Beige Book* compiled in preparation for the Fed's December meeting, regional contacts indicated that overall economic activity continued to expand in October and November with many sectors showing improvement. The report also stated that a number of districts "remained optimistic about the outlook for future economic activity." While labour market conditions were reported to have improved, price pressures remain modest. In all, the results of the report set up for the Federal Open Market Committee (FOMC) to maintain its upbeat assessment of economic conditions when it meets in mid-December. Furthermore, the strength in recent activity numbers will likely induce policymakers to tweak their forward guidance regarding the outlook for policy by removing the concept that it will be a "considerable time" before it will be appropriate to raise the federal funds target. This will open the door for the FOMC explicitly to lay the groundwork for the timing of the first hike. With core inflation holding below the 2% target, the statement may skirt the issue by focusing on policymakers' willingness to react to either upside or downside data surprises in a timely manner. Our forecast assumes that the recent strengthening in growth and employment will put a floor on core inflation, thereby freeing the Fed to begin to rein in policy stimulus with the first hike forecasted to occur in June 2015.

Canada's economy surprised to upside

Real GDP grew at an annualized 2.8% in the third quarter, besting expectations for a more dramatic slowing following the second quarter's robust 3.6% gain. Solid domestic demand and another strong lift from net trade supported the quarterly increase and overcame a sharp pullback in inventories. In September, real GDP increased at a robust 0.4%, thereby providing a strong handoff to growth in the fourth quarter. With US demand for Canadian exports expected to continue at a strong pace, accommodative financial conditions supporting domestic demand, and a lessening drag from inventories, overall GDP growth is forecasted to increase at an annualized 2.7% in the final quarter of 2014.

Oil drop won't clip economy's momentum in 2015

The more than 40% drop in oil prices since mid-June is weighing on financial markets with the Toronto Stock Exchange having trimmed back 2014's gain to about 2%. The Canadian dollar lost 5.5% against its US counterpart over the six-month period. The weakness boosted concerns about Canada's economic outlook especially in regions that derive much of their livelihood from oil. Our analysis shows that the overall hit to economic growth, at a national level, will be muted with declining investment by energy companies largely offset by rising export demand, strengthening investment in industries outside the energy sector, and higher consumer spending as gasoline costs fall. The decline in oil prices, if sustained, would reduce the headline inflation rate in 2015; however, we expect the pass-through to the core measure, which excludes energy costs, to be limited (see *Lower oil prices and the Canadian economic outlook: an update*).

In early December, the Bank raised concerns about the negative effect that falling oil prices and disappointing growth in countries outside the US will have on the outlook for Canada's economy and inflation. The Bank pointed to these downside risks as supporting the view that the 1% policy rate remained appropriate even with the economy growing at a stronger pace recently. The Bank noted that the strengthening in export demand was starting to fuel increased investment and employment, suggesting that a period of "balanced and self-sustaining" growth is underway. The Bank cautioned that labour market data indicated the persistence of "significant slack" in the economy.

November's pullback in hiring didn't dent market conditions

The modest pullback in job creation in November followed two months of extraordinarily large gains. Even with the slippage, the three-month trend rate in employment growth was 35,500 as of November, which made up for the weak pace earlier in the year and resulted in year-to-date job gains that are more consistent with an economy growing at an above-potential pace. Furthermore, the stronger pace of job creation, decline in the unemployment rate in recent months, and improvement in other measures of labour market under-utilization confirm that the slack in the labour market has diminished.

Bank of Canada cautious for now; data to trigger hike in 2015

Another round of strong reports on growth and labour market conditions may finally nudge the Bank toward signalling a shift away from its neutral bias although it is likely to take some time before the Bank sees the downside risks as having diminished sufficiently to do so. Our expectation is that the economy will continue to grow at an above-potential pace and that the output gap will be fully eliminated by mid-2015, which will put a floor under the core inflation rate around 2.0% We also expect this will result in continued hiring and eventually wage increases. Against this backdrop, the Bank of Canada is likely to see the need to reduce the degree of policy stimulus. The Bank's recent acknowledgement that the economy has started to show signs of self-sustaining momentum is a first step toward an eventual change in posture. Our call is that conditions will be in place for the Bank to hike the overnight rate in the third quarter of 2015.

Highlights

▲ Canada's economy grew at a faster than expected clip in Q3, and the labour market showed signs of renewed vigour.

▲ The Bank of Canada acknowledged that the economy is benefitting from rising export growth.

▲ The sharp drop in oil prices raised concerns about the outlook for the Canadian energy sector; however, we look for the effects to be regional with offsetting increases in exports and investment in other industries leaving Canada-wide GDP growth on track.

Highlights

▲ Falling inflation expectations underscore the need for expanded stimulus from the ECB.

▲ Q3 marked the UK economy's seventh consecutive quarter of above-trend growth.

▲ We now expect that the RBA will hold the policy rate steady throughout our forecast horizon.

ECB leaves markets wanting

Euro area GDP growth of 0.2% in the third quarter provided a modest upside surprise to market expectations, but the subdued pace of activity still left the economy expanding at less than a 1% pace relative to a year earlier. Recent Purchasing Managers' Index (PMI) data showed little prospect of a stronger fourth quarter, with the composite measure falling below the narrow 52 to 54 range that had prevailed throughout 2014, although the index still signalled expanding activity. November's 'flash' inflation print showed the annual rate edging downward to 0.3% from 0.4% in October. Risks to the inflation profile are to the downside following the recent slide in oil prices and further decline in inflation expectations. Core inflation held steady but, at an historic low, did little to curb expectations for further ECB action. In the event, markets were disappointed with no policy announcements made in December although the statement reemphasized the ECB's balance sheet target and willingness to alter "the size, pace, and composition" of its asset purchases. We expect the ECB will increase the scope of its purchase programs in January, and while the likelihood of sovereign asset purchases has increased, we anticipate the first move will be into a broader array of private-sector assets, including corporate bonds. These policy measures are not expected to be transformational but will go some way toward addressing lingering credit supply constraints. Along with other tailwinds including currency depreciation, lower commodity prices, and less drag from fiscal consolidation, these should help growth pick up to a modest 1.0% in 2015.

BoE looking for wage growth

The second estimate of third-quarter 2014 UK GDP confirmed a 0.7% quarterly increase with details showing the gain was driven by strong household consumption while net trade provided a drag as exports contracted for a third consecutive quarter. The latter trend may persist into 2015 with euro area growth set to remain weak and sterling having appreciated against the euro. Household consumption should continue to provide support, particularly in the near term with lower gasoline prices leaving more money in consumers' pockets, but stronger wage gains are likely needed to reduce reliance on personal savings. Overall, we expect GDP growth of 2.6% in 2015, slightly slower than our 2014 estimate of 3.0% but still solidly above the trend rate. Despite strong activity, inflation remained near a cycle low in October and lower oil prices have increased the risk of the headline rate dropping below the BoE's 1–3% target range early next year. The optics of a rate hike could be tricky with inflation substantially below target. Additional pressure from continued external headwinds and uncertainty surrounding fiscal policy mean that the risks are tilted toward a hike coming later than our current June 2015 forecast. With that said, a recent BoE report, which indicated households will be able to handle higher interest rates, may leave policymakers more comfortable withdrawing stimulus sooner rather than later. We maintain that wage growth will be an important determinant of the underlying inflation outlook and thus look to firmer wage settlements as providing support to our forecast for rate increases to begin in 2015.

Australian incomes taking a hit

Australian GDP disappointed expectations in the third quarter with growth coming in at 0.3% as private consumption and net export gains were offset by a steeper than expected decline in non-residential construction. Despite production growth, real incomes edged downward in the quarter as a continued slide in commodity prices (particularly iron ore) lowered Australia's terms of trade. This negative effect on incomes is expected to persist in 2015 as the terms of trade deteriorates further. This in turn will weigh on domestic activity, leaving GDP growth at a sub-trend 2.7% in 2015. At the same time, hiring is likely to weaken, and the unemployment rate to edge modestly higher. A soft labour market will keep wages and prices subdued, underpinning our forecast for core inflation to ease into the lower half of the RBA's 2–3% target range. These dynamics argue against monetary policy normalization in the foreseeable future, and as such, we removed our call for a rate hike in the fourth quarter of 2015. While markets are pricing in additional stimulus, we would think a significant increase in the unemployment rate, signs of reduced policy traction, and a more significant decline in core inflation would be required for the RBA to adopt an easing bias and cut rates. At this stage, our base case is for the policy rate to remain steady at an historic low of 2.5% throughout our forecast horizon.

Interest rate outlook

%, end of period

	Actuals			Forecast								
	14Q1	14Q2	14Q3	14Q4	15Q1	15Q2	15Q3	15Q4	16Q1	16Q2	16Q3	16Q4
Canada												
Overnight	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.50	1.75	2.00	2.25	2.75
Three-month	0.90	0.94	0.92	0.90	1.10	1.10	1.35	1.60	1.90	2.15	2.40	2.75
Two-year	1.07	1.10	1.13	1.00	1.20	1.40	1.75	2.00	2.25	2.45	2.60	2.75
Five-year	1.71	1.53	1.63	1.45	1.75	2.00	2.30	2.55	2.70	2.85	3.00	3.20
10-year	2.49	2.24	2.16	1.95	2.30	2.60	2.70	3.00	3.10	3.30	3.40	3.50
30-year	2.97	2.78	2.67	2.50	2.80	3.00	3.10	3.30	3.50	3.60	3.75	3.90
United States												
Fed funds	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.50	2.00	2.50	3.00
Three-month	0.05	0.04	0.02	0.05	0.10	0.40	0.65	0.90	1.40	1.90	2.40	2.80
Two-year	0.44	0.47	0.58	0.60	0.75	1.10	1.60	2.00	2.25	2.50	2.75	3.00
Five-year	1.73	1.62	1.78	1.60	1.85	2.25	2.60	2.85	3.00	3.15	3.30	3.50
10-year	2.73	2.53	2.52	2.30	2.60	3.00	3.20	3.40	3.55	3.70	3.85	4.00
30-year	3.56	3.34	3.21	3.00	3.30	3.65	3.85	4.00	4.10	4.25	4.35	4.50
United Kingdom												
Bank rate	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00	1.25	1.50	1.50	1.75
Two-year	0.71	0.87	0.84	0.60	0.75	0.85	1.10	1.40	1.55	1.70	1.95	2.15
10-year	2.73	2.68	2.43	2.00	2.15	2.50	2.70	2.90	3.00	3.25	3.40	3.50
Eurozone												
Refi rate	0.25	0.15	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
Two-year	0.17	0.03	-0.07	-0.10	-0.10	-0.10	-0.10	-0.10	0.00	0.00	0.10	0.20
10-year	1.57	1.25	0.95	0.75	0.90	1.00	1.10	1.25	1.35	1.50	1.65	1.75
Australia												
Cash target rate	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
Two-year	2.78	2.80	2.61	2.40	2.30	2.40	2.40	2.60	2.60	2.70	2.75	2.75
10-year	4.08	4.00	3.48	3.00	3.40	3.70	3.90	4.00	4.15	4.30	4.35	4.50
New Zealand												
Cash target rate	2.75	3.25	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.75	4.00	4.00
Two-year swap	4.01	3.90	4.04	3.90	3.75	3.75	3.90	3.90	4.00	4.25	4.25	4.25
10-year swap	4.62	5.00	4.53	4.40	4.70	4.90	5.00	5.00	5.10	5.30	5.40	5.60
Yield curve												
Canada	142	114	103	95	110	120	95	100	85	85	80	75
United States	229	206	194	170	185	190	160	140	130	120	110	100
United Kingdom	202	181	159	140	140	165	160	150	145	155	145	135
Eurozone	140	122	102	85	100	110	120	135	135	150	155	155
Australia	130	120	87	60	110	130	150	140	155	160	160	175
New Zealand	61	110	49	50	95	115	110	110	110	105	115	135

* Two-year/10-year spread in basis points

Source: Reuters, RBC Economics Research

Central bank policy rate

%, end of period

		Current	Last	
United States	Fed funds	0.0-0.25	1.00	December 16, 2008
Canada	Overnight rate	1.00	0.75	September 8, 2010
United Kingdom	Bank rate	0.50	1.00	March 5, 2009
Eurozone	Refi rate	0.05	0.15	September 10, 2014
Australia	Cash rate	2.50	2.75	August 7, 2013
New Zealand	Cash rate	3.50	3.25	July 24, 2014

Source: Bloomberg, Reuters, RBC Economics Research

Growth outlook

% change, quarter-over-quarter in real GDP

	14Q1	14Q2	14Q3	14Q4	15Q1	15Q2	15Q3	15Q4	16Q1	16Q2	16Q3	16Q4	2013A	2014F	2015F	2016F
Canada*	1.0	3.6	2.8	2.7	3.0	2.7	2.3	2.2	2.0	1.9	1.9	2.1	2.0	2.5	2.7	2.1
United States*	-2.1	4.6	3.9	2.8	3.3	3.1	3.0	2.9	3.0	2.8	3.0	2.7	2.2	2.3	3.3	2.9
United Kingdom	0.7	0.9	0.7	0.6	0.6	0.5	0.8	0.6	0.6	0.5	0.5	0.4	1.9	3.0	2.6	2.4
Euro Area	0.3	0.1	0.2	0.2	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.4	-0.4	0.7	1.0	1.4
Australia	1.0	0.5	0.3	0.8	0.8	0.6	0.8	0.9	0.8	0.7	0.8	0.7	2.3	2.8	2.7	3.1
New Zealand	1.3	0.4	0.6**	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.5	0.5	2.8	3.5	2.5	2.3

*Seasonally adjusted annualized rates; ** Forecast

Inflation outlook

% change, year-over-year

	14Q1	14Q2	14Q3	14Q4	15Q1	15Q2	15Q3	15Q4	16Q1	16Q2	16Q3	16Q4	2013A	2014F	2015F	2016F
Canada	1.4	2.2	2.1	2.0	1.4	1.1	1.2	1.6	2.3	2.3	2.2	2.0	0.9	1.9	1.3	2.2
United States	1.4	2.1	1.8	1.4	1.1	1.0	1.3	1.9	2.3	2.2	2.2	2.2	1.5	1.7	1.3	2.2
United Kingdom	1.7	1.7	1.5	1.2	1.0	1.3	1.4	1.7	1.8	1.9	2.0	2.0	2.6	1.5	1.4	1.9
Eurozone	0.7	0.6	0.4	0.3	0.5	0.7	0.7	1.0	1.1	1.1	1.1	1.1	1.4	0.5	0.7	1.1
Australia	2.9	3.0	2.3	2.1	2.3	2.5	2.7	2.8	2.8	2.8	2.7	2.6	2.4	2.6	2.6	2.8
New Zealand	1.5	1.6	1.0	1.2	1.5	1.6	1.7	1.8	1.8	1.9	2.0	2.0	1.1	1.3	1.7	1.9

Source: Statistics Canada, Bureau of Labor Statistics, Bank of England, European Central Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, RBC Economics Research

Inflation tracking

Inflation Watch

	Measure	Current period	Period ago	Year ago	Three-month trend	Six-month trend
Canada	Bank of Canada core CPI[1]	Oct.	0.3	2.3	2.3	2.5
United States	Core PCE[2]	Oct.	0.2	1.6	1.4	1.7
United Kingdom	All-items CPI	Oct.	0.1	1.3	1.2	1.3
Eurozone	All-items CPI	Oct.	-0.1	0.4	-0.1	0.5
Australia	Trimmed mean	Q3	0.4	2.5	N/A	N/A
New Zealand	CPI	Q3	0.3	1.0	N/A	N/A

1 Seasonally adjusted measurement.
2 Personal consumption expenditures less food and energy price indices.

Source: Statistics Canada, US Bureau of Labor Statistics, Bank of England, European Central Bank, Reserve Bank of Australia, Reserve Bank of New Zealand, RBC Economics Research

Currency outlook

Level, end of period

	Actuals							Forecast				
	13Q1	13Q2	13Q3	13Q4	14Q1	14Q2	14Q3	14Q4	15Q1	15Q2	15Q3	15Q4
Canadian dollar	1.02	1.05	1.03	1.06	1.11	1.07	1.12	1.15	1.16	1.17	1.17	1.18
Euro	1.28	1.30	1.35	1.38	1.38	1.37	1.26	1.23	1.20	1.18	1.17	1.17
U.K. pound sterling	1.52	1.52	1.62	1.66	1.67	1.71	1.62	1.58	1.54	1.49	1.44	1.43
New Zealand dollar	0.84	0.77	0.83	0.82	0.87	0.88	0.78	0.77	0.76	0.75	0.74	0.74
Japanese yen	94.2	99.1	98.3	105.3	103.2	101.3	109.7	122.0	124.0	127.0	129.0	132.0
Australian dollar	1.04	0.91	0.93	0.89	0.93	0.94	0.87	0.83	0.82	0.81	0.80	0.80

Canadian dollar cross-rates

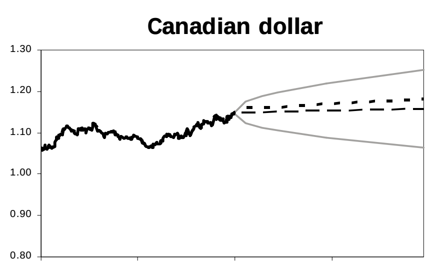
	13Q1	13Q2	13Q3	13Q4	14Q1	14Q2	14Q3	14Q4	15Q1	15Q2	15Q3	15Q4
EUR/CAD	1.55	1.60	1.67	1.47	1.52	1.46	1.41	1.41	1.39	1.38	1.37	1.38
GBP/CAD	1.46	1.60	1.74	1.76	1.84	1.83	1.82	1.81	1.78	1.75	1.69	1.68
NZD/CAD	0.85	0.81	0.86	0.87	0.96	0.93	0.87	0.89	0.88	0.88	0.87	0.87
CAD/JPY	92.6	94.2	95.3	99.1	93.4	95.0	97.9	106.0	107.0	109.0	110.0	112.0
AUD/CAD	1.06	0.96	0.96	0.95	1.02	1.01	0.98	0.95	0.95	0.95	0.94	0.94

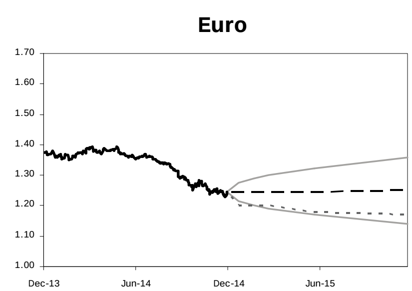
Rates are expressed in currency units per US dollar and currency units per Canadian dollar, except the euro, UK pound, Australian dollar, and New Zealand dollar, which are expressed in US dollars per currency unit and Canadian dollars per currency unit.

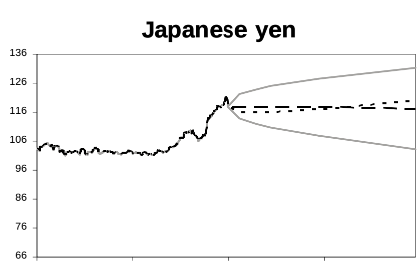
Source: Bloomberg, RBC Economics Research

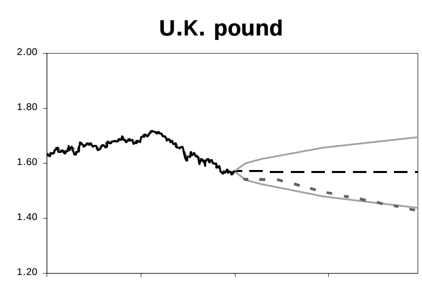
RBC Economics outlook compared to the market

The following charts track historical exchange rates plus the forward rate (dashed line) compared to the RBC Economics forecast (dotted line) out one year. The cone for the forecast period frames the forward rate with confidence bounds using implied option volatilities as of the date of publication.







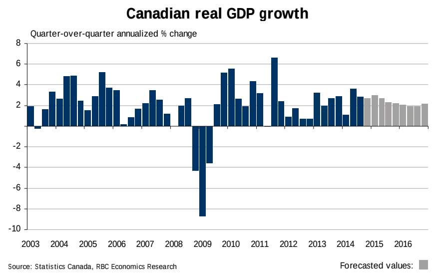


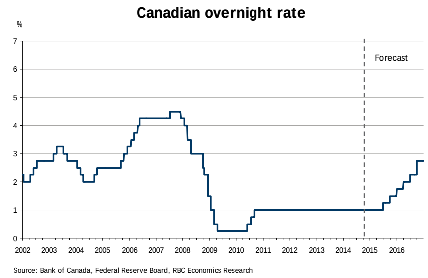
Central bank watch

Bank of Canada

Q3 growth of 2.8% was stronger than both market expectations and the BoC's forecast. September GDP was up a solid 0.4% following weak readings in the prior two months. We look for that momentum to be maintained with a 2.7% gain in Q4.

Despite stronger than expected growth and core inflation, the BoC appears reluctant to raise rates any time soon. Reflecting this, we have moved our forecast for the first overnight rate hike to Q3/15—after the Fed's first move.

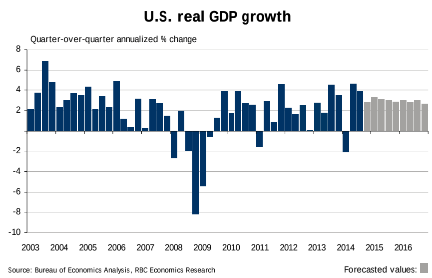


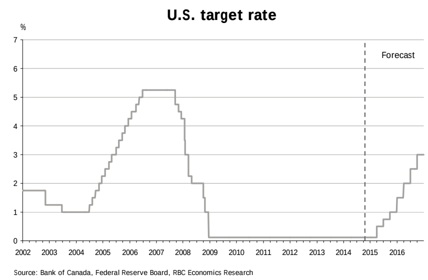


Federal Reserve

The US economy has considerable momentum heading into 2015 with activity continuing to improve and job growth surprising to the upside.

The Fed's mid-December meeting may result in a change to the "considerable time" forward guidance as the Fed continues to prepare markets for what we expect will be a June 2015 rate hike.

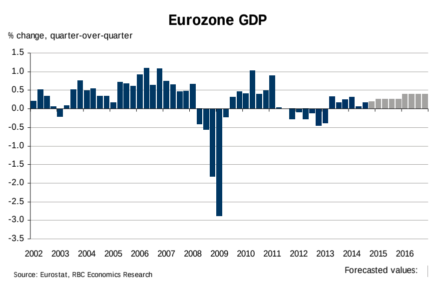


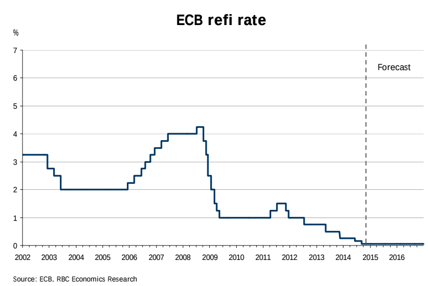


European Central Bank

Euro area growth remains very modest, but the possibility of a slip into deflation is likely a greater worry for policymakers with spot inflation at just 0.3% year over year in November and inflation expectations continuing to fall.

While the likelihood of sovereign-debt purchases has increased, we expect the ECB's first step will be to expand purchases into a broader array of private-sector assets.

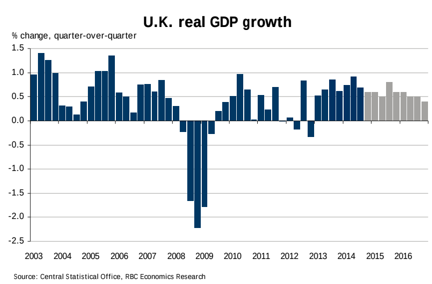


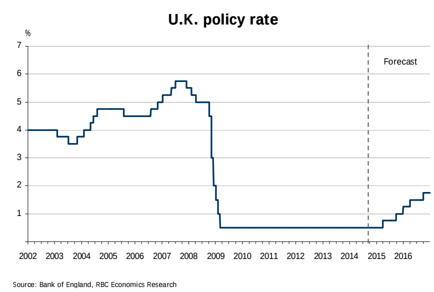


Bank of England

UK growth remains strong, but headline inflation could dip below the BoE's 1–3% target range early next year as lower gasoline prices weigh on an already soft core inflation profile.

We expect indications of firmer wage growth in 2015 will support our forecast for a June rate hike, even if spot inflation remains in the lower half of the BoE's 1–3% target range.

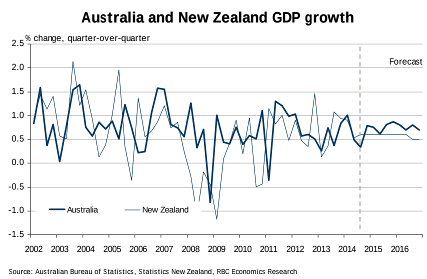


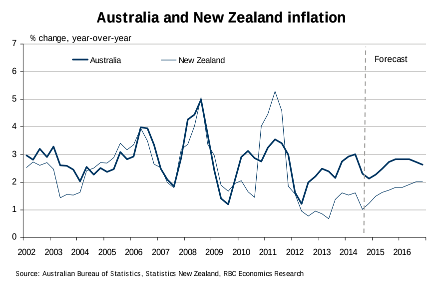


Australia and New Zealand

With declining terms of trade holding back Australian income growth and core inflation expected to remain in the lower half of the RBA's 2–3% target range, we now expect the policy rate will be held steady throughout our forecast horizon.

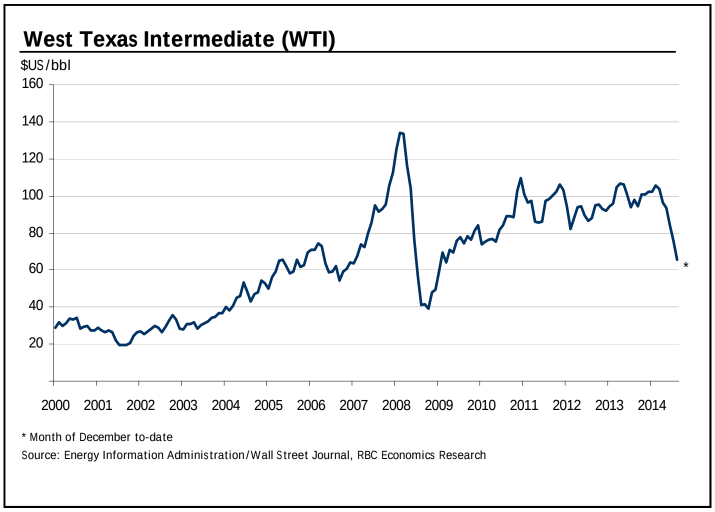
The RBNZ maintained a mild tightening bias but noted that any hikes would be data dependent. With inflation expected to remain below 2% during 2015 and into 2016, we pushed our forecast for the next policy rate hike out to Q2/16.



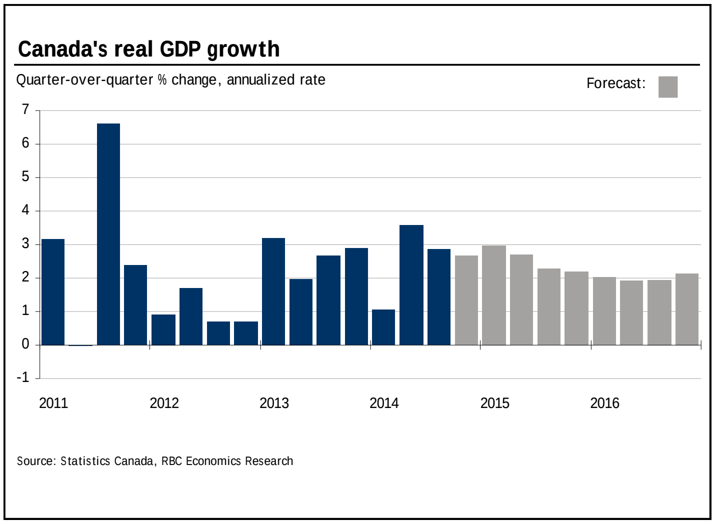


Canada's economy to weather oil price decline

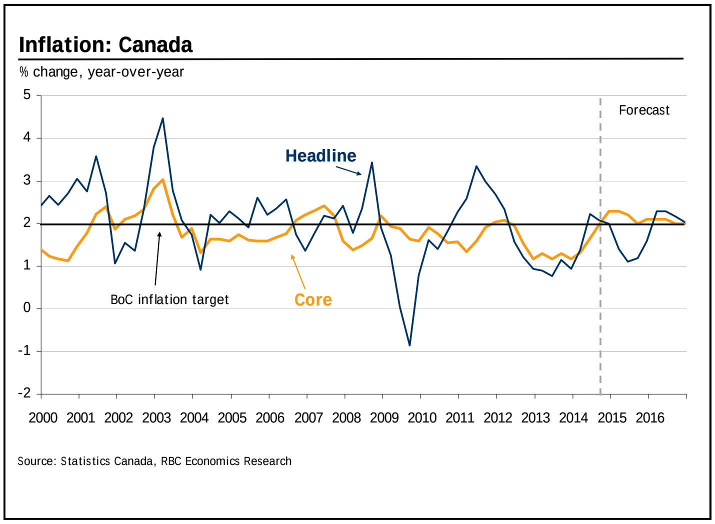
Oil prices have fallen by more than 40% since mid-June 2014.



For Canada's economy, firmer US demand for exports and lower energy costs for consumers and business are expected to offset lower investment by energy companies in 2015.



The headline inflation rate will drop on the back of energy price declines; however, the core measure is likely to remain above 2% given the recent tightening in labour market conditions and the continuation of above-potential growth.



The Bank of Canada is worried about the effect of the oil price decline although views recent data as indicating a self-sustaining expansion is underway. If conditions continue to improve as we expect, then the Bank is likely to raise the policy rate in H2/15.