



Inside...

FINANCIAL MARKETS MONTHLY

February 9, 2018

Overview

..... page 1

Interest rate outlook

..... page 5

Economic outlook

..... page 6

Currency outlook

..... page 7

Central bank watch

..... page 8

Some big market moves to start 2018

..... page 9

Josh Nye
Economist
416-974-3979
josh.nye@rbc.com

Fast times as rates go high

The extraordinarily low equity market volatility seen throughout 2017 ended abruptly in February as the VIX jumped to its second-highest level since the European debt crisis. Losing ground for two consecutive weeks, the S&P 500 entered correction territory falling more than 10% from its January 26 peak. Equity markets in Canada, Europe and around the globe also fell sharply in the past two weeks.

The drop-off in what many feared was an overvalued US equity market seemed to be triggered by rising bond yields. US treasuries sold off sharply to start 2018 with 10-year yields hitting four-year highs by early February. That move was more abrupt than anticipated but reflects a process we expected would unfold. Namely, with the US economy already bumping up against capacity limits and tax cuts set to push demand even higher, inflation risks are tilted to the upside for the first time in recent memory. Stronger wage growth in January seemed to underscore that for markets. With energy prices also picking up, market-based inflation expectations rose to three-year highs and put upward pressure on nominal yields. Investors are also waking up to the reality that the Fed has little reason to slow their tightening cycle amid strong growth momentum and potentially inflationary fiscal stimulus. The promise of increased Treasury supply to finance the tax cuts also played into the bump up in bond yields.

The fixed income selloff wasn't confined to the US as bond yields in Canada, Germany and the UK all trended higher in January. And those moves don't just reflect spillover from the States. The Bank of Canada remains in tightening mode despite Nafta concerns, while positive data in the euro area and UK has investors contemplating an end to ultra-accommodative monetary policy in Europe.

Central bank near-term bias

Three-months out, policy rate



The Bank of Canada raised interest rates in January and maintained a tightening bias. The reality of tight economic conditions and gradually rising inflation is expected to offset persistent Nafta concerns, prompting another rate hike in the first half of the year.



The Fed held policy steady in January but signaled another move is imminent. We think they'll raise rates once a quarter this year as solid growth momentum and a boost from tax cuts risks the central bank falling behind the curve on inflation.



Even as Brexit continues to cloud the UK outlook, the Bank of England is concerned that the economy will bump up against capacity limits over the next few years. Hoping to stem the risk that inflation persists above target, they now look set to raise rates in May.



March's meeting could see the European Central Bank shift their forward guidance, but we still think QE will continue throughout 2018 and rate hikes are off the table for a few months after net purchases have been tapered to zero.



The Reserve Bank of Australia sounded a bit more upbeat at their first meeting of 2018. But even with a somewhat brighter economic outlook, progress toward their inflation target is likely to remain slow. That should keep the central bank on the sidelines this year.



The Reserve Bank of New Zealand's lower inflation projections, with CPI now seen below 2% into 2020, reinforce their bias to leave the cash rate steady at an accommodative 1.75%. We don't see them raising interest rates this year.

Highlights

▲ The recent bout of equity market volatility isn't expected to be sustained and doesn't change a solid US economic outlook for 2018.

▲ The dip in consumer savings in Q4/17 is not expected to persist.

▲ US wages are growing at their fastest pace since 2009 but still not at rates that would push inflation well beyond the Fed's target.

▲ New Fed Chair Jerome Powell inherited a strong US economy and we expect the Fed will raise rates in March despite the recent wobble in equities.

US economy turned on the afterburners in Q4/17

Headline US GDP growth slowed a touch to 2.6% in Q4/17 following back-to-back gains of more than 3% in Q2 and Q3. The composition was more favourable with domestic spending rising at a 4% annualized rate in Q4, the best pace in three years. That reflected impressive growth in consumer spending, a rebound in the residential sector following two quarters of decline, and another solid increase in business investment as companies continued to spend on machinery and equipment. Housing and consumer spending got a lift from post-hurricane rebuilding and the replacement of autos, although underlying fundamentals for both look solid as well. A pullback in inventory investment and a surge in imports that outpaced decent exports weighed on overall GDP growth. But the Q4 gain was still well ahead of the economy's longer run speed limit. All told, the US economy entered 2018 with solid momentum and is set to get a shot in the arm from tax cuts passed late last year. Our forecast assumes GDP growth will rise to 2.6% this year from 2.3% in 2017, with much of the pickup reflecting tax changes.

But are consumers burning through their savings?

One eye-catching number in the latest national accounts was a further dip in the household savings rate, which at 2.6% in Q4/17, was the lowest in more than a decade. A lower savings rate isn't surprising given rising equity values and strong consumer confidence, but the recent dip has raised some concerns that consumers are close to being tapped out. We don't think that's the case. Even with personal savings expected to rebound somewhat this year, solid income growth—due to both rising wages and a boost to take home pay from lower taxes—will keep consumer spending volumes rising at a near-3% pace. Consumers have certainly been heavily relied upon for GDP growth in recent years, but given solid fundamentals, we think they'll come through again in 2018.

Finally some signs of life in US wages

2017 was another impressive year for the US labour market with average monthly job gains of 181k—well ahead of underlying demographic growth—pushing unemployment down to its lowest rate since 2000. The one missing piece was wage growth which remained stuck around 2-1/2%. But January's jobs report showed tentative signs that the story will be different this year. Wage growth picked up for a third consecutive month to 2.9% in January, the fastest year-over-year increase since 2009. That level shouldn't stoke fears of an imminent spike in inflation, but the recent increase certainly has investors thinking that tight labour market conditions are finally feeding through to labour costs, and eventually, will fuel higher consumer prices. That prospect has shifted market pricing, which now points to the Fed following through with plans to raise rates another three times this year.

Chair Yellen hands off a strong economy

As expected, the Fed left interest rates unchanged on January 31—Chair Yellen's final meeting before Jerome Powell took over in early-February. Economic conditions are certainly strong enough to warrant higher interest rates, but in keeping with the gradual, predictable policy changes under her tenure, Yellen and company opted to leave fed funds unchanged and simply set the table for a move in March. We too look for a hike at the upcoming meeting and think a once-a-quarter pace of rate increases will continue through next year. Our call for four rate hikes this year remains slightly ahead of market pricing and the Fed's latest dot plot showing three hikes. In our view, any pause in tightening risks the Fed falling behind the curve at a time when tax cuts are set to push the economy into excess demand and could stoke inflation.

The central bank's latest meeting came before equity market volatility reared its head. But in comments since then, Fed officials didn't sound overly concerned about the stock market correction. We don't think the Fed's March rate hike will be derailed by volatility as policymakers focus on underlying strength in the US economy. We also doubt the new Chair will want to be seen as capitulating to investors' concerns about rising rates.

Canada's economy got back on track in November

Canadian GDP growth rebounded to 0.4% in November following a flat reading in October. Goods production jumped as the weight from transitory shutdowns in the auto, energy and chemical manufacturing sectors were reversed. Services growth, which tends to be less volatile, also picked up in November. The increase is more in line with indications of strong employment growth toward the end of 2017. Our forecast assumes GDP growth ticked up to 1.9% in Q4/17 from 1.7% in the prior quarter. That would be slightly ahead the economy's longer-run potential growth but short of the Bank of Canada's 2.5% forecast—a number we were surprised to see held over from their previous projections given a soft start to the quarter.

Housing continued its wild ride at the turn of the year

Canada's housing market went on a wild ride through 2017 and the close of the year was no different. Home sales rose strongly in November and December, hitting a record high on a seasonally adjusted basis in the final month of the year. Homebuyers rushed into the market ahead of a regulatory change on January 1, 2018 that raised the qualifying rate on insured mortgages. Early data for the Greater Toronto Area market—the country's most volatile last year—showed a sizeable drop in sales in January after sales were pulled forward into 2017. When the dust settles we expect regulatory tightening, in combination with higher interest rates, will result in resales falling at a low single digit pace for a second consecutive year in 2018. Price growth is expected to be limited to just over 2% following a double-digit gain last year.

BoC continues to hike despite Nafta concerns

In the month leading up to the Bank of Canada's January meeting, solid economic data and a positive tone from Governor Poloz raised market expectations that the bank would hike rates to start 2018. They didn't disappoint, raising the overnight rate by 25 basis points to a post-crisis high of 1.25%. The central bank kept a fairly balanced tone in announcing their decision, noting recent indicators had generally outperformed expectations while emphasizing caution given risks surrounding the Nafta renegotiation. Their growth forecasts were little changed on balance despite adding a modest downward impact on business investment and exports related to Nafta uncertainty. Even with that drag, stronger contributions from both sectors this year are expected to help offset more modest gains in consumer spending and housing. Growth of 1.8% on a Q4/Q4 basis in 2018 is still slightly ahead of their upwardly-revised 1.6% potential growth rate, implying the economy should continue to bump up against capacity limits this year.

But while product markets are close to full capacity, the bank continued to see signs of labour market slack—though they admitted that has been narrowing more quickly than expected in recent months. Their view partly hinges on wage growth, which despite picking up in the second half of last year, is still running a bit slower than would be expected if labour markets were pushing beyond capacity. The central bank unveiled a new wage measure that stood at 2.2% in Q4/17—below readings closer to 3% in the household and payroll surveys. This new wage reading as well as the bank's labour market indicator both point to a slightly less impressive jobs backdrop than official statistics and will be watched closely as a sign of how the Governing Council sees slack evolving.

While the bank held onto a not-too-hot, not-too-cold view, the reality of an economy operating close to full capacity with underlying inflation near 2% left their tightening bias intact. We think they'll continue raising rates once a quarter this year, pushing the overnight rate up to 2% by the end of the year. How much further they'll go from there is questionable—the bank noted some continued stimulus is likely to be required given headwinds from trade worries and regulatory changes, as well as increased sensitivity to rate hikes. As such, we expect the policy rate will move only marginally higher in 2019 before the bank pauses to assess the impact of past rate hikes.

▲ Canada's economy returned to positive growth in November as a numbers of transitory factors reversed.

▲ Homebuyers rushed to get ahead of a regulatory change on January 1, leading to a sharp drop in resales to start the year.

▲ Businesses don't seem to be paralyzed by Nafta uncertainty. Neither was the Bank of Canada when they raised rates in January.

▲ The central bank sees a bit more slack in labour markets than headline unemployment and wage growth would suggest.

Highlights

▲ The BoE clearly signaled that interest rates will move higher, and sooner, than markets were expecting.

▲ Meanwhile, euro area survey readings were at their best in a decade with strong readings across the bloc's four largest economies.

▲ Underlying inflation remains below the RBA's 2-3% target range and won't return to the mid-point in the near-term.

▲ New Zealand's central bank isn't likely to start raising rates anytime soon.

Surprisingly hawkish shift from the BoE sets up for a May rate hike

We previously expected the Bank of England would hold interest rates steady this year with the ongoing impact of Brexit uncertainty anticipated to keep economic activity relatively subdued. But a much more hawkish tone from the central bank in February has led us to revise our bank rate forecast—we now expect a rate hike in May, as well as two further increases next year. The BoE didn't mince words, indicating “monetary policy would need to be tightened somewhat earlier and by a somewhat greater extent” than the two hikes over three years markets were previously pricing in. That change in language was despite only modest upward revision to their GDP forecasts and few changes in the expected inflation profile. Rather, it was their characterization of economic slack that seemed to underpin the bank's shift. Growth is expected to outpace potential over the next few years, pushing the economy into excess demand. With survey data already pointing to faster wage growth this year, the concern is that tight conditions will put upward pressure on prices—leaving inflation above target even after currency effects have faded. We were a bit surprised by the timing of the central bank's hawkish turn, coming before more clarity on a Brexit transition deal emerges. And we still have concerns about the economic backdrop, which were reinforced by soft survey data in January. Nonetheless, it looks like the BoE is primed for a follow up to November's hike.

...while the ECB remains in easing mode despite momentum

Euro area GDP was up 0.6% in Q4/17, marking a fifth consecutive quarter of above-potential growth. Early indicators point to momentum continuing to build at the start of 2018. January's composite purchasing managers' index rose for a third straight month, hitting its highest level in more than a decade thanks to further improvement in the services sector. Along with rising new orders and business sentiment, some of the recent strengthening has also been due to higher input and output prices—a welcome development for the European Central Bank given persistently soft inflation readings. The ECB made no changes to monetary policy or forward guidance in January but given the improving economic backdrop there is growing expectation that their language could shift as soon as the March meeting. While current guidance suggests asset purchases will continue until September 2018, “or beyond,” it looks like net purchases might not extend into 2019. But with a pledge to keep interest rates at present levels well past the horizon of net asset purchases, we continue to expect the ECB will hold off on raising rates until the second half of 2019—later than markets are currently pricing.

RBA maintains a positive tone but isn't likely to hike near term

Following their two-month break, the Reserve Bank of Australia left monetary policy unchanged in early February. The central bank once again struck a relatively upbeat tone, noting stronger global growth and a decent domestic outlook albeit with some concerns about housing and consumption. Policymakers seem a bit more confident in their forecasts for above-trend growth and on-target inflation over the medium term. But they also suggested further progress in reducing unemployment and returning inflation to target is likely to be gradual. Indeed, the latest inflation readings showed headline and core CPI persisting below the RBA's 2-3% target at the end of last year. And while underlying inflation appears to have troughed, there are few signs of upward momentum and prices aren't likely to accelerate amid slow wage growth. So even as the central bank's tone improves, they're unlikely to start normalizing monetary policy until they have more confidence that slack is being absorbed, wage pressures are rising and underlying inflation is heading toward the middle of the central bank's target range. We continue to see the cash rate on hold this year.

RBNZ bucking the global trend, staying firmly on the sidelines

The Reserve Bank of New Zealand left their cash rate unchanged at 1.75% in February and continued to note that monetary policy will remain accommodative “for a considerable period.” They marked down their near term GDP projections after growth slowed in the second half of 2017, but activity is seen picking up a bit more later this year with help from both fiscal and monetary stimulus. Their inflation profile was lowered, due in part to a softer starting point, with CPI not expected to return to 2% on a sustained basis until 2020. We agree that domestic inflationary pressures will be slow to materialize and think a further period of steady monetary policy is in order. Look for the cash rate to remain unchanged again this year.

Interest rate outlook

%, end of period

	Actuals				Forecast							
	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
Canada												
Overnight	0.50	0.50	1.00	1.00	1.25	1.50	1.75	2.00	2.25	2.25	2.25	2.25
Three-month	0.52	0.71	1.00	1.06	1.20	1.45	1.70	2.05	2.25	2.15	2.15	2.15
Two-year	0.75	1.10	1.52	1.69	1.75	2.05	2.25	2.45	2.60	2.50	2.40	2.30
Five-year	1.12	1.40	1.75	1.87	2.00	2.30	2.55	2.75	2.90	2.85	2.85	2.80
10-year	1.62	1.76	2.10	2.04	2.20	2.50	2.75	2.95	3.10	3.10	3.05	3.05
30-year	2.30	2.14	2.47	2.27	2.45	2.75	3.05	3.15	3.25	3.25	3.30	3.30
United States												
Fed funds**	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.50
Three-month	0.76	1.03	1.06	1.39	1.55	1.80	2.05	2.30	2.55	2.80	3.05	3.30
Two-year	1.27	1.38	1.47	1.89	2.10	2.35	2.55	2.75	3.00	3.25	3.40	3.55
Five-year	1.93	1.89	1.92	2.20	2.50	2.70	2.90	3.05	3.25	3.45	3.55	3.65
10-year	2.40	2.31	2.33	2.40	2.80	3.00	3.15	3.30	3.45	3.60	3.70	3.75
30-year	3.02	2.84	2.86	2.74	3.20	3.35	3.50	3.60	3.70	3.75	3.80	3.85
United Kingdom												
Bank rate	0.25	0.25	0.25	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.00	1.25
Two-year	0.12	0.36	0.46	0.45	YIELD FORECASTS UNDER REVIEW							
10-year	1.14	1.26	1.38	1.19								
Euro area												
Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.20
Two-year	-0.74	-0.57	-0.69	-0.63	-0.65	-0.65	-0.60	-0.50	-0.50	-0.50	-0.40	-0.30
10-year	0.33	0.47	0.47	0.43	0.65	0.65	0.70	0.80	1.00	1.05	1.25	1.25
Australia												
Cash target rate	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75	2.00	2.00	2.00
Two-year	1.76	1.78	1.94	2.00	2.00	2.10	2.25	2.40	2.50	2.60	2.60	2.60
10-year	2.70	2.60	2.84	2.63	2.90	3.10	3.40	3.55	3.85	4.10	4.10	4.05
New Zealand												
Cash target rate	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00
Two-year swap	2.31	2.32	2.19	2.20	2.20	2.30	2.40	2.50	2.60	2.75	2.80	2.80
10-year swap	3.41	3.35	3.24	3.13	3.40	3.60	3.80	3.95	4.10	4.30	4.40	4.35
Yield curve*												
Canada	87	66	58	35	45	45	50	50	50	60	65	75
United States	113	93	86	51	70	65	60	55	45	35	30	20
United Kingdom	102	90	92	74	-	-	-	-	-	-	-	-
Eurozone	107	104	116	106	130	130	130	130	150	155	165	155
Australia	94	82	90	63	90	100	115	115	135	150	150	145
New Zealand	110	103	105	93	120	130	140	145	150	155	160	155

* Two-year/10-year spread in basis points, **Top of 25 basis point range

Source: Reuters, RBC Economics Research

Central bank policy rate

%, end of period

		Current	Last				Current	Last	
United States	Fed funds	1.25-1.50	1.00-1.25	December 13, 2017	Eurozone	Deposit rate	-0.40	-0.30	March 10, 2016
Canada	Overnight rate	1.25	1.00	January 17, 2018	Australia	Cash rate	1.50	1.75	August 3, 2016
United Kingdom	Bank rate	0.50	0.25	November 2, 2017	New Zealand	Cash rate	1.75	2.00	November 10, 2016

Source: Bloomberg, Reuters, RBC Economics Research

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	2016	2017F	2018F	2019F
Canada*	3.7	4.3	1.7	1.9	1.9	1.7	1.7	1.6	1.6	1.6	1.5	1.5	1.4	2.9	1.9	1.6
United States*	1.2	3.1	3.2	2.6	2.5	2.5	2.7	2.7	2.2	2.0	1.7	1.7	1.5	2.3	2.6	2.2
United Kingdom	0.3	0.3	0.4	0.5	0.3	0.4	0.3	0.4	0.3	0.4	0.3	0.4	1.9	1.8	1.5	1.4
Euro area	0.6	0.7	0.7	0.6	0.6	0.5	0.5	0.4	0.4	0.4	0.4	0.4	1.8	2.5	2.3	1.9
Australia	0.4	0.9	0.6	0.6	0.8	0.6	0.5	0.5	0.7	0.7	0.9	0.9	2.6	2.2	2.8	3.0
New Zealand	0.8	1.0	0.6	0.8	1.0	0.8	0.8	0.7	0.7	0.7	0.7	0.7	4.0	2.7	3.4	2.9

*annualized

Inflation outlook

% change, year-over-year

	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4	2016	2017F	2018F	2019F
Canada	1.9	1.3	1.4	1.8	1.9	2.2	2.3	2.0	1.7	2.0	2.1	2.0	1.4	1.6	2.1	1.9
United States	2.5	1.9	2.0	2.1	2.0	2.3	2.1	1.6	1.4	1.7	2.0	2.1	1.3	2.1	2.0	1.8
United Kingdom	2.2	2.8	2.8	3.0	2.8	2.7	2.7	2.6	2.3	2.2	2.2	2.0	0.6	2.7	2.7	2.2
Euro area	1.8	1.5	1.4	1.4	1.4	1.3	1.4	1.4	1.4	1.4	1.5	1.5	0.2	1.5	1.4	1.5
Australia	2.1	1.9	1.8	1.9	2.1	2.5	2.4	2.3	2.3	2.5	2.6	2.7	1.3	1.9	2.3	2.5
New Zealand	2.1	1.7	1.9	1.6	1.4	2.0	2.1	2.0	2.0	2.0	2.0	2.0	0.6	1.9	2.0	2.0

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	CPI ex food & energy ¹	Dec	0.2	1.7	1.9	1.3
United States	Core PCE ^{1,2}	Dec	0.2	1.5	1.9	1.4
United Kingdom	All-items CPI	Dec	0.3	3.0	3.4	3.0
Euro area	All-items CPI ¹	Jan	0.3	1.3	2.0	1.2
Australia	Trimmed mean CPI ¹	Q4	0.4	1.8	N/A	N/A
New Zealand	All-items CPI	Q4	0.1	1.6	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							
	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
Canadian dollar	1.33	1.30	1.25	1.26	1.28	1.26	1.24	1.22	1.24	1.26	1.27	1.28
Euro	1.07	1.14	1.18	1.20	1.23	1.20	1.16	1.18	1.20	1.22	1.24	1.26
U.K. pound sterling	1.26	1.30	1.34	1.35	1.37	1.32	1.26	1.27	1.29	1.31	1.33	1.35
New Zealand dollar	0.70	0.73	0.72	0.71	0.75	0.74	0.73	0.71	0.69	0.69	0.69	0.69
Japanese yen	111.4	112.4	112.5	112.7	107.0	105.0	107.0	109.0	112.0	115.0	118.0	120.0
Australian dollar	0.76	0.77	0.78	0.78	0.80	0.78	0.75	0.73	0.73	0.73	0.73	0.73

Canadian dollar cross-rates

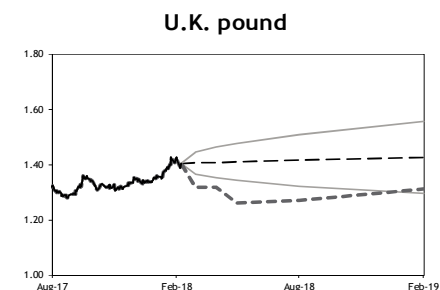
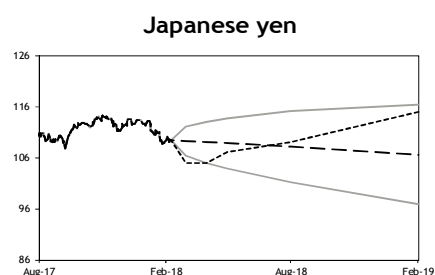
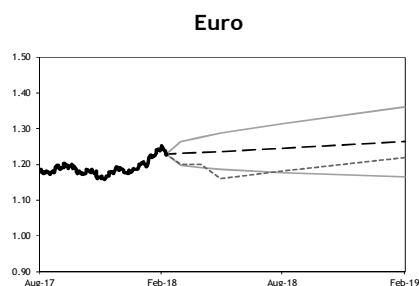
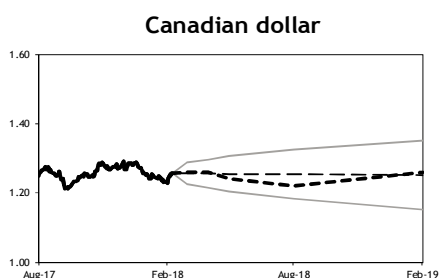
	17Q1	17Q2	17Q3	17Q4	18Q1	18Q2	18Q3	18Q4	19Q1	19Q2	19Q3	19Q4
EUR/CAD	1.42	1.48	1.47	1.51	1.42	1.51	1.44	1.44	1.49	1.54	1.57	1.61
GBP/CAD	1.67	1.69	1.67	1.70	1.75	1.66	1.56	1.55	1.60	1.65	1.69	1.73
NZD/CAD	0.93	0.95	0.90	0.89	0.96	0.93	0.91	0.87	0.86	0.87	0.88	0.88
CAD/JPY	83.6	86.7	90.2	89.6	83.6	83.3	86.3	89.3	90.3	91.3	92.9	93.8
AUD/CAD	1.02	1.00	0.98	0.98	1.02	0.98	0.93	0.89	0.91	0.92	0.93	0.93

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.

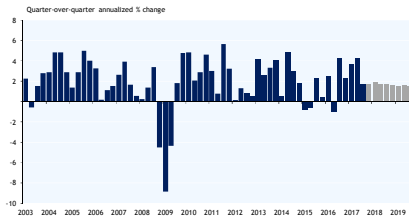


Bank of Canada

Canadian GDP growth picked up in November but there's still some wood to chop to hit the Bank of Canada's 2.5% forecast for Q4/17. We see growth for the quarter at a slightly softer 1.9% pace.

With wages and inflation starting to respond to tight economic conditions, we think the Bank of Canada will continue to pull back on accommodation, raising rates another three times this year.

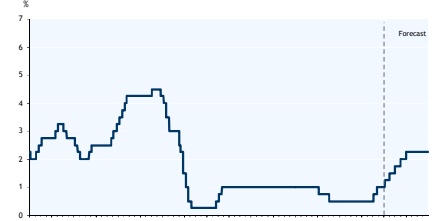
Canadian real GDP growth



Source: Statistics Canada, RBC Economics Research

Forecasted values: ■

Canadian overnight rate



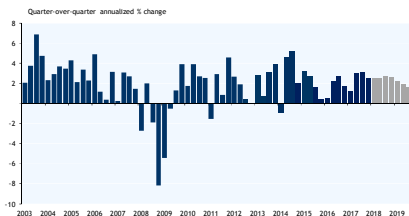
Source: Bank of Canada, Federal Reserve Board, RBC Economics Research

Federal Reserve

The US economy grew at a rate well above trend for a third consecutive quarter in Q4/17. We expect similar gains this year as consumers and businesses spend some of their tax savings.

Inflation is close to the Fed's 2% objective and labour costs are on the rise. And with upside risk coming from fiscal stimulus, we think the central bank will continue steadily removing stimulus with four rate hikes in both 2018 and 2019.

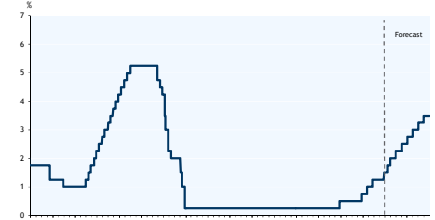
U.S. real GDP growth



Source: Bureau of Economic Analysis, RBC Economics Research

Forecasted values: ■

U.S. target rate



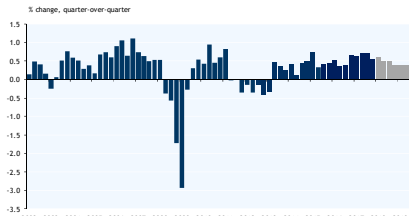
Source: Bank of Canada, Federal Reserve Board, RBC Economics Research

European Central Bank

The euro area's ongoing recovery is showing no signs of fatigue. Above-trend growth is pushing the economy close to its longer-run capacity limits but inflation remains stuck below the European Central Bank's target.

A solid economic backdrop could see the central bank shifting their forward guidance in March. But with few signs that inflation is picking up, we don't see normalization starting anytime soon.

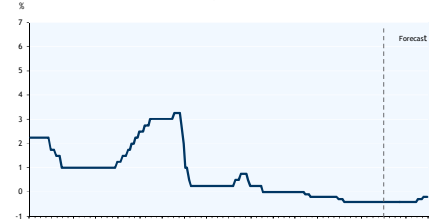
Euro area GDP



Source: Eurostat, RBC Economics Research

Forecasted values: ■

ECB Deposit rate



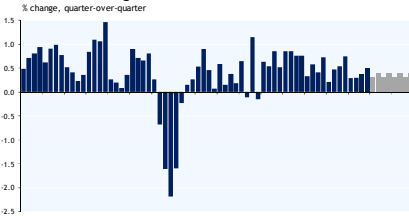
Source: ECB, RBC Economics Research

Bank of England

UK GDP surprised on the upside in Q4/17 but survey data points to a slower start to 2018 as businesses continue to await details of the Brexit transition.

The BoE thinks GDP growth will exceed the economy's potential over the next few years, resulting in excess demand that could lift inflation. Given their hawkish shift, we now look for a rate hike in May.

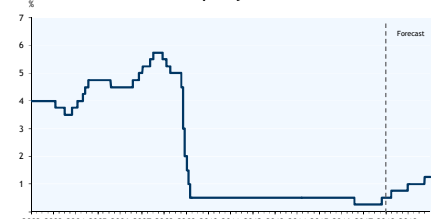
U.K. real GDP growth



Source: Central Statistical Office, RBC Economics Research

Forecasted values: ■

U.K. policy rate



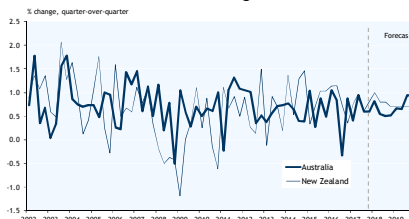
Source: Bank of England, RBC Economics Research

Australia and New Zealand

We have trimmed our forecast for Q4/17 Australian GDP growth and expect challenging conditions for the consumer and housing sectors will persist this year. That should keep the RBA on the sidelines.

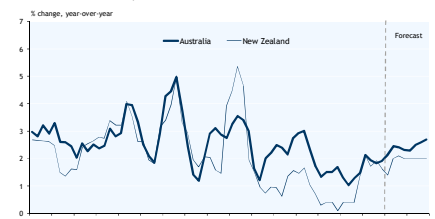
The RBNZ continued to note that accommodative monetary policy will be required for a "considerable period." We see them holding the cash rate steady well into next year.

Australia and New Zealand GDP growth



Source: Australian Bureau of Statistics, Statistics New Zealand, RBC Economics Research

Australia and New Zealand inflation

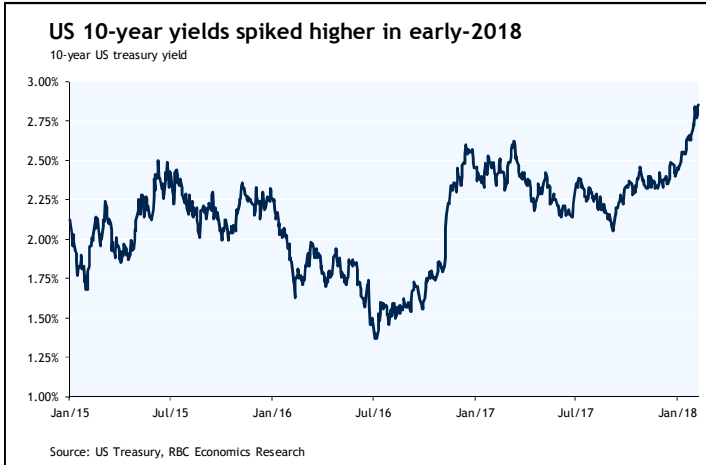


Source: Australian Bureau of Statistics, Statistics New Zealand, RBC Economics Research

Some big market moves to start 2018

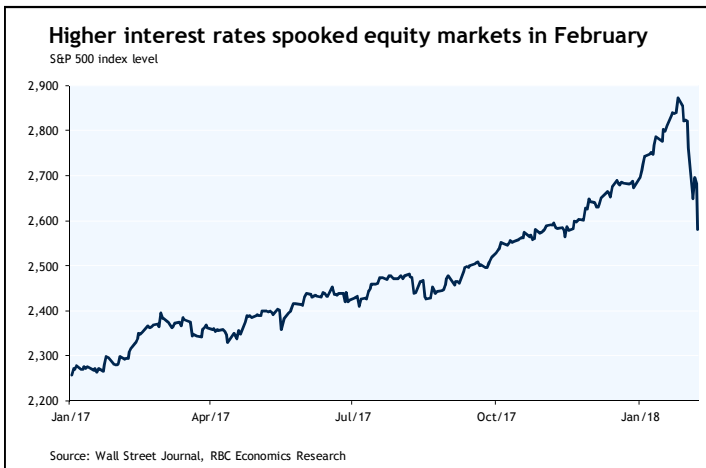
US government bond yields jumped higher at the start of 2018 as markets digested the impact of fiscal stimulus: tighter monetary policy, higher inflation and increased Treasury supply to fund tax cuts.

An increase in market-based inflation expectations helped drive nominal yields higher. Rising energy prices—WTI surged past \$65/barrel for the first time since 2014—were a factor boosting the inflation markup.



With 3% bond yields in sight for the first time in years, investors became worried about the economic impact of rising rates. Equities sold off sharply in early-February but stabilized shortly thereafter. Major benchmarks are still up strongly since last year.

Equity market volatility returned with vengeance after a year of record lows for the VIX. The spike in early-February pushed Wall Street's 'fear gauge' to its second-highest level since the Eurozone crisis.



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.

