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Flagging growth won't derail central bank rate hikes

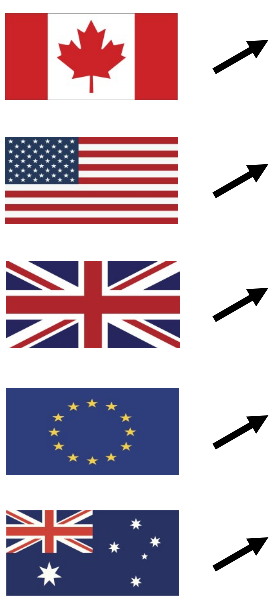
Central banks are hiking interest rates aggressively. Global price pressures appear to be easing. Key commodity prices are lower and ocean shipping costs and times have declined.

But inflation has been too high for too long—heightening the risk that longer-run inflation expectations will come unhinged from central bank targets. That would upend decades of successful inflation targeting monetary policy. It would also require significantly higher interest rates (and a much larger slowdown in economic activity) to counteract.

That hasn't happened yet. Some measures of longer-run inflation expectations have moved lower over the last month and market implied longer-run inflation rates have declined. But from a central bank's perspective, the risks of not doing enough to cool overheating demand probably outweigh the risks of doing too much.

Against that backdrop, the Bank of Canada has continued to 'front-load' interest rate hikes. In July, it unveiled the first full percentage point increase in the overnight rate since 1995. Later that month, the U.S. Fed followed with a second-consecutive 75 basis point hike. And both banks are expected to quickly push interest rates into moderately 'restrictive' territory. We look for the BoC to hike the overnight rate to 3.5% this year (up another percentage point from current levels). In the U.S., we also expect the Fed to hike by another 125 basis points, hitting the 3.50% to 3.75% range by end of year.

Central bank near-term bias



The BoC remains focused on hiking rates aggressively to contain longer-run inflation expectations. The BoC hiked by a larger-than-expected 100 bps in July and we look for another 100 bps of hikes over the next two meetings with the overnight rate hitting 3.50% later this year.

July inflation data posted a rare downside surprise, but price growth is still running too strong to prevent further aggressive interest rate hikes from the Fed. We look for the fed funds target range to rise to 3.50%-3.75% before the end of the year, with a 50 bp hike penciled in for September.

The BoE continues to front-load its hiking cycle, with an outsized 50 basis point hike in August to 1.75% expected to support this goal. We anticipate, however, that the remaining interest rate decisions will result in 25 basis point moves until the bank reaches a terminal rate of 2.75 by mid-2023.

The ECB hiked the deposit rates by 50 basis points in July and is now expected to hike by an additional 25 basis points in Q3, reaching 1.5% by the end of this year.

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Highlights

▲ Inflation expectations have moved lower over the past month, but inflation remains much too high

▲ Central banks continue to execute front-loaded hiking path, with the Bank of Canada hiking by 100 bps in July followed by a 75 bp hike by the Fed

▲ The risk of long-run inflation expectations becoming unhinged outweighs the lesser risk of central banks hiking too high too quickly near-term

▲ We expect that the Bank of Canada will hike by another 75 basis points in September, with the Fed adding a 50 basis point hike

Rising recession odds unlikely to deter central banks

In our view, those interest rate increases will ultimately tip the U.S. and Canadian economies into moderate recessions next year. Overseas, interest rates are also on the rise. In the Euro Area, we expect a downturn to begin later this year. Growth is also softening in the United Kingdom. The drop in demand that accompanies these developments is expected to help lower inflation. But that doesn't mean central banks are done hiking rates. While a 'mild' recession is likely in the cards, forceful action from central banks now is meant to avert a much more damaging recession in which wage and price inflation spiral out of control.

Global inflation pressures may have hit their peak

In the U.S., the recovery in household spending on services is still going strong. But purchases of merchandise in June declined 3% compared to a year ago. Meantime, supply chain pressures have eased, ocean shipping times and costs have declined (bringing more goods into ports). As a result, a glut of inventory has emerged in stores, raising the prospect of outright price declines for some products.

As this plays out, key commodity prices are falling. And the 25% drop in oil prices from early June will help lower headline inflation rates over the summer.

Central banks will be cautious about reversing interest rate increases too quickly. But as long as the economy and inflation slow as we expect, the Fed and BoC will both be in a position to begin easing interest rates in the second half of 2023. Indeed, the expectation that central banks won't be able to maintain 'peak' short-run policy rates for too long has already pushed longer-term bond yields lower. Ten-year government bond yields fell by 60 basis points in Canada over the last month, and 30 basis points in the U.S. That has caused the spread between longer-run (10-year) and shorter-run (2-year) government borrowing costs (a closely watched recession indicator) to invert sharply in both regions.

U.S. GDP declines don't count as a 'recession' (yet) but cracks are forming in labour markets

The U.S. posted two consecutive quarterly GDP declines in the first half of this year. That doesn't yet count as a recession because labour markets have continued to improve. The unemployment rate fell to pre-pandemic levels (matching a 5-decade low) in July and payroll employment surged by 528,000—adding to the 2.8 million increase in jobs over the first half of the year. Still, cracks are starting to appear and we continue to expect a more broadly based softening in the year ahead. Weekly jobless claims have been increasing steadily since mid-March and are outpacing the rate of increase typically seen ahead of historical recessions. Labour markets have been exceptionally tight, and for now, excess hiring demand has been enough to offset those job losses. Job openings are still running more than 50% above pre-pandemic levels, but the pace has been waning. We look for job markets to soften going forward as labour demand continues to ease and layoffs rise.

Bank of Canada to continue to hike despite softer housing markets

Higher commodity prices and the recovery in Canada's travel and hospitality industry have supported near-term economic growth. We're tracking a 4.5% (annualized) increase in GDP in Q2. And at 4.9%, the unemployment rate in June and July was at record lows (dating at least back to 1976). Still, shortages of labour are capping production growth and higher interest rates and inflation are cutting into household purchasing power. Housing markets have pulled back dramatically with home resales down 27% between March and June. National benchmark home prices have started to decline (-3% April through June) and more declines are expected as central banks continue to raise interest rates. An excess of demand in labour markets is keeping unemployment very low for now—job openings are running more than 60% above pre-pandemic levels—and pushing wages higher. But we continue to expect economic growth to slow substantially over the second half of 2022.

Euro area to reach terminal rate sooner on an accelerated hiking path

Euro area PMIs continued to contract in July. Services sector PMIs also exhibited broad-based slowing as the amount of new orders and backlogged work fell. Russia's invasion of Ukraine continued to stoke concerns surrounding energy and supply chains, and persistently elevated inflation hampered business expectations and weighed on buying activity. Retail trade data signals a notable slowdown in purchases as well, both in the Euro area and the European Union. This suggests recession risk may be higher than previously anticipated. But the ECB has joined other global central banks in "front-loading" its hiking path, ratcheting the deposit rate up 50 basis points in July. We changed our interest rate outlook to reflect an accelerated hiking path, while leaving the terminal rate at a neutral level (1.5%) by Q1 2023. The ECB is now expected to hike the deposit rate by an additional 25 basis points in Q3, reaching 1.5% by the end of this year.

U.K. activity slowing with more upside risk to CPI growth

U.K. GDP grew 0.5% in May, notably stronger than the 0.2% increase we'd anticipated. May gains were driven by strength in manufacturing, construction, and services sector output. At the beginning of Q3, however, manufacturing activity appears to be slowing with both output and new orders on the downswing. Falling commodity prices (including global energy prices) lowered producers' capital costs, but businesses continue to face salary pressures as soaring inflation persists. The U.K. labour market remains extremely tight with elevated job vacancies and 3.8% unemployment. The services sector continues to outperform the goods sector, with strength mostly concentrated in health and social work. Activity in accommodation and food services and retail is waning in the face of soaring services inflation (up 5.2% in June). We continue to expect record price growth to worsen once semi-annual price increases take place in October—presenting more upside risk to CPI growth toward the end of this year. The BoE continues to front-load its hiking cycle, with an outsized 50 basis point hike in August to 1.75% expected to support this goal. We anticipate, however, that the remaining interest rate decisions will result in 25 basis point moves until the bank reaches a terminal rate of 2.75 by mid-2023.

Highlights

▲ UK GDP is expected to flatten towards the end of the year

▲ Record inflation will worsen in the UK once semi-annual price increases take place in October

▲ Weakening manufacturing activity, slowing retail sales, and elevated inflation in the Euro Area all point to higher recession risk

▲ The euro area is still expected to slip into a mild recession over the winter months

Interest rate outlook

%, end of period

	Actual						Forecast					
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
Canada												
Overnight	0.25	0.25	0.25	0.25	0.50	1.50	3.25	3.50	3.50	3.50	3.50	3.25
Three-month	0.09	0.15	0.12	0.16	0.60	2.08	3.30	3.40	3.40	3.40	3.25	2.95
Two-year	0.23	0.45	0.53	0.95	2.29	3.09	3.20	3.15	3.00	2.90	2.75	2.60
Five-year	0.99	0.98	1.11	1.26	2.41	3.11	2.85	2.80	2.75	2.70	2.50	2.40
10-year	1.56	1.39	1.51	1.43	2.40	3.23	2.85	2.75	2.70	2.70	2.55	2.45
30-year	1.99	1.84	1.99	1.68	2.38	3.14	2.80	2.75	2.75	2.75	2.65	2.60
United States												
Fed funds*	0.13	0.13	0.13	0.13	0.38	1.63	2.88	3.63	3.63	3.63	3.38	3.13
Three-month	0.03	0.05	0.04	0.06	0.52	1.72	3.45	3.60	3.55	3.40	3.20	3.00
Two-year	0.16	0.25	0.28	0.73	2.28	2.92	3.35	3.45	3.25	3.05	2.90	2.75
Five-year	0.92	0.87	0.98	1.26	2.42	3.01	3.05	3.05	2.90	2.70	2.55	2.40
10-year	1.74	1.45	1.52	1.52	2.32	2.98	2.90	2.85	2.75	2.60	2.50	2.40
30-year	2.41	2.06	2.08	1.90	2.44	3.14	3.05	3.00	2.95	2.85	2.75	2.70
United Kingdom												
Bank rate	0.10	0.10	0.10	0.25	0.75	1.25	2.00	2.50	2.50	2.75	2.75	2.75
Two-year	0.11	0.07	0.40	0.68	1.36	1.85	2.25	2.65	2.55	2.50	2.50	2.50
Five-year	0.40	0.33	0.62	0.82	1.40	1.88	2.25	2.55	2.45	2.40	2.50	2.50
10-year	0.85	0.72	1.02	0.97	1.60	2.22	2.50	2.80	2.70	2.60	2.50	2.50
30-year	1.40	1.24	1.37	1.12	1.77	2.59	2.75	3.00	3.10	3.00	2.90	2.90
Euro area**												
Deposit Rate	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	0.50	1.25	1.50	1.50	1.50	1.50
Two-year	-0.69	-0.67	-0.69	-0.64	-0.08	0.64	1.25	1.35	1.50	1.50	1.50	1.50
Five-year	-0.62	-0.59	-0.56	-0.45	0.37	1.09	1.50	1.65	1.60	1.60	1.55	1.50
10-year	-0.29	-0.20	-0.21	-0.18	0.55	1.36	1.75	1.80	1.75	1.70	1.65	1.55
30-year	0.26	0.30	0.29	0.20	0.67	1.63	1.90	2.00	1.90	1.85	1.80	1.75
Australia												
Cash target rate	0.10	0.10	0.10	0.10	0.10	0.85	2.35	2.85	2.85	2.85	2.85	2.60
Two-year	0.08	0.06	0.04	0.54	1.78	2.73	2.95	2.75	2.60	2.50	2.25	2.00
10-year	1.74	1.49	1.49	1.67	2.84	3.66	3.25	3.05	3.05	3.00	2.90	2.65
New Zealand												
Cash target rate	0.25	0.25	0.25	0.75	1.00	2.00	3.00	3.50	3.50	3.50	3.25	3.00
Two-year swap	0.46	0.78	1.39	2.16	3.27	4.06	4.00	3.80	3.60	3.40	3.20	2.90
10-year swap	1.95	1.87	2.21	2.62	3.38	4.10	3.60	3.50	3.40	3.30	3.20	3.10
Yield curve***												
Canada	133	94	98	48	11	14	-35	-40	-30	-20	-20	-15
United States	158	120	124	79	4	6	-45	-60	-50	-45	-40	-35
United Kingdom	74	65	62	29	24	37	25	15	15	10	0	0
Eurozone	40	47	48	46	63	72	50	45	25	20	15	5
Australia	166	143	145	113	106	93	30	30	45	50	65	65
New Zealand	149	109	82	46	11	4	-40	-30	-20	-10	0	20

*Midpoint of 25 basis point range, **Yields refer to German government bonds, *** Two-year/10-year spread in basis points,

Source: Reuters, RBC Economics

Economic outlook

Growth outlook

% change, quarter-over-quarter in real GDP

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021	2022F	2023F
Canada*	4.4	-3.1	5.3	6.6	3.1	4.5	2.5	1.2	0.5	-0.5	-0.5	0.2	4.5	3.7	0.8
United States*	6.3	6.7	2.3	6.9	-1.6	-0.9	1.8	0.8	-0.3	-0.4	0.0	0.5	5.7	1.6	0.2
United Kingdom	-1.2	5.6	0.9	1.3	0.8	-0.3	0.3	0.0	0.1	0.1	0.2	0.2	7.4	3.5	0.4
Euro Area	-0.1	2.1	2.3	0.4	0.5	0.7	0.2	-0.3	-0.2	0.2	0.3	0.3	5.3	3.0	0.2
Australia	1.8	0.8	-1.8	3.6	0.8	0.3	0.8	0.6	0.5	0.3	0.2	0.2	4.8	3.5	1.8

*annualized

Inflation outlook

% change, year-over-year

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4	2021	2022F	2023F
Canada	1.4	3.3	4.1	4.7	5.8	7.5	7.1	6.2	4.8	2.9	2.6	2.5	3.4	6.7	3.2
United States	1.9	4.8	5.3	6.7	8.0	8.6	8.2	6.3	4.4	2.3	1.7	2.1	4.7	7.8	2.6
United Kingdom	0.6	2.0	2.8	4.9	6.2	8.9	9.2	9.5	8.2	5.5	5.0	3.3	2.6	8.5	5.5
Euro Area	1.1	1.8	2.8	4.6	6.1	8.0	8.5	8.6	7.1	4.3	3.8	3.3	2.6	8.0	4.6
Australia	1.1	3.8	3.0	3.5	5.1	6.1	7.0	7.7	6.7	5.9	5.3	4.3	2.9	6.5	5.6

Source: Statistics Canada, Bureau of Economic Analysis, Bureau of Labor Statistics, Office for National Statistics, Statistical Office of the European Communities, Australian Bureau of Statistics, Statistics New Zealand, RBC Economics

Currency outlook

Level, end of period

	Actuals						Forecast					
	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
Canadian dollar	1.26	1.24	1.27	1.26	1.25	1.29	1.29	1.31	1.32	1.33	1.34	1.34
Euro	1.17	1.19	1.16	1.14	1.11	1.05	1.02	1.00	0.97	1.00	1.03	1.06
U.K. pound sterling	1.38	1.38	1.35	1.35	1.31	1.22	1.16	1.11	1.07	1.10	1.14	1.18
Japanese yen	111	111	111	115	122	136	137	140	140	138	136	134
Australian dollar	0.76	0.75	0.72	0.73	0.75	0.69	0.70	0.69	0.69	0.70	0.70	0.71

Canadian dollar cross-rates

	21Q1	21Q2	21Q3	21Q4	22Q1	22Q2	22Q3	22Q4	23Q1	23Q2	23Q3	23Q4
EUR/CAD	1.47	1.47	1.47	1.44	1.38	1.35	1.32	1.31	1.28	1.33	1.38	1.42
GBP/CAD	1.73	1.71	1.71	1.71	1.64	1.57	1.50	1.46	1.41	1.46	1.53	1.58
CAD/JPY	88	90	88	91	97	105	106	107	106	104	101	100
AUD/CAD	0.95	0.93	0.92	0.92	0.94	0.89	0.90	0.90	0.91	0.93	0.94	0.95

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.

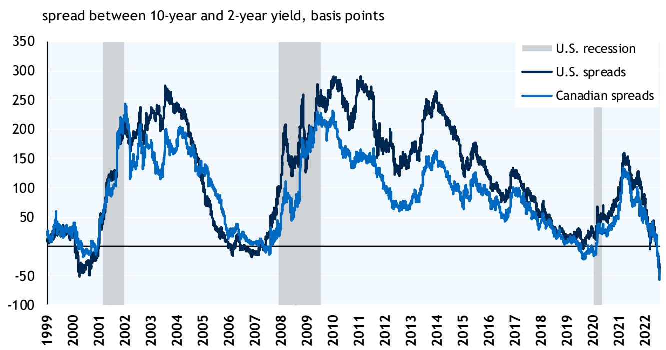
Source: Bloomberg, RBC Economics

Charts we're watching

Both Canadian and U.S. yield curves entered negative territory in July. Historically, negative yield curve have served as a signal that a recession is coming. Since the 1950s, when the spread between U.S. 10-year and 2-year yields turned negative, this has always been followed by a recession. In Canada, negative spreads signaled a recession only 8 out of 12 times. In the current climate, however, we do expect Canada that will follow the U.S. into a recession after record inflation and front-loaded interest rate hikes.

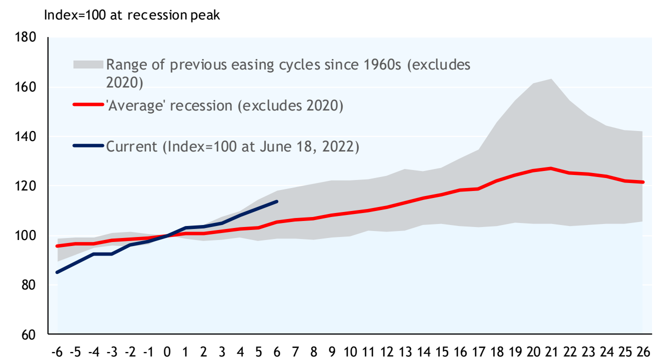
Initial U.S. jobless claims tend to be a reliable leading indicator signaling a U.S. recession is imminent. During the past 6 U.S. recessions that pre-dated the pandemic, once U.S. jobless claims increased by ~30% on average before a recession began. Initial U.S. jobless claims appear to have reached their lowest point in April 2022 and by June 18th, had already grown by over 30%. While jobless claims are still quite low in level terms, to date they are up nearly 50% from the March trough. Jobless claims are growing at a much faster rate than in prior recessions (excluding 2020).

Both U.S.and Canadian yield spreads trend negative in July



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

U.S. initial jobless claims flagging softening labour markets

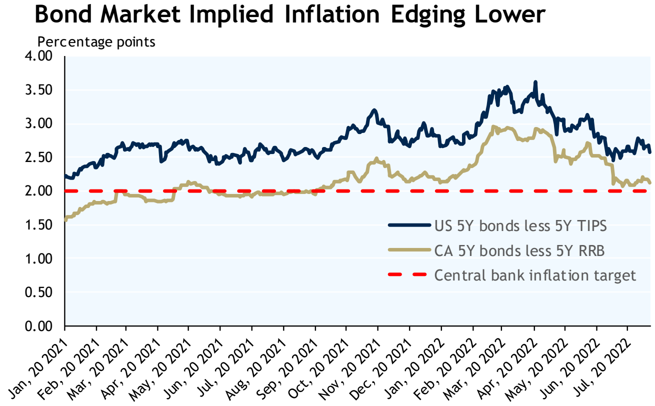


Source: Department of Labour, RBC Economics

Headline inflation may have turned a corner, with year-over-year inflation down 8.5% in July from June's 9.1%. Global commodity prices have been trending lower and consumer demand is cooling. Market inflation expectations edged down in June and July but remains above the central bank inflation target in both the U.S. and Canada. In September meetings, we anticipate a 75 basis point hike from both the Bank of Canada and the Fed.

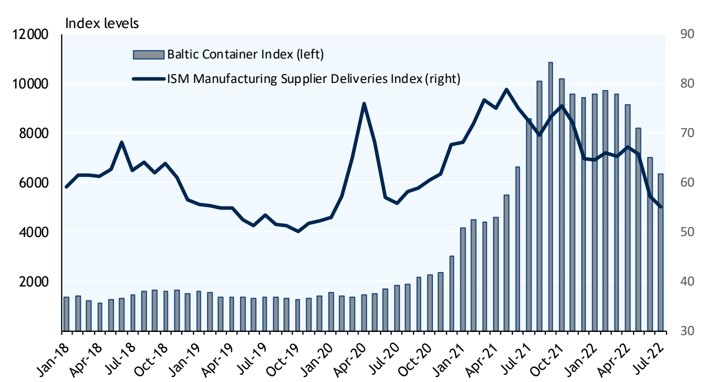
All signs point to global supply chain pressures easing. Shipping times continue to trend lower with delivery times gradually returning to pre-pandemic levels, and shipping costs fell 25% from year-ago levels in July.

Bond Market Implied Inflation Edging Lower



Source: Refinitiv, Haver, RBC Economics Research

Global supply chain pressures have continued to ease



Source: The Baltic Exchange, Institute for Supply Management, RBC Economics