RBC Economics &
Thought Leadership

Financial Markets Monthly

December 2024

Tangled up in trade —
The steep cost of closing doors

Highlights:

- International trade risks are back in focus as the incoming Trump administration prepares to take office—but for now, economic data is tracking broadly in line with prior expectations.
- The U.S. labour market continues to show enough signs of gradual cooling in Q4 to warrant additional, but limited, interest rate cuts.
- The Canadian economy's underperformance stretches on, arguing for more aggressive interest rate cuts from the Bank of Canada (even if that means a weaker Canadian dollar).
- The European Central Bank will keep cutting as much as tight labour markets and elevated wage growth allow. A similar backdrop, plus fiscal uncertainties, means a more cautious stance from the Bank of England.
- **Issue in focus:** The severe tariff threats from the incoming U.S. administration will cost more than what they protect. The goal of those tariffs, i.e. narrowing the U.S. trade deficit would also be at odds with the reality of a persistently large and growing government deficit.

Overview

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Forecast changes: Developments tracking in line with expectations

Adverse risks have increased, particularly for Canada, with the incoming Trump administration's threat of another round of U.S. trade protectionism. However, we view the likelihood of tariff hikes that would substantially destabilize North American supply chains as limited (read more below).

Canadian and U.S. data releases since the last Financial Markets Monthly have gone largely as expected. We didn't feel compelled to make big changes to our forecasts in December.

U.S. economy's outperformance stretches on

U.S. labour market data has been distorted by strikes and hurricanes in recent months, but underlying details point to further softening. The unemployment rate, which is typically less impacted by distortions, was up 0.5% from a year ago, in line with our expectation of a gradual normalization.

That should be enough to warrant further, but limited, interest rate cuts from the U.S. Federal Reserve. In 2025, we think much of the ongoing resilience in the U.S. economy will continue, thanks to the historically large government deficit (see here for more implications on growth).

That, however, will also leave risks to the inflation outlook on the upside, and is why we still think the Fed will pause after 25 basis point cuts in December and January with the Fed funds rate at 4% to 4.25%.

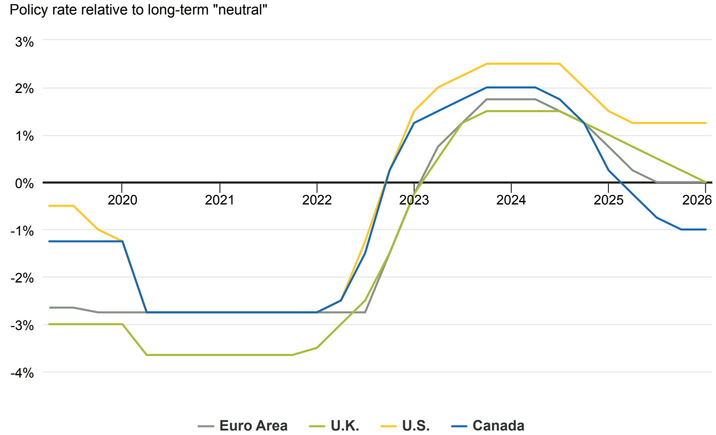
BoC to keep pushing interest rates lower with or without the Fed

In Canada, November's consumer price index saw a small reacceleration in core inflation measures, which should mark volatility rather than a trend. The BoC is likely to keep focusing on broader softening in growth and labour markets, which should continue to press down on inflation pressures in the year ahead. Per capita gross domestic product saw a sixth consecutive decline in Q3, and the unemployment rate rose to 6.8% in November.

With inflation back at the target, any additional softening in the economy could risk an undershoot. To reduce those odds and bring labour markets back into balance, we think the BoC will need to ultimately cut interest rates to "stimulative" levels and expect the overnight rate to be lowered to 2% by mid-2025. Rising inflation remains a risk and will be watched closely in the meantime.

Where we expect rates to settle in 2025, relative to "neutral"

Policy rate relative to long-term "neutral"



Source: Haver, RBC Economics

Wage growth is still elevated, especially when compared to sluggish productivity growth, but we expect it will continue to slow as slack builds in the labour market. Housing market activity also started to heat up more as yearend approaches, but we expect affordability will ultimately keep a lid on the rebound.

Growing monetary policy and economic growth divergence between Canada and the U.S. is likely to keep some downward pressure on the Canadian dollar. We expect the loonie will keep depreciation against the dollar but not to an extent that will stoke inflation in Canada. That means the BoC should have a clear path to cut the overnight rate down to 2%, as we expect.

Tight labour markets limit ECB and BoE rate cuts

A strong Q3 GDP print, driven by robust spending, is bringing demand-side factors back to the forefront at a time when European economies are already considered “inflation prone” due to supply-side constraints.

Indeed, ongoing tightness in the labour market has been shoring up wage growth in the euro area and the U.K., stalling progress on inflation when residual pressures are mostly stemming from the services industries. In the U.K., there’s also the added layer of uncertainty from the recent Autumn budget, the impact of which will likely take longer to untangle. It should keep the BoE on its toes when it comes to the pace of rate cuts.

We expect the BoE will go by a slower pace of one 25 bps cut per quarter, while the ECB keeps cutting by 25 bps at each meeting. That is expected to continue until the policy rate reaches 2.25% for the ECB by April 2025, and 3.75% for the BoE by November. Despite the difference in pacing, those levels should be more or less around where we think the “neutral” rate of interest rates are for those regions.

Central bank bias:

<table>
<tr><th>Central bank</th><th>Current policy rate</th><th>Next decision</th></tr>
<tr><td>BoC</td><td>3.25%
-50 bps in Dec/24</td><td>-25 bps
Jan/25</td></tr>
<tr><td colspan="3">As expected, the Bank of Canada in December cut the overnight rate by another 50 bps to 3.25%, right to the top end of the BoC's "neutral" range estimate. Macklem's opening statement suggested "a more gradual approach" to monetary policy adjustments, in line with our own forecast that for a downshift to 25-bps reductions in their future meetings. A weak economy will still push the BoC to cut all the ways down to 2% in 2025.</td></tr>
<tr><td>Fed</td><td>4.50-4.75%
-25 bps in Nov/24</td><td>-25 bps
Dec/24</td></tr>
<tr><td colspan="3">The Fed slowed the pace of rate cuts in November amid signs of persisting strength in the economy and stickier-than-expected inflation. Labour market has continued to normalize and recent communication from policymakers continues to hint at further, but smaller, rate cuts. We expect a 25 bps cut in December, followed by another one in January 2025 before the Fed will move to the sidelines .</td></tr>
<tr><td>BoE</td><td>4.75%
-25 bps in Nov/24</td><td>0 bps
Dec/24</td></tr>
<tr><td colspan="3">BoE policymakers voted in favour of a 25 bps rate cut in November. Larger planned government budget deficits aren't expected to stop the BoE from cutting interest rates, but it will certainly slow the pace of rate cuts. With a more cautious mindset, we expect the BoE to skip cutting in December before resuming in February. We expect there will be one 25 bps cut every quarter until the bank rate reaches 3.75% by November.</td></tr>
<tr><td>ECB</td><td>3.25%
-25 bps in Oct/24</td><td>-25 bps
Dec/24</td></tr>
<tr><td colspan="3">The ECB lowered the deposit rate by 25 bps in October, while maintaining its guidance of flexibility and data-dependency. At the December meeting, we expect the policy stance will remain unchanged, and the ECB will cut by another 25 bps to lower the deposit rate to a still restrictive 3%. After that, stronger labour markets and higher wage data should leave the ECB on a moderate path lower, to 2.25% by April.</td></tr>
<tr><td>RBA</td><td>4.35%
0 bps in Dec/24</td><td>0 bps
Feb/24</td></tr>
<tr><td colspan="3">Persistent inflation pressures are still holding the Reserve Bank of Australia from joining global peers in the easing cycle. The cash rate was held at 4.35% in December. The macro forecast was mostly revised lower, underpinning a shift in the policy bias further towards neutral. Going forward, more progress in core inflation is required before the RBC can commit to a first cut. We think that will happen later in Q2 2025.</td></tr>
</table>

Issues in focus: One case study on U.S. tariffs worth watching

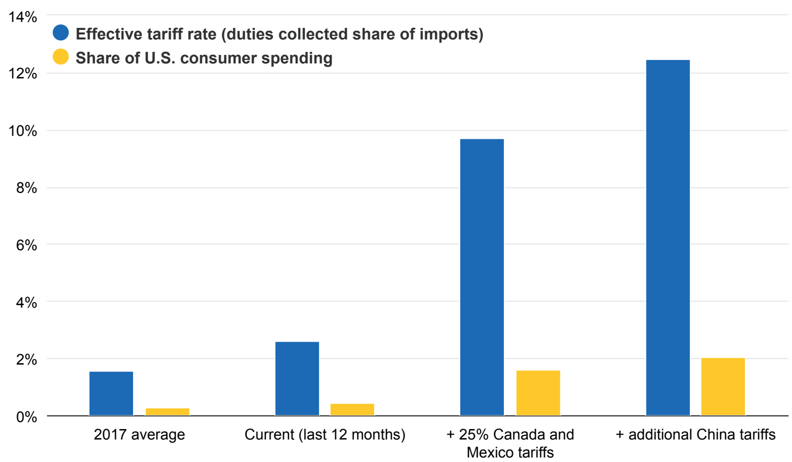
During the first Trump administration, tariff threats were regularly made to leverage other trade or policy concessions. The most punitive and aggressive ones, however, particularly those that would severely damage the U.S. economy, were typically not enacted.

For example, in 2018, the Trump administration threatened to impose 20-25% tariffs on Canadian auto exports to gain leverage in NAFTA renegotiations. That was not enacted with the U.S. and Canada concluding the renegotiation shortly after.

In 2019, the Trump administration floated 25% tariffs on Mexico in a response to illegal immigration but called it off in the following week after a deal on enforcement was reached. These days, modelling broad comments vs. clear economic policy can be incredibly challenging as the amount of economic scenarios is massive.

U.S. custom effective tariff rate by scenario

Import tariff revenue, % of imports (effective tariff rate) and current U.S. consumer spending



Source: Haver, US Census Bureau, RBC Economics

There are also many different tentacles through which tariffs can flow through an economy: lower growth, higher inflation, heightened uncertainty and weakened business investment. For Canada, we've started to explore these scenarios. Here's one extra angle that gets less attention that we find interesting.

The goal of tariffs is at odds with a large U.S. government budget deficit

One of the most common goals of tariff policy is to close a trade deficit. In this case, the U.S. has been running a persistent international trade deficit since the 1980s.

Shrinking the U.S. trade deficit however isn't just about re-balancing trade flows.

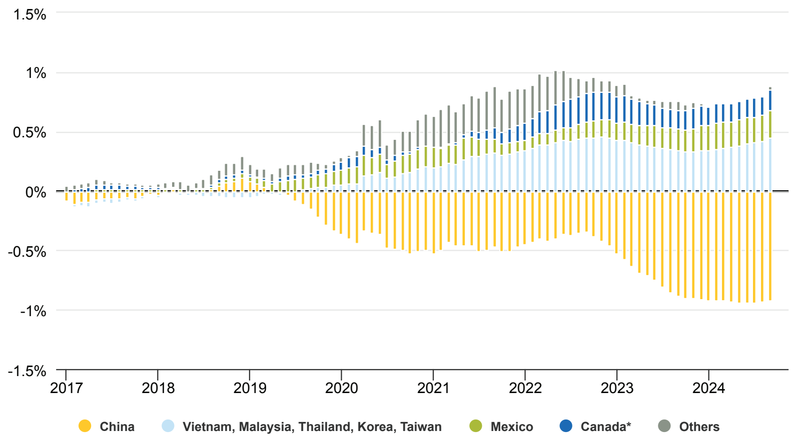
At its core, a net trade balance is a form of borrowing – it means the value of imports is less than can be purchased out of export sales, and that shortfall needs to be made up for by selling assets or borrowing abroad. Balancing the trade gap, therefore, would essentially require re-balancing economy-wide net borrowing, and the biggest net borrower in the economy is (surprise surprise) the federal government.

In the past, the ideas of a trade deficit and government budget deficit are closely linked (often referred to as the "twin deficit" phenomenon.) And while it's not impossible to balance international trade deficit while running a government deficit (Japan has done it for decades), it would be very hard with government deficits running as large as they are currently in the U.S.

Indeed, the U.S. government deficits at 6.4% in fiscal 2024, are too large for it to be solely financed by domestic savers. Trying to shrink the trade gap with tariffs in this scenario is a bit like squeezing a ballon, as in the trade deficits will just be directed elsewhere.

U.S. trade deficit narrows with China but widens elsewhere

Change in U.S. trade deficit (+) as a % of GDP, relative to 2016



*Run-up in trade deficit with Canada is largely accounted for by energy products
Source: Haver, RBC Economics Research

This was evident during the first Trump administration – the tariffs imposed on China at the time did not close the U.S. trade gap, but effectively just shifted deficits away to other peripheral Asian economies and Mexico. After decades of borrowing from abroad, the U.S. now owes $22.5 trillion in foreign liabilities, or 78% of GDP.

The only scenario where tariffs could be trusted to narrow the U.S. trade deficit is if they're so punitive that economy starts to outright contract. In historical downturns, consumption tended to fall more than income, leading to a rise in U.S. saving rates and declines in imports.

In this case, however as outlined above, we do not see a shock to U.S. tariff rates of a magnitude large enough to cause that outcome as likely.

Interest rate outlook

Policy rates and government bond yields, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
Canada												
Overnight rate	4.50	4.75	5.00	5.00	5.00	4.75	4.25	3.25	2.75	2.25	2.00	2.00
Three-month	4.34	4.90	5.07	5.04	4.99	4.64	3.94	3.05	2.55	2.20	2.00	2.00
Two-year	3.74	4.58	4.87	3.88	4.22	3.99	2.92	2.90	2.60	2.30	2.20	2.10
Five-year	3.02	3.68	4.25	3.17	3.58	3.51	2.74	2.85	2.75	2.65	2.55	2.45
10-year	2.90	3.26	4.03	3.10	3.52	3.50	2.95	3.00	2.95	2.90	2.80	2.80
30-year	3.02	3.09	3.81	3.02	3.41	3.39	3.13	3.15	3.05	3.00	3.00	3.00
United States												
Fed funds midpoint	4.88	5.13	5.38	5.38	5.38	5.38	4.88	4.38	4.13	4.13	4.13	4.13
Three-month	4.85	5.43	5.55	5.40	5.45	5.48	4.73	4.20	4.03	4.08	4.13	4.22
Two-year	4.06	4.87	5.03	4.23	4.66	4.71	3.66	4.20	4.40	4.50	4.70	4.85
Five-year	3.60	4.13	4.60	3.84	4.28	4.33	3.58	4.10	4.30	4.40	4.55	4.65
10-year	3.48	3.81	4.59	3.88	4.27	4.36	3.81	4.25	4.40	4.45	4.55	4.60
30-year	3.67	3.85	4.73	4.03	4.41	4.51	4.14	4.45	4.55	4.60	4.70	4.75
United Kingdom												
Bank rate	4.25	5.00	5.25	5.25	5.25	5.25	5.00	4.75	4.50	4.25	4.00	3.75
Two-year	3.42	5.27	4.91	3.98	4.17	4.23	3.97	4.00	4.25	4.35	4.50	4.55
Five-year	3.33	4.66	4.53	3.46	3.84	4.03	3.85	3.90	4.20	4.35	4.50	4.60
10-year	3.47	4.39	4.46	3.54	3.95	4.17	4.00	4.10	4.40	4.60	4.70	4.75
30-year	3.82	4.42	4.92	4.14	4.49	4.67	4.54	4.70	4.85	4.95	5.00	5.00
Euro area*												
Deposit Rate	3.00	3.50	4.00	4.00	4.00	3.75	3.50	3.00	2.50	2.25	2.25	2.25
Two-year	2.66	3.27	3.20	2.40	2.83	2.82	2.09	2.00	2.10	2.15	2.15	2.15
Five-year	2.30	2.58	2.79	1.94	2.32	2.48	1.97	1.85	1.95	2.10	2.15	2.25
10-year	2.28	2.39	2.85	2.03	2.29	2.50	2.14	2.00	2.10	2.20	2.30	2.40
30-year	2.35	2.38	3.05	2.27	2.46	2.69	2.46	2.35	2.40	2.50	2.60	2.70
Australia												
Cash target rate	3.60	4.10	4.10	4.35	4.35	4.35	4.35	4.35	4.35	4.10	3.85	3.85
Two-year	2.96	4.21	4.09	3.71	3.76	4.17	3.64	4.00	4.10	4.15	4.20	4.25
10-year	3.30	4.02	4.49	3.95	3.97	4.31	3.97	4.45	4.50	4.45	4.45	4.50
New Zealand												
Cash target rate	4.75	5.50	5.50	5.50	5.50	5.50	5.25	4.25	4.00	3.50	3.50	3.50
Two-year swap	5.01	5.46	5.69	4.63	4.78	4.95	3.56	3.80	3.75	3.50	3.60	3.75
10-year swap	4.27	4.46	5.13	4.12	4.35	4.48	3.87	4.15	4.30	4.40	4.55	4.60

Sources: Refinitiv, BoC, Fed, BoE, ECB, RBA, RBNZ, RBC Economics, RBC Capital Markets | *German government bond yields

Economic outlook

Real GDP, quarter-over-quarter percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada*	3.5	3.8	2.4	-0.6	3.9	0.8	-0.6	0.7	2.0	2.2	1.0	1.0	1.1	1.2	1.1	1.2	6.0	4.2	1.5	1.2	1.2
United States*	-1.0	0.3	2.7	3.4	2.8	2.5	4.4	3.2	1.6	3.0	2.8	2.8	1.0	1.5	1.8	2.0	6.1	2.5	2.9	2.8	1.9
United Kingdom	0.7	0.3	0.1	0.3	0.1	0.0	-0.1	-0.3	0.7	0.5	0.1	0.2	0.3	0.4	0.4	0.4	8.6	4.8	0.3	0.9	1.4
Euro area	0.5	0.9	0.6	-0.1	0.0	0.1	0.0	0.0	0.3	0.2	0.4	0.1	0.2	0.3	0.3	0.3	6.3	3.6	0.5	0.7	1.0
Australia	1.0	1.0	0.4	0.8	0.5	0.3	0.5	0.2	0.2	0.2	0.3	0.5	0.7	0.6	0.7	0.7	5.4	4.1	2.1	1.0	2.3

*annualized

Inflation, year-over-year percent change

	Q1-22	Q2-22	Q3-22	Q4-22	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25	2021	2022	2023	2024	2025
Canada	5.8	7.5	7.2	6.7	5.1	3.5	3.7	3.2	2.8	2.7	2.0	1.9	2.1	1.7	1.6	1.5	3.4	6.8	3.9	2.4	1.7
United States	8.0	8.6	8.3	7.1	5.8	4.0	3.5	3.2	3.2	3.2	2.6	2.6	2.1	1.9	2.3	2.1	4.7	8.0	4.1	2.9	2.1
United Kingdom	6.2	9.2	10.0	10.8	10.2	8.4	6.7	4.2	3.5	2.1	2.1	2.6	2.6	2.4	2.5	2.3	2.6	9.1	7.3	2.6	2.6
Euro area	6.1	8.0	9.3	10.0	8.0	6.2	5.0	2.7	2.6	2.5	2.2	2.4	2.2	2.2	2.2	2.1	2.6	8.4	5.4	2.4	2.4
Australia	5.1	6.1	7.3	7.8	7.0	6.0	5.4	4.1	3.6	3.8	2.8	2.9	2.8	2.5	3.0	3.0	2.9	6.6	5.6	3.3	2.8

Sources: StatCan, BLS, ONS, EuroStat, ABS, RBC Economics, RBC Capital Markets

Currency outlook

U.S. dollar cross rates, end of period

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
USD/CAD	1.35	1.32	1.35	1.32	1.35	1.37	1.35	1.40	1.42	1.43	1.42	1.41
EUR/USD	1.09	1.09	1.06	1.11	1.08	1.07	1.11	1.06	1.02	1.02	1.03	1.05
GBP/USD	1.24	1.27	1.22	1.27	1.26	1.26	1.34	1.29	1.28	1.24	1.23	1.24
USD/JPY	133	144	149	141	151	161	143	155	160	158	155	150
AUD/USD	0.67	0.67	0.65	0.68	0.65	0.67	0.69	0.66	0.65	0.64	0.64	0.66

Canadian dollar cross rates

	Q1-23	Q2-23	Q3-23	Q4-23	Q1-24	Q2-24	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25	Q4-25
EUR/CAD	1.47	1.44	1.43	1.46	1.46	1.47	1.50	1.48	1.45	1.46	1.46	1.48
GBP/CAD	1.67	1.68	1.65	1.68	1.71	1.73	1.80	1.81	1.81	1.78	1.74	1.74
CAD/JPY	98	109	110	107	112	117	106	111	113	110	109	106
AUD/CAD	0.91	0.88	0.87	0.90	0.88	0.91	0.93	0.92	0.92	0.92	0.91	0.93

Sources: Federal Reserve Board, Bank of Canada, RBC Economics, RBC Capital Markets