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Risky business

Investors thought they heard the death knell for global recession in May and increased their appetite for risk, shying away from government bonds and buying equities, commodities and currencies except the U.S. dollar. As a result, the global stock market index we watch increased by 12.2%, oil prices rose 34%, while non-energy commodity prices hit their highest level since November according to the Bank of Canada's index. In the currency world, the U.S. dollar tumbled, with the trade-weighted index losing 4.4% in May alone.

The fly in the ointment for central banks, however, is that this flight away from safety resulted in a significant pick-up in longer-dated government bond yields and, in turn, limited how much private-sector borrowing costs declined in May. As worries about risk receded, corporate bond spreads maintained their downward trajectory, but this was partly offset by the rise in government yields. On balance, the slide in everything from fixed mortgage rates to corporate bonds yields stalled out. In the United States and the United Kingdom, central bank purchases of government bonds will likely result in yields moving back down in the months ahead, although the size of these easing programs may have to be increased.

It was the worst of times

To be sure, the data reported for the first quarter of 2009 was dismal. Canada's recorded its largest output loss since 1991, the U.S. economy registered its third consecutive quarterly decline with activity in the European and U.K. economies also shrinking substantially. To top it off, Japan's economy shrank at a 15.2% annualized rate. In spite of the rash of bad news, investors gravitated

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Central bank near-term bias

Bias three-months out



The Bank of Canada left the policy rate at 0.25 basis points in June and noted that the sharp rally in the Canadian dollar could boost the downside risks to the growth projection if it persists.



The Fed will be assessing the recent improvement in financial markets and gauging the impact of its QE program on overall borrowing costs against a backdrop of rising longer-term yields.



The BoE continues to purchase gilts in increased size as announced in early May. Despite its efforts, yields have continued to rise. The downward revisions to the Bank's forecasts put the balance of risks toward increasing its purchases.



The ECB left its main refinancing rate at 1.0%, as was widely expected. At this month's press conference, President Trichet released further details regarding the bank's plans for the purchase of covered bonds.



The RBA left its Cash Rate at 3% in early June for the second meeting in a row. Continued stabilization in the global economy and stronger-than-expected Q1 growth mean that the end of the easing cycle is near, although we still see the odds favouring a 2.5% trough in the policy rate.



The RBNZ's next meeting is a close call. We expect the policy rate to be held steady as growth indicators have improved somewhat.

Highlights

- ▲ Risk appetite whetted by less negative economic news.
- ▲ Stocks, commodities and currencies (except the U.S. dollar) have rallied.
- ▲ Longer-dated government bond yields rose.
- ▲ The sharp contraction in key world in the first quarter may represent the worst for this recession...
- ▲ ...with forecasters calling for economies to get back into the black later this year
- ▲ Central banks keep policy accommodative, but are largely tapped out on rate cuts.

toward the better news being reported. U.S. housing statistics showed stability in the pace of sales, the pace of job cuts moderated and consumer confidence picked up. In Canada, confidence rose as did the pace of home sales making the first quarter's slump feel like old news. U.K. house prices have increased in two of the past three months, auto incentives appear to have put a bottom on sales and confidence has improved. Eurozone data proved a mixed bag with the unemployment rate hitting a 10-year high, but business confidence improving and order books growing. Investors took these reports as a signal that it is the beginning of the end for the Great Recession of 2009.

Is the end in sight?

We agree with the consensus that the global recession began to lose momentum in the second quarter but still expect another round of negative growth rates to be reported. The global manufacturing ISM index recorded its fourth consecutive monthly increase in May and the services index averaged 45.3 in April/May, well above the first quarter's 40.4. The levels remain unimpressive but signal a turnaround in sentiment, suggesting that the pace of contraction will be slower in the second quarter and that, if this trend persists, the global economy will likely be expanding in the second half of this year.

U.S. economy's first-quarter drop sets stage for better news ahead

The revised GDP report showed a slower pace of decline in the first quarter with real GDP contracting at a 5.7% annualized pace, down from the preliminary estimate of 6.1% and the fourth quarter's 6.3% drop. The headline number still indicated that the economy remained in deep recession, but some of the underlying details suggest that the pace of decline will ease going forward. The sizeable drawdown in inventories in the quarter means that any pick-up in demand will need to be satisfied by new production, while an unexpected decline in government spending is likely to be reversed once transfers to state and local governments contained in the fiscal stimulus package get under way. Other good news in the report came from the corporate sector where after-tax profits rose unexpectedly, which augurs well for the sharp contraction in business investment to slow. We project that the U.S. economy contracted at an annualized 2.8% in the second quarter but anticipate a return to positive growth by the second half of the year. Despite the gyrations in the quarterly numbers, we are maintaining our 2009 forecast of a 2.9% contraction in U.S. real GDP and a 2.1% increase in 2010.

Short-term interest rates anchored; long rates to fall as Fed continues QE program

Ten-year U.S. Treasury yields are 65 basis points higher than at the end of April when investors turned toward riskier assets, supply concerns flourished and the economic data looked somewhat brighter. Short-term yields, increased by less and remain anchored to the extraordinarily low Fed funds. As the second half of 2009 rolls around, the Fed's quantitative easing program will likely result in lower yields, especially if the program's size is increased as we expect.

Canada's economy took a dive in Q1 but suffered less than thought

Canada's real GDP contracted by a sizeable 5.4% annualized rate in the first quarter. In fact, the decline was smaller than expected with the consensus (and RBC) looking for 6.5% drop, while the Bank of Canada projected an even steeper 7.3% plunge. Monthly GDP reports showed sizeable decreases in output in late 2008 and early 2009 supporting the call for a sharper drop in the quarter. It was the marked slowing in the pace of decline in February and March that saved the economy from a more pronounced downturn. Going forward, with the level of inventories having been drawn down in the first quarter, any

revival in demand will be met by new production. To that end, the report gave encouragement to those looking for Canada's economy to work its way out of recession later this year. RBC's forecast is for the economy to regain its footing in the third quarter with the second quarter's projected decline of 3.2% being softer than the first quarter's drop. The Bank of Canada's forecast similarly projects that the worst of the recession will have occurred in the first quarter, with the pace of decline easing to 3.5% and 1% in the second and third quarters, respectively, and positive growth returning by the fourth quarter. RBC is maintaining its slightly more upbeat forecast for 2009 — we expect the recession to reduce real GDP output by 2.5%, slightly less than the Bank of Canada's -3% forecast. In 2010, RBC's forecast is in line with the central bank's call for a 2.5% increase.

Canadian interest rates to remain low; long-term bond yields to grind lower with USTs

Against the backdrop of burgeoning government deficits and commensurate increased bond supply and rising US Treasury yields, mid- and long-term interest rates rose in Canada in May. Inflation worries remain under wraps as the combination of growing economic slack, a stronger Canadian dollar (reducing imported goods prices) and lower commodity prices compared to a year ago sets up for the headline CPI rate to move lower. Still, the pressure from impending supply both in Canada and the United States is keeping yields up. Our forecast that U.S. yields will slip as the Fed's quantitative easing program gains traction paves the way for Canadian yields to dip as well (see chart on page 9).

Canadian dollar's strength presents clear and present danger to economic outlook

The recent fluctuations in currency markets reflect investors' rising risk appetite and we must acknowledge the impact of these shifts on the economic outlook. In the near-term, we expect the dynamic that supported the increase in risk appetite — with economic data reports generally outperforming weak expectations — will fade as forecasts are ratcheted up to align with the turnaround in the global economy's momentum. This scenario raises the risk that the data won't continue to exceed expectations, which will put riskier assets back under pressure and revive support for the U.S. dollar. In this environment, currencies like the Canadian dollar and the euro will give up some of their recent gains, although are unlikely to return to their cyclical lows. Longer-term, the pressures on the U.S. dollar are likely to re-emerge as the price of the proactive central bank and government policies takes its toll.

For the economy, the Canadian dollar's rally means that the cost of imported machinery and equipment receded once again, giving Canadian companies relief as they invest in productivity-enhancing capital goods. On the downside, Canadian exporters, who are already struggling, face another obstacle to increasing demand for their products. On balance, the risks have grown that the trade account, which was one of the few supportive factors for the economy in the first quarter, will return to acting as a drag on output.

The positive effects of the rally in commodity prices on incomes will mitigate some of the downward pressure on the economy. Oil prices are more than double their December lows and non-energy commodity prices have gained 4.2% from their early March lows. The rebound in commodity prices juiced the Canadian dollar's rally, propelling the currency to levels that were slightly above those predicted by the Bank of Canada's currency model (see chart on page 9). Still, the prospect that some of the froth in the currency will recede in the months ahead stayed the hand of the Bank of Canada on June 4 when they held the policy rate at 0.25% and kept the option of quantitative easing on the backburner.

▲ Canada's first-quarter contraction was less than expected.

▲ The economy likely remained in recession in the second quarter, but moderate growth is expected in the second half of the year.

▲ The Canadian dollar benefitted from the recent pick-up in risk appetite ...

▲ ...presenting downside risk to the outlook for exporters.

▲ The Bank of Canada left the policy rate at 0.25% and reiterated its conditional commitment to maintaining this level until the middle of next year.

Highlights

▲ Eurozone real GDP plunged in the first quarter.

▲ Recent Eurozone survey data have reported steadily more positive readings on the economic growth front .

▲ In its quarterly inflation report, the Bank of England revised its growth forecast down.

▲ S&P revised down its medium-term outlook for the United Kingdom to “negative,” while the outlook for New Zealand was revised up to “stable.”

▲ Australian GDP confounded expectations for a 0.2% fall, rising 0.4% instead.

Eurozone growth disappoints

Eurozone GDP growth disappointed expectations in the first quarter declining 9.7% at an annualized pace. All major countries in the Eurozone suffered negative growth in the quarter. Germany, the Eurozone’s largest economy, saw output plummet at a 14.4% annualized rate, the largest quarterly drop since the quarterly series began in 1970. The decline was driven by lower exports and investment spending. With the prior quarter also revised down, the peak-to-trough decline in real GDP stood at 6.9% compared to 3.2% in the United States where the financial crisis originated. Despite the news on weak growth, the yield on the German 10-year rose by 40 basis points in the past month.

Future looks brighter

Although growth and inflation have been weak, we continue to believe the European Central Bank (ECB) will remain on hold with its Refi rate troughing at 1.00%. Recent survey data have shown steadily more positive readings on the growth front. The expectations component of the IFO survey is up 11.6% from its December low and the composite PMI rose to 44 in May from a low of 36.2 in February. The preliminary inflation rate estimate for May was flat, however, we expect price gains to accelerate to 2.3% year-over-year in the fourth quarter of next year.

Bank of England downgrades its forecast

The likelihood has continued to build that the Bank of England will increase its asset purchases in order to bring down longer-dated yields. Since reaching a low of 2.94% in mid-March, yields have crept up by more than 85 basis points. In its quarterly inflation report, the Bank of England revised its growth forecast down, with its inflation forecast profile showing an undershoot of its 2% target two years hence. The Monetary Policy Committee minutes also indicated an increased likelihood of further asset purchases to bring rates down. The minutes marked the second month in a row that the committee’s decision on interest rates and asset purchases was unanimous. The committee also agreed that the risk of too little stimulus was greater than too much. Going forward, we expect the Bank to ask that the £150-billion limit to quantitative easing be raised. The headline inflation rate decelerated in April to 2.3% year-over-year, putting it within striking distance of its 2% target.

The ratings agencies made news in the past month. S&P revised its medium-term outlook for the United Kingdom to “negative.” The agency stated that even if the U.K government were to follow through on its fiscal tightening proposals, the country’s debt would likely rise to 100% of GDP by 2013 and remain at that level. Earlier in the month, the ratings agencies were more forgiving of Australia’s red ink as all three major ratings agencies affirmed a “stable” outlook because the country’s debt is growing from a low starting point. Subsequent to New Zealand’s budget release, S&P revised its outlook on the country’s AA+ rating to “stable” from “negative” as the budget scrapped tax cut plans.

Things looking up in the land down under

Despite lowering its growth forecast, Reserve Bank of Australia (RBA) left rates unchanged for the second month in a row on evidence of stabilization in the global economy, but indicated that it retains scope for further easing. Although we continue to expect further easing to 2.50%, the risk of a higher trough in rates can’t be discounted since Australia’s first-quarter GDP confounded expectations of a 0.2% quarter-over-quarter fall, instead rising 0.4%. While next week’s Reserve Bank of New Zealand’s (RBNZ) rate decision is a close call, we expect rates to be unchanged on stronger-than-expected domestic data and a brightening global outlook.

Interest rate outlook

%, end of period

	<u>09Q1</u>	<u>09Q2</u>	<u>09Q3</u>	<u>09Q4</u>	<u>10Q1</u>	<u>10Q2</u>	<u>10Q3</u>	<u>10Q4</u>
Canada								
Overnight	0.50	0.25	0.25	0.25	0.25	0.25	0.75	1.25
Three-month	0.40	0.25	0.30	0.35	0.50	0.75	1.25	1.85
Two-year	1.11	1.10	1.10	1.10	1.40	1.55	2.00	2.35
Five-year	1.79	2.25	2.35	2.05	2.25	2.40	2.50	2.60
10-year	2.80	3.20	3.00	2.75	3.00	3.15	3.25	3.40
30-year	3.55	3.95	3.95	3.75	4.00	4.25	4.25	4.50
United States								
Fed funds	0 to 0.25	0 to 0.25	0 to 0.25	0 to 0.25	0 to 0.25	0 to 0.25	0 to 0.25	0.50
Three-month	0.13	0.20	0.20	0.20	0.25	0.30	0.50	0.90
Two-year	1.02	0.92	0.90	0.85	1.10	1.25	1.35	1.50
Five-year	0.91	2.20	2.00	1.50	1.75	1.90	2.00	2.15
10-year	2.01	3.30	3.00	2.75	3.00	3.25	3.35	3.50
30-year	3.12	4.30	4.25	4.00	4.25	4.50	4.75	5.00
United Kingdom								
Repo	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00
Two-year	1.20	1.10	0.90	1.00	1.10	1.30	1.50	1.70
10-year	3.17	3.90	3.70	3.70	4.10	4.60	4.50	4.50
Eurozone								
Minimum bid	1.50	1.00	1.00	1.00	1.00	1.00	1.25	1.75
Two-year	1.20	1.10	0.90	1.00	1.40	1.60	1.90	2.50
10-year	3.00	3.55	3.35	3.30	3.40	3.50	3.60	3.60
Australia								
Cash target rate	3.25	3.00	2.75	2.50	2.50	2.50	3.50	4.50
Two-year	2.60	3.60	3.60	3.75	4.00	4.25	4.50	4.75
10-year	4.25	5.10	5.00	5.00	5.30	5.65	5.85	6.00
New Zealand								
Cash target rate	3.00	2.50	2.25	2.00	2.00	2.00	2.00	2.50
Three-year	3.20	3.60	3.75	4.00	4.25	4.30	4.50	5.00
10-year	4.50	5.90	6.00	6.10	6.20	6.25	6.50	6.50
Yield curve								
Canada	169	210	190	165	160	160	125	105
United States	99	238	210	190	190	200	200	200
United Kingdom	197	280	280	270	300	330	300	280
Eurozone	180	245	245	230	200	190	170	110
Australia	165	150	140	125	130	140	135	125
New Zealand	130	230	225	210	195	195	200	150

*New Zealand's yield curve: 10-year vs. three-year

Source: Reuters, RBC Economics Research

Central bank policy rates

%, end of period

		<u>Current</u>	<u>Last</u>			<u>Current</u>	<u>Last</u>		
United States	Fed funds	0.0-0.25	1.00	Dec. 16, 2008	Eurozone	Min. bid rate	1.00	1.25	May 7, 2009
Canada	Overnight rate	0.25	0.50	Apr. 21 2009	Australia	Cash rate	3.00	3.25	Apr 8, 2009
United Kingdom	Repo rate	0.50	1.00	Mar. 5, 2009	New Zealand	Cash rate	2.50	3.00	Apr. 30, 2009

Source: Bloomberg, Reuters, RBC Economics Research



Economic outlook

Growth outlook

% change, year-over-year in real GDP

	08Q4	09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4	Annual			
										2007A	2008A	2009F	2010F
Canada	-1.0	-2.1	-3.0	-2.9	-1.4	0.8	2.5	3.1	3.5	2.5	0.4	-2.4	2.5
United States	-0.8	-2.5	-3.9	-3.6	-1.4	0.7	2.1	2.7	2.8	2.0	1.1	-2.9	2.1
United Kingdom	-2.0	-4.1	-4.7	-4.4	-3.1	-1.6	-0.7	-0.3	0.2	3.0	0.7	-4.1	0.2
Eurozone	-1.7	-4.8	-4.5	-3.7	-2.2	0.3	0.5	1.0	1.3	2.6	0.7	-3.8	0.8
Australia	0.8	0.4	-0.3	-0.4	0.0	0.2	1.4	2.0	3.3	4.3	2.1	-0.3	1.7
New Zealand	-0.9	-2.6*	-2.8	-2.6	-1.7	-0.5	0.5	1.2	1.7	3.1	0.3	-2.4	0.7

*Forecast

*Forecast

Inflation outlook

% change, year-over-year

	08Q4	09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4	Annual			
										2007A	2008A	2009F	2010
Canada	1.9	1.2	-0.2	-0.8	1.2	2.0	1.6	1.7	1.5	2.1	2.4	0.4	1.7
United States	1.6	0.0	-1.2	-2.2	0.9	1.8	1.3	1.3	1.1	2.9	3.8	-0.6	1.4
United Kingdom	3.9	3.0	1.6	0.2	0.4	1.4	0.9	1.0	1.4	2.3	3.6	1.3	1.2
Eurozone	2.3	1.0	0.0	0.1	0.8	1.9	1.9	2.1	2.3	2.3	3.3	0.5	2.1

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	Month ago	Year ago	Three-month trend	Six-month trend
Canada	Bank of Canada core CPI ¹	April	0.2	1.8	1.1	2.0
United States	Core PCE ²	April	0.3	1.9	2.2	1.4
United Kingdom	All-items CPI	April	0.3	2.3	1.7	0.4
Eurozone	All-items CPI	April	0.4	0.6	0.7	-1.3
Australia	Trimmed mean	2009Q1	1.0	3.9	NA	NA
New Zealand	CPI	2009Q1	0.3	3.0	NA	NA

¹ Seasonally adjusted measurement

² Personal consumption expenditures less food and energy price indices

Source: Statistics Canada, U.S. 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

	Actual		Forecast						
	08Q4	09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4
Canadian dollar	1.23	1.26	1.12	1.16	1.14	1.13	1.11	1.09	1.09
Euro	1.39	1.33	1.37	1.33	1.38	1.43	1.48	1.50	1.52
U.K. pound sterling	1.46	1.43	1.57	1.53	1.60	1.68	1.76	1.81	1.85
New Zealand dollar	0.58	0.56	0.63	0.60	0.59	0.61	0.63	0.63	0.64
Japanese yen	90.8	99.0	95.0	94.0	93.0	93.0	94.0	95.0	96.0
Chinese renminbi	6.82	6.83	6.85	6.85	6.85	6.80	6.70	6.60	6.50
Australian dollar	0.70	0.69	0.81	0.80	0.81	0.83	0.84	0.85	0.85
Mexican peso	13.83	14.17	13.50	13.50	12.75	12.50	12.25	12.00	11.75

Canadian dollar cross-rates

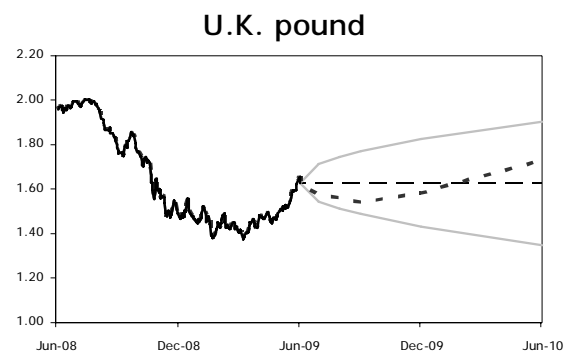
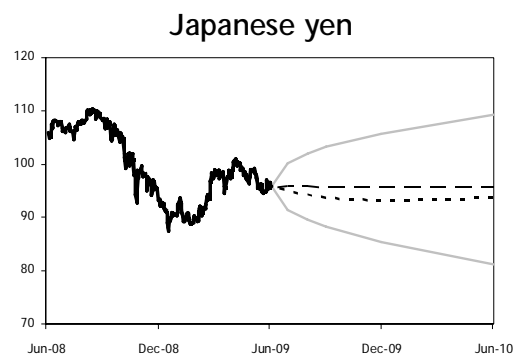
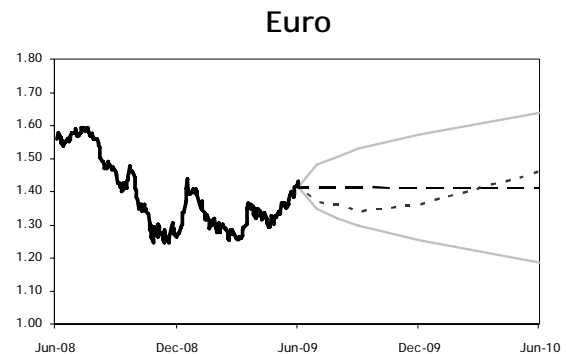
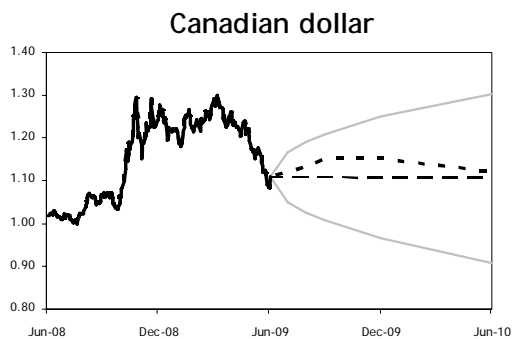
	08Q4	09Q1	09Q2	09Q3	09Q4	10Q1	10Q2	10Q3	10Q4
EUR/CAD	1.70	1.67	1.53	1.54	1.57	1.62	1.64	1.64	1.66
GBP/CAD	1.78	1.80	1.76	1.77	1.83	1.90	1.96	1.97	2.02
NZD/CAD	0.71	0.70	0.71	0.70	0.67	0.69	0.70	0.69	0.70
CAD/JPY	74.0	78.5	84.8	81.0	81.6	82.3	84.7	87.2	88.1
AUD/CAD	0.86	0.87	0.91	0.93	0.92	0.94	0.93	0.93	0.93

Rates are expressed in currency units per US\$ and currency units per C\$, except the euro, U.K. pound, Australian dollar and New Zealand dollar, which are expressed in US\$ per currency unit and C\$ 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.



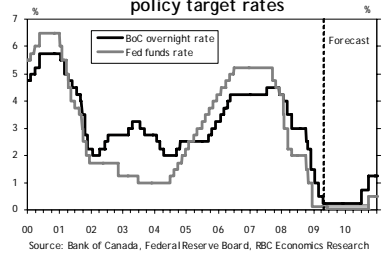
Source: Reuters, RBC Economics Research

Central bank watch

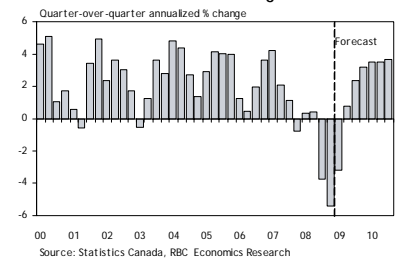
Bank of Canada

- The Bank of Canada held its overnight rate at 0.25% and kept a shift to quantitative easing in reserve.
- The risks to the Bank's forecast are still tilted to the downside and it is concerned that the strengthening C\$ will amplify the downside risks should the appreciation continue.

Canadian and U.S. central bank policy target rates



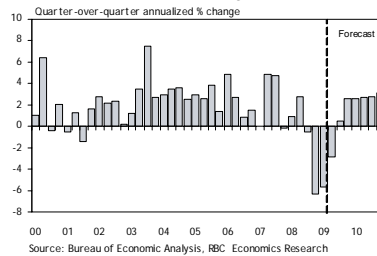
Canadian real GDP growth



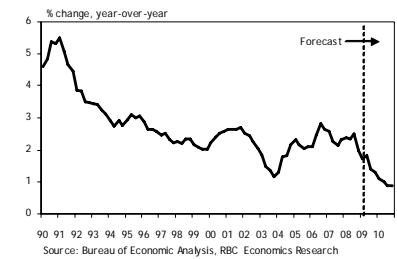
Federal Reserve

- The Federal Reserve has continued its credit easing program along with continued purchases of Treasuries and agencies, as it has announced.
- Although longer-dated yields have moved up in the past month, Chairman Bernanke appeared relatively sanguine about this development in his testimony earlier this week.

U.S. real GDP growth



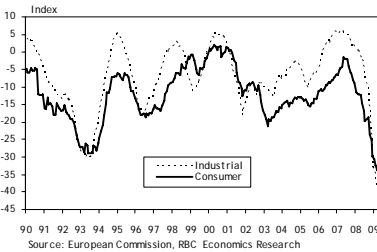
U.S. core CPI inflation



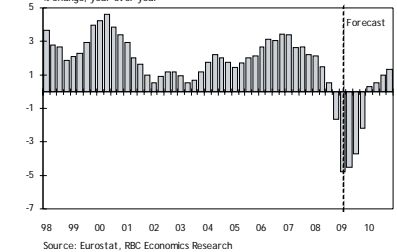
European Central Bank

- The ECB maintained its refi rate at 1.00% and announced further details on its covered bond purchases. President Trichet did not close the door to more cuts to the policy rate, but we think the odds of more easing are low.
- The central bank's quarterly staff forecast revised down its projections for growth.

Eurozone confidence



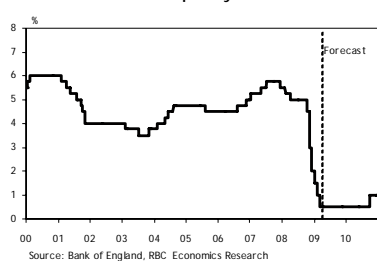
Eurozone GDP



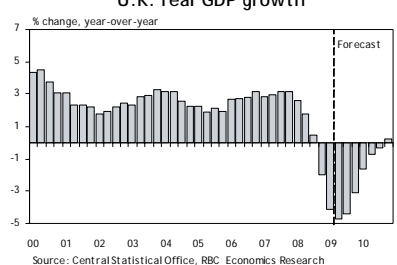
Bank of England

- The Bank of England stayed in a holding pattern at its June meeting with its target rate of 0.50% and £125 billion of asset purchases.
- The Bank's inflation report released in May revised down its growth projection and showed inflation at 1.2% in two years time.

U.K. policy rate



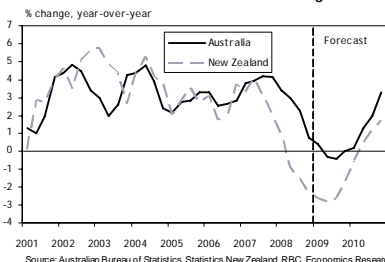
U.K. real GDP growth



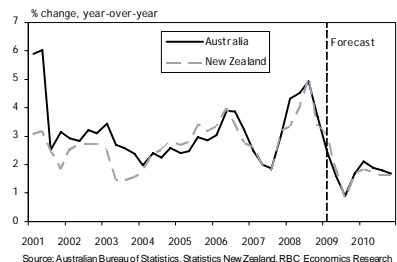
Australia and New Zealand Reserve Banks

- The RBA left rates on hold at 3.00% in June citing continued stabilization of the global economy. First-quarter growth surpassed expectations of a 0.2% fall, instead rising 0.4%.
- Although New Zealand's economy continues to suffer, we have revised our June RBNZ call to unchanged on somewhat stronger domestic data.

Australia and New Zealand GDP growth

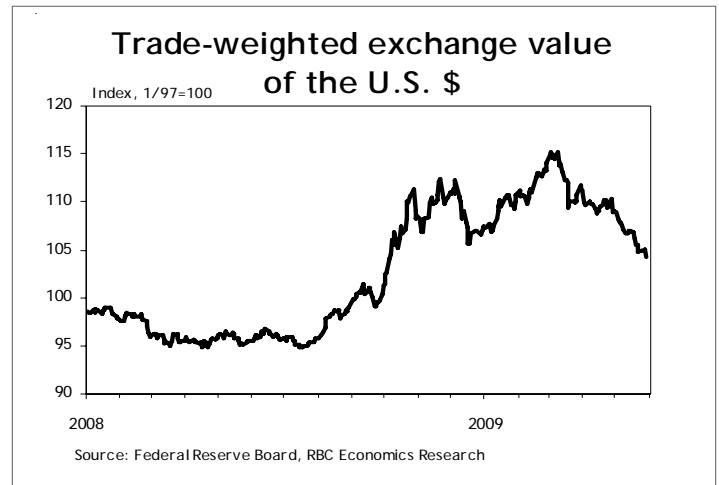
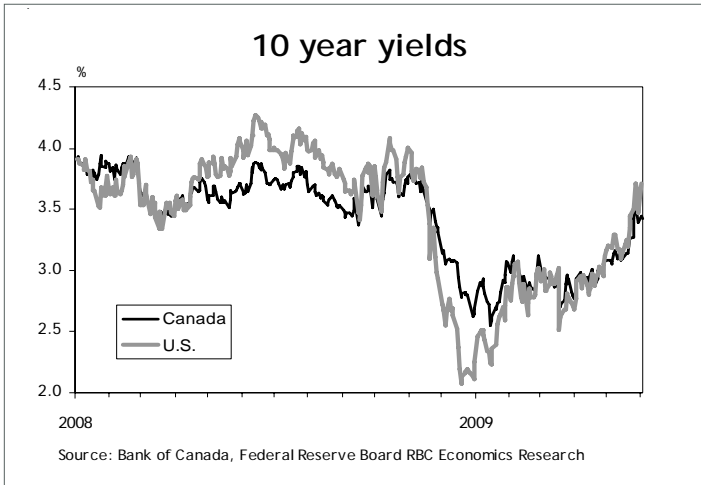


Australia and New Zealand inflation



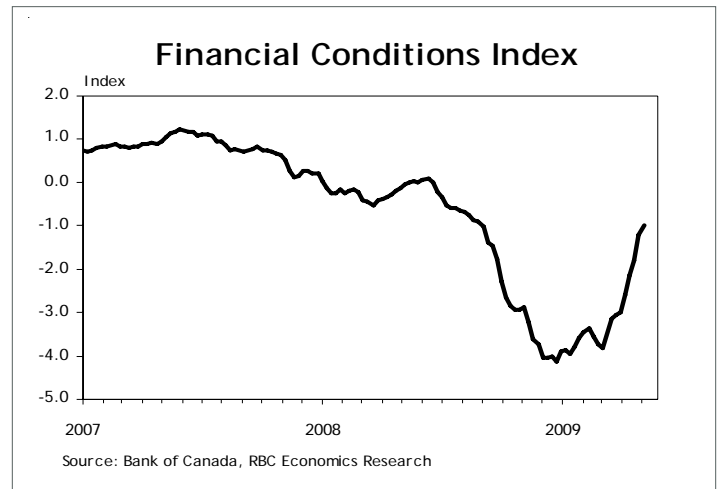
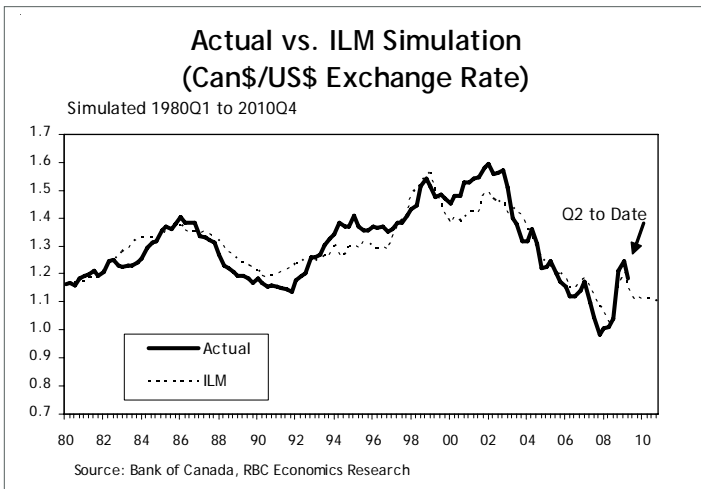
Worries about supply, better economic news and a shift into riskier assets boosted longer-term yields in May.

The U.S. dollar was another casualty of the rise in risk appetite...



...while Canada's dollar benefits from the U.S. dollar weakness and a sharp rally in commodity prices. The currency's gain was broadly in line with that predicted by the Bank of Canada's currency model.

Despite the firmer currency, broad financial conditions in Canada are much easier than in early 2009, with the index showing an 80 basis-point improvement since mid-April.



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