ECONOMICS | RESEARCH

Dawn Desjardins
Assistant Chief Economist
RBC Economics Research
dawn.desjardins@rbc.com

FINANCIAL MARKET UPDATE

August 6, 2008

Click here to view the interest/exchange rate forecast detail table

Central banks plagued by inflation worries and fragile economies

Central bankers are surveying a landscape riddled with risks as the elevated level of energy prices pushes up headline inflation rates while the persistent U.S. housing market correction and financial market turbulence keep downside risks to economic growth alive. Faced with these opposing forces, we expect most central banks to remain on the sidelines in the near-term including the Bank of Canada and the Fed. Policymakers have pledged to monitor the economic data closely, suggesting that the next policy move will be determined by which risk becomes the most pressing — growth or inflation.

Bank of Canada betting on moderate core rate to keep inflation expectations "anchored"

▲ Our tracking of the economy points to GDP growth returning to the positive column in the second quarter at an annualized quarterly rate of close to 1% after the 0.3% annualized decline in the first quarter.

▲ There are both upside and downside risks to the outlook for the economy, but our view is that it is likely to eke out modest real growth of 1.4% in 2008 overall.

▲ We look for the economy to continue to strengthen in the second half of the year, although the re-emergence of weakness in financial markets and attendant tightening in credit plus the forecasted slowing in the U.S. economy will keep downside risks to this forecast alive.

▲ The Bank of Canada forecasts the headline CPI inflation rate to average 4.3% in the first quarter of 2009 and then slow to 2.9% in the second quarter and the core rate (excludes the eight most volatile components) to remain below the mid-point of the Bank's target band until mid-2009. Inflation expectations to expected to be "well anchored to the two per cent inflation target."

▲ The Bank is also optimistic about the outlook for economic growth, with high commodity prices supporting a healthy labour market, firm income growth and strong domestic demand.

▲ We agree with the Bank of Canada's assessment that Canada's economy will continue to build momentum in early 2009 with growth rates returning to potential and the economy shifting back into balance, but we forecast that the core inflation measure will tip over the 2% mark early next year. This modest, yet important, difference makes a rate hike by the Bank of Canada likely in the first quarter of 2009.

U.S. growth concerns resurrected

▲ Economic developments in the past month have resurrected worries about the U.S. economy with the housing market still undergoing a massive correction, the labour market sagging and the price of oil an hitting all-time high.

▲ Equity markets trended lower, denting the value of household assets. Financial market turbulence reared its head once more, with funding spreads widening, mortgage rates rising to their highest level in a year and long-term corporate bond rates climbing after a reprieve in April and May.

- ▲ The bright spot has been the U.S. consumer, with the strength in retail sales data supporting an increase in second-quarter spending growth of 1.5%, up from 0.9% in the first quarter. The increase in consumption boosted second-quarter GDP growth to 1.9%.

- ▲ The ramped-up pace of consumer spending in April and May probably borrowed strength in consumption from the third quarter, which means that the impact from the tax rebates will likely be short-lived and that growth in the second half of the year will be slower than in the first half.

- ▲ With the headline inflation rate running at its fastest pace in 17 years, the Fed is unlikely to alter the current policy rate. Most likely, the opposing risks of rising inflation and slowing growth will keep policymakers in data-watching mode with the Fed funds expected to hold steady at 2.00% until mid-2009.

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.