ECONOMICS | RESEARCH

Inside…

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FINANCIAL MARKETS MONTHLY

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Fed to cut rates further

The ongoing turbulence in financial markets is affecting the outlook for U.S. and Canadian economic growth. Market volatility and tighter credit conditions are taking some of the steam out of the pace of the economic expansion. U.S. real GDP growth is expected to slow to a pace of 1% to 1.5% over the next three quarters, while Canada's economy gears down to grow at less than a 2% pace, much slower than the 3.4% average rate in the first three quarters of the year. Our expectation that the data will increasingly show that the Canadian and U.S. economies are growing more slowly has led us to revise our interest rate forecasts downward. We now expect that the U.S. Federal Reserve will lower the Fed funds rate by a further 75 basis points to 3.75% over the next three meetings. This is a change from the 25 basis points of easing in our previous forecast. The resurgence in financial market volatility since the Fed's October meeting, the widening in credit spreads and weakness in stock markets have boosted the downside risks to the U.S. economy.

Bank of Canada cuts overnight rate by 25 basis points; more easing coming

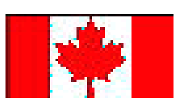
The combination of slower U.S. growth, volatility in global financial markets and moderating inflation rates saw the Bank cut the overnight rate by 25 basis points in December, and we expect another 25 basis-point rate cut in January. A month ago, we expected the Bank to cut the overnight rate by only 25 basis points. The prospect of sharply slower U.S. growth combined with tightening in credit conditions boosted the downside risks to Canada's economic and inflation outlook. This increase in the downside risks, together with the moderation in inflation pressures already apparent in October, mean that the Bank moved into rate cut mode sooner and will likely be more aggressive than we expected one month ago.

Market interest rate forecasts lowered

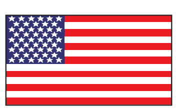
We have revised our forecasts for market interest rates lower in line with the revision to our calls on central bank policy. We now expect that Canada's two-year rate will be 3.25% and the 10-year rate

Central bank watch

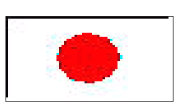
Short-term bias



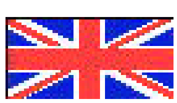
Heightened downside risks to the economic outlook and moderating inflation saw the Bank of Canada trim the overnight rate by 25 basis points in December, with another cut expected early next year.



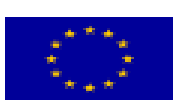
Persistent financial market volatility is boosting the downside risks to the U.S. economic outlook, and another 75 basis points of rate cuts are in store over the next three meetings.



The Bank of Japan remains sidelined by low inflation, moderate growth and financial market uncertainty but is waiting for an opportunity to increase interest rates.



The Bank of England is likely to wait until early 2008 to cut the policy rate on growing evidence that the financial market turbulence is affecting the broader economy.



The European Central Bank (ECB) is worried about the upcoming round of wage negotiations given that the inflation rate has soared to a six-year high. It will, therefore, likely hold the policy rate steady.

Highlights

▲ Central banks to lower rates as financial market volatility boosts the downside risks to the global economic outlook.

▲ Canada's domestic economy has been growing at a healthy clip but is likely to slow as tighter credit conditions bite ...

▲ ... and, combined with a hefty trade drag, push economic growth rates down below 2% over the next three quarters.

▲ The moderation in inflation rates gave the Bank of Canada room to manoeuvre and it cut the overnight rate by 25 basis points in December. Another rate cut is expected early next year.

▲ Interest rate forecasts have been lowered to reflect the growing risks to the economic outlook.

will be 3.95% at the end of 2007. This compares to our earlier forecast of a two-year yield of 4.1% and 10-year yield of 4.25%. We have also lowered our forecast for U.S. interest rates and now look for the two-year yield to close out 2007 at 2.75%, down from 3.75% in our previous forecast. The 10-year bond yield is forecast at 3.85% at the end of 2007, down from 4.35%.

Canada's economy slowed in Q3 but is still solid

The economy grew at a stronger-than-expected 2.9% annualized pace in the third quarter. The strength partly reflected a very large increase in inventory building, although, with a strong domestic economy, some of this was probably desired. The combination of inventory stocking and final domestic demand growth supported the decent showing for the economy in the quarter despite the massive 4.8 percentage-point drag coming from the trade sector. Final domestic demand has been the mainstay of Canada's economic growth during the past several years, and signs that the momentum is slowing will see the Bank of Canada work to offset the restraint coming from the trade sector. Still, the strength in domestic demand is keeping the economy operating above its production capacity and will make the Bank wary about easing too much in 2008. Our expectation that the trade drag will continue to be substantial in coming quarters and that domestic demand will slow as the tightening in credit conditions takes a bite out of household and business spending means that the Bank will edge the policy rate lower in early 2008 as the economy shifts into a lower gear. Persistent financial market uncertainty that keeps further pressure on credit conditions could see the Bank ease more than in our baseline forecast.

Inflation pressures easing

Canada's core inflation rate dipped below 2% for the first time in 16 months in October as retailers aggressively trimmed prices. The three-month running rate in the seasonally adjusted core index slowed sharply to 1.3% in the three months ending October from a high of 2.9% in April. The softening in the core inflation rate to below 2% occurred more rapidly than the Bank of Canada expected as retailers cut prices to levels that are closer to their U.S. counterparts on the back of the surge in the loonie above parity.

In its October *Monetary Policy Report*, the Bank looked for the core inflation rate to hold above the 2% target until the middle of 2008 and then to ease to 2% in the second half of next year. The lower-than-expected prints in October saw the Bank revise its view; it now expects "inflation over the next several months to be lower than was projected in the MPR." Our forecast calls for Canada's all-items inflation rate to remain above the 2% target in the near-term as the energy price-related declines late last year fall out of the year-over-year calculation. However, in early 2008, the rate is expected to fall below 2% on the back of the 1% cut to the GST and continued price discounting by Canadian retailers. We expect the core rate to stay below the 2% target. For monetary policy, the Bank focuses on movements in the core rate as a guide to underlying price pressures, so the move below 2% means that it will focus on the risks to the outlook for growth.

U.S. economy grew strongly in Q3 but is showing signs of weakening

U.S. third-quarter GDP growth was revised up to a 4.9% annual rate from an already-robust 3.9%, implying that the economy had solid momentum as the tightening in credit conditions hit. This robust growth was achieved despite marked weakness in residential investment, which declined an annualized 19.7% and reduced third-quarter growth by one percentage point. However, a major component of the strong performance was a jump in inventory building, which we expect will be partially unwound in the fourth quarter. Additionally, strong consumer spending on durables likely borrowed activity from the fourth quarter, pointing to a sharp slowing ahead. The combination of very weak residential investment, softer durables consumption and a slowing pace of inventory accumulation points to a marked easing in GDP growth to a rate close to 1% in the fourth quarter.

The deepening in credit market tightening and persistent financial market volatility mean that households and businesses are likely to remain nervous and risk-averse heading into 2008. We expect that the economy will eke out a growth rate of 1.5% in the first half of next year. In this environment, the Fed will likely put inflation concerns on the back burner and focus on mitigating the downside risks to the economy. Our view is that the Fed will lower the funds rate by a further 75 basis points; that combined with a government-led program to limit future mortgage defaults should be enough to stave off a recession and support stronger growth in the second half of 2008.

Policy action to produce stronger growth in the second half of 2008

Our 2008 interest rate forecasts have been lowered as well, but the tone of the outlook remains the same. Both the Canadian and the U.S. economies are expected to return to a firmer growth path in the second half of 2008, with central banks likely to begin to reverse the rate cuts from the second half of 2007 and early 2008. We expect that both economies will reaccelerate around mid-year as the lagged effects of the rate cuts revitalize household and business spending, the U.S. housing market recession eases and financial market turbulence ends. Our forecast is for the U.S. economy to grow at an average 2.5% pace in the second half of 2008, much faster than the 1.5% average pace expected in the first six months of the year. As the downside risks to the economic outlook recede, the Fed will begin to pare back the amount of monetary policy stimulus, with 50 basis points of rate increases pencilled in for the final half of the year. Interest rates across the yield curve will shift higher as stronger growth and lingering inflation concerns pressure yields upward. We are forecasting that the Fed funds rate will close 2008 at 4.25%, two-year yields at 4.55% and 10-year at 4.95%.

Our assessment that the U.S. economy will rebound in the second half of next year will remove some of the downside risk to Canada's economic outlook and will limit the drag from the trade sector by bolstering export demand. At the same time, the Canadian dollar is likely to slowly give back some of its 2007 gains as financial market volatility ebbs, setting up for the economy to grow at a rate that is more in line with its potential. Similar to our U.S. forecast, we expect that the Bank of Canada will begin to reverse the rate cuts and we are forecasting that the overnight rate will rise to 4.25% in the final quarter of 2008, with market interest rates of 4.25% for the two-year maturity and 4.7% for the 10-year.

Central banks chart course to combat financial market volatility

We expect that the Bank of England (BoE) will join the Fed and the Bank of Canada in easing interest rates in early 2008 to offset the downside risks to the economy coming from the tightening in credit conditions. No change is expected at the BoE's December meeting, but evidence that financial market weakness is broadening out into the general economy will likely get the central bank into easing mode early next year. RBC now expects the repo rate to be cut to 5% in the second quarter of 2008 from 5.75% today.

The European Central Bank (ECB) has shifted from an aggressive tightening campaign, although inflation concerns appear to be trumping worries about a slowdown in the economy. Eurozone inflation jumped to its highest level in more than six years. The prospect of the pending round of wage negotiations, with an inflation rate of about 3%, means that, even though the ECB will likely maintain a neutral policy stance, it will still be biased toward tighter policy. The strong euro and financial market stresses will likely do much of the heavy lifting for the ECB, with policymakers working on the sidelines with liquidity injections aimed at easing the strain on funding costs.

Highlights

▲ The U.S. economy grew at a robust 4.9% pace in the third quarter…

▲ …implying that the economy had solid momentum as the financial market turbulence hit.

▲ Slower growth is in the pipeline because financial market uncertainty is making consumers and businesses nervous and the housing market recession is not abating yet.

▲ The Fed is likely to cut rates by another 75 basis points to ensure that the economy navigates through the financial market turbulence.

Interest rate outlook

%, end of period

		Actual			Forecast				
		07Q1	07Q2	07Q3	07Q4	08Q1	08Q2	08Q3	08Q4
Canada	**Overnight**	4.25	4.25	4.50	4.25	4.00	4.00	4.00	4.25
	Three-month	4.17	4.43	3.97	3.90	3.80	4.00	4.10	4.25
	Two-year	3.98	4.61	4.12	3.25	3.25	3.55	4.05	4.25
	Five-year	4.02	4.58	4.24	3.45	3.50	3.85	4.35	4.55
	10-year	4.13	4.59	4.35	3.95	4.00	4.25	4.60	4.70
	30-year	4.21	4.51	4.44	4.15	4.10	4.30	4.65	4.75
United States	**Fed funds**	5.25	5.25	4.75	4.25	3.75	3.75	4.00	4.25
	Three-month	4.92	4.69	3.64	3.00	2.75	3.00	4.00	4.25
	Two-year	4.60	4.93	3.94	2.75	2.90	3.30	4.20	4.55
	Five-year	4.55	4.97	4.19	3.05	3.20	3.75	4.55	4.75
	10-year	4.65	5.06	4.53	3.85	3.95	4.25	4.75	4.95
	30-year	4.83	5.16	4.79	4.25	4.25	4.50	4.95	5.15
Japan	**Call**	0.50	0.50	0.50	0.50	0.75	1.00	1.25	1.25
	Two-year	0.84	1.05	0.88	0.90	1.05	1.15	1.30	1.40
	10-year	1.66	1.87	1.68	1.75	2.00	2.10	2.25	2.35
United Kingdom	**Repo**	5.25	5.50	5.75	5.75	5.25	5.00	5.00	5.00
	Two-year	5.43	5.77	5.08	4.50	4.00	4.30	4.50	4.80
	10-year	4.94	5.44	5.06	4.60	4.25	4.80	5.05	5.25
Eurozone	**Minimum bid**	3.75	4.00	4.00	4.00	4.00	4.00	4.00	4.00
	Two-year	4.00	4.45	4.04	3.75	3.50	3.70	4.15	4.25
	10-year	4.05	4.55	4.33	4.10	4.00	4.25	4.60	4.65
Australia	**Cash target rate**	6.25	6.25	6.50	6.75	7.00	7.00	7.00	7.00
	Two-year	6.30	6.46	6.45	6.65	6.80	6.60	6.50	6.40
	10-year	5.88	6.26	6.18	5.95	6.20	6.25	6.40	6.45
New Zealand	**Cash target rate**	7.50	8.00	8.25	8.25	8.25	8.25	8.25	8.25
	Two-year	6.90	7.35	6.98	7.30	7.25	7.10	6.90	6.75
	10-year	5.96	6.73	6.25	6.25	6.45	6.50	6.75	6.45

Inflation watch

	Measure	Current period	Month ago	Year ago	3-month trend	6-month trend
Canada	Bank of Canada core CPI[1]	October	-0.2	1.8	1.3	2.1
United States	Core PCE[2]	October	0.2	1.9	2.0	1.8
United Kingdom	All-items CPI	October	0.5	2.0	0.8	1.9
Eurozone	All-items CPI	October	0.5	2.6	1.4	2.8
Japan	All-items (excl. fresh food)	October	0.1	0.0	0.3	0.1
Australia	Trimmed mean	2007Q2	0.9	2.7	NA	NA
New Zealand	CPI	2007Q2	1.0	2.0	NA	NA

[1] Seasonally adjusted measurement
[2] Personal consumption expenditures less food and energy price indices

Central bank policy rates

		Current	Last				Current	Last	
United States	Fed funds	4.50%	4.75%	Oct. 31, 2007	Eurozone	Min. bid rate	4.00%	3.75%	Jun. 06, 2007
Canada	Overnight rate	4.25%	4.50%	Dec. 04, 2007	Australia	Cash rate	6.75%	6.50%	Nov. 07, 2007
Japan	Call rate	0.50%	0.25%	Feb. 21, 2007	New Zealand	Cash rate	8.25%	7.75%	Jul. 26, 2007
United Kingdom	Repo rate	5.75%	5.50%	Jul. 05, 2007					

Currency outlook

Level, end of period

	Actual			Forecast				
	07Q1	**07Q2**	**07Q3**	**07Q4**	**08Q1**	**08Q2**	**08Q3**	**08Q4**
Canadian dollar	1.15	1.06	1.00	0.93	0.92	0.95	0.99	1.02
Euro	1.33	1.35	1.42	1.46	1.48	1.45	1.40	1.38
U.K. pound sterling	1.96	2.00	2.04	2.09	2.10	2.04	1.99	1.96
New Zealand dollar	0.71	0.77	0.76	0.77	0.80	0.77	0.75	0.76
Japanese yen	118.3	123.4	115.2	117.0	119.0	119.0	118.0	117.0
Chinese renminbi	7.73	7.61	7.51	7.35	7.30	7.25	7.15	7.10
Australian dollar	0.81	0.85	0.88	0.92	0.96	0.93	0.91	0.89
Mexican peso	11.00	10.78	10.92	10.85	10.85	10.95	11.00	11.10

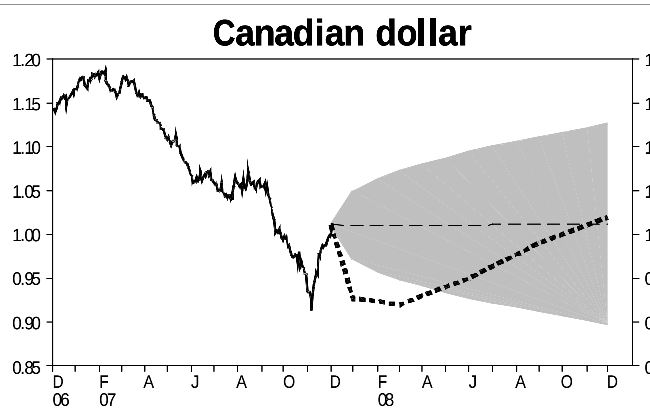
Canadian dollar cross-rates

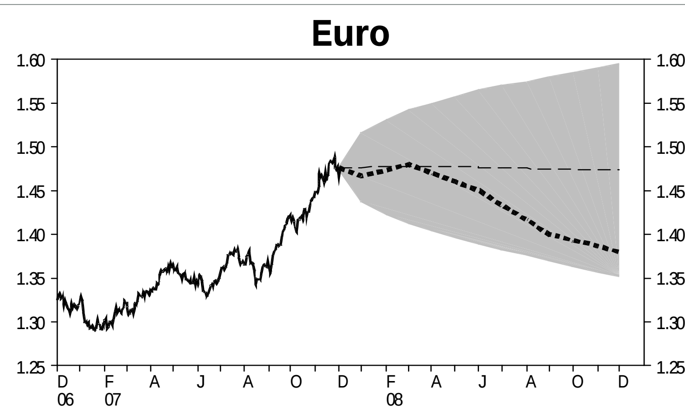
	07Q1	**07Q2**	**07Q3**	**07Q4**	**08Q1**	**08Q2**	**08Q3**	**08Q4**
EUR/CAD	1.54	1.43	1.41	1.36	1.36	1.38	1.39	1.41
GBP/CAD	2.26	2.13	2.03	1.94	1.93	1.94	1.97	2.00
NZD/CAD	0.82	0.82	0.75	0.72	0.74	0.73	0.74	0.78
CAD/JPY	102.4	116.3	115.7	125.8	129.3	125.3	119.2	114.7
AUD/CAD	0.93	0.90	0.88	0.86	0.88	0.88	0.90	0.91

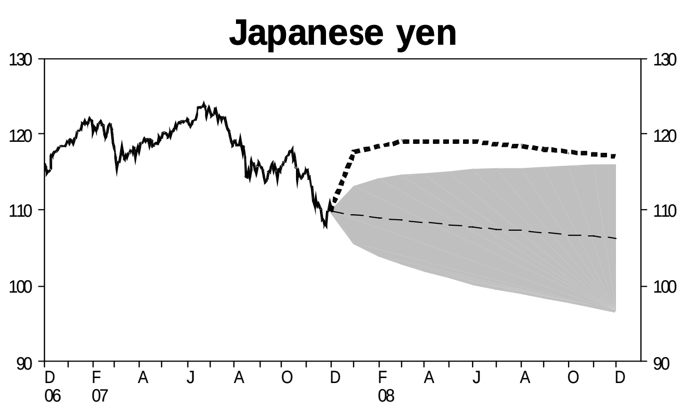
Rates are expressed in currency units per US$ and currency units per C$, except the euro, U.K. pound , Australian dollar and New Zealand dollar, which are expressed in US$ per currency unit and C$ per currency unit.

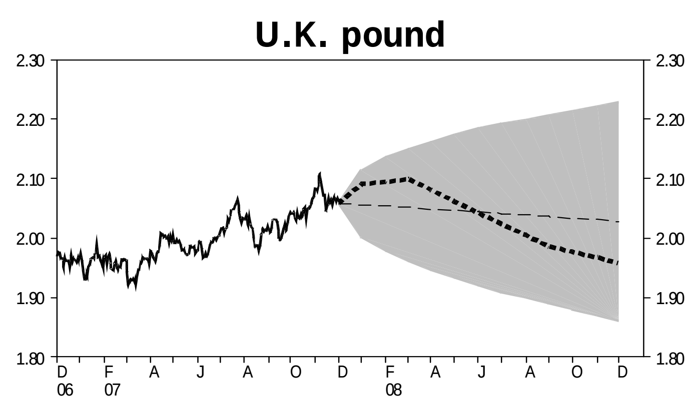
RBC Economics outlook relative to the market

These charts track historical exchange rates plus the forward rate (dashed line) relative 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.









Central bank watch

Policy bias tighter easier neutral

Bank of Canada

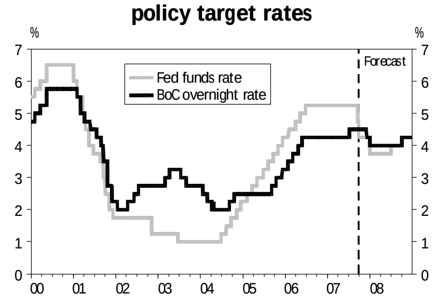
3M

12M

• Slower U.S. growth and easing inflation pressures prompted the Bank of Canada to cut the overnight rate 25 basis points in December, with another cut likely in the first quarter of 2008.

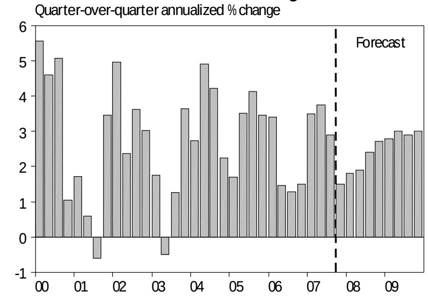
• As the trade drag lessens, the U.S. economy improves and financial market volatility eases, we expect the Bank to start to reverse the rate cuts by the end of next year.

Canadian and U.S. central bank policy target rates



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

Canadian real GDP growth



Source: Statistics Canada, RBC Economics Research

Federal Reserve

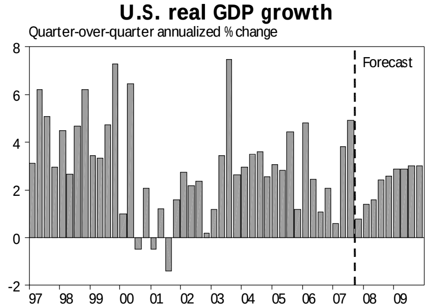
3M

12M

• We expect the Fed to cut rates by another 75 basis points to ensure that the U.S. economy weathers the financial market turbulence.

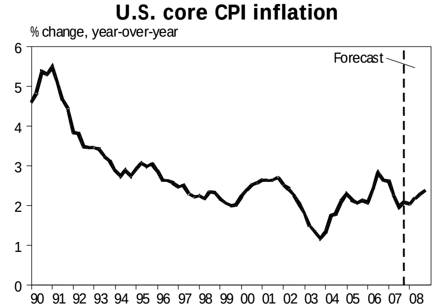
• As the downside risks to the economic outlook recede, the Fed will start to unwind the easing in late 2008.

U.S. real GDP growth



Source: Bureau of Economic Analysis, RBC Economics Research

U.S. core CPI inflation



Source: Bureau of Economic Analysis, RBC Economics Research

Bank of Japan

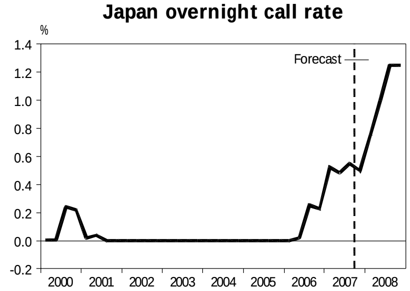
3M

12M

• Although core inflation climbed above zero, it will not persuade the Bank of Japan to hike the rates...

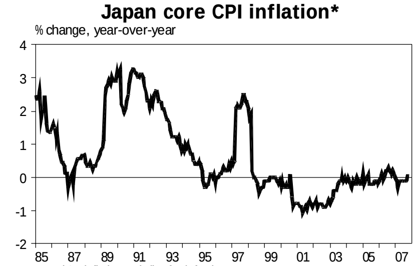
• ...until the financial market turmoil recedes.

Japan overnight call rate



Source: Bank of Japan, RBC Economics Research

Japan core CPI inflation*



* Total CPI inflation excluding fresh foods

Source: Ministry Of Public Management, Home Affairs, Posts and Telecom, RBC Economics Research

European Central Bank

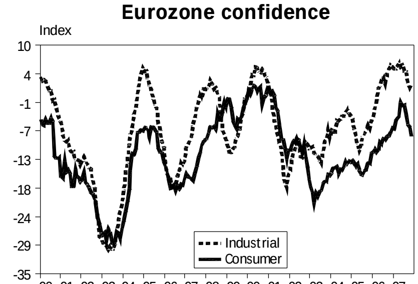
3M

12M

• Inflation worries are trumping concerns about the economy...

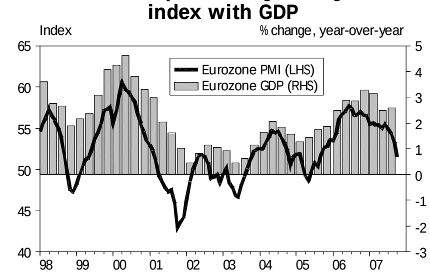
• ...and the spike in the inflation rate will keep the ECB on the sidelines.

Eurozone confidence



Source: European Commission, RBC Economics Research

Eurozone purchasing managers index with GDP



Source: OECD, Eurostat, Reuters, RBC Economics Research

Bank of England

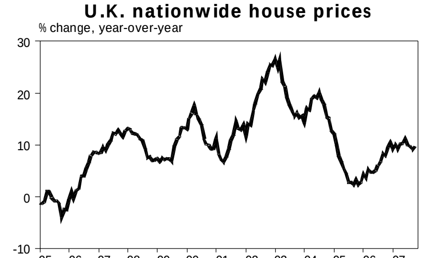
3M

12M

• Evidence that financial market weakness is broadening out into the general economy...

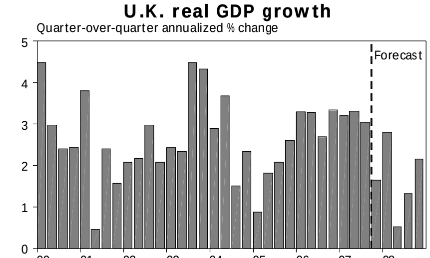
• ...will see the Bank of England cut the repo rate by 75 basis points in the first half of 2008.

U.K. nationwide house prices



Source: Nationwide Building Society, RBC Economics Research

U.K. real GDP growth



Source: Central Statistical Office, RBC Economics Research

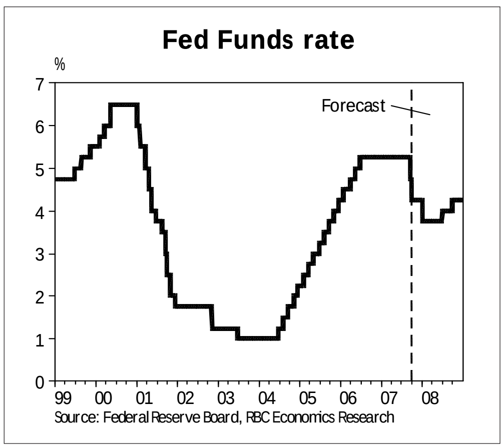
Forecast of key indicators

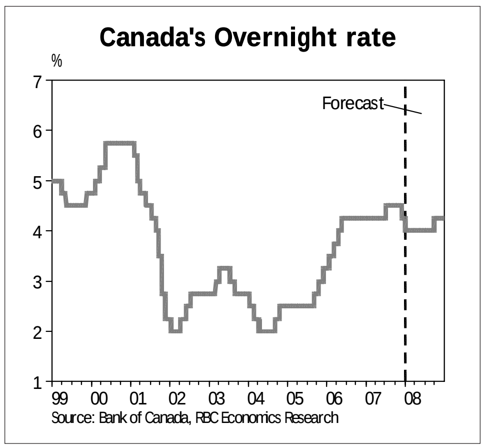
	Real GDP				Inflation			
	2005	2006	2007	2008	2005	2006	2007	2008
Canada	3.1	2.8	2.6	2.1	2.2	2.0	2.2	1.4
United States	3.1	2.9	2.2	2.1	3.4	3.2	2.8	2.7
Japan	1.9	2.2	2.1	2.0	-0.3	0.2	0.0	0.4
United Kingdom	1.8	2.8	3.0	2.0	1.9	3.0	1.7	2.1
Eurozone	1.7	2.8	2.8	2.2	2.2	2.3	1.9	2.1
Australia	2.8	2.6	4.3	3.8	2.7	3.5	2.4	3.1
New Zealand	2.2	1.6	3.0	2.4	3.0	3.5	2.3	2.9

Central bank policy geared to ensure that economies skirt recession

The Fed is expected to cut the funds rate by a further 75 basis points as persistent financial market turbulence boosts downside risks to the economy.

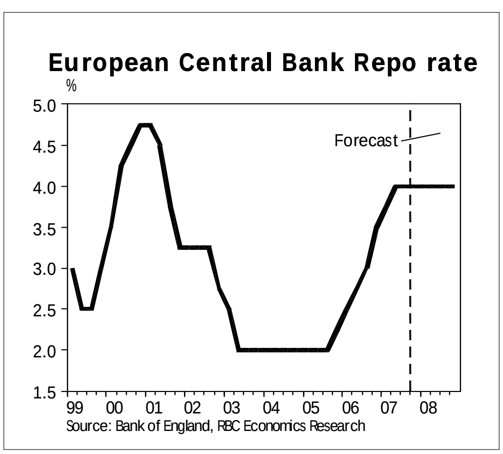
Slower U.S. growth may dampen export growth and, combined with slowing domestic demand, may see the Bank follow up its December rate cut with another in early 2008.

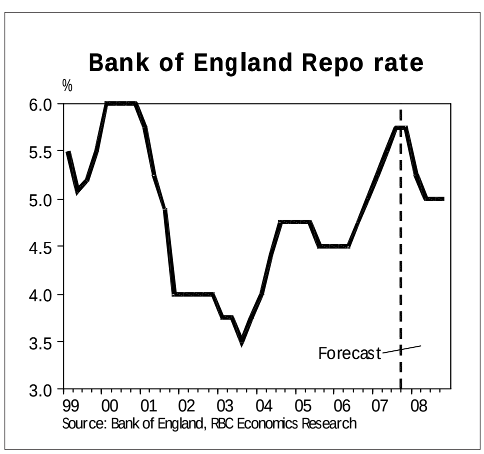




The ECB remains worried about inflation, but the prospect of slower growth will keep policymakers on the sidelines.

The Bank of England will get into rate cut mode early next year as tighter credit conditions begin to affect the broader economy.





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