



ECONOMIC AND FINANCIAL MARKET UPDATE

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Global economy set to grow at more sustainable pace

The global economy grew at a rapid rate in early 2010 with the International Monetary Fund (IMF) calculating that GDP output increased at a faster than 5% annualized pace in the first quarter of the year. Trade volumes and global industrial production surged, and the global purchasing managers' and OECD leading indicators indices returned to pre-recession levels. Not surprisingly, the pace of increase in the global leading indicators slowed in the second quarter, which was consistent with the world economy growing at a more sustainable pace.

U.S. economy slows

The U.S. economy geared down in the second quarter of 2010 following strong gains in the prior six-month period. Consumers are spending at a moderate pace as they rebuild savings. A broad-based increase in business investment in the second quarter and inventory rebuilding provided support for the 2.4% annualized increase in real GDP. A factor acting to restrain the growth rate was some of the strength in domestic spending was met by imports. Revisions going back to 2007 showed a generally softer profile for growth and a peak-to-trough decline during the recession of 4.1%, higher than previously estimated. Much of the anxiety about the outlook for the second half of the year is due to the pace of job growth, which has picked up but remains lacklustre. Private-sector employment (excluding the effect of census hiring and firing) accelerated from the first quarter's 79,000 average monthly gain to 108,000/month in the second quarter mainly due to a surge in April. In July, private payrolls increased by 71,000. Our view that the pace of job growth will rise is consistent with the economy staying on its moderate recovery path in the near term and accelerating in 2011. This forecast implies limited progress in eliminating the large output gap this year meaning the unemployment rate will remain elevated and inflation benign. Faster growth in 2011 will support a more substantive improvement in the labour market and sustained downward pressure on the unemployment rate.

'Unusually uncertain' outlook

While the base case is for the recovery to continue, Fed Chairman Bernanke's statement that the outlook is "unusually uncertain" raised the possibility of the Fed implementing a further easing in monetary policy. In early August, the Fed downgraded the forecast for the economy further and announced they will reinvest the principal payments from agency debt and MBS in longer-term US Treasuries and will roll over their existing holdings of Treasury securities in order to support the economic recovery through low market interest rates. The Fed's actions highlight their intention to do whatever is necessary to ensure that the recovery stays on course. Policymakers kept the door open to further steps to ease policy by committing to "employ its policy tools as necessary to promote economic recovery and price stability."

Economy gears down but remains in drive

Recent Canadian economic reports have been a mixed bag culminating with the May GDP report showing a mild 0.1% gain. We are sticking to our call that the economy grew at a 3.0% annualized pace in the second quarter of 2010 although the limited gain in May GDP implies some downside risk. Looking through the recent volatility, the data signal that the domestic economy has not buckled under the strains created by the European debt crisis and the weaker tone in some of the U.S. reports. Though the data points to GDP growth in the second quarter running at a pace that one-half of the 6.1% surge in the first quarter, the near-record pop in employment in the quarter is consistent with the economy maintaining its solid growth momentum even with a mild decline in July employment. We forecast growth at an above-potential rate in the remainder of 2010 with the unemployment rate expected to decline further. The domestic data are consistent with the Bank raising the overnight rate to 1% at the September fixed-action date and 1.25% by the end of 2010. Government bond yields have taken their direction from U.S. Treasuries, grinding to the year's lows in most maturities despite firming a labour market, evidence of a sustained recovery and the Bank of Canada's assumption that there will be a, "gradual reduction in monetary stimulus."

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