

## US & Canadian Monetary Policy & Capital Markets

- The Bank of Canada is still forecast to raise its policy rate five more times between now and the end of 2019 including twice more this year.
- The Federal Reserve is forecast to raise the fed funds target range four more times by the end of 2019 including the addition of one more forecast rate hike this year to two more by the end of 2018. Peak balance sheet run-off by this Fall adds 1-2 more equivalent hikes.
- The Federal Reserve's pace of balance sheet unwinding will peak this Fall and impose unconventional policy tightening in addition to rate hikes.
- There are no material changes to our US or Canadian bond market forecasts.

### BANK OF CANADA—SLIPPING BEHIND, REGARDLESS OF NAFTA

There are no changes to our Bank of Canada (BoC) forecast for five rate hikes between now and the end of 2019. This includes two more increases this year—bringing the year's total to 3 hikes including January's and an ending rate of 1.75%—and three more next year. That would leave the overnight rate at 2.5% by the end of next year and either in line with or not far from the estimated neutral rate. There is the risk of going at a slower pace should NAFTA developments take a much deeper turn for the worse than has been apparent to date or anticipated, but there is also the opposite risk of overshooting the long-run neutral rate if this cycle's wage and price pressures continue to evolve in a fashion that further jeopardizes the BoC's inflation mandate. Such a neutral rate would remain low by historical standards because of various drivers of slower non-inflationary growth limits this cycle versus prior cycles including a relatively large household debt overhang. Relatively more of the pressure upon market rates is expected through shorter-term interest rates as longer-term borrowing costs are more advanced along the path of adjusting to tighter monetary policy this cycle (chart 1, table 1). This continues to drive expectations for a flatter borrowing curve over time—particularly under 2 years—and one that means greater pressure upon variable rate borrowers than fixed rate debt.

Inflation is running at about a four-year high and back to before the slide in commodity prices in 2014–15. Headline inflation is tracking above the 2% target and core measures are just beneath. The recent rise has been based upon a combination of tightening capacity limits that increase pricing power in the overall economy, real wage gains that increase purchasing power, overall base effects, gas price increases, and minimum wage pass-through effects. Some of these effects would and should be looked through by the BoC but many are more durable and some of them—like currency weakening, tariffs, gas, and minimum wages—offer second round pass-through effects deeper into the CPI basket. Given a multitude of factors driving inflation higher, it is going to be dicey to dismiss every one of them as idiosyncratic and/or temporary; indeed, past episodes of unmoored inflation expectations have often started off by providing too many excuses to look through inflationary pressures.

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Chart 1

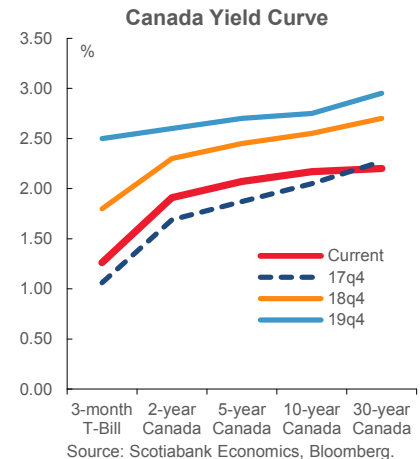


Chart 2

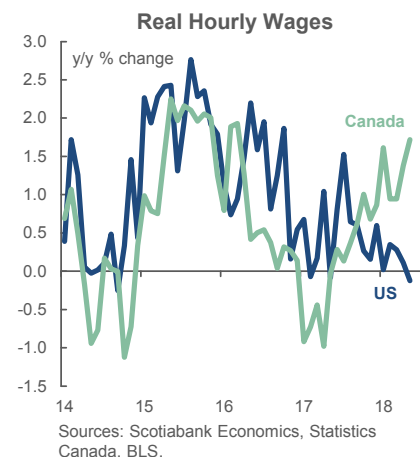
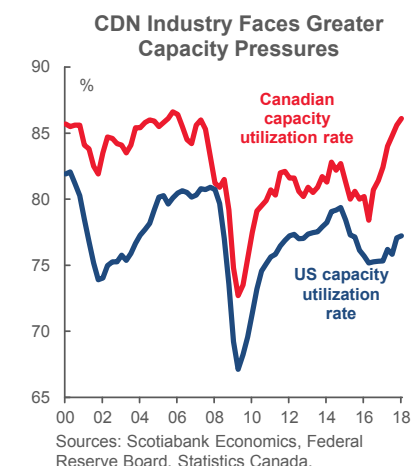


Chart 3



Further upward pressure on inflation could easily be forthcoming as capacity limits become more binding but also due to currency and tariff adjustments, additional pass-through effects of minimum wage hikes, plus tightening wage influences. Steel and auto tariffs and Canada's retaliation across a broad range of US imports are estimated to add a modest 0.1% to inflation and subtract under 0.1% from GDP growth over coming months. Auto tariffs are a bigger risk to CPI pressures but we are not yet prepared to treat this as a serious gambit by the US administration. The currency's sharp depreciation from around 1.21 on a USDCAD basis last September to over 1.33 today will also carry modest pass-through consequences into import prices and then the CPI basket. Scotia's René Lalonde estimates that a *persistent* 10% depreciation in the currency adds 0.6% to CPI within six months and 0.1% to the average of the core inflation measures. It is typically treated as a transitory development but one that can spawn spillover effects across items within the basket.

**The consequence is that inflation is pushing deeper into the upper half of the BoC's 1–3% “flexible” target range and could well keep rising.** One cannot dismiss the risk that inflation breaches the upper end of the target range by year-end. Now combine that with wage pressures that are exceeding inflation (chart 2) and the message is that the wage and price dynamic is at serious risk of putting the BoC behind its inflation mandate.

Several related considerations will be explored. **One is that we believe risks such as a trade shock would have to be quite severe in order to lead the BoC to allow inflationary pressures to build without tightening policy.** At this point in time we don't judge the risk of the abrogation of the NAFTA agreement as a serious one, in large part because Congress—not the executive branch—controls trade agreements and the Trump administration could not execute a notification of intent to withdraw. What is key in this regard is that trade policy uncertainty operates very differently as a macroeconomic influence when the economy is already at capacity limits, especially industrial capacity (chart 3). There is an option to invest when trade uncertainty exists at a point of slack in the economy. When trade uncertainty exists at the point of full capacity utilization—let alone excess utilization—then the element of choice diminishes. A business can choose to invest and hire in order to expand capacity to meet incremental demand in a solidly performing global economy, or it may raise prices more aggressively in order to ration demand. The only other alternative is to sit back and watch others eat its lunch.

**Secondly, growth is unimpressive.** Current tracking for Q2 GDP growth is only about 1.7% using monthly income-based GDP accounts at a very preliminary stage but this is expected to improve somewhat and it wouldn't take much to do so. Further, quarterly expenditure-based GDP should perform better than current tracking of the monthlies. This follows actual Q1 growth of 1.3% on a quarterly expenditure accounts basis. Nevertheless, growth is roughly trending at or slightly below the BoC's estimated 1.5–2.1% range for the economy's potential growth rate. Some of this disappointment in early Q2 tracking may be transitory ([here](#) and [here](#) for instance) but a combination of weak growth and persistent varying transitory factors nevertheless leaves behind continued growth disappointments. The risk of further escalation of retaliatory tariffs could also well prove to be a growth headwind. This will limit the move by the economy into excess aggregate demand conditions at least in the near-term, though we continue to forecast that the economy will continue to transition toward improved growth as temporary headwinds dissipate and to therefore migrate

Chart 4

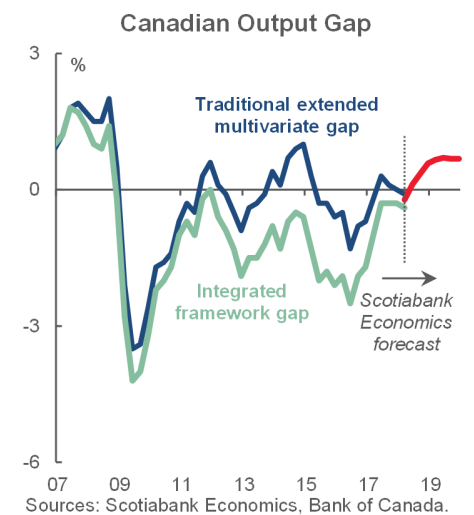


Chart 5

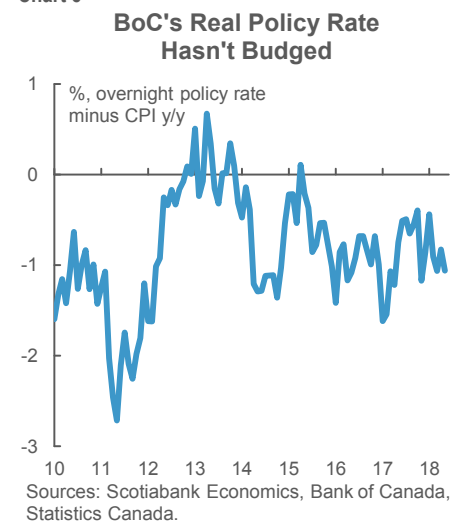
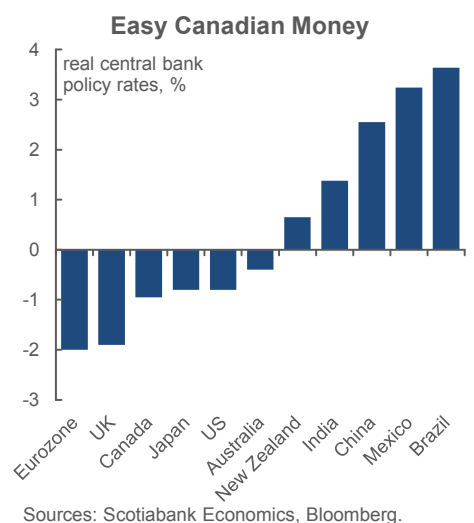


Chart 6



toward excess demand from its current balanced state over the forecast horizon (chart 4).

**So what is the BoC to do when confronted with the risk of building wage and price pressures and soft or little growth that may be labelled a stagflation scenario? Stick to its guns on the growth outlook which is in line with ours for one.** Respect its mandate for another, but tread carefully from decision to decision. We continue to forecast a rate hike in July. There may be rising pressure into an election year for fiscal and regulatory policies to mitigate the distribution effects across sectors of various trade-related risks. **Not acting to tighten monetary policy in the face of rising wage and price pressures risks unmooring inflation expectations and causing greater longer-term risks to the economy and financial system.** That, in turn, risks disavowing the BoC's role in the building price pressures.

**A third related consideration involves how to view broad monetary conditions.** Overall, the real policy rate is among the lowest in the world (chart 5). Left unchecked, Canada's real policy rate would become lower than the Eurozone's and much lower than Japan's (chart 6). While the BoC would also look at the real rate using inflation expectations, it is also true that the real policy rate has not tightened as the nominal rate has been raised using market-derived measures of inflation expectations instead of actual inflation. The real policy rate is what matters to any attempt to forecast real GDP growth and the broad framework for spare capacity and inflationary pressures. Governor Poloz has hiked three times to date in order to keep conditions from easing on a real rate basis, with the real policy rate staying roughly constant at around -100bps. Monetary conditions have not tightened when judged through this lens. All that three rate hikes to date have achieved is to prevent monetary policy conditions from easing in real rate terms. Canadian dollar depreciation, tight credit spreads in products like mortgage and provincial bonds, as well as elevated high-yield debt indices continue to point to easy if not easing broader financial conditions.

Chart 7

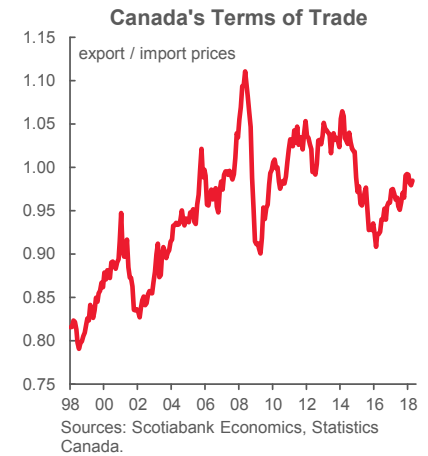


Chart 9

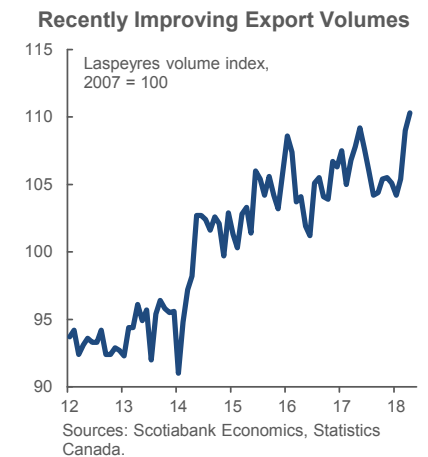
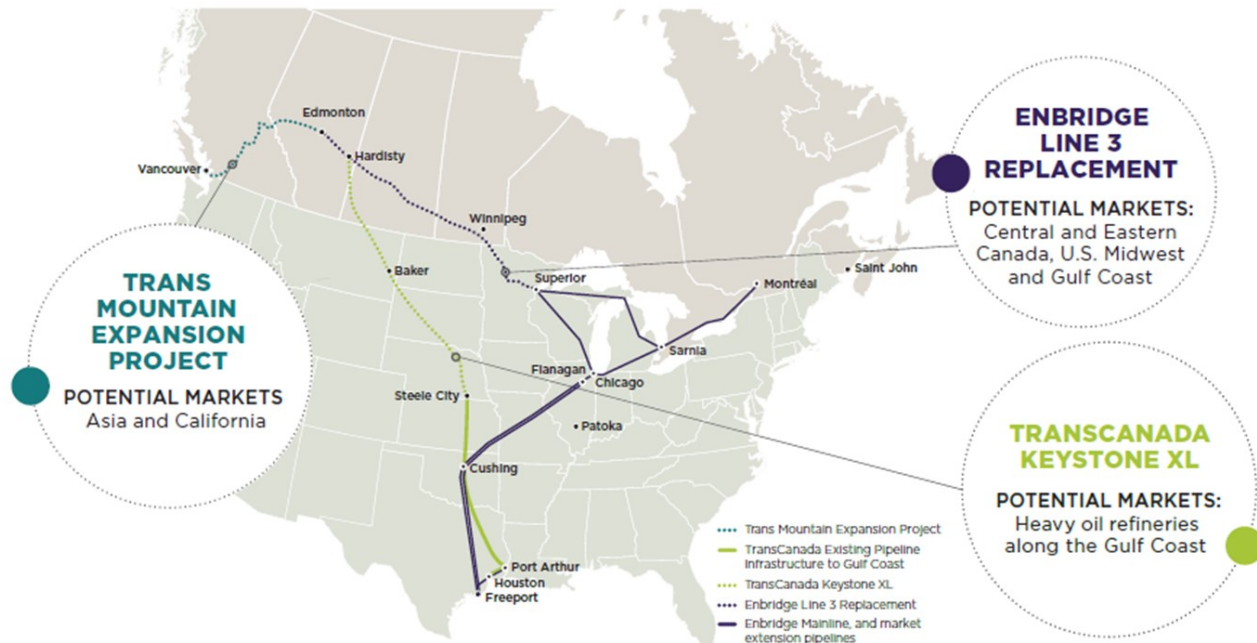


Chart 8



**A fourth related matter is that the terms of trade have improved rather significantly over the past year (chart 7).** The faster rise in export prices relative to import prices has occurred as commodity prices have recovered over time and the Canadian dollar has depreciated. Being able to sell exports at prices that are rising more quickly than imports induces positive dynamics for income growth. This carries positive effects for gross national income that then trickle down into more positive developments for household incomes, corporate profits and government revenues. Recall that when the shoe was on the other foot over 2014H2 into 2015 as commodity prices fell and the terms of trade worsened, the BoC's response was to ease monetary policy. As the terms of trade have improved, this counsels the opposite policy response.

**A fifth related matter concerns production bottlenecks that are particularly focused upon the energy sector due to a shortage of pipeline capacity.** A first consideration when evaluating this effect is that bottlenecks can prove to be inflationary. An inability to invest in upstream capacity due to downstream capacity limits means a greater likelihood that improved free cash flow positions are relatively more likely to be distributed to workers and shareholders, some of which may be spent. A second consideration, however, entails viewing pipeline capacity limits as relatively transitory. Three major pipelines—TransMountain, Keystone XL and Line 3 (chart 8)—are expected to become operational around a 2020–2021 horizon. In other words, by next year, the alleviation of production bottlenecks begins to be a material consideration for the BoC within the monetary policy horizon of 1–2 years. Upstream investment will face a greater need to invest in advance of this improvement in pipeline capacity.

**A sixth related consideration for present purposes is that the BoC is tentatively observing the long-awaited rotation of the sources of growth away from reliance upon consumers and housing markets and proportionately more toward exports and investment.** Export volumes have been sharply improving (chart 9) and the currency's depreciation may provide a further assist. Business investment has also been improving (chart 10) and intentions point to expectations for more to come (chart 11). Canada ranked #2 in the world for foreign direct investment confidence across global corporations in [this](#) 2018 survey partly due to the new Invest Canada agency and significant trade agreements including CETA with the EU, the

Chart 10

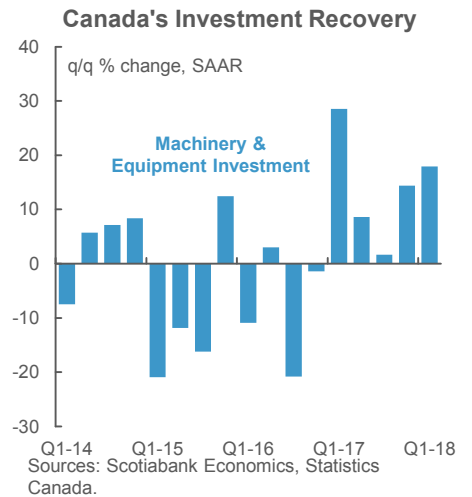


Chart 11

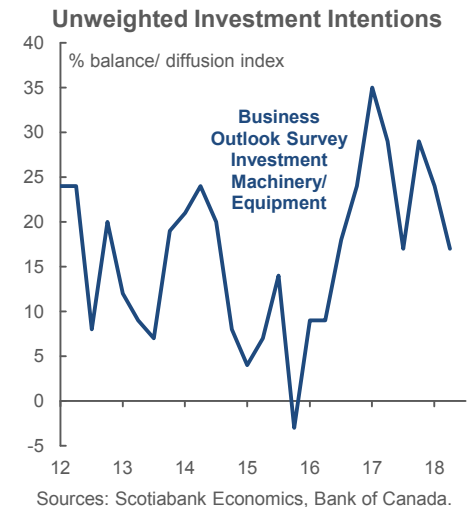


Chart 12

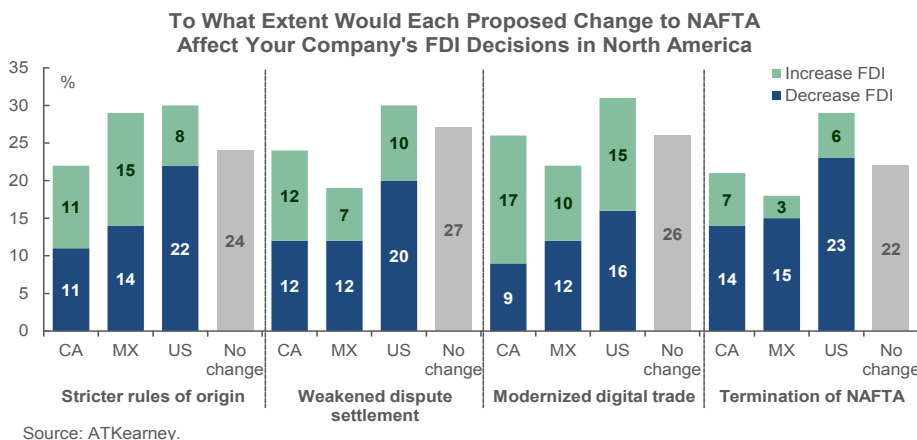
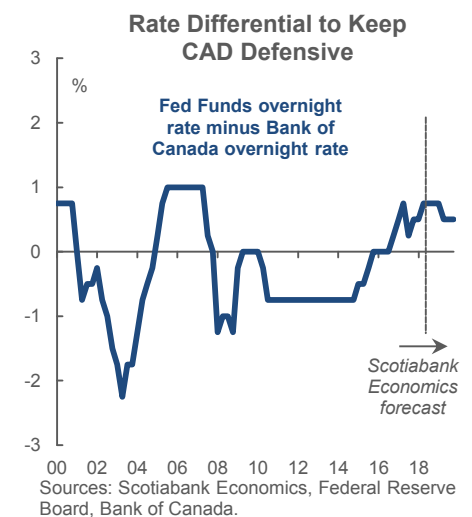


Chart 13





TPP ex-US and with South Korea. The same FDI survey also signalled that firms would either maintain or increase investment plans in Canada under various NAFTA-related scenarios except for full termination (chart 12). As exports and investment return, the economy can adapt to a softer growth profile for consumption and a modest expected drag effect from housing. For more on the general macroeconomic outlook see pages 4–11 of the [Global Outlook](#).

**Finally, that the Federal Reserve remains confident about tightening monetary policy allows the BoC considerable leeway to tighten policy from the standpoint of the effects on the Canadian dollar.** The BoC is well behind the Fed's pace of tightening that has raised the policy rate faster from a lower initial starting depth to a higher present level alongside unwinding unconventional US monetary policy stimulus, and this helps to explain why the USD has strengthened versus CAD. The next section will consider the outlook for US rates, but for now, the implication for Canada is that the negative shorter-term interest rate differential may widen relative to our prior forecast round as we've tentatively added one more Fed rate hike (chart 13). That has motivated us to weaken the outlook for the Canadian dollar which further insulates against trade policy risks. The prospect of currency depreciation should trade policy developments markedly worsen is the country's first line of defence. Indirectly, the Trump administration's possible further escalation of trade policy uncertainty would manipulate the Canadian dollar to a weaker position as a flexible exchange rate regime does what it must.

**FEDERAL RESERVE—RETAINING OPTIONALITY ALONG A MORE HAWKISH PATH**

**We've tentatively added one more rate hike compared to our prior forecast round** and now expect the Federal Reserve to raise twice more this year, bringing the total to four hikes in 2018 including the two that have already been delivered. Two more hikes then continue to be forecast in 2019 that would bring the policy rate to 3% by the end of 2019. That would equal the FOMC's estimate of the longer-run neutral rate as the Treasury curve bear flattens (chart 14), though the FOMC consensus has signalled an overshoot on the policy rate into 2020 when it anticipates two more rate hikes to 3.5%. Throughout it all, the Fed's pace of balance sheet unwinding is assumed to remain on auto-pilot as the pace of balance sheet reduction accelerates to its maximum monthly rate this Fall (chart 15). By the end of 2020, the balance sheet will be under US\$3 trillion which means that purchases under the QE3 program will have been fully reversed. **The combined degree of Federal Reserve policy tightening through conventional and unconventional tools is estimated to be equivalent to between five and six 25bp increases in the Fed funds target range by the end of 2019. This combined pace of policy tightening exceeds the Bank of Canada's forecast rate increases.**

Because this view—unlike our BoC forecast—is on-consensus and in line with the FOMC's revised 'dot plot', the value to a write-up comes from guidance over the direction of risks. On that note, while another hike has been added to our forecast for this year and linear uninterrupted paths for conventional and unconventional policy tightening are being communicated by the FOMC, **such plans over time are likely to be proven to be relatively aggressive.**

First, conviction toward expedited policy tightening this year is moderated by the fact that Chair Powell himself tamped down a literal interpretation of revised FOMC projections in what was tantamount to one of the lowest conviction hawkish turns

Chart 14

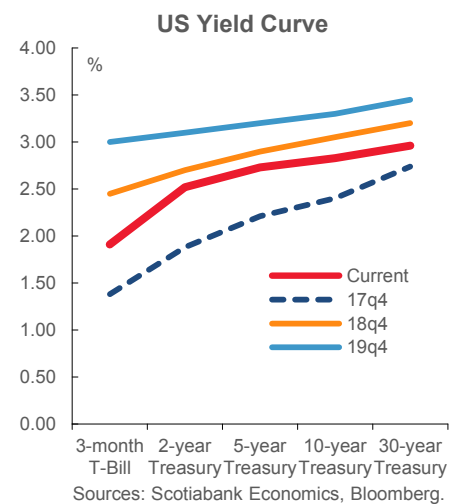


Chart 15

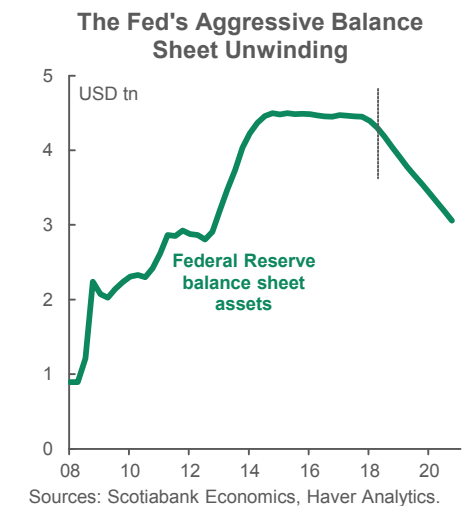
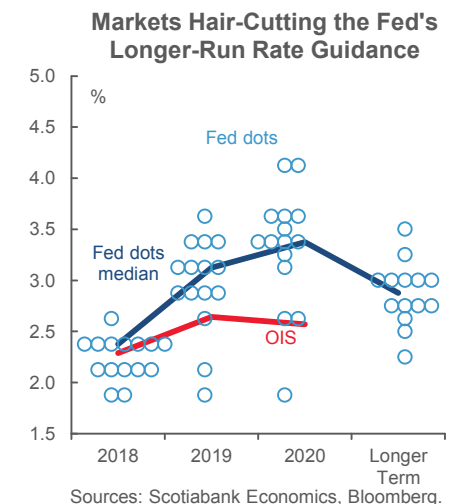


Chart 16

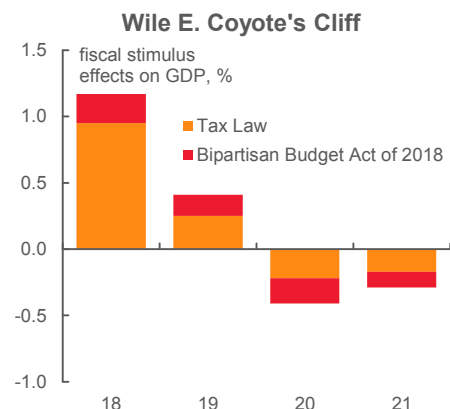


signalled by a central bank head in quite some time. Indeed, Powell appeared to douse the dots, so to speak, when he stated in the recent press conference that **“most participants did not revise their projections.”** In so doing, Powell distanced himself from the addition of an extra rate hike this year. Indeed, it took only one FOMC participant to go from predicting one more rate hike to two more this year in order to swing the median projection toward an added rate hike as highlighted in chart 16. The takeaway is that the FOMC has left the door wide open to two more hikes this year but also wide open to just one more hike pending further developments.

**Second, a key assumption to the Fed’s exit plans is a linear path of relatively strong above-potential growth. Near-term GDP growth, however, must be weighed against former Chair Bernanke’s warning about the 2020 environment** when he recently spoke in conversation at the American Enterprise Institute ([here](#)). **Bernanke’s warning that fiscal stimulus “is going to hit the economy in a big way this year and next year, and then in 2020, Wile E. Coyote is going to go off the cliff” is something the FOMC consensus should take into account.** Bernanke went on to remark that “What you are getting is a stimulus at the very wrong moment. The economy is already at full employment.” Most estimates of the fiscal impulse to GDP growth this year and next from the Tax Cuts and Jobs Act and the February spending bill are then followed by modest fiscal drag effects into 2020 (chart 17). As fiscal stimulus turns to fiscal drag—and assuming it is not extended into the 2020 election year—adding to rate hikes before then could risk over-tightening by the Fed.

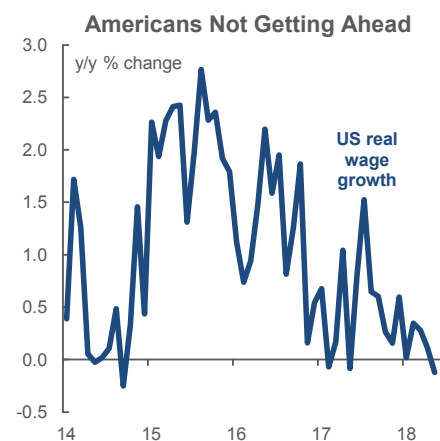
Having said this, we find talk of US recession risk to be too cavalier. Household imbalances are hardly apparent with a debt service burden near a record low and a wealth-adjusted saving rate at a record high. Corporate credit quality remains strong including when interest coverage is shocked for the Fed’s ‘dot plot’ ([here](#)). Fiscal stimulus will turn to only mild fiscal drag in 2020 and that assumes Congress doesn’t add another spending bill into the 2020 Presidential election.

Chart 17



Sources: Scotiabank Economics, Joint Committee on Taxation, Central Budget Office, "The Tax Cuts and Jobs Act: A Boost to Growth or Missed Opportunity?" - Jason Furman.

Chart 18



Sources: Scotiabank Economics, Statistics Canada, BLS.

Table 1

Scotiabank Economics' Canada-US Yield Curve Forecast									
	2017		2018			2019			
	(end of quarter, %)								
Canada	Q4	Q1	Q2	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
BoC Overnight Target Rate	1.00	1.25	1.25	1.50	1.75	2.00	2.25	2.25	2.50
Prime Rate	3.20	3.45	3.45	3.70	3.95	4.20	4.45	4.45	4.70
3-month T-bill	1.06	1.15	1.26	1.55	1.80	2.05	2.30	2.30	2.50
2-year Canada	1.69	1.78	1.91	2.05	2.30	2.40	2.50	2.55	2.60
5-year Canada	1.87	1.97	2.07	2.25	2.45	2.55	2.60	2.65	2.70
10-year Canada	2.05	2.09	2.17	2.40	2.55	2.60	2.65	2.70	2.75
30-year Canada	2.27	2.23	2.20	2.50	2.70	2.80	2.85	2.90	2.95
United States	Q4	Q1	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
Fed Funds Target Rate	1.50	1.75	2.00	2.25	2.50	2.50	2.75	2.75	3.00
Prime Rate	4.50	4.75	5.00	5.25	5.50	5.50	5.75	5.75	6.00
3-month T-bill	1.38	1.70	1.92	2.20	2.45	2.50	2.70	2.75	3.00
2-year Treasury	1.88	2.27	2.53	2.60	2.70	2.80	2.90	3.00	3.10
5-year Treasury	2.21	2.56	2.73	2.85	2.90	2.95	3.00	3.10	3.20
10-year Treasury	2.40	2.74	2.84	3.00	3.05	3.10	3.15	3.20	3.30
30-year Treasury	2.74	2.97	2.96	3.15	3.20	3.30	3.35	3.40	3.45

Sources: Scotiabank Economics, Bloomberg.

**Third, increasing policy tightening this year is not supported by recent inflationary pressures that communicate a sense of urgency. Recent US inflation sits roughly on the Fed's target and we believe the Fed will tolerate a moderate and temporary overshoot of its 2% inflation goal.**

**Fourth, the inflation outlook is unlikely to get the same assist from dollar depreciation that it has over recent quarters.** The broad dollar index's depreciation from the beginning of 2017 through to earlier this year likely contributed a fair portion of the pick-up in core PCE inflation. The dollar's appreciation since then may point to topped-out inflation with downside risk later this year and into next year. Recall that the Federal Reserve's research estimates that every 10% depreciation/appreciation in the USD in trade-weighted broad dollar terms translates into a 0.5% rise/fall in core inflation within six months and 0.3% within one year as the transitory effects begin to dissipate.

**Fifth, wage growth remains range-bound.** May's 2.7% y/y nominal figure is well within the mostly 2.4–2.8% range of the past two and a half years. Only 2015 into 2016H1 saw an acceleration. In real terms, however, the **real average hourly earnings growth rate is 0% which is the second lowest print of the past five and a half years (chart 18)**. Wage gains are not pointing toward fanning inflation risk. Indeed, if anything, it's the opposite.

**One added uncertainty concerns global trade tensions that are being led by the US administration.** I generally agree with the Federal Reserve's assessment of modest influences thus far, but the degree of uncertainty going forward counsels fairly wide bands around forecasts for many variables in the context of the increased uncertainty that the Trump administration has imposed upon the longer-run outlook for the global and domestic economies.

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